Contents

Preface
About the Authors
About the 2010 Update Authors
Selected Developments
Cutoff Dates and CEB Citation

1 Contract
Victor B. Harris

2 Real Estate Seller/Buyer
David Dimitruk
Jane L. O'Hara Gamp
C. Darrell Sooy

3 Labor
Robert M. Cassel
Barbara A. Lawless

4 Landlord/Tenant
Myron Moskovitz
Diana D. Sam

5 Injury to Property
Stephen L. R. McNichols

6 Intellectual Property Infringement and Misappropriation
Surjit P. Soni
Leo E. Lundberg, Jr.

7 Tax Aspects
Robert W. Wood

Table of Statutes, Regulations, and Rules
Table of Cases
Table of References
Index

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Preface

Early in their careers, attorneys ask "what is a case about?"— asking questions about facts, seeking answers on the relevant law, and learning how to apply the law to the facts in order to make informed judgments on their client's remedies or liability. A more complicated and often more perplexing question is "what is a case worth?" This is a question on the measure and proof of damages and the subject matter of this book.

Realizing the need to provide a single-volume guide to the general practitioner on the subject of damages, CEB published its first edition of this book in 1974, and, despite its age, California Attorney's Damages Guide (supplemented annually) has enjoyed continued popularity up to the present. Of course, some would say "all good things come to an end." Fortunately, in this case, good things just get better. With this new edition, renamed California Attorney's Guide to Damages, CEB continues to provide a basic orientation on the law of damages in areas that the practitioner is likely to deal with in his or her day-to-day work. Unlike its predecessor, it also provides a convenient looseleaf format that will be supplemented annually, revised chapters, discussion broken down into concise and easily accessible sections, chapter tabs, and a new chapter on intellectual property law damages.

Excellent coverage of personal injury and wrongful death damages can be found in California Tort Damages (2d ed Cal CEB 2002).

CEB expresses its thanks and gratitude to the following authors without whom this book would not have been possible: Robert M. Cassel, Mill Valley; David Dimitruk, Irvine; Victor Harris, San Rafael; Jane L. O'Hara Gamp, San Francisco Law School; Stephen L. R. McNichols, Pleasanton; Myron Moskovitz, Golden Gate University Law School; C. Darrell Sooy, San Francisco; Surjit P. Soni, Pasadena; Robert W. Wood, San Francisco. Concise biographies of these attorneys can be found on the "About the Authors" page. CEB also wishes to extend its thanks and gratitude to Edward M. Opton, Jr., who has contributed to the update of California Attorney's Damages Guide for many years and whose comments on this edition are much appreciated.

CEB also wishes to thank the authors of California Attorney's Damages Guide, first published in 1974, whose efforts have set a standard of quality to which we continue to aspire: Roger H. Bernhardt, Richard M. Bryan, Robert M. Cassel, Thomas J. Gundlach, Charles S. Loughran, Judith G. McKelvey, Leslie A. Minkus, Anthony J. Pagano, and Paul Peyrat.

Special thanks go to Bonnie C. Maly, CEB project manager of California Real Property Remedies and Damages (2d ed Cal CEB 2002), on which portions of chapters 2 and 5 of this book have been based.

Robert Waxman, CEB Attorney, served as project manager for the second edition. Legal research was provided by Shawn Ridgell, Andy Rosner, and Kenneth Scudder. Richard Dempewolf served as copy and production editor. Robert Burke created the index. Composition was performed by CEB's Electronic Publishing staff.

January 2010 Update

CEB wishes to thank David M. Austin, Victor B. Harris, Barbara A. Lawless, Leo E. Lundberg, Jr., Myron Moskovitz, Diana D. Sam, C. Darrell Sooy, and Robert W. Wood for their work on this update.

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Selected Developments

January 2010 Update

Contract

On the injured party's election of remedies in the event of an anticipatory breach of contract, see *Central Valley Gen. Hosp. v Smith* (2008) 162 CA4th 501, 515, 75 CR3d 771, discussed in §1.7.

A recent case holding that CC §3287(a) does not apply when prejudgment interest is part of the contractual amount owed is *Roodenburg v Pavestone Co., L.P.* (2009) 171 CA4th 185, 191, 89 CR3d 558. See §1.20.

On the award of attorney fees to the prevailing party under CC §1717(b), see *Silver Creek, LLC v BlackRock Realty Advisors, Inc.* (2009) 173 CA4th 1533, 1540, 93 CR3d 864, cited in §1.26.

Chinese Yellow Pages Co. v Chinese Overseas Mktg. Serv. Corp. (2008) 170 CA4th 868, 884, 887, 88 CR3d 250, addressed CC §1717 recovery of attorney fees incurred in obtaining a dismissal of a party's bankruptcy proceeding. See §1.27.

A prevailing party's entitlement to attorney fees under CC §798.85 in an action under the Mobilehome Residency Law was at issue in *Employers Mut. Cas. Co. v Philadelphia Indem. Ins. Co.* (2008) 169 CA4th 340, 351, 86 CR3d 383. See §1.30.

A recent case on contractual liquidated damages under CC §1671 is *El Centro Mall, LLC v Payless ShoeSource, Inc.* (2009) 174 CA4th 58, 63, 94 CR3d 43. See §1.42.

The court affirmed a tortious retaliatory discharge judgment in *Boston v Penny Lane Ctrs., Inc.* (2009) 170 CA4th 936, 947, 88 CR3d 707, discussed in §1.55.

For a case holding that a claim seeking tort recoveries based on an allegation that the employer breached the employment contract *other than* by wrongful discharge is barred, see *Brewer v Premier Golf Props., LP* (2008) 168 CA4th 1243, 1256, 86 CR3d 225, discussed in §1.55.

Two recent cases that reflect the courts' stringent enforcement of the implied covenant of good faith and fair dealing in the insurance context are *McCoy v Progressive W. Ins. Co.* (2009) 171 CA4th 785, 794, 90 CR3d 74, and *Major v Western Home Ins. Co.* (2009) 169 CA4th 1197, 87 CR3d 556, discussed in §1.58.

Real Estate Seller/Buyer

A recent case on a broker's right to a commission in a cancelled transaction is *Schaffter v Creative Capital Leasing Group, LLC* (2008) 166 CA4th 745, 83 CR3d 19. See §2.30.

Labor

For a recent case addressing supplemental jurisdiction, see *California Dep't of Water Resources v Powerex Corp.* (9th Cir 2008) 533 F3d 1087, cited in §3.21.

Two recent cases addressed preemption of state law under ERISA. See *Coast Plaza Doctors Hosp. v Blue Cross of Cal.* (2009) 173 CA4th 1179, 93 CR3d 479, and *Golden Gate Restaurant Ass'n v City & County of San Francisco* (9th Cir 2009) 558 F3d 1000, discussed in §3.66.

Landlord/Tenant

In *Espinoza v Calva* (2008) 169 CA4th 1393, 87 CR3d 492, the court held that the tenant owed no rent when the landlord did not have a certificate of occupancy. See §4.86.

Under *Marina Glencoe, L.P. v Neue Sentimental Film AG* (2008) 168 CA4th 874, 85 CR3d 800, discussed in §4.95, there is no prevailing party for purposes of awarding attorney fees under CC §1717(b)(2) when the plaintiff voluntarily dismisses the case after trial begins but before a ruling dispositive of the case is made.

Injury to Property

Secondhand smoke in the common areas of a private apartment complex was found to constitute a public nuisance in *Birke v Oakwood Worldwide* (2009) 169 CA4th 1540, 87 CR3d 602, discussed in §§5.7 and 5.12.

For a recent case holding that ownership of a house by the builder for approximately 16 months after its completion did not bar the application of CCP §337.15, see *Gundogdu v King Mai, Inc.* (2009) 171 CA4th 310, 89 CR3d 489, discussed in §5.44A.

In *San Diego Unified Sch. Dist. v County of San Diego* (2009) 170 CA4th 288, 87 CR3d 796, the court held that an action based on damages caused by a landfill constructed and operated by the defendant more than 10 years before suit was commenced was not barred by CCP §337.15. See §5.44A.

Intellectual Property Infringement and Misappropriation

Under the recent case of *Crown Packaging Technol., Inc. v Rexam Beverage Can Co.* (Fed Cir 2009) 559 F3d 1308, when the patentee owns a mixed patent that contains both method claims and apparatus claims, the marking requirement does not apply if the patentee asserts only infringement of the method claims. See §6.1.

State law controls any transfer of patent ownership by operation of law not deemed an assignment. See *Sky Technols. LLC v SAP AG* (Fed Cir 2009) 576 F3d 1374 and *Akazawa v Link New Technol. Int'l, Inc.* (Fed Cir 2008) 520 F3d 1354, discussed in §6.1.

A patentee's entitlement to royalties may be limited by the patent exhaustion doctrine. See *Quanta Computer, Inc. v LG Electronics, Inc.* (2008) 553 US ___, 170 L Ed 2d 996, 1006, 128 S Ct 2109, discussed in §6.12.

Statutory damages are not available for foreign works not registered in the United States, despite the fact that registration is not required to file a lawsuit for infringement of a foreign work under the Berne Convention. See *The Football Ass'n Premier League Ltd. v YouTube, Inc.* (SD NY 2009) 633 F Supp 2d 159, discussed in §6.25.

Under *Dream Games of Arizona, Inc. v PC Onsite* (9th Cir 2009) 561 F3d 983, the illegal use of a work by the copyright owner does not preclude a damages award for copyright infringement unless the defendant can show personal injury by the plaintiff's conduct. See new §6.27A.

St. Luke's Cataract & Laser Inst., P.A. v Sanderson (11th Cir 2009) 573 F3d 1186 held that an award of statutory damages under the Anticybersquatting Consumer Protection Act is not duplicative of damages for service mark infringement under the Lanham Act. See §6.30.

Statutory damages for counterfeit marks were changed by 2008 legislation amending 15 USC §1117. See new §6.31A.

See new §6.57A on insurance as a source for collection of damages.

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1

Contract

Victor B. Harris

I. INTRODUCTION §1.1

II. ANALYSIS OF CONTRACT DAMAGES PROBLEMS
- A. Negotiation and Drafting Stage §1.2
  - 1. Improving Amount of Recovery §1.3
  - 2. Limiting Amount of Recovery §1.4
  - 3. Venue and Arbitration Clauses §1.5
- B. Handling Potential or Actual Breach Situations Before Litigation §1.6
  - 1. When Performance Will Continue
    - a. Notice of Breach and Demand for Performance §1.7
    - b. Protection of Security Interests §1.8
    - c. Avoidance of Future Breach §1.9
    - d. Avoidance of Aggravation of Damages §1.10
    - e. Documentation §1.11
  - 2. When Performance Will Not Continue
    - a. Notice of Claim and Protection of Security Rights §1.12
    - b. Analysis and Proof of Client's Recoverable Damages §1.13
  - 3. Alternative or Supplemental Remedies §1.14
  - 4. Alternative or Supplemental Causes of Action §1.15
- C. Litigation Checklist §1.16

III. POSSIBLE ITEMS OF RECOVERY
- A. Measure of Damages
  - 1. Controlling Civil Code Provisions §1.17
  - 2. Rule of *Hadley v Baxendale:* General and Special Damages §1.18
- B. Specific Items Recoverable
  - 1. Loss of Profits and Benefits §1.19
  - 2. Interest §1.20
  - 3. Attorney Fees
    - a. General Rule §1.21
    - b. Right to Reciprocal Recovery of Attorney Fees (CC §1717) §1.22
      - (1) Examples of Recovery Under CC §1717 §1.23
      - (2) Recovery of Attorney Fees Under CC §1717 by Strangers to Contract §1.24
      - (3) Recovery of Attorney Fees by Attorney Litigants and "In-House" Counsel Under CC §1717 §1.25
      - (4) Determination of Prevailing Party Under CC §1717 §1.26
      - (5) Limits of CC §1717 §1.27
      - (6) Award of CC §1717 Attorney Fees in Arbitration §1.28
      - (7) Procedure for Recovery Under CC §1717 §1.29
    - c. Recovery Under Statutes Other Than CC §1717 §1.30
    - d. Recovery for Bad Faith Breach of Contract and Breach of Fiduciary Duty §1.31
    - e. Recovery Under "Tort of Another" or "Third Party Tort" Doctrine §1.32
  - 4. Expert Witness Fees §1.33
  - 5. Exemplary and Nominal Damages
    - a. General Rule §1.34
    - b. Exemplary Damages May Be Available in Cases Involving Breach of Insurance Contract or Existence of Independent Tort §1.35
    - c. Exemplary Damages Not Available for Bad Faith Denial of Contract's Existence §1.36

d. Proof of Defendant's Financial Condition §1.37
6. Mental Distress or Physical Suffering §1.38
7. Loss of Goodwill §1.39

IV. LIMITATIONS ON AMOUNT OF DAMAGES
A. Uncertain and Speculative Damages §1.40
B. Mitigation of Damages §1.41
C. Liquidated Damages
1. Validity and Scope §1.42
2. In Public Contracts §1.43
3. Liquidated Damages as "Processing Charges" and "Late Fees" §1.44
D. Disclaimer of Warranties §1.45
E. Disclaimer and Limitation of Damages §1.46

V. SPECIFIC BREACH SITUATIONS; RULES AND APPROACHES TO CONTRACT DAMAGES
A. Total Failure to Perform §1.47
B. Partial Performance §1.48
C. Delay in Performance §1.49
D. Defect in Performance §1.50
E. Prevention or Obstruction of Performance §1.51
F. Failure to Pay Money §1.52
G. Breach of Employment, Service, or Agency Contracts §1.53
1. *Foley v Interactive Data Corp.* §1.54
2. Cases After *Foley v Interactive Data Corp.* §1.55
H. Damages for Unauthorized Services §1.56
I. Breach of Insurance Contracts
1. Breach of Covenant of Good Faith and Fair Dealing §1.57
2. Examples §1.58
J. Breach of Contracts to Negotiate Agreements §1.59

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§1.1 I. INTRODUCTION

The subject of this chapter is breach of contract damages as analyzed under traditional common law rules and the statutes and rules referenced in this chapter. See chap 2 on damages for breach of or fraud in real estate sales contracts, and chap 4 on damages for breach of lease. See also California UCC Sales and Leases (Cal CEB 2002) and Secured Transactions in California Commercial Law Practice (2d ed Cal CEB 2001) on damages in connection with the sale of goods. This chapter does not deal with any of the state or federal statutory remedies for specialized contract problems such as the California Consumer Legal Remedies Act (CC §§1750-1784) or the federal Truth in Lending Act (15 USC §§1601-1667e).

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II. ANALYSIS OF CONTRACT DAMAGES PROBLEMS

§1.2 A. Negotiation and Drafting Stage

The lawyer is confronted with contract damages problems in a variety of contexts. When negotiating and drafting a contract, favorable damages provisions should be considered as a bargaining point. See §§1.3-1.5.

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§1.3 1. Improving Amount of Recovery

A prime consideration in every contract is the financial capability of the other party to respond to a judgment for damages. This capability can be improved by bargaining for a surety or guarantor for performance of the agreement or security in the event of nonperformance. The practitioner is cautioned to review the various types of surety and fidelity bonds available in different contract situations to make certain that the type of surety bond obtained satisfies the client's purposes.

Insurance requirements should always be considered. Generally, casualty and liability insurers do not ensure the performance of a contract. However, insurance is available against some instances of breach of contract. For example, defective or delayed performance by a building contractor or errors and omissions by an architect or engineer may give rise to causes of action that can be covered by insurance.

Often, a breach of contract may expose the innocent party to liability to third parties. Indemnity and hold-harmless provisions should be considered as protection against this possibility. Indemnity is covered in CC §§2772-2784.5. The practitioner considering a construction contract is cautioned to study carefully CC §§2782-2784 for special rules concerning indemnity agreements in the construction industry. In this regard, consideration should also be given to a provision in the contract requiring the procurement of insurance against liability to third persons.

Interest should also be considered. Given the legal rate of interest at 10 percent per year (see §1.20), market fluctuations in interest rates may govern the desirability of an interest clause. Special attention should be given to CC §3287. See generally §1.20 on interest as an item of damages.

Counsel should carefully weigh the relative advantages and disadvantages of a provision for attorney fees and other litigation expenses. The practitioner should bear in mind that, under CC §1717, a provision for attorney fees for one party creates the right to attorney fees for the prevailing party in a lawsuit, whether or not that party is expressly entitled to attorney fees under the contract. See §1.22. In many contracts, particularly construction contracts, in which performance occurs over a relatively long period of time, during which one or more breaches by both parties may occur, an attorney fee provision may be burdensome. However, if counsel wants to include a provision for attorney fees, he or she should also consider including a specific provision for other litigation expenses, *e.g.,* expert witness fees (see §1.33) and investigation expenses normally not recoverable as costs of suit.

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§1.4 2. Limiting Amount of Recovery

One method of limiting damages is a "notice of claim" requirement. These are frequently seen in construction contracts in which an owner requires that a contractor must, during the performance of the contract, give notice of a claim for any extra work, delay, or extensions of time within a specified time period after the claim first arises.

Liquidated damages clauses should be viewed with caution. For example, in a construction contract an owner may feel that liquidated damages are a good prod to a building contractor. But an owner with substantial interest payments on a construction loan and possible loss of rental income due to delays may suffer substantially greater damages than a liquidated penalty of a few hundred dollars per day. Additionally, the enforceability of a particular liquidated damages clause might be questionable. See §§1.42-1.44

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§1.5 3. Venue and Arbitration Clauses

The practitioner should note that the forum for resolution of disputes can affect the recovery available to the client. For example, a contractual provision for a forum that is distant from the client's normal place of business can significantly increase litigation expenses. On the other hand, arbitration is considered by some to be a rapid and inexpensive method of dispute resolution, but the procedure in an arbitration can be detrimental. For example, depositions for discovery are not available in arbitration proceedings in connection with breach of contract unless the agreement to arbitrate specifically so provides (CCP §1283.1(b)), and arbitration proceedings require payment of fees to the arbitrators. Therefore the practitioner should not merely assume that arbitration is either a favorable or less expensive forum for resolution of a dispute.

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Source: Civil Litigation/California Attorney's Guide to Damages/1 Contract/§1.6 B. Handling Potential or Actual Breach Situations Before Litigation

§1.6 B. Handling Potential or Actual Breach Situations Before Litigation

The contract may be breached even though its performance continues, and the practitioner must consider the implications of continuing performance by the client on the recoverable damages for a breach. Of course, consideration of the recoverable damages is of major importance when contemplating litigation.

The practitioner is usually confronted with two different situations before litigation when a breach of contract has occurred or is likely to occur. In some cases, even though there may be a breach of contract, performance of the contract will continue. In other cases, the breach of contract may lead to a cessation of performance. Each situation requires different considerations.

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1. When Performance Will Continue

§1.7 a. Notice of Breach and Demand for Performance

Counsel should immediately give written notice to the breaching party that a breach has occurred and a claim will be made. This should be done whether or not there is a notice requirement in the contract. If the contract contains a notice requirement, the procedure established by the contract should be scrupulously followed.

Note that in this regard that when there is an anticipatory breach of contract (also referred to as a repudiation), the injured party faces an election of remedies: The injured party may immediately seek and recover damages for a total breach before the other party's performance is due, or the injured party may treat the anticipatory breach as an empty threat, wait until the time the other party's performance is due, and exercise its remedies for actual breach if a breach in fact occurs at that time. *Central Valley Gen. Hosp. v Smith* (2008) 162 CA4th 501, 515, 75 CR3d 771. If the judgment precedes the date all or a part of the other party's performance is due, future damages are limited to their value at the time of judgment by discounting the amounts payable from their due dates to the judgment date. Compare the Third District Court of Appeal's decision in *Ninety Five Ten v Crain* (1991) 231 CA3d 36, 40, 282 CR 141, with its earlier decision in *Daum Dev. Corp. v Yuba Plaza, Inc.* (1970) 11 CA3d 65, 89 CR 458. Note that *Ninety Five Ten* disapproved *Daum* to the extent that *Daum* might be read to approve an award of interest on interest in the absence of an agreement for such payment.

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§1.8 b. Protection of Security Interests

Counsel should determine whether there are statutory or contract security provisions. Care must be used to make sure that security interests are not waived merely because performance continues. In addition to giving notice of breach to the breaching party (see §1.7), written notice should be given separately to any surety, guarantor, or insurer of the breaching party.

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§1.9 c. Avoidance of Future Breach

The practitioner should carefully counsel the client during the balance of performance to avoid a breach or further breaches if the client is the breaching party. Frequently, this will involve a skillful assessment of personality conflicts and other human factors. Counsel should review all significant correspondence between the client and other parties to the contract and advise the client to seek counsel's advice concerning future contacts with the other parties.

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Source: Civil Litigation/California Attorney's Guide to Damages/1 Contract/§1.10 d. Avoidance of Aggravation of Damages

§1.10 d. Avoidance of Aggravation of Damages

The practitioner should counsel the client, whether he or she is the breaching or innocent party (the latter having the obligation to mitigate damages (see §1.41)), on how to avoid aggravating damages already suffered. In this respect, counsel should review the general requirements of good faith dealing between the parties and should not permit personality or other factors to permit a breach situation to get out of hand. Specifically, counsel should be wary of defamation or retaliation between the parties. Counsel should bear in mind that consequential damages flowing from the breach may be substantial and should not be overlooked in evaluating a client's position.

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§1.11 e. Documentation

Documenting the conduct of the parties, conversations between them, and the amount of damages is very important. For example, in a construction contract, if repairs are necessary, careful records should be kept by the injured party of labor and material expenses incurred. These records should be preserved so that they will be available to prove damages if litigation becomes necessary. For an example of a case in which *lack* of documentation did not prevent the recovery of damages, see *C. Norman Peterson Co. v Container Corp. of Am.* (1985) 172 CA3d 628, 646, 218 CR 592 (contractor awarded damages based on its total reasonable costs, even though it was unable to keep totally accurate cost records, because that inability was fault of property owner).

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2. When Performance Will Not Continue

§1.12 a. Notice of Claim and Protection of Security Rights

Counsel for plaintiff should immediately notify the breaching party in writing of the breach and demand performance. Separate written notice should also be given to any sureties, guarantors, or insurers. Likewise, the practitioner should explore possible lien rights, security agreements, and related documents, including without limitation financing statements under the Commercial Code.

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§1.13 b. Analysis and Proof of Client's Recoverable Damages

- **Consider applicable law.** Counsel should analyze recoverable damages in light of the principles discussed in this chapter.
- **Determine actual damages.** Although many cases deal with the measure of damages for breach of contract, no hard and fast rules can be stated because often the outcome depends on the particular factual situation. In addition, damages must be analyzed in the context of the type of breach that is involved because the measure of damages can differ significantly depending on the type of breach and the nature of the contract. See §§1.47-1.59. A good rule for the practitioner to follow is to ask himself or herself: "In what financial position would the innocent party be if the breach had not occurred?" When this rule is applied, the practitioner may incidentally find that a breach of contract does not always result in recoverable damages because of changed market conditions or other circumstances.
- **Consider defendant's ability to satisfy a judgment.** Not only must the appropriate measure of damages be analyzed, but the financial capability of the defendant to satisfy a judgment must be considered.
- **Consider counterclaims and suits against third parties.** Counsel should also consider the possibility of counterclaims against the client if a suit is filed. Likewise, the possibility of third party actions against others or against the client should be considered.
- **Take care in pleading damages.** The burden of pleading and proving damages rests on the party claiming them. Care should be given to plead all items of recovery sought. There are no clear rules setting forth what constitute items of general damages as contrasted with special damages in breach of contract cases. See §1.18. Therefore, the best practice is to spell out each item of recovery that is sought.

WARNING: Particular care must be taken when pleading the amounts for different types of damages in the event a default judgment is sought. See *Greenup v Rodman* (1986) 42 C3d 822, 231 CR 220. For example, a prayer for compensatory damages "in excess of $20,000… or according to proof" is inadequate under CCP §580 to support a default judgment for $26,457.50. Similarly, CCP §580 prohibits the awarding of attorney fees as part of a default judgment if the complaint contains no prayer for attorney fees. *Becker v S.P.V. Constr. Co.* (1980) 27 C3d 489, 165 CR 825. Counsel should be aware, however, that a CCP §425.11 statement of damages can give a defendant the requisite notice of the amount of damages to be included in a default judgment, if the defendant does not respond to the complaint. See *California Novelties, Inc. v Sokoloff* (1992) 6 CA4th 936, 945, 7 CR2d 795 (actual notice of statement of damages is sufficient; personal notice is not required). But see CCP §425.11(d)(1) (statement must be served in same manner as summons); *Fasuyi v Permatex, Inc.* (2008) 167 CA4th 681, 692, 84 CR3d 351 (noting that record was unclear whether complete statement of damages was served). For a statement of the correct standard of proof for entry of default judgment, see *Johnson v Stanhiser* (1999) 72 CA4th 357, 361, 85 CR2d 82 (plaintiff need only establish proof of prima facie case for award of damages).

- **Proving damages at trial.** Proof of contract damages can be enhanced by careful preparation and imaginative trial technique. Often, expert witnesses must be employed. For example, loss of market value is generally a matter of expert opinion, and appraisers may be essential to persuasive proof. Likewise, accountants are often necessary to interpret and analyze accounting records that contain the best evidence of actual damages.

PRACTICE TIP: The practitioner should keep in mind the provisions of Evid C §§1520-1523 in cases involving voluminous documentary evidence. For example, in cases involving extensive repair costs, a suggested technique is to collect items, such as timecards of laborers and invoices regarding materials, and to prepare a summary of them in a presentable form for use at trial. At trial, counsel should have the originals of all documents used in making the summary. The summary itself, though, is admissible under Evid C §1521 and is often a graphic portrayal of the damages suffered.

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§1.14 3. Alternative or Supplemental Remedies

A prospective plaintiff's counsel should always consider whether the client's purposes would be better served by alternative remedies to damages or supplemental remedies in addition to damages. Examples of alternative remedies include injunctions (but note that it has long been established that a successful plaintiff may recover damages as well as obtain injunctive relief (*Dauberman v Grant* (1926) 198 C 586, 246 P 319), specific performance, bankruptcy or other creditor remedies, claim and delivery (see Debt Collection Practice in California (2d ed Cal CEB 1999)), rescission, restitution, and arbitration or mediation. Supplemental remedies include attachment and the enforcement of mechanics' or other statutory lien rights. See California Mechanics' Liens and Related Construction Remedies (3d ed Cal CEB 1998).

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§1.15 4. Alternative or Supplemental Causes of Action

Counsel should be aware that a breach of an express contract provision is not the only basis for recovering breach of contract damages; a breach of the covenant of good faith and fair dealing implied in every contract is also a breach of contract for which a party may recover damages. See *Pasadena Live, LLC v City of Pasadena* (2004) 114 CA4th 1089, 8 CR3d 233.

Moreover, a breach of contract may involve conduct that gives rise to other causes of action in which different damage principles apply. See *Robinson Helicopter Co. v Dana Corp.* (2004) 34 C4th 979, 22 CR3d 352 (economic loss rule did not bar fraud and misrepresentation claims, which the supreme court held were independent of breach of contract). For instance, the breaching party may have been guilty of negligence, or there may be conduct of agents amounting to negligence or conduct of third parties constituting interference with contractual relations. In such a case, a prospective plaintiff's counsel should join an applicable tort cause of action because the tort measure of damages is usually more favorable. See §1.18. Also, there may be other torts committed by the breaching party, such as fraud, for which exemplary damages may be awarded. In *Robinson Helicopter Co. v Dana Corp., supra,* for example, the defendant clutch manufacturer breached its contract with the plaintiff helicopter manufacturer by providing parts that did not conform to the contract and, in addition, supplied plaintiff with false certificates that the parts were conforming. The supreme court held that the issuance of the false certificates was a tort independent of the breach of contract and that the plaintiff could thus pursue fraud and misrepresentation claims and recover punitive damages, despite the absence of any physical injury. See CC §§3294, 3333; §1.34. In short, counsel should not limit the scope of inquiry to contract damages merely because the matter is presented as a breach of contract. See, *e.g.,* discussion of *Gruenberg v Aetna Ins. Co.* (1973) 9 C3d 566, 108 CR 480, and other cases in §1.38. In addition, the practitioner should bear in mind that other parties with greater financial capability may be involved as potential defendants, *e.g.,* sureties, guarantors, or insurers, who have greater capacity to satisfy a judgment than the party who committed the breach.

WARNING: If both contract and tort causes of action are pursued simultaneously, plaintiff's counsel should carefully consider that pursuing a provisional remedy may result in an unintended election between the two causes of action before judgment when both causes of action arise out of the same obligation and operative facts. See *Baker v Superior Court* (1983) 150 CA3d 140, 197 CR 480; *Roam v Koop* (1974) 41 CA3d 1035, 116 CR 539.

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§1.16 C. Litigation Checklist

The following is a checklist of items affecting the recoverability of damages for the practitioner who is prosecuting or defending a breach of contract case.

- Has notice of breach and demand for performance been given to all appropriate parties, sureties, guarantors, and insurers?
- Are there lien rights or security agreements that can be enforced, and are all time requirements and other measures being monitored to avoid a waiver?
- If the contract contains an arbitration clause, consider whether it should be enforced. Bear in mind that either party may waive arbitration by consent, by conduct inconsistent with an assertion of the right to arbitrate, or by unreasonable delay or evidence of bad faith. CCP §1281.2. See *Platt Pac., Inc. v Andelson* (1993) 6 C4th 307, 318, 24 CR2d 597; *Christensen v Dewor Devs.* (1983) 33 C3d 778, 782, 191 CR 8. Whether or not litigation by one party results in prejudice to the other party is critical in determining whether a contractual right to arbitration has been waived. See *Saint Agnes Med. Ctr. v PacifiCare* (2003) 31 C4th 1187, 1203, 8 CR3d 517. The lack of discovery, expense of arbitration, and other factors may compel a waiver. A court may not, however, deny a petition to compel arbitration solely because a statute of limitations has expired on the claims the parties agreed to arbitrate. See *Wagner Constr. Co. v Pacific Mechanical Corp.* (2007) 41 C4th 19, 25, 58 CR3d 434. If there is no arbitration clause, counsel should consider whether to seek an arbitration agreement with the other party.
- Consider all alternative or supplemental remedies and causes of action (see §§1.14-1.15).
- Consider whether there are tort causes of action or actions against third parties that may improve the amount of recovery or permit recovery of exemplary damages (see §§1.34-1.36).
- Consider the possibility of counterclaims by or against the client.
- Document all proof of damages (see §1.11).
- Consider measures to avoid aggravation of damages (see §1.10) and to ensure mitigation of damages (see §1.41).

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III. POSSIBLE ITEMS OF RECOVERY

A. Measure of Damages

§1.17 1. Controlling Civil Code Provisions

Civil Code §3300 is the general measure of damages for breach of contract. It provides that the measure is the amount that will compensate the aggrieved party for all the detriment proximately caused by the breach or that in the ordinary course of things would be likely to result from it. See §1.18.

Civil Code §3301 prohibits speculative damages by providing that damages must be clearly ascertainable in both their nature and origin. See §1.40.

Civil Code §3358 provides that a plaintiff cannot recover a greater amount in damages than he or she could have gained by the full performance of the contract, except as expressly provided by statute. However, CC §3358 cannot be invoked when there is no showing as to what the performance on both sides would have been. *Benard v Walkup* (1969) 272 CA2d 595, 77 CR 544. See also §§1.53-1.55 on employment contracts.

Civil Code §3359 contains a general prohibition that damages must be reasonable and cannot be imposed when unconscionable, grossly oppressive, or contrary to substantial justice.

Civil Code §3360 provides for nominal damages when the injured party suffers no appreciable detriment. For the distinction between two types of nominal damages, see discussion of *Kluge v O'Gara* (1964) 227 CA2d 207, 38 CR 607, in §1.34.

It should be noted that CC §3275 provides against a forfeiture, except in the case of a grossly negligent, willful, or fraudulent breach of duty.

On exemplary damages, see §1.34; 1 Witkin, Summary of California Law, *Contracts* §§874-877 (10th ed 2005).

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§1.18 2. Rule of *Hadley v Baxendale:* General and Special Damages

In the landmark case of *Hadley v Baxendale* (1854) 9 Ex 341, 27 Eng L&Eq 396, 156 Eng Reprint 145, the court held:

> Where two parties have made a contract which one of them has broken, the damages which the other party ought to receive in respect to such breach of contract should be such as may fairly and reasonably be considered either arising naturally, i.e., according to the usual course of things, from such breach of contract itself, or such as may reasonably be supposed to have been in the contemplation of both parties, at the time they made the contract, as the probable result of the breach of it. Now, if the special circumstances under which the contract was actually made were communicated by the plaintiffs to the defendants, and thus known to both parties, the damages resulting from the breach of such contract, which they would reasonably contemplate, would be the amount of injury which would ordinarily follow from a breach of contract under these special circumstances so known and communicated.

Although the language of CC §3300 differs from that above, California courts have held that the foreseeability test of *Hadley v Baxendale* is incorporated into that Civil Code section. *Hunt Bros. v San Lorenzo Water Co.* (1906) 150 C 51, 87 P 1093. The foreseeability test is stated in *Hunt Bros.* as follows (150 C at 56, 87 P at 1095):

> It is the well-settled general rule of damages for any breach of contract that the damages that can be recovered for a breach are only such as may reasonably be supposed to have been within the contemplation of the parties at the time of the making of the contract, as the probable result of a breach.… This rule does not mean that the parties should actually have contemplated the very consequence that occurred, but simply that the consequence for which compensation is sought, must be such as the parties may be reasonably supposed, *in the light of all the facts known, or which should have been known to them,* to have considered as likely to follow, in the ordinary course of things, from a breach, and, therefore, to have in effect stipulated against.

See also *Millikan v American Spectrum Real Estate Servs. Cal., Inc.* (2004) 117 CA4th 1094, 1104, 12 CR3d 459 (foreseeability requires only reason to foresee; not actual foresight); *Sun Maid Raisin Growers v Victor Packing Co.* (1983) 146 CA3d 787, 194 CR 612 (foreseeability is normally question of fact, and unexpected crop damage from heavy rains is infrequent but periodic occurrence naturally causing prices for raisins to increase and, therefore, not unforeseeable as matter of law).

The foreseeability test measure of damages for breach of contract differs from the measure of damages for torts. Civil Code §3333, dealing with tort damages, has been interpreted to permit recovery for all damages actually suffered, whether foreseeable or not, that are the proximate result of the defendant's wrongful act.

However, as the court stated in *Hadley v Baxendale, supra,* when at the time the contract is made the parties have knowledge of special circumstances or unusual consequences that could flow from a breach, those items of special damages are recoverable even though they would not normally be implied by the contract or flow from it as a natural and probable result of its breach. *Grosse v Petersen* (1916) 30 CA 482, 158 P 511.

The natural and ordinary damages resulting from a breach of contract, *i.e.,* general damages, may be recovered under a general allegation of damages and are the subject of evidence rather than of pleading. However, special damages must be specifically pleaded or plaintiff will not be permitted to introduce evidence of them. *Colvig v RKO Gen., Inc.* (1965) 232 CA2d 56, 42 CR 473. See 1 Witkin, Summary of California Law, *Contracts* §§871-873 (10th ed 2005) for discussion of cases illustrating the existence or nonexistence of special circumstances that justify the award of special damages. As becomes obvious from a reading of those cases (and as pointed out in §1.13), there are no clear rules on what constitute items of general damages as contrasted with special damages. Therefore the best practice is to spell out in the pleadings each item of recovery sought.

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B. Specific Items Recoverable

§1.19 1. Loss of Profits and Benefits

The plaintiff may recover the loss of profits or benefits he or she would have received had the contract been fully performed. See *Buxbom v Smith* (1944) 23 C2d 535, 145 P2d 305.

Recovery of profits lost by an established business is available if the extent and occurrence of those lost profits can be ascertained with reasonable certainty, even though the amount cannot be shown with mathematical precision. For decisions applying this rule, see *Parlour Enters., Inc. v Kirin Group, Inc.* (2007) 152 CA4th 281, 61 CR3d 243; *Parlour Enters., Inc. v Kirin Group, Inc.* (2007) 149 CA4th 529, 57 CR3d 187; and *Westrec Marina Mgmt., Inc. v Jardine Ins. Brokers* (2000) 85 CA4th 1042, 1051, 102 CR2d 673. Determination of the amount of lost profits can be based on the profits earned by substantially similar businesses operating under similar circumstances. *Sanchez-Corea v Bank of America* (1985) 38 C3d 892, 907, 215 CR 679; *Berge v International Harvester Co.* (1983) 142 CA3d 152, 190 CR 815.

The fact that a business is new does not automatically preclude recovery of lost profits if they can be ascertained with reasonable certainty. *A&M Produce Co. v FMC Corp.* (1982) 135 CA3d 473, 186 CR 114; *S. Jon Kreedman & Co. v Meyers Bros. Parking-W. Corp.* (1976) 58 CA3d 173, 130 CR 41. For a case applying this point, but finding the evidence lacking, see *Resort Video, Ltd. v Laser Video, Inc.* (1995) 35 CA4th 1679, 1698, 42 CR2d 136.

Moreover, a going concern with a history of loss is not automatically precluded from recovery of lost profits. The measure of damages for delayed profits is the financial loss due to delay in the realization of profit rather than the total profit. *Dean W. Knight & Sons v First W. Bank & Trust Co.* (1978) 84 CA3d 560, 148 CR 767. See also *California Shoppers, Inc. v Royal Globe Ins. Co.* (1985) 175 CA3d 1, 61, 221 CR 171 (plaintiff could not recover loss of future profits plus fair market value of its business and failed to prove lost profits to requisite degree of certainty).

Lost profits are also recoverable in breach of warranty cases. See, *e.g., Serian Bros., Inc. v Agri-Sun Nursery* (1994) 25 CA4th 306, 30 CR2d 382.

The plaintiff has the burden of producing the best evidence available in the circumstances when attempting to establish a claim for lost profits. *S.C. Anderson, Inc. v Bank of America* (1994) 24 CA4th 529, 536, 30 CR2d 286. In meeting this burden, the plaintiff must prove that the lost profits are the natural and direct consequence of the specific breach of contract at issue. *Postal Instant Press, Inc. v Sealy* (1996) 43 CA4th 1704, 1709, 51 CR2d 365. The loss of future profits was not allowed in *Postal Instant Press* when a franchisor terminated a franchise agreement after the franchisee failed to make required monthly payments. In these circumstances, the potential loss of future earnings was not proximately caused by the franchisee's breach, but by the franchisor's decision to terminate the agreement.

In determining damages for breach of contract by the defendant for services to be rendered by the plaintiff, prospective profits should be diminished by the plaintiff's costs in furnishing the services, but this does not include remote costs, overhead or otherwise, that would not be decreased because the plaintiff did not render the services. *Oakland Cal. Towel Co. v Sivils* (1942) 52 CA2d 517, 126 P2d 651.

Civil Code §3283 allows recovery for future damages for detriment resulting after the beginning of the judicial proceeding or certain to result in the future from the breach.

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Source: Civil Litigation/California Attorney's Guide to Damages/1 Contract/§1.20 2. Interest

§1.20 2. Interest

Civil Code §3289 provides that any legal rate of interest stipulated in a contract remains chargeable after its breach. A specific agreement to pay interest gives a right of action to recover the interest whenever, under the contract, it becomes due. *Los Angeles v City Bank* (1893) 100 C 18, 34 P 510. For a recent case holding that CC §3287(a) (discussed below) does not apply when prejudgment interest is part of the contractual amount owed, see *Roodenburg v Pavestone Co., L.P.* (2009) 171 CA4th 185, 191, 89 CR3d 558. The term "contract" in CC §3289 does not include a note secured by a deed of trust on real property. CC §3289.

In the absence of an express contractual provision for interest, CC §3287(a) states the general rule on the right to recover interest for breach of contract, *i.e.,* a party may recover interest from the date the debt becomes due if the damages are certain or the damages are capable of being made certain by calculation. The rate of interest in such cases is 10 percent per year. CC §3289.

Civil Code §3287(a) states the general rule that interest may not be awarded on unliquidated damages. In other words, when there is conflicting evidence on the calculation or determination of damages, interest is generally not recoverable. *Distefano v Hall* (1968) 263 CA2d 380, 69 CR 691. As the California Supreme Court stated in *Olson v Cory* (1983) 35 C3d 390, 402, 197 CR 843, "[G]enerally, the certainty required of Civil Code section 3287, subdivision (a), is absent when the amounts due turn on disputed facts, but not when the dispute is confined to the rules governing liability." Nonetheless, prejudgment interest is awardable "if the amount due can be determined by reference to a fixed standard." *Marine Terminals Corp. v Paceco, Inc.* (1983) 145 CA3d 991, 995, 193 CR 687. For an example of a decision upholding an interest award under CC §3287(a), see *Santa Clara County Envt'l Health Ass'n v County of Santa Clara* (1985) 173 CA3d 74, 85, 218 CR 678. For examples of decisions denying an interest award under CC §3287(a), see *Great W. Drywall, Inc. v Roel Constr. Co.* (2008) 166 CA4th 761, 770, 83 CR3d 235; *Wisper Corp. v California Commerce Bank* (1996) 49 CA4th 948, 962, 57 CR2d 141.

Despite the provisions of CC §3287(a), the plaintiff in a breach of contract action may recover interest, even when the claim is unliquidated, from such a date before entry of judgment as the court may in its discretion fix, but not earlier than the date the action was filed. CC §3287(b). For an example of a decision upholding an interest award under CC §3287(b), see *A&M Produce Co. v FMC Corp.* (1982) 135 CA3d 473, 186 CR 114.

Interest may be awarded even though there is no specific prayer for it in the complaint. *Benson v City of Los Angeles* (1963) 60 C2d 355, 33 CR 257. When the verdict omits an award of prejudgment interest, a prayer in the complaint is sufficient to support an award for prejudgment interest when the jury awards such interest, or when the judge awards it in the event that the damages are considered to be unliquidated. However, in the absence of such an award, the plaintiff, in order to avoid waiving such interest, must either make a specific request for prejudgment interest before entry of judgment or make the request in the form of a motion for new trial no later than the time allowed for filing such a motion. *North Oakland Med. Clinic v Rogers* (1998) 65 CA4th 824, 76 CR2d 743.

Under CC §3287(a), interest begins to run from the date the principal sum becomes due. *Perry v Magneson* (1929) 207 C 617, 279 P 650; *Flynn v California Casket Co.* (1951) 105 CA2d 196, 233 P2d 131. Likewise, prejudgment interest runs from the date when damages are certain or are capable of being calculated to a certainty. *Levy-Zentner Co. v Southern Pac. Transp. Co.* (1977) 74 CA3d 762, 798, 142 CR 1. The certainty test has been reduced to two tests: (1) whether the debtor knows the amount owed, or (2) whether the debtor would be able to compute the damages. *Chesapeake Indus. v Togova Enters.* (1983) 149 CA3d 901, 911, 197 CR 348. Reasoning that "where a defendant does not know what amount he owes and cannot ascertain it except by accord or judicial process, he cannot be in default for not paying it," courts have held that the plaintiff must supply the debtor with a statement and supporting data so that the debtor can ascertain the damages. *Polster, Inc. v Swing* (1985) 164 CA3d 427, 435, 210 CR 567.

Prejudgment interest is awardable in an action for equitable indemnity under *American Motorcycle Ass'n v Superior Court* (1978) 20 C3d 578, 146 CR 182, from the *date of payment* of the primary judgment because the amount of that payment is certain even if the proportion for which the defendant-indemnitor is liable is uncertain. *E.L. White, Inc. v City of Huntington Beach* (1982) 138 CA3d 366, 187 CR 879, superseded by statute on other grounds as stated in *Baur v*

WCAB (2009) 176 CA4th 1260, 1267 n5, 98 CR3d 493. In an action for implied contractual indemnity, however, prejudgment interest is awardable from the *date of entry* of the primary judgment, because that is the date on which the plaintiff's right to indemnity vests and the damages become certain. *Bear Creek Planning Comm. v Title Ins. & Trust Co.* (1985) 164 CA3d 1227, 1247, 211 CR 172, disapproved on other grounds in *Bay Dev., Ltd. v Superior Court* (1990) 50 C3d 1012, 1032 n12, 269 CR 720. In an action for wrongfully withheld pension payments, prejudgment interest is recoverable on each such payment from the date it fell due. *Austin v Board of Retirement* (1989) 209 CA3d 1528, 258 CR 106. But see *Weber v Board of Retirement* (1998) 62 CA4th 1440, 73 CR2d 769 (retroactive lump-sum pension benefits do not constitute damages entitled to prejudgment interest under CC §3287(a) when petitioners had not been wrongfully denied benefits).

Occasionally, a party may seek to recover the interest cost of borrowing money as an element of contract damages. This recovery is not ordinarily permitted unless the contracting parties expressly agree that that cost may be included as an element of damages. See *C. Norman Peterson Co. v Container Corp. of Am.* (1985) 172 CA3d 628, 650, 218 CR 592. Moreover, in *Ninety Five Ten v Crain* (1991) 231 CA3d 36, 282 CR 141, the court held that a creditor may not recover prejudgment interest on interest-only installment payments due on a standard promissory note. There are, however, a number of cases that have awarded to a wronged buyer of real estate in a specific performance context the differential in interest rates that the buyer has to pay a lender as the result of the seller's breach of contract. See *Hutton v Gliksberg* (1982) 128 CA3d 240, 180 CR 141; *Stratton v Tejani* (1982) 137 CA3d 758, 187 CR 231; *Housing Auth. v Monterey Senior Citizen Park* (1985) 164 CA3d 348, 356, 210 CR 497.

On postjudgment interest, see Debt Collection Practice in California §7.41 (2d ed Cal CEB 1999).

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3. Attorney Fees

§1.21 a. General Rule

Generally, each party pays his or her attorney fees unless otherwise provided by statute or agreement. As the California Supreme Court stated in *Trope v Katz* (1995) 11 C4th 274, 278, 45 CR2d 241:

> California follows what is commonly referred to as the American rule, which provides that each party to a lawsuit must ordinarily pay his own attorney fees. [Citations omitted.] The Legislature codified the American rule in 1872 when it enacted Code of Civil Procedure section 1021, which states in pertinent part that "Except as attorney's fees are specifically provided for by statute, the measure and mode of compensation of attorneys… is left to the agreement, express or implied, of the parties…" [Citation omitted.] The Legislature has since enacted several statutory exceptions to the American rule, and we have relied on our "inherent equitable authority" to develop… additional exceptions. [Citations omitted.]
>
> Here, however, we are not concerned either with a statutory exception to the American rule or with an equitable theory of recovery. Rather, we address the third scenario in which the American rule does not apply—*i.e.,* when there is an "agreement, express or implied, of the parties" that allocates attorney fees. Although Code of Civil Procedure section 1021 gives individuals a rather broad right to contract out of the American rule by executing such an agreement, these arrangements are subject to the restrictions and conditions of [Civil Code] section 1717 in cases to which that provision applies.

The right to recover attorney fees under CC §1717 and under some other bases is discussed in §§1.22-1.29. See generally California Attorney Fee Awards (2d ed Cal CEB 1994).

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§1.22 b. Right to Reciprocal Recovery of Attorney Fees (CC §1717)

Civil Code §1717(a) provides in pertinent part:

> In any action on a contract, where the contract specifically provides that attorney's fees and costs, which are incurred to enforce that contract, shall be awarded either to one of the parties or to the prevailing party, then the party who is determined to be the party prevailing on the contract, whether he or she is the party specified in the contract or not, shall be entitled to reasonable attorney's fees in addition to other costs.
>
> Where a contract provides for attorney's fees, as set forth above, that provision shall be construed as applying to the entire contract, unless each party was represented by counsel in the negotiation and execution of the contract, and the fact of that representation is specified in the contract.

In other words, if a contract provides for recovery of attorney fees and costs by one of the parties to the contract or by the prevailing party, then the party who actually prevails in the litigation is entitled to attorney fees and costs, whether or not that party is specified in the contract. Counsel should be aware of cases interpreting the second sentence in CC §1717(a). Those cases hold that (unless each party was represented by counsel and that fact is stated in the contracts) CC §1717(a) prohibits parties from limiting recovery of attorney fees to a particular claim on the contract. *Kangarlou v Progressive Title Co.* (2005) 128 CA4th 1174, 1178, 27 CR3d 754; *Paul v Schoellkopf* (2005) 128 CA4th 147, 153, 26 CR3d 766. Counsel should also be aware that it is not uncommon for a court to award attorney fees in an amount higher than the total damages awarded to a plaintiff in a particular case. See *Cruz v Aryromloo* (2007) 155 CA4th 1270, 1276, 66 CR3d 725.

A prevailing party is not entitled to attorney fees under CC §1717 if the contract he or she championed did not contain an attorney fees provision even though the losing party championed a contract containing an attorney fees provision. *Brittalia Ventures v Stuke Nursery Co.* (2007) 153 CA4th 17, 62 CR3d 467. If a statute only allows attorney fees to a prevailing plaintiff, a prevailing defendant is not entitled to fees in a case with contract and tort claims arising from the same transaction. *Wood v Santa Monica Escrow Co.* (2007) 151 CA4th 1186, 60 CR3d 597 (voluntary dismissal of case with elder abuse and breach of contract claims).

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Source: Civil Litigation/California Attorney's Guide to Damages/1 Contract/§1.23 (1) Examples of Recovery Under CC §1717

§1.23 (1) Examples of Recovery Under CC §1717

The primary purpose of CC §1717 is to make attorney fee provisions in contracts reciprocal. The courts have given broad effect to that purpose, as illustrated by the following cases:

- *Hsu v Abbara* (1995) 9 C4th 863, 877, 39 CR2d 824 (trial court does not have any discretion to deny attorney fees under CC §1717, when defendant obtains judgment defeating only contract claim in action);
- *Reynolds Metals Co. v Alperson* (1979) 25 C3d 124, 158 CR 1 (fees awarded to defendants who successfully defended breach of contract action on basis that they were not parties to contract);
- *Profit Concepts Mgmt., Inc. v Griffith* (2008) 162 CA4th 950, 956, 76 CR3d 396 (under CC §1717, "party who is determined to be the party prevailing on the contract" does not require determination of merits of contract claim; fees awarded to defendant who successfully moved to quash service of summons and obtained dismissal of underlying action);
- *Otay River Constructors v San Diego Expressway* (2008) 158 CA4th 796, 807, 70 CR3d 434 (fees awarded to defendant who successfully defeated petition to compel arbitration);
- *Loduca v Polyzos* (2007) 153 CA4th 334, 341, 62 CR3d 780 (fees awarded to third party beneficiary who prevailed in breach of contract action against contract signatory);
- *MBNA Am. Bank, N.A. v Gorman* (2006) 147 CA4th Supp 1, 8, 54 CR3d 724 (fees awarded to defendant who established the contract was unenforceable);
- *ABF Capital Corp. v Grove Props. Co*. (2005) 126 CA4th 204, 23 CR3d 803 (reciprocity provision in CC §1717 is fundamental public policy of California that can override parties' contractual choice of governing law);
- *Baldwin Builders v Coast Plastering Corp.* (2005) 125 CA4th 1339, 1346, 24 CR3d 9 (action to enforce indemnity under indemnity agreement is "on [the] contract" within meaning of CC §1717; therefore attorney fee clause that authorizes recovery of attorney fees by party bringing action is subject to statutory reciprocity requirement);
- *Gil v Masano* (2004) 121 CA4th 739, 17 CR3d 420 (successful assertion of defense to tort action when defense is based on contract provision may not justify attorney fee award under CC §1717);
- *International Billing Servs., Inc. v EMIGH* (2000) 84 CA4th 1175, 1190, 101 CR2d 532 (if party claims that contract allows for attorney fees and then loses on merits, that party must pay attorney fees to prevailing party, regardless of what contract states about attorney fees);
- *Pacific Preferred Props., Inc. v Moss* (1999) 71 CA4th 1456, 84 CR2d 500 (attorney fees properly awarded to sellers against nonsignatory broker who supplied purchase contract signed by seller and buyer);
- *Webber v Inland Empire Invs., Inc.* (1999) 74 CA4th 884, 919, 88 CR2d 594 (attorney fees need not be apportioned between various causes of action if causes of action are so intertwined that particular fee items cannot be allocated to specific causes of action);
- *Korech v Hornwood* (1997) 58 CA4th 1412, 1418, 68 CR2d 637 (fees awarded to successful defendant as against plaintiff who was not party to contract containing attorney fee provision);
- *Gonzales v Personal Storage, Inc.* (1997) 56 CA4th 464, 478, 65 CR2d 473 (fees awarded to successful plaintiff, even though plaintiff had contingency fee agreement with her lawyer);
- *Real Prop. Servs. Corp. v City of Pasadena* (1994) 25 CA4th 375, 30 CR2d 536 (fees awarded to defendant who successfully defended breach of contract action brought by nonsignatory to contract);
- *Siligo v Castellucci* (1994) 21 CA4th 873, 26 CR2d 439 (fees recoverable under CC §1717 for successful defense against noncontractual claim, whose defense was necessary to succeed on contractual claim);
- *Texas Commerce Bank v Garamendi* (1994) 28 CA4th 1234, 34 CR2d 155 (action for declaration of rights based on agreement is "on the contract" within meaning of CC §1717);
- *Anmaco, Inc. v Bohlken* (1993) 13 CA4th 891, 902, 16 CR2d 675 (if one party would be entitled to recover attorney fees under contract if that party prevails in lawsuit, other party should also be entitled to attorney fees if it prevails, even if it does so by successfully arguing inapplicability, invalidity, unenforceability, or nonexistence of same contract); but see *Hasler v Howard* (2005) 130 CA4th 1168, 1171, 30 CR3d 714 (prevailing party is not

entitled to attorney fees simply because opposing party requested them);

- *Brusso v Running Springs Country Club, Inc.* (1991) 228 CA3d 92, 278 CR 758 (fees awarded under CC §1717 to plaintiff shareholders in derivative suit alleging breach of contract);
- *Bovard v American Horse Enters.* (1988) 201 CA3d 832, 247 CR 340 (request for attorney fees denied when party successfully defended action on contract on ground that contract violated public policy);
- *Yuba Cypress Hous. Partners v Area Developers* (2002) 98 CA4th 1077, 1081, 120 CR2d 273 (distinguishing *Bovard v American Horse Enters., supra,* court awarded attorney fees to plaintiff who successfully rescinded contract because of illegality);
- *Perry v Robertson* (1988) 201 CA3d 333, 247 CR 74 (fees awarded under CC §1717 even though judgment was based on general jury verdict on *both* contract and tort claims);
- *South Bay Transp. Co. v Gordon Sand Co.* (1988) 206 CA3d 650, 253 CR 753 (fees awarded to carrier in undercharge action even though part of contract was illegal and recoverable damages were dictated by regulation);
- *Mackinder v OSCA Dev. Co.* (1984) 151 CA3d 728, 198 CR 864 (recognizing that regardless of form, whether by contract, deed, or binding equitable servitude, an instrument providing for recovery of attorney fees in event of litigation is governed by CC §1717);
- *Jones v Drain* (1983) 149 CA3d 484, 196 CR 827 (fees awarded to successful defendants who were sued for breach of contract containing attorney fee provision even though trial court found that no contract existed between plaintiff and defendants).

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§1.24 (2) Recovery of Attorney Fees Under CC §1717 by Strangers to Contract

Despite the breadth of the holdings in *Reynolds Metals Co. v Alperson* (1979) 25 C3d 124, 158 CR 1, and *Jones v Drain* (1983) 149 CA3d 484, 196 CR 827, cited in §1.23, requests for attorney fees have been denied when the competing litigants were contractual strangers to each other. See *Wilson's Heating & Air Conditioning v Wells Fargo Bank* (1988) 202 CA3d 1326, 249 CR 553; *Clar v Cacciola* (1987) 193 CA3d 1032, 238 CR 726.

The court in *Curry v Moody* (1995) 40 CA4th 1547, 48 CR2d 627, gave a narrowing interpretation to *Reynolds Metals Co. v Alperson*, *supra*. As the court stated (*Curry,* 40 CA4th at 1557):

> What the Supreme Court said in *Reynolds Metal* was that Civil Code section 1717 should be interpreted to "provide a reciprocal remedy for a nonsignatory defendant, sued on a contract as if he were a party to it, *when a plaintiff would clearly be entitled to attorney's fees should he prevail in enforcing the contractual obligation against the defendant*." (25 Cal.3d at p. 128, italics added.) In other words, if the *plaintiff* in the action would be entitled to attorney fees against the defendant, the mutuality provisions of Civil Code section 1717 entitle the defendant to attorney fees against the plaintiff, even though the defendant did not sign the contract.

For a similar interpretation of *Reynolds Metal,* see *Blickman Turkus v MF Downtown Sunnyvale* (2008) 162 CA4th 858, 896, 76 CR3d 325.

Counsel should also be aware of *Artesia Med. Dev. Co. v Regency Assocs.* (1989) 214 CA3d 957, 266 CR 657 (unlawful detainer action against lessee and lessee's assignees), which held that attorney fees were not recoverable by the assignees. Although the primary lease contained an attorney fee provision, the court held that the action was based not on the lease but on wrongful possession by the assignees, who had no privity with the lessor.

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§1.25 (3) Recovery of Attorney Fees by Attorney Litigants and "In-House" Counsel Under CC §1717

In *Trope v Katz* (1995) 11 C4th 274, 292, 45 CR2d 241, the supreme court resolved part of a divergence of authority concerning whether attorneys representing themselves and in-house attorneys are entitled to recover attorney fees under CC §1717. *Trope* held that attorney litigants cannot recover such fees. But although the supreme court referred to *Garfield Bank v Folb* (1994) 25 CA4th 1804, 31 CR2d 239, which held that in-house counsel fees are recoverable under CC §1717, the court expressly refrained from determining the correctness of the *Garfield Bank* decision. *Trope,* 11 C4th at 291.

In *PLCM Group, Inc. v Drexler* (2000) 22 C4th 1084, 95 CR2d 198, the supreme court, citing *Trope* and *Garfield Bank,* held that a prevailing party may recover "in-house" counsel fees under CC §1717. As the court stated (22 C4th at 1094):

> The reasoning in *Garfield Bank v Folb* [citation omitted] and the federal cases is persuasive. We discern no basis for discriminating between counsel working for a corporation in-house and private counsel engaged with respect to a specific matter or on retainer. Both are bound by the same fiduciary and ethical duties to their clients. [Citation omitted.] Both are qualified to provide and do provide, equivalent legal services. And both incur attorney fees and costs within the meaning of CC §1717 in enforcing the contract on behalf of their clients.

In *Gilbert v Master Washer & Stamping Co.* (2001) 87 CA4th 212, 104 CR2d 461, the appellate court, citing *Trope* and *PCLM,* held that a prevailing party who is an attorney is entitled to recover attorney fees under CC §1717 when that attorney is represented by members of his or her own law firm. See also *Mix v Tumanjan Dev. Corp.* (2002) 102 CA4th 1318, 126 CR2d 267 (permitting attorney in propria persona to recover attorney fees for retained counsel).

NOTE: Attorney litigants cannot recover attorney fees as sanctions under CCP §128.7. *Musaelian v Adams* (2009) 45 C4th 512, 520, 87 CR3d 475.

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§1.26 (4) Determination of Prevailing Party Under CC §1717

In any action based on a contract providing that attorney fees that were incurred to enforce the provisions of that contract are to be awarded either to one of the parties or to the prevailing party, the court, on notice and motion by a party, must determine who is the prevailing party entitled to attorney fees, regardless of whether the action proceeds to final judgment. CC §1717(a)-(b)(1). Civil Code §1717(b)(1) defines the prevailing party in pertinent part as follows:

> Except as provided in paragraph (2), the party prevailing on the contract shall be the party who recovered a greater relief in the action on the contract. The court may also determine that there is no party prevailing on the contract for purposes of this section.

In *Hsu v Abbara* (1995) 9 C4th 863, 876, 39 CR2d 824, the California Supreme Court directed trial courts to determine whether there is a "party prevailing on the contract" as follows:

> [W]e hold that in deciding whether there is a "party prevailing on the contract," the trial court is to compare the relief awarded on the contract claim or claims with the parties' demands on those same claims and their litigation objectives as disclosed by the pleadings, trial briefs, opening statements, and similar sources. The prevailing party determination is to be made only upon final resolution of the contract claims and only by "a comparison of the extent to which each party ha[s] succeeded and failed to succeed in its contentions."

In *Hsu,* the supreme court held that a trial court does not have any discretion to deny attorney fees under CC §1717, when a defendant obtains a judgment defeating the only contract claim in the action. 9 C4th at 877. For other cases applying this part of §1717, see *Silver Creek, LLC v BlackRock Realty Advisors, Inc.* (2009) 173 CA4th 1533, 1540, 93 CR3d 864; *Pacific Custom Pools, Inc. v Turner Constr. Co.* (2000) 79 CA4th 1254, 1271, 94 CR2d 756; *Hilltop Inv. Assocs. v Leon* (1994) 28 CA4th 462, 33 CR2d 552; and *McLarand, Vasquez & Partners, Inc. v Downey Sav. & Loan Ass'n* (1991) 231 CA3d 1450, 282 CR 828.

NOTE: A defendant may not qualify under CC §1717(b)(1) as a "party prevailing on the contract" if the court dismisses the breach of contract claim for lack of jurisdiction. See, *e.g., N.R. v San Ramon Valley Unified Sch. Dist*. (ND Cal, July 6, 2006, No. C-05-0441 SI) 2006 US Dist Lexis 47287. See also *Estate of Drummond* (2007) 149 CA4th 46, 50, 56 CR3d 691 (no prevailing party on contract after party filed petition in wrong forum).

Civil Code §1717(b)(2) specifies that there shall be no prevailing party on the contract when the action has been voluntarily dismissed or dismissed under a settlement. It also specifies that when the defendant alleges in the answer that he or she tendered the full sum due the plaintiff, and then deposits that sum in court, the defendant is the prevailing party on the contract if the allegation is found to be true. For cases strictly applying the voluntary dismissal provision in CC §1717(b)(2), see *Gogri v Jack in the Box, Inc.* (2008) 166 CA4th 255, 274, 82 CR3d 629; *Exxess Electronixx v Heger Realty Corp*. (1998) 64 CA4th 698, 707, 75 CR2d 376; and *Rosen v Robert P. Warmington Co*. (1988) 201 CA3d 939, 247 CR 635.

When a party dismisses an action after requesting a trial de novo in the wake of an arbitration award, the trial court must vacate the dismissal and enter judgment on the arbitration award, including previously awarded attorney fees. In other words, "a dismissal filed after an arbitration award carries with it the consequence of paying previously awarded attorney fees." *Kelley v Bredelis* (1996) 45 CA4th 1819, 1832, 53 CR2d 536.

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§1.27 (5) Limits of CC §1717

The bar of CC §1717(b)(2) applies only to the recovery of attorney fees incurred in the defense of a breach of contract claim. It does not apply to claims that are not based on contract, even though the right to attorney fees is based on a contractual provision. "Whether attorney fees incurred in defending tort or other noncontract claims are recoverable after a pretrial dismissal depends upon the terms of the contractual attorney fee provision." *Santisas v Goodin* (1998) 17 C4th 599, 602, 71 CR2d 830.

On appropriate facts, however, attorney fees still may be awarded to a "prevailing" party pursuant to a settlement that expressly reserves for the court determination and award of attorney fees in a postsettlement motion (*Reveles v Toyota By The Bay* (1997) 57 CA4th 1139, 67 CR2d 543, disapproved on other grounds in *Gavaldon v DaimlerChrysler Corp.* (2004) 32 C4th 1246, 1261, 13 CR3d 793), to a prevailing party seeking to enforce a settlement agreement (*Hastings v Matlock* (1985) 171 CA3d 826, 840, 217 CR 856), and to a party to settlement under CCP §998, because such a settlement results in a judgment and not a dismissal. For a decision following the analysis in *Reveles,* see *Jackson v Homeowners Ass'n Monte Vista Estates-East* (2001) 93 CA4th 773, 782, 113 CR2d 363. See also *Share v Casiano Bel-Air Homeowners Ass'n* (1989) 215 CA3d 515, 523, 263 CR 753; *Lanyi v Goldblum* (1986) 177 CA3d 181, 189, 223 CR 32.

Civil Code §1717 has been held not to apply to attorney fees incurred in enforcing a judgment. *Chelios v Kaye* (1990) 219 CA3d 75, 268 CR 38. Following *Chelios,* the court in *Hambrose Reserve, Ltd. v Faitz* (1992) 9 CA4th 129, 11 CR2d 638, held that §1717 does not apply to a proceeding to enforce a sister-state judgment based on a contract having an attorney fee clause. Attorney fees incurred before the filing of the lawsuit in which they were awarded, however, have been held to be recoverable. *Stokus v Marsh* (1990) 217 CA3d 647, 266 CR 90. Also, depending on the language of the attorney fee provision, attorney fees incurred in obtaining a dismissal of a party's bankruptcy proceeding may be recoverable under §1717. See *Circle Star Ctr. Assocs., L.P. v Liberate Technols.* (2007) 147 CA4th 1203, 55 CR3d 232. See also *Chinese Yellow Pages Co. v Chinese Overseas Mktg. Serv. Corp.* (2008) 170 CA4th 868, 884, 887, 88 CR3d 250 (following *Circle Star* in postjudgment context in which bankruptcy proceeding was dismissed at debtor's request).

A 1992 amendment to CCP §685.040 changes the rule applied in *Chelios* by providing as follows: "Attorney's fees incurred in enforcing a judgment are included as costs collectible under this title if the underlying judgment includes an award of attorney's fees" under CCP §1033.5(a)(10)(A). For decisions applying the 1992 amendment, see *Jaffe v Pacelli* (2008) 165 CA4th 927, 935, 82 CR3d 423, and *Miller v Givens* (1994) 30 CA4th 18, 21, 37 CR2d 1. However, such enforcement fees have been denied to a plaintiff who obtained attorney fees in a clerk's judgment by default under CCP §585(a), Cal Rules of Ct 3.1800(b), and a local court fee schedule. *Mollala Holdings, Inc. v Akers* (2002) 100 CA4th Supp 6, 123 CR2d 342. Counsel should also be aware that CC §1717 does not authorize recovery of costs or expenses that are not specified in CCP §1033.5. See *Hsu v Semiconductor Sys., Inc*. (2005) 126 CA4th 1330, 25 CR3d 82.

Civil Code §1717 has also been held not to apply to indemnity provisions that include attorney fees, as opposed to a contractual attorney fee provision. *Carr Bus. Enters., Inc. v City of Chowchilla* (2008) 166 CA4th 14, 20, 82 CR3d 128; *Southern Pac. Thrift & Loan Ass'n v Savings Ass'n Mortgage Co.* (1999) 70 CA4th 634, 642, 82 CR2d 874.

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§1.28 (6) Award of CC §1717 Attorney Fees in Arbitration

Counsel should take note of two supreme court decisions that have addressed refusals by arbitrators to award attorney fees under contract. In *Moshonov v Walsh* (2000) 22 C4th 771, 94 CR2d 597, the supreme court refused to correct an arbitrator's decision denying attorney fees when the arbitrator interpreted the contract's attorney fees provision as inapplicable to the causes of action on which the defendant prevailed. In *Moore v First Bank of San Luis Obispo* (2000) 22 C4th 782, 94 CR2d 603, the supreme court refused to correct the denial of attorney fees by arbitrators because the arbitrators did not designate the plaintiffs as the prevailing parties. The court in *Moore* concluded as follows (22 C4th at 789):

> Consequently, this court has yet to decide whether, in view of the principle that "[t]he powers of an arbitrator derive from, and are limited by, the agreement to arbitrate" [citation omitted], an arbitrator's refusal to award fees expressly mandated by the underlying contract may be judicially corrected under [CCP] section 1286.6.

Although an arbitrator may deny attorney fees, one appellate court has held that a prevailing party on a CC §1717 contract claim is entitled to an award of attorney fees for postarbitration judicial proceedings under CCP §1293.2. *Carole Ring & Assocs. v Nicastro* (2001) 87 CA4th 253, 104 CR2d 519.

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Source: Civil Litigation/California Attorney's Guide to Damages/1 Contract/§1.29 (7) Procedure for Recovery Under CC §1717

§1.29 (7) Procedure for Recovery Under CC §1717

Code of Civil Procedure §1033.5(c)(5) specifies that attorney fees under CC §1717 "shall be fixed either upon a noticed motion or upon entry of default judgment, unless otherwise provided by stipulation of the parties." California Rules of Court 3.1702 applies to claims for statutory attorney fees and claims for attorney fees provided in a contract. Under Rule 3.1702, a notice of motion to claim attorney fees for services up to and including the rendition of judgment in the trial court must be served and filed within the time for filing a notice of appeal under Cal Rules of Ct 8.104 and 8.108.

NOTE: In *Saben, Earlix & Assocs. v Fillet* (2005) 134 CA4th 1024, 1029, 36 CR3d 610, the court held that entry of an *order* granting a motion for summary judgment did not trigger the running of this time limit, but rather the entry of the summary *judgment* itself.

Despite the language of CCP §1033.5 and Rule 3.1702, courts disagree on whether motions for attorney fees are required or whether a memorandum of costs will suffice. Compare *Hydratec, Inc. v Sun Valley 260 Orchard & Vineyard Co.* (1990) 223 CA3d 924, 272 CR 899 (both are required), *Allstate Ins. Co. v Loo* (1996) 46 CA4th 1794, 1797, 54 CR2d 541 (motion required), and *Chinn v KMR Prop. Mgmt.* (2008) 166 CA4th 175, 194, 82 CR3d 586 (motion required), with *Simpson v Smith* (1989) 214 CA3d Supp 7, 263 CR 110 (former Rule 870.2 (now Rule 3.1702) requirement of motion for attorney fees is invalid). In *Simpson,* the court observed that a previous version of CC §1717(a), with which former Rule 870.2 (now Rule 3.1702) was consistent, contained language that attorney fees shall be fixed by the court "upon notice and motion by a party." However, according to the court, the legislature intended to eliminate the requirement of a noticed motion for attorney fees when it amended §1717(a) to delete the above-quoted language. In *Gunlock Corp. v Walk on Water, Inc.* (1993) 15 CA4th 1301, 19 CR2d 197, the court held that, assuming former Rule 870.2 (now Rule 3.1702) requires a motion, the time limitation in the Rule is not jurisdictional. Thus, a trial court has broad discretion in allowing relief from a late filing absent prejudice to the opposing party. *Russell v Trans Pac. Group* (1993) 19 CA4th 1717, 24 CR2d 274, however, disagrees with *Gunlock,* holding that the motion and time requirements of CCP §1033.5 and former Rule 870.2 (now Rule 3.1702) are mandatory. See also *Sanabria v Embrey* (2001) 92 CA4th 422, 429, 111 CR2d 837 (time requirements of former Rule 870.2 (now Rule 3.1702) are mandatory), and *Miller v Provost* (1994) 26 CA4th 1703, 33 CR2d 288 (judgment that includes judicial entitlement to fees satisfies statutory requirement of noticed motion). For further discussion of this issue, see California Attorney Fee Awards §§14.2, 14.13-14.14, 14.22 (2d ed Cal CEB 1994).

In *Harvard Inv. Co. v Gap Stores, Inc.* (1984) 156 CA3d 704, 202 CR 891, the court held that, when a judgment includes attorney fees awarded under a contractual fee clause, the court must exclude the portion of the fee award that represents services performed *after* a statutory CCP §998 offer is made when the court decides that §998 applies. In *Scott Co. v Blount, Inc.* (1999) 20 C4th 1103, 1106, 86 CR2d 614, the defendant made a §998 pretrial settlement offer that the plaintiff rejected. At trial, the plaintiff received a money judgment that was less than the defendant's offer. Without citing *Harvard*, the supreme court held that the plaintiff is entitled to its pre-offer attorney fees and that the defendant is entitled to its postoffer attorney fees.

Trial courts have jurisdiction to award attorney fees incurred in successfully prosecuting or defending an appeal. *M.C. & D. Capital Corp. v Gilmaker* (1988) 204 CA3d 671, 251 CR 178; *MST Farms v C.G. 1464* (1988) 204 CA3d 304, 251 CR 72. See also *Harbour Landing-Dolfann, Ltd. v Anderson* (1996) 48 CA4th 260, 264, 55 CR2d 640 (attorney fees may be requested either of appellate court while appeal is pending or of trial court on issuance of remittitur), and *Butler-Rupp v Lourdeaux* (2007) 154 CA4th 918, 65 CR3d 242 (trial court may award prevailing party attorney fees incurred on appeal, even if appellate court ordered parties to bear their own costs).

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§1.30 c. Recovery Under Statutes Other Than CC §1717

Counsel should be alert to California statutes other than CC §1717 that may provide for recovery of attorney fees in cases involving breach of contract issues. For example, attorney fees may be awarded to a prevailing plaintiff in a damages action based on the defendant's felonious conduct if the defendant has been convicted on the felony charge. CCP §1021.4. Also, an attorney fee award is possible under the private attorney general statute in contract cases that result in a significant benefit for the general public or a large class of persons under CCP §1021.5. See also California Trial Practice: Civil Procedure During Trial §§26.61-26.76 (3d ed Cal CEB 1995); California Attorney Fee Awards, chap 3 (2d ed Cal CEB 1994).

Attorney fees incurred in defending an action may also be recovered under CCP §1021.6 by a party who later prevails on a claim for implied indemnity. See *Bear Creek Planning Comm. v Title Ins. & Trust Co.* (1985) 164 CA3d 1227, 1245, 211 CR 172, disapproved on other grounds in *Bay Dev., Ltd. v Superior Court* (1990) 50 C3d 1012, 1032 n12, 269 CR 720. Under CCP §1141.21, a party who requests trial de novo of an arbitration award, but does not obtain a more favorable judgment, may be required to pay attorney fees. *Bhullar v Tayyab* (1996) 46 CA4th 582, 54 CR2d 17. An award of attorney fees under CCP §1293.2 is mandatory when authorized by contract. *Marcus & Millichap Real Estate Inv. Brokerage Co. v Woodman Inv. Group* (2005) 129 CA4th 508, 513, 28 CR3d 584. An automobile purchaser who prevails against the seller in an action under the Song-Beverly Act may recover attorney fees. *Levy v Toyota Motor Sales, U.S.A., Inc.* (1992) 4 CA4th 807, 813, 5 CR2d 770. A prevailing party in an action under the Mobilehome Residency Law is entitled to attorney fees under CC §798.85. *Employers Mut. Cas. Co. v Philadelphia Indem. Ins. Co.* (2008) 169 CA4th 340, 351, 86 CR3d 383.

Under CC §1021, contracting parties may validly agree that the prevailing party will be awarded attorney fees incurred in any litigation between themselves, whether such litigation sounds in tort or in contract. *Santisas v Goodin* (1998) 17 C4th 599, 608, 71 CR2d 830; *Tanner v Tanner* (1997) 57 CA4th 419, 923, 67 CR2d 204; *Palmer v Shawback* (1993) 17 CA4th 296, 21 CR2d 575; *Lerner v Ward* (1993) 13 CA4th 155, 159, 16 CR2d 486; *Xuereb v Marcus & Millichap, Inc.* (1992) 3 CA4th 1338, 5 CR2d 154. For a decision following *Lerner* and *Xuereb,* see *Johnson v Siegel* (2000) 84 CA4th 1087, 101 CR2d 412. Whether attorney fees are available on this basis involves questions concerning interpretation of the parties' agreement and the issues presented in the litigation. See *Hasler v Howard* (2004) 120 CA4th 1023, 16 CR3d 217. However, such an agreement will not be interpreted reciprocally to award fees to a party not specified in the agreement. See *Moallem v Coldwell Banker Commercial Group, Inc.* (1994) 25 CA4th 1827, 31 CR2d 253. Moreover, a voluntary dismissal will not prevent the prevailing party from recovering fees in a tort action in which the entitlement to fees is based on a contractual fee agreement under CC §1021, because CC §1717 does not apply to tort causes of action. *Santisas v Goodin* (1998) 17 C4th 599, 619, 71 CR2d 830. *Santisas* disapproved *Jue v Patton* (1995) 33 CA4th 456, 39 CR2d 364, and *Ryder v Peterson* (1996) 51 CA4th 1056, 1060, 59 CR2d 562, to the extent inconsistent with this position. 17 C4th at 622 n9.

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Source: Civil Litigation/California Attorney's Guide to Damages/1 Contract/§1.31 d. Recovery for Bad Faith Breach of Contract and Breach of Fiduciary Duty

§1.31 d. Recovery for Bad Faith Breach of Contract and Breach of Fiduciary Duty

California courts have developed rules providing for recovery of attorney fees in cases alleging causes of action for bad faith breach of the implied covenant of good faith and fair dealing and breach of fiduciary duty.

In *Brandt v Superior Court* (1985) 37 C3d 813, 210 CR 211, the California Supreme Court held that the successful plaintiff in a case alleging that an insurer has in bad faith denied a payment due on an insurance contract is entitled to recover attorney fees regardless of whether such contract contains an attorney fee clause. The rationale for the *Brandt* decision is that a plaintiff in such a case is allowed to recover for all detriment proximately resulting from the insurer's bad faith. However, the supreme court limited the recoverable attorney fees as follows (37 C3d at 819):

> The fees recoverable … may not exceed the amount attributable to the attorney's efforts to obtain the rejected payment due on the insurance contract. Fees attributable to obtaining any portion of the plaintiff's award which exceeds the amount due under the policy are not recoverable.

In *White v Western Title Ins. Co.* (1985) 40 C3d 870, 890, 221 CR 509, the supreme court applied the reasoning of *Brandt* to include witness fees and other litigation expenses as elements of damage. Further, an insured's assignee may recover *Brandt* fees under *Essex Ins. Co. v Five Star Dye House, Inc.* (2006) 38 C4th 1252, 1263, 45 CR3d 362.

In *Cassim v Allstate Ins. Co.* (2004) 33 C4th 780, 811, 16 CR3d 374, the supreme court explained the proper method of calculating *Brandt* fees in a contingent fee context as follows:

> This method requires the trier of fact to determine the percentage of the legal fees paid to the attorney that reflects the work attributable to obtaining the contract recovery. Some outer limits are immediately discernible. First, no portion of legal fees attributable to the punitive damage award can be recovered as *Brandt* fees. *Brandt's* focus was solely on ensuring that attorney fees for contract recovery did not diminish a plaintiff's compensatory damages award, and did not concern diminution of the punitive damages award, which is essentially a windfall for plaintiffs that the law permits for public policy reasons. Second, the *Brandt* fees can never exceed the legal fees for the combined tort and contract recovery; in most cases the amount will be far less.
>
> To determine the percentage of the legal fees attributable to the contract recovery, the trial court should determine the total number of hours an attorney spent on the case and then determine how many hours were spent working exclusively on the contract recovery. Hours spent working on issues jointly related to both the tort and contract should be apportioned, with some hours assigned to the contract and some to the tort. This latter figure, added to the hours spent on the contract alone, when divided by the total number of hours worked, should provide the appropriate percentage.

Several appellate decisions since *Brandt* indicate the scope of its application. For example, in *CNA Cas. v Seaboard Sur. Co.* (1986) 176 CA3d 598, 621 n12, 222 CR 276, the court held that no fees may be recovered under *Brandt* unless the plaintiff both pleads and proves bad faith (which requires that the insurer be shown to have acted unreasonably). In *Campbell v Cal-Gard Sur. Services, Inc.* (1998) 62 CA4th 563, 571, 73 CR2d 64, the court held that *Brandt* entitles a successful bad faith plaintiff to only those attorney fees attributable to the contract cause of action. In *Track Mortgage Group, Inc. v Crusader Ins. Co.* (2002) 98 CA4th 857, 867, 120 CR2d 228, the appellate court affirmed a trial court's allocation of attorney fees incurred on the contract cause of action. In *Northbrook Excess & Surplus Ins. Co. v Coastal Rescue Sys.* (1986) 182 CA3d 763, 771, 227 CR 639, the court held that *Brandt* does not authorize an award of attorney fees to an insured who successfully defended an action by an insurer seeking a declaratory judgment of noncoverage.

In *Palmer v Ted Stevens Honda, Inc.* (1987) 193 CA3d 530, 539 n4, 238 CR 363, the court stated that the *Brandt* rule is confined to the special insurer-insured relationship, and that bad faith in disputing an ordinary commercial obligation cannot overcome the general rule of nonrecovery of attorney fees in the absence of a contractual provision. In *California Fair Plan Ass'n v Politi* (1990) 220 CA3d 1612, 1618, 270 CR 243, the court held that the *Brandt* rule does not apply to an action by the insurer against its insured, because its action only "sounds in contract." The courts disagree concerning whether *Brandt* permits recovery of attorney fees incurred on an insurer's unsuccessful appeal. See *Baron v Fire Ins. Co.* (2007) 154 CA4th 1184, 1198, 65 CR3d 502 (attorney fees recoverable; following *McGregor*

v Paul Revere Life Ins. Co. (9th Cir 2004) 369 F3d 1099); *Burnaby v Standard Fire Ins. Co.* (1995) 40 CA4th 787, 47 CR2d 326 (fees not recoverable).

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§1.32 e. Recovery Under "Tort of Another" or "Third Party Tort" Doctrine

Under the "tort of another" or "third party tort" doctrine, a plaintiff may recover attorney fees from a defendant if the plaintiff is required to employ counsel to prosecute or defend an action against a third party because of the tort of the defendant. *Prentice v North Am. Title Guar. Corp.* (1963) 59 C2d 618, 620, 30 CR 821. This doctrine has been applied to actions involving breach of contract in which the breach has the foreseeable consequence of embroiling the innocent party in civil or criminal litigation unconnected with the contract. See *De La Hoya v Slim's Gun Shop* (1978) 80 CA3d Supp 6, 146 CR 68 (defendant sold plaintiff stolen gun; plaintiff was arrested for possessing stolen property and had to defend against criminal charges; plaintiff was awarded attorney fees incurred in defending criminal charges). In *Gray v Don Miller & Assocs.* (1984) 35 C3d 498, 198 CR 551, the California Supreme Court allowed recovery of attorney fees attributable to an action for specific performance against sellers under the "tort of another" rationale in an action by a prospective buyer against a real estate broker (fiduciary) for fraud, and rejected the argument that such recovery required exceptional circumstances. For a case applying the "third party tortfeasor" rule, see *Shapiro v Sutherland* (1998) 64 CA4th 1534, 1551, 76 CR2d 101.

The "tort of another" doctrine does not apply in the case of an exonerated alleged tortfeasor. *Watson v Department of Transp.* (1998) 68 CA4th 885, 80 CR2d 594. In *Watson,* the court held that, absent some theory of implied indemnity, each party must follow the general rule of paying its own attorney fees.

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§1.33 4. Expert Witness Fees

Code of Civil Procedure §998(c)(1) permits expert witness fees to be recovered as costs when the prevailing party receives a judgment more favorable than an offer to compromise submitted under that section. Code of Civil Procedure §998 applies to settlement offers to resolve contractual arbitrations under CCP §§1281 and 1295 as well as civil cases in court. It does not apply to any enforcement action brought in the name of the People of the State of California by either the Attorney General, a district attorney, or a city attorney acting as a public prosecutor. CCP §998(g)(2).

If a prevailing party receives a judgment or arbitration award less favorable than a rejected offer of settlement, under CCP §998 expert witness fees may be awarded at the court's discretion to the nonprevailing party as costs. For a discussion on the standards governing the court's discretion in this context, see *People ex rel Lockyer v Fremont Gen. Corp*. (2001) 89 CA4th 1260, 1270, 108 CR2d 127.

Two appellate courts have recognized that contracting parties may provide for the recovery of expert witness fees by appropriate contract language and that such fees are recoverable if the parties specifically plead and prove their right to recover them. See *First Nat'l Bank v Mountain Cascade, Inc.* (2000) 77 CA4th 871, 878, 92 CR2d 145; *Ripley v Pappadopoulos* (1994) 23 CA4th 1616, 1627, 28 CR2d 878. This reasoning has been applied to plaintiffs and defendants. *Carwash of America-PO v Windswept Ventures No. 1* (2002) 97 CA4th 540, 118 CR2d 536.

For discussion of different types of expert witness fees that may be recoverable under §998, see *Goodstein v Bank of San Pedro* (1994) 27 CA4th 899, 32 CR2d 740, and *Evers v Cornelson* (1984) 163 CA3d 310, 209 CR 497.

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5. Exemplary and Nominal Damages

§1.34 a. General Rule

Civil Code §3294(a) provides that a plaintiff in an action not arising from breach of contract may recover exemplary damages (often referred to as punitive damages) when the defendant has been guilty of oppression, fraud, or malice. However, the general rule is that, in the absence of an independent tort, punitive damages may not be awarded for breach of a noninsurance contract, even when the defendant's conduct in breaching the contract was willful, fraudulent, or malicious. *City of Hope Nat'l Med. Ctr. v Genentech, Inc.* (2008) 43 C4th 375, 392, 75 CR3d 333; *Cates Constr., Inc. v Talbot Partners* (1999) 21 C4th 28, 61, 86 CR2d 855; *Freeman & Mills, Inc. v Belcher Oil Co.* (1995) 11 C4th 85, 102, 44 CR2d 420; *JRS Prods., Inc. v Matsushita Elec. Corp.* (2004) 115 CA4th 168, 179, 8 CR3d 840.

The primary purpose of the limitation of CC §3294 to a "breach of an obligation not arising from contract" is to avoid injecting questions of fraud, malice, or oppression into contract actions because most contract breaches arise from inability to perform or uncertainty as to the scope of the obligation, and the defendant is subject to strict liability on showing of breach regardless of his or her intent. See *Haurat v Superior Court* (1966) 241 CA2d 330, 50 CR 520.

The term "nominal damages" describes two types of awards—a token allowance for mere technical invasion of a right and an allowance made when actual damages are substantial but their extent and amount are difficult of precise proof. Generally, exemplary damages are not recoverable in the first instance but may be awarded in the second. *Kluge v O'Gara* (1964) 227 CA2d 207, 38 CR 607.

Exemplary damages cannot be awarded in the absence of actual damages. However, courts appear split on whether this means that there must be an award of compensatory damages or if proof of some damage only is necessary. Compare *Gagnon v Continental Cas. Co.* (1989) 211 CA3d 1598, 1603 n5, 260 CR 305, and *Esparza v Specht* (1976) 55 CA3d 1, 127 CR 493 (award of compensatory damages not necessary), with *Berkley v Dowds* (2007) 152 CA4th 518, 530, 61 CR3d 304 (an award of compensatory damages in some amount is a prerequisite to a punitive damage award, whether in the form of nominal damages, restitution, offset, or damages presumed by law), and *Cheung v Daley* (1995) 35 CA4th 1673, 1677, 42 CR2d 164 (any award of punitive damages must be accompanied by award of compensatory damages).

A jury may not consider injuries to nonparties in setting punitive damages, but jurors may consider the harm to nonparties in determining the reprehensibility of defendant's conduct. *Philip Morris USA v Williams* (2007) 549 US 346, 166 L Ed 2d 940, 948, 127 S Ct 1057.

A sum awarded as exemplary damages must bear a reasonable relationship to the actual damages. In *State Farm Mut. Auto. Ins. Co. v Campbell* (2003) 538 US 408, 155 L Ed 2d 585, 123 S Ct 1513, the United States Supreme Court reversed a punitive damage award of $145 million when the compensatory award was only $1 million. The Court stated that there is a presumption against the 145-to-1 ratio in the case before it and that punitive to compensatory ratios that exceed single digits generally risk being considered excessive under constitutional due process, strongly suggesting that a 4-to-1 ratio between punitive and compensatory damages would normally be at the upper end of appropriate. Nonetheless, the Court refused to rule out completely the possibility that some conduct might be so reprehensible as to justify a higher ratio. See *Honda Motor Co., Ltd. v Oberg* (1994) 512 US 415, 129 L Ed 2d 336, 114 S Ct 2331 (due process requires that size of punitive damage awards be subject to judicial review).

In *Simon v San Paolo U.S. Holding Co*. (2005) 35 C4th 1159, 29 CR3d 379, the California Supreme Court interpreted and applied the *State Farm* decision, stating (35 C4th at 1172):

> In deciding whether an award of punitive damages is constitutionally excessive under *State Farm*… we are to review the award de novo, making an independent assessment of the reprehensibility of the defendant's conduct, the relationship between the award and the harm done to the plaintiff, and the relationship between the award and civil penalties authorized for comparable conduct.

Most of the supreme court's analysis is very fact specific, and counsel should read the entire *Simon* decision, but the supreme court's discussion concerning ratios between punitive damages and the plaintiff's actual or potential

compensatory damages is useful. On this subject, *Simon* holds (35 C4th at 1182):

> We understand the court's statement in *State Farm* that "few awards" significantly exceeding a single digit ratio will satisfy due process to establish a type of presumption: ratios between the punitive damages award and the plaintiff's actual or potential compensatory damages significantly greater than 9 or 10 to 1 are suspect and, absent special justification (by, for example, extreme reprehensibility or unusually small, hard-to-detect or hard-to-measure compensatory damages), cannot survive scrutiny under the due process clause.
>
> * * *
>
> Multipliers *less* than nine or 10 are not, however, presumptively *valid* under *State Farm*.

Based on all the facts in *Simon* and the factors in *State Farm,* the California Supreme Court concluded that the maximum permissible punitive damage award in *Simon* was a sum equal to ten times the compensatory award.

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§1.35 b. Exemplary Damages May Be Available in Cases Involving Breach of Insurance Contract or Existence of Independent Tort

As noted in §1.34, exemplary damages may be recovered in certain cases involving breach of an insurance contract, and in cases involving both (1) an independent tort and (2) breach of a noninsurance contract. *Robinson Helicopter Co. v Dana Corp.* (2004) 34 C4th 979, 22 CR3d 352 (breach of contract and intentional misrepresentation or fraud); *Fletcher v Western Nat'l Life Ins. Co.* (1970) 10 CA3d 376, 89 CR 78 (breach of insurance contract and bad faith); *Wetherbee v United Ins. Co.* (1971) 18 CA3d 266, 95 CR 678; *Wetherbee v United Ins. Co.* (1968) 265 CA2d 921, 71 CR 764 (breach of insurance contract and bad faith). In the latter two cases, the award of exemplary damages turned on defendant's bad faith in failing to pay its insured's claim. But see *Silberg v California Life Ins. Co.* (1974) 11 C3d 452, 113 CR 711, in which the supreme court determined that the defendant's failure to pay benefits constituted bad faith but that the trial court did not abuse its discretion in ruling that there was insufficient evidence to support an award of exemplary damages. Exemplary damages may also be awarded against one who fraudulently induces another to enter into a contract. *Kuchta v Allied Builders Corp.* (1971) 21 CA3d 541, 98 CR 588.

The terms "malice," "oppression," and "fraud" are defined in CC §3294. In *Blegen v Superior Court* (1981) 125 CA3d 959, 178 CR 470, the court held that pleading the statutory language is acceptable if sufficient facts are pleaded to support the allegations. Omitting the terms "willful," "fraudulent," "malicious," and "oppressive" from the complaint does not defeat a claim for punitive damages if the complaint pleads sufficient facts to apprise the defendant of the basis on which relief is sought. 125 CA3d at 963.

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§1.36 c. Exemplary Damages Not Available for Bad Faith Denial of Contract's Existence

Controversy has existed over whether damages in tort, including exemplary damages, are available for the bad faith denial that a contract exists. In *Seaman's Direct Buying Serv., Inc. v Standard Oil Co.* (1984) 36 C3d 752, 769, 206 CR 354, the California Supreme Court held that a party to a contract may incur tort remedies when, in addition to breaching the contract, it seeks to shield itself from liability by denying in bad faith and without probable cause that the contract exists. Subsequent to *Seaman's,* the state supreme court and the appellate courts decided numerous cases involving the availability of tort damages, including exemplary damages, for breach of the implied covenant of good faith and fair dealing. While most of those decisions reflected the rule of law that exemplary damages were generally not available in cases involving the breach of commercial contracts, those decisions also employed inconsistent standards for determining when such damages might be available.

In *Freeman & Mills, Inc. v Belcher Oil Co.* (1995) 11 C4th 85, 44 CR2d 420, the supreme court expressly overruled *Seaman's* because (1) supreme court decisions after *Seaman's* indicated a continuing reluctance to authorize tort recovery for noninsurance contract breaches (citing *Foley v Interactive Data Corp.* (1988) 47 C3d 654, 254 CR 211; *Hunter v Up-Right, Inc.* (1993) 6 C4th 1174, 1180, 26 CR2d 8; *Applied Equip. Corp. v Litton Saudi Arabia Ltd.* (1994) 7 C4th 503, 28 CR2d 475); (2) appellate courts applied *Seaman's* inconsistently; (3) other jurisdictions either criticized or refused to follow the *Seaman's* analysis; and (4) scholarly commentary on *Seaman's* was critical. Accordingly, the supreme court concluded as follows (11 C4th at 102):

> *Seaman's* should be overruled in favor of a general rule precluding tort recovery for noninsurance contract breach, at least in the absence of violation of "an independent duty arising from principles of tort law" (*Applied Equipment, supra,* 7 Cal.4th at p. 515) other than the bad faith denial of the existence of, or liability under, the breached contract.

As a result of the *Freeman* decision, most of the cases decided under *Seaman's* have become historical footnotes. Moreover, *Freeman* has been held applicable to cases pending in trial courts and on appeal as of the date when *Freeman* was decided. See *Sutherland v Barclays American/Mortg. Corp.* (1997) 53 CA4th 299, 61 CR2d 614; *Norager v Nakamura* (1996) 42 CA4th 1817, 50 CR2d 481.

In *Cates Constr., Inc. v Talbot Partners* (1999) 21 C4th 28, 86 CR2d 855, the supreme court followed the *Freeman* decision and refused to permit tort recovery against a surety for breach of the implied covenant of good faith and fair dealing in the context of a construction project surety bond. In reaching its decision, the court stated (21 C4th at 43):

> Because the covenant of good faith and fair dealing essentially is a contract term that aims to effectuate the contractual intentions of the parties, "compensation for its breach has almost always been limited to contract rather than tort remedies." [Citations omitted.] At present, this court recognizes only one exception to that general rule: tort remedies are available for a breach of the covenant in cases involving insurance policies.

The court distinguished surety contracts from traditional insurance contracts and disallowed tort recovery. Finally, the court reversed the award of punitive damages by quoting the rule from *Applied Equip. Corp. v Litton Saudi Arabia Ltd., supra* (21 C4th at 61):

> In the absence of an independent tort, punitive damages may not be awarded for breach of contract "even where the defendant's conduct in breaching the contract was willful, fraudulent or malicious."

Counsel should also be aware that an *insured* cannot be held liable in tort for breaching the implied covenant of good faith and fair dealing. See, *e.g., Agricultural Ins. Co. v Superior Court* (1999) 70 CA4th 385, 396, 82 CR2d 594.

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§1.37 d. Proof of Defendant's Financial Condition

Courts are required to consider meaningful evidence of a defendant's financial condition before awarding punitive damages. *Adams v Murakami* (1991) 54 C3d 105, 118, 284 CR 318. The plaintiff has the burden of producing such evidence. 54 C3d at 119. Cases decided after *Adams* have elaborated on its meaning. See *Kelly v Haag* (2006) 145 CA4th 910, 52 CR3d 126 (failure to submit evidence of defendant's net worth and exclusive reliance on defendant's admissions made long before trial precludes punitive damage award); *Rich v Schwab* (1998) 63 CA4th 803, 815, 75 CR2d 170 (*Adams'* rule, that defendant's financial condition must be considered before assessment of punitive damages, does not apply when statute sets minimum and maximum penalty; however, defendant may show evidence of financial condition in mitigation); *Stevens v Owens-Corning Fiberglass Corp.* (1996) 49 CA4th 1645, 1660, 57 CR2d 525 (amount of defendant's profits does not limit punitive damage award); *Lara v Cadag* (1993) 13 CA4th 1061, 16 CR2d 811 (evidence of defendant's income alone is inadequate); *Cummings Med. Corp. v Occupational Med. Corp.* (1992) 10 CA4th 1291, 13 CR2d 585 (punitive damages may be based on profitability of defendant's misconduct). In *Mike Davidov Co. v Issod* (2000) 78 CA4th 597, 608, 92 CR2d 897, the court agreed with *Cummings* and awarded punitive damages in a case in which the trial court ordered the defendant to produce financial records, but the defendant failed to do so. But see *Kenly v Ukegawa* (1993) 16 CA4th 49, 19 CR2d 771, which criticized *Cummings* and held that, in most cases, an award of punitive damages cannot be justified solely on the profitability of the defendant's misconduct. The California Supreme Court did not overrule *Adams* in the *Simon* decision (*Simon v San Paolo U.S. Holding Co.* (2005) 35 C4th 1159, 29 CR3d 379), discussed in §1.34.

Civil Code §3295 permits a defendant to ask the court to preclude any evidence of the defendant's financial condition until after malice, oppression, or fraud has been proved.

Before a trial court may enter an order allowing discovery of financial condition information under CC §3295(c), it must (1) weigh the evidence presented by both sides, and (2) make a finding that it is "very likely" the plaintiff will prevail on the punitive damages claim. *Jabro v Superior Court* (2002) 95 CA4th 754, 755, 115 CR2d 843. For an illustration of the type of financial documents that may be discoverable concerning the punitive damages issue, see *Weingarten v Superior Court* (2002) 102 CA4th 268, 125 CR2d 371.

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§1.38 6. Mental Distress or Physical Suffering

The general rule is that a plaintiff cannot recover damages for mental distress or physical suffering experienced as a result of the breach of a noninsurance contract, regardless of any impairment of the plaintiff's health or any injury occasioned to his or her feelings or reputation. Such damage is generally considered too remote. *Erlich v Menezes* (1999) 21 C4th 543, 87 CR2d 886 (negligent breach of noninsurance contract will not support an award of damages for emotional distress); *Westwater v Grace Church* (1903) 140 C 339, 73 P 1055.

However, when the terms of a contract relate to matters that directly concern the comfort or personal welfare of a party or the subject matter of a contract directly affects or moves a party's affection, self-esteem, or tender feelings, he or she may recover damages for physical illness and mental suffering proximately caused by a breach of the contract. *Chelini v Nieri* (1948) 32 C2d 480, 196 P2d 915; *Windeler v Scheers Jewelers* (1970) 8 CA3d 844, 851, 88 CR 39 (collecting cases illustrating application of this rule). See also *Saari v Jongordon Corp.* (1992) 5 CA4th 797, 803, 7 CR2d 82 (damages for emotional distress for breach of mortuary and crematorium contracts).

Emotional distress damages are also recoverable when a defendant, in breaching a contract, violates a fiduciary obligation owed to the plaintiff. *Cross v Bonded Adjustment Bureau* (1996) 48 CA4th 266, 55 CR2d 801 (violation of fiduciary duty between collection agency and judgment creditor who retained agency to collect judgment). Such damages are also recoverable in the insurance contract context when an insurer breaches its duty to the insured of good faith and fair dealing. *Gruenberg v Aetna Ins. Co.* (1973) 9 C3d 566, 108 CR 480.

Additionally, when a breach of an insurance contract includes the elements of the tort of intentional infliction of emotional distress, the aggrieved party may recover damages for such distress in a cause of action sounding in tort. *Crisci v Security Ins. Co*. (1967) 66 C2d 425, 58 CR 13; *Fletcher v Western Nat'l Life Ins. Co.* (1970) 10 CA3d 376, 89 CR 78 (defendant willfully, maliciously, and in bad faith withheld payment of its insured's claim).

In *Fletcher*, the court defined the elements of a prima facie case for the tort of intentional infliction of emotional distress as follows (10 CA3d at 394):

> (1) [O]utrageous conduct by the defendant; (2) the defendant's intention of causing or reckless disregard of the probability of causing emotional distress; (3) the plaintiff's suffering severe or extreme emotional distress; and (4) actual and proximate causation of the emotional distress by the defendant's outrageous conduct. [Citations omitted.] Whether treated as an element of the prima facie case or as a matter of defense, it must also appear that the defendants' conduct was unprivileged. [Citations omitted.]

In *Gruenberg v Aetna Ins. Co., supra,* the state supreme court made it easier for an insured to recover damages for mental distress from an insurer that failed to pay a claim. The court held that a complaint in which the plaintiff alleged mental distress and severe economic damage because the insurer violated its implied duty of good faith and fair dealing in failing to pay his claim is sufficient to state a cause of action for damages for mental distress even if the insurer's alleged conduct is not so extreme or outrageous as to constitute the tort of intentional infliction of mental distress. See also *Silberg v California Life Ins. Co.* (1974) 11 C3d 452, 113 CR 711.

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§1.39 7. Loss of Goodwill

The general rule is that a plaintiff cannot recover damages for injury to his or her reputation as a result of a breach of contract. However, a plaintiff may obtain compensatory damages for loss of goodwill of a business. *Walpole v Prefab Mfg. Co.* (1951) 103 CA2d 472, 230 P2d 36. See also *Baker v Pratt* (1986) 176 CA3d 370, 222 CR 253 (former shareholder in construction company brought action against other shareholder based on defendant's wrongful exclusion of plaintiff from corporate enterprise; court held that damages were awardable to corporation for unlawful use of corporation's goodwill); *Tamarind Lithography Workshop, Inc. v Sanders* (1983) 143 CA3d 571, 193 CR 409 (court awarded compensatory damages and injunctive relief for loss of publicity to film producer who did not receive screen credit agreed on in film production contract).

NOTE: In *Colvig v RKO Gen., Inc.* (1965) 232 CA2d 56, 42 CR 473, however, the court held that general damages for wrongful discharge as a radio announcer could include not only loss of salary but also loss of public standing in the plaintiff's profession. The plaintiff in *Colvig* had already been paid his salary and obtained a judgment that, by confirming an arbitration award, in effect ordered the radio station to allow him back on the air as an announcer. The station refused, and the plaintiff apparently did not seek injunctive relief to compel the station to comply. Instead, he filed another action on the judgment, which the court pointed out was "a contract upon which the parties may maintain a separate action between themselves." 232 CA2d at 65. The decision made no reference to *Westwater v Grace Church* (1903) 140 C 339, 73 P 1055, an early case in which the California Supreme Court held that a breach of contract could not give rise to a cause of action for damages for loss of a choir singer's reputation. Such damages were held not clearly ascertainable and therefore not within CC §3300 or §3301. In *Colvig v RKO Gen*., *Inc*., *supra,* the court found that the complaint sufficiently alleged general damages that would not "necessarily [be] restricted to plaintiff's salary." 232 CA2d at 69. It also observed, however, that the complaint did not sufficiently allege special damages. Therefore, counsel could argue that the court did not decide whether a properly pleaded claim for loss of goodwill or reputation could withstand a special demurrer. The *Colvig* court did not discuss the application of federal labor law to the case. The court instead treated the claim as one for breach of contract under state law. *Colvig* has been held not to support a claim for specific performance of a contract as a means of compensating the plaintiff for damage to his reputation. *Barndt v County of Los Angeles* (1989) 211 CA3d 397, 405, 259 CR 372. Generally, older employment agreements in the entertainment field contain a so-called pay or play clause under which the employer fully discharges its obligation by paying the employee's salary and is not required to utilize the employee's services. See *RKO Radio Pictures, Inc. v Sheridan* (9th Cir 1952) 195 F2d 167, 169 (interpretation of pay or play clause).

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IV. LIMITATIONS ON AMOUNT OF DAMAGES

§1.40 A. Uncertain and Speculative Damages

Civil Code §3301 provides that damages cannot be recovered for breach of a contract if they are not ascertainable in both their nature and origin. This is the general rule against uncertain and speculative damages

But the mere fact that the amount cannot be precisely ascertained does not bar the plaintiff's right to recover damages if they can be reasonably estimated. In this regard, the trial court may call on its own general knowledge of the value of services of a common or nontechnical nature and is not necessarily bound by express evidence of such value. See *Ross v Frank W. Dunne Co.* (1953) 119 CA2d 690, 260 P2d 104. In addition, the law does not require that the extent of detriment be determined with an absolute degree of certainty. See *Zinn v Ex-Cell-O Corp.* (1944) 24 C2d 290, 149 P2d 177. See also *Tamarind Lithography Workshop, Inc. v Sanders* (1983) 143 CA3d 571, 577, 193 CR 409 (if existence of damages was certain and actual damages awarded were based on "calculations, inferences or observations that are logical," they were not precluded on basis of uncertainty). In *Zinn v Ex-Cell-O Corp., supra,* the court pointed out that one whose wrongful conduct has rendered the calculation of damages difficult cannot complain because the court must make an estimate rather than an exact calculation of the amount of damages.

Damages for loss of publicity will also be denied if the publicity that is lost is too remotely associated with the plaintiff's vocation or profession. In *Ericson v Playgirl, Inc.* (1977) 73 CA3d 850, 140 CR 921, the court disallowed a claim for loss of publicity, except for nominal damages, caused by a magazine's failure to feature the plaintiff on its cover, because the promised publicity bore no relation to the plaintiff's art. The resulting financial harm, if any, was too speculative to be compensated. The court stated (73 CA3d at 858):

> Assessment of the value of general publicity unrelated to professional performance takes us on a random walk whose destination is as unpredictable as the lottery and the roulette wheel. When, as at the bench, damages to earning capacity and loss of professional publicity in the practice of one's art are not involved, we think recovery of compensable damages for loss of publicity is barred by the Civil Code requirement that damages for breach of contract be clearly foreseeable and clearly ascertainable.

When the injured party's loss of profits is too conjectural to be the basis for awarding damages, the proper measure of damages instead is the value of his or her services in attempting to perform the contract. *Mendoyama, Inc. v Mendocino* (1970) 8 CA3d 873, 87 CR 740. Under these circumstances, the plaintiff is also entitled to his or her reasonable and necessary expenses in preparing to perform under the contract. *Walpole v Prefab Mfg. Co.* (1951) 103 CA2d 472, 230 P2d 36.

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§1.41 B. Mitigation of Damages

Generally, a party who suffers damages from a breach of contract must do all that the party reasonably can do to mitigate the party's damages (*Johnson v Comptoir* (1955) 135 CA2d 683, 288 P2d 151), but the party may recover as mitigation damages the costs of such attempts (*Millikan v American Spectrum Real Estate Servs. Cal., Inc.* (2004) 117 CA4th 1094, 1105, 12 CR3d 459).

However, a plaintiff is not required to mitigate damages if financially unable to do so. *Berge v International Harvester Co.* (1983) 142 CA3d 152, 190 CR 815 (defective truck failed to operate properly, causing plaintiff's business to fail). Also, a plaintiff is not required to incur expenses in trying to mitigate damages that are out of proportion to the damages that result from the defendant's breach. *Dutra v Cabral* (1947) 80 CA2d 114, 181 P2d 26. Moreover, the mitigation of damages doctrine does not require a lender to obtain insurance for its collateral as a condition to recovery on a defaulted loan. *Valle de Oro Bank v Gamboa* (1994) 26 CA4th 1686, 32 CR2d 329.

For discussion of the distinction between cases in which the obligor repudiates the contract before the obligee has an opportunity to perform (contract price is prima facie measure of damages and matters of mitigation and reduction must be proved by obligor) and other types of cases in which only actual damages are recoverable and the burden of proving them is on plaintiff, see *Marconi Wireless Tel. Co. v North Pac. S. S. Co.* (1918) 36 CA 653, 173 P 103.

See generally 1 Witkin, Summary of California Law, *Contracts* §§914-922 (10th ed 2005). On mitigation of damages in employment contracts, see §1.53.

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C. Liquidated Damages

§1.42 1. Validity and Scope

Civil Code §1671 governs contractual liquidated damages clauses. The general rule is that such provisions are valid, unless the breaching party can show that the provision was unreasonable at the time the contract was made. CC §1671(b). See *El Centro Mall, LLC v Payless ShoeSource, Inc.* (2009) 174 CA4th 58, 63, 94 CR3d 43.

However, the general rule does not apply to consumer retail purchases or rentals, or to housing rentals by a tenant or by a person whose dependents will reside on the property. CC §1671(c). For these contracts, there is a two-part test for determining whether a liquidated damages clause is valid:

- The amount of actual damages must be impracticable or extremely difficult to fix (see CC §1671(c)-(d)); and
- The amount selected must "represent a reasonable endeavor by the parties to estimate fair compensation for the loss sustained" (see *Utility Consumers' Action Network, Inc. v AT&T Broadband* (2006) 135 CA4th 1023, 1029, 37 CR3d 827).

To determine whether the actual damages are difficult to fix, a court will place itself in the position of the parties at the time the contract was made and not at the time of breach. *Better Foods Mkts., Inc. v American Dist. Tel. Co*. (1953) 40 C2d 179, 253 P2d 10. In addition, the reasonable endeavor test does not require both parties to expressly negotiate the amount of liquidated damages; rather, it depends on the motivation, purpose, and effect of the liquidated damages clause. *Utility Consumers' Action Network, Inc. v AT&T Broadband, supra*. However, the parties' failure to make any attempt to anticipate the damages that might flow from a breach of contract may render the amount set as liquidated damages an unenforceable penalty. *Greentree Fin. Group, Inc. v Execute Sports, Inc.* (2008) 163 CA4th 495, 499, 78 CR3d 24. Thus, in proving the validity of a liquidated damages clause, counsel should gather evidence showing all of the circumstances at the time the contract was entered into, not at the time the breach occurred or the lawsuit arose.

In addition, CC §1671 does not apply to (1) any contract for which another statute expressly sets standards under which the validity of a liquidated damages provision is determined (CC §1671(a)) or (2) a buyer's default for failure to complete a contract for the purchase of real property (see CC §§1675-1681). See *Guthman v Moss* (1984) 150 CA3d 501, 198 CR 54 (interpreting and applying CC §§1675-1681).

A liquidated damages provision is not invalid merely because it is intended to encourage a party to perform, as long as it represents a reasonable attempt to anticipate the losses to be suffered. See *Californians for Population Stabilization v Hewlett-Packard Co.* (1997) 58 CA4th 273, 286, 67 CR2d 621 (liquidated damages provision upheld despite its purpose to keep employee at job); *Weber, Lipshie & Co. v Christian* (1997) 52 CA4th 645, 656, 60 CR2d 677 ("penalty" for violation of noncompetition agreement upheld as valid liquidated damages clause).

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§1.43 2. In Public Contracts

Liquidated damage clauses in various public contracts are authorized by Pub Cont C §§10226 and 10826, and Govt C §53069.85. Each of these sections specifically provides that such a clause is valid unless "manifestly unreasonable under the circumstances existing at the time the contract was made." See *Vrgora v Los Angeles Unified Sch. Dist.* (1984) 152 CA3d 1178, 1186, 200 CR 130 (recognizing validity of liquidated damage provision authorized by Govt C §53069.85). Education Code §92050 authorizes such clauses and validates them in the same manner in construction contracts to which the Regents of the University of California are a party.

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§1.44 3. Liquidated Damages as "Processing Charges" and "Late Fees"

Some liquidated damages clauses, masquerading as late charges or provisions for alternative performance, may be void under CC §3275 as penalties or forfeitures or under CC §1671(d) as unreasonable. See *Poseidon Dev., Inc. v Woodland Land Estates* (2007) 152 CA4th 1106, 1116, 62 CR3d 59 (late charge of 10 percent, as applied to balloon payment in a promissory note, held unrecoverable as an element of damages); *Hitz v First Interstate Bank* (1995) 38 CA4th 274, 285, 44 CR2d 890 (credit card late and overlimit fees held invalid); *Sybron Corp. v Clark Hosp. Supply Corp.* (1978) 76 CA3d 896, 143 CR 306 (breach of installment obligation to pay money). But see *Utility Consumers' Action Network, Inc. v AT&T Broadband* (2006) 135 CA4th 1023, 1028, 37 CR3d 827 (late fee provision in providers' service agreements held valid under CC §1671); *O'Connor v Televideo Sys.* (1990) 218 CA3d 709, 718, 267 CR 237 (1-1/2 percent monthly late charge on invoices for sales of goods held valid under CC §1671).

The California Supreme Court has held that contractually imposed bank charges for processing checks drawn on accounts without sufficient funds cannot be treated as a penalty under CC §1671, because the writing of such checks is not a breach of contract. Instead, the court held that the fee that the bank may charge for processing such checks is limited by principles of "good faith, reasonableness, unconscionability, and the like." *Perdue v Crocker Nat'l Bank* (1985) 38 C3d 913, 932, 216 CR 345. See *California Grocers Ass'n v Bank of America* (1994) 22 CA4th 205, 27 CR2d 396 ($3 fee for returned checks held not unconscionable). To be a liquidated damages clause, the conduct triggering the payment must breach the contract in some manner. *Morris v Redwood Empire Bancorp* (2005) 128 CA4th 1305, 1315, 27 CR3d 797.

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§1.45 D. Disclaimer of Warranties

Courts may deny enforcement of unconscionable disclaimers of warranties and consequential damages even in commercial transactions. In *A&M Produce Co. v FMC Corp.* (1982) 135 CA3d 473, 186 CR 114, the court upheld the trial court's rejection of a machinery seller's attempt to expressly disclaim warranties and thereby preclude recovery of consequential damages. The seller's express or implied guaranties of the machine's capabilities and fitness for use, the machine's wholly ineffective performance, the unequal bargaining power of the parties, and the commercial unreasonableness of the disclaimer provisions were key factors in the court's determination that the disclaimers in the contract were unconscionable and therefore unenforceable.

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§1.46 E. Disclaimer and Limitation of Damages

Civil Code §1668 provides that all contracts having as their purpose the exemption of one from responsibility for his or her own fraud, willful injury to the property of another, or willful or negligent violation of law are against public policy. Civil Code §1668 has been held to apply to violations of regulations as well as statutes. See *Health Net, Inc. v Department of Health Servs.* (2003) 113 CA4th 224, 227, 6 CR3d 235.

The modern interpretation of this statute is that a contractual provision exempting one from liability is valid only when no public interest is involved and no statute expressly prohibits it. See *Gardner v Downtown Porsche Audi* (1986) 180 CA3d 713, 225 CR 757. As stated in *Tunkl v Regents of Univ. of Cal.* (1963) 60 C2d 92, 32 CR 33, to determine whether a contract affects public interest, courts consider six factors: (1) whether the contract concerns business of a type generally thought suitable for public regulation; (2) whether the party seeking exculpation performs a service of great public importance, often a matter of practical necessity for some members of the public; (3) whether this party holds itself out as willing to perform this service for any member of the public who seeks it, or at least for any member coming within certain established standards; (4) whether, as a result of the essential nature of the service, in the economic setting of the transaction, the party invoking exculpation possesses a decisive advantage of bargaining strength against any member of the public who seeks its services; (5) whether, in exercising a superior bargaining power, the party confronts the public with a standardized adhesion contract of exculpation, making no provision whereby a purchaser may pay additional reasonable fees and obtain protection against negligence; and (6) whether, as a result of the transaction, the person or property of the purchaser is placed under the control of the seller, subject to the risk of carelessness by the seller or its agent.

For three cases applying the *Tunkl* factors and finding them not present, see *Blue Booth v Santa Barbara Biplane Tours* (2008) 158 CA4th 1173, 1178, 70 CR3d 660, *McCarn v Pacific Bell Directory* (1992) 3 CA4th 173, 4 CR2d 109, and *Appalachian Ins. Co. v McDonnell Douglas Corp.* (1989) 214 CA3d 1, 27, 262 CR 716.

In *City of Santa Barbara v Superior Court* (2007) 41 C4th 747, 750-751, 62 CR3d 527, the supreme court concluded that an agreement made in the context of sports or recreational programs or services, purporting to release liability for future gross negligence, generally is unenforceable as a matter of public policy.

Counsel should also be aware, however, that when the subject contract involves the sale of goods, Com C §2719 controls the validity of a clause limiting or excluding consequential damages for commercial loss because a special act is an exception to a general enactment such as CC §1668. See *Nunes Turfgrass, Inc. v Vaughan-Jacklin Seed Co.* (1988) 200 CA3d 1518, 1538, 246 CR 823. Commercial Code §2719(b)(3) allows the limitation or exclusion of such damages unless the limitation or exclusion is unconscionable.

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V. SPECIFIC BREACH SITUATIONS; RULES AND APPROACHES TO CONTRACT DAMAGES

§1.47 A. Total Failure to Perform

When the breaching party is obligated to provide some performance other than payment of money (see §1.52), it is necessary to ascertain the position in which the plaintiff would be if the contract had been fully performed. Generally, the object of contract damages is to place the plaintiff in this position. See §1.13. For example, when a building contractor fails to perform a construction contract, the usual measure of damages for the owner is the extra cost of having another party perform the contract. *Fairlane Estates, Inc. v Carrico Constr. Co.* (1964) 228 CA2d 65, 39 CR 35.

However, when an agreement gives a party the right to terminate it on payment of a certain sum, that sum becomes the measure of damages for his breach in not performing even though he does not exercise his right to terminate in the manner provided in the agreement. *Pecarovich v Becker* (1952) 113 CA2d 309, 248 P2d 123.

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§1.48 B. Partial Performance

The general measure of damages for partial performance is the cost of completion by the other party, plus incidental damages, less expenses saved by the breach. *Kennedy v Reece* (1964) 225 CA2d 717, 37 CR 708; *Graham-Hall Sheet Metal Works, Ltd. v Douglas* (1946) 72 CA2d 452, 164 P2d 778.

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§1.49 C. Delay in Performance

Damages for delay can result from either a total (see §1.47) or partial (see §1.48) failure of performance. In both cases, delay damages are an extra item of recovery in addition to the normal measure of damages. However, even when there has been complete performance of a contract, damages for delay can result when performance was not completed on time.

Examples of such damages are varied and depend on the circumstances. For example, an owner of income property may recover loss of rent occasioned by a delay in construction. *Bird v American Sur. Co.* (1917) 175 C 625, 166 P 1009. Given the extensive use of construction financing by owners, additional or increased interest payments due to increased interest rates may be recoverable by an owner. Note, however, that it has been held that interest paid by the plaintiff on a loan to enable it to carry out its performance of a contract is an item of special damages that is not recoverable unless the defendant knew or should have known at the time it entered into the contract that the plaintiff's performance was to be financed through loans. *Mendoyama, Inc. v Mendocino* (1970) 8 CA3d 873, 87 CR 740. See generally §1.18 on special damages.

A building contractor whose performance is delayed by the owner may have increased overhead and fixed costs resulting from a delay and may suffer labor and material cost increases or loss of labor productivity due to delays for all of which he or she would be entitled to damages.

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§1.50 D. Defect in Performance

Generally, the measure of damages for deficient performance of a contract is the sum required to make the product conform to the contract, *i.e.,* the so-called cost rule. *Jones v Kvistad* (1971) 19 CA3d 836, 97 CR 100; *Amerson v Christman* (1968) 261 CA2d 811, 68 CR 378. The court also applied this rule in *Shell v Schmidt* (1958) 164 CA2d 350, 330 P2d 817. In doing so, the court in *Shell* stated that the exceptional measure of damages, *i.e.,* the difference between the value of the building if it had been constructed in accordance with the contract and its value as constructed (the so-called value rule, which is sometimes applied), is not applicable when there have been intentional major deviations from the contract by the contractor, or when the contractor fails to prove that there would be economic waste because a substantial part of what has been done must be undone. On the other hand, when the repair of defects involves significant cost that exceeds the loss of market value under circumstances in which there would be economic waste in making repairs, the measure of damages is the loss of market value due to the defects. *Bayuk v Edson* (1965) 236 CA2d 309, 46 CR 49. See also *Avery v Fredericksen & Westbrook* (1944) 67 CA2d 334, 154 P2d 41, in which the court held that, under CC §§3300 and 3358-3359, the measure of damages for breach of contract that causes an injury to the plaintiff's land is its fair market value if this is less than the cost of repairs.

Although, as indicated above, depending on the particular circumstances, the measure of damages is either the cost of repairs or the diminution in market value, there may also be a recoverable residual diminution in value after repairs are made. For instance, an owner of a home subjected to landslide may have a loss of value due to the landslide history of the property even though the landslide damage is completely repaired. In such a case, it appears that the measure of damages would be the cost of repairs, plus the residual diminution in value after repairs are made.

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§1.51 E. Prevention or Obstruction of Performance

The measure of damages for prevention or obstruction of performance is closely related to damages for delays in performance (see §1.49). Nevertheless, delay alone is not the only result. For example, an owner of a building under construction may prevent or obstruct a contractor's performance by not removing or clearing obstructions on the property as required by the contract or by allowing other contractors to perform functions that interfere with the building contractor's work.

Common items of recovery due to prevention or obstruction of performance are loss of profits and other incidental expenses (see *Buxbom v Smith* (1944) 23 C2d 535, 145 P2d 305; *Shelley v Hansen* (1966) 244 CA2d 210, 53 CR 20).

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§1.52 F. Failure to Pay Money

Civil Code §3302 provides that the measure of damages for breach of an obligation to pay money only is deemed to be the amount due with interest. See §1.20 on interest.

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§1.53 G. Breach of Employment, Service, or Agency Contracts

The general rule in employment, agency, or service contracts is stated as follows in *Oliver v Campbell* (1954) 43 C2d 298, 302, 273 P2d 15:

> [O]ne who has been injured by a breach of contract has an election to pursue any of three remedies, to wit: "He may treat the contract as rescinded and may recover upon a quantum meruit so far as he has performed; or he may keep the contract alive, for the benefit of both parties, being at all times ready and able to perform; or, third, he may treat the repudiation as putting an end to the contract for all purposes of performance, and sue for the profits he would have realized if he had not been prevented from performing." [Citations omitted.]

Under the first alternative, when an employee is wrongfully prevented from full performance of the contract, he or she may as a general rule elect to rescind the contract and sue on a quantum meruit to recover the reasonable value of the services he or she has performed *even though this value exceeds the contract price;* however, the contract price is competent evidence of the reasonable value of the services. If the injured party has fully performed his or her services under the contract or a severable part of it for which the injured party is entitled to a liquidated sum of money, the measure of damages is what he or she is entitled to under the contract. When an employee has partly performed and has been prevented from full performance by the employer's repudiation of the contract and pleads on a quantum meruit, he or she need not plead the contract, its repudiation by the employer, or his or her own rescission of it. *Oliver v Campbell, supra.*

In *Warner Bros. Pictures, Inc. v Bumgarner* (1961) 197 CA2d 331, 17 CR 171, the court held that an employer's wrongful suspension of an employee and refusal to pay him his compensation does not by itself constitute a discharge of the employee, even though it does constitute a material breach that justifies the employee's electing to terminate the contract. In that event, however, the employee is entitled only to damages equal to the compensation he would have received between the employer's breach and the employee's termination. The employee also has the right to continue in the employer's service and if he elects to do so he may require payment of his salary as it accrues. The holding in *Bumgarner* seems to be in accord with the extensive quotation from the Restatement of Contracts in *Oliver v Campbell, supra.*

The general rule is that a wrongfully discharged employee may recover the salary agreed on for the period of service concerned, less the amount the employer proves he or she earned or with reasonable effort might have earned from other employment. However, before projected earnings from other employment not sought or accepted by the employee can be applied in mitigation, the employer must show that the other employment was comparable to that of which the employee was deprived. *Parker v Twentieth Century-Fox Film Corp.* (1970) 3 C3d 176, 89 CR 737. Moreover, the rule on mitigation of damages does not apply to employment contracts that do not require all or the greater portion of the employee's time or that do not preclude the employee rendering contemporaneous services for third parties. *Payne v Pathe Studios, Inc.* (1935) 6 CA2d 136, 44 P2d 598.

A wrongfully discharged employee may accept temporary menial work without waiving the future right to refuse employment less than comparable to the original position. To hold otherwise would "senselessly" penalize the employee who is already suffering the distress of unemployment. *Rabago-Alvarez v Dart Indus.* (1976) 55 CA3d 91, 99, 127 CR 222. Recovery from the former employer is not reduced by any unemployment compensation received by the employee. *Billetter v Posell* (1949) 94 CA2d 858, 211 P2d 621. Nor is recovery from a former employer reduced by any compensation received by the employee from any subsequent employer when the employment contract provides for a salary "guarantee." *National Football League Players Ass'n v National Football League Mgmt. Council* (1986) 188 CA3d 192, 233 CR 147. For a case applying the rule that the employer has the burden of proof concerning mitigation of damages in the employment context, see *Chyten v Lawrence & Howell Invs.* (1993) 23 CA4th 607, 46 CR2d 459.

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§1.54 1. *Foley v Interactive Data Corp.*

In the 1980s, contract and tort actions for wrongful termination of employees had been a rapidly expanding area of the law. Cases had expanded the consequential damages recoverable for termination of employees previously considered employed at will. See, *e.g., Wayte v Rollins Int'l* (1985) 169 CA3d 1, 215 CR 59 (wrongful termination of employee for assertion of rights under an employee benefit plan); *Rulon-Miller v IBM Corp.* (1984) 162 CA3d 241, 208 CR 524 (upholding award of compensatory and punitive damages for wrongful discharge from employment in manner breaching implied covenant of good faith and fair dealing). For further discussion, see Wrongful Employment Termination Practice, chap 5 (2d ed Cal CEB 1997). In *Foley v Interactive Data Corp.* (1988) 47 C3d 654, 688, 254 CR 211*,* however, the supreme court expressly disapproved the theory espoused in cases such as *Wayte* and *Rulon-Miller.* Instead, *Foley* held that tort remedies are not available for breach of the implied covenant of good faith and fair dealing in an employment contract to employees who allege they have been discharged in violation of the covenant. 47 C3d at 700.

Yet, *Foley* left intact the basic holding in *Tameny v Atlantic Richfield Co.* (1980) 27 C3d 167, 164 CR 839 (individual may seek relief through tort remedies when employer's discharge of that individual contravenes dictates of public policy). 47 C3d at 666. But in following *Tameny, Foley* leaves counsel guessing about when such conduct exists. On this subject, the court in *Foley* stated the following (47 C3d at 669):

> We do not decide in this case whether a tort action alleging a breach of public policy under *Tameny* may be based only on policies derived from a statute or constitutional provision or whether nonlegislative sources may provide the basis for such a claim. Even where, as here, a statutory touchstone has been asserted, we must still inquire whether the discharge is against public policy and affects a duty which inures to the benefit of the public at large rather than to a particular employer or employee. For example, many statutes simply regulate conduct between private individuals, or impose requirements whose fulfillment does not implicate fundamental public policy concerns. Regardless of whether the existence of a statutory or constitutional link is required under *Tameny,* disparagement of a basic *public* policy must be alleged, and we turn now to determine whether plaintiff has done so here.

On the facts involved in *Foley,* the supreme court held that discharging an employee because he reported what he knew about his supervisor, who was under investigation for embezzlement by the FBI, did not justify tort remedies.

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Source: Civil Litigation/California Attorney's Guide to Damages/1 Contract/§1.55 2. Cases After Foley v Interactive Data Corp.

§1.55 2. Cases After *Foley v Interactive Data Corp.*

Cases decided after *Foley v Interactive Data Corp.* (1988) 47 C3d 654, 254 CR 211, have begun to indicate the circumstances under which tort remedies might still be available to a wrongfully discharged employee. Discussion of these cases follows.

The rule of *Foley* was followed by the supreme court in *Guz v Bechtel Nat'l, Inc.* (2000) 24 C4th 317, 100 CR2d 352. Applying *Foley,* the supreme court stated as follows (24 C4th at 352):

> A breach of the contract may also constitute a breach of the implied covenant of good faith and fair dealing. But insofar as the employer's acts are directly actionable as a breach of an implied-in-fact contract term, a claim that merely realleges that breach as a violation of the covenant is superfluous. This is because, as we explained at length in *Foley*, the remedy for breach of an employment agreement, including the covenant of good faith and fair dealing implied by law therein, is *solely contractual*. In the employment context, an implied covenant theory affords no separate *measure of recovery*, such as tort damages. [Citation omitted.] Allegations that the breach was wrongful, in bad faith, arbitrary, and unfair are unavailing; there is no tort of "bad faith breach" of an employment contract.
>
> We adhere to these principles here. To the extent Guz's implied covenant cause of action seeks to impose limits on Bechtel's termination rights *beyond* those to which the parties actually agreed, the claim is invalid. To the extent the implied covenant claim seeks simply to invoke terms to which the parties *did* agree, it is superfluous. Guz's remedy, if any, for Bechtel's alleged violation of its personnel policies depends on proof that they were contract terms to which the parties actually agreed. The trial court thus properly dismissed the implied covenant cause of action.

Gantt v Sentry Ins. (1992) 1 C4th 1083, 4 CR2d 874, recognized that a termination in retaliation for testifying truthfully concerning a coworker's sexual harassment claim in the context of an administrative investigation is actionable. Concerning the public policy requirement in *Tameny* and *Foley,* the court in *Gantt* stated that the employer is held to know the fundamental policies of the state and nation as expressed in their constitutions and statutes and that employees are protected against employer actions that contravene fundamental state policy. *Holmes v General Dynamics Corp.* (1993) 17 CA4th 1418, 22 CR2d 172, applied *Gantt* to support a punitive damage award for dismissing an employee in retaliation for disclosing the employer's violation of the federal False Statements Act. Likewise, *Gantt* was applied to validate a plaintiff's cause of action for wrongful discharge based on his alleged questioning of an employer's right to make a payroll deduction constituting an allegedly illegal setoff of debts under CCP §487.020. See *Phillips v Gemini Moving Specialists* (1998) 63 CA4th 563, 571, 74 CR2d 29. But see *Jersey v John Muir Med. Ctr.* (2002) 97 CA4th 814, 118 CR2d 807, applying *Gantt* in holding that no strong public policy prevents an employer from discharging an employee for commencing litigation against customers of the employer.

The rule of *Gantt v Sentry Ins., supra,* was reaffirmed by the supreme court in *Green v Ralee Eng'g Co.* (1998) 19 C4th 66, 80, 78 CR2d 16. Applying *Gantt,* the court upheld an employee's claim for wrongful discharge based on his termination for reporting the employer's alleged violation of federal aviation regulations promulgated by the Federal Aviation Administration. The court, however, overruled *Gantt* to the extent that it could be interpreted to mean that such regulations could be the basis for a wrongful termination action even when the regulations do not reflect the rule-making agency's enabling legislation. Nonetheless, the court refrained from speculating on the validity of alternative sources of policy. 19 C4th at 80 n6.

In *General Dynamics Corp. v Superior Court* (1994) 7 C4th 1164, 32 CR2d 1, the California Supreme Court recognized that termination of an in-house attorney in retaliation for refusal to violate a mandatory ethical duty embodied in the Rules of Professional Conduct was actionable.

In *Boston v Penny Lane Ctrs., Inc.* (2009) 170 CA4th 936, 947, 88 CR3d 707, the court affirmed a tortious discharge judgment in favor of an at-will employee, who was terminated in retaliation for making a complaint about an unsafe work environment. In *Badih v Myers* (1995) 36 CA4th 1289, 43 CR2d 229, the court held that pregnancy discrimination is a form of sex discrimination and is prohibited by the California Constitution, which expresses a fundamental public policy against sex discrimination in employment. In *Gould v Maryland Sound Indus., Inc.* (1995) 31 CA4th 1137, 37 CR2d 718, the court held that a plaintiff stated causes of action for tortious discharge by alleging that his employment

was terminated to avoid paying him accrued commissions and vacation pay and in retaliation for reporting to management the violation of overtime wage laws applicable to other employees.

In *Turner v Anheuser-Busch, Inc.* (1994) 7 C4th 1238, 32 CR2d 223, the supreme court emphasized that to sustain a claim of wrongful discharge in violation of a fundamental public policy, the employee must prove that the dismissal violated a policy that is (1) fundamental, (2) beneficial for the public, and (3) embodied in a statute or constitutional provision. See also *Grinzi v San Diego Hospice Corp.* (2004) 120 CA4th 72, 79, 14 CR3d 893.

At least one court has held that tort remedies are not available for breach of a franchise contract. See *Harris v Atlantic Richfield Co.* (1993) 14 CA4th 70, 17 CR2d 649 (stating that current case law does not recognize cause of action under *Tameny v Atlantic Richfield Co.* (1980) 27 C3d 167, 164 CR 839, discussed in §1.54, outside employment relationship).

The supreme court held in *Hunter v Up-Right, Inc.* (1993) 6 C4th 1174, 26 CR2d 8, that wrongful termination of employment ordinarily does not give rise to a cause of action for fraud or deceit, even if some misrepresentation is made in the course of the employee's dismissal. Tort recovery is available only if the employee can establish all of the elements of fraud with respect to misrepresentation that is separate from the termination of the employment contract, *i.e.*, when fraud damages cannot be said to result from the termination itself. For examples of decisions permitting an employee to sue his or her former employer for promissory fraud, see *Lazar v Superior Court* (1996) 12 C4th 631, 49 CR2d 377, and *Agosta v Astor* (2004) 120 CA4th 596, 15 CR3d 565.

Finally, courts recognize that, although a claim for wrongful *discharge* in violation of public policy can support a tort claim, a claim seeking tort recoveries based on the allegation that the employer *otherwise* breached the employment contract is barred by *Foley*. See *Brewer v Premier Golf Props., LP* (2008) 168 CA4th 1243, 1256, 86 CR3d 225.

For further discussion, see Wrongful Employment Termination Practice (2d ed Cal CEB 1997).

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§1.56 H. Damages for Unauthorized Services

In *Harris v Dixon Cadillac Co.* (1982) 132 CA3d 485, 183 CR 299, a $45,000 punitive damages award was upheld for a violation of the Automotive Repair Act, which requires an automotive repair dealer to submit a written cost estimate to the customer and to obtain the customer's authorization before commencing repair work. Bus & P C §9884.9. The plaintiff brought a replevin action after she refused to pay for a repair she claimed she never authorized and the defendant refused to return her car. The court held that, on the evidence presented, the jury was entitled to consider the defendant's conduct a flagrant violation of Bus & P C §9884.9. The court stated that punitive damages were further justified by other acts of the defendant that showed bad faith and an apparent attempt to forge the plaintiff's signature on a work order. See also *Zhadan v Downtown Los Angeles Motor Distribs.* (1979) 100 CA3d 821, 161 CR 225.

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I. Breach of Insurance Contracts

§1.57 1. Breach of Covenant of Good Faith and Fair Dealing

There is an implied covenant of good faith and fair dealing in every contract, including insurance policies, that neither party will do anything that will injure the right of the other party to receive the benefits of the contract. As noted in *Cates Constr., Inc. v Talbot Partners* (1999) 21 C4th 28, 43, 86 CR2d 855:

> Because the covenant of good faith and fair dealing is a contract term that aims to effectuate the contractual intentions of the parties, "compensation for its breach has almost always been limited to contract rather than tort remedies" [citations omitted]. At present, this court recognizes only one exception to that rule: tort remedies are available for a breach of the covenant in cases involving insurance policies.

The case law is vast concerning breach of the covenant of good faith and fair dealing in the insurance policy context. Accordingly, the discussion of this topic in this chapter is not intended to be exhaustive, but only to cover some highlights and provide some examples of the case law.

The insurer has a duty not to compromise the insured's rights during settlement negotiations; breach of that duty to the insured is a breach of the implied covenant of good faith and fair dealing. *Barney v Aetna Cas. & Sur. Co.* (1986) 185 CA3d 966, 230 CR 215. When an insurer tortiously withholds benefits under a policy, attorney fees reasonably incurred to compel payment are recoverable as an element of damages for the insurer's breach of the implied covenant of good faith and fair dealing. *Brandt v Superior Court* (1985) 37 C3d 813, 819, 210 CR 211. For discussion of *Brandt,* see §1.31.

When an insurer fails to accept a settlement offer within the policy limits on a claim by a third party against its insured and there is great risk of recovery beyond the policy limits, the insurer is liable to its insured for the full amount of the judgment obtained by the third party. *Comunale v Traders & Gen. Ins. Co.* (1958) 50 C2d 654, 328 P2d 198. The test in such cases is whether a prudent insurer without policy limits would have accepted the settlement offer. In addition, the plaintiff is entitled to damages for mental suffering as a result of the insurer's tortious conduct in not accepting the settlement offer. *Crisci v Security Ins. Co.* (1967) 66 C2d 425, 58 CR 13. But see *Merritt v Reserve Ins. Co.* (1973) 34 CA3d 858, 110 CR 511.

An insurer that defaults in its agreement to defend its insured is bound to reimburse the insured for the full amount of any obligation reasonably incurred. The insured has the right to make any reasonable and bona fide compromise of the action against the insured and this is presumptive evidence of the insured's liability and the amount of it. *Northwestern Title Sec. Co. v Flack* (1970) 6 CA3d 134, 85 CR 693. Attorney fees and costs are proper items of damage for breach of an insurer's duty to defend its insured against third party claims. *State Farm Mut. Auto. Ins. Co. v Allstate Ins. Co.* (1970) 9 CA3d 508, 88 CR 246.

For discussion of exemplary damages and damages for mental distress in insurance contract cases, see §§1.34-1.37.

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Source: Civil Litigation/California Attorney's Guide to Damages/1 Contract/§1.58 2. Examples

§1.58 2. Examples

Numerous cases reflect the courts' stringent enforcement of the implied covenant of good faith and fair dealing in the insurance context, as illustrated by the following:

- *Kransco v American Empire Surplus Lines Ins. Co.* (2000) 23 C4th 390, 97 CR2d 151 (insurer may not assert its insured's comparative bad faith as affirmative defense in bad faith action brought against it by insured for breach of covenant of good faith and fair dealing);
- *White v Western Title Ins. Co.* (1985) 40 C3d 870, 221 CR 509 (insurer's conduct relating to settlement offers during litigation against it by insured may provide evidence of breach of implied covenant);
- *Samson v Transamerica Ins. Co.* (1981) 30 C3d 220, 178 CR 343 (insurance carrier may be held liable for entire amount of judgment against insured if it refuses policy limits settlement offer after entry of judgment exceeding policy limits);
- *McCoy v Progressive W. Ins. Co.* (2009) 171 CA4th 785, 794, 90 CR3d 74 ("genuine dispute" rule does not relieve insurer from its obligation to thoroughly and fairly investigate, process, and evaluate insured's claim; genuine dispute exists only when insurer's position is maintained in good faith on reasonable grounds);
- *Major v Western Home Ins. Co.* (2009) 169 CA4th 1197, 87 CR3d 556 (insurer's bad faith refusal to pay homeowners policy benefits resulted in total judgment of approximately $1.3 million, including approximately $650,000 punitive damages);
- *Boicourt v Amex Assur. Co.* (2000) 78 CA4th 1390, 93 CR2d 763 (insurer's blanket refusal to disclose or to give insured option of disclosing policy limits exposes insurer to liability for breach of covenant of good faith and fair dealing);
- *Amato v Mercury Cas. Co.* (1997) 53 CA4th 825, 833, 61 CR2d 909 (if insured suffers default judgment because insurer tortiously refused to defend, insurer is liable for judgment amount, even if it is later determined that judgment is not covered);
- *Campbell v Superior Court* (1996) 44 CA4th 1308, 52 CR2d 385 (unreasonable failure to defend insured);
- *Hand v Farmers Ins. Exch.* (1994) 23 CA4th 1847, 29 CR2d 258 (unreasonable, bad faith refusal to pay judgment creditor claimant entire amount of judgment against insured exposes insurer to bad faith liability);
- *Betts v Allstate Ins. Co.* (1984) 154 CA3d 688, 201 CR 528 (bad faith denial of settlement offer within policy limits resulted in verdict against insured in excess of policy limits; award of $50,000 compensatory damages (which trial court had remitted from $500,000 as condition of not granting new trial) and $3,000,000 punitive damages upheld);
- *Century Sur. Co. v Polisso* (2006) 139 CA4th 922, 963, 43 CR3d 468 (bad faith denial of policy benefits; award of $622,911 compensatory and $2,015,000 punitive damages upheld under *State Farm Mut. Auto. Ins. Co. v Campbell* (2003) 538 US 408, 155 L Ed 2d 585, 123 S Ct 1513, discussed in §1.34);
- *Moore v American United Life Ins. Co.* (1984) 150 CA3d 610, 197 CR 878 (bad faith denial of disability benefits; award of $30,000 compensatory and $2,500,000 punitive damages upheld);
- *Chodos v Insurance Co. of N. Am.* (1981) 126 CA3d 86, 178 CR 831 (carrier unfairly refused to reimburse $146.71 of $407.72 reasonably advanced by insured to settle minor collision claim for which insured's liability was clear; award of $200,000 punitive damages and $5000 for emotional distress upheld for breach of covenant of good faith and for breach of duty to accept reasonable settlements);
- *Pistorious v Prudential Ins. Co.* (1981) 123 CA3d 541, 176 CR 660 (carrier arbitrarily terminated disability payments and misrepresented independent physician's findings that confirmed plaintiff's disability; $45,000 compensatory tort damages including present cash value of future policy benefits and $1,000,000 punitive damages upheld for bad faith refusal to pay disability benefits);
- *Miller v Elite Ins. Co.* (1980) 100 CA3d 739, 161 CR 322 (carrier knowingly exposed insured to $11,000 in damages when claim could have been settled within policy limits, denied insured opportunity to contribute to settlement, and failed to inform insured of settlement offer; award of $150,000 punitive damages upheld for breach of implied covenant of good faith and fair dealing);

- *Miller v National Am. Life Ins. Co.* (1976) 54 CA3d 331, 126 CR 731 (exemplary damages upheld on basis of false promise);
- *Cain v State Farm Mut. Auto. Ins. Co.* (1975) 47 CA3d 783, 121 CR 200 (carrier's bad faith rejection of settlement offers within policy limits resulted in verdict against insured in excess of policy limits; award of $115,000 punitive damages upheld);
- *California Ins. Co. v Krusiewicz* (2005) 131 CA4th 273, 286, 31 CR3d 619 (mistaken or erroneous withholding of policy benefits if reasonable or if based on a legitimate dispute as to insurer's liability under California law does not expose insurer to bad faith liability; without more, this denial of benefits is merely breach of contract);
- *Hamilton v Maryland Cas. Co.* (2002) 27 C4th 718, 730, 117 CR2d 318 (defending insurer cannot be bound by settlement made without its participation and without any commitment on its insured's part to pay stipulated judgment, even when settlement has been found to be in good faith for purposes of CCP §877.6);
- *Old Republic Ins. Co. v FSR Brokerage, Inc.* (2000) 80 CA4th 666, 687, 95 CR2d 583 (insured failed to state cause of action for bad faith against insurer when its only bad faith claim rested squarely on insurer's allegations of fraud against insured in insurer's complaint; such allegations are within absolute privilege of CC §47);
- *PPG Indus., Inc. v Transamerica Ins. Co.* (1999) 20 C4th 310, 319, 84 CR2d 455 (insurer's failure to settle lawsuit against insured does not make insurer responsible for payment of punitive damages awarded against insured as result of insured's intentional, morally culpable behavior that gave rise to underlying lawsuit);
- *Safeco Ins. Co. v Superior Court* (1999) 71 CA4th 782, 787, 84 CR2d 43 (insurer is not obligated to pay stipulated judgment entered into by its insureds without its consent when insurer has provided defense);
- *New Hampshire Ins. Co. v Ridout Roofing Co*. (1998) 68 CA4th 495, 505, 80 CR2d 286 (covenant of good faith and fair dealing held not to limit insurer's right to settle claims and to thereafter seek reimbursement of deductibles);
- *Maxwell v Fire Ins. Exch.* (1998) 60 CA4th 1446, 1450, 70 CR2d 866 (third party judgment creditor's loss of use of money during defendant insurer's delay in paying balance due (with interest) under judgment fails to meet threshold financial loss requirement to allow recovery of emotional distress damages for bad faith);
- *Rangel v Interinsurance Exchange* (1992) 4 C4th 1, 14 CR2d 783 (insurer did not commit tortious breach of contract by delaying payment on claim when insured's workers' compensation claim arising from same accident had not yet been resolved);
- *Gourley v State Farm Mut. Auto. Ins. Co.* (1991) 53 C3d 121, 3 CR2d 666 (prejudgment interest under CC §3291 not available in insurance bad faith actions);
- *Waters v United Servs. Auto. Ass'n* (1996) 41 CA4th 1063, 48 CR2d 910 (insured may not recover emotional distress damages without first proving financial loss);
- *Dalrymple v United Servs. Auto. Ass'n* (1995) 40 CA4th 497, 46 CR2d 845 (absent other facts, mere filing of action to declare insurer's rights and duties relative to insurance policy cannot form basis of breach of duty of good faith and fair dealing);
- *Globe Indem. Co. v Superior Court* (1992) 6 CA4th 725, 8 CR2d 251 (summary judgment directed in favor of insurer, which did not unreasonably delay in acknowledging coverage because it was first entitled to examine insured under oath on coverage issues);
- *Mock v Michigan Millers Mut. Ins. Co.* (1992) 4 CA4th 306, 328, 5 CR2d 594 (to establish that insurer's conduct has gone sufficiently beyond mere bad faith to warrant punitive award, it must be shown by clear and convincing evidence that insurer has acted maliciously, oppressively, or fraudulently);
- *Hess v Transamerica Occidental Life Ins. Co.* (1987) 190 CA3d 941, 235 CR 715 (precontract conduct in evaluating health of applicant for insurance will not support bad faith action).

NOTE: Counsel should be aware that the California Supreme Court decision in *Moradi-Shalal v Fireman's Fund Ins. Cos.* (1988) 46 C3d 287, 250 CR 116, does not have any effect on an insurer's liability to an insured for fraud, infliction of emotional distress, breach of contract, or breach of the implied covenant of good faith and fair dealing. *Moradi-Shalal* held only that Ins C §790.03(h) does not create a private cause of action against insurers who commit the unfair practices enumerated in that provision, thus overruling *Royal Globe Ins. Co. v Superior Court* (1979) 23 C3d 880, 153 CR 842. See also *California State Auto. Ass'n v Superior Court* (1990) 50 C3d 658, 268 CR 284.

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§1.59 J. Breach of Contracts to Negotiate Agreements

An appellate court has held that breach of a contract to negotiate an agreement gives rise to a cause of action for damages. *Copeland v Baskin Robbins U.S.A.* (2002) 96 CA4th 1251, 1255, 117 CR2d 875. *Copeland* explained how such a contract may be breached (96 CA4th at 1257):

> Failure to agree is not, itself, a breach of the contract to negotiate. A party will be liable only if a failure to reach ultimate agreement resulted from a breach of that party's obligation to negotiate or to negotiate in good faith.

Although *Copeland* held that the specific plaintiff involved could not establish recoverable damages, it discussed the appropriate measure of damages as follows (96 CA4th at 1262):

> [D]amages for breach of a contract to negotiate an agreement are measured by the injury the plaintiff suffered in relying on the defendant to negotiate in good faith. This measure encompasses the plaintiff's out-of-pocket costs in conducting the negotiations and may or may not include lost opportunity costs. The plaintiff cannot recover for lost expectations (profits) because there is no way of knowing what the ultimate terms of the agreement would have been or even if there would have been an ultimate agreement.

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2

Real Estate Seller/Buyer

David Dimitruk
Jane L. O'Hara Gamp
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I. INTRODUCTION §2.1

II. ESSENTIALS OF DAMAGES ACTION
- A. Nature of Action; Jurisdiction; Venue
  - 1. Legal or Equitable Nature of Action §2.2
  - 2. Jurisdiction §2.3
  - 3. Venue §2.4
- B. Establishing Breach §2.5
- C. Inadequacy of Remedies §2.6
- D. Selection of Remedies §2.7

III. SELLER'S BREACH
- A. Buyer's First Steps After Seller's Breach §2.8
- B. Buyer's Damages
  - 1. General Damages Under CC §3306 §2.9
  - 2. Damages for Breach Other Than Failure to Convey Title §2.10
  - 3. Prejudgment Interest §2.11
  - 4. Attorney Fees §2.12
  - 5. Punitive Damages; Emotional Distress §2.13
- C. Seller's Defenses §2.14

IV. BUYER'S BREACH
- A. Purchase Agreement and Installment Land Contract Distinguished §2.15
- B. Breach of Purchase and Sale Agreement §2.16
  - 1. Seller's Remedies
    - a. First Steps After Breach §2.17
    - b. Disposition of Deposit
      - (1) General Considerations §2.18
      - (2) No Liquidated Damages Clause
        - (a) Failure of Condition §2.19
        - (b) Buyer's Breach §2.20
      - (3) Liquidated Damages
        - (a) Agreements Executed Before July 1, 1978 §2.21
        - (b) Agreements Executed on or After July 1, 1978 §2.22
          - (i) Residential Real Property §2.23
          - (ii) Nonresidential Real Property §2.24
    - c. Seller's Damages
      - (1) General Damages Under CC §3307 §2.25
      - (2) Effect of Market §2.26
      - (3) Discounting Price to Cash Equivalent §2.27
      - (4) Proof of Damages §2.28
      - (5) Special Damages
        - (a) Resale Expenses §2.29
        - (b) Broker's Commission §2.30
        - (c) Other Expenses §2.31
  - 2. Buyer's Defenses and Offsets
    - a. Antideficiency Bar §2.32
    - b. Other Defenses and Offsets §2.33

V. ELEMENTS OF FRAUD §2.34
A. Damages When Buyer Is Victim
1. Three Rules §2.35
2. Measure of Damages Compared §2.36
3. Actual Value Means Market Value
a. Proving Market Value §2.37
b. Use of Opinion Testimony §2.38
c. Methods of Establishing Value §2.39
4. Additional Damages §2.40
a. Labor §2.41
b. Repairs and Improvements §2.42
c. Expenses §2.43
d. Lost Profits §2.44
e. Personal Injuries and Emotional Distress §2.45
f. Interest §2.46
g. Punitive Damages §2.47
h. Attorney Fees §2.48
5. Fraud by Fiduciaries §2.49
6. Damages Versus Equitable Remedies §2.50
B. Damages When Seller Is Victim
1. Same Remedies and Defenses §2.51
2. Special Lost Profits Rule §2.52
3. Statutory Protection for Sellers of Residential Real Property §2.53
C. LITIGATION CONSIDERATIONS IN FRAUD ACTIONS
1. Setoff §2.54
2. Mitigation §2.55
3. Rents §2.56
4. Selling Property; Involuntary Foreclosure §2.57
5. Contract Performance §2.58
6. Real Estate Recovery Fund §2.59

VI. INSTALLMENT LAND SALE CONTRACTS §2.60

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§2.1 I. INTRODUCTION

This chapter focuses on damages for breach of real property purchase and sale agreements, although damages for breach of installment land contracts are also briefly addressed in §2.60. Damages available for the seller's breach are discussed in §§2.8-2.14, and damages for the buyer's breach are discussed in §§2.15-2.33. Damages available for fraud in the transaction are discussed in §§2.34-2.59.

Although the focus of this book is damages, it can be difficult, if not impossible, to completely separate a discussion of damages from a discussion of other remedies and of liability. For that reason, this chapter also includes a brief discussion of these matters, especially the factors involved in establishing a breach of contract (see §2.5). Appropriate remedies are discussed in §§2.6-2.7. Defenses and offsets are discussed in §§2.14, 2.32-2.33. For a comprehensive discussion of remedies involving the breach of real property purchase and sale agreements, see California Real Property Remedies and Damages (2d ed Cal CEB 2002).

To support a complaint for breach of contract, an enforceable contract must exist. The essentials of formation and content of the purchase and sale agreement are discussed in California Real Property Sales Transactions (4th ed Cal CEB 2007). In addition, remedies on the underlying financing of the sale are discussed in detail in California Mortgages, Deeds of Trust, and Foreclosure Litigation (4th ed Cal CEB 2009). For transactional approaches to buying and selling property, see the following book or action guide: Real Property Sales; Handling Real Property Sales Transactions (Cal CEB Action Guide April 2007).

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II. ESSENTIALS OF DAMAGES ACTION

A. Nature of Action; Jurisdiction; Venue

§2.2 1. Legal or Equitable Nature of Action

In the initial evaluation of a potential litigation, one must consider whether the action will be cast as legal or equitable in nature. This characterization will establish whether the party is entitled to a jury trial. Usually, if the action seeks only equitable relief, there is no right to a jury. *C & K Eng'g Contractors v Amber Steel Co.* (1978) 23 C3d 1, 8, 151 CR 323; *Interactive Multimedia Artists, Inc. v Superior Court* (1998) 62 CA4th 1546, 1556, 73 CR2d 462. If the action seeks only a legal remedy, such as damages, the right to a jury is usually clear. *Paularena v Superior Court* (1965) 231 CA2d 906, 911, 42 CR 366; *Medeiros v Medeiros* (1960) 177 CA2d 69, 72, 1 CR 696. Note, however, that neither the prayer of the complaint nor the form of the action is conclusive on whether the action is legal or equitable. See *NMSBPCSLDHB v County of Fresno* (2007) 152 CA4th 954, 959, 61 CR3d 425 (court examined nature of rights involved and determined that "gist of the action" was equitable because plaintiff sought to recover "something other than the consideration [plaintiff] gave under the contract"); *Interactive Multimedia Artists, Inc. v Superior Court, supra* (court undertook its own analysis of plaintiff's claim for breach of fiduciary duty to determine its classification as legal or equitable).

Many real property transactions involve a combination of legal and equitable causes of action, such as fraud, specific performance, rescission, or quiet title. When equitable and legal claims are combined, the parties are entitled to a jury trial on the legal issues and a court trial on the equitable issues unless, in the discretion of the court, a jury is allowed on the equitable issues. *Thomson v Thomson* (1936) 7 C2d 671, 62 P2d 358; *Unilogic, Inc. v Burroughs Corp.* (1992) 10 CA4th 612, 12 CR2d 741; *Medeiros v Medeiros, supra*.

PRACTICE TIP: Either pretrial conferences or motions in limine are used to set the order and procedure for hearing combined claims. Even if the parties wish to bifurcate, the court may decide to proceed with both a trial on the bench and jury issues simultaneously as the most efficient use of court resources as well as avoiding duplication of witness testimony and other evidence.

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§2.3 2. Jurisdiction

In a pure action for damages, subject matter jurisdiction is governed by the jurisdictional limits of the various divisions of the superior court. If the amount in controversy exceeds $25,000, the action is designated as an "unlimited" civil case in the superior court. See Cal Const art VI, §10; CCP §§85, 88. Below this amount, it is filed as a "limited" civil case. CCP §86(a). Matters below $5000 are filed as limited civil cases in the small claims division. CCP §§87, 116.220. Code of Civil Procedure §86 provides a list of civil cases and proceedings that are limited civil cases—including some equitable matters. The consistent criterion for limited jurisdiction is the $25,000 amount in controversy. On determining the amount in controversy, see California Civil Procedure Before Trial §§6.23-6.26 (4th ed Cal CEB 2004).

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§2.4 3. Venue

Venue in an action for breach of a real property purchase and sale agreement is subject either to CCP §392(a)(1), governing actions for recovery of an estate or interest in real property (local), or to CCP §395(a), governing actions for breach of contract (transitory). If it is the former, the action must be tried in the county in which the real property is located; if the latter, in the county of the defendant's residence or in which the obligation is to be performed.

Venue in a damages action based on a real property transaction is determined by application of the "main relief rule." See California Civil Procedure Before Trial §§8.49-8.51 (4th ed Cal CEB 2004). Thus, if the principal relief sought concerns rights in the property, and damages are only incidental, the action will be considered local; if the main relief sought affects only personal rights, the action is transitory. This rule may be difficult to put into practice in a given action for damages, and counsel must be careful to draft the complaint in such a way as to support the preferred venue. See Civ Proc Before Trial §§8.48-8.54.

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§2.5 B. Establishing Breach

A breach of contract occurs when there is a wrongful failure to perform a contract or a material promise or covenant in a contract. *Woodard v Glenwood Lumber Co.* (1915) 171 C 513, 153 P 951; *Sterling v Gregory* (1906) 149 C 117, 85 P 305. A failure to perform that is legally excused or justified is not wrongful and is thus not a breach. *Goudal v Cecil B. DeMille Pictures Corp.* (1931) 118 CA 407, 5 P2d 432. Nonperformance or nonoccurrence of a condition that a party has a duty to fulfill is a breach, unless it is excused or waived. *Britschgi v McCall* (1953) 41 C2d 138, 257 P2d 977.

A true breach of contract, whether partial or total, can entitle the injured party to damages. CC §3300. A total breach will excuse further performance by the nonbreaching party. In a partial breach, only a *material* partial breach will excuse performance. See *Axis Petroleum Co. v Taylor* (1941) 42 CA2d 389, 108 P2d 978; *Karz v Department of Prof. & Vocational Standards* (1936) 11 CA2d 554, 54 P2d 35. An anticipatory breach occurs if a party expressly or impliedly repudiates the contract and can provide the basis for excusing further performance by the nonbreaching party. See California Real Property Remedies and Damages §§4.6-4.9 (2d ed Cal CEB 2002).

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§2.6 C. Inadequacy of Remedies

Remedies for a breach of a purchase and sale agreement may be insufficient to avoid or alleviate hardship, even for the party not at fault. When a buyer breaches in an appreciating market, the seller may not be entitled to any damages (see §2.26) and may be unable to retain the buyer's deposit (see §2.18). When a seller sues for specific performance, the seller will hold the property off the market pending the conclusion of the litigation, and the judgment may be ineffective to compel the buyer's performance in any event. Also, the disputing buyer may have clouded title by filing a lis pendens. See California Real Property Sales Transactions §4.116 (4th ed Cal CEB 2007).

The "not at fault" buyer may find available remedies equally unsatisfactory. A suit for specific performance usually requires the buyer to perform, which could prevent the buyer from acquiring another property as an independent way to resolve the dispute. The buyer seeking damages as an alternative to specific performance may be caught in a costly contradiction regarding the market value of the property. See §2.9. Even if the buyer is entitled to recover the deposit, an uncooperative seller can make it difficult to recover the deposited funds from the escrow company.

PRACTICE TIP: Unless requested at the time of deposit, escrow funds are generally not placed in an interest-bearing account. If a conflict occurs, the parties (and especially their counsel), usually agree to have the money transferred to an interest-bearing account pending resolution of the dispute, even if only as a mitigation of damages measure.

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§2.7 D. Selection of Remedies

Breach of a purchase and sale contract usually entitles the nonbreaching party to either legal or equitable remedies that can be sought and pleaded concurrently in the alternative, even if they are inconsistent with each other. Despite the plaintiff's ability to join alternative remedies, however, specific performance and damages are mutually exclusive remedies for breach of contract. To award both would constitute a double recovery. *Rogers v Davis* (1994) 28 CA4th 1215, 34 CR2d 716 (court also explained that "damages" is misnomer for monetary recovery accompanying specific performance).

Acts inconsistent with a prospective remedy can result in a waiver and loss of that remedy. Thus, when a default or repudiation occurs, the nondefaulting party should immediately consider all potential remedies and either act consistently with the preferred remedy or act appropriately to maintain options for alternative remedies, with a view toward electing the remedy that is most advantageous after investigation and formal discovery are completed. For example, a buyer seeking damages for breach of contract or specific performance must take care to avoid conduct and statements evidencing intent to rescind. See *Cook v Nordstrand* (1948) 83 CA2d 188, 188 P2d 282 (demand for and receipt of deposit constituted rescission).

A buyer who seeks specific performance after the seller's breach should always record a lis pendens against the property; this action will ensure that any intervening purchaser will have notice of the buyer's claim and thus be required to recognize the buyer's superior claim to title if a judgment for specific performance is obtained. In practice, however, the defendant seller may move to expunge the lis pendens, arguing that posting a bond is sufficient to protect the buyer's claims. The seller's motion to expunge conditioned on an undertaking is likely to succeed unless the property is improved with a single-family dwelling that the buyer intends to occupy, or the buyer can convince the court that the property is unique. See CCP §405.33.

If the lis pendens is expunged and title to the property is then transferred to a third party, the buyer's only recourse will be to bring a motion to amend the complaint to state a cause of action for breach of contract seeking damages. In a rising real estate market, this alternative will not be wholly satisfactory to the disappointed buyer.

Pleading in the alternative creates practical problems. To obtain specific performance, the buyer must allege that the contract is fair to both parties and, to recover damages for the breach, allege in the same complaint that the value of the property exceeded the contract price on the date of the breach. If this contradiction is too great, the entire action may fail. See *Baran v Goldberg* (1948) 86 CA2d 506, 194 P2d 765.

PRACTICE TIP: This dilemma can be avoided at the pleading stage by omitting allegations of a specific amount in the damages cause of action and simply alleging on information and belief that the value of the property exceeded the price on the date of the breach. Because the complaint seeks specific relief, it should survive a demurrer based on CCP §425.10 for failure to allege damages.

After a buyer's breach, the sellers can find themselves in a vulnerable position if they attempt to resell to a new party. The first buyer, disputing the breach, could file a complaint for specific performance and a concurrent lis pendens. See *Williams Plumbing Co. v Sinsley* (1975) 53 CA3d 1027, 126 CR 345. See also California Real Property Sales Transactions §4.116 (4th ed Cal CEB 2007). The seller also risks being caught in the crossfire in the form of a suit by the subsequent purchaser to compel performance of the sale. One possible course of action is to return the original defaulting buyer's deposit and reserve the right to recover damages after a resale.

PRACTICE TIP: Although most purchase and sale contracts contain an attorney fee clause, most potential and actual litigation settles before trial—often through successful mediation if there is no arbitration clause. In most settlements, monetary recovery, and especially attorney fees, are compromised.

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III. SELLER'S BREACH

§2.8 A. Buyer's First Steps After Seller's Breach

To preserve the availability of potential remedies, as soon as a breach occurs or is threatened, the nonbreaching buyer should be counseled on how to act in a manner consistent with the types of remedies desired. The buyer's subsequent action will depend on:

- The nature of the breach (repudiation, inability to perform, or delay);
- The duties that have been performed to date by each party;
- Any outstanding conditions;
- Conduct that was waived or excused;
- The remaining duties; and
- The sequence of performance (who must perform next, or whether another event must occur first).

Typically, the buyer's deposit of the balance of the purchase price is the last step in the transaction. So the question arises of whether the buyer should tender payment in the face of a breach or an anticipated or potential breach. Unless the contract provides otherwise, payment and conveyance of title are concurrent conditions that require a party to perform or tender performance in order to put the other party into default. *Diamond v Huenergardt* (1959) 175 CA2d 214, 346 P2d 37. A buyer who fails to act may also lose the ability to enforce a remedy. See *Pittman v Canham* (1992) 2 CA4th 556, 3 CR2d 340 (time to perform is not unlimited).

If the breach consists of the seller's repudiation of the agreement, the buyer need not tender the price. CC §1440; *Beverage v Canton Placer Mining Co.* (1955) 43 C2d 769, 278 P2d 694; *County of Solano v Vallejo Redev. Agency* (1999) 75 CA4th 1262, 90 CR2d 41. The buyer is also excused if the seller is unable to perform, because tender would be an idle act. *Hunt v Mahoney* (1947) 82 CA2d 540, 187 P2d 43. If the price is not yet due under the agreement, the buyer need not tender it. *Lifton v Harshman* (1947) 80 CA2d 422, 182 P2d 222, disapproved on other grounds in 50 C2d at 506. And if the seller's failure to timely perform its escrow obligations prevents escrow from closing and the buyer's loans from funding by the closing date, the buyer's obligation to perform by the closing date is excused. *Ninety Nine Invs. v Overseas Courier Servs. (Singapore) Private, Ltd.* (2003) 113 CA4th 1118, 6 CR3d 891 (granting specific performance to buyer). The buyer must tender, however, to claim successfully that the seller has breached by failing to perform by the closing date. Without the buyer's tender and demand for the seller's performance, the seller is not in breach. *Weneda Corp. v Dispalatro* (1964) 225 CA2d 187, 37 CR 267; *Baird v Barton* (1958) 163 CA2d 502, 329 P2d 492.

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B. Buyer's Damages

§2.9 1. General Damages Under CC §3306

When a seller breaches the purchase contract, the buyer can recover the specific measure of damages allowed under CC §3306, which prevails over general contract damages. Section 3306 provides for recovery of:

- The price actually paid;
- Title and escrow expenses;
- The difference between the price agreed on and the value of the property at the time of breach;
- Expenses in preparing to enter the property;
- Consequential damages; and
- Interest.

See *Stevens Group Fund IV v Sobrato Dev. Co.* (1991) 1 CA4th 886, 2 CR2d 460. See also *Crag Lumber Co. v Crofoot* (1956) 144 CA2d 755, 301 P2d 952.

If the breach occurs early on in the contract, the difference in the purchase price and the property's value at the breach may not be great. In a rising real estate market, the property may be worth a great deal more by the time the case goes to trial and reaches judgment. Under CC §3306, the buyer is limited to the difference at the time of the breach regardless of market conditions. *Reese v Wong* (2001) 93 CA4th 51, 112 CR2d 669. In a falling market, the property may be worth less than the selling price at the time of breach and much less by the time the case goes to trial. Monetary damages may thus be an unsatisfactory remedy for a damaged buyer.

PRACTICE TIP: Before starting down the path of costly litigation, counsel should investigate the value of the property at the time of breach and then advise the client on the risks and merits of pursuing litigation on a breach of contract damages claim. This information will also assist counsel in calculating whether to proceed with an unlimited jurisdiction complaint or to elect the more economical limited jurisdiction.

Rents received from leasing the property are not usually an item of consequential damages. *Stevens Group Fund IV v Sobrato Dev. Co., supra*. But if the seller has miscalculated the amount of rent received from a lease of an office building and has represented to the buyer that it is higher than it actually is, the buyer may be able to recover the overstated amounts as damages in a breach of contract action. See *Linden Partners v Wilshire Linden Assocs.* (1998) 62 CA4th 508, 73 CR2d 708.

Breach of contract by repudiation, occurring any time after formation of the agreement and before closing, results in entitlement to damages under CC §3306. Mere inability to convey before the time for performance is not a breach. *Fara v Wells* (1957) 156 CA2d 322, 319 P2d 394; *Lloyd v Locke-Paddon Land Co.* (1935) 5 CA2d 211, 42 P2d 367. A breach can consist of failure to convey title within the time specified in the contract (*Post v Palpar, Inc.* (1960) 184 CA2d 676, 7 CR 823; *Lloyd v Locke-Paddon Land Co., supra*), or it can be a defective conveyance of less than the agreed title (*Levy v Wolff* (1956) 46 C2d 367, 294 P2d 945).

That the seller does not have clear title to the property, however, does not foreclose the buyer from demanding conveyance of whatever interest the seller *does* have in the property and enforcing performance accordingly on reasonable notice of this intent. *Weneda Corp. v Dispalatro* (1964) 225 CA2d 187, 37 CR 267.

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§2.10 2. Damages for Breach Other Than Failure to Convey Title

When the buyer's damages claims are based on other duties or promises and are not the direct result of the promise to convey land, the specific damage limitations of CC §3306 may not apply. For example, damages for breach of warranty or other duties that survive the conveyance of title, and recovery for all damages "proximately caused" by the breach, will be recoverable under CC §3300. Other examples of buyer recoveries include *Coughlin v Blair* (1953) 41 C2d 587, 262 P2d 305 (damages under CC §3300 for seller's breach of covenant to install improvements); *Cory v Villa Props.* (1986) 180 CA3d 592, 598, 225 CR 628 (damages under CC §3343(a) for seller fraud); *Pepitone v Russo* (1976) 64 CA3d 685, 134 CR 709 (damages under CC §§1709, 3333 for fiduciary fraud), cited with approval in *Alliance Mortgage Co. v Rothwell* (1995) 10 C4th 1226, 44 CR2d 352; *Christensen v Slawter* (1959) 173 CA2d 325, 343 P2d 341 (damages incurred from work stoppage caused by delay in delivery of deed).

On covenants of title, see California Real Property Sales Transactions, chap 12 (4th ed Cal CEB 2007).

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§2.11 3. Prejudgment Interest

Civil Code §3306 expressly authorizes the recovery of prejudgment interest on the price paid, on the difference between the contract price and market value, and on special damages in an action for the breach of a real property sales agreement. Before 1983, CC §3306 placed the word "interest" only after the price paid and special damages. After the 1983 revisions to §3306, the word "interest" is located at the end of §3306's list of the elements of damage for breach of an agreement to convey real property. In *Rifkin v Achermann* (1996) 43 CA4th 391, 398, 50 CR2d 661, the court held that this change in §3306 (and a similar change in CC §3307 regarding damages following a breach by the buyer) extended the right to prejudgment interest to the damages measured by the difference between the fair market value of the property on the date of breach less the contract price. *Rifkin* also held that, under CC §3287(b), interest should be calculated from the date the lawsuit is filed. 43 CA4th at 399.

If a seller breaches a sales agreement, prejudgment interest can also be awarded on the amount of the buyer's escrow deposit. *Al-Husry v Nilsen Farms Mini-Market, Inc.* (1994) 25 CA4th 641, 31 CR2d 28. In *Al-Husry,* the court held that there was no inconsistency with the rule that nondefaulting parties are limited to recovery of the benefit of the bargain, because CC §3287(a) did not apply to an award of prejudgment interest on the compensatory damages.

PRACTICE TIP: The *Rifkin* court apparently sought to harmonize earlier decisions by stating that *Al-Husry* did not "provide assistance," because it dealt with the sale of a business with underlying real estate and addressed CC §3287(a) without mentioning subsection (b).

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Source: Civil Litigation/California Attorney's Guide to Damages/2 Real Estate Seller/Buyer/§2.12 4. Attorney Fees

§2.12 4. Attorney Fees

Although not required, it is standard for purchase and sale contracts to include an attorney fee provision, especially if a preprinted form is used. See, *e.g.,* California Real Property Sales Transactions §§4.153, 4.178 (4th ed Cal CEB 2007).

WARNING: A party bringing an action may be barred from recovering otherwise contractually permitted attorney fees if the party refuses to participate in required mediation. *Frei v Davey* (2004) 124 CA4th 1506, 1519, 22 CR3d 429.

In *Frei,* the Freis and Daveys entered into a standard printed form residential purchase and sales agreement. A month later, the Daveys attempted to cancel the agreement. The agreement permitted the prevailing party to recover attorney fees. The agreement also obligated the parties to attempt mediation before arbitration or litigation (except for certain actions, including filing an action in order to record a lis pendens) and barred attorney fees to any party who refused to participate in mediation. The Freis filed an action for specific performance and recorded a lis pendens. Two weeks before filing the action, the attorney for the Freis wrote to the attorney for the Daveys requesting mediation. The Daveys did not agree to mediate, believing their cancellation of the agreement ended the duty to mediate. 124 CA4th at 1513.

The Daveys won the specific performance action on appeal and sought their attorney fees as the prevailing party in the trial court. They argued that the attempted settlement negotiations between the parties before the litigation was filed satisfied the mediation requirement. The appellate court held that communications between the parties or their attorneys regarding settlement are *not* the same as mediation, which involves analysis of the strengths and weaknesses of each party's case by a neutral third party. 124 CA4th at 1514. The appellate court also held that one party's belief that mediation would have been unfruitful does not excuse the failure to participate in mediation. 124 CA4th at 1515.

Attorney fees are not recoverable unless allowed by a statute or an express or implied provision in the contract. CCP §1021. If the contract contains a fee clause, it is enforceable under CC §1717. In addition, if the contract (*e.g.,* a purchase and sale agreement) provides that only one party may recover attorney fees incurred while enforcing the contract, the provision is treated as reciprocal and any prevailing party can recover the fees. CC §1717; *Reynolds Metals Co. v Alperson* (1979) 25 C3d 124, 158 CR 1.

WARNING: Section 1717 bears careful reading; it provides several "options" under which "reasonable" attorney fees may be awarded. For more information about fees under CC §1717, see California Attorney Fee Awards, chap 6 (2d ed Cal CEB 1994).

With an enforceable attorney fee provision and a clear winner on a contract cause of action, the court must award fees under CC §1717. *Hsu v Abbara* (1995) 9 C4th 863, 39 CR2d 824.

Notably, CC §1717(b)(1) gives the court the option of deciding that there is no prevailing party for the purpose of awarding attorney fees. The court usually decides on a noticed motion who is the prevailing party for awarding attorney fees. CC §1717(b)(1). Attorney fees authorized by contract are usually calculated and awarded under a noticed motion or an entry of default, unless the fees are fixed by a predetermined formula (*e.g.,* most courts have established schedules of attorney fees for actions based on contract). CC §1033.5(c)(5); Cal Rules of Ct 3.1702. The court cannot reduce contractual attorney fees solely to punish a party or for purely subjective reasons, such as its view of the merits of the case or its antipathy toward a party or litigation strategy. *EnPalm, LLC v Teitler* (2008) 162 CA4th 770, 775 n5, 75 CR3d 902.

Even a party who is found liable for damages on a cause not based on contract, but who *has* prevailed on a contract cause of action, is entitled to an offset of the net recovery of attorney fees under a CC §1717(c) recovery. When a defendant voluntarily deposits with the court the amount tendered to the plaintiff under a contract, alleges this tender in its answer, and then proves that the allegation is true, that defendant is the prevailing party for the purpose of awarding attorney fees under the contract. CC §1717(b)(2). If the action "involves" a contract or is "on a contract," attorney fees may be awarded to the prevailing party even if he or she prevails by successfully arguing the inapplicability, invalidity, unenforceability, or nonexistence of the contract. *Milman v Shukhat* (1994) 22 CA4th 538, 27 CR2d 526.

Attorney fees provided for by CC §1717 cannot be waived by the parties, and the fee provision will be construed to apply to the entire contract, unless each party was represented by counsel in the negotiations and in the execution of the contract, and the document specifically represents this fact. CC §1717(a).

At the same time, CC §1717(b)(2) specifically prohibits recovery of attorney fees when a contract cause of action is voluntarily dismissed or dismissed under a settlement. This dismissal bar, however, does not prevent the recovery of fees when a party dismisses other causes of action. For example, a defendant can recover attorney fees after a dismissal of (or successful defense against) a tort claim, as long as the contract or a statute authorizes the award. *Stantisas v Goodin* (1998) 17 C4th 599, 71 CR2d 830. For further discussion of fee awards in tort actions, see California Attorney Fee Awards, chap 6 (2d ed Cal CEB 1994).

Clauses providing for attorney fees in the listing agreement between the seller and the broker, or in the escrow instructions providing for attorney fees between the seller or buyer and the escrow holder, will not support an award of attorney fees in an action between the buyer and the seller. *Citizens Sav. & Loan Ass'n v Khoury* (1978) 84 CA3d 244, 148 CR 529.

Generally, although most purchase and sale contracts do not include the real estate agent or broker in the attorney fee clause applicable between the buyer and the seller, the contract should be examined carefully to ascertain whether the agent or broker is bound by the fee clause, even with a form contract. See *Pacific Preferred Props., Inc. v Moss* (1999) 71 CA4th 1456, 84 CR2d 500 (attorney fee provision clearly included broker); *Super 7 Motel Assocs. v Wang* (1993) 16 CA4th 541, 20 CR2d 193 (broker not a party to purchase and sale contract). See also *Moallem v Coldwell Banker Commercial Group, Inc.* (1994) 25 CA4th 1827, 31 CR2d 253; *Lerner v Ward* (1993) 13 CA4th 155, 16 CR2d 486; *Xuereb v Marcus & Millichap, Inc.* (1992) 3 CA4th 1338, 5 CR2d 154. In each of these cases, the contract provided that attorney fees would be awarded in any action "arising out of" the agreement.

In some instances, attorney fees can be awarded to a buyer or seller against a broker based on the "tort of another" theory. This theory allows attorney fees to be awarded as an element of damages to a party who was required to protect his or her interest by bringing or defending an action against a third party. *Earp v Nobmann* (1981) 122 CA3d 270, 293, 175 CR 767, disapproved on other grounds in 50 C3d at 212; *Walters v Marler* (1978) 83 CA3d 1, 147 CR 655, disapproved on other grounds in 35 C3d at 507.

An individual who represents himself or herself is *not* entitled to attorney fees under CC §1717. *Jacobson v Simmons Real Estate* (1994) 23 CA4th 1285, 28 CR2d 699, disapproved on other grounds in 11 C4th at 292. This prohibition includes attorneys who represent themselves. *Trope v Katz* (1995) 11 C4th 274, 45 CR2d 241. Corporate in-house counsel, however, may recover under §1717, when they, unlike pro se litigants, stand in an attorney-client relationship. *PLCM Group, Inc. v Drexler* (2000) 22 C4th 1084, 95 CR2d 198.

A buyer who is awarded attorney fees in a successful specific performance action for real property is not entitled to deduct the award from the purchase price, because the award would convert a judgment lien on the property seller into a super-priority lien. *Behniwal v Mix* (2007) 147 CA4th 621, 630, 54 CR3d 427 (seller would be deprived of homestead exemption if buyer was able to deduct attorney fees award from purchase price).

For a comprehensive discussion of CC §1717 and attorney fees in general, see California Attorney Fee Awards (2d ed Cal CEB 1994).

PRACTICE TIP: If investigating whether a contract provides for attorney fees, counsel should carefully review the entire contract. Many contracts condition an award of fees on a party seeking to arbitrate or mediate a dispute before proceeding to litigation. Failure to comply with this provision can be fatal to an otherwise successful litigant's right to recover attorney fees.

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§2.13 5. Punitive Damages; Emotional Distress

Prevailing on a breach of contract cause of action does not support an award of punitive damages, even if the breach was willful. *Tomaselli v Transamerica Ins. Co.* (1994) 25 CA4th 1269, 31 CR2d 433. Civil Code §3294 provides only for recovery of punitive damages for oppressive, fraudulent, or malicious conduct relating to an obligation "not arising from contract." CC §3294(a).

The facts of the real estate transaction, however, may support other causes of action, making punitive damages available if the requirements for oppressive, fraudulent, or malicious conduct are also met. Some examples are (1) fraud, (2) a promise made without intent to perform as distinguished from mere failure to perform (*Las Palmas Assocs. v Las Palmas Ctr. Assocs.* (1991) 235 CA3d 1220, 1 CR2d 301), and (3) a breach of fiduciary duty (*Godfrey v Steinpress* (1982) 128 CA3d 154, 180 CR 95 (sellers' broker failed to inform buyers of second termite report showing more damage than shown in first report)).

In rare situations, it might be possible to argue that the seller's breach constituted a tort as well as a breach of contract. The implied covenant of good faith and fair dealing, a cause of action sounding in both tort and contract, is well established in insurance situations. *Johansen v California State Auto. Ass'n Inter-Ins. Bureau* (1975) 15 C3d 9, 123 CR 288 (liability insurer's failure to settle within policy limits). Breach of the implied covenant of good faith and fair dealing, however, is not a favored cause of action when (1) no insurance contract is at issue and (2) the transaction is not otherwise marked by adhesion, public interest, or fiduciary responsibility. See *Cates Constr., Inc. v Talbot Partners* (1999) 21 C4th 28, 86 CR2d 855 (contracting party's unjustified failure or refusal to perform is breach of contract and cannot be transmuted into tort liability by claiming that breach detrimentally affected promisee's business). Yet, this same cause of action may be available on the proper facts. *R. J. Kuhl Corp. v Sullivan* (1993) 13 CA4th 1589, 17 CR2d 425 (affirming recovery of broker's commission based on seller's good faith obligation to complete purchase).

Courts have also looked unfavorably on attempts to use emotional distress as a springboard for additional recovery, particularly when the plaintiff suffers only economic damage. See, *e.g., Erlich v Menezes* (1999) 21 C4th 543, 87 CR2d 886 (denied recovery for emotional distress for breach of new home construction contract); *Soto v Royal Globe Ins. Corp.* (1986) 184 CA3d 420, 434, 229 CR 192.

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§2.14 C. Seller's Defenses

The mere existence of a purchase and sale agreement is no guaranty that a legally valid and binding contract has been formed. Consequently, the formation and provisions of the agreement must be analyzed with basic contract principles in mind. Potential defenses to the valid formation of a purchase and sale contract can include:

- Missing or uncertain material terms (see California Real Property Remedies and Damages §4.19 (2d ed Cal CEB 2002));
- Failure to comply with the statute of frauds (see Real Property Remedies §4.20);
- Failure of consideration/illusory contracts (see Real Property Remedies §4.21);
- Lack of acceptance or failed agreements to agree (see Real Property Remedies §4.22);
- Mutual mistake of fact (see Real Property Remedies, chaps 1-2);
- Fraud or undue influence (see §§2.34-2.59; Real Property Remedies, chap 3);
- Impossibility or illegality (see Real Property Remedies, chap 1).

For discussion of these issues when raised as affirmative claims, see Real Property Remedies, including the chapters on fraud (chap 3), rescission (chap 1), reformation (chap 2), and cancellation of instruments (chap 6). For an in-depth treatment of contract formation, see California Real Property Sales Transactions, chap 4 (4th ed Cal CEB 2007).

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IV. BUYER'S BREACH

§2.15 A. Purchase Agreement and Installment Land Contract Distinguished

In determining the seller's right to damages or any other relief, it is necessary to categorize or identify the type of contract that has been breached. Traditional contract remedies apply if the contract is treated as a purchase and sale agreement, which typically includes a deposit receipt. See California Real Property Sales Transactions §§6.3, 6.24-6.28 (4th ed Cal CEB 2007). If the contract is treated as an installment land contract (also called a "land sale contract"; see authorities cited in *Petersen v Hartell* (1985) 40 C3d 102, 219 CR 170), the seller's remedies are closer to those of a secured creditor. Depending on the specific provisions of the particular contract, the buyer may have the same debtor protections that apply to mortgages and deeds of trust.

Although many agreements to purchase real property clearly fall into one category or the other, those that fall into the borderline area between them can be difficult to characterize. See, *e.g., Cain v Hunter* (1958) 161 CA2d 808, 327 P2d 583. On the remedies under an installment land contract, see §2.60.

In an installment land contract, the buyer agrees to make a series of periodic payments for the property over a period of time and, typically, the seller retains title until the purchase price is fully paid. *Roemer v Pappas* (1988) 203 CA3d 201, 249 CR 743. See generally California Mortgages, Deeds of Trust, and Foreclosure Litigation §§1.59-1.66 (4th ed Cal CEB 2009). This arrangement functions like a security device, similar to a mortgage or deed of trust, and precludes any action for past-due installments. *Venable v Harmon* (1965) 233 CA2d 297, 300, 43 CR 490.

Unlike installment land contracts, purchase and sale agreements (sometimes called "marketing contracts") contemplate transfer of title to the buyer *concurrently* with payment of the purchase price through escrow. On closing, any deferred balance of the purchase price under a marketing contract is secured by a deed of trust, mortgage, or other security device. Compounding the confusion over terminology, the Civil Code calls an installment land contract a "real property sales contract" and defines it as an agreement to convey title on satisfaction of specified conditions that do "not require conveyance of title within one year from the date of formation of the contract." CC §2985(a). Note that this definition could include a purchase and sale contract that does not require closing within 1 year, even though the parties have no intention that the contract function as a security device.

NOTE: A "real property sales contract" does *not* include a contract for the purchase of an attached residential condominium unit entered into under a conditional public report issued by the Department of Real Estate under Bus & P C §11018.12. CC §2985(b).

In distinguishing between a purchase and sale agreement and an installment land contract, the courts consider the parties' intent as shown by their conduct. *Venable v Harmon, supra*. This standard requires analysis of the facts of a particular transaction to discern the purpose of the contract.

Facts to be established hinge on the following questions:

- Who had *possession* during the contract period? If possession changes from seller to buyer, leaving the seller with only title as security, the contract looks more like a security device.
- Who will pay current and recurring *expenses* of the property? The buyer's discharge of these expenses is more consistent with an installment land contract.
- How many *payments* will the buyer have to make before receiving a deed, and how regular are the payments? When several periodic payments are to be made, and if the payments are made over a long period of time (see CC §2985), the contract looks like an installment land contract.
- Will the contract be fulfilled by conveyance of a deed without further financing or payments, or will it be replaced by a note and deed of trust? A true purchase and sale agreement is replaced at close of escrow by a deed of trust or related security instrument. An installment land contract is itself the security device and endures until the buyer has paid the number of installments that entitles the buyer to conveyance of the deed. *Roemer v Pappas, supra.* See also *Venable v Harmon, supra.*

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§2.16 B. Breach of Purchase and Sale Agreement

The buyer's basic obligation under a purchase and sale agreement is ordinarily to pay the purchase price, and breach consists of failure to pay the price when due. Many purchase agreements make the buyer's performance conditional (*e.g.,* on obtaining financing) and will excuse the buyer's performance if the condition does not occur. In *WYDA Assocs. v Merner* (1996) 42 CA4th 1702, 50 CR2d 323, the court distinguished between the ability to get a loan and actually signing a loan document. Implicit in this distinction is that the loan financing contingency would be fulfilled if the buyer was able to obtain the loan within the contract time but failed to sign the loan contract with the intention of canceling the purchase.

If a condition fails through no fault of the buyer, nonperformance is not a breach, and the buyer is entitled to recover the deposit regardless of the language of the agreement. *Rodriguez v Barnett* (1959) 52 C2d 154, 338 P2d 907. The seller must stay alert to see that conditions do not fail solely because the buyer wants to back out. Thus, if performance is contingent on the buyer's obtaining financing, the seller could try to find the buyer a loan that matches the contract terms. *WYDA Assocs. v Merner, supra*; *Fry v George Elkins Co.* (1958) 162 CA2d 256, 327 P2d 905.

The seller can also claim that the buyer has waived a condition through inactivity if the buyer has the exclusive power to make a condition (such as sale of his or her own property) occur, but fails to do so. See *Consolidated World Invs. v Lido Preferred Ltd.* (1992) 9 CA4th 373, 11 CR2d 524; *Noel v Dumont Builders, Inc.* (1960) 178 CA2d 691, 3 CR 220.

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1. Seller's Remedies

§2.17 a. First Steps After Breach

When a buyer fails to perform when required, or gives irrevocable notice that he or she will not or cannot perform, the seller may sue for rescission (see California Real Property Remedies and Damages, chap 1 (2d ed Cal CEB 2002)), specific performance (see Real Property Remedies, chap 5), or damages (see §§2.25-2.31). Although not without risk, a seller who *effectively* rescinds the contract is free to sell the property to a new buyer, while sellers seeking specific performance must retain title to the property until the end of the lawsuit because they may have to convey title to the buyers.

Sellers claiming monetary damages should base their decision about resale on the real estate market, because a breach in an appreciating market evidences no price damage; only incidental consequential damages are recoverable, with interest. CC §3307. See §2.26. Resale during a market downtrend might have the same effect, because price differential is based on the price difference at the time of the breach, not at a resale; thus, the timing of the resale is crucial.

Lurking beside these decisions is the aggrieved party's obligation to take reasonable steps to mitigate damages. See *Spurgeon v Drumheller* (1985) 174 CA3d 659, 220 CR 195. Whichever remedy is selected, the sellers should elect the type of potential damages as soon as possible to prevent an inadvertent and potentially irrevocable election of remedies.

To successfully place a buyer in default, sellers must be able to demonstrate that they are able to perform. *Weneda Corp. v Dispalatro* (1964) 225 CA2d 187, 37 CR 267. Sellers must tender performance and demand strict performance (timely payment) from the buyer. See *Baird v Barton* (1958) 163 CA2d 502, 329 P2d 492. Unless the breach consists of repudiation, a tender and a demand for performance seem to be necessary, regardless of the remedy chosen. *McKinley v Lagae* (1962) 207 CA2d 284, 24 CR 454. Any unfulfilled conditions benefiting the seller must be waived.

After the buyer's failure to complete performance on time and the seller's notice that no delay will be tolerated, the buyer may still attempt to perform at a later date. Furthermore, the buyer may sue for specific performance and record a lis pendens, perhaps successfully contending that the seller was not entitled to enforce strict time limits for performance. See *Nash v Superior Court* (1978) 86 CA3d 690, 150 CR 394, overruled on other grounds in 29 C3d at 528; *Katemis v Westerlind* (1953) 120 CA2d 537, 261 P2d 553, appeal after new trial (1956) 142 CA2d 799, 299 P2d 383.

PRACTICE TIP: Unless the seller has irrevocably chosen rescission, he or she should consider accepting belated performance because the buyer's late attempt to perform may seriously diminish the seller's damages, and a lis pendens would seriously delay a resale.

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b. Disposition of Deposit

§2.18 (1) General Considerations

A seller who wants to retain the buyer's entire deposit should insist on including, in the purchase and sale agreement, a liquidated damages provision that complies with CC §§1675-1681. Depending on the amount of the deposit, the seller may be able to obtain a larger recovery by leaving the damages remedy open in the purchase and sale agreement. See California Real Property Sales Transactions §§4.141-4.143 (4th ed Cal CEB 2007). Without a liquidated damages clause, the seller may be unable to retain all, or even a part of, the deposit when the sale is not completed. See §2.20.

For property intended to be occupied by the buyer that contains four or less units, the buyer has the burden of proving that a liquidated damages clause is unreasonable, if the amount actually paid under the clause does not exceed 3 percent of the purchase price. CC §1675(c). If the liquidated damage amount does exceed 3 percent of the purchase price, the party seeking to uphold the damages clause must show that the amount is reasonable. CC §1675(d). See §2.23.

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(2) No Liquidated Damages Clause

§2.19 (a) Failure of Condition

Buyers are entitled to a return of their entire deposit if the contract cannot be performed because of a failure of a condition. Usually, the buyers' deposit is part of the consideration for performance of the purchase and sale contract, so that when a failure of a condition excuses performance, the buyer is entitled to a return of the deposit. *Rodriguez v Barnett* (1959) 52 C2d 154, 161, 338 P2d 907. But if the deposit is actually a separate consideration paid for an option to purchase, the seller may retain the deposit. See 52 C2d at 160. See also *Caplan v Schroeder* (1961) 56 C2d 515, 519, 15 CR 145 (awarded return of deposit, found not to be separate consideration, to "willfully" defaulting buyer). See also California Real Property Sales Transactions, chap 4 (4th ed Cal CEB 2007).

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§2.20 (b) Buyer's Breach

Without the benefit of a valid liquidated damages clause, the seller may retain the deposit only to the extent that actual damages were incurred according to CC §3307. A deposit, however, can serve as a fund from which the seller obtains whole or partial reimbursement for actual losses. See *Beason v Griff* (1954) 127 CA2d 382, 274 P2d 47.

The seller must refund the excess over actual damages to the buyer, regardless of whether the breach was innocent or willful. *Freedman v The Rector* (1951) 37 C2d 16, 230 P2d 629. This is true whether the buyer paid the deposit directly to the seller or into an escrow account. See *Caplan v Schroeder* (1961) 56 C2d 515, 15 CR 145. The deposit gives the seller the practical advantage of shifting the burden to the buyer to show that the seller's retention of the deposit constitutes unjust enrichment. *Baffa v Johnson* (1950) 35 C2d 36, 216 P2d 13.

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(3) Liquidated Damages

§2.21 (a) Agreements Executed Before July 1, 1978

In the past, sellers had difficulty enforcing liquidated damages clauses in real property purchase agreements because they had to establish the validity of the clause. Before CC §1671 was amended, the party seeking to enforce such a clause had to prove (1) that there was an agreement between the parties, (2) that it was impracticable or extremely difficult to fix actual damages, and (3) that there was a reasonable endeavor by the parties to agree on an amount bearing a reasonable relationship to actual damages. See, *e.g., Barbera v Sokol* (1980) 101 CA3d 725, 161 CR 843. The conclusionary recital of these elements in a contract was insufficient evidence of their validity. *United Sav. & Loan Ass'n v Reeder Dev. Corp.* (1976) 57 CA3d 282, 129 CR 113; *Cook v King Manor & Convalescent Hosp.* (1974) 40 CA3d 782, 115 CR 471.

NOTE: The parties' reasonable endeavor to agree on an amount of liquidated damages does *not* necessarily require face-to-face negotiations of the amount. See *Utility Consumers' Action Network, Inc. v AT&T Broadband* (2006) 135 CA4th 1023, 1035, 37 CR3d 827 (late fee liquidated damages provision in preprinted form contracts of cable Internet service providers held valid despite not having been individually negotiated).

For an interesting case upholding a liquidated damages clause that provided for $20,000 in damages if the buyer resold to a particular person, see *Zlotoff v Tucker* (1984) 154 CA3d 988, 201 CR 692.

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§2.22 (b) Agreements Executed on or After July 1, 1978

Effective July 1, 1978, the legislature added CC §§1675-1681, which specifically govern the validity of liquidated damage provisions in real property purchase and sale agreements, but do not apply to installment land contracts as defined in CC §2985. Sections 1675-1681 apply only to liquidated damages clauses when the *buyer* defaults on a real property purchase agreement. CC §1679. If the *seller* defaults, CC §1671, which governs general contract liquidated damages, applies. Also effective July 1, 1978, the legislature amended §1671. (For an overview of the amendment to §1671, see *Ridgeley v Topa Thrift & Loan Ass'n* (1998) 17 C4th 970, 73 CR2d 378.)

Whether the purchase agreement is for residential or nonresidential property, the liquidated damages clause must be separately signed or initialed by each party, and if the clause is in a printed agreement it must be set out in 10-point bold type or contrasting red 8-point bold type. CC §1677. An uninitialed liquidated damages clause is a valid limitation on the *buyer's* liability if the buyer defaults. Failure to comply with §1677 makes the clause voidable at the option of the buyer *only,* because the legislature intended the initialing requirement to protect the buyer, not the seller. See CC §1679.

Civil Code §§1675-1681 do not affect any party's right to obtain specific performance of a purchase and sale agreement. CC §1680.

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§2.23 (i) Residential Real Property

In addition to the formal requirements of CC §1677 (see §2.22), CC §1675 provides additional protections for a buyer under a purchase agreement for residential property, which is defined to include dwellings of no more than four residential units, at least one of which the buyer intends, when the agreement is executed, to occupy as his or her residence. CC §1675(a). To be valid, the liquidated damages clause must meet the following tests: (1) the payment to be kept by the seller as liquidated damages must actually have been made in cash or by check (including postdated check), and (2) the amount paid must not exceed 3 percent of the purchase price unless the seller can establish that the amount was reasonable as liquidated damages. CC §1675(b)-(d).

To recover a deposit that exceeds 3 percent, the burden is on the seller to prove that the amount was reasonable; if the seller fails to do so, the entire clause is invalid, and the seller cannot keep as liquidated damages even that part of the payment that does not exceed 3 percent. CC §1675(d); *Timney v Lin* (2003) 106 CA4th 1121, 1126, 131 CR2d 387 (court will not enforce illegal forfeiture provision in settlement agreement). If the deposit is less than 3 percent, the buyer can still invalidate the clause by showing that the amount was unreasonable (CC §1675(c)), but in this situation the burden is on the buyer.

The reasonableness of the amount actually paid as liquidated damages is to be determined by the circumstances at the time the agreement was executed and the price and other terms and circumstances of any subsequent sale or sale agreement that is made within 6 months after the buyer defaults. CC §1675(e).

When the agreement calls for the buyer to make more than one payment that will constitute liquidated damages, the seller may validly retain any amount beyond the first payment as liquidated damages if the total of all such payments meets the 3-percent requirement of CC §1675 and a separate liquidated damages provision meeting the requirements of CC §1677 is separately signed or initialed by each party for each subsequent payment. CC §1678.

For provisions relating to newly constructed attached condominium units, see CC §1675(f)-(g).

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§2.24 (ii) Nonresidential Real Property

In addition to the formal requirements of CC §1677 (see §2.22), CC §1676 provides that, in agreements for the purchase and sale of real property other than residential property, liquidated damages clauses are governed by CC §1671(b). *Guthman v Moss* (1984) 150 CA3d 501, 198 CR 54. If the liquidated damages clause meets the formal requirements of CC §1677, it is valid unless the party seeking to invalidate it establishes that it was unreasonable under the circumstances at the time the agreement was made. The amount of damages actually incurred by the party seeking to enforce the liquidated damages clause is irrelevant. *Guthman v Moss, supra*.

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c. Seller's Damages

§2.25 (1) General Damages Under CC §3307

Damages recoverable by the seller for the buyer's breach of a real property purchase agreement are governed by CC §3307, which allows the seller to recover "the excess, if any, of the amount that would have been due to the seller under the contract over the value of the property to him or her, consequential damages according to proof, and interest." Considerations of good or bad faith are irrelevant. The seller's main measure of damages is essentially the difference between the contract price and the property's value at the time of breach. See CC §3307.

Whether the default is willful or innocent *may* still have some significance, however, under CC §3275 (relief from forfeitures) and CC §3369 (penalties and forfeitures). For example, *Petersen v Hartell* (1985) 40 C3d 102, 219 CR 170, held that there is an absolute right to redeem with an installment land contract, *regardless* of the fact that the purchaser had willfully defaulted on the payments.

PRACTICE TIP: The seller's primary problem is to prove that the property's value decreased significantly from the contract date to the date of the breach. Under CC §3307, if the property's value either increases or remains constant, damages are not recoverable—other than recovery for consequential damages and interest. See §2.26.

The seller has a duty to mitigate damages. As a matter of law, sellers did not fulfill their duty to mitigate damages when the property increased in value by the time of trial to a value exceeding the contract price plus sellers' actual expenses, and the sellers' decision to take the property off the market was solely in the sellers' control of and for the sellers' benefit and for reasons unrelated to the marketability of the property. *Spurgeon v Drumheller* (1985) 174 CA3d 659, 665, 220 CR 195.

Sellers may recover damages from defaulting buyers who breach purchase agreements in partition matters under CCP §873.760 (former CCP §785), which includes recovery of the loss caused by the resale. See *Kerrigan v Maloof* (1950) 98 CA2d 605, 221 P2d 153 (directions to court on remand).

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§2.26 (2) Effect of Market

During a period of rising property values, when a seller seeks damages from a defaulting buyer, if the property has increased in value before trial and the seller resells the property at a price equal to or higher than the value of the contract, there are no longer any loss-of-bargain damages. Nor are any loss-of-bargain damages available to the seller when the value at the time of trial equals or exceeds the value of the contract and the seller has chosen not to mitigate damages by reselling the property. See CC §3307; *Spurgeon v Drumheller* (1985) 174 CA3d 659, 220 CR 195.

In a declining market, the longer the time between execution of the contract and breach, the greater will be the buyer's liability. See *Bouchard v Orange* (1960) 177 CA2d 521, 2 CR 388. Once the breach occurs, however, the buyer's liability is fixed by the market value as of that date and cannot be increased. Thus, if it takes the seller a considerable time to resell, and the resale is at a substantial loss because of the continued downward trend of prices, the seller cannot recover any increment of this downward trend beyond the date of the breach. *Royer v Carter* (1951) 37 C2d 544, 233 P2d 539.

If the market is stable, the market value on the date of breach will probably be the same as the contract price, and the seller will be unable to recover loss-of-benefit damages (see *Fleischer v Cosgrove* (1956) 145 CA2d 14, 301 P2d 911), although consequential damages and interest would still be available under CC §3307.

Practically, in a rising market, if it is clear that the buyers do not want the property, the seller's best course of action is to simply remarket the property and proceed with an advantageous resale. Consequential damages to the seller are often minimal, and the expenditures are such that they would have been incurred in the second transaction as well. *Royer v Carter, supra.*

PRACTICE TIP: If personal negotiation is not successful, the choice of a resolution forum is influenced by the out-of-pocket expenses incurred, the amount of the deposit, and the existence of a liquidated damages clause.

Mediation is both highly effective and widely used to resolve real estate disputes. Almost all form purchase and sale contracts have a clause requiring mediation before litigation, excluding small claims court. Mediation costs are minimal compared to the anger, hard-feeling, and heightened emotions that can result when the seller and the buyer cannot expeditiously resolve their failed transaction.

Small claims court is an effective forum for speedy resolution of claims with a low monetary value. Although the parties are not allowed to have attorneys appear on their behalf, they should take the time to seek counsel before the hearing for assistance to ensure clarity and organization at their court presentation.

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§2.27 (3) Discounting Price to Cash Equivalent

In assessing damages under CC §3307, the value of the property should be estimated on a cash basis. The contract price in a credit sale must be discounted to reflect its cash equivalent. Thus, when the seller takes back a note and deed of trust, the contract price is discounted on the basis of various factors such as the value of the real property securing the note, the amount of senior encumbrances, the provisions of the note, the risk of economic changes during the term of the note, the risk and expense of foreclosure, and the risk of changing interest rates. This discounting in a credit sale could eliminate any excess of the purchase price over the value of the property to the seller at the date of breach. *Abrams v Motter* (1970) 3 CA3d 828, 83 CR 855.

PRACTICE TIP: The discount rate, the factors to consider, and the method of calculation are generally proved by expert witness testimony. Most counsel engage a real estate appraiser or an economist experienced in real estate valuation for this purpose. Counsel should make sure that the expert's experience is in valuating the same type of real property as that at issue (*e.g.,* residential, restaurant, golf course, unimproved rural acreage).

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§2.28 (4) Proof of Damages

Although they are usually not experts, sellers may testify about their opinion of the property's market value if they still own the property. Evid C §813; *Fleischer v Cosgrove* (1956) 145 CA2d 14, 301 P2d 911. If not an owner, either party might also qualify to testify when the former seller or the inchoate buyer is a party in an action "to determine the ownership of the property between the parties if the court determines that it would not be in the interest of efficient administration of justice to determine the issue of ownership" before admitting into evidence the opinion of the party. Evid C §813(c)(2). Conspicuously absent from §813(c)(2) is any mention of a "prior owner." A prior owner or prospective purchaser may also qualify under the general nonexpert definition as one whose opinions are rationally based on the perception of the witness and are helpful to a clear understanding of his or her testimony. See Evid C §800. See also *Marriage of Stoll* (1998) 63 CA4th 837, 74 CR2d 506.

The seller should do more than just guess at the property's value; otherwise, no finding can be based on this testimony. *Newhart v Pierce* (1967) 254 CA2d 783, 62 CR 553. Expert testimony should be elicited from either a broker or an appraiser. *Newhart v Pierce, supra.*

Opinions of value at the date of breach may be based on subsequent events. The resale price is relevant evidence, but adjustments must be made for subsequent changes in market conditions (*Royer v Carter* (1951) 37 C2d 544, 233 P2d 539; *Bouchard v Orange* (1960) 177 CA2d 521, 2 CR 388) and for subsequent improvements added by the seller (*Mathews v MacArthur* (1953) 119 CA2d 196, 258 P2d 1068). The trial court may ignore the resale price if it is an inappropriate indicator of value under the circumstances. *Fleischer v Cosgrove, supra*; *Major-Blakeney Corp. v Jenkins* (1953) 121 CA2d 325, 263 P2d 655. If no resale has occurred, the seller may testify about the highest offer received in order to corroborate his or her opinion of value. *Bouchard v Orange, supra*.

PRACTICE TIP: The seller always faces the problem of explaining the difference between price sought or paid and the market value being claimed, especially if the breach occurred soon after execution of the contract, when there was little appreciable change in the market. On the correct facts, one possible way to address this is through experts who can testify about the chilling effects of a buyer's breach on the resale market after property has had its initial exposure. *Abrams v Motter* (1970) 3 CA3d 828, 83 CR 855; *Bouchard v Orange, supra*. As a practical matter, though, when the market is active, it is hard to argue a chilling effect, especially if the property sold fairly quickly the first time.

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(5) Special Damages

§2.29 (a) Resale Expenses

In addition to general damages under CC §3307 (see §2.25), the seller may recover expenses incurred in reselling the property after the original sale fails. *Royer v Carter* (1951) 37 C2d 544, 233 P2d 539. When the property's market value increases or remains constant (see §2.26), resale expenses may be the only damages the seller can recover. *Allen v Enomoto* (1964) 228 CA2d 798, 39 CR 815. If no second sale occurs, a court might conclude that the wasted expenses are roughly equivalent to the expenses of a hypothetical second sale and award that amount to the seller as damages. See *Royer v Carter, supra*.

In one case, the property sold at less than market value because of a lis pendens against the property, which the defaulting buyer agreed to clear. Although the sellers later resold the property at a higher price, they were permitted to recover additional attorney fees incurred because of the lis pendens, property taxes paid after the date of breach, and interest on amounts due but not paid by the buyers. *Yackey v Pacifica Dev. Co.* (1979) 99 CA3d 776, 160 CR 430.

The effect of rising property values on the calculation of damages was considered in *Askari v R & R Land Co.* (1986) 179 CA3d 1101, 225 CR 285, when an escrow failed because the parties refused to execute matching escrow instructions. The appellate court remanded and, citing *Yackey,* emphasized that the damages should put the seller in the same position as if the buyer completed the transaction. The trial court was directed to make findings concerning the seller's expenses from the date of the breach to the date of the judgment, including lost interest and operating costs. Further, the appellate court agreed that, if the property's value had appreciated between the breach and the trial, the buyer was entitled to offset that appreciation against the seller's consequential damages.

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Source: Civil Litigation/California Attorney's Guide to Damages/2 Real Estate Seller/Buyer/§2.30 (b) Broker's Commission

§2.30 (b) Broker's Commission

The seller may incur out-of-pocket expenses for a broker's commission on both the failed sale and a subsequent sale held to mitigate damages. In most residential purchase and sales, the seller is responsible for paying the broker's commission. See *Chan v Tsang* (1991) 1 CA4th 1578, 1583, 3 CR2d 14. If the seller is liable to the broker for a commission without completing the sale, the seller might be able to recover that expense from a defaulting buyer. *Caplan v Schroeder* (1961) 56 C2d 515, 15 CR 145. Occasionally, the broker may recover directly from the defaulting buyer. *Chan v Tsang, supra*. A broker acting as a principal in a transaction is not entitled to recover a broker's commission. *Horning v Shilberg* (2005) 130 CA4th 197, 204, 29 CR3d 717.

The statute of frauds requires a written contract for any agreement authorizing or employing an agent, a broker, or anyone else to purchase or sell real estate. CC §1624(a)(4). Without such a writing, a licensed broker cannot recover a commission, even on a theory of promissory estoppel or quantum meruit. *Phillippe v Shapell Indus., Inc.* (1987) 43 C3d 1247, 241 CR 22.

PRACTICE TIP: Counsel might review the listing agreement, the purchase and sale contract, and any addendums to determine the seller's potential liability when the buyer cannot or does not complete the sale. A validly executed liquidated damages clause can provide the measure of recovery by the realtor. Also, a separate agreement between the buyer and any broker or agent might exist. See, *e.g., Chan v Tsang, supra*. These documents will also show whether the broker's commission is payable on execution of the contract, close of escrow, the recordation of the deed, or some other event.

Because the broker's rights typically depend on the language in the listing agreement or in the purchase and sale agreement, if the commission is earned when the broker produces a ready, willing, and able buyer, the seller could be liable for two commissions—one on the failed sale to the defaulting first buyer and one on the resale. For a case considering the risk that a seller might owe two commissions, see *Metzenbaum v R.O.S. Assocs.* (1986) 188 CA3d 202, 232 CR 741 (in dictum indicated that client could be liable to mortgage broker after violating exclusive loan brokerage agreement if broker proves he procured loan acceptable to client during period of exclusivity). A prudent seller can avoid this problem by conditioning the commission on consummation of the transaction. See California Real Property Sales Transactions §§2.110-2.113, 2.119 (4th ed Cal CEB 2007).

Brokers have been allowed to collect their commission from sellers or buyers who have allowed the transaction involving the broker to fail in order to negotiate a subsequent deal eliminating the broker's commission. *Schaffter v Creative Capital Leasing Group, LLC* (2008) 166 CA4th 745, 83 CR3d 19 (buyer cancelled multiple purchases because it anticipated insufficient profit on transactions); *Torelli v J. P. Enters., Inc.* (1997) 52 CA4th 1250, 61 CR2d 76 (seller breached implied covenant of good faith by allowing signed counteroffer to expire, only to enter into subsequent contract with same buyer); *R. J. Kuhl Corp. v Sullivan* (1993) 13 CA4th 1589, 17 CR2d 425 (client traded his position as buyer for option on half of property and right to indemnification for half of broker's commission); *Buckaloo v Johnson* (1975) 14 C3d 815, 122 CR 745, disapproved on other grounds in 11 C4th at 393. A seller who is required to pay a broker's commission because of the buyer's breach can recover that payment and is entitled to keep the benefit of any savings made by reselling without a broker's assistance. *Caplan v Schroeder, supra*.

If the property is not resold, the seller is entitled to a broker's commission based on a hypothetical resale at the market price at the time of breach, but from this must be subtracted anything the seller saved by paying less than the full commission on the original sale. *Royer v Carter* (1951) 37 C2d 544, 233 P2d 539. This result was confirmed in *Barton v White Oak Realty, Inc.* (1969) 271 CA2d 579, 76 CR 587.

If the buyer and the seller have initialed the liquidated damages provision in the sale agreement, the broker may be entitled to a specified amount under that provision. These provisions generally allow recovery to the broker for half of what the seller recovers from a defaulting buyer, and a full commission from the seller if the seller defaults. However, such a liquidated damages clause does not prohibit the broker from seeking independent recovery from the buyer directly, as long as the broker had a preexisting relationship with the buyer and was retained by the buyer. *Chan v*

Tsang (1991) 1 CA4th 1578, 1583, 3 CR2d 14.

On the broker's right to a portion of the deposit on the buyer's default, see California Real Property Sales Transactions §2.119 (4th ed Cal CEB 2007).

On actions against the broker for breach of fiduciary duty or constructive fraud, see California Real Property Remedies and Damages §§3.21-3.28 (2d ed Cal CEB 2002).

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§2.31 (c) Other Expenses

Courts have permitted sellers to recover some other categories of expenses. For example, in *Yackey v Pacifica Dev. Co.* (1979) 99 CA3d 776, 160 CR 430, a lis pendens created additional damages by preventing resale. In *McKinley v Lagae* (1962) 207 CA2d 284, 24 CR 454, the seller who evicted a tenant because of the sale agreement was entitled after the breach to recover the lost rental value until the resale date. Other courts have permitted recovery of various operating expenses after the breach, such as (1) penalty interest paid on a note on a new residence (*Angell v Rowlands* (1978) 85 CA3d 536, 149 CR 574); (2) the cost of the commute between the old and new residences (*Jensen v Dalton* (1970) 9 CA3d 654, 88 CR 426); and (3) fire insurance, mortgage payments, and property taxes (*Allen v Enomoto* (1964) 228 CA2d 798, 39 CR 815).

In light of the obligation to mitigate damages, it is not surprising that recovery is allowed only for operating expenses when the seller resells with reasonable diligence (*Sutter v Madrin* (1969) 269 CA2d 161, 74 CR 627) and only in connection with a resale—not continued use of the property (*Abrams v Motter* (1970) 3 CA3d 828, 83 CR 855).

One appellate court reversed an award for taxes when the parties failed to consider adverse tax consequences when forming or even modifying the contract, and the buyer's default was not in fact the cause of the seller's tax liability. *Nielsen v Farrington* (1990) 223 CA3d 1582, 273 CR 312. The *Nielsen* court cited *Walker v Signal Cos.* (1978) 84 CA3d 982, 993, 149 CR 119, for the rule that special damages are generally not recoverable without special circumstances that were known or should have been known to the defaulting party at the time the contract was entered into.

EXAMPLE: A buyer, a seller, or both can be involved in a 26 USC §1031 tax-deferred exchange, commonly called a "1031 exchange," which is both property and time specific. Failure to meet the requirements for this complex and detailed transfer will result in the loss of the tax-deferral benefits. The purchase and sale contract should specifically recite that the sale is intended to be a §1031 exchange and that the other party will cooperate with the exchange and should reiterate that "time is of the essence," to alert the other party to the importance of timely performance of the transaction in all respects, and to protect the potential right to recover lost tax benefits in the event of a default.

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2. Buyer's Defenses and Offsets

§2.32 a. Antideficiency Bar

When a seller of real property finances the sale by carrying back a note and deed of trust secured by the property, the buyer who defaults on payment may raise the antideficiency bar of CCP §580b, which limits the seller's recovery solely to the property. See California Mortgages, Deeds of Trust, and Foreclosure Litigation, chap 5 (4th ed Cal CEB 2009). The form of the transaction is crucial to a buyer's ability to use the antideficiency bar as a defense, because it is also available to a buyer who defaults on an installment land contract. See §2.60.

A buyer's waiver of the antideficiency protection is not possible in ordinary purchase money secured land transactions. *DeBerard Props. v Lim* (1999) 20 C4th 659, 85 CR2d 292. See also *Thompson v Allert* (1991) 233 CA3d 1462, 285 CR 367; *Palm v Schilling* (1988) 199 CA3d 63, 244 CR 600. There are limited (*i.e.,* nonstandard) transactions in which the courts will imply a waiver, such as when the seller subordinates its secured interest in the property to another interest, like a construction loan deed of trust. See *DeBerard Props. v Lim, supra*; *Lawlor v Jacobs* (2000) 83 CA4th 723, 100 CR2d 52. See also Mortgage Deed of Trust Foreclosure §§5.64-5.70.

NOTE: The economic policy considerations underlying the protections of CCP §580b do not bar a seller from recovering sums omitted from the original payoff demand statement sent to and paid by the buyers. *Ghirardo v Antonioli* (1996) 14 C4th 39, 57 CR2d 687.

A creative attempt to circumvent antideficiency protections was raised in *Birman v Loeb* (1998) 64 CA4th 502, 75 CR2d 294. In *Birman,* the buyers successfully sued the sellers for fraud, negligent misrepresentation, and nondisclosure, recovering both a large money judgment and attorney fees. The sellers, holding an unpaid purchase money secured loan, then reacquired the property in a nonjudicial foreclosure sale, leaving $2 million outstanding in unsecured debt. When the sellers sought to have this debt set off against the attorney fee award in the litigation, the court refused to allow the setoff because it violated the policies underlying §580b.

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§2.33 b. Other Defenses and Offsets

The buyer has a strong argument that a liquidated damages clause in the purchase agreement, or other writing that is signed by the buyer, limits the seller to recovery of the buyer's deposit. *Fleischer v Cosgrove* (1956) 145 CA2d 14, 301 P2d 911. If any essential element is absent, the liquidated damage clause may be invalid. However, the provisions will be interpreted liberally in favor of the buyer, especially a residential buyer. See §2.23.

The statute of limitations in a seller's suit for damages is generally 4 years under CCP §337(1), but this affirmative defense is waived if it is not timely asserted. *Minton v Cavaney* (1961) 56 C2d 576, 15 CR 641. Defenses that vitiate the contract altogether (*e.g.,* statute of frauds, uncertainty, nonacceptance) are available to the buyer, just as they are to the seller. See §2.14.

The buyer may reduce the seller's damages (either as a defense to the seller's damage action or with an action brought to recover the deposit) by showing unjust enrichment to the seller, *i.e.,* that the amounts received or claimed by the seller exceed actual damages. Although this defense is available even if the buyer's breach is willful (*Freedman v The Rector* (1951) 37 C2d 16, 230 P2d 629), the buyer has the burden of proof on this issue (*Baffa v Johnson* (1950) 35 C2d 36, 216 P2d 13).

Decisional law is split on whether a defaulting buyer may offset damages awarded to the seller by the amount of the increased price obtained by the seller in a subsequent, rapid resale. Compare *Smith v Mady* (1983) 146 CA3d 129, 194 CR 42 (offset not permitted), with *Askari v R & R Land Co.* (1986) 179 CA3d 1101, 225 CR 285 (allowed increased value between breach and sale to offset sellers' consequential damages).

Improvements made by the buyer should be offset against any award made to the seller. See *Behrendt v Abraham* (1966) 64 C2d 182, 49 CR 292.

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§2.34 V. ELEMENTS OF FRAUD

The elements of fraud, which give rise to the tort action for deceit, are the following (*Robinson Helicopter Co. v Dana Corp.* (2004) 34 C4th 979, 22 CR3d 352; *Lazar v Superior Court* (1996) 12 C4th 631, 638, 49 CR2d 377; *City of Atascadero v Merrill Lynch, Pierce, Fenner & Smith, Inc.* (1998) 68 CA4th 445, 481, 80 CR2d 329):

- Misrepresentation (*e.g.,* false representation, concealment, or nondisclosure) (see California Real Property Remedies and Damages §§3.11-3.20 (2d ed Cal CEB 2002));
- Knowledge of falsity (or "scienter") (see Real Property Remedies §§3.11-3.20);
- Intent to defraud, *i.e.,* to induce reliance (see Real Property Remedies §3.37);
- Justifiable reliance (see Real Property Remedies §§3.38-3.39); and
- Resulting damage (see Real Property Remedies §3.44).

To establish liability for fraud it is not essential that the person charged have received any advantage from the fraud. 68 CA4th at 482.

The burden of proving fraud is by a preponderance of the evidence. *Liodas v Sahadi* (1977) 19 C3d 278, 137 CR 635. If the plaintiff seeks punitive damages for the defendant's conduct that was malicious, fraudulent, or oppressive, the burden of proof must be made by clear and convincing evidence. CC §3294(a).

In many instances, the facts establishing fraud qualify as two or more types of fraud. For example, if a party affirmatively represents that fact A is true, but it is not, and conceals fact B, which may be either the opposite of fact A or a fact that is different from fact A, the seller is guilty of misrepresentation and concealment. Thus, if a seller represents that Blackacre was once contaminated but that the contamination was removed, and knows instead that the contamination was either not removed or not completely removed, the representation is a misrepresentation and the withheld information—the "opposite" of the misrepresentation—is a concealment.

PRACTICE TIP: Because of the requirements of pleading and proving specific facts in fraud cases, it is prudent to either (1) allege each instance of fraud involved in a real property dispute as a separate cause of action or (2) group all affirmative misrepresentations in one cause of action, all concealed facts in a second cause of action, and all false promises in a third cause of action. See California Civil Procedure Before Trial §§22.56, 25.46 (4th ed Cal CEB 2004).

The facts may support a case for constructive fraud (see CC §1573), which most often involves a real estate broker's or sales agent's breach of a confidential or fiduciary duty. See California Real Property Remedies and Damages §§3.21-3.28 (2d ed Cal CEB 2002). The elements of such a cause of action are the existence of a fiduciary relationship, its breach, and damages caused by that breach. *Warren v Merrill* (2006) 143 CA4th 96, 109, 49 CR3d 122 (real estate broker committed constructive fraud when she deliberately and falsely promised to place plaintiff's name on title to condominium if he agreed to initially place broker's daughter's name on title); *Roberts v Lomanto* (2003) 112 CA4th 1553, 5 CR3d 866 (real estate broker who violated Bus & P C §1017(g) duty to disclose to seller her anticipated profit from the agency relationship also violated her fiduciary duty; broker forced to disgorge her secret profit). On actions against real estate brokers and sales agents, see Approaching an Action Against a Real Estate Broker (Cal CEB Action Guide August 2006); California Real Property Sales Transactions, chap 2 (4th ed Cal CEB 2007).

For a comprehensive discussion of fraud, including misrepresentation, concealment, and nondisclosure, in the real estate context, see California Real Property Remedies and Damages, chap 3 (2d ed Cal CEB 2002).

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A. Damages When Buyer Is Victim

§2.35 1. Three Rules

Unfortunately, the names given to the two primary measures of damages in fraud-based cases are, in a sense, themselves misleading. The prevailing rule today is known as the "out-of-pocket" measure of damages, and another rule is known as the "benefit-of-the-bargain" measure of damages (see §2.36). *Bagdasarian v Gragnon* (1948) 31 C2d 744, 759, 192 P2d 935. The labels for these rules and the rules themselves suggest a wide range of applications. In some cases, the outcome from the measure for breach of contract damages and for fraud damages is the same. *Glendale Fed. Sav. & Loan Ass'n v Marina View Heights Dev. Co.* (1977) 66 CA3d 101, 141, 135 CR 802.

Until 1935, California followed the benefit-of-the-bargain rule. *Jacobs v Levin* (1943) 58 CA2d Supp 913, 915, 137 P2d 500. It was viewed as the "extreme rule" and was only to be applied in clear cases and on just terms. In 1935, however, the legislature changed the landscape by enacting CC §3343, which adopted the out-of-pocket measure of damages followed in England and by the federal courts. 58 CA2d Supp at 916. The rationale underlying the formula was repeated by the *Jacobs* court, citing a prior federal case as follows: "A person is not cheated when that which he gets is worth all that he pays for it, which is also common sense." 58 CA2d Supp at 916. (Note that the benefit-of-the-bargain rule applies in personal property cases because of the effect of Com C §2721. *Continental Airlines, Inc. v McDonnell Douglas Corp.* (1989) 216 CA3d 388, 430, 264 CR 779.)

Finally, a third rule, CC §1709, provides that a defendant who willfully deceives the plaintiff, with an intent to induce the plaintiff to alter his or her position to his or her injury or risk, is liable for any damages the plaintiff suffers. Although §1709 looks like a measure of damages statute, in real property fraud cases not involving fiduciary or confidential relations, CC §3343 generally applies. See authorities discussed in *Overgaard v Johnson* (1977) 68 CA3d 821, 137 CR 412.

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Source: Civil Litigation/California Attorney's Guide to Damages/2 Real Estate Seller/Buyer/§2.36 2. Measure of Damages Compared

§2.36 2. Measure of Damages Compared

Civil Code §3343 applies to real property fraud claims that do not concern the fraud of a fiduciary or its agent. *Stout v Turney* (1978) 22 C3d 718, 725, 150 CR 637; *Bagdasarian v Gragnon* (1948) 31 C2d 744, 759, 192 P2d 935. It also applies to actions for breach of statutory disclosure duties under CC §§1102-1102.17. *Saunders v Taylor* (1996) 42 CA4th 1538, 50 CR2d 395. The basic measure of damages, referred to as an "out-of-pocket" standard, is described in CC §3343(a) as follows: One defrauded in the purchase, sale, or exchange of property is entitled to recover the difference between the actual value of that with which the defrauded person parted and the actual value of that which was received.

EXAMPLE: If the value of the property at the time of the transaction was $100,000 because of the effect of the fraud on its value, but the buyer paid $125,000, the buyer's damages are $25,000 because the buyer paid that much more than the property's value. *Cory v Villa Props.* (1986) 180 CA3d 592, 600, 225 CR 628. If the value of property (measured on the sale date) was greater than or equal to the price paid by the buyer, the buyer suffered no general damages under CC §3343(a), although there may be other damages the buyer may recover. See 180 CA3d at 601.

The plaintiff may recover damages even if the property is foreclosed on. *Ford v Cournale* (1973) 36 CA3d 172, 183, 111 CR 334; *Burkhouse v Phillips* (1971) 18 CA3d 661, 665, 96 CR 197. In that event, the plaintiff is entitled to recover its downpayment and the installment payments made before the foreclosure. *Burkhouse v Phillips*, *supra*. The property's actual value should not be reduced by a collateral source receipt, such as raising the rent to cover the cost of repairing the misrepresented condition. *Philip Chang & Sons Assocs. v La Casa Novato* (1986) 177 CA3d 159, 165, 222 CR 800.

NOTE: The supreme court held that CC §3343 does not require the plaintiff to show "out-of-pocket" loss to recover consequential or additional damages. See *Alliance Mortgage Co. v Rothwell* (1995) 10 C4th 1226, 1241 n5, 44 CR2d 352; §2.40.

In contrast, under the benefit-of-the-bargain measure of damages, a plaintiff is entitled to recover the difference between the actual value of what the defrauded plaintiff received and the value that it would have received if the property had been as represented. *Bagdasarian v Gragnon* (1948) 31 C2d 744, 760, 192 P2d 935. The words "as represented" are problematic.

EXAMPLE: If the actual value of the property was $100 and its value as represented was $4000, the plaintiff's damages would be $3900, regardless of the selling price. To that measure, a plaintiff may likewise show and recover the depreciation in the value of the improvements that the plaintiff may have placed on the property—a depreciation resulting from the fact that the actual value was not the represented value. The plaintiff may also recover for any other legitimate expenditures. *Hines v Brode* (1914) 168 C 507, 510, 143 P 729. This approach to measuring damages enabled plaintiffs in *Hines* to prove fraud claims through expert testimony and essentially recover the benefit of the bargain.

Despite the passage of CC §3343 (see §2.36), the California Supreme Court held that, when the party guilty of a misrepresentation provides a service, such as a property soils test for the buyer (ancillary to a purchase), the measure of damages, whether for deceit or negligence, must be measured under CC §§1709 and 3333 by the actual losses resulting from the misrepresentation. *Gagne v Bertran* (1954) 43 C2d 481, 490, 275 P2d 15 (despite statutory language, construed §§1709 and 3333 as out-of-pocket standard similar to §3343 and allowed additional consequential damages if proved on remand). The supreme court later suggested in dictum that §§1709 and 3333 read together are the equivalent of benefit-of-the-bargain damages when applied in fiduciary fraud actions. *Alliance Mortgage Co. v Rothwell* (1995) 10 C4th 1226, 1241, 1250, 44 CR2d 352. See §2.40.

Real property transactions often involve equipment that may not constitute fixtures. With respect to items that are properly classified as personal property rather than as fixtures, a different measure of damages may apply. It is

appropriate to make a deduction for some kinds of personal property. See Com C §2721; *Unger v Campau* (1956) 142 CA2d 722, 728, 298 P2d 891.

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3. Actual Value Means Market Value

§2.37 a. Proving Market Value

Actual value, as used in CC §3343, generally means the market value of the property. *Bagdasarian v Gragnon* (1948) 31 C2d 744, 752, 192 P2d 935; *Glendale Fed. Sav. & Loan Ass'n v Marina View Heights Dev. Co.* (1977) 66 CA3d 101, 141, 135 CR 802. The market value is usually calculated as of the date of sale, and, if the appraisal is made later, an adjustment should be made for repairs and improvements subsequently made by the buyer. *Graf v Sumpter* (1962) 207 CA2d 391, 393, 24 CR 590; *Unger v Campau* (1956) 142 CA2d 722, 727, 298 P2d 891. But see *Housley v City of Poway* (1993) 20 CA4th 801, 812, 24 CR2d 554. The *measurement* of damages and the *methods* used to arrive at the measurement are related but distinct matters. As a rule, §3343 prescribes the measure of damages while the Evidence Code and related case law prescribe the methods to use in arriving at that measurement.

The actual value that the defrauded party received and parted with is determined as of the date the fraud occurred, which is usually the date of sale. *McCue v Bruce Enters., Inc.* (1964) 228 CA2d 21, 39 CR 125. Under this rule, a defrauded party may not be entitled to any recovery if the property was worth the price paid at the time of sale. In one case, buyers of property alleged that they were defrauded when the sellers misrepresented the property's acreage. However, because the value of the property exceeded the purchase price, the trial court granted summary judgment in the sellers' favor. The appellate court reversed, holding that, even though there was no out-of-pocket loss, §3343 allows the buyers to prove "additional damages." It therefore remanded the case for a trial on that issue. *Cory v Villa Props.* (1986) 180 CA3d 592, 225 CR 628.

Despite the rule that damages are to be calculated as of the date of the fraud, the statute contains nothing to show that the difference must be calculated solely on the basis of facts existing at the time the contract was made or performed. *Garrett v Perry* (1959) 53 C2d 178, 184, 346 P2d 758. Thus, subsequent circumstances, like payments on notes to the seller and foreclosure, have evidentiary value toward determining actual value. *Garrett v Perry, supra*.

A plaintiff's recovery is not reduced if the defrauded buyer later resells the property at a profit. *Burkett v J. A. Thompson & Son* (1957) 150 CA2d 523, 310 P2d 56.

The cost of repairs caused by misrepresentations about the condition of the property is not an element of recoverable damages but may be introduced to show the actual value of the property. *Glendale Fed. Sav. & Loan Ass'n v Marina View Heights Dev. Co.* (1977) 66 CA3d 101, 148, 135 CR 802; *McNeill v Bredberg* (1961) 192 CA2d 458, 469, 13 CR 580; *Central Mut. Ins. Co. v Schmidt* (1957) 152 CA2d 671, 313 P2d 132. If evidence is introduced on the cost of repairs, the court's failure to give a jury instruction on the limits of fraud damages under CC §3343 is prejudicial error. *Housley v City of Poway* (1993) 20 CA4th 801, 812, 24 CR2d 554.

Some courts have permitted defrauded buyers to recover the entire purchase price paid, despite the out-of-pocket measure, because the misrepresented or undisclosed conditions effectively denied the buyers use of the property. *Garrett v Perry* (1959) 53 C2d 178, 184, 346 P2d 758 (foreclosure as result of misrepresented rental income from property); *Buist v C. Dudley DeVelbiss Corp.* (1960) 182 CA2d 325, 6 CR 259 (property had no value because of landslide problem).

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Source: Civil Litigation/California Attorney's Guide to Damages/2 Real Estate Seller/Buyer/§2.38 b. Use of Opinion Testimony

§2.38 b. Use of Opinion Testimony

The market value of real property is normally established by the testimony of either the owner of the property or an expert witness. Evid C §813; *Southern Pac. Transp. Co. v Santa Fe Pac. Pipelines, Inc.* (1999) 74 CA4th 1232, 1246, 88 CR2d 777 (easement valuation); *Buist v C. Dudley DeVelbiss Corp.* (1960) 182 CA2d 325, 334, 6 CR 259) (appraisers); *Brady v Carman* (1960) 179 CA2d 63, 3 CR 612 (same). In addition to professional real estate appraisers, the courts have allowed the opinion testimony of various experts on the value of fraudulently sold property. *McCue v Bruce Enters., Inc.* (1964) 228 CA2d 21, 39 CR 125 (brokers); *Hardy v Carmichael* (1962) 207 CA2d 218, 24 CR 475 (building contractors); *Ashburn v Miller* (1958) 161 CA2d 71, 326 P2d 229 (brokers). On the potential effect of testimony about value that is not precisely calculated as of the sale date, see *Cory v Villa Props.* (1986) 180 CA3d 592, 601, 225 CR 628.

If an expert's opinion is based on inadmissible material, the opinion becomes unreliable. *People ex rel Dep't of Pub. Works v Dunn* (1956) 46 C2d 639, 641, 297 P2d 964 (when witness testimony on market value is based on improper considerations, it may be stricken); *Korsak v Atlas Hotels, Inc.* (1992) 2 CA4th 1516, 1526, 3 CR2d 833 (expert's failure to show any connection between his opinion and alleged data resulted in erroneous admission of expert's opinion, requiring reversal for new trial); *Redevelopment Agency v First Christian Church* (1983) 140 CA3d 690, 703, 189 CR 749 (lack of knowledge about essential matter by otherwise highly qualified real estate appraiser rendered his opinion inadmissible). See also Evid C §822 (prescribing standards for inadmissibility based on improper bases for opinion).

PRACTICE TIP: Counsel who believe that the expert's opinion is based on improper considerations should file a motion in limine to exclude the testimony. Relevant portions of the expert's deposition and exhibits should be attached to counsel's declaration supporting the motion.

The buyer may testify regarding value, although not as an expert. *Buist v C. Dudley DeVelbiss Corp.* (1960) 182 CA2d 325, 6 CR 259. The buyer's opinion need not be as solidly grounded as that of an expert (*Sanders v Park Beverly Corp.* (1952) 109 CA2d 698, 241 P2d 597) and may be based on information about neighboring property values (*Koch v Williams* (1961) 193 CA2d 537, 14 CR 429). If the buyer fails to provide competent testimony on value, the action will fail. *Nece v Bennett* (1963) 212 CA2d 494, 497, 28 CR 117.

The general rule applicable to nonexperts is that their opinions are limited to such opinions as are permitted by law, including but not limited to an opinion that is (1) rationally based on the perception of the witness and (2) helpful to a clear understanding of his or her testimony. Evid C §800. The general rules on expert testimony are set forth in Evid C §801.

Special rules, however, apply to the valuation of real property. Under Evid C §813(a), the value of real property may be shown *only* by the opinions of (1) witnesses qualified to express such opinions, (2) the owner or the spouse of the owner, or (3) an officer, regular employee, or partner designated by the owner as long as that person is knowledgeable about the value of the property.

An owner as defined in Evid C §813(c) also means:

- A person entitled to possession of the property; and
- Either party in an action to decide ownership of the property when the court rules that it would not be in the interest of efficient administration of justice to decide the issue of ownership prior to the admission of the opinion of the party.

Thus, in an ordinary lawsuit for fraud damages unaccompanied by causes of action for rescission, specific performance or other causes of action that have ownership or possession as an issue to be resolved within the meaning of that section, the seller, as a former owner, appears to be disqualified as a person who can render an opinion about value, because the collective import of Evid C §813(a)(2) and (c) is that a former owner is not an owner. It is arguable, however, that if the seller is giving an opinion on the property's value during a time when the seller owned it, such testimony should be permitted under Evid C §813, if it is relevant to the action. See *Marriage of Stoll*

(1998) 63 CA4th 837, 74 CR2d 506.

Similarly, an unsuccessful buyer also seems to be disqualified as a person who can render an opinion about value because such a person never acquired the status of an owner. This is, of course, unless the seller as a former owner and an unsuccessful buyer do not otherwise qualify as experts and perhaps, if the circumstances warrant, the court allows the person to testify under Evid C §800 *or* §813(a)(1).

PRACTICE TIP: Even if a witness qualifies to testify about the value because of his or her status as an owner, it may be unwise to rely on his or her abilities to testify. The inability to explain the factors that a witness uses in forming an opinion and standing up to cross-examination may be as damaging as having no witness testify about value. Thus, the witness must be able to articulate in a manner that can be understood. See Evid C §701. The witness should also be able to state the reasons and the bases for the opinion. See Evid C §802.

Moreover, an opinion on the property's value must be based on matters perceived by or personally known to the witness or made known to the witness at or before the hearing, whether or not those matters are admissible, as long as they are the type that an expert may reasonably rely on in forming a value opinion. Evid C §814. Many cases are won and lost, or at least decided, on the disparity between the convincing quality of the reasons as articulated by the witnesses of why the property has one value instead of another. The value of opinion evidence rests not in the conclusion reached but in the factors considered and the reasoning used. *PG&E v Zuckerman* (1987) 189 CA3d 1113, 1135, 234 CR 630. Trial courts have a duty to independently examine the experts' reasoning. *Marriage of Micalizio* (1988) 199 CA3d 662, 673, 245 CR 673. Against the opinion of an experienced appraiser accustomed to testifying in court, the opinion of a party to the lawsuit may be overpowered solely by the convincing quality of the expert's reasoning.

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§2.39 c. Methods of Establishing Value

There are three recognized methods of establishing value for real property. *People ex rel Department of Water Resources v Andresen* (1987) 193 CA3d 1144, 1163, 238 CR 826 (rock quarry); *Redevelopment Agency v First Christian Church* (1983) 140 CA3d 690, 705, 189 CR 749 (church). The one used most often is the comparable sales approach. See Evid C §816. The other methods are the cost of reproduction and capitalization. *People ex rel Dep't of Water Resources v Andresen, supra*. See Evid C §819. Generally, the nature of the property in question governs the method that should be used to value it. 193 CA3d at 1164. See also *Barnes v Dobbins* (1958) 159 CA2d 737, 324 P2d 696; *Bice v Stevens* (1955) 136 CA2d 368, 289 P2d 95; *Oliver v Benton* (1949) 92 CA2d 853, 208 P2d 375. Finally, if no relevant, comparable market exists, the value of property may be established by any just and equitable method. Evid C §823.

Because any tract of land is considered unique, the question of admissibility of evidence of prices paid on other sales is most often considered in cases requiring valuation. The view of the majority of courts that admit this evidence, with safeguarding limits, seems preferable. These safeguards are that the sales of the other tracts must have occurred sufficiently near in time, must be located sufficiently near the land to be valued, and must be sufficiently alike in character, situation, usability, and improvements to make it clear that the two tracts are comparable in value and that the price of the other land may be considered. *County of Los Angeles v Faus* (1957) 48 C2d 672, 678, 312 P2d 680.

When the comparable sales method is used, the comparable sales should be close to the subject property in time of sale, location, and characteristics. *PG&E v Zuckerman* (1987) 189 CA3d 1113, 1129 n6, 234 CR 630 (the closer a property is in physical characteristics and time of sale, the more comparable it is to the subject transaction); *Oldenburg v Brody* (1956) 139 CA2d 543, 557, 293 P2d 844 (valuation should be determined at time of transaction). In one case, an expert was allowed to use a sale of a property that was to be sold ten days *after* the witness testified at trial. *People ex rel Department of Pub. Works v Jarvis* (1969) 274 CA2d 217, 223, 79 CR 175. One appellate court affirmed a trial court's ruling allowing an expert to use a sale of property in the same neighborhood seven months after the date for valuation. *County of Los Angeles v Hoe* (1955) 138 CA2d 74, 79, 291 P2d 98, disapproved on other grounds in *Merced Irrig. Dist. v Woolstenhulme* (1971) 4 C3d 478, 495, 93 CR 833.

No general rules can be laid down on the degree of similarity required to exist between the properties, and on the nearness in respect of time and distance, because these are matters resting largely in the trial judge's discretion. The time element goes merely to the weight of the opinion. *PG&E v Zuckerman* (1987) 189 CA3d 1113, 1128, 1130, 234 CR 630 (court reversed valuation when expert compared single transaction occurring 24 years before). In some cases, there is insufficient data on which to draw appropriate comparisons. In other cases, data may exist but may require some adjustment. This common sense approach reflects the fact that things tend to cost more as time goes by. *City of Los Angeles v Retlaw Enters., Inc.* (1976) 16 C3d 473, 486, 128 CR 436 (rates of appreciation tend to show in logic and common sense that such rates affect similar properties). See also *Merced Irrig. Dist. v Woolstenhulme* (1971) 4 C3d 478, 502, 93 CR 833 (courts have accepted adjustment process as integral element of comparable sales approach).

It is axiomatic that appraisals cannot be based on the success of a tenant's business. It is settled that evidence of profits derived from a business conducted on the land is too speculative, uncertain, and remote to be considered as a basis for ascertaining market value. *PG&E v Zuckerman* (1987) 189 CA3d 1113, 1133, 234 CR 630. See *People ex rel Department of Pub. Works v Dunn* (1956) 46 C2d 639, 641, 297 P2d 964. It follows that the use of or reliance on such speculative evidence renders an opinion based on it unreliable itself. But see *Nece v Bennett* (1963) 212 CA2d 494, 497, 28 CR 117.

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§2.40 4. Additional Damages

Civil Code §3343 allows a plaintiff to recover any additional damage arising from the transaction, including the following:

- Amounts actually and reasonably expended in reliance on the fraud.
- An amount that would compensate the plaintiff for loss of use and enjoyment of the property to the extent that the fraud proximately caused that loss.
- When the plaintiff was induced through fraud to sell or part with the property in question, an amount that will compensate the plaintiff for profits or other gains that might reasonably have been earned by use of the property had he or she retained it.
- When the plaintiff was induced through fraud to acquire the property in question, an amount that will compensate the plaintiff for any loss of profits or other gains that were reasonably anticipated and would have been earned from the use or sale of the property had it possessed the characteristics fraudulently represented by the defendant. Lost profits, however, are recoverable only to the extent that all of the following apply:
- The plaintiff acquired the property for the purpose of using or reselling it for a profit.
- The plaintiff reasonably relied on the fraud in entering into the transaction and in anticipating profits from the subsequent use or sale of the property.
- Any loss of profits was proximately caused by the fraud and the plaintiff's reliance on it.

Nothing in CC §3343 shall either:

- Permit the plaintiff to recover any amount measured by the difference between the value of property as represented and its actual value; or
- Deny to anyone having a cause of action for fraud or deceit any legal or equitable remedies to which such person may be entitled.

The plaintiff need not show "out-of-pocket" losses to recover consequential or additional damages. See *Alliance Mortgage Co. v Rothwell* (1995) 10 C4th 1226, 1241 n5, 44 CR2d 352, quoting *Stout v Turney* (1978) 22 C3d 718, 729, 150 CR 637. Civil Code §3343(a)(1) codifies previous decisions allowing expenditures in reliance on the fraud. *Stout,* 22 C3d at 726 (actual expenditures of time and money in reliance on misrepresentation, including rental of suitable premises, and damage to other property); *Sixta v Ochsner* (1960) 187 CA2d 485, 490, 9 CR 617 (legal fees incurred in defense of plaintiff's action); *Lawson v Town & Country Shops, Inc.* (1958) 159 CA2d 196, 198, 205, 323 P2d 843 (shopping center operating losses, loss of personal services, and unpaid rents). Reliance damages are those incurred in reliance on the fraud and are recoverable for agreements executed both before and after the 1971 changes only if the damages have a causal connection with the fraudulent misrepresentation or nondisclosure. *Gagne v Bertran* (1954) 43 C2d 481, 275 P2d 15; *Walters v Marler* (1978) 83 CA3d 1, 147 CR 655, disapproved on other grounds in 35 C3d at 507.

Civil Code §3343(a)(2) codifies previous decisional law on loss of use and enjoyment of property. *Channell v Anthony* (1976) 58 CA3d 290, 315, 129 CR 704 (contract entitled seller to damages); *Williams v Graham* (1948) 83 CA2d 649, 653, 189 P2d 324 (recovery of deposit and amount required to rent other property). But see *Gray v Don Miller & Assocs.* (1984) 35 C3d 498, 504, 198 CR 551 (delay damages not recoverable if not caused by misrepresentation); *Eatwell v Beck* (1953) 41 C2d 128, 134, 257 P2d 643 (anticipated revenues not recoverable under §3343, but are "an element to be considered in determining the actual value of the property").

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§2.41 a. Labor

Actual expenditures of time and money are recoverable as additional damages if they were incurred in reliance on the fraud. *Stout v Turney* (1978) 22 C3d 718, 726, 150 CR 637; *Hartong v Partake, Inc.* (1968) 266 CA2d 942, 969, 72 CR 722 (plaintiff's reasonable hourly wages were representative of loss of time). But see *Earle v Lambert* (1962) 205 CA2d 452, 459, 23 CR 79 (not error to disallow loss of wages resulting from being made ill and mentally and physically upset). In one case, however, the court disapproved damages for material and labor to put a well into the condition as represented by the seller. The basis for the ruling was that there was no evidence of CC §3343 out-of-pocket damages. *Crawford v Nastos* (1960) 182 CA2d 659, 669, 6 CR 425.

NOTE: If *Crawford* is understood as an improvements case, it was correctly decided. If it is understood as a labor case, it is doubtful that it can stand in the face of the 1971 amendments to §3343 and *Stout v Turney, supra,* because *Stout* made it clear that such out-of-pocket "actual expenditures of time and money" damages are not required to recover such additional damages.

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§2.42 b. Repairs and Improvements

When, as a result of the fraud, the defrauded person made expenditures that were reasonable under the circumstances, the expenditures may ordinarily be recovered insofar as they were lost or rendered fruitless because of the deceit. *Garrett v Perry* (1959) 53 C2d 178, 186, 346 P2d 758. Therefore, a buyer who makes improvements that are worthless because of fraud may recover the cost of these improvements as additional damages. *Buist v C. Dudley DeVelbiss Corp.* (1960) 182 CA2d 325, 333, 6 CR 259 (cost of improvements damaged by undisclosed ancient slide in area of underground water).

When improvements (*i.e.,* repairs and construction) are not lost or rendered fruitless by the fraud, the buyer cannot recover for them. *McNeill v Bredberg* (1961) 192 CA2d 458, 469, 13 CR 580. See also *Roberts v Karr* (1960) 178 CA2d 535, 547, 3 CR 98 (leveling work not caused by erroneous survey); *County of Mariposa v Yosemite W. Assocs.* (1988) 202 CA3d 791, 813, 248 CR 778 (developer that failed to provide adequate water and sewer services could be liable to homeowners' association for maintenance district annexation fees).

Repair costs that a seller is obligated to make under the terms of a contract without charge are unrecoverable as damages. *Gonsalves v Hodgson* (1951) 38 C2d 91, 101, 237 P2d 656. See also *Housley v City of Poway* (1993) 20 CA4th 801, 812, 24 CR2d 554; *McNeill v Bredberg* (1961) 192 CA2d 458, 469, 13 CR 580. It may nevertheless be possible to use the cost of repairs as evidence to show the actual value of property. *Philip Chang & Sons Assocs. v La Casa Novato* (1986) 177 CA3d 159, 163, 222 CR 800; *Sanfran Co. v Rees Blow Pipe Mfg. Co.* (1959) 168 CA2d 191, 205, 335 P2d 995.

In an action based on rescission, because the improvements made by the buyer must be returned to the seller with the property, the rescinding buyer can recover for the improvements. *Lobdell v Miller* (1952) 114 CA2d 328, 343, 250 P2d 357. The recovery appears to be measured by the increase in the property's market value caused by the improvements rather than by their cost. *Tarrant v Butler* (1960) 180 CA2d 235, 243, 4 CR 230. See California Real Property Remedies and Damages, chap 1 (2d ed Cal CEB 2002).

PRACTICE TIP: If the buyer were awarded only the increase on the market value, theoretically there would be no recovery for an improvement rendered totally worthless by the land conditions about which the buyer was defrauded. For example, for a house built on fill that collapses, it is doubtful whether the rule would be applied. Nevertheless, this prospect might be sufficient to induce a buyer to pursue an action for damages rather than one for rescission.

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§2.43 c. Expenses

Expenditures that would have been incurred regardless of the fraud are not recoverable, because they were not spent in reliance on the fraud. See CC §3343(a)(1). Hence, closing costs are not recoverable in an action for damages because they do not result from the fraud. *Isaacs v Frank Meline Co.* (1934) 2 CA2d 341, 347, 37 P2d 1045. They may, however, be awarded to the buyer in a rescission action. *Curran v Heslop* (1953) 115 CA2d 476, 483, 252 P2d 378. See California Real Property Remedies and Damages, chap 1 (2d ed Cal CEB 2002).

Expenditures made in reliance on the fraud are recoverable. CC §3343(a)(1). But if the buyer does not produce admissible evidence of the costs, the action must fail. *Gulke v Brock* (1963) 222 CA2d 459, 460, 35 CR 200. For example, recoverable expenditures in attempting to obtain a duly recorded subdivision map are escrow fees, moving expenses, building permits, telephone connections and charges, mileage expenses, fences, yard cleaning, garage materials, door locks, shrubbery, taxes, rent, and labor. *Cory v Villa Props.* (1986) 180 CA3d 592, 603, 225 CR 628; *Hartong v Partake, Inc.* (1968) 266 CA2d 942, 969, 72 CR 722; *Younis v Hart* (1943) 59 CA2d 99, 107, 138 P2d 323 (rescission action).

PRACTICE TIP: Some of these decisions are either unclear or questionable because of the negligible analysis given to the small damage components in the cases. For instance, the court approved a variety of such expenses in *Hardy v Carmichael* (1962) 207 CA2d 218, 24 CR 475, but gave no reasons why each such expense qualified as an expenditure in reliance on the fraud. Uncritical reliance on cases like *Hardy,* as legal support for similar expenses in another case when they would have been incurred whether or not fraud was present, may be unwarranted.

On attorney fee expenses as an element of damages, based on the third party tort doctrine, see §2.48.

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§2.44 d. Lost Profits

Under CC §3343(a)(3), a defrauded *seller* can recover for profits or other gains that might have been earned if the property had been retained. See §2.52. Also, CC §3343(a)(4) provides for recovery by a defrauded *buyer* of the loss of profits and other gains that could have been earned if the property had been as represented, as long as (*Stout v Turney* (1978) 22 C3d 718, 727, 150 CR 637; *Cory v Villa Props.* (1986) 180 CA3d 592, 603, 225 CR 628):

- The property was acquired in order to generate profits or to resell at a profit (CC §3343(a)(4)(i));
- The buyer reasonably relied on the fraud in buying the property and anticipating such profits (CC §3343(a)(4)(ii)); and
- The lost profits were proximately caused by the fraud and the buyer's reliance on it (CC §3343(a)(4)(iii)).

With respect to a buyer's action for fraud, the buyer must actually acquire the property before he or she can recover lost profits. *Kenly v Ukegawa* (1993) 16 CA4th 49, 55, 19 CR2d 771 (defrauded prospective purchaser of real property who does not succeed in acquiring the property can recover only out-of-pocket losses in action against seller); *Nguyen v Scott* (1988) 206 CA3d 725, 740, 253 CR 800 (action by prospective buyer against broker).

These loss-of-profits provisions give CC §3343 some aspects of a benefit-of-the-bargain measure of damages, but the section itself declares that it does not authorize recovery of the difference between the value of the property as represented and its actual value. CC §3343(b)(1). See *Stout v Turney* (1978) 22 C3d 718, 726, 150 CR 637.

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§2.45 e. Personal Injuries and Emotional Distress

Some cases have asserted that personal injuries are recoverable in fraud actions. *Sixta v Ochsner* (1960) 187 CA2d 485, 491, 9 CR 617; *Oliver v Benton* (1949) 92 CA2d 853, 855, 208 P2d 375. Neither case, however, actually involved a claim for personal injuries. Apparently, no case has considered the question of whether a victim of fraud also suffered personal injuries in connection with the fraud. Personal injuries may result, for example, from an undisclosed defective condition in a building that causes personal injuries. Because of the rule that precludes the imposition of negligence liability for preexisting defects caused by a former owner (see *Preston v Goldman* (1986) 42 C3d 108, 227 CR 817), liability for nondisclosure might serve as a separate ground for imposing liability (see *Newhall Land & Farming Co. v Superior Court* (1993) 19 CA4th 334, 349, 23 CR2d 377). (Note that the *Preston* rule does not preclude fraud liability.)

If deceit is a substantial factor in causing personal physical injuries, the injured party should be able to recover damages. Landlords are liable for personal injuries to tenants caused by defects concealed from tenants. *Merrill v Buck* (1962) 58 C2d 552, 25 CR 456; *Burks v Blackman* (1959) 52 C2d 715, 344 P2d 301. Because both the landlord and the seller have similar duties to disclose the existence of defective or dangerous conditions as an incident to conveying the property, there should be no reason a tenant should be entitled to recover for physical injuries and a buyer should not.

Emotional distress resulting from fraud is not an allowable element of damages under CC §3343. *Devin v United Servs. Auto. Ass'n* (1992) 6 CA4th 1149, 1162, 8 CR2d 263; *Branch v Homefed Bank* (1992) 6 CA4th 793, 798, 8 CR2d 182; *Marriage of McNeill* (1984) 160 CA3d 548, 559, 206 CR 641, disapproved on other grounds in 41 C3d at 451. The source of this rule is *Newman v Smith* (1888) 77 C 22, 27, 18 P 791, in which the supreme court held that the plaintiff could not recover for anxiety, worry, and harassment and that the allegations on the subject should be treated as surplusage. From that statement sprang the rule (that emotional distress damages are not recoverable in real property fraud actions), which has stood the test of time.

PRACTICE TIP: If physical injury/emotional distress is a large component of the plaintiff's damages, counsel should consider the pros and cons of pursuing the action under different or additional theories, such as nuisance (see chap 6) or infliction of emotional distress (see California Tort Damages, chap 6 (2d ed Cal CEB 2002)).

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§2.46 f. Interest

Negotiated contractual interest is not recoverable under CC §3343, because the purpose of tort-based damage measurement does not include a contract-based method of calculating that interest. Instead, statutory interest under CC §3287 is appropriate. *Christiansen v Roddy* (1986) 186 CA3d 780, 790, 231 CR 72. Under CC §3288, a defrauded party may recover prejudgment interest in an action for damages, within the trial court's discretion. *Pepitone v Russo* (1976) 64 CA3d 685, 690, 134 CR 709; *Conger v White* (1945) 69 CA2d 28, 40, 158 P2d 415.

Interest runs from the date of sale (*Pavlovich v Neidhardt* (1954) 128 CA2d 559, 562, 275 P2d 836; *Williams v Graham* (1948) 83 CA2d 649, 653, 189 P2d 324), except that, for additional items of damages, interest runs from the date payments were made in reliance on the fraud (*Sixta v Ochsner* (1960) 187 CA2d 485, 9 CR 617). Civil Code §3288 commits recovery of interest to the discretion of the trier of fact, and a trial court's award or denial is unlikely to be overturned on appeal. See *Nathanson v Murphy* (1955) 132 CA2d 363, 373, 282 P2d 174; *Conger v White*, *supra*.

If a seller breaches a sales agreement, prejudgment interest can be awarded on the amount of the buyer's escrow deposit. *Al-Husry v Nilsen Farms Mini-Market, Inc.* (1994) 25 CA4th 641, 647, 31 CR2d 28 (parties were in escrow for purchase of mini-market business when defendant sellers refused to execute amended escrow instructions). See also *Rifkin v Achermann* (1996) 43 CA4th 391, 50 CR2d 661 (prejudgment interest to potential buyer in breach of contract case calculated from date action filed).

A rescinding buyer may also recover interest on the award in the court's discretion. *Smith v Rickards* (1957) 149 CA2d 648, 654, 308 P2d 758; *Younis v Hart* (1943) 59 CA2d 99, 107, 138 P2d 323. In an action based on rescission, however, interest runs from the date notice of rescission was given. *Younis v Hart*, *supra; Wilson v Rigali & Veselich* (1934) 138 CA 760, 768, 33 P2d 455.

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§2.47 g. Punitive Damages

A fraud cause of action seeking punitive damages need not include an allegation that the fraud was motivated by a malicious desire to injure the victim. Pleading fraud is sufficient. *Stevens v Superior Court* (1986) 180 CA3d 605, 610, 225 CR 624 (distinguishing *Ebaugh v Rabkin* (1972) 22 CA3d 891, 99 CR 706, which relied on CC §3294 requiring "oppression, fraud, or malice" as basis for awarding exemplary damages).

The court may award punitive damages in an action for breach of an obligation not arising from a contract if the plaintiff proves by clear and convincing evidence that the defendant's conduct was fraudulent. CC §3294(a); *Pat Rose Assocs. v Coombe* (1990) 225 CA3d 9, 21, 275 CR 1, disapproved on other grounds in *Adams v Murakami* (1991) 54 C3d 105, 116, 284 CR 318; *Storage Servs. v Oosterbaan* (1989) 214 CA3d 498, 514, 262 CR 689. The duty not to commit fraud does not arise from a contract but instead is imposed by law. *Ward v Taggart* (1959) 51 C2d 736, 743, 336 P2d 534. If the underlying facts show both fraud and breach of contract, punitive damages are not precluded. *Walker v Signal Cos.* (1978) 84 CA3d 982, 996, 149 CR 119; *Glendale Fed. Sav. & Loan Ass'n v Marina View Heights Dev. Co.* (1977) 66 CA3d 101, 135, 135 CR 802.

Punitive damages may be awarded in addition to the damages authorized by CC §3343 (*Simon v San Paolo U.S. Holding Co.* (2005) 35 C4th 1159, 1176, 29 CR3d 379; *Hartman v Shell Oil Co.* (1977) 68 CA3d 240, 248, 137 CR 244; *Channell v Anthony* (1976) 58 CA3d 290, 320, 129 CR 704) or in addition to restitution after rescission of the purchase agreement (*Mahon v Berg* (1968) 267 CA2d 588, 589, 73 CR 356; *Millar v James* (1967) 254 CA2d 530, 533, 62 CR 335).

NOTE: In *Simon v San Paolo U.S. Holding Co., supra,* the supreme court decided whether, when determining if an award of punitive damages violated due process, the ratio between compensatory and punitive damages should be based solely on the actual compensatory damages awarded or on the plaintiff's loss that was uncompensated due to the statutory limitations of CC §3343.

Although fraud as defined in CC §§1572 and 1710 includes negligent misrepresentation, nondisclosure, and constructive fraud as types of fraud, punitive damages under CC §3294 requires proof of willful or intentional misconduct. Thus, punitive damages may not be awarded for negligent misrepresentation (*Branch v Homefed Bank* (1992) 6 CA4th 793, 799, 8 CR2d 182; *Reid v Moskovitz* (1989) 208 CA3d 29, 32, 255 CR 910; *Delos v Farmers Ins. Group* (1979) 93 CA3d 642, 656, 155 CR 843) or constructive fraud (*Palmer v Ted Stevens Honda, Inc.* (1987) 193 CA3d 530, 536, 238 CR 363; *Flyer*'s *Body Shop Profit Sharing Plan v Ticor Title Ins. Co.* (1986) 185 CA3d 1149, 1154, 230 CR 276).

Punitive damages cannot be awarded unless actual damages are suffered. *Esparza v Specht* (1976) 55 CA3d 1, 6, 127 CR 493. The broker's deliberate concealment of an unfavorable termite report justified an award of punitive damages and damages for emotional distress in *Godfrey v Steinpress* (1982) 128 CA3d 154, 181, 180 CR 95, 109.

On appealing excessive punitive damages awards, see §1.34.

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§2.48 h. Attorney Fees

It is sometimes possible to obtain attorney fees in fraud and nondisclosure actions. The general rule in California is that attorney fees are not recoverable unless provided for by law, statute, or contract. CCP §1021; *Trope v Katz* (1995) 11 C4th 274, 278, 45 CR2d 241. The general fraud statutes (CC §§1571-1573, 1709-1710) do not provide for attorney fees to the prevailing party. Thus, if the transaction documents lack an appropriate fee clause, a party's entitlement to attorney fees may depend on a special statute (*e.g.,* CC §§1133(d), 1368(d)) or the tort-of-another rule (see *Gray v Don Miller & Assocs.* (1984) 35 C3d 498, 508, 198 CR 551).

If the litigation results in an unqualified winner on a single contract claim on a contract with an attorney fee clause, then the court must award fees under §1717. *Hsu v Abbara* (1995) 9 C4th 863, 877, 39 CR2d 824.

If a contractual fee provision is phrased broadly enough (*e.g.,* allows award of fees in actions "arising out of or related to" the contract), it may support an award of attorney fees to the prevailing party in either contract or tort causes of action, or both. See, *e.g., Santisas v Goodin* (1998) 17 C4th 599, 71 CR2d 830 (decided question of whether defendant residential sellers were entitled to fees in defending against dismissed contract claims and dismissed tort claims, including fraud claims; see California Attorney Fee Awards §6.21 (2d ed Cal CEB 1994)). Code of Civil Procedure §§1021, 1032, and 1033.5 govern the award of attorney fees as costs if the claim is not based on contract. *Wakefield v Bohlin* (2006) 145 CA4th 963, 974, 52 CR3d 400. Code of Civil Procedure §1032 provides that the prevailing party is:

- The party with the net monetary recovery (which may be either the plaintiff or the defendant);
- The defendant, if the defendant is dismissed from the action;
- The defendant, if neither the plaintiff nor the defendant recovers anything; or
- A defendant as against a plaintiff who does not recover anything against that defendant (*e.g.*, if the plaintiff does not recover any damages against that defendant, but does recover against codefendants).

Under CCP §1032, the trial court may determine the prevailing party if the case does not fit into any of these classes or categories, or a party recovers something other than monetary relief. Under Cal Rules of Ct 3.1702, the court, on a noticed motion, may determine who is the prevailing party and whether fees should be awarded on a particular cause of action. See *Santisas v Goodin, supra*; Attorney Fee Awards, chap 14.

If a broker's misrepresentation leads the client/buyer to mistakenly sue for specific performance against the seller, the broker may be held liable for the client's legal fees (incurred in the specific performance action) as an element of damages in the fraud action against the broker. The client is not entitled to the fees on the theory that the broker was a fiduciary who committed fraud. Rather, the fees are recoverable by the person who incurs them to prosecute or defend a separate action against a third party because of the defendant's tort. See *Gray v Don Miller & Assocs.* (1984) 35 C3d 498, 507, 198 CR 551 (broker misrepresented to buyers that sellers had accepted buyers' offer; subsequent suit for specific performance by buyers against sellers failed). In *Pacific Preferred Props., Inc. v Moss* (1999) 71 CA4th 1456, 1463, 84 CR2d 500, "a tripartite contract concerning the award of attorney's fees" was formed that obligated the broker for the legal fees the seller incurred in defending an action. Compare *Gray* and *Moss* with *Super 7 Motel Assocs. v Wang* (1993) 16 CA4th 541, 20 CR2d 193.

On pleading and proving attorney fees as damages based on the third party tort doctrine, see Attorney Fee Awards, chap 9.

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§2.49 5. Fraud by Fiduciaries

If an intentional misrepresentation or nondisclosure is committed by one who stands in a fiduciary relationship to the defrauded party, recovery is arguably governed not by CC §3343 but by the "broader standards" of CC §§1709 and 3333. See *Alliance Mortgage Co. v Rothwell* (1995) 10 C4th 1226, 1241, 44 CR2d 352 (dictum); *Stout v Turney* (1978) 22 C3d 718, 150 CR 637; *Fragale v Faulkner* (2003) 110 CA4th 229, 1 CR3d 616; *Salahutdin v Valley of Cal., Inc.* (1994) 24 CA4th 555, 565, 29 CR2d 463. But see *Hensley v McSweeney* (2001) 90 CA4th 1081, 109 CR2d 489.

The courts of appeal are divided on the measure of damages for intentional fraud by a fiduciary and the California Supreme Court has yet to definitively decide the issue. Some courts have held that the measure of damages for intentional breach of fiduciary duty is the benefit-of-the-bargain standard applicable to breach of contract actions under CC §§3300-3321. *Pepitone v Russo* (1976) 64 CA3d 685, 134 CR 709; *Walsh v Hooker & Fay* (1963) 212 CA2d 450, 28 CR 16; *Simone v McKee* (1956) 142 CA2d 307, 298 P2d 667. Others have held that §3334 limits the defrauded principal's recovery to the extent of the financial injury actually sustained and does not authorize the plaintiff to recover the benefit of his or her bargain. See *Walters v Marler* (1978) 83 CA3d 1, 147 CR 655, disapproved on other grounds in 35 C3d at 507; *Overgaard v Johnson* (1977) 68 CA3d 821, 137 CR 412 (out-of-pocket rule applies to real estate fraud cases under both CC §§3333 and 3343). Others have held that the damages for a fiduciary broker's fraud are governed by CC §3333 and are not limited to the out-of-pocket damages of CC §3343. See *Fragale v Faulkner* (2003) 110 CA4th 229, 1 CR3d 616.

NOTE: Another possible approach was used in *Strebel v Brenlar Invs., Inc.* (2006) 135 CA4th 740, 748, 37 CR3d 699. There, the plaintiff closed escrow on the sale of his San Bruno home expecting to soon close escrow on a replacement home in Sonoma, but the plaintiff's real estate agent had fraudulently concealed facts about liens on the Sonoma house that prevented that purchase from closing and plaintiff was unable to buy another house before housing values increased. Because the facts that had been concealed had nothing to do with the value of either of the properties at issue, the plaintiff's damages could not be measured in terms of either out-of-pocket loss or benefit-of-the-bargain damages. Accordingly, the court allowed recovery of the lost appreciation on the home plaintiff sold, finding it "was reasonable compensation for [plaintiff's] inability to purchase an acceptable home in Sonoma concurrently with the sale of his San Bruno home."

The supreme court noted that a plaintiff is entitled to only its actual or out-of-pocket losses suffered under CC §3333 when a fiduciary is guilty of negligent misrepresentation. *Alliance Mortgage Co. v Rothwell* (1995) 10 C4th 1226, 1249, 44 CR2d 352. See *Christiansen v Roddy* (1986) 186 CA3d 780, 231 CR 72. Although the court stated in dicta that the measure of damages under CC §§1709 and 3333 might be greater for a fiduciary's intentional misrepresentation, that issue was not before it in *Alliance*. 10 C4th at 1250. See *Salahutdin v Valley of Cal., Inc., supra* (discussing commentators' suggestion that benefit-of-bargain measure of damages applies when fiduciary's misrepresentation is intentional, and out-of-pocket measure of damages applies when misrepresentation is negligent); *Fragale v Faulkner* (2003) 110 CA4th 229, 1 CR3d 616 (aligned with the view of *Salahutdin v Valley of Cal., Inc., supra,* stating "the preferable view is that damages for [intentional] fraud by a fiduciary should not be limited by out-of-pocket losses").

In *Hensley v McSweeney* (2001) 90 CA4th 1081, 109 CR2d 489, the court (the same court that decided *Overgaard v Johnson* (1977) 68 CA3d 821, 137 CR 412) squarely held that it was error to instruct the jury about both measures and that the out-of-pocket measure was the only measure applicable to claims against a fiduciary.

PRACTICE TIP: *Alliance'*s apparent distinction between negligent and intentional misrepresentation as having an effect on the measure of damages under CC §3333 should not be hastily embraced. First, the text of §3333 contains no such distinction. Second, the narrow facts alleged in *Alliance* suggested only an out-of-pocket-type measure of damages for *lenders*. Third, as a corollary to the second reason, it is unclear how a lender might claim a measure of damages greater than the out-of-pocket measure because the lender is typically satisfied with its security interest rather than the bargain of a hypothetical greater market value. The combined application of both CC §§1709 and 3333 in intentional fraud cases may be the key, however, because §1709 provides that anyone guilty of willful deceit is liable for "any damages" that the injured party suffers. See *Alliance Mortgage Co. v Rothwell*

(1995) 10 C4th 1226, 1241, 44 CR2d 352.

The problem of anticipating which rule or jury instruction will be applied by the trial judge is further complicated by the language of the constructive fraud statute pertaining to the "breach of any duty." See CC §1573. If the breach-of-any-duty component of the constructive fraud statute includes the duty to disclose, then the *sellers* may be exposed to the wider measure of damages for constructive fraud because of the language in opinions such as *Alliance* and *Salahutdin*. An argument can be made for limiting the scope of damage measurement in constructive fraud because the legislature said so, *i.e.,* because CC §3343 arguably preempts all other salutatory formulas for measuring damages in real estate fraud actions.

PRACTICE TIP: If nonfiduciary fraud is the cause of action, the damages are CC §3343 damages (requiring appraisal and value testimony), not cost-of-repair damages. See §§2.35-2.39.

For further discussion of damages for brokers' fraud, see California Real Property Sales Transactions §§2.152-2.170 (4th ed Cal CEB 2007); Approaching an Action Against a Real Estate Broker (Cal CEB Action Guide August 2006).

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Source: Civil Litigation/California Attorney's Guide to Damages/2 Real Estate Seller/Buyer/§2.50 6. Damages Versus Equitable Remedies

§2.50 6. Damages Versus Equitable Remedies

An action for damages may not be the best remedy for the plaintiff in every instance of fraud in a real property transaction. A comparison between damages and rescission with restitution is illustrated by the following examples of the application of each remedy to the same set of facts. On the measure of recovery of incidental damages in rescission actions, see California Real Property Remedies and Damages, chap 1 (2d ed Cal CEB 2002).

EXAMPLES: Assume that, because of misrepresentations, a buyer pays $100,000 for a house that is actually worth $70,000. The buyer pays the seller $10,000 cash as a downpayment, pays $3500 for closing costs and title insurance, obtains a first loan from a bank for $70,000, and gives the seller a note and second deed of trust for the remaining $20,000. After living in the house for six months, the buyer discovers the fraud. In that time, the buyer pays $2800 interest and $2000 principal on the two loans. Finally, assume that the property has a fair rental value of $700 per month.

Rescission remedy: If the buyer rescinds, the buyer is entitled to an award of $14,100 and the property will be returned to the seller. The $14,100 represents the $10,000 paid to the seller plus the $2000 paid to reduce the principal of the loans, plus the $2800 interest paid, plus the $3500 closing costs and title insurance, less $4200 rent for six months of possession.

Damages remedy: If the buyer sues for fraud damages, the buyer will be entitled to keep the property and receive a judgment of $30,000, which represents the out-of-pocket loss measured by the difference between the purchase price of $100,000 and the actual value of $70,000.

This simplified comparison can be misleading, however, because in another case in which the assumptions are changed, the rescission award could exceed the damage award, depending on the CC §3343 computation as well as on the additional damages components authorized by §3343. Thus, if there is little or no difference between the contract price and the market value even if fraud occurred (*i.e.,* in either a stable or a rapidly rising real estate market), and there are few or no additional damages, rescission may afford the better monetary relief.

A damages action imposes heavier problems of proof than does an action based on rescission because the buyer must prove the §3343 differential by competent evidence. In a rescission action, the rescinding party need not establish such evidence. Rescission does not always require proof of a reduced market value. The buyer need show only that the purpose for which the property was bought cannot be fulfilled or some other sort of prejudice from the fraud. *Hefferan v Freebairn* (1950) 34 C2d 715, 721, 214 P2d 386; *Thomas v Krug* (1956) 139 CA2d Supp 941, 944, 294 P2d 785. In fact, the seller cannot avoid rescission even if the misstated fact actually increased rather than decreased the value of the property. *Wood v Jotham Bixby Co.* (1938) 29 CA2d 294, 297, 84 P2d 204.

However, proving the value of the consideration given in a rescission cause of action may be a problem in an exchange transaction if the defrauding party subsequently disposed of the property received in the exchange. When the defrauded buyer trades other property as all or part of the purchase price of new property, the seller may also be able to show that the property received was as overvalued as the property conveyed. See *Goren v Griffin* (1957) 152 CA2d 35, 44, 312 P2d 743. Some courts look only at the agreed valuation of the exchanged property (*Lobdell v Miller* (1952) 114 CA2d 328, 341, 250 P2d 357), but because paper values in exchanges may be unreliable, there is no error in looking past the represented value to the real value (*Feckenscher v Gamble* (1938) 12 C2d 482, 492, 85 P2d 885).

Although the buyer's general damages for fraud are fixed as of the date of sale, the seller's fraudulent representations can lead to further, later injuries to the buyer for which compensation may be available under CC §3343, which may change the comparison between a rescission action and an action for fraud damages. *Garrett v Perry* (1959) 53 C2d 178, 184, 346 P2d 758. Similarly, the rescinding buyer is often able to recover more than the purchase price if necessary to restore the parties to their status quo. See California Real Property Remedies and Damages, chap 1 (2d ed Cal CEB 2002); *Lobdell,* 114 CA2d at 341.

The rescinding buyer must also pay the seller reasonable rent for the time he or she was in possession of the

property, and the seller therefore has a setoff for this charge. *Kent v Clark* (1942) 20 C2d 779, 784, 128 P2d 868. When the rescinding buyer recovers for improvements made to the property, there is an inference that the improvements may be depreciated to offset their use by the buyer. *Kalkruth v Resort Props., Ltd.* (1943) 57 CA2d 146, 148, 134 P2d 513. If the buyer is forced to remain in possession to protect the property because the seller refuses to take it back, the court may relieve the buyer of the rent charge. See *Smith v Rickards* (1957) 149 CA2d 648, 651, 308 P2d 758.

In a damages action, the buyer remains the owner of the property and thus does not owe rent. Even when the buyer recovers as damages the entire price paid (*e.g.,* when the property had a market value of zero because the seller lacked title), there is still no setoff for rent. *Sixta v Ochsner* (1960) 187 CA2d 485, 4912, 9 CR 617. But because a damages action is an affirmance of the contract, the buyer remains liable for any balance of the purchase price owed to the seller. Thus the seller may have a setoff for any arrearages in payment. *Bagdasarian v Gragnon* (1948) 31 C2d 744, 763, 192 P2d 935; *Pat Rose Assocs. v Coombe* (1990) 225 CA3d 9, 21, 275 CR 1, disapproved on other grounds in *Adams v Murakami* (1991) 54 C3d 105, 284 CR 318. The seller has no setoff of damages for payments that have not yet matured. *Haines v Fisher* (1957) 147 CA2d 415, 416, 305 P2d 124. The buyer, however, may set off the judgment for damages against the balance due the seller, including the part of it that has not yet matured. See *Bagdasarian v Gragnon*, *supra*.

PRACTICE TIP: The facts of each case merit careful analysis regarding how the components of recovery compare in the causes of action for rescission and for fraud damages. This may be equally true of causes of action for breach of contract and for negligence. For example, in the previous example in which the buyer paid $100,000 for a property worth $70,000, from the fraudulent seller's standpoint, paying fraud damages is better than rescission. The seller starts with a house worth $70,000. By defrauding the buyer, the seller receives $80,000 in cash (from the downpayment and bank loan) and a secured note for $20,000. Under the *rescission* remedy, the seller gets the house back, the bank is repaid the $68,000 balance owed on the bank loan and the seller repays the $10,000 downpayment plus $4100 to the buyer. Consequently, the seller net loss is $2,100. Under fraud damages, the seller keeps the $70,000 already received from the bank loan, cancels his or her $20,000 personal loan, and returns the $10,000 downpayment to the buyer. To the seller (excluding the litigation costs and possible return to the buyer of the $2000 principal pay down on the bank loan), paying fraud damages is the monetary equivalent to selling the property for $70,000 all cash. Likewise, the buyer will have the $10,000 downpayment returned under both remedies but receive an extra $2100 under the rescission remedy but just have a $70,000 house subject to a $70,000 loan under the damages remedy.

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B. Damages When Seller Is Victim

§2.51 1. Same Remedies and Defenses

The cases are fewer in which the seller sues the buyer for fraud. *Kahn v Lischner* (1954) 128 CA2d 480, 487, 275 P2d 539. Like defrauded buyers, defrauded sellers may also sue for damages (*Feckenscher v Gamble* (1938) 12 C2d 482, 500, 85 P2d 885), seek rescission (12 C2d at 492), or assert fraud as an affirmative defense to an action by the buyer (*Seeger v Odell* (1941) 18 C2d 409, 414, 115 P2d 977; *Rodes v Shannon* (1963) 222 CA2d 721, 35 CR 339). Because of the frequency with which buyers make promises to a seller (*i.e.*, in promissory notes and deeds of trust), a cause of action for promissory fraud may lie. *Vogelsang v Wolpert* (1964) 227 CA2d 102, 111, 38 CR 440; *Palm v Smither* (1942) 52 CA2d 500, 505, 126 P2d 428. An action for constructive fraud may also apply. *Gross v Needham* (1960) 184 CA2d 446, 456, 7 CR 664; *Martin v Martin* (1952) 110 CA2d 228, 233, 242 P2d 688. In addition, CC §3343(a)(1) should apply to enable the seller to recover expenses that the seller incurred in reliance on the fraud. See §2.43.

In one case, the buyer wrote to the seller and said that he offered a price for the property similar to the price he offered for similar property. Among other reasons, the court held that the statement about the value of the property did not support a cause of action for fraud. The court distinguished *Palm v Smither, supra,* in that there was evidence in that case that the seller relied on representations other than value and that the representations were made under circumstances that supported reliance. *Kahn v Lischner* (1954) 128 CA2d 480, 488, 275 P2d 539. See also *Seeger v Odell, supra* (statements of opinion are generally not actionable). Factors like these generally translate into a difficult case by a seller against a buyer unless promissory or constructive fraud is present.

A seller seeking damages from the buyer and the buyer's broker for misrepresenting the value of the consideration given for the property may recover the difference between the actual value of the consideration and its represented value. *Banville v Schmidt* (1974) 37 CA3d 92, 98, 112 CR 126; *Metz v Malley* (1957) 155 CA2d 848, 849, 318 P2d 843. The seller may also be awarded punitive damages if the requirements of fraudulent conduct in CC §3294 are met (see §2.47). *Banville v Schmidt*, *supra*; *Austin v Duggan* (1958) 162 CA2d 580, 584, 328 P2d 224. Sellers, of course, are entitled to sue their brokers for misrepresentations that cause damages (*Earle v Lambert* (1962) 205 CA2d 452, 457, 23 CR 79), but they are not entitled to recover emotional distress damages (205 CA2d at 459).

A seller who was induced to accept 24 worthless second deeds of trust in exchange for land recovered damages from the buyer on the ground that the transaction was a sale of securities without a license or permit, in violation of the Real Property Securities Dealers Act (Bus & P C §§10237-10238.8). *Harvey v Davis* (1968) 69 C2d 362, 71 CR 129. The Act currently requires every real property securities dealer to file and maintain with the commissioner a cash deposit, cash equivalent, or bond in the sum of $10,000 executed by an admitted surety insurer in favor of "the People of the State of California" as security for complying with and performing on all obligations and the honest and faithful application of all funds received. See Bus & P C §10237.8.

A seller who is victimized by fraud is entitled to assert the buyer's fraud as a defense and rescind, get the property back, recover the "monetary equivalent of its use" (*i.e.,* rent), and get punitive damages. *Millar v James* (1967) 254 CA2d 530, 532, 62 CR 335. However, the defrauding buyer may be entitled to credits for the amount paid to the seller or expended for the benefit of the property. 254 CA2d at 532. Reformation may also be granted to make the security correspond to the buyer's description of it. See California Real Property Remedies and Damages, chap 2 (2d ed Cal CEB 2002). A constructive trust may be imposed if the property devolves to the heirs of the guilty buyer. *Mills v Mills* (1956) 147 CA2d 107, 123, 305 P2d 61.

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§2.52 2. Special Lost Profits Rule

Civil Code §3343(a)(3) entitles a defrauded seller to recover "for profits or other gains which might reasonably have been earned by use of the property had he retained it." For the most part, this section grants the right to recover the portion of rents that represents the profit portion of such receipts. With respect to a *seller's* action for fraud, one court held that sellers could maintain an action for fraud in the sale of their business against the officer of the corporate buyer for his promissory fraud. The sellers were precluded from recovering lost profits that they might have earned had they kept the business because such an award would amount to a double recovery inasmuch as the sellers effectively "sought to enforce the sale" and keep the sales price. *Croeni v Goldstein* (1994) 21 CA4th 754, 759, 26 CR2d 412.

The appellate court reversed the judgment on the pleadings ruling by the trial court to enable the sellers to establish a loss-of-profit component measured by the consideration paid to the sellers for a covenant not to compete. The court explained that the payment for the covenant represents income or profits that the appellants might have earned had they not been fraudulently induced to refrain from engaging in that type of business. 21 CA4th at 760. But see *Channell v Anthony* (1976) 58 CA3d 290, 316, 129 CR 704 (sellers entitled to certain profits from property because of contract clause that entitled them to generate such profits). Civil Code §3343(a)(3) claims, however, present for the seller the same kind of problem of proving lost profits that any such claims present for the buyer under CC §3343(a)(4). See §2.44.

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§2.53 3. Statutory Protection for Sellers of Residential Real Property

The Home Equity Sales Contract Act (Home Equity Act) (CC §1695-1695.17) contains a statutory scheme that provides certain protections and remedies, including a statutory right of rescission, to owner-occupants of one- to four-unit residential real property in foreclosure (against which a notice of default has been recorded) who enter into contracts for the sale of their residences. Transfers excluded from the Home Equity Act include sales in which the buyer acquires the residence for use as a personal residence, deeds in lieu of foreclosure, transfers pursuant to nonjudicial and judicial foreclosures, transfers pursuant to court order, and transfers to a spouse, blood relative, or blood relative of a spouse. CC §1695.1(a).

A seller may bring an action for the recovery of damages or equitable relief against the buyer for violation of the statutory provisions and is entitled to actual damages plus reasonable attorney fees. CC §1695.7. A seller may also be entitled to recover punitive damages if the court considers such an award to be proper. CC §1695.7. No waiver of the provisions of the Home Equity Act is enforceable against the seller. CC §1695.10.

The Home Equity Act also prohibits anyone to from initiating, entering into, negotiating, or consummating any transaction involving residential real property in foreclosure if such person, by the terms of the transaction, takes "unconscionable advantage" of the property owner. CC §1695.13. If a buyer is guilty of such unconscionable conduct, the seller may (by written notice to the buyer or a successor who is not a bona fide purchaser or encumbrancer) void the transaction and rescind the sale within 2 years of the date the deed to the property was recorded. CC §1695.14(a). The seller may bring an action to enforce the rescission and cancel the deed (CC §1695.13(b)) and is entitled to recover costs and reasonable attorney fees. CC §1695.14(d).

The Home Equity Act is to be interpreted liberally to effect its intent and achieve its purposes. *Segura v McBride* (1992) 5 CA4th 1028, 7 CR2d 436 (Act applied to buyer who was not in business of purchasing home equities in foreclosure and who was first approached by seller). However the Act may only protect a seller who actually deals with the buyer. *Handy v Shields* (1987) 190 CA3d 512, 235 CR 543 (seller whose signature was forged not entitled to protection of the Act).

For further discussion of the Home Equity Act, see California Real Property Remedies and Damages §1.22 (2d ed Cal CEB 2002).

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C. LITIGATION CONSIDERATIONS IN FRAUD ACTIONS

§2.54 1. Setoff

Real property transactions sometimes include arrangements in which the seller agrees to finance a portion of the purchase price, resulting in the buyer owing executory contractual obligations to the seller. Whether in the form of installment payments or other obligations, damages caused by failure to perform a promise may serve as a ground for a claim of setoff in a fraud action, even if those obligations do not arise from the same transaction and despite the expiration of the statute of limitations on the claim used as the setoff. See CCP §431.70.

A seller may claim as a setoff the unpaid and past-due payments that a defrauded buyer has not paid. The seller may not, however, set off unmatured payments. *Bagdasarian v Gragnon* (1948) 31 C2d 744, 764, 192 P2d 935. The rationale for the defense is that in seeking fraud damages, the defrauded party seeks to affirm the contract. *Pavlovich v Neidhardt* (1954) 128 CA2d 559, 561, 275 P2d 836.

WARNING: A buyer who stops payments to the seller based on an allegation of fraud risks finding itself "deeply in default" if fraud cannot be established. *Pavlovich v Neidhardt, supra.*

Other types of loss may serve as a basis for the setoff defense. *Sangster v Paetkau* (1998) 68 CA4th 151, 171, 80 CR2d 66. Thus, when a defrauded party, as the result of a tort of another, "is entitled to compensation for the reasonably necessary loss of time, attorney's fees, and other expenditures" (*Prentice v North Am. Title Guar. Corp.* (1963) 59 C2d 618, 620, 30 CR 821), such damages may constitute a basis for asserting them as a setoff (*Sangster v Paetkau*, *supra*). See also *Gray v Don Miller & Assocs.* (1984) 35 C3d 498, 507, 198 CR 551.

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§2.55 2. Mitigation

A defrauded party must attempt to mitigate its damages to the extent of the other party's nonperformance of the contract. *Kent v Clark* (1942) 20 C2d 779, 783, 128 P2d 868; *Paolini v Sulprizio* (1927) 201 C 683, 687, 258 P 380; *McCauley v Dennis* (1963) 220 CA2d 627, 632, 34 CR 90. A buyer, however, need not resell the property purchased because of its right to affirm the contract (*Harold v Pugh* (1959) 174 CA2d 603, 610, 345 P2d 112), but a resale can be a form of mitigation (see *Kruse v Miller* (1956) 143 CA2d 656, 300 P2d 855).

One court rejected the defendant's argument that the rent the plaintiff received was a means of mitigating damages. Because the action was not for rescission, the court felt that its hands were tied even though there might appear to be an element of unjust enrichment. *Birch v Ciria* (1962) 205 CA2d 1, 8, 22 CR 798. If a plaintiff proceeds to build on property without knowing the true facts (*e.g.*, presence of fill), it may reach a point when it would be unreasonable to require mitigation of damages by termination of (or change in) the building plans. *Gagne v Bertran* (1954) 43 C2d 481, 491, 275 P2d 15.

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§2.56 3. Rents

The buyer incurs no jeopardy by continuing to collect rent from the property after discovering the fraud. A buyer who sues for damages has elected to affirm the contract and is thus entitled to retain whatever benefits it offers. Although rescission does not constitute an affirmance, the buyer owes the seller rent as a condition of restitutionary relief, and collection of rents is thus consistent with the relief that will ultimately be granted in the action and is neither a waiver of a right nor an election of a remedy. See *Soderling v Tomlin* (1959) 170 CA2d 169, 174, 338 P2d 946.

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§2.57 4. Selling Property; Involuntary Foreclosure

A sale by the buyer for an equal or higher price before fraud is discovered seriously limits any recovery from the seller. The buyer has received the desired price and has therefore suffered no injury from the fraud. See *Donkin v Killefer* (1939) 32 CA2d 729, 732, 90 P2d 810. But if the next buyer sues the first buyer for repeating the earlier seller's misrepresentation, the first buyer then has a cause of action against that seller or can assign this cause of action to the second buyer. *Sixta v Ochsner* (1960) 187 CA2d 485, 487, 494, 9 CR 617; *Burkett v J. A. Thompson & Son* (1957) 150 CA2d 523, 526, 310 P2d 56. If the seller knows that the property will be resold, the ultimate purchaser may sue that seller directly. *Massei v Lettunich* (1967) 248 CA2d 68, 73, 56 CR 232.

A sale after discovery of fraud has a different effect. Because the buyer cannot restore the property to the seller, rescission is impossible, but an action for damages will survive. *Hancock v Williams* (1950) 99 CA2d 80, 82, 221 P2d 129. Further, if the defrauded plaintiff can negotiate better terms on the indebtedness against the property, the defrauding party is not entitled to the benefits of such arrangements. *Hancock v Williams, supra*. When the benefit should accrue to a seller, however, an adjustment in the award should be made. For example, in one case a seller foreclosed on a note secured by a deed of trust resulting in the elimination of further liability because of the antideficiency effects of CCP §580b. That reduction in liability was allocated to the defrauding seller in the computing of CC §3343 damages. *Garrett v Perry* (1959) 53 C2d 178, 185, 346 P2d 758.

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§2.58 5. Contract Performance

The position of a buyer who still owes performance under the executory provisions of a contract will not be prejudiced by the fact that he or she continues to perform under that contract. For example, if a buyer continues to make installment payments to the seller after discovery of the fraud, the buyer will not be estopped, held to have waived the fraud, or otherwise prejudiced by such payments. This rule is based on the principle that the affirmance of the contract in a damages suit requires the buyer to continue to make payments owed under the contract. *Bagdasarian v Gragnon* (1948) 31 C2d 744, 750, 192 P2d 935; *Williamson v Clapper* (1948) 88 CA2d 645, 653, 199 P2d 337. But if a defrauded buyer stops making payments, this default does not preclude a cause of action for the seller's fraud or a defense based on the seller's fraud. *Kent v Clark* (1942) 20 C2d 779, 783, 128 P2d 868; *Nevada Land & Inv. Corp. v Sistrunk* (1934) 220 C 174, 178, 30 P2d 389. In addition, a buyer who continues to make payments after giving notice of rescission can be justified in doing so as an attempt to avoid default and foreclosure rather than as a ratification of the fraud. *Hefferan v Freebairn* (1950) 34 C2d 715, 722, 214 P2d 386.

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§2.59 6. Real Estate Recovery Fund

Business and Professions Code §10471 allows a plaintiff to recover unsatisfied monetary judgments against real estate licensees from the Real Estate Recovery Fund. Recovery is limited to broker or agent transactions in which a real estate license is required. *Doyle v Department of Real Estate* (1994) 30 CA4th 893, 36 CR2d 193. Section 10471 was intended to protect the public from loss resulting from unsatisfied judgments against licensed real estate personnel arising from their fraud, misrepresentation, deceit, conversion, and breach of fiduciary duty. Thus, §10471 allows a recovery against the Real Estate Recovery Fund when a stipulated judgment is based on a single cause of action alleging fraud. *Doyle v Department of Real Estate*, *supra*. However, recovery may be denied when the stipulation for the entry of judgment pertains only to claims for professional negligence and breach of duty and does not specifically stipulate that fraud was committed. *Yergan v Department of Real Estate* (2000) 77 CA4th 959, 968, 92 CR2d 189.

PRACTICE TIP: Attorneys representing claimants against the Real Estate Recovery Fund should familiarize themselves with the requirements of §10471. Failure to satisfy the prerequisites will preclude recovery against the fund, which is difficult even in the best of circumstances.

For further discussion of recovery from the Real Estate Recovery Fund administered by the Department of Real Estate for unsatisfied judgments against real estate licensees, see California Real Property Sales Transactions §§2.164-2.170 (4th ed Cal CEB 2007); Approaching an Action Against a Real Estate Broker, step 35 (Cal CEB Action Guide August 2006).

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§2.60 VI. INSTALLMENT LAND SALE CONTRACTS

The remedies and damages available to buyers and sellers discussed above do not apply when the seller retains title to the real property sold only as security for amounts payable by the buyer in installments under the purchase agreement. Such a transaction is usually referred to as an installment land sale contract or a real property sales contract, which is defined in CC §2985.

Installment land sales contracts have been rarely used since the mid-1960s. Although title does not pass to the buyer until the final payment is made (*Glock v Howard & Wilson Colony Co*. (1898) 123 C 1, 55 P 713; *Post v Palpar, Inc.* (1960) 184 CA2d 676, 7 CR 823), the installment land sales contract is generally viewed as a financing device. See *Petersen v Hartell* (1985) 40 C3d 102, 219 CR 170. However, the usual creditor rights and debtor rights under a standard sale with the seller taking back a note and deed of trust may not be available to either the seller or buyer under an installment land sales contract. See *Petersen v Harrell, supra.*

When a buyer defaults under an installment land sale contract by failing to pay amounts due, whether willfully or otherwise, after having paid a substantial part of the purchase price or making substantial improvements to the property, the buyer has a right to redeem the property when the seller attempts to terminate the installment land sale contract. Redemption is accomplished by paying the balance of the purchase price due and other amounts due the seller under the contract. *Petersen v Harrell, supra*. When a buyer has defaulted under an installment land sale contract, the seller can only terminate the right of redemption by a *foreclosure* sale or by strict foreclosure, which is a judicial proceeding quieting the seller's title against the buyer's right of redemption (40 C3d at 115) or, if a power of sale is included in the installment land sale contract, a nonjudicial foreclosure sale under CC §§2924-2924h. If the seller does not take steps to terminate the right of redemption, the buyer may bring an action for redemption of the buyer's interest in the real property, but not an action for specific performance. 40 C3d at 116.

Although *Peterson* does not fully apply all the laws applicable to real property secured transactions to installment land sale contract transactions, until contrary authority is established it is advisable to analyze the damages and remedies available to both the buyer and seller under installment land sale contracts as if they are the borrower and lender under a secured real property transactions and not a buyer and seller under a standard purchase and sale agreement.

PRACTICE TIP: Today there is little reason to prefer an installment land sale contract over a note and deed of trust, and counsel should avoid using an installment land sale contract unless specific considerations of the parties require such a contract.

For a comprehensive discussion of installment sale contracts, see California Real Property Remedies and Damages §§4.27-4.28, 4.48-4.55 (2d ed Cal CEB 2002).

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3

Labor

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I. ACTIONS UNDER FEDERAL STATUTES
- A. Labor Management Relations Act of 1947
  - 1. Purpose and Structure §3.1
  - 2. Federal Preemption and Jurisdiction §3.2
  - 3. Unfair Labor Practices §3.3
  - 4. Procedure §3.4
  - 5. Awards to Employees
    - a. Partial Shutdown to "Chill Unionism" §3.5
    - b. Discrimination by Employer for Union Activity
      - (1) Restoration of Position and Back Pay §3.6
      - (2) What Constitutes Back Pay
        - (a) Inclusions §3.7
        - (b) Exclusions §3.8
        - (c) Reductions §3.9
        - (d) Period for Which Allowed §3.10
        - (e) Burden of Proof §3.11
        - (f) NLRB Rules on Back Pay §3.12
      - (3) Back Pay Calculated on Quarterly Basis §3.13
      - (4) Back Pay Under IRCA §3.13A
      - (5) Successor Employer §3.14
    - c. Employer's Refusal to Bargain §3.15
    - d. Employer Domination of Union §3.16
    - e. "Runaway Shops" §3.17
    - f. Unlawful Unilateral Activity §3.18
  - 6. Employer and Union Liability §3.19
  - 7. Awards to Employers
    - a. Union's Refusal to Bargain §3.20
    - b. Damage Actions Under §303 of LMRA §3.21
    - c. Actions for Breach of Collective Bargaining Agreement
      - (1) When Federal Law Applies §3.22
      - (2) Measure and Proof of Damages §3.23
- B. Labor-Management Reporting and Disclosure Act of 1959 §3.24
  - 1. Compensatory Damages §3.25
  - 2. Attorney Fees §3.26
  - 3. Punitive Damages §3.27
  - 4. Elections §3.28
  - 5. Cause of Action Against Employer §3.29
- C. Rehabilitation Act of 1973 §3.30
- D. Americans with Disabilities Act of 1990 §3.31
- E. Railway Labor Act §3.32
  - 1. Major and Minor Disputes §3.33
  - 2. Back Pay §3.34
  - 3. Attorney Fees §3.35
- F. Sherman and Clayton Antitrust Acts §3.36
  - 1. Examples §3.37
  - 2. Employers Exempt §3.38
- G. Fair Labor Standards Act of 1938 §3.39
  - 1. Exemptions §3.40
  - 2. Remedies §3.41
  - 3. Defenses §3.42
  - 4. Gender Discrimination §3.43
  - 5. Examples §3.44

6. Statute of Limitations §3.45
H. Age Discrimination in Employment Act §3.46
I. Veteran's Reemployment Rights §3.47
J. Title VII of Civil Rights Act of 1964
1. Prohibition of Discrimination in Employment §3.48
2. Back Pay Awards §3.49
a. Back Pay Formula §3.50
b. Back Pay Defined §3.51
c. Bona Fide Offers of Employment §3.52
d. Duplicate Pay §3.53
e. Front Pay §3.54
f. Mental Distress Damages §3.55
g. Prejudgment Interest §3.56
h. Good Faith §3.57
i. Equivalent Employment §3.58
j. Unemployment Benefits §3.59
3. Seniority §3.60
4. Exemplary Damages §3.61
5. Attorney Fees §3.62
6. Civil Rights Act of 1991 §3.63
7. Civil Rights Acts of 1866 and 1871 §3.64
K. Employee Retirement Income Security Act §3.65
1. Preemption of State Law §3.66
2. Coverage §3.67
3. Reporting and Disclosure §3.68
4. Damages §3.69
5. Remedies §3.70
6. Attorney Fees §3.71
7. Punitive Damages §3.72
8. Measure of Damages §3.73
9. Breach by Fiduciary §3.74
L. Walsh-Healey Act §3.75
M. Davis-Bacon Act §3.76
N. Federal Employee Protections
1. Federal Service Labor Management Relations Act §3.77
a. Employees' Grievances §3.78
b. Back Pay and Attorney Fees §3.79
2. First Amendment Rights and Political Activity §3.80
3. Privacy §3.81

II. ACTIONS UNDER CALIFORNIA STATUTES
A. Labor-Management Relations §3.82
B. Agricultural Labor Relations Act §3.83
C. Restraint of Trade Under Cartwright Act §3.84
D. Use of State Funds for Anti-Union Activities §3.84A
E. Timely Payment of Wages §3.85
1. Collective Bargaining Agreements §3.86
2. Wage Periods §3.87
3. Vacation Benefits §3.88
4. Meal and Rest Periods §3.88A
5. *Berman* Hearing §3.89
6. Enforcement §3.90
7. Labor Code Private Attorneys General Act of 2004 §3.90A
F. Indemnity for Work-Related Expenses or Losses §3.91
G. Illegal Termination of Employment §3.92
1. Statutory Wrongful Termination Claims §3.93
2. Public Employee Termination §3.94
3. Damages for Wrongful Termination
a. Contract Damages §3.95
b. Tort Damages §3.96
4. Exhaustion of Administrative Remedies §3.97
5. Additional Damages Claims in Wrongful Termination Cases §3.98
6. Privacy Rights §3.99
H. Equal Pay, Minimum Wage, and Overtime Pay

Provisions §3.100
I. Miscellaneous Statutes
1. Solicitation of Employees by Misrepresentation §3.101
2. Misrepresentation Concerning Former Employee §3.102
3. Interference With Employees' Political Activities §3.103
4. Commission Contracts by Out-of-State Employers §3.104
5. Fair Employment and Housing Act Damages §3.105

III. DAMAGE AWARDS IN ARBITRATION UNDER COLLECTIVE BARGAINING AGREEMENTS
A. Arbitration Favored by Courts §3.106
B. Computation of Damages §3.107
C. Union or Employee Grievances §3.108
D. Employer Grievance: Violation of Express or Implied No-Strike Commitment §3.109

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I. ACTIONS UNDER FEDERAL STATUTES

A. Labor Management Relations Act of 1947

§3.1 1. Purpose and Structure

Section 7 of the Labor Management Relations Act of 1947 (LMRA) (29 USC §157) establishes the following employees' rights:

> Employees shall have the right to self-organization, to form, join, or assist labor organizations, to bargain collectively through representatives of their own choosing, and to engage in other concerted activities for the purpose of collective bargaining or other mutual aid or protection, and shall also have the right to refrain from any or all of such activities except to the extent that such right may be affected by an agreement requiring membership in a labor organization as a condition of employment as authorized in [LMRA] section 8(a)(3) [29 USC §158(a)(3)].

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§3.2 2. Federal Preemption and Jurisdiction

A labor organization has a statutory duty of fair representation "to serve the interests of all members without hostility or discrimination toward any, to exercise its discretion with complete good faith and honesty, and to avoid arbitrary conduct." *Vaca v Sipes* (1967) 386 US 171, 177, 17 L Ed 2d 842, 850, 87 S Ct 903.

Federal courts have jurisdiction over disputes involving the duty of fair representation (see *Vaca* v *Sipes*, *supra*), even if the breach of the duty might also arguably constitute an unfair labor practice. *Breininger v Sheetmetal Workers Int'l* (1989) 493 US 67, 107 L Ed 2d 388, 110 S Ct 424. However, the federal courts do not gain jurisdiction simply because an employee uses the term "duty of fair representation." The employee must also allege facts that, if proven, will amount to a breach of the duty of fair representation. *Marquez v Screen Actors Guild* (1998) 525 US 33, 49, 142 L Ed 2d 242, 257, 119 S Ct 292.

When a state law tort action for unjust discharge is substantially dependent on analysis of the terms of a collective bargaining agreement, it is preempted by §301 of the Labor Management Relations Act (LMRA) (29 USC §185). *Allis-Chalmers Corp. v Lueck* (1985) 471 US 202, 85 L Ed 2d 206, 105 S Ct 1904.

For discussion of attempt to assert federal preemption of Govt C §§16645-16649 (use of state funds for anti-union activities), see §3.84A.

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§3.3 3. Unfair Labor Practices

Subsection 8(a)-(b) of the LMRA (29 USC §158(a)-(b)) proscribes specific acts, labeled "unfair labor practices," by employers and labor organizations respectively. The Supreme Court in *NLRB v Weingarten, Inc.* (1975) 420 US 251, 43 L Ed 2d 171, 95 S Ct 959, and *Garment Workers v Quality Mfg. Co.* (1975) 420 US 276, 43 L Ed 2d 189, 95 S Ct 972, ruled that the discharge of an employee for refusal to cooperate in an employer's investigatory interview violated National Labor Relations Act (NLRA) §8(a)(1) (29 USC §158(a)(1)) when the employee reasonably believed that the interview might result in disciplinary action against the employee and insisted on union representation. A "make whole" remedy might be appropriate in a *Weingarten* context, but only if the assertion of the *Weingarten* right to representation is the cause of the discipline. See *Pacific Tel. & Tel. Co. v NLRB* (9th Cir 1983) 711 F2d 134; *Taracorp Indus.* (1984) 273 NLRB 221 (both of which overrule in part *Kraft Foods, Inc.* (1980) 251 NLRB 598). See also *Communication Workers of Am. v NLRB* (7th Cir 1986) 784 F2d 847; *NLRB v Potter Elec. Signal Co.* (8th Cir 1979) 600 F2d 120; *NLRB v Illinois Bell Tel. Co.* (7th Cir 1982) 674 F2d 618.

NOTE: Concerning the right of employees who are not represented by a labor organization to have coworkers present during a disciplinary interview, the NLRB (after many reversals in policy) has returned to its earlier position that employers need not allow coworkers to be present, because the employer must be allowed to conduct the investigation "in a thorough, sensitive, and confidential manner." *IBM Corp.* (2004) 341 NLRB 1288.

Union officials are protected from discriminatory or selective disciplinary action based on union status by an employer under §8(a)(1) and (3) of the National Labor Relations Act (29 USC §158(a)(1), (3)). An employer may not discipline union officials more severely than other employees who violated a no-strike clause in the same manner unless the parties have agreed on a clause that imposes a higher standard of conduct on union officials. *Metropolitan Edison Co. v NLRB* (1983) 460 US 693, 75 L Ed 2d 387, 103 S Ct 1467 (in which all involved employees refused to cross another union's informational picket line). The Court observed that singling out union officers for more severe sanctions may deter qualified employees from seeking union office.

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§3.4 4. Procedure

Section 10(b) of the LMRA (29 USC §160(b)) outlines procedures for processing charges. The charge must be filed and served on the respondent party within 6 months of the conduct on which it is based.

Section 10(c) of the LMRA (29 USC §160(c)) establishes the sanctions available to the NLRB if it concludes that an unfair labor practice has occurred:

> [I]f upon the preponderance of the testimony taken the Board shall be of the opinion that any person named in the complaint has engaged in or is engaging in any such unfair labor practice, then the Board shall state its findings of fact and shall issue and cause to be served on such person an order requiring such person to cease and desist from such unfair labor practice, and to take such affirmative action including reinstatement of employees with or without back pay, as will effectuate the policies of this subchapter….

The order may further require "such person" to make reports from time to time showing the extent to which it has complied with the order, but "no order of the Board shall require the reinstatement of any individual as an employee who has been suspended or discharged, or the payment to him of any back pay, if such individual was suspended or discharged for cause." LMRA §10(c) (29 USC §160(c)).

The NLRB's orders are not self-enforcing. Under LMRA §10(e) (29 USC §160(e)), the NLRB must petition the appropriate federal court of appeals for enforcement of its orders.

Section 10(f) (29 USC §160(f)) is the reciprocal section of §10(e) and permits any "aggrieved" person to file a petition with the court of appeals for review of an NLRB order without waiting for the NLRB to petition for enforcement. The appropriate court for review of a final NLRB order is any federal circuit court of appeals in the circuit where the unfair labor practice was alleged to have occurred; where the petitioner resides or transacts business; or in the U.S. Court of Appeals for the District of Columbia. Section 10(f) (29 USC §160(f)).

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5. Awards to Employees

§3.5 a. Partial Shutdown to "Chill Unionism"

The remedies discussed in §§3.6-3.19, potentially involving millions of dollars and threatening the continued existence of a business entity, are imposed sparingly and will not be ordered when the employer has acted in good faith and on the basis of compelling economic reasons. *Renton News Record* (1962) 136 NLRB 1294. However, when the NLRB determines that the employer's motivation was to chill unionism, it has, with judicial approval, ordered far-reaching status quo ante remedies when one plant among several operated by the employer was shut down and subsequently dismantled. *Darlington Mfg. Co. v NLRB* (4th Cir 1968) 397 F2d 760. In *Darlington,* the employer was a group of commonly owned and controlled companies, and the NLRB's order required that the displaced employees be offered available employment at the employer's other plants, that their transportation expenses be paid, or, if work was unavailable, that they be placed on a preferential hiring list. The NLRB also ordered that the employees be made whole for loss of pay until they obtained substantially equivalent employment or were placed on the employer's preferential hiring list. See §§3.6-3.13 on back pay.

On the other hand, the United States Supreme Court has held that an employer has the absolute right to terminate an entire business enterprise at any time without bargaining with a union, regardless of the motive for doing so. *Textile Workers v Darlington Mfg. Co.* (1965) 380 US 263, 13 L Ed 2d 827, 85 S Ct 994. The court noted that (380 US at 270)

> a proposition that a single businessman cannot choose to go out of business if he wants to would represent such a startling innovation that it should not be entertained without the clearest manifestation of legislative intent or unequivocal judicial precedent so construing the Labor Relations Act.

The court distinguished between a full and partial closing, stating that a discriminatory lockout (380 US at 271)

> is a lever which has been used to discourage collective employee activities in the future. But a complete liquidation of a business yields no such future benefit for the employer if the termination is bona fide. It may be motivated more by spite against the union than by business reasons, but it is not the type of discrimination which is prohibited by the Act….

The Supreme Court distinguished between a full and partial closing of business not only on the basis of possible benefit to the employer from illegal conduct but also on the basis of remedies available to the NLRB (380 US at 275):

> Moreover, a possible remedy open to the Board in such a case [*i.e.,* a partial closing], like the remedies available in the "runaway shop" and "temporary closing" cases, is to order reinstatement of the discharged employees in the other parts of the business. No such remedy is available when an entire business has been terminated.

A shutdown of a single office of a larger enterprise is not unlawful under the NLRA unless the motivation was to chill unionism at other branches or offices of the business. *Bruce Duncan Co. v NLRB* (4th Cir 1979) 590 F2d 1304.

In response to *NLRB v Bildisco & Bildisco* (1984) 465 US 513, 79 L Ed 2d 482, 104 S Ct 1188, Congress enacted 11 USC §1113 prohibiting the unilateral rejection of a collective bargaining agreement by a debtor and trustees in bankruptcy.

On unlawful unilateral activities generally, see §3.18.

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b. Discrimination by Employer for Union Activity

§3.6 (1) Restoration of Position and Back Pay

The most common form of unfair labor practice by an employer, discrimination against employees for union activity, is prohibited by LMRA §8(a)(3) (29 USC §158(a)(3)). Section 8(b)(2) of the LMRA (29 USC §158(b)(2)) correspondingly forbids a union

> to cause or attempt to cause an employer to discriminate against an employee in violation of subsection (a)(3) [29 USC §158(a)(3)] of this section or to discriminate against an employee with respect to whom membership in such organization has been denied or terminated on some ground other than his failure to tender the periodic dues and the initiation fees uniformly required as a condition of acquiring or retaining membership.

When an employer discriminates on the basis of union activity, the NLRB will generally require the employees' restoration to the position previously held and restitution for lost pay. Back pay begins from the date of the employer's action and runs until an offer of full and unconditional reinstatement. *Crosset Lumber Co.* (1938) 8 NLRB 440. Even though the former employee's position has been filled by a permanent replacement (*NLRB v Mackay Radio & Tel. Co.* (1938) 304 US 333, 82 L Ed 1381, 58 S Ct 904), or the employee has subsequently acquired substantially equivalent employment elsewhere (*Phelps Dodge Corp. v NLRB* (1941) 313 US 177, 85 L Ed 1271, 61 S Ct 845), or he is engaged in fulltime employment at his own business (*Heinrich Motors, Inc. v NLRB* (2d Cir 1968) 403 F2d 145), the party against whom the NLRB order is directed is not relieved of the obligation to offer reinstatement with full back pay less interim earnings. Undocumented aliens, however, who are not legally authorized to work, are an important exception to the rule. *Hoffman Plastic Compounds, Inc. v NLRB* (2002) 535 US 137, 152 L Ed 2d 271, 122 S Ct 1275 (back pay would conflict with Immigration Reform and Control Act of 1986 (8 USC §1324a), although reinstatement may be ordered by NLRB contingent on the employee's obtaining documentation within reasonable time).

Reinstatement orders have been held to be inappropriate when the employee's conduct was so egregious that the work place could not accept his or her return. In *Precision Window Mfg. v NLRB* (8th Cir 1992) 963 F2d 1105, the court held that an employee wrongfully discharged for union activity forfeited his right to reinstatement by threatening to kill a supervisor and by lying under oath, claiming falsely that he had distributed union cards before his dismissal. But see *ABF Freight Sys., Inc. v NLRB* (1994) 510 US 317, 127 L Ed 2d 152, 114 S Ct 835 (wrongfully discharged employee reinstated with back pay despite false testimony under oath in unfair labor practice proceeding).

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(2) What Constitutes Back Pay

§3.7 (a) Inclusions

Included in back pay is all compensation that an employee who has been discriminated against would have received in connection with his or her previous employment had the employee remained employed for the period of the award, *e.g.,* overtime earnings lost (see *NLRB v Ellis & Watts Prod., Inc.* (6th Cir 1965) 344 F2d 67); bonuses (*NLRB v United States Air Conditioning Corp.* (6th Cir 1964) 336 F2d 275); renewal commissions on insurance policies (*NLRB v Phoenix Mut. Life Ins. Co.* (7th Cir 1948) 167 F2d 983); wage increases that were generally granted (*Richard W. Kaase Co.* (1967) 162 NLRB 1320); vacation pay (*Spitzer Motor Sales, Inc.* (1953) 102 NLRB 437).

Back pay awarded to employees who have been on strike may also include contributions that the employer would normally have made to a pension fund and hospital and medical expenses incurred that would have been reimbursed by the employer's health plan. *NLRB v Rice Lake Creamery Co.* (DC Cir 1966) 365 F2d 888. The employer may be required to include as back pay reimbursement for medical expenses improperly excluded from coverage under the employer's group plan (*Cone Bros. Contracting Co.* (1966) 158 NLRB 186) or reimbursement for medical expenses of a dependent who would have been covered under the employer's group plan (*Tennessee Packers, Inc.* (1966) 158 NLRB 1316). The NLRB has also included tips as part of wages normally earned by employees who were waitresses and car hops. *Home Restaurant Drive-In* (1960) 127 NLRB 635.

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§3.8 (b) Exclusions

Back pay does not include periods when the employee would not have worked even absent discrimination, such as a period during which the employee would have been laid off for economic reasons (see *NLRB v Carolina Mills, Inc.* (4th Cir 1951) 190 F2d 675) or a period of illness for which the employee had no sick leave benefits (*Harvest Queen Mill & Elevator Co.* (1950) 90 NLRB 320).

Strike benefits are not deducted from back pay awards unless receipt of such benefits interfered with the striking employees' efforts to obtain interim employment. *Madison Courier, Inc.* (1973) 202 NLRB 808, 82 LRRM 1667, on remand from (DC Cir 1972) 472 F2d 1307, 80 LRRM 3377.

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§3.9 (c) Reductions

Back pay is reduced by net earnings received by the individual from other employment and certain other sources (*F. W. Woolworth Co.* (1950) 90 NLRB 289) and by severance pay (*Hearst Consol. Publications, Inc.* (1939) 10 NLRB 1299). "Net earnings" from other employment are total earnings less expenses that the employee incurred in seeking or maintaining interim employment, *e.g.,* travel expenses, and commuting and living expenses while away from home that exceed normal expenses of these types. *Harvest Queen Mill & Elevator Co.* (1950) 90 NLRB 320.

Income received from federal or state work relief projects (see *Republic Steel Corp. v NLRB* (1940) 311 US 7, 85 L Ed 6, 61 S Ct 77) and any portion of a workers' compensation award intended to compensate for wages lost rather than for physical injury (*American Mfg. Co.* (1967) 167 NLRB 520) is deducted from back pay awards. However, back pay continues to accrue during the disability period. Any workers' compensation award intended as reparation for permanent physical injury is not deducted from the back pay award. *Aquinaga v United Food & Commercial Workers Int'l Union* (D Kansas 1989) 720 F Supp 862, 876, aff'd in part and rev'd in part (10th Cir 1993) 993 F2d 1463. Similarly, a state permanent disability award—unlike temporary disability payments—is not deducted from a back pay award. *Canova v NLRB* (9th Cir 1983) 708 F2d 1498. State unemployment benefits received during the period of the back pay award do not reduce back pay. *NLRB v Gullett Gin Co.* (1951) 340 US 361, 95 L Ed 337, 71 S Ct 337.

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§3.10 (d) Period for Which Allowed

While normally the period of back pay begins from the date on which the unfair labor practice occurred and extends to the date on which the aggrieved employee is reinstated in his former or an equivalent position (see *Phelps Dodge Corp. v NLRB* (1941) 313 US 177, 85 L Ed 1271, 61 S Ct 845), it is shortened or "tolled" if the employee refuses an unconditional offer of reinstatement (*Southwestern Pipe, Inc.* (1969) 179 NLRB 364) or if the employee makes himself unavailable for work or fails to exercise reasonable diligence in seeking interim employment (*NLRB v Brown & Root, Inc.* (8th Cir 1963) 311 F2d 447).

When employees lawfully strike an employer to protest the employer's unfair labor practices, the period of back pay commences with each employee's unconditional application to return to work (see *NLRB v Crosby Chems., Inc.* (5th Cir 1951) 188 F2d 91), or, when lay-offs have intervened due to the unavailability of work, the date on which recalls would be expected on the basis of seniority (*Robinson Freight Lines* (1960) 129 NLRB 1040). The period of back pay continues until the employer offers employees reinstatement to equivalent positions without imposing unlawful reemployment conditions or otherwise making such positions less attractive, *e.g.,* by reducing the paid number of hours of work per week (*NLRB v Kohler Co.* (DC Cir 1965) 351 F2d 798).

If the employer offers an unconditional reinstatement, the employee's acceptance must also be unconditional. If the acceptance is conditional, *e.g.,* subject to agreement to certain union proposals, the employee is not entitled to back pay. *NLRB v Beverage-Air Co.* (4th Cir 1968) 402 F2d 411.

Employees claiming back pay generally must make a reasonable effort to find other work or have deducted from the back pay award amounts of wage losses willfully incurred. *Phelps Dodge Corp. v NLRB, supra*.

On a union's liability to an employee for lost wages and benefits, see §3.19.

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§3.11 (e) Burden of Proof

The burden of proving that an employee seeking back pay failed to fulfill his duty to mitigate back pay by not exercising due diligence in searching for interim employment is on the employer. *NLRB v Brown & Root, Inc.* (8th Cir 1963) 311 F2d 447. However, the court acknowledged that when a strike occurred, the burden was on the NLRB to establish that nontestifying strikers had in fact applied for work and were discriminatorily refused reemployment. The court also established ground rules for back pay proceedings when the employee does not appear and thereby attempts to frustrate the employer's effort to show failure to mitigate by holding that no part of the back pay award should be disbursed to such an individual unless he appears within one year and testifies before the NLRB as to his interim wage-earning and job seeking activities.

What constitutes suitable interim employment depends on the individual's background and experience, as well as on the wages and working conditions of the interim job. For example, an employee need not search for or accept employment that is dangerous, distasteful, or essentially different from his or her regular job, or unreasonably distant from his or her home. The "lower sights doctrine," however, provides that after being unable, over a reasonable period, to locate the kind of employment to which he or she is accustomed, an employee may "lower his or her sights" and consider other suitable employment, even at a lower rate of pay, than his or her regular job, or outside the industry in which he or she is usually employed. See *NLRB v Madison Courier, Inc.* (DC Cir 1974) 505 F2d 391. An employee should begin looking outside his or her usual area of employment when it becomes apparent that employment in that field is not available. An employee who does not seek employment outside his or her customary field may not be entitled to back pay for the period after it becomes apparent that there is no work in the employee's usual field. However, "even under the 'lower sights' doctrine, the employee need not accept employment which is not consonant with his particular skills, background and experience, or which involves conditions that are substantially more onerous than his previous position." 505 F2d at 395. See *Kawasaki Motors Mfg. Corp. v NLRB* (9th Cir 1988) 850 F2d 524 (following *NLRB v Madison Courier, Inc., supra*).

An employer who asserts that jobs were not available to strikers entitled to reinstatement during the back pay period has the burden of proving this defense because the pertinent records are in its possession. *NLRB v Mastro Plastics Corp.* (2d Cir 1965) 354 F2d 170. In the same decision, the court was careful to point out that while the NLRB had the duty to produce the employee for testimony on interim job and wage activities, this does not shift the burden away from the employer to prove the employee's willful loss of pay.

When an employer raises the defense of an employee's failure to exercise due diligence in finding interim employment, the NLRB must examine the record as a whole and consider the particular facts of each individual employee. *NLRB v Rice Lake Creamery Co.* (DC Cir 1966) 365 F2d 888. The NLRB may not consider strikers as a single group for purposes of determining the adequacy of interim employment search efforts. *NLRB v Madison Courier, Inc., supra*.

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§3.12 (f) NLRB Rules on Back Pay

In *Mastro Plastics Corp.* (1962) 136 NLRB 1342 the NLRB set out the rules it applies in determining back pay for employees discriminatorily discharged. These include the following:

(1) An individual need only make the effort to find substantially equivalent employment, and the failure of search efforts is of no consequence.

(2) An individual who refuses to accept substantially equivalent interim employment or who after having secured such employment leaves it unjustifiably does not forever toll his or her back pay claim but rather loses an amount of back pay equivalent to what he or she would have earned if he or she had taken or held onto the interim employment.

(3) An individual may leave interim employment for justifiable reasons without tolling the back pay period, unless he or she would have left the employment from which he or she was discriminatorily discharged for the same reasons, in which case his or her back pay period would be considered terminated on his departure date.

(4) An individual who becomes self-employed during the interim is treated similarly to other employees and his or her net profits are treated as earnings from interim employment.

Reasonable minds differ, of course, with regard to the type and amount of effort necessary to meet the requirement of seeking with due diligence substantially equivalent interim employment. In one case, the NLRB concluded that an employee's failure to register with a government employment office and his placement of only six applications for work in 46 months constituted insufficient diligence. *Seamprufe, Inc.* (1953) 106 NLRB 1143. In another case, however, the NLRB found that an employee who had registered with the government employment office and the union and had shown up for union "work calls" had exercised reasonable diligence even though he had never sought work directly from private employers, because employers in his industry customarily hired only union applicants with union clearances. *Associated Gen. Contractors* (1957) 119 NLRB 663.

The concept of substantially equivalent employment has also created difficult problems for the NLRB, the courts, and employees. For example, an employee who voluntarily accepted reemployment at a lower paying and not substantially equivalent job with his previous employer who had violated the LMRA, even though his refusal to do so would not have jeopardized his back pay, and who thereafter unjustifiably quit, was held to have tolled his back pay period on the basis that while his new, lower paying job was not reinstatement to an equivalent position, it was interim employment deductible from back pay, and his resignation from it constituted willful loss of earnings. *NLRB v Aycock* (5th Cir 1967) 377 F2d 81.

Occasionally the courts impose a higher standard of conduct on an employee to mitigate back pay than the NLRB does. In *NLRB v Southern Silk Mills, Inc.* (6th Cir 1957) 242 F2d 697 it was held that two employees who were unsuccessful in finding substantially equivalent employment and who consequently were idle for three years should have sought and accepted lower paying work after a reasonable period of time, and that the NLRB should have reduced their back pay award accordingly.

Once an unfair labor practice charge is filed and litigated, back pay begins from the date of the unlawful conduct, notwithstanding interim NLRB or court decisions in favor of the charged party (*Golay & Co. v NLRB* (7th Cir 1971) 447 F2d 290) or even a reversal of NLRB policy after remand that results in a finding of violation on the same facts on which the employer had earlier been exonerated (*NLRB v A.P. W. Prods. Co.* (2d Cir 1963) 316 F2d 899).

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§3.13 (3) Back Pay Calculated on Quarterly Basis

With judicial approval, the NLRB calculates back pay on a quarterly basis. See *NLRB v Seven-Up Bottling Co.* (1953) 344 US 344, 97 L Ed 377, 73 S Ct 287. This protects the individual's social security and unemployment insurance rights because eligibility for these benefits is also determined on a quarterly earnings basis. Because each calendar quarter is calculated separately and without regard to any other quarter, the recipient of back pay may receive more total pay from a combination of back pay plus other net earnings than the recipient normally would have earned had he or she been at his or her previous employment for the full period for which back pay is being awarded. This results from the fact that when interim net earnings exceed back pay in any calendar quarter, no credit is allowed against the employer's back pay liability for any other calendar quarter in which net earnings were less than back pay.

Once the final back pay award figure is determined by totaling back pay liability and subtracting net earnings (see §3.6) for each quarter, interest is added at the rate of 6 percent per year. *Isis Plumbing & Heating Co.* (1962) 138 NLRB 716, rev'd on other grounds in *NLRB v Isis Plumbing & Heating Co.* (1963) 322 F2d 913. This amount, less normal payroll deductions, becomes the amount due if the order is directed against an employer solely or against an employer and union jointly and severally (see §3.19). However, payroll deductions are not made when the order is directed solely against a union (unless, of course, the union is the individual's employer) because employers are solely responsible for payroll taxes.

The interest rate is the "short-term federal rate" used by the IRS. See *New Horizons for the Retarded* (1987) 283 NLRB 1173.

Back pay claims directed by the NLRB are not entitled to priority status as a debt due the United States in bankruptcy proceedings. *Nathanson v NLRB* (1952) 344 US 25, 97 L Ed 23, 73 S Ct 80.

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§3.13A (4) Back Pay Under IRCA

In *Hoffman Plastic Compounds, Inc. v NLRB* (2002) 535 US 137, 152 L Ed 2d 271, 122 S Ct 1275, the Supreme Court held that undocumented workers who had used false documents to obtain employment were not entitled to back pay for unearned wages resulting from unfair labor practices, because the Immigration Reform and Control Act of 1986 (IRCA) (8 USC §§1101-1537) precluded them from asserting back pay claims. Under IRCA it is a crime for an employer to hire or employ an alien that the employer knows to be an unauthorized alien, or for an unauthorized alien to subvert the employer verification system by tendering false documents. *Hoffman* does not categorically rule out the recovery of wages by unauthorized aliens in all circumstances, and several courts have held that a prevailing wage claim may be brought by undocumented workers for work already performed. See *Reyes v Van Elk, Ltd.* (2007) 148 CA4th 604, 614, 56 CR3d 68. The Immigration Reform and Control Act of 1986 does not preempt California law that declares immigration status irrelevant to claims under state labor, civil rights, and employment laws. See Lab C §1171.5; CC §3339; Govt C §7285; *Reyes v Van Elk, Ltd., supra*.

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§3.14 (5) Successor Employer

The NLRB's authority to direct remedies for unfair labor practices against "successors and assigns" of the offending employer has long been recognized and approved by the Supreme Court. *Regal Knitwear Co. v NLRB* (1945) 324 US 9, 89 L Ed 661, 65 S Ct 478. Much less well established are criteria relevant to a determination of "successorship." After several reversals of policy, the NLRB returned to an earlier principle enunciated in *Alexander Milburn Co.* (1947) 78 NLRB 747, stating that when an employer has committed unfair labor practices under circumstances that should reasonably charge a later purchaser with notice of their existence and the purchaser continues to operate the business in basically the same form as it was previously operated, the purchaser and the seller will be held jointly and severally liable for remedying the seller's unfair labor practices. *Perma Vinyl Corp.* (1967) 164 NLRB 968, enforced, *United States Pipe & Foundry Co. v NLRB* (5th Cir 1968) 398 F2d 544.

In 1973 the United States Supreme Court again reviewed and reaffirmed the NLRB's *Perma Vinyl* policy of imposing reinstatement and back pay orders on a bona fide purchaser for the unfair labor practices committed by its predecessor. *Golden State Bottling Co. v NLRB* (1973) 414 US 168, 38 L Ed 2d 388, 94 S Ct 414. In *Golden State Bottling,* the court also held that Fed R Civ P 65(d) was not a bar to the enforcement of NLRB cease and desist orders against bona fide purchasers in addition to liabilities for back pay and reinstatement, an issue that had not been decided in *Regal Knitwear Co. v NLRB, supra*.

The successorship doctrine may have very far-reaching implications for the purchaser who acquires a business, as distinct from listed assets and liabilities, from an employer who has pending unfair labor practices charged against it or has failed to properly notify and bargain with a union regarding the impact of the sale on the employees. Under such circumstances the NLRB, with judicial approval, has ordered the purchaser to restore the wages and benefits provided by the seller and reimburse the employees for the losses resulting from unilateral changes. *Overnite Transp. Co.* (1966) 157 NLRB 1185, enforced (4th Cir 1967) 372 F2d 765.

Administratively, the NLRB has been held to have authority for summoning both the predecessor employer and successor employer before it to conduct an inquiry into the potential derivative liability of successor or alter ego employers for back pay remedies without initiating new unfair labor practice charges. *NLRB v C.C.C. Assocs., Inc.* (2d Cir 1962) 306 F2d 534. Such an inquiry will focus on the issues of the alleged successor's state of knowledge regarding the predecessor's unfair labor practices and the extent to which the predecessor's business operations have continued without substantial change or interruption. When the NLRB has imposed derivative liability on the successor, the Supreme Court, reaffirming the NLRB's authority to impose joint and several liability on the purchaser and seller, noted in *Golden State Bottling Co. v NLRB* (1973) 414 US 168, 187, 38 L Ed 2d 388, 404, 94 S Ct 414:

> [J]oint and several liability will more fully insure that the employee is fully recompensed by protecting him, e.g., against the insolvency of the successor. The possibility that the successor will unjustifiably delay reinstatement to the predecessor's prejudice can be met by a protective provision in the contract of sale.

NOTE: In the typical purchase and sale of a business, the buyer conducts a thorough due diligence examination of documents and personnel to determine the probability of unfair labor practice litigation resulting from the transaction. The parties will often insert into the agreement language apportioning liability between them in case of such litigation. In addition, in cases in which the seller may be judgment-proof or no longer in business following the sale, it may be necessary to include hold-back provisions freezing funds for the duration of the 6-month statute of limitations for filing unfair labor practice charges (29 USC §160(b); see §3.4).

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§3.15 c. Employer's Refusal to Bargain

An employer's refusal to bargain with a labor union is prohibited by LMRA §8(a)(5) (29 USC §158(a)(5)). When the NLRB has determined that an employer has refused to bargain, the usual remedy is to order the employer to cease and desist and, on the union's request, to commence collective bargaining on rates of pay, wages, hours, and other conditions of employment. However, the NLRB may not require the employer to adopt specific contract provisions over which it has unlawfully refused to bargain. *H.K. Porter Co. v NLRB* (1970) 397 US 99, 25 L Ed 2d 146, 90 S Ct 821. The NLRB, in addition to giving cease and desist orders, may also award damages as "make whole" compensation, at least in the District of Columbia. This was made explicit in *UAW v NLRB* (DC Cir 1971) 449 F2d 1046.

The *UAW v NLRB* court followed *International Union of Elec., Radio & Mach. Workers v NLRB* (DC Cir 1970) 426 F2d 1243, which sanctioned damages equal to the back wages that would have been paid if the company had bargained with the union and reached an agreement. This so-called *Tiidee Products* remedy (*Tiidee Prods., Inc.* (1972) 194 NLRB 1234, enforced as modified sub nom *Electrical Radio & Machine Workers v NLRB* (DC Cir 1974) 502 F2d 349) is available only if the employer flagrantly violates its duty to bargain. See *East Bay Chevrolet v NLRB* (9th Cir 1981) 659 F2d 1006, 1010; *Retail Clerks Union Local 1401 v NLRB* (DC Cir 1972) 463 F2d 316, 325.

In *United Steelworkers v NLRB* (5th Cir 1974) 496 F2d 1342, the Fifth Circuit acknowledged concern that a back wages award might violate NLRA §8(d) (29 USC §158(d)) by imposing contract terms on the employer, but it found §8(d) no obstacle to a "make whole" remedy that included a union's costs and expenses of a strike protesting an unfair labor practice, attorney fees and expenses, and organizing costs. The court found, however, that in this case the employer had not acted frivolously, and therefore the case was inappropriate for a damages award.

The Eighth Circuit has specifically allowed attorney fees in the court's discretion if the employer's refusal to bargain was wholly unjustified. *General Drivers & Helpers Union Local 554 v Young & Hay Transp. Co.* (8th Cir 1975) 522 F2d 562; *United Steelworkers v Butler Mfg. Co.* (8th Cir 1971) 439 F2d 1110. Note that, in the absence of statutory authorization or agreement to award attorney fees, the general rule is that attorney fees may be awarded against a litigant only in extreme circumstances. *Alyeska Pipeline Serv. Co. v Wilderness Soc'y* (1975) 421 US 240, 44 L Ed 2d 141, 95 S Ct 1612; *Seattle Times Co. v Seattle Mailer's Union* (9th Cir 1982) 664 F2d 1366, 1370 (LMRA does not specifically provide for an award of attorney fees); *National Ass'n of Letter Carriers v U.S. Postal Serv.* (DC Cir 1978) 590 F2d 1171. The extreme circumstances that may warrant the use of the court's inherent power to award attorney fees for bad faith litigation conduct include acts of the party as well as acts of the attorney. In *Chambers v Nasco, Inc.* (1991) 501 US 32, 115 L Ed 2d 27, 111 S Ct 2123, a television station owner was assessed attorney fees when he made a sham transfer of ownership in defiance of the court's order to maintain the status quo. See also *A-Z Int'l v Phillips* (9th Cir 2003) 323 F3d 1141. Further, the Civil Rights Attorney's Fees Awards Act of 1976 (42 USC §1988) permits an award of fees under the same standard as the Civil Rights Act of 1964. See *Perez v Rodriguez Bou* (1978) 575 F2d 21, 24.

The implications of the *Gissel* doctrine (*NLRB v Gissel Packing Co.* (1969) 395 US 575, 23 L Ed 2d 547, 89 S Ct 1918), which provides that certain unfair labor practices might warrant a bargaining order, have been further refined. In *Trading Port, Inc.* (1975) 219 NLRB 298, 89 LRRM 1565, the NLRB held that an employer's obligation under a bargaining order remedy begins when the employer embarks on a "clear course of unlawful conduct or has engaged in sufficient unfair labor practices to undermine the union's majority status." 219 NLRB at 301.

Cognizant of the limitations placed on it by such cases as *H.K. Porter Co. v NLRB, supra,* the NLRB in fashioning meaningful remedies has augmented its standard cease and desist orders by requiring the offending party to reimburse both the charging party and the NLRB for the expenses incurred in the investigation, preparation, and presentation of the matter at the NLRB and court levels when "clear and flagrant violations of the law" are present. See *Tiidee Prods., Inc.* (1972) 194 NLRB 1234, supplementing (1969) 174 NLRB 705. Expenses include such items as reasonable attorney fees, salaries of NLRB staff, witnesses' fees, and cost of transcripts, stenographic services, printing, and travel.

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§3.16 d. Employer Domination of Union

When an employer has dominated a union in violation of LMRA §8(a)(2) (29 USC §158(a)(2)), the NLRB normally will disestablish the union and bar the employer from further dealings with it until the union has been officially certified by the NLRB as the employees' majority bargaining representative. *James R. Kearney Corp.* (1949) 81 NLRB 26. If the employer has deducted union dues and initiation fees pursuant to check-off arrangements with an unlawfully dominated union, it may be required to reimburse employees for such deductions. *Plumbing & Pipefitters Local 231* (1956) 115 NLRB 594. The United States Supreme Court later tempered the NLRB's use of this remedy by requiring it to establish that such deductions were coerced, and held that absent a showing of coercion the NLRB's remedy was essentially punitive in effect and therefore beyond its power. *United Brotherhood of Carpenters v NLRB* (1961) 365 US 651, 6 L Ed 2d 1, 81 S Ct 875. See also *Shepard v NLRB* (1983) 459 US 344, 74 L ED 2d 523, 103 S Ct 665.

The NLRB may also require that any agreement between the employer and the union be terminated. *International Ass'n of Machinists v NLRB* (1940) 311 US 72, 85 L Ed 50, 61 S Ct 83.

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§3.17 e. "Runaway Shops"

Far-reaching orders have been employed by the NLRB in "runaway shop" situations when it finds a violation of LMRA §8(a)(3) (29 USC §158(a)(3)). The NLRB has required employers to offer employees payment of moving expenses from the old to the new location or transportation costs between the old and new locations. *J. Klotz & Co.* (1939) 13 NLRB 746. When the employer has changed the nature of the business in the process of relocating so that reemployment of the displaced employees is not feasible, the NLRB may require that back pay (see §§3.6-3.13) be paid to the employees until they find other substantially equivalent employment. *Bonnie Lass Knitting Mills, Inc.* (1960) 126 NLRB 1396.

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§3.18 f. Unlawful Unilateral Activity

Employers who have unilaterally made unscheduled changes in wages, hours, or working conditions without bargaining with a union under LMRA §8(a)(5) (29 USC §158(a)(5)) may be ordered, in addition to bargaining with the union, to cease and desist from unilaterally changing wage rates or instituting merit increases and to reimburse the affected employees for losses they have incurred. *NLRB v Katz* (1962) 369 US 736, 8 L Ed 2d 230, 82 S Ct 1107. In *Katz,* the Supreme Court held that the NLRB was warranted in finding unilateral action to be a violation of the statutory duty to bargain without the necessity of also finding the employer guilty of overall subjective bad faith. Unfair labor practices of this type are characterized as "per se violations."

Less frequent but more dramatic in impact are NLRB orders directing employers who have taken unlawful unilateral action in violation of §8(a)(5), such as subcontracting work normally performed by affected employees or partially terminating a plant operation, to restore the status quo ante. This may include reinstituting the terminated operations and reinstating with back pay (see §§3.6-3.13) employees who were displaced by the unlawful unilateral action. *Fibreboard Paper Prods. Corp.* (1962) 138 NLRB 550, enforced, *Machinists Local 1304 v NLRB* (DC Cir 1963) 322 F2d 411, aff'd, *Fibreboard Paper Prods. Corp. v NLRB* (1964) 379 US 203, 13 L Ed 2d 233, 85 S Ct 398.

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§3.19 6. Employer and Union Liability

Section 10(c) of the LMRA (29 USC §160(c)) states that "where an order directs reinstatement of an employee, back pay may be required of the employer or labor organization, as the case may be, responsible for the discrimination suffered by him."

Notwithstanding the statutory disjunctive, the NLRB does not apportion liability for back pay (see §§3.6-3.13) between employers and labor organizations when both are found to be in violation of the act; rather, it directs its order against them jointly and severally. *Union Starch & Refining Co. v NLRB* (7th Cir 1951) 186 F2d 1008. The NLRB does not apportion responsibility for back pay even when the employer was coerced into the discriminatory act by the union. *NLRB v Pinkerton's Nat'l Detective Agency, Inc.* (9th Cir 1953) 202 F2d 230. After a joint and several order against an employer and a union for back pay, the NLRB may hold the union for the full amount when the employer becomes insolvent. *NLRB v Acme Mattress Co.* (7th Cir 1951) 192 F2d 524.

In cases in which the union and the employer are jointly charged, a union may limit its liability by notifying the employer that it has no objection to the reinstatement of the employee, and requesting that the employee be reinstated and that the employer make the employee whole for losses of wages and benefits until the employee is reemployed or obtains substantially equivalent employment. *Local 595, Int'l Ass'n of Bridge, Structural & Ornamental Iron Workers* (1954) 109 NLRB 73. In addition, a union may be directed to refund fines it unlawfully imposed on members who worked behind a sister union's picket line as a remedy for the union's unlawful secondary boycott. *Bricklayers & Masons Local No. 2* (1967) 166 NLRB 117.

When the union is solely responsible for an act of discrimination against an employee resulting in the loss of his or her job and the NLRB's order is therefore directed only against the union, the order may not direct reinstatement because the union (unless it is also the employer) has no power to force the employer to reinstate the individual. However, the NLRB order may direct the union to advise the employer that it is withdrawing any objections it may have had to the individual's employment or reinstatement without prejudice to seniority or other rights or benefits, and the union will be held liable for the full back pay award. *Teamsters Local 249* (1956) 116 NLRB 399. In cases in which the union alone is charged, its liability for lost wages and benefits suffered by the employee "includes all wages and benefits lost until the employee either is reinstated or obtains substantially equivalent employment elsewhere." *Sheet Metal Workers Int'l Ass'n Local 355 v NLRB* (1983) 716 F2d 1249, 1256.

Orders by the NLRB against employers and unions directing back pay are limited to cases in which the discriminatory conduct practiced by either directly affect an employee's job rights, resulting in lost wages to the employee. See *Ironworkers, Local 111* (1990) 298 NLRB 930, upheld in *Ironworkers, Local 111 v NLRB* (7th Cir 1991) 946 F2d 1264, 138 LRRM 2703 (union may be required to compensate employees for back pay when illegal union activity caused loss of pay).

A union that breaches its duty of fair representation by failing to pursue arbitration procedures on behalf of a wrongfully discharged union member is liable for the member's lost wages and benefits to the extent those damages are increased by the union's wrongful conduct. *Bowen v U.S. Postal Serv.* (1983) 459 US 212, 103 S Ct 588, 74 L Ed 2d 402. This rule is based on federal labor policy expressed in federal common law. *Bowen* follows and clarifies *Vaca v Sipes* (1967) 386 US 171, 177, 17 L Ed 2d 842, 850, 87 S Ct 903, which held that an employee who proves an employer violation and a union breach of the duty of fair representation may be entitled to damages from the union and employer with liability apportioned according to the damage caused by the fault of each.

A concurring and dissenting opinion in *Bowen* characterized the decision as holding that (459 US at 230, 74 L Ed 2d at 418):

> [a]n employer who wrongfully discharges an employee protected by a collective bargaining agreement with an arbitration clause is only responsible for back pay that accrues prior to the hypothetical date upon which an arbitrator would have issued an award had the employee's union taken the matter to arbitration.

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7. Awards to Employers

§3.20 a. Union's Refusal to Bargain

Union refusals to bargain are less common than employer refusals (see §3.15) because bargaining is one of the principal activities of most unions. However, unions violate LMRA §8(b)(3) (29 USC §158(b)(3)) when they impose unreasonable conditions as a prerequisite to bargaining with an employer, *e.g.,* a performance bond (*Teamsters Local 294* (1949) 87 NLRB 972), or insist on illegal contract provisions (*National Maritime Union* (1948) 78 NLRB 971, overruled on other grounds in *International Ass'n of Machinists, Lodge 942* (1957) 119 NLRB 307, 308). On the other hand, it is not an unfair labor practice for a union to engage in harassing tactics during negotiations, *e.g.,* slowdowns and sit-down demonstrations, although these practices may be in violation of an existing collective bargaining agreement. *NLRB v Insurance Agents Int'l Unions* (1960) 361 US 477, 4 L Ed 2d 454, 80 S Ct 419.

When the NLRB concludes that a union has unlawfully refused to bargain, it usually orders the union to cease and desist from such conduct, but it lacks authority to award damages to an employer even if the union's unlawful refusal to bargain is coupled with a strike. *National Maritime Union, supra.* But an employer may recover damages for a strike in contravention of a contract. LMRA §301 (29 USC §185). See §§3.22-3.23.

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§3.21 b. Damage Actions Under §303 of LMRA

Section 303 of the LMRA (29 USC §187) permits recovery by an employer of damages and costs of suit from a union that engages in activity defined as an unfair labor practice in LMRA §8(b)(1)-(4) (29 USC §158(b)(1)-(4)), which proscribes and defines such conduct as "hot cargo" activities, secondary boycotts, and jurisdictional strikes. A damage action under §303 is totally independent of the NLRB's cease and desist remedies, and the prior filing of a charge is not a jurisdictional prerequisite for maintaining a §303 damage suit. *International Longshoremen's & Warehousemen's Union v Juneau Spruce Corp.* (1952) 342 US 237, 96 L Ed 275, 72 S Ct 235. However, when the damage action under §303 has been preceded by the filing of a charge and an NLRB decision finding a violation of §8(b)(1)-(4) has issued, the decision may be given res judicata effect in a subsequent §303 suit. *Painters Dist. Council No. 38 v Edgewood Contracting Co.* (5th Cir 1969) 416 F2d 1081. Generally, however, the courts have not accorded res judicata status to prior NLRB decisions. See, *e.g., Fibreboard Paper Prods. Corp. v Machinists Local 1304* (9th Cir 1965) 344 F2d 300; *Aircraft & Engine Maintenance Employees Local 290 v I. E. Schilling Co.* (5th Cir 1965) 340 F2d 286; *Brick & Clay Workers v Deena Artware, Inc.* (6th Cir 1952) 198 F2d 637. In practice, the courts frequently adopt the NLRB's findings of fact or at a minimum give such findings substantial weight.

A §303 damage action may be maintained by anyone who has been directly injured by the union's unlawful conduct. LMRA §303(b) (29 USC §187(b)); *Brick & Clay Workers v Deena Artware, Inc., supra*. In these actions the courts apply the common law tort measure of damages, *i.e.,* damages that are a direct and proximate result of the unlawful conduct (see *Carpenters Local 978 v Markwell* (8th Cir 1962) 305 F2d 38), except when a mixture of both lawful and unlawful conduct is involved and it is impossible to separate the respective effects of each, in which case total damages are recoverable (*UMW v Osborne Mining Co.* (8th Cir 1960) 279 F2d 716). If a union's conduct has not only violated §8(b)(4) but also has been violent, separate actions under both §303 and state law may be joined in a state or federal court. Federal preemption does not apply to damages recoverable under state law for violent conduct. See *San Diego Bldg. Trades Council v Garmon* (1959) 359 US 236, 3 L Ed 2d 775, 79 S Ct 773. Federal courts must apply federal law to the §303 action, but they may also exercise pendent jurisdiction over the state action for damages proximately caused by the violent conduct despite lack of diversity of citizenship (*UMW v Gibbs* (1966) 383 US 715, 16 L Ed 2d 218, 86 S Ct 1130). However, pendent jurisdiction is based on considerations of economy and is therefore discretionary with the court. It is not a plaintiff's right. *Lomax v Armstrong Cork Co.* (5th Cir 1970) 433 F2d 1277. See 28 USC §1367 (supplemental jurisdiction). See also *Executive Software N. Am., Inc. v U.S. Dist. Court* (9th Cir 1994) 24 F3d 1545 for discussions of pendent jurisdiction under *UMW v Gibbs, supra; Ortiz v U.S.* (1st Cir 1979) 595 F2d 65; *Brennan v Chestnut* (D Minn 1991) 777 F Supp 1469; *California Dep't of Water Resources v Powerex Corp.* (9th Cir 2008) 533 F3d 1087. For discussion of 28 USC §1367 and of supplemental, pendent, and ancillary jurisdiction generally, see California Civil Procedure Before Trial §7.33 (4th ed Cal CEB 2004).

The question of whether strikes and bargaining tactics interfere unlawfully with an employer's business must be answered by the NLRB, not by a state court. *Falls Stamping & Welding Co. v UAW* (6th Cir 1984) 744 F2d 521 (company brought suit in state court to recover damages for breach of contract during unauthorized strikes in 1975 and tortious interference with its business arising out of union's conduct in 1977 during negotiations for new contract).

Referring back to the statutory principles of restitution to the injured party rather than resorting to penalties against the wrongdoer, the United States Supreme Court has held that exemplary damages may not be awarded in a §303 action against a union's unlawful but peaceful conduct violating §8(b)(4). *Teamsters Local 20 v Morton* (1964) 377 US 252, 12 L Ed 2d 280, 84 S Ct 1253.

Damages are recoverable from a local union involved in illegal conduct but not from individual members. LMRA §301(h) (29 USC §185(h)). An international union may also be liable for damages if it participates in, directs, or encourages the local's illegal activity. *UMW v Patton* (4th Cir 1954) 211 F2d 742. Conversely, a union is not subject to a damage action under §303 for acts of individual members unless they were acting as agents of the union under ordinary agency principles. *International Longshoremen's & Warehousemen's Union v Hawaiian Pineapple Co.* (9th Cir 1955) 226 F2d 875.

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c. Actions for Breach of Collective Bargaining Agreement

§3.22 (1) When Federal Law Applies

The LMRA does not provide that the breach of a collective bargaining agreement by either an employer or a union is an unfair labor practice. However, subsections (a) and (b) of LMRA §301 (29 USC §185(a)-(b)) state:

> (a) Suits for violation of contracts between an employer and a labor organization representing employees in an industry affecting commerce as defined in this chapter, or between any such labor organizations, may be brought in any district court of the United States having jurisdiction of the parties, without respect to the amount in controversy or without regard to the citizenship of the parties.
>
> (b) Any labor organization which represents employees in an industry affecting commerce as defined in this chapter and any employer whose activities affect commerce as defined in this chapter shall be bound by the acts of its agents. Any such labor organization may sue or be sued as an entity and in behalf of the employees whom it represents in the courts of the United States. Any money judgment against a labor organization in a district court of the United States shall be enforceable only against the organization as an entity and against its assets, and shall not be enforceable against any individual member or his assets.

These provisions were intended to serve as a brake on the growing power of unions and to promote greater responsibility on their part by providing a means by which they could be sued for breach of no-strike commitments in collective bargaining agreements. S Rep No. 105, 80th Cong, 1st Sess, 17-18 (1947).

Federal or state law. The issue of whether substantive federal or state law should apply to §301 (29 USC §185) actions was decided in favor of federal law, "which the courts must fashion from the policy of our national labor laws." *Textile Workers Union v Lincoln Mills* (1957) 353 US 448, 1 L Ed 2d 972, 77 S Ct 912. The strong likelihood that concurrent jurisdiction of state and federal courts over §301 actions would lead to conflicting interpretations of collective bargaining agreements and thereby confuse and impede, rather than encourage, the negotiation of labor contracts led the United States Supreme Court to clearly establish the preeminence of federal law in §301 actions. *Teamsters Local 174 v Lucas Flour Co.* (1962) 369 US 95, 7 L Ed 2d 593, 82 S Ct 571. State courts have concurrent jurisdiction over an action to enjoin a strike that breaches a no-strike commitment, even though the violation may also violate LMRA §301. *William E. Arnold Co. v Carpenters Dist. Council* (1974) 417 US 12, 40 L Ed 2d 620, 94 S Ct 2069.

Conflicting decisions. Conduct that constitutes both an unfair labor practice (see §§3.3) and a breach of a collective bargaining agreement raises the danger of conflicting decisions by the NLRB and the courts. This danger was specifically confronted by the United States Supreme Court in *Vaca v Sipes* (1967) 386 US 171, 17 L Ed 2d 842, 87 S Ct 903, in which the high court held that a state court had jurisdiction to entertain a damage suit by a union member against his local union for failure to represent him fairly even though the same conduct was also found by the NLRB to be an unfair labor practice under the LMRA. The court went on to hold that a union was not liable to a member for damages unless it could be established that the union acted arbitrarily, discriminatorily, or in bad faith. In *Complete Auto Transit, Inc. v Reis* (1981) 451 US 401, 68 L Ed 2d 248, 101 S Ct 1836, the Supreme Court held that an employer could not bring a damages action against individual employees under LMRA §301(a) (29 USC §185) for violations of a contract no-strike commitment.

Arbitration. The NLRB may decline to assert its jurisdiction when it believes that federal labor policy will be better served by a judicial resolution. *Smith v Evening News Ass'n* (1962) 371 US 195, 9 L Ed 2d 246, 83 S Ct 267. The NLRB has announced a policy of deferring cases involving the possible breach of a collective bargaining agreement to the arbitration provisions contained in the agreement if they contain procedural safeguards that meet standards enunciated earlier in *Spielberg Mfg. Co.* (1955) 112 NLRB 1080, which guarantee a full and fair resolution of all relevant issues. See *Collyer Insulated Wire* (1971) 192 NLRB 837. See also *Local 715, IBEW v NLRB* (DC Cir 1974) 494 F2d 1136 for a full discussion of the policy announced in *Spielberg Mfg. Co.,* under which the NLRB defers to arbitration certain unfair labor practice complaints.

The NLRB will also defer to arbitration or decisions of joint union-employer committees if both parties agree, *Spielberg* standards are met, statutory interpretation will not be required, and procedures are fair and regular to all

participants. *Dubo Mfg. Corp.* (1963) 142 NLRB 431.

The NLRB may decline to defer to arbitration if the party requesting deferral has been dilatory in making its request. *New Jersey Bell Tel. Co.* (1992) 308 NLRB 277, 141 LRRM 1017. See *Falls Stamping & Welding Co. v UAW* (6th Cir 1984) 744 F2d 521, discussed in §3.21.

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§3.23 (2) Measure and Proof of Damages

In LMRA §301 (29 USC §185) breach of contract suits, the next best evidence may be used to measure damages when the best evidence has been destroyed. *Burlesque Artists Ass'n v Hirst Enters., Inc.* (3d Cir 1959) 267 F2d 414. However, an employer has been held not entitled to recover damages from a union when no records at all are introduced from which it could be determined that the strike in fact caused a loss in business operations. *United Textile Workers Local 120 v Newberry Mills, Inc.* (WD SC 1965) 238 F Supp 366.

When a union has been responsible for refusing to permit employees to perform as agreed under a collective bargaining agreement, with the result that the work is done less efficiently, the employer is entitled to reimbursement of wages paid to the employees idled as damages. See *Alcoa S.S. Co. v Conerford* (SD NY 1949) 17 CCH Lab Cas ¶65,480.

When the union is liable for damages caused by a strike and a subsequent refusal to arbitrate a labor dispute, the court may divide damages into two parts: damages during the strike, and prospective damages thereafter. Damages occurring during a strike include loss of profits plus the actual cost of operation or of maintaining the plant in readiness during the strike. *W.L. Mead, Inc. v Teamsters Local 25* (D Mass 1955) 129 F Supp 313. Lost profits may be computed on the basis of past experience. See *Roadway Express, Inc. v Highway Truck Drivers & Helpers Local 107* (ED Pa 1969) 299 F Supp 1058 (defendant union's motion for new trial or judgment notwithstanding verdict denied with opinion).

Overhead expenses incurred during a strike are recoverable as damages for violation of a no-strike commitment (*Structural Steel & Ornamental Iron Ass'n, Inc. v Shopmens Local 545* (D NJ 1959) 172 F Supp 354), and it is erroneous for the court to consider only increased costs rather than actual loss of profits in such an action (*Lewis v Benedict Coal Corp.* (6th Cir 1958) 259 F2d 346, aff'd and modified (1960) 361 US 459, 4 L Ed 2d 442, 80 S Ct 489).

The costs of a suit brought under LMRA §301 have been held to be nonrecoverable because there is no provision for such recovery in the Act. *Upholsterers v Star Upholstery & Mfg. Co.* (WD Pa 1960) 39 CCH Lab Cas ¶66,414.

It is generally held that federal courts lack jurisdiction to award exemplary damages in breach of contract actions under §301 on the basis that Congress intended to limit recovery to restitutionary damages. *Shoeworkers Local 127 v Brooks Shoe Mfg. Co.* (3d Cir 1962) 298 F2d 277. However, there is precedent for award of exemplary damages in a case in which the defendant has engaged in sufficiently egregious and repeated acts that the court concludes that exemplary damages will be required for their abatement. *Sidney Wanzer & Sons v Teamsters Local 753* (ND Ill 1966) 249 F Supp 664.

For an unlawful one-day work stoppage, a court may allow as alternative measures of damages either the amount by which the day's profits fell below a normal day's profits, or the direct expenses and percentage of fixed expenses that generated no revenue because of the stoppage. *Foam & Plastics Div., Tenneco Chem. v General Drivers & Helpers Local 401* (3d Cir 1975) 520 F2d 945. In this case, the latter method of calculating damages was inappropriate because the strikers were replaced and the employer could not show any loss of production.

The courts have also permitted future damages extending beyond the term of the contract when the injured party could establish that a strong likelihood that future contracts and future employment existed and had been unlawfully terminated by defendant's breach. *Richardson v Communications Workers* (8th Cir 1971) 443 F2d 974.

Damages for mental distress are generally not allowed under LMRA §301. See *Richardson v Communications Workers, supra*.

Standard mitigation rules (see §1.41) apply to LMRA §301 actions. The party seeking damages is under a duty to act to minimize damages and may not recover for losses due to unreasonable delays in recommencing work after the breach. *Alcoa S.S. Co. v Conerford, supra*.

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§3.24 B. Labor-Management Reporting and Disclosure Act of 1959

In 1959 Congress amended certain existing statutory provisions (*i.e.,* 29 USC §§153, 158-160, 164, 186-187) of the LMRA and also added a number of provisions that are contained in 29 USC §§401-531. (See Historical Note to 29 US Code Anno §401, West Publishing Co. (1965), for details on the amended and added provisions.) These amendments and added provisions are known as the Labor-Management Reporting and Disclosure Act of 1959 (LMRDA) or more commonly as the Landrum-Griffin Labor Reform Act. Liability for civil damages, principally on the part of the unions, discussed below, can result from engaging in certain types of conduct prohibited by the act.

Section 101 of LMRDA (29 USC §411) provides a bill of rights for members of labor organizations: Discrimination among union members regarding rights and privileges is prohibited; members have the right of free speech; dues may not be increased nor assessments levied without membership approval; and disciplinary action against a member, *i.e.,* expulsion, fines, or suspension, is subject to certain due process protections. Section 102 of LMRDA (29 USC §412) provides for civil action to obtain appropriate relief in a United States district court by an individual deprived of his or her rights. Under §101(a)(4) of LMRDA (29 USC §411(a)(4)), a union member may be required to exhaust internal union procedure for up to four months before seeking judicial relief. But the Supreme Court has held that a court or agency may determine if the union's internal procedure was reasonable and, if it was not, the court or agency may entertain the complaint without exhaustion of the union's procedures. *NLRB v Marine & Shipbuilding Workers* (1968) 391 US 418, 20 L Ed 2d 706, 88 S Ct 1717.

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§3.25 1. Compensatory Damages

Compensatory damages are recoverable, *e.g.,* for improper removal from union office (*Sands v Abelli* (SD NY 1968) 290 F Supp 677), for suspension from membership for insubstantial reasons (*Simmons v Avisco Textile Workers Local 713* (4th Cir 1965) 350 F2d 1012), and for wrongful imposition of fines (*Boilerwakers Local 445 v Terry* (5th Cir 1968) 398 F2d 491).

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§3.26 2. Attorney Fees

The holding in *Gartner v Soloner* (3d Cir 1967) 384 F2d 348, that attorney fees are recoverable in suits under the Labor-Management Reporting and Disclosure Act of 1959 (LMRDA) §412 was adopted by the Ninth Circuit in *Kerr v Screen Extras Guild, Inc.* (9th Cir 1972) 466 F2d 1267. In a footnote the court commented that the clear trend since *Gartner* has been to allow the trial court discretion to award attorney fees to successful plaintiffs. See also *Southerland v ILWU Local 8* (9th Cir 1987) 845 F2d 796. There is, however, a conflict on the question of punitive damages. *International Bhd. of Boilermakers v Braswell* (5th Cir 1968) 388 F2d 193 (punitive damages recoverable); *Cole v Hall* (ED NY 1964) 35 FRD 4 (punitive damages not recoverable). See also §3.27.

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§3.27 3. Punitive Damages

The trend is to allow punitive damages if actual malice or wanton indifference to the rights of the injured party is shown. *Morrissey v National Maritime Union* (2d Cir 1976) 544 F2d 19, 24; *Cooke v Orange Belt Dist. Council of Painters 48* (9th Cir 1976) 529 F2d 815, 820; *Berg v Watson* (SD NY 1976) 417 F Supp 806, 813; *Sipe v Local 191, United Bhd. of Carpenters & Joiners* (MD Pa 1975) 393 F Supp 865, 871. Punitive damages may be awarded against both the union and its officials who act with malice or ill will toward a union member and violate a union member's rights under the LMRDA. *Quinn v DiGiulian* (DC Cir 1984) 739 F2d 637. See also *Bender v Teamsters Local 63* (9th Cir, Dec. 23, 1991) 1991 US App Lexis 30601.

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§3.28 4. Elections

In *Local 82, Furniture & Piano Moving v Crowley* (1984) 467 US 526, 81 L Ed 2d 457, 104 S Ct 2557, the Supreme Court ruled that the Secretary of Labor has the exclusive authority to supervise new elections under Title IV of LMRDA. The Court also ruled that a preliminary injunction and order declaring the interrupted election invalid and setting forth detailed procedures to be followed in a new election was not an "appropriate" remedy for a suit under Title I of LMRDA filed during the course of an election. Thus, if the remedy sought is invalidation of an election already being conducted, union members must pursue the remedies provided in Title IV of the Act. If less intrusive remedies are sought during an election, then the district court may retain jurisdiction to order other appropriate relief under Title I.

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§3.29 5. Cause of Action Against Employer

The Labor-Management Reporting and Disclosure Act of 1959 does not create a cause of action against an employer even when it conspired with a union to violate an employee's statutory rights. *Duncan v Peninsula Shipbuilders Ass'n* (4th Cir 1968) 394 F2d 237.

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§3.30 C. Rehabilitation Act of 1973

Litigation has been extensive under §504 of the Rehabilitation Act of 1973 (29 USC §794), which prohibits employers receiving federal funds from discriminating against otherwise qualified individuals on account of physical disability. A private right of action exists to enforce the statute. See *Consolidated Rail Corp. v Darrone* (1984) 465 US 624, 79 L Ed 2d 568, 104 S Ct 1248; *Mustafa v Clark County Sch. Dist.* (9th Cir 1998) 157 F3d 1169, 1174. However, Health and Human Services administrative remedies should be exhausted before a lawsuit is filed. See 45 CFR pt 84. Affirmative remedies, including "make whole" relief, are available. *Gurmankin v Costanzo* (ED Pa 1976) 411 F Supp 982. Although the U.S. Supreme Court has not addressed the issue, one state court has held that exemplary damages may not be awarded. *Silverstein v Sisters of Charity* (Colo Ct App 1976) 559 P2d 716. See also *Witbeck v Embry-Riddle Aeronautical Univ., Inc.* (MD Fla 2003) 269 F Supp 2d 1338, 1340.

Under §504, a cause of action for employment discrimination has been found to exist even when the primary objective of the federal financial assistance was not to provide employment. *Consolidated Rail Corp. v Darrone, supra*. Further, a federal district court in New York has ruled that an employer's employees and officers may be sued in their individual capacities under §504, rejecting a contention that only a "recipient" of federal funding can be sued and that §504's regulations do not define employees and officers as "recipients." The court went on to say that it does not necessarily follow from the statutory reference to "recipients" that agents are not liable for discriminatory policies carried out by a recipient of funding. Section 504 does not speak of discrimination by a recipient, but instead forbids discrimination under federally funded programs or activities. *Chaplin v Consolidated Edison Co.* (SD NY 1984) 587 F Supp 519.

Despite the recognition of a private right of action under §504 of the Rehabilitation Act, several courts of appeal have concluded that neither the legislative history, nor the Rehabilitation Act in general, supports the inference of congressional intent to create a private right of action under §503 of the Act (29 USC §793), which requires that government contracts contain affirmative action covenants in favor of handicapped individuals. See *Meyerson v Arizona* (9th Cir 1983) 709 F2d 1235, overruled on other grounds (after being remanded by the Supreme Court) in *Meyerson v Arizona* (9th Cir 1984) 740 F2d 684; *Davis v United Air Lines, Inc.* (2d Cir 1981) 662 F2d 120; *Simpson v Reynolds Metals Co.* (7th Cir 1980) 629 F2d 1226; *Rogers v Frito-Lay, Inc.* (5th Cir 1980) 611 F2d 1074.

Moreover, the Rehabilitation Act's comprehensive administrative scheme for enforcing mandatory affirmative action clauses regarding handicaps in federal contracts under §503 (29 USC §793) has been held to preempt a handicapped individual's state law claim as a third party beneficiary against a federal contractor for alleged breach of the affirmative action clause in the contract between the contractor and the federal government. *Howard v Uniroyal, Inc.* (11th Cir 1983) 719 F2d 1552. Thus, the Department of Labor appears to be the only appropriate plaintiff in an action brought under §503.

Under 29 USC §794(d), the standards used to determine whether the Rehabilitation Act has been violated are the standards applied under the Americans with Disabilities Act of 1990 (42 USC §§12201-12204, §§12210-12213) (see §3.31).

Under the Civil Rights Act of 1991 (Pub L 102-166, 105 Stat 1072), compensatory and punitive damages are available in cases of intentional discrimination. See 42 USC §1981a.

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§3.31 D. Americans with Disabilities Act of 1990

The Americans with Disabilities Act of 1990 (ADA) (42 USC §§12101-12213) was enacted to address the problem of discrimination that individuals with disabilities face in such areas as employment, housing, voting, education, and public services. See 42 USC §12101. Only those aspects of the law relative to employment will be discussed here.

Under 42 USC §§12111-12112, an employer, employment agency, labor organization, or joint labor-management committee may not discriminate against any qualified individual with a disability in regard to any term, condition, or privilege of employment. All aspects of employment are covered, including the application and hiring process, job training, advancement, wages, benefits, and other terms, conditions, and privileges of employment. Many of the standards of discrimination set out in regulations implementing §504 of the Rehabilitation Act of 1973 (29 USC §794) are incorporated into the ADA, including the obligation to provide reasonable accommodations unless to do so would result in an undue hardship on the operation of the business. See 42 USC §12112(b)(5)(A).

States are not immune from actions in federal court for violation of the ADA. 42 USC §12202. Public-sector employers should also take note of 42 USC §§12131-12134, prohibiting discrimination in all programs, activities, and services provided or made available by state and local governments, whether or not such entities receive federal financial assistance.

Miscellaneous provisions in the ADA include:

(1) A construction clause explaining the relationship between provisions in the ADA and provisions of other federal and state laws (42 USC §12201);

(2) A prohibition against retaliation (42 USC §12203);

(3) Authority to award attorney fees (42 USC §12205);

(4) A nonexhaustive list of disorders that are not considered disabilities under the ADA (42 USC §12211);

(5) A statement that persons using illegal drugs are not protected by the ADA; however, a person who has been successfully rehabilitated and is no longer a user of illegal drugs is covered by the definition of "disability" (42 USC §12210; see also 42 USC §12114);

(6) A statement that employers have a right to conduct drug tests or take reasonable actions to ensure that an individual participating in, or having completed, a drug rehabilitation program is no longer using illegal drugs, as long as the drug testing does not violate the Act (42 USC §12210; see also 42 USC §12114);

(7) Amendments to 29 USC §706 of the Rehabilitation Act of 1973 regarding alcohol and drug use consistent with (5) and (6), above.

The Act applies to all employers, including state and local governments, who employ a minimum of 15 employees. 42 USC §12111.

Two methods of enforcement regarding employment discrimination are set out by the ADA: administrative and judicial actions brought by the Equal Employment Opportunity Commission (EEOC) or the Attorney General, and private judicial action. The powers, remedies, and procedures available to persons discriminated against on the basis of disability are the same as those available to persons discriminated against due to their race, color, religion, sex, or national origin. 42 USC §12117.

Under the Civil Rights Act of 1991 (Pub L 102-166, 105 Stat 1072), compensatory and punitive damages are available in cases of intentional discrimination. See 42 USC §1981a.

The ADA is not preempted by the National Labor Relations Act. *Smith v National Steel & Shipbuilding Co.* (9th Cir 1997) 125 F3d 751.

On disability discrimination under FEHA, see Govt C §12940; Wrongful Employment Termination Practice §§2.78-2.80 (2d ed Cal CEB 1997).

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§3.32 E. Railway Labor Act

The Railway Labor Act (45 USC §§151-163, 181-188) regulates the relationships among carriers (railroads and airlines), their employees, and labor unions. Damages result principally from the failure of an employer to observe the provisions of a collective bargaining contract and from a union's failure to represent its members adequately. The Act guarantees employees the right to organize; although such rights must be enforced in the courts, the willful failure of employers to afford such rights is punishable by fine or imprisonment. 45 USC §152.

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§3.33 1. Major and Minor Disputes

Disputes over which the Railway Labor Act has jurisdiction have been classified as major and minor. Major disputes concern the inability of employers and unions to reach agreement over the terms and conditions of employment. Such disputes do not normally give rise to damages. Minor disputes are essentially the same as labor contract grievances arising between parties subject to the LMRA. See *Elgin, Joliet & E. Ry. v Burley* (1945) 325 US 711, 89 L Ed 1886, 65 S Ct 1282 (adhered to after rehearing at 327 US 661, 90 L Ed 928, 66 S Ct 721); *English v Burlington Northern R.R. Co.* (9th Cir 1994) 18 F3d 741. The Act provides for a multistep procedure between the parties to settle disputes. The final stage is submission to the National Railroad Adjustment Board in the case of railroads (see 45 USC §153) or to the appropriate System Board of Adjustment for each carrier in the case of airlines (see 45 USC §184). These tribunals may order damages in the form of back pay awards for discharge, suspension, or other actions in violation of a labor agreement. See *Cottrell v Gulf, M. & O.R.R.* (SD Ala 1971) 321 F Supp 1401. Awards of the adjustment boards are enforceable by the federal district courts. 45 USC §159. If a carrier does not comply with an order of a division of the adjustment board and suit is brought to enforce the order in the courts and the petitioner finally prevails, "he shall be allowed a reasonable attorney's fee, to be taxed and collected as a part of the costs of suit." 45 USC §153(p). The scope of review of these awards is narrowly drawn and the courts may not redetermine the amount of damages awarded by the adjustment board. *Brotherhood of Railroad Trainmen v Denver & Rio Grande W.R.R.* (10th Cir 1966) 370 F2d 833. Although previously employees were permitted to bring an individual suit on their own behalf based on a contract violation, resort to the adjustment procedures provided in the Act is now the exclusive remedy for wrongful discharge. *Andrews v Louisville & N.R.R.* (1972) 406 US 320, 32 L Ed 2d 95, 92 S Ct 1562. See also *Edelman v Western Airlines, Inc.* (9th Cir 1989) 892 F2d 839, 842. The railroad adjustment board has wide latitude in framing awards and need not deduct mitigating amounts in back pay awards. See *Brotherhood of Railroad Trainmen v Central of Georgia Ry.* (5th Cir 1969) 415 F2d 403.

The Railway Labor Act's scheme of administrative grievance procedures and remedies has been held to preempt a federal district court's pendent jurisdiction when the employee's claim is arguably governed by the collective bargaining agreement and when the gravamen of the complaint is wrongful discharge. See, *e.g., Saridakis v United Airlines* (9th Cir 1999) 166 F3d 1272 (RLA preempted claim for intentional infliction of emotional distress). See also *Allen v United Transp. Union* (8th Cir 1992) 964 F2d 818 (because claim required interpretation of collective bargaining agreement, Railway Labor Act preempted claim that union and railroad made fraudulent misstatements about seniority rights to induce employees to accept positions with railroad). However, the RLA does not preempt state tort claims for discharge in violation of public policy. See *Hawaiian Airlines, Inc. v Norris* (1994) 512 US 246, 129 L Ed 2d 203, 114 S Ct 2239.

A controversy is deemed to be a minor dispute if the action is arguably justified by the terms of the parties' collective bargaining agreement, and a major dispute if the employer's claims are frivolous or obviously insubstantial. *Consolidated Rail Corp. v Railway Labor Executives Ass'n* (1989) 491 US 299, 109 S Ct 2477, 105 L Ed 2d 250 (railroad's inclusion of urinalysis drug screening in certain employee physical examinations "arguably justified" under "relatively light burden" railroad bears in establishing exclusive arbitral jurisdiction; discusses *Elgin, Joliet & E. Ry. v Burley*, *supra*). See *Hawaiian Airlines, Inc. v Norris, supra* (employee's wrongful discharge claims under state law not preempted by Railway Labor Act).

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§3.34 2. Back Pay

Unions may be liable for back pay damages for failure to represent their members fairly. Racial discrimination falls within the category of unfair representation. *Steele v Louisville & Nashville R.R.* (1944) 323 US 192, 89 L Ed 173, 65 S Ct 226. Actions against unions are not subject to administrative remedies; a civil suit against the union is the proper means to seek relief. *Czosek v O'Mara* (1970) 397 US 25, 25 L Ed 2d 21, 90 S Ct 770. An employer is also subject to civil actions for unlawful racial discrimination under the Railway Labor Act when joined as a defendant with a labor union after administrative remedies have been exhausted. See *Glover v St. Louis-San Francisco Ry.* (1969) 393 US 324, 21 L Ed 2d 519, 89 S Ct 548. Failure to exhaust administrative remedies was not a bar in *Glover* because the dispute was essentially between the employee and his union, and because the existence of discrimination by the union suggested that the administrative remedies were not apt to be fairly applied to plaintiff. 393 US at 329, 21 L Ed 2d at 524.

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§3.35 3. Attorney Fees

In *Harrison v United Transp. Union* (4th Cir 1975) 530 F2d 558, the appellate court found that the plaintiff, an employee whose union denied him fair representation, was entitled to attorney fees because his action vindicated a right held by all the union members. The court's holding that punitive damages were available if the union acted wantonly, maliciously, or in reckless disregard of the plaintiff's rights was reversed, however, in *Peterson v Air Line Pilots Ass'n, Int'l* (4th Cir 1985) 759 F2d 1161. Punitive damages are not available in duty of fair representation actions. See *IBEW v Foust* (1979) 442 US 42, 52 60 L Ed 2d 698, 707, 99 S Ct 2121.

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§3.36 F. Sherman and Clayton Antitrust Acts

The applicability of the Sherman and Clayton Antitrust Acts (15 USC §§1-7, 12-27) to labor union activities is restricted to the situation when a union acts in collusion with an employer in such a way as to impose economic sanctions or burdensome conditions on other employers. *Allen Bradley Co. v IBEW Local 3* (1945) 325 US 797, 89 L Ed 1939, 65 S Ct 1533. By the same token, employers are liable for conspiracies in restraint of trade in collusion with unions just as they would be for collusion with other employers. *U.S. v Employing Plasterers Ass'n* (1954) 347 US 186, 98 L Ed 618, 74 S Ct 452. The effect of the union-employer combination must be to control prices or restrain competition. Violations of the Sherman and Clayton Acts are subject to treble damage judgments. 15 USC §15.

Because of specific exemptions in §6 of the Clayton Act (15 USC §17) and §5 of the Norris-La Guardia Act (29 USC §105), unions may conspire to restrain trade for their own economic or institutional benefit without violating the Sherman or Clayton Antitrust Acts. Certain conduct is not exempt and may make the union liable to the employer. These exempt and nonexempt areas were thoroughly reviewed in *Bodine Produce, Inc. v UFW* (9th Cir 1974) 494 F2d 541. The court explained that union cooperation that enables one or more employers to control a product's supply and price in a particular market or to eliminate competition is illegal under *Allen Bradley Co. v IBEW Local 3, supra*. Union-imposed restraints related to wages, hours, and conditions of employment are legal. Unions may unilaterally use strikes, boycotts, and other sanctioned activities to restrain trade, but may not aid or abet a nonlabor group to achieve the same result or a labor group to achieve a result that is not directly linked to wages, hours, or terms and conditions of employment.

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§3.37 1. Examples

Examples of such illegal conspiracies include (1) collective bargaining agreements between a union and an employer that required the union to impose the same economic terms on other employers (*UMW v Pennington* (1965) 381 US 657, 14 L Ed 2d 626, 85 S Ct 1585), (2) agreements designed to allow members of a manufacturers' association to fix prices by boycotting customers for whom members of the association performed services unless the customers gave all of their work to association members who were in "good standing" with a particular union, and to police their members to ensure they did not engage in price competition with each other (*U.S. v Women's Sportswear Mfrs. Ass'n* (1949) 336 US 460, 93 L Ed 805, 69 S Ct 714), and (3) agreements between a union and several employers in the same industry that provided for a uniform increase in prices (*U.S. v Olympia Provision & Baking Co.* (SD NY 1968) 282 F Supp 819, aff'd per curiam in *Provision Salesmen Local 627 v U.S.* (1969) 393 US 480, 21 L Ed 2d 688, 89 S Ct 708).

In a case expanding the application of the Sherman Antitrust Act to labor unions, the Supreme Court in *Connell Constr. Co. v Plumbers & Steamfitters Local 100* (1975) 421 US 616, 44 L Ed 2d 418, 95 S Ct 1830, narrowed the range of union methods that are within the antitrust exemption. By a 5-4 margin, the court held that a construction union could not require a general contractor to subcontract only with firms having a collective bargaining agreement with the union. The union had a legitimate objective—to aid its organizing campaign—but the contract did not fall within the Clayton Act's labor union exemption because the union admittedly had no interest in representing the general contractor's employees. The court also relied on the fact that the contractual restriction against subcontracting with firms not having an agreement with the union applied to areawide construction and not to specific job sites. The court ruled that National Labor Relations Act (NLRA) §8(e) (29 USC §158(e)), which exempts construction industry unions from prohibitions against secondary boycotts, did not apply. It held further that the remedies afforded by the NLRA were not exclusive, and that conduct that could restrain competition was actionable under both the Sherman Antitrust Act and the NLRA. But see *Burlington Northern Santa Fe Railway Co. v International Bhd. of Teamsters, Local 174* (9th Cir 2000) 203 F3d 703 (no antitrust violation when union pickets employer that discontinues contracts with subcontractor whose employees were represented by union).

Following *Connell,* courts have noted that liability for violation of antitrust laws on the basis of an agreement between a union and a business organization requires consideration of the actual and potential anticompetitive effects of the agreement, independent of NLRA §8(e) issues. See *Larry V. Muko, Inc. v Southwestern Pa. Bldg. & Constr. Trades Council* (3d Cir 1979) 609 F2d 1368, 1375. Stated another way, a finding of an NLRA §8(e) violation does not necessarily render the agreement a per se violation of the Sherman Act. *Commerce Tankers Corp. v National Maritime Union* (2d Cir 1977) 553 F2d 793.

Subsequent to its decision in *Connell,* the Supreme Court redefined the scope of the construction industry proviso (29 USC §158(e)) in its unanimous decision in *Woelke & Romero Framing, Inc. v NLRB* (1982) 456 US 645, 72 L Ed 2d 398, 102 S Ct 2071. The Court held that the construction industry proviso ordinarily shelters union signatory subcontracting clauses that are sought or negotiated in the context of a collective bargaining relationship, even when they are *not* limited in application to particular job sites at which both union and nonunion workers are employed. 456 US at 654, 72 L Ed 2d at 407. See also *Building & Constr. Trades Council of Metropolitan Dist. v Associated Builders & Contractors* (1993) 507 US 218, 122 L Ed 2d 565, 113 S Ct 1190 (construction industry pre-hire exemptions under NLRA §8(e)-(f) (29 USC §158(e)-(f)) apply to public agencies as well as private owners).

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§3.38 2. Employers Exempt

Employers have generally been held exempt from the Sherman and Clayton Acts, insofar as the Acts might prohibit combinations to fix wages or salaries. An agreement by a group of securities dealers to set uniform compensation scales, however, was ruled a violation of the Sherman Act because the agreement was made in the absence of a collective bargaining relationship. *Cordova v Bache & Co.* (SD NY 1970) 321 F Supp 600. Even in a collective bargaining context, employers who combine to prevent unions from representing their employees are subject to antitrust laws. *International Ass'n of Heat & Frost Insulators v United Contractors Ass'n* (3d Cir 1973) 483 F2d 384. A union and an employer were held liable under antitrust laws when they conspired to force a successor employer to default on a government contract. *Embry-Riddle Aero. Univ. v Ross Aviation, Inc.* (5th Cir 1974) 504 F2d 896. The union and the employer had reached an eleventh-hour agreement intended to bind the successor. The court found that this violated the rule in *UMW v Pennington* (1965) 381 US 657, 14 L Ed 2d 626, 85 S Ct 1585. The trial court trebled the jury's verdict and also allowed attorney fees.

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§3.39 G. Fair Labor Standards Act of 1938

The Fair Labor Standards Act of 1938 (FLSA) (29 USC §§201-219) establishes minimum hourly wages ($6.55 as of July 24, 2008; $7.25 as of July 24, 2009) and overtime pay (time and one half for hours worked over 40 in one week). The Act requires equal pay for males and females for equal work, restricts child labor, and imposes certain recordkeeping requirements.

To be subject to the FLSA, an employer must be engaged in interstate commerce or in production of goods for transportation in interstate or foreign commerce. 29 USC §203. Under 29 USC §203(s) as amended, most employers who have interstate commerce ties and who have annual gross sales of $500,000 or more are covered by the Act. 29 USC §203(s). Many of the separate "enterprise" tests previously provided in the statute have been eliminated. The sales of individual operations of one employer will not be lumped together to determine the jurisdictional amount if the facilities are engaged in businesses that are unrelated, that are not under common operation or control, and that do not have a common business purpose. However, certain industries and institutions, such as laundry, dry cleaning, construction, hospitals, and schools, are covered even if they do not meet the "dollar volume test." The principal area in which damages may be recovered lies in an employer's failure to pay the required minimum wage, required overtime pay, or equal pay for substantially equal work for males and females.

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§3.40 1. Exemptions

The FLSA exempts a number of different types of employees including executive, administrative, professional, outside sales personnel, agricultural employees, and employees of an independent retail or service business more than 50 percent of whose business is intrastate. 29 USC §213.

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§3.41 2. Remedies

Remedies under the FLSA are injunction and back pay suits. Actions for injunctive relief and recovery of back pay may be filed by the secretary of labor. An action solely for back pay may be filed by an individual employee. 29 USC §216. Back pay suits by the secretary must be authorized by the affected employee(s), and the secretary may represent a number of employees in a suit similar to a class action. 29 USC §216. However, a suit by the secretary for an injunction with an incidental back pay claim need not be authorized by the affected employees. *Jones v American Window Cleaning Corp.* (ED Va 1962) 210 F Supp 921. A back pay suit filed by an individual employee or class action on behalf of a number of affected employees, if successful, makes an employer liable for full back pay for a period of up to 2 years (see 29 USC §255(a)) plus liquidated damages in an equal amount, *i.e.,* a total equivalent to double damages. Furthermore, damages in such private actions may include attorney fees and court costs. 29 USC §216.

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§3.42 3. Defenses

Proof that an employer acted in good faith and had reasonable grounds for believing that no violation of the FLSA was involved, *e.g.,* reliance on an interpretation by the Wage and Hour Division, is a good defense in a suit for back pay and liquidated damages. 29 USC §259. The good faith standard is determined by an objective test. *Clifton D. Mayhew, Inc. v Wirtz* (4th Cir 1969) 413 F2d 658.

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§3.43 4. Gender Discrimination

In 1963, the FLSA was amended to add provisions prohibiting unequal pay for equal work for male and female employees. See 29 USC §206(d). The work need not be identical but only substantially equal. *Shultz v Wheaton Glass Co.* (3d Cir 1970) 421 F2d 259. Equal pay also applies to benefits. Thus employers are required to make contributions toward employee benefits for female employees in an equal amount or based on the same formula as for male employees. Opinions, Wage-Hour Administrator (6A RNA Lab Rel Rep: 95 WHM 608 (May 27, 1964), 95 WHM 609 (Oct. 14, 1965)). Unequal benefits may also result in violation of Title VII of the Civil Rights Act of 1964 (42 USC 2000e—2000e-17) (see §§3.48-3.64). The exceptions and exemptions that are referred to above generally apply to the equal pay provisions of the FLSA, but the exemptions of 29 USC §213 for executive, administrative, professional, and outside sales personnel (see §3.40) do not apply to the equal pay provisions.

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§3.44 5. Examples

The holding in *National League of Cities v Usery* (1976) 426 US 833, 49 L Ed 2d 245, 96 S Ct 2465, which held that the Commerce Clause did not empower Congress to enforce the minimum wage and overtime provisions of the FLSA against states in "areas of traditional governmental functions," was overturned by the Supreme Court in *Garcia v San Antonio Metro. Transit Auth.* (1985) 469 US 528, 83 L Ed 2d 1016, 105 S Ct 1005. The Court found that the minimum wage and overtime provisions of the FLSA, as applied to a local metropolitan transit authority, was not destructive of state sovereignty or violative of any constitutional provision. The Ninth Circuit has ruled that *Garcia* is to be applied prospectively only. *Austin v City of Bisbee* (9th Cir 1988) 855 F2d 1429.

Congress moved quickly to neutralize the effects of *Garcia* by enacting the Fair Labor Standards Amendments of 1985 (Pub L 99-150, 99 Stat 787). The amendments, which took effect April 15, 1986, exempt employees of the legislative body of a state or a political subdivision or agency from FLSA coverage to the same extent that employees of Congress are exempt, authorize compensatory time off under certain conditions, address multiple job situations, and prohibit discrimination against employees asserting FLSA coverage (including court action under §16(b) of the FLSA seeking back pay, reinstatement, liquidated damages, attorney fees, and costs; 29 USC §216(b)). See *Drollinger v Arizona* (9th Cir 1992) 962 F2d 956. The Ninth Circuit has accorded these amendments limited retroactive application. See *Austin v City* of *Bisbee*, *supra*.

The Supreme Court held, in *Tony & Susan Alamo Found. v Secretary of Labor* (1985) 471 US 290, 85 L Ed 2d 278, 105 S Ct 1953, that the FLSA covers religiously connected businesses and that applying the Act's minimum wage, overtime, and recordkeeping requirements to such businesses did not violate freedom of religion. The decision does not affect volunteers who work for charitable, educational, or religious institutions without pay, but the Court found that the Act does cover "ordinary commercial activities" of religious organizations.

The Ninth Circuit has held that state prison inmates who work for state prison industries programs are not entitled to minimum wage under the FLSA. See *Hale v Arizona* (9th Cir 1993) 993 F2d 1387. State prisoners are, however, subject to the Americans with Disabilities Act and Rehabilitation Act. *Armstrong v Wilson* (9th Cir 1997) 124 F3d 1019.

The burden of proof of persons seeking liquidated damages from an employer who violates the wage and recordkeeping provisions of the FLSA will be substantially lessened if the ruling in *Williams v Tri-County Growers, Inc.* (3d Cir 1984) 747 F2d 121 is followed. In that case, the court held that such claimants need not establish intentional violations of the Act; rather, the employer must affirmatively establish that it acted in good faith by attempting to ascertain the Act's requirements.

Migrant workers who prevailed in a wage suit were entitled to an award of costs that covered expenses incurred for out-of-state depositions and travel to the trial because the FLSA allows reasonable costs to be taxed against violators. *Certilus v Peeples* (MD Fla 1984) 101 Lab Cas (CCH) ¶34,587.

Under the Equal Pay Act (29 USC §206(d)), appropriate damages have been found to include prejudgment interest on the back pay awarded (*EEOC v County of Erie* (2d Cir 1984) 751 F2d 79), as well as executive retirement benefits (*Crabtree v Baptist Hosp.* (11th Cir 1985) 749 F2d 1501).

Public employers are also covered by the Fair Labor Standards Act without meeting the "dollar volume test." 29 USC §203(d), (s).

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§3.45 6. Statute of Limitations

The statute of limitations for a back pay suit under the FLSA is 2 years; the limitations period for willful violations is 3 years. 29 USC §255(a). When an employee uses a Labor Commissioner administrative hearing (Lab C §98) to claim back pay, the action for unpaid wages is deemed to have commenced for statute of limitations purposes from the date of filing. *Cuadra v Millan* (1998) 17 C4th 855, 72 CR2d 687, disapproved on other grounds in *Samuels v Mix* (1999) 22 C4th 1, 16 n4, 91 CR2d 273.

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§3.46 H. Age Discrimination in Employment Act

The Age Discrimination in Employment Act of 1967 (ADEA) (29 USC §§621-634) prohibits arbitrary discrimination in the workplace based on age. *Lorillard v Pons* (1978) 434 US 575, 55 L Ed 2d 40, 98 S Ct 866. ADEA claims may be the subject of compulsory arbitration. *Circuit City, Inc. v Adams* (2001) 532 US 105, 149 L Ed 2d 234, 121 S Ct 1302.

Amendments in 1990 to the ADEA specify that the Act's prohibition against age discrimination applies to employee benefit plans except when age-based reductions are justified by significant cost considerations. See Pub L 101-433, 104 Stat 978 (1990). The amendments are intended to counteract the Supreme Court decision in *Public Employees Retirement Sys. v Betts* (1989) 492 US 158, 106 L Ed 2d 134, 109 S Ct 2854, which held that the ADEA does not prohibit age-based employment decisions taken under a bona fide employee benefit plan, as long as the plan is not a method of discriminating in non-fringe-benefit aspects of the employment relationship. See *Kentucky Retirement Sys. v EEOC* (2008) 554 US ___, 171 L Ed 2d 322, 334, 128 S Ct 2361 (discussing *Betts* and subsequent amendments); *Erie County Retirees Ass'n v County of Erie* (3d Cir 2000) 220 F3d 193 (*Betts* explained). Although the ADEA prohibits favoring the young over the old, it does not prohibit favoring the old over the young. *General Dynamics Land Sys., Inc. v Cline* (2004) 540 US 581, 157 L Ed 2d 1094, 124 S Ct 1236 (certain benefits provided to employees at least 50 years old, but not to those under 50). See also *Hamilton v Caterpillar, Inc.* (7th Cir 1992) 966 F2d 1226 (ADEA does not prohibit "reverse" age discrimination, *e.g.,* an early retirement program that favors older employees).

The ADEA incorporates the remedies of the Fair Labor Standards Act (FLSA) (29 USC §§201-219), including double damages. Section 7(b) of the ADEA provides that a prevailing plaintiff is entitled to double damages in cases of willful violations. In *Trans World Airlines, Inc. v Thurston* (1985) 469 US 111, 83 L Ed 2d 523, 105 S Ct 613, the Supreme Court held that a violation is willful within the meaning of §7(b) if the employer knew its conduct was prohibited by the ADEA or showed a reckless disregard for whether it was prohibited. The violation is not willful if the employer simply knew of the potential applicability of the ADEA or that the ADEA was "in the picture." This is the same standard adopted by the Supreme Court for application to the FLSA. See *McLaughlin v Richland Shoe Co.* (1988) 486 US 128, 100 L Ed 2d 115, 108 S Ct 1677, which reaffirmed *Thurston*'s definition of willfulness. In *Hazen Paper Co. v Biggins* (1993) 507 US 604, 123 L Ed 2d 338, 113 S Ct 1701, the Supreme Court again reaffirmed that definition and also held that to show "willfulness," the employee need not demonstrate that the employer's conduct was outrageous, or provide direct evidence of the employer's motivation, or prove that age was the predominant rather than a determinative factor in the employment decision.

The ADEA provisions for back pay are similar to those in Title VII. 29 USC §626(b). See also Lindemann & Grossman, Employment Discrimination Law, p 1776, n6 (3d ed 1996).

Although the ADEA authorizes awards of attorney fees against any "employer" who violates the Act, attorney fees may not be awarded against a nonemployer intervenor. *Richardson v Alaska Airlines, Inc.* (9th Cir 1984) 750 F2d 763 (attorney fees not awarded against union that intervened to oppose entry of consent judgment settling case between employer and employee). Unlike Title VII actions, legal fees for work done at the administrative level may not be available. See *Kennedy v Whitehurst* (DC Cir 1982) 690 F2d 951.

The scope of damages available to the prevailing party in ADEA actions has continued to be considered by the courts. Among the most frequently litigated items of damages are future damages, *i.e.,* front pay. Future damages have been awarded when reinstatement is not a suitable remedy for discharge violations of the ADEA. *Whittlesey v Union Carbide Corp.* (2d Cir 1984) 742 F2d 724. See also *Naton v Bank of Cal.* (9th Cir 1981) 649 F2d 691; *EEOC v Prudential Fed. Sav. & Loan* (10th Cir 1985) 763 F2d 1166, 1172. Front pay may not be appropriate, however, when the employer has offered to reinstate a former employee, and the employee has unreasonably rejected the offer. In *O'Donnell v Georgia Osteopathic Hosp.* (11th Cir 1984) 748 F2d 1543, the court held that front pay could be awarded if it was shown that reinstatement was not a realistic option.

On the effect of rejection or conditional acceptance of reinstatement on a unionized employee's right to back pay under the Labor Management Relations Act, see §3.7.

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§3.47 I. Veteran's Reemployment Rights

Reemployment rights of persons who serve in the uniformed services are governed by the Uniformed Services Employment and Reemployment Rights Act of 1994 (USERRA) (38 USC §§4301-4333), which is the successor act to the former Military Selective Service Act of 1967. Under USERRA, employees who leave their employment for non-career military service on an active or reserve basis are entitled to reinstatement to their former position or a position of like seniority, status, and pay if they apply for reinstatement within 90 days of release from active duty if the length of service was more than 180 days. If the length of service was between 31 and 180, days application for reemployment must be made within 14 days after completion of service, or if impossible or unreasonable through no fault of the person, the next full calendar day when submission of such application becomes possible. If the length of service was less then 31 days, by reporting to the employer either (a) not later then the beginning of the first full regularly scheduled work period on the first full calendar day following the completion of the period of service and the expiration of 8 hours after a period allowing for the safe transportation of the person from the place of that service to the person's residence, or (b) as soon as possible after the expiration of the 8-hour period referred to in (a), if reporting within the period referred to in such clause is impossible or unreasonable through no fault of the person. 38 USC §4312(e)(1).

If an employee served more than 180 days in the service, on his or her return to work, the employee may not be discharged except for cause for 1 year after the date of reemployment. If an employee served more than 30 but less than 180 days, the employee may not be discharged except for cause for 180 days after the date of reemployment. 38 USC §4316(c).

An employer is required to place the employee in the position he would have been in but for the absence due to military service. See *Fishgold v Sullivan Drydock & Repair Corp.* (1946) 328 US 275, 90 L Ed 1230, 66 S Ct 1105 (former Act). With respect to placement in a job, pay, and seniority, as well as eligibility for benefits, the veteran is considered to have stepped off an escalator to serve in the military; when he returns, he returns to his former step on the escalator even though it is at a higher level than when he left. See *McKinney v Missouri-Kansas-Texas R.R.* (1958) 357 US 265, 2 L Ed 2d 1305, 78 S Ct 1222 (former Act).

If an employer does not reinstate the veteran in the appropriate position with the appropriate pay, status and benefits, the employer is liable for back pay and benefits from approximately the day the veteran applied for reinstatement. *McCoy v Olin Mathieson Chem. Corp.* (SD Ill 1973) 360 F Supp 1336. In *McCoy,* plaintiff applied for reemployment about January 7, 1969 and was held to be entitled to damages from February 1, 1969. If the veteran is not properly reinstated, the back pay due includes overtime pay or other incremental pay that would have been earned had he been properly reinstated. See *Paredez v Pillsbury Co.* (CD Cal 1966) 259 F Supp 493 (former Act). The approved method used to determine amounts due is to refer to an employee in the same or a comparable position and calculate the pay and benefits for the appropriate period of time. See *Loeb v Kivo* (2d Cir 1948) 169 F2d 346 (former Act); *Brown v Consolidated Rail Corp.* (ND Ohio 1985) 614 F Supp 289. Interest accrues from the date of failure to reinstate (see *Carmalt v General Motors Acceptance Corp.* (WD Pa 1961) 197 F Supp 266, rev'd on other grounds (1962) 302 F2d 589 (former Act)). Prejudgment interest is discretionary with the court. *Hembree v Georgia Power Co.* (5th Cir 1981) 637 F2d 423.

The veteran who is not reinstated as required by the 1994 Act must mitigate damages by seeking other employment. See *Hanna v American Motors Corp.* (7th Cir 1984) 724 F2d 1300; *John S. Doane Co. v Martin* (1st Cir 1947) 164 F2d 537 (former Act). The burden is on the defendant to prove the plaintiff's failure to mitigate damages. *Graham v Hall-McMillen Co.* (ND Miss 1996) 925 F Supp 437. Offsets to damages resulting from other employment are applied on a pay period basis so that earnings for one period do not affect back pay for another period. Sums obtained from state unemployment compensation plans are generally not held to be an offset against back pay due (see *Coyne v Westinghouse Elec. Corp.* (SD Cal 1962) 204 F Supp 403 (former Act); *Dickey v Ryan Aeronautical Co.* (SD Cal 1947) 20 LRRM 2389 (former Act)), although some courts have deducted such payments from the back pay award (see *Chernoff v Pandick Press, Inc.* (SD NY 1977) 440 F Supp 822 (former Act); *Fortenberry v Owen Bros. Packing Co.* (SD Miss 1966) 267 F Supp 605 (former Act)).

The 1994 Act does not specify any statute of limitations, and specifically bars use of state statutes of limitations.

Instead, courts are commanded to focus solely on the doctrine of laches in determining whether the individual's claim is time barred. *Wallace v Hardee's Inc.* (MD Ala 1995) 874 F Supp 374. See *Witty v Louisville & Nashville R.R.* (7th Cir 1965) 342 F2d 614 (former Act).

Suits under the 1994 Act are maintained by the individual veteran, although the United States attorney for the district in which the employer maintains a place of business has a statutory obligation to appear for and act as attorney for the veteran if the attorney is reasonably satisfied that the veteran who applies for assistance is entitled to the benefits of the statutory provisions. See 38 USC §§4322-4323.

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Source: Civil Litigation/California Attorney's Guide to Damages/3 Labor/ J. Title VII of Civil Rights Act of 1964/§3.48 1. Prohibition of Discrimination in Employment

J. Title VII of Civil Rights Act of 1964

§3.48 1. Prohibition of Discrimination in Employment

Title VII of the Civil Rights Act of 1964 (42 USC §§2000e—2000e-17) prohibits discrimination in employment by employers or employment agencies, or in membership by unions (§703(a)-(c) (42 USC §2000e-2(a)-(c))) based on race, color, religion, sex, or national origin. See §706(g) (42 USC §2000e-5(g)), patterned after LMRA §10(c) (29 USC §160(c)). Damage awards under the LMRA have been limited to back pay (see §§3.6-3.13), and from the paucity of evidence of legislative intent, it has generally been concluded that relief under Title VII should follow the same pattern. See 110 Cong Rec 6527, 6549 (1964) (remarks of Senator Humphrey).

Section 706(g) sets forth the judicial remedies available for violation of Title VII:

> If the court finds that the respondent has intentionally engaged in or is intentionally engaging in an unlawful employment practice charged in the complaint, the court may enjoin the respondent from engaging in such unlawful employment practice, and order such affirmative action as may be appropriate, which may include, *but is not limited to,* reinstatement or hiring of employees, with or without back pay (payable by the employer, employment agency, or labor organization, as the case may be, responsible for the unlawful employment practice), *or any other equitable relief as the court deems appropriate. Back pay liability shall not accrue from a date more than two years prior to the filing of a charge with the Commission*. Interim earnings or amounts earnable with reasonable diligence by the person or persons discriminated against shall operate to reduce the back pay otherwise allowable. No order of the court shall require the admission or reinstatement of an individual as a member of a union or the hiring, reinstatement, or promotion of an individual as an employee, or the payment to him of any back pay, if such individual was refused admission, suspended, or expelled or was refused employment or advancement or was suspended or discharged for any reason other than discrimination on account of race, color, religion, sex or national origin or in violation of section 704(a) of this title [42 USC §2000e-3(a)]. [Emphasis added.]

Examples of actionable employment discrimination under Title VII include:

- Employer may be vicariously liable for sexually hostile work environment. *Pennsylvania State Police v Suders* (2004) 542 US 129, 159 L Ed 2d 204, 124 S Ct 2342 (absent employer-sanctioned adverse action against employee, constructive discharge does not by itself result in employer's vicarious liability); *Faragher v City of Boca Raton* (1998) 524 US 775, 141 L Ed 2d 662, 118 S Ct 2275 (absent employer's adverse action against employee, employer may raise affirmative defense that (1) it exercised reasonable care to prevent or correct harassment and (2) employee unreasonably failed to take advantage of the employer-provided avenues for prevention or correction).
- Sexual harassment, including conduct that creates a hostile work environment, violates Title VII. *Meritor Sav. Bank v Vinson* (1986) 477 US 57, 91 L Ed 2d 49, 106 S Ct 2399.
- Title VII protects undocumented alien workers, even if they are employed illegally, under the Immigration Reform and Control Act (IRCA). *EEOC v Tortilleria La Mejor* (ED Cal 1991) 758 F Supp 585.
- The U.S. Court of Appeals for the Seventh Circuit has held that Title VII does not protect transsexuals from discrimination. *Ulane v Eastern Airlines, Inc.* (7th Cir 1984) 742 F2d 1081. For protections under FEHA, see Govt C §12926(p).
- A female attorney who claimed she had been discriminated against on the basis of her sex when the law firm she worked for failed to invite her to become a partner was found to have stated a claim cognizable under Title VII in *Hishon v King & Spalding* (1984) 467 US 69, 81 L Ed 2d 59, 104 S Ct 2229.
- Consistent with the interpretation of necessary "intent" normally given by courts to remedial statutory language, the courts have held squarely that "intentionally engaged in" as set forth in §706(g) requires no more than a showing that the defendant's employment practices under review were intentionally performed and were not accidental. *Schaeffer v San Diego Yellow Cabs, Inc.* (9th Cir 1972) 462 F2d 1002.
- Absence of evidence establishing identifiable instances of prior or contemporary discriminatory practices (*Barela*

v United Nuclear Corp. (10th Cir 1972) 462 F2d 149) and failure to prove a specific present intent to discriminate (*U.S. v Jacksonville Terminal Co.* (5th Cir 1971) 451 F2d 418) do not constitute impediments to obtaining §706(g) relief.

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§3.49 2. Back Pay Awards

Successful Title VII litigants may be entitled to back pay as an incident of equitable relief for the purpose of restoring to them their rightful economic status absent the effects of the unlawful discrimination; therefore, back pay is not punitive in nature. *Robinson v Lorillard Corp.* (4th Cir 1971) 444 F2d 791.

Although, as amended, Title VII of the Civil Rights Act of 1964 (42 USC §§2000e—2000e-17) quite clearly limits back pay to a date not more than 2 years before a charge is filed with the Commission (see §3.48), it is well to note that back pay continues to accrue during the course of litigation, which may add many years to the initial 2-year period. It should also be noted that when the plaintiff's action is brought under 42 USC §1981, the 2-year limitation of Title VII would not, of course, be applicable. See *Brown v Gaston County Dyeing Mach. Co.* (4th Cir 1972) 457 F2d 1377.

The Ninth Circuit has held that proceeds from the settlement of a discrimination and wrongful termination case under Title VII represent lost wages and, as such, are subject to federal tax withholding. *Rivera v Baker W., Inc.* (9th Cir 2005) 430 F3d 1253. See 26 USC §3121; Treas Reg §31.3121(a)-1(i) ("Remuneration for employment… constitutes wages" even if the employer-employee relationship no longer exists).

Back pay includes not only the regular wages of the relevant job but also overtime (*Pettway v American Cast Iron Pipe Co.* (5th Cir 1974) 494 F2d 211, 263), raises, promotions, and a wide variety of fringe benefits. See collected cases in Lindemann & Grossman, Employment Discrimination Law, p 1779 (3d ed 1996) and current supplement. For additional discussion of back pay awards, see generally Wrongful Employment Termination Practice, chap 2 (2d ed Cal CEB 1997).

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§3.50 a. Back Pay Formula

The courts have generally followed the back pay calculation formula developed by the NLRB and deducted net earnings from interim employment less travel expenses, room and board, and costs of moving in connection with such other employment. See §§3.7-3.9. In addition, some courts have reduced back pay by amounts received from unemployment insurance benefits (*Diaz v Pan Am. World Airways* (SD Fla 1972) 348 F Supp 1083). In the Ninth Circuit, however, unemployment benefits from a state fund supported by a tax on employers are not deducted from back pay in Title VII cases. See §3.59; *Kauffman v Sidereal Corp.* (9th Cir 1982) 695 F2d 343, 347 n2. See also *Sam Teague Ltd. v Hawaii Civil Rights Comm'n* (1999) 89 Haw 269, 971 P2d 1104 (reviews state and federal authority and concludes benefits are not deductible in equal pay action).

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§3.51 b. Back Pay Defined

The courts have given a broad definition to back pay and have included such elements as the differential between actual pay and the pay of the higher position to which promotion was refused (see *Jenkins v United Gas Corp.* (5th Cir 1968) 400 F2d 28); the monetary equivalent of vacations and Christmas bonuses that would have been received (*Bowe v Colgate-Palmolive Co.* (SD Ind 1967) 272 F Supp 332); pension benefits (*Rosen v Public Serv. Elec. & Gas Co.* (3d Cir 1973) 477 F2d 90); and interest at the rate of 6 percent (*Tidwell v American Oil Co.* (D Utah 1971) 332 F Supp 424).

Plaintiffs seeking back pay must establish that they invested a sufficient amount of time and effort to show they were ready, willing, and available for work. *U.S. v Wood, Wire & Metal Lathers Local 46* (SD NY 1971) 328 F Supp 429.

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§3.52 c. Bona Fide Offers of Employment

The unreasonable refusal of an unconditional, bona fide offer of employment, reinstatement, or promotion sought by the employee, as supplemented by a right to full court-ordered compensation, will terminate the back pay period. *Ford Motor Co. v EEOC* (1982) 458 US 219, 73 L Ed 2d 721, 102 S Ct 3057 (Title VII); *Morris v American Nat'l Can Corp.* (8th Cir 1991) 952 F2d 200; *Ortiz v Bank of Am. Nat'l Trust & Sav. Ass'n* (9th Cir 1987) 852 F2d 383 (reasonableness is question for trier of fact); *DFEH v San Francisco Mun. Ry.* (1982) No. 82-23, FEHC Precedential Decisions; *Fiedler v Indianhead Truck Line, Inc.* (8th Cir 1982) 670 F2d 806, 808, 28 FEP Cases 849, 850 (ADEA); *Billetter v Posell* (1949) 94 CA2d 858, 861, 211 P2d 621 (California common law). The plaintiff's duty to accept such an offer or forego further back pay is linked to the long-recognized duty to mitigate damages, discussed above. *Ford Motor Co. v EEOC* (1982) 458 US 219, 231 n15, 73 L Ed 2d 721, 732 n15, 102 S Ct 3057. On the effect of rejection or conditional acceptance of reinstatement on a unionized employee's right to back pay under the Labor Management Relations Act, see §3.6.

Amounts that could have been earned under such an offer are "amounts earnable with reasonable diligence," which, by the explicit terms of Title VII, "operate to reduce the back pay otherwise allowable" under Title VII. 42 USC §2000e-5(g).

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§3.53 d. Duplicate Pay

Back pay has been held recoverable even when it duplicates a previous back pay recovery from the same employer in a personal injury action (see *Peters v Missouri Pac. R.R.* (5th Cir 1973) 483 F2d 490); but other types of loss, *e.g.,* loss of a home suffered by a mortgagor, have been considered too remotely related to the discriminatory practice to be recoverable (*St. Clair v Teamsters Local 515* (6th Cir 1969) 422 F2d 128).

The back pay award will be reduced by the plaintiff's interim earnings or by amounts the plaintiff could have earned with reasonable diligence. 42 USC §2000e-5(g); *Richardson v Restaurant Mktg. Assocs., Inc.* (ND Cal 1981) 527 F Supp 690, 698; *Brown v Colman-Cocker Co.* (WD NC 1975) 16 FEP Cases 1046. Such deductions should be calculated on a year-by-year or even a quarterly basis. *U.S. v Lee Way Motor Freight, Inc.* (WD Okla 1977) 15 FEP Cases 1385, 1389, aff'd in part (10th Cir 1979) 625 F2d 918; *Mays v Motorola, Inc.* (ND Ill 1979) 22 FEP Cases 803. Interim earnings from a part-time job that could have been held while employed with defendant should not be deducted. *Bing v Roadway Express, Inc.* (5th Cir 1973) 485 F2d 441.

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§3.54 e. Front Pay

Courts in over half of the circuits, including the Ninth Circuit, have approved awards of front pay, *i.e.,* earnings and benefits from the date of judgment forward to such time as the plaintiff is hired, promoted, retired, or reinstated. See, *e.g.*, *Gotthardt v National R.R. Passenger Corp.* (9th Cir 1999) 191 F3d 1148, 1156; *Bartlett v U.S.* (ED Wash 1993) 835 F Supp 1246, 1263; *EEOC v Pacific Press Publ'g Ass'n* (ND Cal 1979) 482 F Supp 1291, 1320, aff'd on other grounds in (9th Cir 1981) 676 F2d 1272. See also *EEOC v Enterprise Ass'n Steamfitters* (2d Cir 1976) 542 F2d 579, 590; *Patterson v American Tobacco Co.* (4th Cir 1976) 535 F2d 257, 269; *James v Stockham Valves & Fittings Co.* (5th Cir 1977) 559 F2d 310, 358; *Spiva v Copperweld Steel Co.* (ND Ohio 1980) 22 FEP Cases 900; *Wattleton v Ladish Co.* (ED Wis 1981) 520 F Supp 1329, aff'd on other grounds (7th Cir 1982) 686 F2d 586; *EEOC v Safeway Stores, Inc.* (10th Cir 1980) 634 F2d 1273, 1281; *Thompson v Sawyer* (DC Cir 1982) 678 F2d 257. Factors considered in determining the amount of a front pay award are discussed in *Price v Marshall Erdman & Assoc.* (7th Cir 1992) 966 F2d 320.

NOTE: All cases under the Immigration Reform and Control Act of 1986 (IRCA) (8 USC §§1101-1537) should be reviewed for instances in which an undocumented alien who has used false documents to gain or retain employment may receive benefits (*e.g.*, unemployment compensation). On the IRCA, see §3.13A.

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§3.55 f. Mental Distress Damages

Damages for mental distress have been rejected under the LMRA, which served as a model for Title VII, because of their intangible and speculative nature; they have generally been held unrecoverable under Title VII for similar reasons. *St. Clair v Teamsters Local 515* (6th Cir 1969) 422 F2d 128.

However, in a case arising before the 1972 amendment of Title VII authorizing courts to order "any other equitable relief as the court deems appropriate," one federal court was persuaded to award damage for "psychic injuries" suffered by a discriminatee (*Humphrey v Southwestern Portland Cement Co.* (WD Tex 1973) 5 FEY Cas 897, rev'd on other grounds (5th Cir 1974) 488 F2d 691), reasoning that inclusion of all injuries in private suits would enhance the effectiveness of Title VII.

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§3.56 g. Prejudgment Interest

Prejudgment interest is regularly granted as part of back pay awards under Title VII. See, *e.g., EEOC v Pacific Press Publ'g Ass'n* (ND Cal 1979) 482 F Supp 1291, aff'd on other grounds in (9th Cir 1981) 676 F2d 1272; *Harmon v San Diego County* (SD Cal 1979) 477 F Supp 1084, 20 FEP Cases 1427 (appealed on other issues at (9th Cir 1982) 664 F2d 770); *Chapman v Pacific Tel. & Tel. Co.* (ND Cal 1978) 456 F Supp 77; *James v KID Broad. Corp.* (D Idaho 1983) 559 F Supp 1153; *Richerson v Jones* (3d Cir 1977) 551 F2d 918; *Pettway v American Cast Iron Pipe Co*. (5th Cir 1974) 494 F2d 211. However, prejudgment interest should not be awarded in an age discrimination case in which the award has been doubled because the violation was willful. *Fortino v Quasar Co.* (7th Cir 1991) 950 F2d 389. See also *Bennett v Total Minetone Corp.* (5th Cir 1998) 138 F3d 1053.

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§3.57 h. Good Faith

In an action for violation of Title VII, the employer's good faith is not a defense to a request for a back pay award. Back pay may be denied only for reasons that, if applied generally, would not frustrate the remedial "make whole" purpose of Title VII. *Albemarle Paper Co. v Moody* (1975) 422 US 405, 45 L Ed 2d 280, 95 S Ct 2362. But see *Hoffman Plastic Compounds, Inc. v NLRB* (2002) 535 US 137, 152 L Ed 2d 271, 122 S Ct 1275. See also *International Bhd. of Teamsters v U.S.* (1977) 431 US 324, 52 L Ed 2d 396, 97 S Ct 1843.

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§3.58 i. Equivalent Employment

When a violation of Title VII has occurred, an employer cannot escape full liability for back pay by offering a successful job bias claimant promotion to a job that is not equivalent to the one that had been improperly denied. In determining the equivalency of jobs, it has been found appropriate to consider such factors as the overtime requirements of the jobs. *EEOC v Exxon Shipping Co.* (5th Cir 1984) 745 F2d 967. Further, back pay liability under Title VII may extend to an international union that chartered two racially segregated locals and defended this arrangement. In *Williams v New Orleans S.S. Ass'n* (ED La 1983) 32 FEP Cases 1785, a union was held liable for back pay to black employees who were discriminated against in violation of Title VII.

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§3.59 j. Unemployment Benefits

In the Ninth Circuit, unemployment benefits are not deducted from back pay in Title VII cases, not at least when they are paid from a state fund supported by a tax on employers. *Kauffman v Sidereal Corp.* (9th Cir 1982) 695 F2d 343, 347 n2.

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§3.60 3. Seniority

A troubling aspect of Title VII actions and the remedies awarded as a result has been their effect in periods of declining employment. Such questions are further complicated when remedial actions are taken to remedy discriminatory practices, and such actions benefit persons who have not been victims of past discrimination. These issues were dealt with in *Firefighters Local No. 1784 v Stotts* (1984) 467 US 561, 81 L Ed 2d 483, 104 S Ct 2576. In that case, a class action suit brought by a black member of a fire department had resulted in a consent decree to remedy hiring and promotion practices regarding blacks. When subsequently faced with budget deficits, the city proposed layoffs using its "last hired, first fired" seniority system. The district court enjoined the city from following its seniority system and laying off any black employees and the court of appeals affirmed. The Supreme Court reversed, holding that the consent decree did not authorize displacement of white employees with seniority over blacks, and further held that a court can award competitive seniority only when the beneficiary of the award has actually been a victim of illegal discrimination. A similar result was reached in *International Bhd. of Teamsters v U.S.* (1977) 431 US 324, 52 L Ed 2d 396, 97 S Ct 1843.

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§3.61 4. Exemplary Damages

Under the Civil Rights Act of 1991 (Pub L 102-166, 105 Stat 1071), compensatory and punitive damages are available in cases of intentional discrimination under Title VII of the Civil Rights Act of 1964. 42 USC §1981a(a)(1). See *Kolstad v American Dental Ass'n* (1999) 527 US 526, 144 L Ed 2d 494, 505, 119 S Ct 2118. According to the Supreme Court in *Kolstad,* punitive damages may be awarded without a showing that the employer's conduct was "egregious" if the employer acted "with malice or with reckless indifference to the federally protected rights" of the plaintiff. 144 L Ed 2d at 502. The malice or reckless indifference refers not to the employer's awareness that it is engaging in discrimination, but to its knowledge that it may be violating federal law. 144 L Ed 2d at 505. Even when the conduct meets this test, however, the employer may not be vicariously liable for the discriminatory employment decision of managerial agents when those decisions are contrary to the employer's good faith efforts to comply with Title VII. 144 L Ed 2d at 512. See also *Passantino v Johnson & Johnson Consumer Prods., Inc.* (9th Cir 2000) 212 F3d 493; *Yamaguchi v United States Air Force* (9th Cir 1997) 109 F3d 1475, 1481.

Compensatory but not punitive damages are available in discrimination suits brought against federal, state, and local governments and government agencies. 42 USC §1981a(b)(1). Compensatory and punitive damages are available only in cases of "intentional" discrimination, not in disparate impact cases. 42 USC §1981a(a)(1). For a case involving an award of retroactive seniority, see *International Bhd. of Teamsters v U.S.* (1977) 431 US 324, 52 L Ed 2d 396, 97 S Ct 1843 (court awarded retroactive seniority for the preferred positions to all rejected minority applicants and to those minority employees who could show they would have applied but for the union's pattern of discrimination).

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§3.62 5. Attorney Fees

Section 706(k) of Title VII (42 USC §2000e-5(k)) provides that "the court, in its discretion, may allow the prevailing party… a reasonable attorney's fee as part of the costs." In practice, the courts have consistently exercised their discretion in favor of awarding attorney fees to prevailing plaintiffs. *Robinson v Lorillard Corp.* (4th Cir 1971) 444 F2d 791; *U.S. v Operating Eng'rs* (ND Cal 1973) 6 Empl Prac Dec (CCH) P8946.

Plaintiffs may be granted attorney fees even though they prevail on only some claims litigated in a Title VII action. *Hensley v Eckerhart* (1983) 461 US 424, 76 L Ed 2d 40, 103 S Ct 1933 (plaintiffs are "prevailing parties" for attorney fee purposes if they succeed on any significant issue); *Texas State Teachers Ass'n v Garland Indep. Sch. Dist.* (1989) 489 US 782, 103 L Ed 2d 866, 109 S Ct 1486. If the plaintiff succeeds on some but not all claims, fees may be reduced in order to exclude fees for unsuccessful claims. *Schwarz v Secretary of Health & Human Servs.* (9th Cir 1995) 73 F3d 895. However, California decisions support full fees in most partial success cases, even though the fees far exceed the plaintiff's award. *Vo v Las Virgenes Mun. Water Dist.* (2000) 79 CA4th 440, 94 CR2d 143; *Beaty v BET Holdings, Inc.* (9th Cir 2000) 222 F3d 607. Fees may be denied if the damages award is nominal. *Farrar v Hobby* (1992) 506 US 103, 121 L Ed 2d 494, 113 S Ct 566. However, if the plaintiff wins significant injunctive relief, the court must grant attorney fees even if it makes no monetary award. *Fischer v SJB-P.D., Inc.* (9th Cir 2000) 214 F3d 1115 (decision under Americans with Disabilities Act).

The starting point for calculation of fees is the reasonable number of hours multiplied by the reasonable hourly rate. In determining the hourly rate, market rates (*i.e.,* rates charged by attorneys, paralegals, and law clerks of comparable skill and experience in the community) are the benchmark. *Missouri v Jenkins* (1989) 491 US 274, 105 L Ed 2d 229, 109 S Ct 2463; *Blum v Stenson* (1984) 465 US 886, 79 L Ed 2d 891, 104 S Ct 1541. A number of factors may be used to increase or reduce this "lodestar" figure. *Pennsylvania v Delaware Valley Citizens' Council* (1987) 483 US 711, 97 L Ed 2d 585, 107 S Ct 3078 (*Delaware Valley II*). "Contingent risk," *i.e.,* the fact that the party's attorneys were retained on a contingent fee basis and thus assumed the risk of receiving no fee for their services, may not be used to enhance the lodestar figure. *City of Burlington v Dague* (1992) 505 US 557, 120 L Ed 2d 449, 112 S Ct 2638. The right to collect fees and costs may be cut off by an offer of judgment under Fed R Civ P 68. *Marek v Chesny* (1985) 473 US 1, 87 L Ed 2d 1, 105 S Ct 3012.

A prevailing plaintiff may be granted attorney fees even though neither back pay nor an injunction is found to be an appropriate form of relief. *Parham v Southwestern Bell Tel. Co.* (8th Cir 1970) 433 F2d 421; *Taylor v Goodyear Tire & Rubber Co.* (ND Ala 1973) 6 FEP 672; *Clark v American Marine Corp.* (ED La 1970) 320 F Supp 709.

An award of fees is not limited by the amount provided in a private contingent fee agreement. *Venegas v Mitchell* (1990) 495 US 82, 109 L Ed 2d 74, 110 S Ct 1679; *Blanchard v Bergeron* (1989) 489 US 87, 103 L Ed 2d 67, 109 S Ct 939. See California Attorney Fee Awards (2d ed Cal CEB 1994).

The district court for the Northern District of Illinois ordered the EEOC to pay attorney fees to an employer and a union for bringing an unreasonable action under Title VII, and the union and the employer were found to be entitled to attorney fees for defending against the EEOC on appeal as well. *Le Beau v Libby-Owens-Ford Co.* (ND Ill 1984) 36 FEP Cases 910. Attorney fees may be awarded against losing intervenors who have not been found to have violated Title VII or other federal law only when the intervenors' action is frivolous, unreasonable, or without foundation. *Independent Fed'n of Flight Attendants v Zipes* (1989) 491 US 754, 105 L Ed 2d 639, 109 S Ct 2732.

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§3.63 6. Civil Rights Act of 1991

The Civil Rights Act of 1991 (Pub L 102-166, 105 Stat 1071) effectively reversed several U.S. Supreme Court decisions that had restricted the scope of older civil rights statutes. The most important of these decisions were *Patterson v McLean Credit Union* (1989) 491 US 164, 105 L Ed 2d 132, 109 S Ct 2363, and *Wards Cove Packing Co. v Atonio* (1989) 490 US 642, 104 L Ed 2d 733, 109 S Ct 2115, a burden of proof case. *Patterson* had held that 42 USC §1981, prohibiting discrimination on the basis of race, ethnicity, or national origin in the making of contracts, applied only to the formation of contracts, *e.g.,* hiring. The 1991 Act restores to §1981 its former scope: not just hiring, but also on-the-job discrimination, such as promotions, discipline, and termination. In *Flores v Arizona* (1999) 48 F Supp 2d 937, 950, the court noted that the 1991 Act also restored the burden of proof standards to what they were before *Wards Cove*. The statute of limitations for such a §1981 action is 4 years. *Jones v R.R. Donnelley & Sons Co.* (2004) 541 US 369, 158 L Ed 2d 645, 124 S Ct 1836 (28 USC §1658, which provides a 4-year statute of limitations for claims created by federal statutes enacted after December 1, 1990, applies to actions arising under 42 USC §1981 as amended by the Civil Rights Act of 1991).

The 1991 Act also authorizes jury trials in most discrimination cases and expands the relief available in many cases. See 42 USC §1981a. Before the 1991 Act, plaintiffs were limited to "make-whole" remedies, such as back pay and front pay, in cases brought under Title VII of the Civil Rights Act of 1964, the Americans with Disabilities Act of 1990 (42 USC §§12101-12213), and the Rehabilitation Act of 1973 (29 USC §§701-796*l*). The 1991 Act provides for compensatory damages in most cases brought under these statutes and, in cases of intentional discrimination by nongovernmental entities, punitive damages as well. 42 USC §1981a(b). However, the total of compensatory and punitive damages is limited, *except* for §1981 claims based on race, ethnicity, or national origin. Employers of 15 to 100 employees may be assessed no more than $50,000; employers of more than 500 are liable for a maximum of $300,000. 42 USC §1981a(b)(3).

In addition, the 1991 Act allows the award of expert witness fees to prevailing plaintiffs in most civil rights litigation. See 42 USC §§1988(c), 2000e-5(k).

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§3.64 7. Civil Rights Acts of 1866 and 1871

Race and alienage discrimination actions brought under the Civil Rights Acts of 1866 and 1871 (42 USC §§1981, 1983) may seek compensatory damages (including damages for emotional distress) and punitive damages in addition to back pay and attorney fees. See, *e.g., Johnson v Railway Express Agency, Inc.* (1975) 421 US 454, 460, 44 L Ed 2d 295, 301, 95 S Ct 1716 (42 USC §1981); *Cinevision Corp. v City of Burbank* (9th Cir 1984) 745 F2d 560, 577 (42 USC §1983); *Flores v Pierce* (9th Cir 1980) 617 F2d 1386, 1392 (42 USC §1983); *Donovan v Reinbold* (9th Cir 1970) 433 F2d 738, 743 (42 USC §1983); *Richardson v Restaurant Mktg. Assocs., Inc.* (ND Cal 1981) 527 F Supp 690, 697 (42 USC §1981); *Harman v City & County of San Francisco* (2007) 158 CA4th 407, 415, 69 CR3d 750 (42 USC §1983).

Compensatory and punitive damages may be obtained even when the civil rights claims are related to, or based on, a violation of Title VII of the Civil Rights Act of 1964. *Claiborne v Illinois Cent. R.R.* (5th Cir 1978) 583 F2d 143 (42 USC §1981); *Bradshaw v Zoological Soc'y* (9th Cir 1978) 569 F2d 1066 (42 USC §1983); *Allen v Amalgamated Transit Union* (8th Cir 1977) 554 F2d 876 (42 USC §1981); *Richardson v Restaurant Mktg. Assocs., Inc., supra* (42 USC §1981); *Rolfe v Arizona* (D Ariz 1983) 578 F Supp 1467, 1472.

Reliance on §1981 as a mechanism to remedy the effects of race and alienage discrimination was severely restricted in *Patterson v McLean Credit Union* (1989) 491 US 164, 105 L Ed 2d 132, 109 S Ct 2363. In *Patterson,* a black woman employed as a teller and file coordinator in a credit union filed an action under §1981, claiming that her employer had harassed her and failed to promote her. The Supreme Court acknowledged that §1981 reaches private conduct and prohibits racial discrimination in the making and enforcing of private contracts. However, the Court held that racial harassment relating to *conditions* of employment is *not* actionable under §1981, because that section does not apply to conduct that occurs after the formation of the contract and that does not interfere with the right to enforce established contract obligations. In the Civil Rights Act of 1991 (see §3.63), Congress enlarged §1981, effectively overriding *Patterson.* See also 42 USC §1981a. Section 1981 now covers all aspects of the contractual relationship. *Great American Tool & Mfg. Co. v Adolph Coors Co.* (D Colo 1992) 780 F Supp 1354, disapproved on other grounds in *Guides, Ltd. v Yarmouth Group Prop. Mgmt., Inc*. (10th Cir 2002) 295 F3d 1065.

It appears that a 4-year federal statute of limitations applies to an action that could not have been brought before the Civil Rights Act of 1991 amended the civil rights statutes. See *Jones v R.R. Donnelley & Sons Co.* (2004) 541 US 369, 158 L Ed 2d 645, 124 S Ct 1836 (28 USC §1658, which provides a 4-year statute of limitations for claims created by federal statutes enacted after December 1, 1990, applies to actions arising under 42 USC §1981 as amended by the Civil Rights Act of 1991).

California punitive damages standards apply in a 42 USC §1981 action. *Mitchell v Keith* (9th Cir 1985) 752 F2d 385, 390, 36 FEP Cases 1443, 1446.

Back pay is available under the Civil Rights Acts of 1866 and 1871, and it is not limited to the 2-year time period set out in Title VII. *Johnson v Railway Express Agency*, *Inc*., *supra*. Other declaratory and injunctive relief may also be awarded under the Civil Rights Acts, including reinstatement, promotion, and, in the case of a class action, goals, quotas, and timetables. See generally Lindemann & Grossman, Employment Discrimination Law, p 974 (3d ed 1996).

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Source: Civil Litigation/California Attorney's Guide to Damages/3 Labor/§3.65 K. Employee Retirement Income Security Act

§3.65 K. Employee Retirement Income Security Act

Designed over a 10-year period, the Employee Retirement Income Security Act of 1974 (ERISA) (29 USC §§1001-1461) is considered one of the most comprehensive single pieces of federal legislation of the twentieth century. It was passed primarily to protect benefits of employees covered under private pension and profit-sharing plans and other benefit programs.

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§3.66 1. Preemption of State Law

Under §514(a) of ERISA, the Act preempts all state laws (including judicial decisions having the effect of law) that "relate to" any employee benefit plan covered by the Act. 29 USC §1144(a); *Ingersoll Rand v McClendon* (1990) 498 US 133, 112 L Ed 2d 474, 111 S Ct 478. State statutes have been held preempted under this provision. *Aetna Health Inc. v Davila* (2004) 542 US 200, 159 L Ed 2d 312, 124 S Ct 2488 (statute requiring HMO to exercise ordinary care in making decision affecting diagnosis, care, and treatment); *Mackey v Lanier Collections Agency & Serv.* (1988) 486 US 825, 100 L Ed 2d 836, 108 S Ct 2182 (antigarnishment statute referring to employee benefit plans); *Commercial Life Ins. v Superior Court* (1988) 47 C3d 473, 253 CR 682 (private cause of action under Insurance Code provision conflicts with ERISA's exclusive remedies). State common law causes of action have also been preempted. See *Egelhoff v Egelhoff* (2001) 532 US 141, 149 L Ed 2d 264, 121 S Ct 1322; *Pilot Life Ins. Co. v Dedeaux* (1987) 481 US 41, 95 L Ed 2d 39, 107 S Ct 1549; *Sanson v General Motors Corp.* (11th Cir 1992) 966 F2d 618. But see *Pharmaceutical Care Mgmt. Ass'n v Rowe* (1st Cir 2005) 429 F3d 294 (Maine's unfair prescription drug practices statute not preempted by ERISA); *Guardian Life Ins. Co. v Finch* (5th Cir 2004) 395 F3d 238 (extension of ERISA preemption to federal common law not warranted); *Coast Plaza Doctors Hosp. v Blue Cross of Cal.* (2009) 173 CA4th 1179, 93 CR3d 479 (state statute requiring health care insurer to reimburse emergency care provider not preempted by ERISA). Further, in *Golden Gate Restaurant Ass'n v City & County of San Francisco* (9th Cir 2009) 558 F3d 1000, the court distinguished *Egelhoff v Egelhoff, supra,* on the grounds the San Francisco ordinance requiring restaurants to offer employee health insurance does not require any change in any ERISA plan.

The Supreme Court retreated somewhat from the expansive preemption doctrine of *Pilot Life* in *California Div. of Labor Standards Enforcement v Dillingham Constr. N.A., Inc.* (1997) 519 US 316, 136 L Ed 2d 791, 117 S Ct 832 (California law prohibiting public works contractors from paying apprentice wages to apprentices trained in unapproved program is not preempted by ERISA). See *Bankamerica Pension Plan v McMath* (9th Cir 2000) 206 F3d 821; *Albin v QWEST Communications Corp.* (D Or 2002) 194 F Supp 2d 1138.

ERISA may also preempt certain wrongful termination claims that implicate employee benefit plans. See also *Duffy v Cavalier* (1989) 215 CA3d 1517, 264 CR 740 (ERISA did not preempt state common law on stockbrokers' fiduciary duties, because it affected benefit plan so remotely that it did not infringe on duties imposed or interests protected by ERISA). A fiduciary's state law action to enforce reimbursement of third party benefit is preempted by ERISA. *Totten v Hill* (2007) 154 CA4th 40, 51, 64 CR3d 357. However, as noted above, some state law claims are not preempted. *Peckham v Gem State Mut.* (10th Cir 1992) 964 F2d 1043.

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§3.67 2. Coverage

ERISA covers employee benefit plans established, maintained, or financed by an employer or association of employers engaged in interstate commerce. The Act sets up intricate rules for establishing and administering plan trusts and other funding mechanisms such as insurance policies. It is administered by both the Department of Labor and the Treasury Department (Internal Revenue Service). A group annuity contract has been held not to be a "plan" subject to ERISA. *Thompson v Prudential Ins. Co. of Am.* (D NJ 1992) 795 F Supp 1337, aff'd (3d Cir 1993) 993 F2d 226.

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§3.68 3. Reporting and Disclosure

ERISA provides extensive reporting and disclosure requirements (29 USC §§1021-1031), minimum waiting periods for eligibility and vesting (29 USC §§1051-1053), maximum annual accrual rates for benefits (29 USC §1054), requirements for joint and survivor annuities (29 USC §1055), strict standards for benefit obligations funding (29 USC §§1081-1086), standards and detailed rules for plan fiduciaries (29 USC §§1101-1114), and limitations on investing plan assets in employer's securities or real property (29 USC §1107). It also establishes a Pension Benefit Guaranty Corporation to ensure that employees do not lose benefits when defined benefit plans are terminated (29 USC §§1301-1310).

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§3.69 4. Damages

In addition to criminal sanctions for willful violations, ERISA provides for civil damages and penalties for violations by plan administrators and other fiduciaries. (A fiduciary is anyone who has discretionary power of control, management, or disposition of plan funds. 29 USC §1002(21)(A).) See *Yeseta v Baima* (9th Cir 1988) 837 F2d 380 (attorney rendering professional services not fiduciary as long as he or she does not exercise any authority over plan in manner other than by usual professional functions).

Plan participants or beneficiaries may collect up to $100 per day (but in no event more than $1000 per request) from plan administrators who fail to provide information to which the participant or beneficiary is legally entitled within 30 days of the request. 29 USC §1132(c). Former employees are entitled to disclosure only if they have a reasonable expectation of returning to covered employment or possess a colorable claim to vested benefits. *Firestone Tire & Rubber Co. v Bruch* (1989) 489 US 101, 103 L Ed 2d 80, 109 S Ct 948. Also, any plan participant or beneficiary may bring an action under ERISA to recover benefits due under the plan or to establish his or her right to future benefits. 29 USC §1132(a)(1)(B). A de novo standard of review generally applies in such actions. *Firestone Tire & Rubber Co*. *v Bruch*, *supra*. Plan fiduciaries are personally liable to participants and beneficiaries for breach of fiduciary obligations in an amount equal to losses incurred by the plan plus profits made by use of plan assets. 29 USC §§1109(a), 1132(a). Standards of fiduciary duty are stated in 29 USC §1104: A fiduciary must exercise his or her duties (1) solely to benefit plan participants and their beneficiaries and to defray expenses of administering the plan, (2) in accordance with the prudent investor rule as to investments, (3) by diversifying investments, and (4) in accordance with plan instruments.

A fiduciary may also incur severe penalties if the plan engages in prohibited transactions as defined in 29 USC §1106, or if the fiduciary engages in certain self-interested dealings with the plan. See 29 USC §1132(i); IRC §4975. A fiduciary may also be liable for breach by a cofiduciary. 29 USC §1105.

An employee benefit plan may sue or be sued as an entity. 29 USC §1132(d)(1). Any money judgment against the plan is enforceable only against the plan as an entity. 29 USC §1132(d)(2). The court may award attorney fees and costs to either party in any action brought by a participant, beneficiary, or fiduciary. 29 USC §1132(g).

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§3.70 5. Remedies

Donovan v Mazzola (9th Cir 1983) 716 F2d 1226 demonstrates the broad range of remedies available under ERISA. In that case, the court subjected the individual appellants, present and former trustees of ERISA-covered plans, to joint and several liability for losses resulting from their breaches of fiduciary duty, including restitution for losses resulting from loans at below-market interest rates and from paying an excessive price for a feasibility study. The court also ordered individual appellants to post a $1 million indemnity bond to insure against potential losses resulting from loans when the risk of default was great. When the bond was not posted, the district court held the defendants in contempt and, when they failed to purge themselves of contempt, imposed a penalty of $100 per day per defendant. Finally, the court appointed an independent investment manager to control the pension fund's investments for a period of 10 years.

In *Great-West Life & Annuity Ins. Co. v Knudson* (2002) 534 US 204, 151 L Ed 2d 635, 122 S Ct 708, the Supreme Court ruled that 29 USC §1132(a)(3) does not allow recovery of third party payments from plan beneficiaries, even if the plan provides for such payments to be recovered. Title 29 USC §1132(a)(3) allows only equitable relief; an action for money is an action at law. In *Sereboff v Mid Atl. Med. Servs.* (2006) 547 US 356, 164 L Ed 2d 612, 619, 126 S Ct 1869, 1874, the Supreme Court held that a fiduciary's action for reimbursement constituted equitable relief under 29 USC §1132(a)(3), because the action sought to enforce the terms of the plan. See also *Pell v E.I. DuPont de Nemours & Co.* (3d Cir 2008) 539 F3d 292, 305 (under *Great-West,* injunction as to calculation of future benefits and restitution for underpaid pension benefits were forms of equitable relief permissible under ERISA).

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§3.71 6. Attorney Fees

The circuits are split on the criteria for awarding attorney fees in ERISA cases. The Ninth Circuit, together with the Seventh Circuit, awards attorney fees to prevailing plaintiffs unless special circumstances would make an award unjust. See *Little v Cox's Supermarkets* (7th Cir 1995) 71 F3d 637, 644; *Kayes v Pacific Lumber Co.* (9th Cir 1995) 51 F3d 1449; *Smith v CMTA-IAM Pension Trust* (9th Cir 1984) 746 F2d 587. The Third, Fourth, Fifth and Eighth Circuits, however, follow the less liberal rule of *Ursic v Bethlehem Mines* (3d Cir 1983) 719 F2d 670 (setting out five factors court must consider in evaluating propriety of attorney fee award under ERISA). See *Martin v Arkansas Blue Cross & Blue Shield* (8th Cir 2002) 299 F3d 966, 971; *Quesinberry v Life Ins. Co. of N. Am.* (4th Cir 1993) 987 F2d 1017; *Ellison v Shenango Inc. Pension Bd.* (3d Cir 1992) 956 F2d 1268; *Iron Workers Local No. 272 v Bowen* (5th Cir 1980) 624 F2d 1255.

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§3.72 7. Punitive Damages

The courts have also addressed the question of when punitive damages may be available under ERISA. In *Meyer v Phillip Morris, Inc.* (ED Mo 1983) 575 F Supp 1232, it was held that punitive damages are not available under ERISA against a plan administrator who violates 29 USC §1024(b)(1) and (3) by failing to provide participants with documents describing the plan. However, a pension fund was found to be entitled to an award of punitive damages against an employer who willfully failed to make required contributions to the plan. *Winterrowd v David Freedmen & Co.* (9th Cir 1984) 724 F2d 823. In *Miner v Typographical Union Pension Plan* (D Colo 1985) 601 F Supp 1390, former employees of the International Typographical Union Negotiated Pension Plan alleged wrongful and retaliatory discharge from employment after they discovered violations of ERISA's fiduciary provisions by the defendants, who administered the plan. The court held that the remedy of punitive damages is available under ERISA when a fiduciary has acted with actual malice or wanton indifference to the rights of plan beneficiaries or participants.

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§3.73 8. Measure of Damages

Addressing the issue of what constitutes "losses," the court in *Donovan v Bierwirth* (2d Cir 1985) 754 F2d 1049 held that, under ERISA §409, the proper measure of loss to the pension fund, which resulted from the trustees' investment in shares of the sponsoring employer as part of an attempt to avoid a takeover, required a comparison of what the fund actually earned on the employer stock investment with what the fund would have earned had the assets been available for other fund purposes. Extracontractual damages due to improper claims processing, however, are not recoverable under §409. In *Massachusetts Mut. Life Ins. Co. v Russell* (1985) 473 US 134, 87 L Ed 2d 96, 105 S Ct 3085, a beneficiary who ultimately received all benefits to which she was contractually entitled brought suit for extracontractual compensatory and punitive damages based on a 5-month interruption of benefits. The Court held that §409 did not provide a cause of action for extracontractual damages, noting that recovery under that section inured to the benefit of the plan as a whole rather than to an individual beneficiary. See also *Varity Corp. v Howe* (1996) 516 US 489, 134 L Ed 2d 130, 116 S Ct 1065; *Bowles v Reade* (9th Cir 1999) 198 F3d 752. But see *LaRue v DeWolff, Boberg & Assocs.* (2008) 552 US 248, 169 L Ed 2d 847, 854, 128 S Ct 1020, in which the Court held that 29 USC §1132(a) provides a remedy for fiduciary breaches impairing the value of plan assets in a participant's account but not for an individual participant's account losses.

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§3.74 9. Breach by Fiduciary

The courts have continued to find fiduciaries to be personally liable for their breaches. In *Katsaros v Cody* (ED NY 1983) 4 EBC 2697, aff'd (except regarding appointment of fund manager) (2d Cir 1984) 744 F2d 270, trustees of a pension plan who breached their fiduciary duty in connection with plan loans were held to be jointly and severally liable for over $2 million, plus interest, costs, and legal fees. The trustees were also enjoined from exercising authority as trustees of the pension fund and related funds. In *Donovan v Williams* (ND Ohio 1983) 4 EBC 1237, a union official and fiduciary of five benefit plans who breached ERISA's fiduciary responsibility provisions was held liable to the plans for financial losses from the time he became a fiduciary until the time a court-appointed receiver assumed his responsibilities, as well as for amounts owed the plans that the defendant failed, without justification, to collect when he became a fiduciary.

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§3.75 L. Walsh-Healey Act

The Public Contracts Act (41 USC §§35-45), popularly known as the Walsh-Healey Act, prescribes standards for wages, hours of work, child labor, safety, and health for employees of employers who contract with the federal government for the manufacture or furnishing of goods totaling more than $10,000. The statute provides for overtime pay for hours worked in excess of 40 in one week and minimum wages appropriate to those prevailing in the area as determined by the Secretary of Labor.

The primary means of enforcing the Act lie in the government's right to cancel the contract and possible blacklisting to preclude additional government contracts for a period of 3 years. 41 USC §§36-37. In addition, the Act provides for liquidated damages of $10 per day for employment of child or convict labor and damages for wage underpayments. The Secretary of Labor obtains these sums by withholding payments to contractors, through administrative hearings and/or by means of civil action, which he or she then pays to the aggrieved employees. 41 USC §36.

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§3.76 M. Davis-Bacon Act

The Davis-Bacon Act (40 USC §§3141-3148) applies some of the same provisions to the construction industry that are applicable to manufacturing by the Walsh-Healey Act (see §3.25). It provides that wage and benefit standards for employees of government contractors holding government construction contracts of more than $2000 in value must conform to those generally prevailing in the particular labor market area as determined by the Secretary of Labor. Underpayments may be withheld by the government from amounts due to a contractor (40 USC §3142) or, if this is not possible, the aggrieved employee may file suit against the contractor on his or her own behalf. 40 USC §3144(a)(2); *Martinez v Phillips Petroleum Co.* (D Idaho 1968) 283 F Supp 514. The Act also provides that the President may suspend its provisions in a national emergency. 40 USC §3147.

In *Universities Research Ass'n v Coutu* (1981) 450 US 754, 67 L Ed 2d 662, 101 S Ct 1451, the Court ruled that there is no private right of action for back wages under the Davis-Bacon Act if the contracting federal agency has made an administrative determination that the contract was not to be subject to the Act and therefore expressly excluded Davis-Bacon Act stipulations governing prevailing wages.

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N. Federal Employee Protections

§3.77 1. Federal Service Labor Management Relations Act

In 1978, the Congress enacted the Federal Service Labor Management Relations Act (FSLMRA) (5 USC §§7101-7135). This legislation created a law for federal employees that is comparable to the NLRA for private sector employees. The law confers on federal employees the right to join labor organizations and to engage in collective bargaining on conditions of employment. The law also establishes a three-member independent Federal Labor Relations Authority (FLRA) to administer the statute, and creates an office of the General Counsel to investigate and prosecute unfair labor practices. The FLRA and its General Counsel have exclusive enforcement authority over unfair labor practice proceedings, and no private cause of action lies with federal employees against a union for breach of the duty of fair representation. *Karahalios v National Fed'n of Fed. Employees Local 1263* (1989) 489 US 527, 103 L Ed 2d 539, 109 S Ct 1282.

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§3.78 a. Employees' Grievances

Under the FSLMRA, all labor-management agreements must include a grievance procedure with binding arbitration as the final step. 5 USC §7121(a)-(b). Nearly all matters related to an employee's employment must be grievable, unless the parties agree otherwise or the subject falls within one of five specific excluded areas. 5 USC §7121(c)(1)-(5).

Employees with grievances alleging discrimination based on race, color, creed, national origin, sex, age, or physical disability must elect to proceed under either the grievance procedure or the separate equal employment opportunity statutes. 5 USC §7121(d). Similarly, an employee must elect to proceed under the grievance procedure in the labor-management agreement or the statutory procedure that allows the Merit Systems Protection Board to resolve grievances on matters such as removal, suspension, reductions in pay or grade, furloughs of 30 days or less, or actions based on unacceptable performance. 5 USC §7121(e)(1). Procedures for appeals to the Merit Systems Protection Board and judicial review of that board's decisions are in 5 USC §§7701-7703.

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§3.79 b. Back Pay and Attorney Fees

The FSLMRA amends 5 USC §5596(b) to authorize the award of back pay and attorney fees in unfair labor practice and grievance cases. 5 USC §§5596(b), 7701(g)(1). For U.S. Postal Service employees, however, attorney fees are not authorized by statute and therefore may be awarded only if the agency acted in bad faith or in willful disobedience of a court order. *National Ass'n of Letter Carriers v U.S. Postal Serv.* (DC Cir 1978) 590 F2d 1171.

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§3.80 2. First Amendment Rights and Political Activity

In *Givhan v Western Line Consol. Sch. Dist.* (1979) 439 US 410, 58 L Ed 2d 619, 99 S Ct 693, the Court applied the test set forth in *Pickering v Board of Educ.* (1968) 391 US 563, 20 L Ed 2d 811, 88 S Ct 1731, to determine whether a federal employee's publicly expressed criticism of his employer was constitutionally protected. The *Pickering* analysis also protects participation in union activities. See *Butcher v City of McAlester* (10th Cir 1992) 956 F2d 973.

In *Branti v Finkel* (1980) 445 US 507, 63 L Ed 2d 574, 100 S Ct 1287, the Supreme Court held that public employees can be removed from their positions solely because of their political affiliations only if the nature of their job is such that political affiliation is crucial to effective performance. See also *Elrod v Burns* (1976) 427 US 347, 49 L Ed 2d 547, 96 S Ct 2673. This rule extends to promotion, transfer, recall, and hiring decisions as well. *Rutan v Republican Party* (1990) 497 US 62, 111 L Ed 2d 52, 110 S Ct 2729.

In determining whether a public employee has an unfettered right to free speech, the Ninth Circuit has found that a balance must be struck between the employee's interests as a citizen to comment on matters of public concern and the employer's interests in promoting the efficiency of the public service it provides. *Cochran v City of Los Angeles* (9th Cir 2000) 222 F3d 1195. When a public employee speaks not as a citizen on matters of public concern, but as an employee on matters only of personal interest, in an appropriate case the public agency may take disciplinary action against the employee as a result of such speech, without offending the First Amendment, and, absent unusual circumstances, a federal court is not the appropriate forum to review such action. *Connick v Myers* (1983) 461 US 138, 75 L Ed 2d 708, 103 S Ct 1684. But see *Waters v Churchill* (1994) 511 US 661, 128 L Ed 2d 686, 114 S Ct 1878 (court will review reasonableness of public employer's belief that employee's speech was unprotected). See also *Bauer v Sampson* (9th Cir 2001) 261 F3d 775 (affirming award of attorney fees when public college professor was terminated for engaging in protected speech). In a split decision, the Ninth Circuit ruled that *Waters* does not apply to protect an employee from discipline for alleged speech when the employee denies having spoken at all. *Wasson v Sonoma County Jr. College* (9th Cir 2000) 203 F3d 659.

The Ninth Circuit has held that the interest of the Immigration and Naturalization Service (INS) in promoting employee efficiency justified an INS regulation that employees not wear union insignia pins on their uniforms. *I.N.S. v Federal Labor Relations Auth.* (9th Cir 1988) 855 F2d 1454. Compare *I.N.S.* with *Roth v Veterans Admin.* (9th Cir 1988) 856 F2d 1401 (plaintiff's speech found protected because it predominantly concerned matters of public interest at time adverse action taken by defendant), and *Gillette v Delmore* (9th Cir 1989) 886 F2d 1194 (criticism by municipal fireman of manner in which police and firefighters performed their duties on particular occasion held to be matter of public concern even though comments not directed to public at large).

In a similar vein, the case of *Gonzalez v Benavides* (5th Cir 1983) 712 F2d 142, aff'd following remand (5th Cir 1985) 774 F2d 1295, involved an appointed public official and discussed the issue of whether the terminated employee's position fell within that narrow band of fragile relationships requiring job security and loyalty, at the expense of unfettered speech. See also *Fazio v City & County of San Francisco* (9th Cir 1997) 125 F3d 1328; *Jones v Dodson* (4th Cir 1984) 727 F2d 1329.

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§3.81 3. Privacy

The Federal Privacy Act (5 USC §552a) protects an individual's right to privacy from unwarranted disclosure of personal information by a federal agency. Personnel and employment records are within the scope of the Act. *Local 2047, American Fed'n of Gov't Employees v Defense Gen. Supply* (4th Cir 1978) 573 F2d 184; *White v U.S. Civil Serv. Comm'n* (DC Cir 1978) 589 F2d 713. With limited exceptions, the Act requires federal agencies to give any individual access to information and records about the individual and to respond promptly to requests to correct information the individual believes is not accurate, relevant, timely, or complete. 5 USC §552a(d). If access is denied or if inaccurate records are maintained, and if proposed corrections are improperly refused, a federal court may award actual damages, attorney fees, and other litigation costs against the United States. 5 USC §552a(g)(1). Those remedies are also available if a federal agency fails to maintain any record concerning an individual with such accuracy, relevance, timeliness, and completeness as is necessary to ensure fair determinations on matters of interest to the individual and such failure causes an adverse determination on the individual's qualifications, character, rights, opportunities, or benefits. 5 USC §552a(g)(1)(C). Significantly, because the rights under the law accrue to individuals, neither corporations nor labor unions have standing to pursue remedies under the law. *Cell Assocs. v National Inst. of Health* (9th Cir 1978) 579 F2d 1155, 1157; *Parks v IRS* (10th Cir 1980) 618 F2d 677, 684.

Certain federal employee drug testing programs may not violate the Fourth Amendment proscription on unreasonable searches and seizures even in the absence of probable cause or some level of individualized suspicion. See *National Treasury Employees Union v Von Rabb* (1989) 489 US 656, 103 L Ed 2d 685, 109 S Ct 1384 (upholding in part U.S. Customs Service urinalysis testing for employees seeking transfer or promotion to certain positions; discusses diminished privacy expectation of some public employees).

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II. ACTIONS UNDER CALIFORNIA STATUTES

§3.82 A. Labor-Management Relations

Although labor relations between employers and unions and disputes pertaining to such relations are largely matters of federal law under the LMRA (see §§3.1-3.23), state law is applicable when little or no interstate commerce is involved. The California Supreme Court has held that state courts have concurrent jurisdiction with federal courts in actions that can be brought in either forum, although the state court must apply federal law. *O'Malley v Wilshire Co.* (1963) 59 C2d 482, 30 CR 452; *McCarroll v Los Angeles County Dist. Council of Carpenters* (1957) 49 C2d 45, 315 P2d 322.

California has several statutes governing public employer-employee labor relations. The Meyers-Milias-Brown Act (MMBA) (Govt C §§3500-3511) governs local government employer-employee relations. The Act requires local government employers to meet and confer in good faith with employee representatives on wages, hours, and other terms and conditions of employment. In 1975, the Educational Employment Relations Act (EERA) (Govt C §§3540-3549.3) established collective bargaining rights for elementary, secondary, and community college employees. The California Supreme Court has ruled that the EERA divests superior courts of jurisdiction to consider a school district's tort action for damages based on a teachers' strike led by noncertified unions. The Public Employment Relations Board (PERB) has exclusive initial jurisdiction to determine what remedies are available. *El Rancho Unified Sch. Dist. v National Educ. Ass'n* (1983) 33 C3d 946, 961, 192 CR 123. See also *Link v Antioch Unified Sch. Dist.* (1983) 142 CA3d 765, 191 CR 264 (PERB has initial jurisdiction over money claims of nonunion public school teachers even if constitutional violation is alleged; exhaustion of available PERB remedies required).

NOTE: The California Supreme Court is currently considering whether the PERB has exclusive initial jurisdiction to determine whether certain local government employees covered by the MMBA have the right to strike. See *City of San Jose v Operating Eng'rs Local Union No. 3* (review granted June 18, 2008, S162647; superseded opinion at 160 CA4th 951, 73 CR3d 159), and *County of Sacramento v AFSCME Local 146* (review granted Oct. 16, 2008; superseded opinion at 165 CA4th 401, 80 CR3d 911).

In 1977, the State Employer-Employee Relations Act (SEERA) (Govt C §§3512-3524) gave similar rights to state employees. In 1978, collective bargaining was extended to employees of the University of California and the California State University with passage of the Higher Education Employer-Employee Relations Act (HEERA) (Govt C §§3560-3599). All of these statutes except the MMBA are administered by PERB. They prohibit unfair practices and provide that discrimination for union activities may be remedied by reinstatement with or without back pay, and by cease and desist orders.

Labor Code §1126 clothes collective bargaining contracts between employers and unions with the same status as other kinds of contracts, including equitable and legal remedies for their breach. See generally chap 1 on contract damages. While an employer may be sued for damages for violating a collective bargaining agreement, the more common avenue of relief is arbitration; although an employer may sue a union for damages for breaching a contract, the more common relief sought is an injunction.

Although peaceful picketing for a lawful purpose is protected by the First Amendment (see *Seven-Up Bottling Co. v Grocery Drivers Union Local 848* (1953) 40 C2d 368, 374, 254 P2d 544), California has outlawed jurisdictional strikes (Lab C §1115), *i.e.,* a strike caused by a dispute between two or more unions as to which of them has the right to represent an employer's employees (Lab C §1118). Both injunctive relief and damages are available to anyone injured or threatened with injury by a jurisdictional strike. Lab C §1116.

In *County Sanitation Dist. No. 2 v Los Angeles County Employees Ass'n, Local 660* (1985) 38 C3d 564, 214 CR 424, the California Supreme Court ruled that, on the basis of California common law, it was not unlawful for public employees to strike for the purpose of improving their wages or conditions of employment unless it was determined that the strike posed a substantial and imminent threat to public health or safety. Because the case arose under the MMBA, which at that time was not administered by PERB, the court did not address the question of PERB's exclusive initial

jurisdiction to determine whether a strike by employees covered by the EERA, SEERA, or HEERA constituted an unfair practice, or the question of what remedies, if any, PERB could pursue. See *San Diego Teachers Ass'n v Superior Court* (1979) 24 C3d 1, 154 CR 893. The court in *County Sanitation* (opinions of Broussard, Kaus, and Grodin, J.J.) did not rule on the continued availability of common law tort remedies for an unlawful strike, as earlier recognized in *Pasadena Unified Sch. Dist. v Pasadena Fed'n of Teachers* (1977) 72 CA3d 100, 140 CR 41. However, *Pasadena* was disapproved in *City & County of San Francisco v United Ass'n of Journeymen* (1986) 42 C3d 810, 818, 230 CR 856, in which the court held that maintenance of an illegal strike is not a tort for which damages may be recovered.

The supreme court subsequently held, however, that an illegal strike is not prima facie grounds for recovery in tort and directed the courts not to create a common law right to sue for damages; instead, it held that fashioning a remedy was the prerogative of the legislature. *United Ass'n of Journeymen,* 42 C3d at 818. The court held that its decision would not preclude an employer from suing for a breach of an explicit no-strike clause, or for tortious acts during the strike.

Labor Code §1122 has outlawed the company union. Any party injured as a result of an employer's interference with, or its financing, domination, or control of a union may recover damages and costs of suit. See *Messner v Journeymen Barbers Local 256* (1960) 53 C2d 873, 4 CR 179.

A local government may not unilaterally decertify a public employee union as a bargaining representative because it instigates a strike. In *International Bhd. of Elec. Workers v City of Gridley* (1983) 34 C3d 191, 193 CR 518, the California Supreme Court ruled that such action conflicts with the provisions of the MMBA that confer on local government employees the right to join and participate in employee organizations of their own choosing.

The California courts have interpreted state labor laws liberally to ensure their effectiveness. In *San Joaquin County Employees Ass'n v County of San Joaquin* (1974) 39 CA3d 83, 113 CR 912, the court held that a public employer has a duty to meet and confer in good faith in a succeeding fiscal year over salaries for the previous fiscal year when bargaining had not been completed during the preceding year. The county argued that the close of the fiscal year made any retroactive pay increase a gift of public funds prohibited by the constitution, but the court held that retroactive payment would be constitutional.

In *Los Angeles County Civil Serv. Comm'n v Superior Court* (1978) 23 C3d 55, 151 CR 547, the supreme court determined that the meet and confer requirement of the MMBA (Govt C §3505) overrides a contrary city charter provision.

Labor Code §§922-923, which make certain antiunion activities a misdemeanor, provide a basis for civil liability as well. *Glenn v Clearman's Golden Cock Inn, Inc.* (1961) 192 CA2d 793, 13 CR 769. An employee may state a cause of action for compensatory and punitive damages and for injunctive relief against an employer whose dominant motive in discharging the employee is retaliation for union activity. See *Escamilla v Marshburn Bros.* (1975) 48 CA3d 472, 121 CR 891, in which the plaintiffs went to trial with their claims but were unable to prove the employer's motive.

Under Lab C §1122, which creates a cause of action for damages for a person injured as a result of employer or employee association interference with an employee organization, an employer who withdraws recognition from a union it had voluntarily recognized as a collective bargaining agent and instead recognizes a competing union may be held liable for damages unless the employer can demonstrate reasonable good faith belief in the majority status of the latter union. *Service Employees Int'l Union v Hollywood Park, Inc.* (1983) 149 CA3d 745, 197 CR 316.

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§3.83 B. Agricultural Labor Relations Act

The Agricultural Labor Relations Act (ALRA) (Lab C §§1140-1166.3) was enacted in 1975 to fill a void left by the National Labor Relations Act, which expressly excludes agricultural laborers from the definition of "employees" (29 USC §152(3)). The ALRA is designed to provide agricultural workers with protection for their collective bargaining rights in the same way the NLRA protects nonagricultural workers. The ALRA provides that the Agricultural Labor Relations Board shall follow applicable precedents of the NLRA, and courts are to look to interpretations of the federal Act for indications of the appropriate interpretation of the state legislation. *Pasillas v ALRB* (1984) 156 CA3d 312, 202 CR 739.

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§3.84 C. Restraint of Trade Under Cartwright Act

Business and Professions Code §§16700-16770, commonly known as the Cartwright Act, prohibits restraint of trade. The Act does not restrict use of a union's economic power to set wages and benefits when the primary purpose is for a valid union objective, *e.g.,* higher wages or respect of union picket lines. *Messner v Journeymen Barbers Local 256* (1960) 53 C2d 873, 4 CR 179; *Schweizer v Waiters & Bartenders Local 500* (1953) 121 CA2d 45, 262 P2d 568. However, a union is liable for damages under the Act when an unlawful purpose to restrain trade is found in an agreement between the union and an employers' association to demand higher wages of an employer-member in order to make it unprofitable for that member to continue in business. *Alfred M. Lewis, Inc. v Teamsters Local 542* (1958) 163 CA2d 771, 330 P2d 53. Likewise, a union that restricted the hours during which goods processed by its members could be sold was held to be guilty of an objective in restraint of trade. *Kold Kist, Inc. v Meat Cutters Local 421* (1950) 99 CA2d 191, 221 P2d 724. Damages to those whose business or property is injured by the unlawful restraint of trade are set at three times the actual injury suffered plus reasonable attorney fees and costs. Bus & P C §16750.

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Source: Civil Litigation/California Attorney's Guide to Damages/3 Labor/§3.84A D. Use of State Funds for Anti-Union Activities

§3.84A D. Use of State Funds for Anti-Union Activities

Government Code §§16645-16649, passed in 2000, prohibits employers from using state funds to assist, deter, or promote union organizing. Employers who violate the statute's provisions are subject to fines and penalties, including disgorgement of the state funds used and a civil penalty paid to the state equal to twice the amount of those funds.

NOTE: In *Chamber of Commerce v Brown* (2008) 554 US ___, 171 L Ed 2d 264, 128 S Ct 2408, the Supreme Court held that §16645.2 (applicable to grant recipients) and §16645.7 (applicable to private employers receiving more than $10,000 in program funds per year) are preempted under *Machinists v Wisconsin Employment Relations Comm'n* (1976) 427 US 132, 49 L Ed 2d 396, 96 S Ct 2548, because those sections "regulate within a zone protected and reserved for market freedom." 171 L Ed 2d at 272.

Suspected violators may be sued by the state attorney general or by any private taxpayer. Govt C §16645.8. Prevailing plaintiffs and prevailing taxpayer intervenors who make substantial contributions to a lawsuit under the statute are entitled to recover reasonable attorney fees and costs. Govt C §16645.8(d).

NOTE: Given the breadth of coverage of Govt C §§16645-16649, which applies to all employers who do virtually any form of business with the state by providing goods or services, and employers' presumed reluctance to turn over their books and records for review by the state, further litigation on this issue can be expected.

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§3.85 E. Timely Payment of Wages

On voluntary termination of employment, an employee not having a written contract for a definite period who quits without providing a 72-hour notice is entitled to receive payment by mail if he or she so requests and designates a mailing address. The date of the mailing constitutes the date of payment for purposes of Lab C §202.

If at least 72 hours' advance notice was given by the employee before quitting, the employee is entitled to his or her wages when he or she quits. Lab C §202.

If an employee is discharged, wages earned are due and payable immediately on termination. Lab C §201. Failure to pay wages when due to an employee who is fired or quits subjects an employer to continue such wage payments to the employee for a period not to exceed 30 days as a penalty until all payments are made. Lab C §203(a).

NOTE: An individual released by an employer on completion of the particular job assignment or the particular time duration for which he or she was hired is "discharged" within the meaning of Lab C §201; thus, the employer is required under §201 to pay the individual "immediately" on completion and the individual is entitled to a "waiting time penalty" under Lab C §203 if the individual is not promptly paid. *Smith v Superior Court* (2006) 39 C4th 77, 45 CR3d 394. Note that the 1-year statute of limitations of CCP §340(a) applies to a claim seeking only a waiting time penalty under §203. *McCoy v Superior Court* (2007) 157 CA4th 225, 229, 68 CR3d 483.

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§3.86 1. Collective Bargaining Agreements

The Labor Commissioner's policy under Lab C §229 of not enforcing Lab C §§201 and 203 when the complaining employee is subject to a collective bargaining agreement containing an arbitration clause was considered in *Livadas v Bradshaw* (1994) 512 US 107, 129 L Ed 2d 93, 114 S Ct 2068, which held that the Labor Commissioner's refusal to enforce Lab C §§201 and 203 under these circumstances was preempted by the National Labor Relations Act. The Court reasoned that such a policy impermissibly forced the employee to choose between the right of collective bargaining and rights enjoyed under the state labor code. An employee's rights under the Labor Code are enforceable in state court unless the employee's collective bargaining agreement has expressly bargained away the rights.

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§3.87 2. Wage Periods

In addition, Lab C §§204, 204b, and 205 establish the periods during which wages are to be paid in relation to when the work was performed, *e.g.,* work performed between the 1st and 15th day of the month must be paid for between the 16th and 26th day of that month. Labor Code §201.3 establishes wage periods for temporary workers. Employees who leave work to go on strike must be paid wages previously earned on the next regular payday. Lab C §209.

An employer who fails to pay wages in a timely manner is subject to a $100 penalty for an initial violation and a $200 penalty for each subsequent violation, or any intentional or willful violation, plus 25 percent of the amount unlawfully withheld. Lab C §210(a). The Division of Labor Law Enforcement may sue to recover such amounts. Lab C §210(b). The court may also award costs to plaintiff in such a suit. Lab C §211.

For purposes of Lab C §206(b), which provides for assessment of treble damages against an employer for willful failure to pay wages as required by law following a Labor Commission hearing, vacation pay and severance pay constitute wages. See *Triad Data Servs. v Jackson* (1984) 153 CA3d Supp 1, 200 CR 418, disapproved on other grounds in *Smith v Rae-Venter Law Group* (2002) 29 C4th 345, 368, 127 CR2d 516 (under facts of case, Lab C §206(b) held not to apply).

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§3.88 3. Vacation Benefits

There is no required minimum vacation benefit in California. Vacation benefits are earned and vest as wages when they are voluntarily provided by the employer or earned under collective bargaining agreements. See *Amaral v Cintas Corp.* (2008) 163 CA4th 1157, 1206, 78 CR3d 572 (plaintiffs accrued vacation benefits under employment contracts and municipal living wage ordinance). When provided, vacation benefits cannot be forfeited and are earned incrementally in the same manner as wages. Lab C §227.3; *Suastez v Plastic Dress-Up Co.* (1982) 31 C3d 774, 784, 183 CR 846. Vacations are not lost if not used within a specified time or if the employee is fired or quits before completion of the vacation, because such a loss would be a forfeiture. Lab C §227.3.

On termination, an employee is entitled under Lab C §227.3 to prorata earned vacation benefits. *Suastez v Plastic Dress-Up Co., supra*. Vacation pay is, in effect, additional wages for services performed, the receipt of which is postponed. Although a use-it-or-lose-it policy is illegal as a forfeiture, a future-looking rule that conditions the future accrual of additional vacation benefits on the use a fixed number of vacation days already accrued is permissible. This is because such a rule applies to the accrual of future benefits, before the employee's service has been performed, rather than divesting the employee of benefits already earned for services the employee has performed. *Henry v Amrol, Inc.* (1990) 222 CA3d Supp 1, 5, 272 CR 134; California Labor Commissioner Interpretive Bull No. 86-3. Absent a vacation limit imposed by a maximum accrual rule, vacation continues to be earned on a daily basis in the same way as wages. Employers have the right to control when and how much vacation can be taken at one time. *Henry v Amrol, Inc., supra.*

The rate of pay in effect at the time vacation is taken controls even if some or all vacation was earned while the employee was working at a lower rate of pay. Lab C §227.3. Moreover, pay may not be reduced before vacation because to do so would result in a reduction of wages after the employee performed the services and thus constitute a forfeiture.

Labor Code §227.3 as interpreted by *Suastez* is not preempted by the Employee Retirement Income Security Act of 1974 (ERISA). *California Hosp. Ass'n v Henning* (9th Cir 1985) 770 F2d 856, 860, modified at 783 F2d 946 ("vacation wages paid promptly and directly from the employer's general assets are not covered by ERISA"). See also *Massachusetts v Morash* (1989) 490 US 107, 104 L Ed 2d 98, 109 S Ct 1668 (policy of paying discharged employees for their unused vacation time does not constitute employee welfare benefit plan within meaning of ERISA). But see *Smith v Rochester Tel. Bus. Mktg. Corp.* (WD NY 1992) 786 F Supp 293 ("pre-pension leave" is not vacation and is covered by ERISA).

In *Church v Jamison* (2006) 143 CA4th 1568, 1583, 50 CR3d 166, the court held that the limitations periods applicable to contracts (2 years for oral contracts (CCP §339(1)) or 4 years for written contracts (CCP §337(1)) cannot be used as "look-back" periods to limit an employer's liability to pay for unused, earned vacation at the time of an employee's termination. In so holding, the court rejected *Sequeira v Rincon-Vitova Insectaries, Inc.* (1995) 32 CA4th 632, 38 CR2d 264, as well as the position of the California Division of Labor Standards Enforcement (DLSE). Both had taken the position that actions to collect unused earned vacations under Lab C §227.3 were limited by a "look-back" application of the statute of limitations, which required employees to bring actions for breach of payment of vested vacation under §227.3 within 4 years following termination. *Sequeira* and the DLSE additionally imposed a second statute of limitations by "looking back" to limit the vacation claims to those brought within a 4-year period from the date they were "earned."

The *Church* court rejected this dual statute of limitations because it was based on the erroneous notion that employees are obligated to take vacation when earned, and that the statute of limitations begins to run when the employee earns the vacation benefit. 143 CA4th at 1581. Rather, the court reasoned, although employees have a right to a vacation at the intervals agreed to in their contract, they are not required to take, nor was the employer required to give, vacation pay for earned and unpaid vacation at any time short of the employee's request for vacation. Thus, the employer's breach of its duty to pay the employee for his earned vacation did not occur until termination. 143 CA4th at 1582. Accordingly, there was no breach of the contract until the employer denied the employee payment for the earned but unused vacation, regardless of how long the employee had delayed before requesting his vacation during his

employment.

NOTE: Because of the nature of the case (a malpractice action against the attorney who had brought the employee's suit against his employer), the *Church* decision does not address when and how an employee perfects a claim for vacation pay other than by termination, nor when and how an employer breach occurs to trigger the statute of limitations. Presumably, these issues will be decided in the future.

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§3.88A 4. Meal and Rest Periods

NOTE: The California Supreme Court has granted review in *Brinker Restaurant Corp. v Superior Court* (review granted Oct. 22, 2008, S166350; superseded opinion at 165 CA4th 25, 80 CR3d 781), which presents the issue of whether employers are required to ensure that employees actually take scheduled meal and rest breaks or whether employers only have a duty to make meal and rest breaks available.

Meal periods. Under Lab C §512(a), an employee may not be required to work for a period of more than 5 hours per day without a meal period of at least 30 minutes; however, if the total work period per day is 6 hours or less, the meal period may be waived by mutual consent of both the employer and employee. A second meal period of at least 30 minutes is required if an employee works more than 10 hours per day; again, however, the second meal period may be waived by mutual consent of the employer and employee if the total hours worked is no more than 12 hours and if the first meal period was not waived. Lab C §512(a).

Rest periods. Employers must authorize and permit nonexempt employees to take a rest period that must, to the extent possible, be taken in the middle of each work period, although several categories of employees are exempted. The rest period is based on the total hours worked daily and must be at the minimum rate of a net 10 consecutive minutes for each 4-hour work period or major fraction thereof. 8 Cal Code Regs §11090. The Division of Labor Standards Enforcement (DLSE) considers anything more than 2 hours to be a "major fraction" of 4. See the Department of Industrial Relations (DIR) website at http://www.dir.ca.gov/dlse/faq%5Frestperiods.htm. A rest period is not required for employees whose total daily work time is less than 3½ hours. The rest period is counted as time worked; thus, the employer must pay for it. Because employees are paid for their rest periods, they can be required to remain on the employer's premises during such periods. See the DIR website at http://www.dir.ca.gov/dlse/faq%5Frestperiods.htm. See also the Industrial Welfare Commission (IWC) Wage Orders 1-2001—17-2001 regulating wages, hours, and working conditions for the various industries; they can be found on the DIR website at http://www.dir.ca.gov/IWC/WageOrderIndustries.htm.

Remedies. If an employer fails to provide an employee a meal or rest period, the employer must pay 1 "additional hour of pay" at the employee's regular pay for each workday that the meal or rest period is not provided. Lab C §226.7.

NOTE: If an employer does not provide all of the rest periods required in a workday, the employee is entitled to 1 additional hour of pay for that *workday,* not 1 additional hour of pay for each rest period that was not provided during that workday. For more information on rest periods, see the DIR's website at http://www.dir.ca.gov/dlse/faq%5Frestperiods.htm.

The "additional hour of pay" constitutes a claim for a premium wage (not a penalty) and is governed by the 3-year statute of limitations for a compensation claim (CCP §338). *Murphy v Kenneth Cole Prods., Inc.* (2007) 40 C4th 1094, 1114, 56 CR3d 880.

Whether the penalty is an unpaid wage is crucial for the application of Lab C §203, which provides that if an employer willfully fails to pay, under Lab C §§201, 201.3, 201.5, 202, and 205.5, "any wages" of an employee who is discharged or who quits, the employee's wages "continue as a penalty from the due date thereof at the same rate until paid or until an action therefore is commenced" up to 30 days. The possibility of a month's back pay for a missed meal and rest period has been a major concern to employers.

Nonavailability of punitive damages. In *Brewer v Premier Golf Props., LP* (2008) 168 CA4th 1243, 1252, 86 CR3d 225, the court held that punitive damages are not recoverable when an employer's liability is based solely on violations of Labor Code provisions regulating meal and rest periods.

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§3.89 5. *Berman* Hearing

When a claim for unpaid wages is made under Lab C §§98-98.8 (known as the "*Berman*" hearing procedure, named after the sponsor of the legislation), a back pay award is calculated from the filing date of the wage claim, rather than from the date of the hearing on the claim. *Cuadra v Millan* (1998) 17 C4th 855, 72 CR2d 687, disapproved on other grounds in *Samuels v Mix* (1999) 22 C4th 1, 16 n4, 91 CR2d 273. The court reasoned that this interpretation of the statute best fulfilled the statutory intent that claimants be awarded all unpaid wages from the date those wages became due and that claimants could utilize the administrative process to secure a full recovery. 17 C4th at 867.

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§3.90 6. Enforcement

Enforcement of claims for unpaid wages is the responsibility of the Division of Labor Law Enforcement, which conducts hearings on claims submitted by employees. "The Labor Commissioner… shall, upon the filing of a claim therefor by an employee…, take assignments of:" wage and other claims. Lab C §96. It may also institute civil actions to recover amounts due when in the labor commissioner's judgment the employee is financially unable to employ counsel. Lab C §98. Judgments in such cases must include costs (Lab C §102) and attorney fees up to a maximum of 20 percent of the amount claimed provided that amount does not exceed $300 (CCP §1031).

See Lab C §203 for special penalty provisions applicable to motion picture employees who have been discharged or laid off.

See Lab C §§96-98.5 on the Labor Commissioner's authority to investigate complaints, collect wages, and hold hearings, and on procedure generally.

The California Supreme Court has held that corporate agents acting within the scope of their agency are not personally liable for the corporate employer's failure to pay its employees' wages. *Reynolds v Bement* (2005) 36 C4th 1075, 1087, 32 CR3d 483. Although corporate directors may be jointly liable with the corporation if they personally directed or participated in the tortious conduct (*Frances T. v Village Green Owners Ass'n* (1986) 42 C3d 490, 504, 229 CR 456), the simple failure to comply with statutory overtime requirements does not qualify. 36 C4th at 1090. Following *Reynolds*, one court of appeal has held that a chief executive officer of a corporation, even one with operational control, could not be held personally liable for corporate employees' unpaid wages. *Jones v Gregory* (2006) 137 CA4th 798, 803, 40 CR3d 581.

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§3.90A 7. Labor Code Private Attorneys General Act of 2004

The Labor Code Private Attorneys General Act of 2004 (Lab C §§2698-2699.5) authorizes an aggrieved employee to bring a civil action for assessment of civil penalties against an employer for violations of over 100 designated Labor Code sections. Lab C §2699.5. A stated purpose of the Act is to improve enforcement of existing Labor Code provisions through adequate financing of essential labor law enforcement functions. This goal is accomplished by distributing 75 percent of recovered civil penalties to the Labor and Workforce Development Agency (LWDA) and the remaining 25 percent to the aggrieved employee(s). Note to Lab C §2698, quoting Stats 2003, ch 906, §1; Lab C §2699(i).

NOTE: In some cases, statutory penalties are imposed only when the violation is willful. See, *e.g.,* Lab C §§203, 226(e). In other cases, penalties are increased when the violation is willful or intentional. See, *e.g.,* Lab C §225.5. See also *Amaral v Cintas Corp.* (2008) 163 CA4th 1157, 1202, 78 CR3d 572 (employer's Labor Code violations were not willful because requirements of city's Living Wage Ordinance were unclear at time of violations).

Rights under the Act extend to some Labor Code violations that did not previously carry civil penalties. Existing statutory penalties permitted under various other Labor Code sections are unaffected, and may be obtained in addition to the civil penalties of the Act. Lab C §2699(a).

For violations of Labor Code sections that do not provide for a civil penalty, the Act establishes penalties starting at $500, and increasing to $200 per employee per pay period for each violation. Lab C §2699(f). However, there are restrictions. Before a civil action may be filed, the aggrieved employee or representative must give the LWDA and the named employer defendant a written 30-day notice of the intended action. Lab C §2699.3(a)(1). The LWDA then has 120 days to investigate and, if possible, negotiate a cure. Lab C §2699.3(a)(2)(B). If the plaintiff disagrees with the negotiated cure, it may challenge the cure in court. Lab C §2699.3(c)(3). Nothing in the Act diminishes or inhibits employees' present rights to pursue claims under existing federal and state law. For example, in *Caliber Bodyworks, Inc. v Superior Court* (2005) 134 CA4th 365, 36 CR3d 31, plaintiff employees filed four different categories of claims against defendant: (1) those seeking only civil penalties; (2) hybrids, seeking both civil penalties and unpaid wages; (3) those seeking only unpaid wages or statutory penalties or both; and (4) those under Bus & P C §17200. Due to notice deficiencies, the court granted demurrer as to the causes of action seeking civil penalties under the Labor Code Private Attorneys General Act of 2004. But the claims seeking unpaid wages, statutory penalties, and §17200 relief were unaffected. 134 CA4th at 383.

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§3.91 F. Indemnity for Work-Related Expenses or Losses

Under Lab C §2802, an employer is required to fully indemnify an employee for necessary expenditures or losses that directly result from the discharge of employment duties. In *Machinists Automotive Trades Dist. v Utility Trailer Sales Co.* (1983) 141 CA3d 80, 190 CR 98, an employee was held entitled to the value of tools stolen from his employer's premises. Interpreting Lab C §2802 in a common-sense manner, the court noted that the tools were provided by the employee as is the custom of the industry, that the employee could not reasonably be expected to bring the tools to work and home every day because they weighed hundreds of pounds, and that the employer inventoried employees' tools and provided a place for their storage.

An employer complies with its duty under Lab C §2802 to indemnify employees for expenses that they necessarily incur in the discharge of their duties by paying the employees increased wages or commissions, instead of reimbursing them for their actual expenses. *Gattuso v Harte-Hanks Shoppers, Inc.* (2007) 42 C4th 554, 67 CR3d 468.

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Source: Civil Litigation/California Attorney's Guide to Damages/3 Labor/§3.92 G. Illegal Termination of Employment

§3.92 G. Illegal Termination of Employment

Generally, in the absence of an employment contract providing for a specified term of employment, either party may terminate the employment with or without cause. Lab C §2922; *Swaffield v Universal Ecsco Corp.* (1969) 271 CA2d 147, 76 CR 680; *Wilson v Red Bluff Daily News* (1965) 237 CA2d 87, 46 CR 591. However, the Labor Code does proscribe discharge of an employee in two specific instances:

- Labor Code §2929 provides that no employee may be discharged because his or her wages have been subjected to a threat of garnishment or to garnishment for the payment of one judgment. Damages for violation of this section are continuation of wages until reinstatement up to a maximum of 30 days.
- Labor Code §6311 forbids discharge for refusing to perform work that violates "any occupational safety or health standard" as well as code provisions and safety orders of the Division of Industrial Safety.

Collective bargaining agreements. Wrongful termination claims of employees subject to collective bargaining agreements may be preempted by Labor Management Relations Act §301 (29 USC §185). Similarly, wrongful termination claims implicating rights under an employee benefit plan (*e.g.,* termination to deprive the employee of benefits) usually, but not always, are preempted by ERISA (29 USC §§1001-1461). *Christopher v Mobil Oil Corp.* (5th Cir 1992) 950 F2d 1209; *Sorosky v Burroughs Corp.* (9th Cir 1987) 826 F2d 794; *Barnick v Longs Drug Stores* (1988) 203 CA3d 377, 250 CR 10. But see *Stewart v United States Bancorp* (9th Cir 2002) 297 F3d 953, 959, (questioning *Sorosky v Burroughs Corp., supra*).

At-will employment. For many years an employee who was not protected by a union contract, written rules, or tenure obtained through public employment could generally be fired at any time unless the employee had an employment contract with a clause restricting the power of termination. See Lab C §2922. Employees who did not have a contract and could be fired at the will of the employer were called "at will" employees.

The presumption of at-will employment codified in Lab C §2922 is subject to the following five common law exceptions:

1. Violation of public policy. If an employee is terminated in violation of public policy, the employee may bring a wrongful termination claim seeking tort damages. *Tameny v Atlantic Richfield Co.* (1980) 27 C3d 167, 164 CR 839 (termination in violation of antitrust laws). This exception may extend to disciplinary action short of discharge in some circumstances. *Garcia v Rockwell Int'l Corp.* (1986) 187 CA3d 1556, 232 CR 490. Even when a collective bargaining agreement applies, a wrongful termination in violation of public policy claim is not necessarily preempted by federal labor law and may be brought in state court. *Garibaldi v Lucky Food Stores, Inc.* (9th Cir 1984) 726 F2d 1367 (employee responsible for milk deliveries, who was allegedly discharged for reporting adulterated milk to health officials, stated claim for tortious termination).

NOTE: The current balancing test for determining preemption under §301 of the LMRA (29 USC §185), set out in *Allis-Chalmers Corp. v Lueck* (1985) 471 US 202, 214, 85 L Ed 2d 206, 217, 105 S Ct 1904, differs from the test set out in *Farmer v United Bd. of Carpenters & Joiners* (1977) 430 US 290, 295, 51 L Ed 2d 338, 347, 97 S Ct 1056, and applied in *Garibaldi Vincent v Trend W. Tech. Corp.* (9th Cir 1987) 828 F 2d 563, 566. *Allis-Chalmers,* not *Farmer,* controls preemption by §301. *Hyles v Mensing* (9th Cir 1988) 849 F 2d 1213, 1217.

Courts are split on whether the right of privacy is a subject of public policy concern sufficient to sustain a cause of action for wrongful termination in violation of public policy. Compare *Semore v Poole* (1990) 217 CA3d 1087, 266 CR 280, with *Luck v Southern Pac. Transp. Co.* (1990) 218 CA3d 1, 267 CR 618, disapproved on other grounds in *Hill v National Collegiate Athletic Ass'n* (1994) 7 C4th 1, 56, 26 CR2d 834.

2. Agreement for good cause termination. If the parties have agreed either expressly or impliedly that the employee will not be terminated unless there is good cause, the employment is not at will. See *Foley v Interactive Data Corp.* (1988) 47 C3d 654, 254 CR 211; *Pugh v See's Candies* (1981) 116 CA3d 311, 171 CR 917; *Cleary v American Airlines, Inc.* (1980) 111 CA3d 443, 168 CR 722, disapproved on other grounds in *Guz v Bechtel Nat'l, Inc.* (2000) 24 C4th 317, 350, 100 CR2d 352. In determining whether an implied-in-fact contract exists, a variety of factors are

examined, including (*Pugh v See's Candies*, *supra*):

- Longevity of service;
- Personnel practices, procedures, or policies of the employer;
- Actions or communications by the employer that reflect assurances of continued employment;
- Industry practices;
- Commendations or promotions received; and
- Lack of direct criticism of the employee.

The existence of an implied contract is a jury question. See *Foley v Interactive Data Corp., supra; Walker v Northern San Diego County Hosp. Dist.* (1982) 135 CA3d 896, 905, 185 CR 617. In *Guz v Bechtel Nat'l, Inc., supra,* the California Supreme Court carved out an exception to *Foley, Cleary,* and *Pugh,* ruling that the existence of the above factors will not establish an implied-in-fact contract when an explicit employer policy stated that employment was at will. *Guz* in theory leaves open the possibility of an implied-in-fact contract even when the employer's policy states the employment is at will, but the decision leaves little room for practical application of the theoretical possibility.

An employment contract provision defining at-will employment as terminable "at any time" is not per se ambiguous even if it fails to specify that no cause is required for termination; to imply a requirement that termination must be for cause would be directly contrary to the plain "at any time" language of the contract. *Dore v Arnold Worldwide, Inc.* (2006) 39 C4th 384, 46 CR3d 668.

3. Implied covenant of good faith and fair dealing. The court in *Foley v Interactive Data Corp., supra,* presumed that there was a cause of action for the covenant of good faith and fair dealing without addressing the elements of this claim. Therefore, prior law on what constitutes a breach of the implied covenant of good faith and fair dealing, which exists in every contract, is still intact. Thus far, courts have identified at least three types of conduct that will constitute breach of the covenant:

- Termination of a long-term employee without good cause (see, *e.g., Cleary v American Airlines, Inc., supra*);
- Termination in violation of personnel policies or by nonuniform application of personnel policies if the employment is not expressly at will (*Rulon-Miller v IBM Corp.* (1984) 162 CA3d 241, 247, 208 CR 524); and
- Bad faith conduct that is extraneous to the contract and that is intended to frustrate the employee's contract rights.

Koehrer v Superior Court (1986) 181 CA3d 1155, 226 CR 820; *Gray v Superior Court* (1986) 181 CA3d 813, 226 CR 570; *Khanna v Microdata Corp.* (1985) 170 CA3d 250, 215 CR 860. The court in *Foley* disapproved *Cleary* "and its progeny" to the extent that they permitted a cause of action seeking *tort* remedies for breach of the implied covenant of good faith and fair dealing. See *Foley v Interactive Data Corp.* (1988) 47 C3d 654, 700 n42, 254 CR 211.

Guz v Bechtel Nat'l, Inc., supra, firmly closed the door on actions for breach of the implied covenant of good faith and fair dealing in the termination of an at-will employee. Even if termination was arbitrary and malicious, unfair and in bad faith, if the employment was at will, *Guz* allows no action for breach of the implied covenant.

4. Limited to breach of contract damages. In *Foley v Interactive Data Corp., supra,* the California Supreme Court held that damages for breach of the covenant of good faith and fair dealing are limited to those available for breach of contract. The decision explicitly reserved the issue of what constitutes contract damages. Presumably, parties should therefore look to existing general case law and statutory law. See CC §3300. Because the *Foley* majority held only that tort damages for emotional distress were not available under a covenant cause of action and did not reach the issue of contract damages for emotional distress, counsel should also be aware of cases holding that emotional distress damages are available for breach of contract. See *Rogoff v Grabowski* (1988) 200 CA3d 624, 246 CR 185; *Frazier v Metropolitan Life Ins. Co.* (1985) 169 CA3d 90, 214 CR 883; *Allen v Jones* (1980) 104 CA3d 207, 163 CR 445 (cites several other cases on point); *Windeler v Scheers Jewelers* (1970) 8 CA3d 844, 88 CR 39. See also *Foley v Interactive Data Corp., supra* (opinion of Broussard, J., dissenting in part and concurring in part); Restatement (Second) of Contracts §353 (1981).

5. Independent torts. Foley does not change existing law with regard to the availability of tort damages for discharges based on breaches of public policy. Nor does it affect independent causes of action in tort arising in a termination context (*e.g.,* intentional infliction of emotional distress, fraud, or defamation) or affect the availability of emotional distress damages under state antidiscrimination statutes (Govt C §§12940-12996).

For further discussion of *Foley* and cases in its aftermath, see §§1.54-1.55. See also Wrongful Employment Termination Practice (2d ed Cal CEB 1997).

FEHA. The Fair Employment and Housing Act (FEHA) (Govt C §§12900-12996), the principal statute governing employment discrimination in California, applies generally to any employer regularly employing at least five persons, and to the state and its political subdivisions. Govt C §12926(d). FEHA protects the right of all persons to seek, obtain, and hold employment without discrimination based on race, religion, color, national origin, ancestry, physical or mental disability, medical condition, marital status, sex, sexual orientation, age (at least 40), or pregnancy. Govt C §§12940(a), 12941, 12945(a). This protection extends to persons perceived to have any such characteristic or to be associated with a person who has, or is perceived to have, any such characteristic. Govt C §12926(m). FEHA also prohibits employers from retaliating against employees for opposing any practices forbidden by FEHA or for filing a complaint, testifying, or assisting in any proceeding under FEHA. Govt C §12940(h).

For discussion of discrimination claims under FEHA, see Wrongful Emp Term §§2.44-2.115.

For an extensive discussion of wrongful termination of employment, see Wrongful Emp Term. See also §3.105.

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§3.93 1. Statutory Wrongful Termination Claims

A broad variety of California statutes limit an employer's right to terminate an employee.

Labor Code §1102.5 makes it a misdemeanor to terminate, or otherwise retaliate against, whistleblowers who disclose information to a governmental agency. Other statutory protections include:

- Protection for employees who complain about unsafe work places. Lab C §§6310-6312.
- Protection for employees who file wage claims. Lab C §98.6.
- Protection for employees against discrimination on account of industrial injuries or for employees who file workers' compensation claims. Lab C §132a; *Judson Steel Corp. v WCAB* (1978) 22 C3d 658, 150 CR 250. See also *City of Moorpark v Superior Court* (1998) 18 C4th 1143, 77 CR2d 445.
- Protection for employees who are on jury duty or who appear in court as witnesses or as victims of sexual assault or domestic violence. Lab C §230.
- Protection for employees against political intimidation. Lab C §§1101-1102.
- Protection against coerced lie detector tests. Lab C §432.2.
- Protection against discharge for wage garnishment. Lab C §2929.
- Protection against discharge as a result of participation in state militia or military. Mil & V C §394.
- Protection against termination for disclosing wages to coemployees. Lab C §232.
- Protection for employees who take time off to perform emergency duty as volunteer firefighters. Lab C §230.3.
- Protection for employees who are parents or guardians of pupils and who take time off to appear in the school of a pupil under a request made under Ed C §48900.1 if the employee gives reasonable notice to the employer. Lab C §230.7. See also Lab C §230.8 (protection for employees who take up to 40 hours per year to participate in school activities of children).

All protections, rights, and remedies available under state law, except any reinstatement remedy prohibited by federal law, are available to all individuals regardless of immigration status. CC §3339, Govt C §7285, Health & S C §24000, and Lab C §1171.5. See also *Reyes v Van Elk, Ltd.* (2007) 148 CA4th 604, 56 CR3d 68 (standing to assert prevailing wage claim not preempted by federal immigration law). This applies to past or current employees or applicants. Under the language of these provisions, this is declarative of existing law.

Myriad other statutes may apply. However, causes of action under some of these statutory provisions may be subject to preemption under the National Labor Relations Act (NLRA) (29 USC §§151-169). See *Haney v Aramark Unif Servs., Inc.* (2004) 121 CA4th 623, 17 CR3d 336 (no NLRA preemption); *Rodriguez v Yellow Cab Co-Op.* (1988) 206 CA3d 668, 253 CR 779. See generally Wrongful Employment Termination Practice (2d ed Cal CEB 1997).

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§3.94 2. Public Employee Termination

In addition to civil service administrative and statutory rights, public employees may have claims based on the theories discussed below.

The Supreme Court has held that a public employee is entitled to a pre-termination hearing before being fired from his or her job. *Cleveland Bd. of Educ. v Loudermill* (1985) 470 US 532, 84 L Ed 2d 494, 105 S Ct 1487. The Court of Appeals for the Sixth Circuit had ruled in favor of a former school security guard, who was fired after his earlier criminal conviction was discovered, and a former school district bus mechanic, who had failed a vision test. Neither was afforded a pre-termination hearing. Having found that the respondents' continued employment constituted a property interest under state law, the court reiterated that the principle of due process required "some kind of a hearing" before discharge. The court's reasoning rested on a balancing of the competing interests at stake. "The tenured public employee is entitled to oral or written notice of the charges against him, an explanation of the employer's evidence, and an opportunity to present his side of the story." 470 US at 546. The Court noted that a "pre-termination 'hearing,' though necessary, need not be elaborate" (470 US at 545):

> The formality and procedural requisites… can vary, depending upon the importance of the interests involved and the nature of the subsequent proceedings.… In general, "something less" than a full evidentiary hearing is sufficient prior to adverse administrative action.

Partly because of the state statutory provisions for a full post-termination hearing, the court held that the pre-termination hearing "need not definitively resolve the propriety of the discharge." Rather, "[i]t should be an initial check against mistaken decisions—essentially, a determination of whether there are reasonable grounds to believe that the charges against the employee are true and support the proposed action." 740 US at 545.

Although the issue of remedies was not presented in *Loudermill,* other courts relying on federal due process standards in employment have discussed it. The Court of Appeals for the Ninth Circuit in *Vanelli v Reynolds Sch. Dist.* (9th Cir 1982) 667 F2d 773 held that an employee was entitled to compensatory damages for mental and emotional distress caused by the failure to satisfy predisciplinary due process requirements, despite the fact that the termination was ultimately determined to be proper. In *Busche v Burkee* (7th Cir 1981) 649 F2d 509, the court upheld an award of compensatory and punitive damages, while the award for a similar violation in *Miller v City of Mission* (D Kan 1981) 516 F Supp 1333, aff'd in relevant part (10th Cir 1983) 705 F2d 368, amounted to almost $300,000, including punitive damages.

Under the California Constitution, tenured public employees enjoy certain due process rights before disciplinary action is taken. These rights are popularly referred to as *Skelly* rights. See *Skelly v State Personnel Bd.* (1975) 15 C3d 194, 124 CR 14. Those rights include notice of proposed disciplinary action, the reasons for the proposed action, the proposed penalty, a copy of the charges, a copy of all materials on which the action is based, and an opportunity to reply. 15 C3d at 215. Compare *Hinchliffe v City of San Diego* (1985) 165 CA3d 722, 211 CR 560 (discharge of probationary police officer without hearing upheld; probationary employee's right to hearing is not constitutional right and may be granted or denied by statute), with *Williams v County of Los Angeles* (1978) 22 C3d 731, 150 CR 475 (*Skelly* rights granted to nonpermanent, but seasonal civil service employee; plaintiff worked on intermittent basis, but his employment status was sufficient to entitle him to *Skelly* rights).

In fact, there is a wide variation, and some apparent inconsistency, in identifying employees entitled to *Skelly* rights. See Whitmore, *Skelly v State Personnel Board: A Ten-Year Perspective*, 66 Cal Pub Employees Rel 2 (1985), which also notes that, similarly, courts have recognized varying requirements on the degree of due process and the identity of the appropriate person(s) conducting the *Skelly* proceeding.

An employee who has been terminated without appropriate due process is minimally entitled to back pay until he or she is afforded due process. See *Barber v State Personnel Bd.* (1976) 18 C3d 395, 134 CR 206. See also *Roe v State Personnel Bd.* (2004) 120 CA4th 1029, 16 CR3d 207 (employee's resignation following termination without due process did not extinguish right to back pay). While some courts, like *Barber,* limited relief to back pay (*e.g., Mitchell v State Personnel Bd.* (1979) 90 CA3d 808, 153 CR 552; *Pipkin v Board of Supervisors* (1978) 82 CA3d 652, 147 CR 502; *Kirkpatrick v Civil Serv. Comm'n* (1978) 77 CA3d 940, 144 CR 51), at least one California court has concluded that

damages in addition to back pay may be appropriate. See *Bush v California Conserv. Corps* (1982) 136 CA3d 194, 185 CR 892 (42 USC §1983 damages). And at least one California court has ordered reinstatement of a probationary employee whose liberty interest was adversely affected by the denial of a pre-termination hearing. See *Lubey v City & County of San Francisco* (1979) 98 CA3d 340, 159 CR 440. See also *Adler v Los Angeles Unified Sch. Dist.* (1979) 98 CA3d 280, 159 CR 528 (probationary teacher had right to hearing to challenge poor evaluation because it would affect his ability to obtain subsequent employment, a property interest cognizable under Fourth Amendment). Compare *Lubey* and *Adler* with *Phillips v Civil Serv. Comm'n* (1987) 192 CA3d 996, 237 CR 751 (terminated probationary employee not entitled to back pay, because "liberty-interest hearing" granted her by Civil Service Commission gave her adequate opportunity to clear her name). Violation of the constitutional rights of a nontenured teacher gives rise to "make whole" back pay liability. *Ofsevit v Trustees of Cal. State Univs. & Colleges* (1978) 21 C3d 763, 148 CR 1.

Contract employees without civil service protection are entitled to a hearing to challenge their dismissals. *Bush v California Conserv. Corps*, *supra*. See *Kemmerer v County of Fresno* (1988) 200 CA3d 1426, 246 CR 609 (civil service employment fixed by statute, not contract; therefore remedies are limited to those established by civil service system).

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3. Damages for Wrongful Termination

§3.95 a. Contract Damages

It is well-established that lost compensation, including salary and benefits, is recoverable for breach of an employment contract. See, *e.g., Rabago-Alvarez v Dart Indus.* (1976) 55 CA3d 91, 127 CR 222. See also 3 Witkin, Summary of California Law, Agency and Employment §§267-270 (10th ed 2005). That compensation includes the value of fringe benefits such as life and medical insurance. *Wise v Southern Pac. Co.* (1970) 1 C3d 600, 607, 83 CR 202. Contract damages may sometimes include damages for emotional distress. See §1.38. Lost compensation is properly projected into the future as far as the finder of fact determines the employment agreement would have lasted. See, *e.g., Drzewiecki v H & R Block, Inc.* (1972) 24 CA3d 695, 705, 101 CR 169 (contract for employment as long as employee managed employer's business in competent and profitable manner; damages projected 10 years after termination).

Although interim earnings are deductible from contract damages, and the terminated employee is obligated to mitigate damages by obtaining other employment, the employee need not accept employment that is not comparable, or substantially similar, to the lost job. An employee's rejection of, or failure to seek, inferior employment may not be used to show a failure to mitigate damages. *CSEA v Personnel Comm'n* (1973) 30 CA3d 241, 106 CR 283; *Parker v Twentieth Century-Fox Film Corp.* (1970) 3 C3d 176, 182, 89 CR 737. Earnings from employment that is not comparable or substantially similar to the terminated position are deducted from back pay owed the plaintiff as interim earnings. The court may not deduct sums that the plaintiff might have earned, but did not in fact earn from such employment. *Rabago-Alvarez v Dart Indus*., *supra*.

Disability benefits are deducted from back pay, but they do not substitute for back pay. The employer's argument that acceptance of disability benefits proves that the employee would have been unavailable for work was rejected in *Mayer v Multistate Legal Studies, Inc.* (1997) 52 CA4th 1428, 1435, 61 CR2d 336. In addition, an employer is not liable for back pay during periods that an improperly discharged employee is unable to work due to non-work-related disability. *Davis v Los Angeles Unified Sch. Dist. Personnel Comm'n* (2007) 152 CA4th 1122, 1134, 62 CR3d 69.

Unemployment compensation benefits may not be deducted from back pay. *Rabago-Alvarez v Dart Indus.* (1976) 55 CA3d 91, 99, 127 CR 222; *Billetter v Posell* (1949) 94 CA2d 858, 211 P2d 621. For further discussion, see §3.50.

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§3.96 b. Tort Damages

Tort damages, including emotional distress, injury to reputation, and punitive damages, are available for wrongful termination in violation of public policy. *Tameny v Atlantic Richfield Co.* (1980) 27 C3d 167, 164 CR 839. See *Miklosy v Regents of Univ. of Cal.* (2008) 44 C4th 876, 901, 80 CR3d 690 (damages claim for wrongful termination in violation of public policy lies only against employer, not against supervisorial employees). See also §3.105 on the availability of tort damages under the Fair Employment and Housing Act.

General tort damages include lost past and future earnings as well as compensation for pain, discomfort, fears, anxiety, and mental and emotional distress suffered by the plaintiff. See, *e.g.,* BAJI 14.10-14.13; 6 Witkin, Summary of California Law, Torts §§1666-1669 (10th ed 2005). For the Judicial Council-approved civil jury instructions on wrongful termination, see CACI 2400-2433; for the approved employment discrimination instructions, see CACI 2500-2561. In addition, damages proximately caused to the plaintiff's reputation may be recovered. CC §3333. Punitive damages are appropriate when the defendant has been shown by clear and convincing evidence to be guilty of "oppression, fraud, or malice." CC §3294(a)-(b). Conscious disregard for a person's rights is necessary to establish malice and oppression under the statute. See CC §3294(c); *Schroeder v Auto Driveaway Co.* (1974) 11 C3d 908, 114 CR 622.

Civil Code §3294 provides (1) that "malice" includes not only conduct that is intended by the defendant to cause injury to the plaintiff but also "despicable" conduct carried on with a willful and conscious disregard of the rights or safety of others, (2) that to be oppressive, conduct must be "despicable," and (3) that oppression, fraud, or malice must be proved by clear and convincing evidence (not merely by a preponderance of evidence).

Civil Code §3295 permits a defendant to ask the court to preclude any evidence of the defendant's financial condition until after malice, oppression, or fraud has been proved.

A corporation assumes liability for punitive damages (1) if it was guilty of oppression, fraud, or malice, (2) if it authorized or ratified the wrongful conduct, or (3) if a director, officer, or manager acted in a manner evincing oppression, malice, or fraud. CC §3294(b).

On the availability of fraud damages for wrongful termination of employment, see *Hunter v Up-Right, Inc.* (1993) 6 C4th 1174, 26 CR2d 8, discussed in §3.98.

Although there is no fixed measure for determining the appropriate level of punitive damages, courts have focused on the reprehensibility of the defendant's conduct, the defendant's wealth, and the relationship between compensatory or actual damages and punitive damages. See, *e.g., State Farm Mut. Auto. Ins. Co. v Campbell* (2003) 538 US 408, 155 L Ed 2d 585, 123 S Ct 1513 (setting guidelines on when punitive damages are constitutionally appropriate); *Gober v Ralphs Grocery Co.* (2006) 137 CA4th 204, 40 CR3d 92. See also *Exxon Shipping Co. v Baker* (2008) 554 US ___, 171 L Ed 2d 570, 591, 128 S Ct 2605 (in maritime tort cases, punitive damages in excess of compensatory damages are improper); *Philip Morris USA v Williams* (2007) 549 US 346, 353, 166 L Ed 2d 940, 948, 127 S Ct 1057 (punitive damages may not be used to punish defendant for injuries to nonparties).

Attorney fees incurred in seeking to enforce the contract may not be recovered as an element of damages for breach of the covenant of good faith and fair dealing. *Mouchette v Board of Educ*. (1990) 217 CA3d 303, 317, 266 CR 1, disapproved on other grounds in *Caldwell v Montoya* (1995) 10 C4th 972, 984 n6, 42 CR2d 842.

Attorney fees may be recovered under CCP §1021.5, the private attorney general statute, under some circumstances. *Wilkerson v City of Placentia* (1981) 118 CA3d 435, 173 CR 294 (decision affected rights of virtually all public employees).

For additional discussion, see Wrongful Employment Termination Practice, chap 16 (2d ed Cal CEB 1997).

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§3.97 4. Exhaustion of Administrative Remedies

When statutes offer alternative administrative remedies, the employee need not exhaust one before pursuing the other. *Ruiz v Department of Corrections* (2000) 77 CA4th 891, 92 CR2d 139 (employee need not exhaust State Personnel Board remedies before pursuing discrimination claim under Fair Employment and Housing Act (Govt C §§12900-12996)).

In *Tiernan v Trustees of Cal. State Univs. & Colleges* (1982) 33 C3d 211, 188 CR 115, the court held that an employee challenging a termination was not required to pursue the matter through the internal grievance procedure, because the procedural claims were clearly beyond the scope of the internal grievance procedure.

Similarly, in *Snipes v City of Bakersfield* (1983) 145 CA3d 861, 193 CR 760, the court held that there was no requirement for an employee to file a tort claim with the city in order to pursue recovery under the state fair employment statutes (Govt C §§12900-12996). The court held that the action for back pay was not for damages under the governing statute. Damages claims also need not be filed to pursue actions under 42 USC §1983. However, a damages claim must be filed against a public employer to pursue a tort or contract claim. *Loehr v Ventura Community College Dist.* (1983) 147 CA3d 1071, 195 CR 576.

In *Knickerbocker v City of Stockton* (1988) 199 CA3d 235, 244 CR 764, the court held that judicial review of an agency determination (in this case, a determination by the civil service commission) is not considered part of the administrative process that must be exhausted before a subsequent judicial action can commence.

Administrative procedures must be exhausted before bringing a discrimination lawsuit under the California Fair Employment and Housing Act. *Duncan v Department of Personnel Admin.* (2000) 77 CA4th 1166, 92 CR2d 257; *Rojo v Kliger* (1990) 52 C3d 65, 276 CR 130. See, *e.g., Strauss v A.L. Randall Co.* (1983) 144 CA3d 514, 194 CR 520. This involves filing an administrative claim with the Department of Fair Employment and Housing (DFEH); at this point, the claimant may request either an administrative investigation or an immediate right-to-sue letter. Possible exceptions to the exhaustion requirement are those discrimination claims based on preexisting common law. See *Merrell v All Seasons Resorts, Inc.* (CD Cal 1989) 720 F Supp 815 (pregnancy discrimination); *Froyd v Cook* (ED Cal 1988) 681 F Supp 669 (sex discrimination and retaliatory discharge).

Exhaustion of administrative remedies under the Fair Employment and Housing Act is not required in discrimination lawsuits based on grounds independent of the act (*i.e.,* wrongful discharge in violation of public policy or actions under 42 USC §§1981, 1983). *Rojo v Kliger*, *supra*.

A claim that a job termination is retaliatory under Lab C §6310 (part of the California Occupational Safety and Health Act (OSHA)) is a common law right predating OSHA. Because that portion of OSHA does not contain comprehensive administrative remedies, the claimant may sue on his or her own behalf without first exhausting the administrative remedies. *Hentzel v Singer Co.* (1982) 138 CA3d 290, 188 CR 159. The workers' compensation administrative system is the exclusive remedy for claims of retaliation for filing a workers' compensation claim. *Portillo v G.T. Price Prods.* (1982) 131 CA3d 285, 182 CR 291. See *Berkley v Dowds* (2007) 152 CA4th 518, 530, 61 CR3d 304 (punitive damages may not be awarded if compensatory damages are not recovered).

An employee's action against an employer for intentional infliction of emotional distress may also be precluded by the exclusive remedy bar of workers' compensation when the misconduct attributable to the employer consists of actions that are a normal part of the employment relationship. *Cole v Fair Oaks Fire Protection Dist.* (1987) 43 C3d 148, 233 CR 308 (interpreting pre-1983 law). If the misconduct goes beyond the scope of the normal employment relationship, an emotional distress action is not preempted by workers' compensation. *Fretland v County of Humboldt* (1999) 69 CA4th 1478, 82 CR2d 359. See also *Goldman v Wilsey Foods, Inc.* (1989) 216 CA3d 1085, 265 CR 294; *Meninga v Raley's, Inc.* (1989) 216 CA3d 79, 264 CR 319; *La Jolla Beach & Tennis Club, Inc. v Industrial Indem. Co.* (1994) 9 C4th 27, 36 CR2d 100. Employee termination constitutes a normal part of the employment relationship. *Shoemaker v Myers* (1990) 52 C3d 1, 276 CR 303 (no cause of action for intentional infliction of emotional distress in employee termination unless conduct is beyond scope of normal employment). Compare *Shoemaker* with *Hart v National Mortgage & Land Co.* (1987) 189 CA3d 1420, 235 CR 68, and *Renteria v County of Orange* (1978) 82 CA3d 833, 147 CR 447, which had allowed recovery for emotional distress without consequent physical injuries. See *Horn v Bradco*

Int'l, Ltd. (1991) 232 CA3d 653, 283 CR 721 (citing *Shoemaker* in holding that plaintiff employee's failure to claim physical injury from termination did not exempt him from exclusive workers' compensation remedy). However, the exclusivity of workers' compensation does not extend to claims based on violation of public policy, such as retaliation against a whistleblower (Govt C §19683) or retaliation for exercising the right to counsel under the Public Safety Officers Procedural Bill of Rights Act (Govt C §§3300-3313). *Shoemaker v Myers* (1992) 2 CA4th 1407, 4 CR2d 203.

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§3.98 5. Additional Damages Claims in Wrongful Termination Cases

A termination may give rise to a variety of claims, each of which should be considered:

Intentional or negligent infliction of emotional distress. *Agarwal v Johnson* (1979) 25 C3d 932, 160 CR 141, disapproved on other grounds in *White v Ultramar, Inc.* (1999) 21 C4th 563, 88 CR2d 19; *Alcorn v Anbro Eng'g* (1970) 2 C3d 493, 86 CR 88; *Robinson v Hewlett Packard Corp.* (1986) 183 CA3d 1108, 228 CR 591. Normally, workers' compensation is the exclusive remedy for emotional distress resulting from the employment relationship, including such painful events as demotion and termination. *Davaris v Cubaleski* (1993) 12 CA4th 1583, 16 CR2d 330. However, the California Supreme Court has left open the possibility that egregious conduct in connection with termination could exceed the normal risks of the employment relationship. If so, tort claims based on that conduct apparently would not be preempted by workers' compensation. See *Livitsanos v Superior Court* (1992) 2 C4th 744, 7 CR2d 808.

Invasion of privacy. *Payton v City of Santa Clara* (1982) 132 CA3d 152, 183 CR 17.

Defamation. *Kelly v General Tel. Co.* (1982) 136 CA3d 278, 186 CR 184. Unlike personal injury claims, defamation claims are not preempted by workers' compensation. See *Davaris v Cubaleski* (1993) 12 CA4th 1583, 16 CR2d 330.

Fraud and misrepresentation. When an employee states a claim for wrongful termination, tort recovery based on fraud is not available unless all elements of the fraud are separate from termination of the employment contract. In other words, recovery based on fraud is not available unless the employee's fraud damages do not result from the termination itself. Thus, a wrongfully terminated employee cannot recover fraud damages if the only allegations of fraud relate to the employer's misrepresentations in the course of wrongfully terminating the employee. *Hunter v Up-Right, Inc.* (1993) 6 C4th 1174, 26 CR2d 8. As the court stated (6 C4th at 1184):

> [I]t is difficult to conceive of a wrongful termination case in which a misrepresentation made by the employer to effect termination could ever rise to the level of a separately actionable fraud. In essence, such misrepresentations are merely the means to the end desired by the employer, i.e., termination of employment.

For discussion of solicitation of employees by misrepresentation, see §3.101.

Negligence. *Chamberlain v Bissell, Inc.* (WD Mich 1982) 547 F Supp 1067 (negligent evaluation of job performance).

Wrongful interference with prospective employment. For discussion of Lab C §1050 (prohibiting false reference concerning former employee that prevents or is intended to prevent employee from securing other employment), see §3.102.

Interference in contractual relations. In *Kelly v General Tel. Co., supra,* the court found a duty by the company to investigate carefully allegations against an employee who voluntarily resigned because the accuser was known to harbor malice towards the employee. *Kelly* is a message to companies that they should adopt fair internal review procedures, or risk legal action. See also *Cleary v American Airlines, Inc.* (1980) 111 CA3d 443, 456, 168 CR 722, disapproved on other grounds in *Guz v Bechtel Nat'l, Inc.* (2000) 24 C4th 317, 350, 100 CR2d 352.

Libel or slander. See, *e.g., Kelly v General Tel. Co., supra*.

Breach of fiduciary duties. See, *e.g., Hannon Eng'g v Reim* (1981) 126 CA3d 415, 179 CR 78.

Negligent entrustment of responsibility or supervision. *Prilliman v United Air Lines, Inc.* (1997) 53 CA4th 935, 62 CR2d 142. But see *Vuillemainroy v American Rock & Asphalt, Inc.* (1999) 70 CA4th 1280, 1282, 83 CR2d 269; *Coit Drapery Cleaners, Inc. v Sequoia Ins. Co.* (1993) 14 CA4th 1595, 18 CR2d 692.

Arbitrary action. In *Gay Law Students Ass'n v Pacific Tel. & Tel. Co.* (1979) 24 C3d 458, 156 CR 14, the telephone company, as a public utility, was held to have engaged in state action, making it subject to the general prohibition on arbitrary action by a public employer. See also 42 USC §1983.

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§3.99 6. Privacy Rights

Although constitutional protections generally apply only to governmental activity, California courts have recognized the right to privacy embodied in Cal Const art I, §1 as limiting or prohibiting certain employment practices by private employers. See, *e.g., Luck v Southern Pac. Transp. Co.* (1990) 218 CA3d 1, 15, 267 CR 618, disapproved on other grounds in *Hill v National Collegiate Athletic Ass'n* (1994) 7 C4th 1, 56, 26 CR2d 834, in which the court held that an employer's termination of an employee for the latter's refusal to submit to an unannounced drug test implicated the employee's constitutional right to privacy. But see *Hill v National Collegiate Athletic Ass'n, supra* (drug urinalysis of collegiate athletes upheld); *Loder v City of Glendale* (1997) 14 C4th 846, 59 CR2d 696; *Wilkinson v Times Mirror Corp.* (1989) 215 CA3d 1034, 264 CR 194 (drug urinalysis test of applicants for employment with book publisher upheld). See also Lab C §§1101-1102, which protect an employee's fundamental right to engage in political activity without employer interference and which apply to both applicants and employees. *Gay Law Students Ass'n v Pacific Tel. & Tel. Co., supra*.

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Source: Civil Litigation/California Attorney's Guide to Damages/3 Labor/§3.100 H. Equal Pay, Minimum Wage, and Overtime Pay Provisions

§3.100 H. Equal Pay, Minimum Wage, and Overtime Pay Provisions

Labor Code §§1171-1204 and Industrial Orders authorized to be promulgated thereunder by the Industrial Welfare Commission establish minimum wages and working conditions. Note, however, that Lab C §1171 exempts outside salesmen from coverage and that the proposed Industrial Orders additionally exclude professional, executive, and administrative employees.

Labor Code §1197.5 provides that males and females are to be paid the same rates of pay for the same quantity and quality of work with exceptions for such factors as length of service, skill, and time of day when the work is performed. The section creates a cause of action for back pay, plus costs of suit. Labor Code §1197.5 provides that an employer who violates equal pay requirements is liable to the employee for the unpaid wages and interest, an equal additional amount as liquidated damages, costs of suit, and reasonable attorney fees, notwithstanding any agreement to work for a lesser wage. Lab C §1197.5(b), (g).

Under Lab C §1182, the Industrial Welfare Commission enacted wage orders effective January 1, 1980, for each of 17 separate industry groupings. The wage orders can be found online at http://www.dir.ca.gov/Iwc/WageOrderIndustries.htm. They are designed to comply with court decisions that held that protective provisions for women in former Lab C §§1350-1350.5 and previous wage orders were invalid because they conflicted with Title VII. For example, in *Rosenfeld v Southern Pac. Co.* (9th Cir 1971) 444 F2d 1219, the court found weight-lifting and working-hours distinctions invalid. The court came to a similar conclusion with regard to premium and overtime pay distinctions based on sex in *Homemakers, Inc. v Division of Indus. Welfare* (9th Cir 1974) 509 F2d 20. The court decided that without statutory authorization it could not achieve equality by simply applying premium pay provisions to male employees, and it was forced to strike down the premium pay provisions entirely.

The wage orders establish a minimum hourly wage of $8.00 effective January 1, 2008. See Order No. MW-2007, effective January 1, 2007, which can be found online at http://www.dir.ca.gov/IWC/Minwage2007.pdf. Limited exceptions for learners and minors permit a lower rate of 85 percent of the minimum wage, rounded to the nearest nickel. Overtime is payable at 1-1/2 times the employee's regular rate for daily hours worked in excess of 8. Double time must be paid for daily hours in excess of 12 and for daily hours in excess of 8 on the seventh work day in any work week. Extra pay provisions for overtime, however, do not apply to all occupations. Provisions are also made for 4-day, 40-hour work weeks.

A former wage order that permitted restaurant employers to receive credit against minimum wages for the value of meals furnished was invalidated by the court as a "compelled purchase" violation of Lab C §450. *California State Restaurant Ass'n v Whitlow* (1976) 58 CA3d 340, 129 CR 824. However, the regulatory scheme and remedial provisions of the new wage orders remain basically unchanged. For further discussion of orders governing wages, see Advising California Employers and Employees §5.3 (Cal CEB 2005).

Civil actions by the Industrial Welfare Commission or an employee to recover back pay for violation of the minimum wage and overtime provisions are authorized by Lab C §§1193.6 and 1194, the latter providing for recovery of costs of suit. See, *e.g., Advanced-Tech Sec. Servs., Inc. v Superior Court* (2008) 163 CA4th 700, 705, 77 CR3d 757 (employee was not entitled to time and one-half of premium holiday pay as overtime); *Armenta v Osmose, Inc.* (2005) 135 CA4th 314, 323, 326, 37 CR3d 460 (in employees' suit for minimum wages under Lab C §1194, trial court properly calculated whether each employee was paid minimum wage "for all hours worked" rather than using federal averaging formula; plaintiffs properly awarded attorney fees). Injunctive relief is also available. Lab C §1194.5.

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I. Miscellaneous Statutes

§3.101 1. Solicitation of Employees by Misrepresentation

Labor Code §970 prohibits knowingly false representations to induce a person to change employment from one location to another. In addition to criminal penalties, Lab C §972 establishes double damages for violations. See also *Helmer v Bingham Toyota Isuzu* (2005) 129 CA4th 1121, 29 CR3d 136 (future lost income recoverable by employee induced to leave secure employment because of false promises regarding salary).

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§3.102 2. Misrepresentation Concerning Former Employee

Labor Code §1050 prohibits misrepresentation concerning a former employee that is designed to or has the effect of preventing that person from securing other employment. In addition to criminal penalties, Lab C §1054 provides treble damages for violations. See also *Marshall v Brown* (1983) 141 CA3d 408, 190 CR 392.

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§3.103 3. Interference With Employees' Political Activities

Employers may not establish or enforce rules that restrict, control, or direct employees' political activities or affiliations, or discharge or threaten to discharge employees in order to influence their political activities or affiliations. Lab C §§1101-1102. Criminal penalties are provided (Lab C §1103) and employees may sue for the damages suffered. Lab C §1105; *Lockheed Aircraft Corp. v Superior Court* (1946) 28 C2d 481, 171 P2d 21.

Labor Code §§1101-1102, which prohibit interference with an employee's political activities, were held to protect applicants for employment, as well as employees. *Gay Law Students Ass'n v Pacific Tel. & Tel. Co.* (1979) 24 C3d 458, 156 CR 14. The holding in this case (based on the theory that advocacy of equal rights for homosexuals is political) was codified and expanded by the enactment of former Lab C §1102.1. Repealed effective January 1, 2000, the substance of former Lab C §1102.1 prohibiting employment discrimination based on sexual orientation was incorporated into the California Fair Employment and Housing Act (Govt C §§12900-12996).

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§3.104 4. Commission Contracts by Out-of-State Employers

By state statute, contracts for performance of services within California for employers with no permanent and fixed place of business in the state and involving payment of employees by commission are required to be in writing. In addition, the employer must deliver a signed copy of the contract to the employee and obtain a signed receipt to show that the employee has a copy. Lab C §2751. Failure to comply with the requirements of Lab C §2751 subjects the employer to treble damages in a civil action under Lab C §2752. Note, however, that Lab C §§2751-2752 have been held unconstitutional under the commerce clause and the equal protection clause. See *Lett v Paymentech, Inc.* (ND Cal 1999) 81 F Supp 2d 992, 998.

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§3.105 5. Fair Employment and Housing Act Damages

Civil Actions. The California Fair Employment and Housing Act (FEHA) (Govt C §§12900-12996) provides broader damages for employment discrimination than does Title VII. Unlike Title VII, FEHA has no cap on compensatory and punitive damages. FEHA also prohibits discrimination on the basis of physical or mental disability, medical condition, marital status, age (at least 40), and sexual orientation. Govt C §12940. Under FEHA, sex discrimination includes gender discrimination, as defined in Pen C §422.56. Govt C §12926(p).

In addition to back pay, front pay, and prejudgment interest, recovery under FEHA may include tort damages, including compensatory damages for pain and suffering as well as punitive damages. See *Commodore Home Sys., Inc. v Superior Court* (1982) 32 C3d 211, 185 CR 270 (affirming availability of punitive damages in FEHA cases); *Wysinger v Automobile Club* (2007) 157 CA4th 413, 419, 69 CR3d 1 (in FEHA disability discrimination and retaliation case, court affirmed $80,000 noneconomic damages award and $1 million punitive damages award). See also *Goldman v Wilsey Foods, Inc.* (1989) 216 CA3d 1085, 265 CR 294 (action under FEHA not barred by workers' compensation law); *Meninga v Raley's, Inc.* (1989) 216 CA3d 79, 264 CR 319 (action under FEHA for disabling emotional distress from discrimination not barred by workers' compensation law). Injunctive relief is available (see *Aguilar v Avis Rent a Car Sys., Inc.* (1999) 21 C4th 121, 87 CR2d 132) and the court may award attorney fees and costs. See Govt C §12965(b); *Horsford v Board of Trustees of Cal. State Univ.* (2005) 132 CA4th 359, 393, 33 CR3d 644.

NOTE: The employer is strictly liable for hostile environment sexual harassment by a supervisor, but under the avoidable consequences doctrine, the employee's FEHA damages do not include damages that he or she could have avoided with reasonable effort and without undue risk, expense, or humiliation. *State Dep't of Health Servs. v Superior Court* (2003) 31 C4th 1026, 6 CR3d 441.

The Fair Employment and Housing Commission (FEHC) has authority under FEHA to award limited "actual damages," including damages for emotional injuries and other "nonpecuniary losses," and may impose an "administrative fine" (which is deposited in the state's general fund) if the employer is held guilty of "oppression, fraud or malice" under CC §3294. Govt C §12970(a)(3), (c)-(d). The FEHC has no authority to award punitive damages. Govt C §12970(d).

Administrative Actions Before the FEHC. Government Code §12970 sets forth the remedies in a proceeding before the FEHC. Under §12970, the FEHC may issue cease-and-desist orders and may order the employer to hire, reinstate, or upgrade the aggrieved employee, with or without back pay. Govt C §12970(a)(1). In addition, the FEHC may award limited "actual damages," including damages for emotional injuries and other "nonpecuniary losses," and may impose an "administrative fine" if the employer is held guilty of "oppression, fraud or malice" under CC §3294. Govt C §12970(a)(3), (c)-(d).

Any award of actual damages for nonpecuniary losses, when added to the amount of any administrative fine, cannot exceed $150,000 per aggrieved person for each respondent. Govt C §12970(a)(3). Public employers are exempt from the administrative fine provision. Govt C §12970(d). Notably, the administrative fines are deposited in the state's general fund, and the FEHC has no authority to award punitive damages for employment discrimination. Govt C §12970(d).

For further discussion, see Wrongful Employment Termination Practice (2d ed Cal CEB 1997).

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III. DAMAGE AWARDS IN ARBITRATION UNDER COLLECTIVE BARGAINING AGREEMENTS

§3.106 A. Arbitration Favored by Courts

Perhaps the means most often used to obtain damages when a collective bargaining agreement exists between a union and an employer is that of arbitration of disputes arising out of the interpretation and application of the agreement. These arbitrations usually stem from provisions in the collective bargaining agreements themselves. In California, CCP §§1280-1294.2 set forth the provisions regulating the conduct of arbitration in general, including labor arbitration.

The United States Supreme Court has indicated a strong policy of favoring arbitration of collective bargaining contract disputes. See *Textile Workers Union v Lincoln Mills* (1957) 353 US 448, 1 L Ed 2d 972, 77 S Ct 912. Some exceptions exist, however. For example, for purposes of an action brought under 42 USC §1983, an unappealed arbitration award will not be accorded preclusive effect. *McDonald v City of W. Branch* (1984) 466 US 284, 80 L Ed 2d 302, 104 S Ct 1799. Most California school districts are precluded from subjecting their disciplinary decisions regarding permanent, classified (nonteaching) employees to binding arbitration. *Board of Educ. v Round Valley Teachers Ass'n* (1996) 13 C4th 269, 52 CR2d 115; *California Teachers Ass'n v Mendocino Unified Sch. Dist.* (2001) 92 CA4th 522, 111 CR2d 879.

There is general agreement among the federal and state courts that an arbitrator's decision will not be reversed by a court unless the arbitrator has exceeded his or her authority as set forth in the labor contract or unless there were serious improprieties in his or her handling of the case. See, *e.g., Steelworkers v Enterprise Wheel & Car Corp.* (1960) 363 US 593, 4 L Ed 2d 1424, 80 S Ct 1358; *General Precision, Inc. v International Ass'n of Machinists* (1966) 241 CA2d 744, 50 CR 921. One such narrowly construed exception is when the award is found to violate public policy. See *City of Palo Alto v Service Employees Int'l Union* (1999) 77 CA4th 327, 91 CR2d 500; *Stead Motors v Automotive Machinists Lodge No. 1173* (9th Cir 1989) 886 F2d 1200; *Exxon Shipping Co. v Exxon Seamen's Union* (3d Cir 1993) 993 F2d 357.

Under California law, arbitration awards are self-enforcing although CCP §1285 provides for judicial enforcement on petition and alternatively provides for a petition to vacate an award. On enforcement of an arbitration award in the federal courts, see *Steelworkers v Enterprise Wheel & Car Corp., supra*.

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§3.107 B. Computation of Damages

Arbitrators normally set forth as the concluding part of their decision any remedy that may be awarded, which may include damages, the most common form of which is back pay. In some situations, arbitrators may simply decide the merits of a case, outline the remedy in general terms, and allow the parties themselves to determine the specific amount of damages payable. In such a situation, arbitrators usually retain jurisdiction for purposes of settling any dispute over the amount of the award. However, an award that leaves the amount uncertain can result in failure to obtain enforcement of the award for lack of certainty. See *Bowman v Ruchti Bros*. (1970) 4 CA3d 897, 84 CR 563.

Arbitrators have wide latitude in the remedies they may award. Damages may be awarded even though they were not included as an issue in the original submission to the arbitrator. *Grunwald Marx, Inc. v Los Angeles Joint Bd., Amalgamated Clothing Workers of Am.* (1959) 52 C2d 568, 343 P2d 23. In instances of awards of back pay for wrongful discharge, an arbitrator may order reinstatement with full back pay (*Dallas Typographical Union No. 173 v A. H. Belo Corp*. (5th Cir 1967) 372 F2d 577), no back pay (*Railway Employees v Universal Carloading & Distrib. Co.* (1969) 1 CA3d 145, 81 CR 516), partial back pay (*Permanente Med. Group* (1968) 52 Lab Arb 217), or full back pay without reinstatement (*Yellow Cab Co. v Democratic Union Local 777* (7th Cir 1968) 398 F2d 735). Back pay normally includes lost wages as well as fringe benefits not received. *Wise v Southern Pac. Co.* (1970) 1 C3d 600, 83 CR 202. However, there is a generally recognized duty by the employee to mitigate damages by trying to secure other employment and deducting earnings from such employment from the back pay award (see *American Airlines, Inc.* (1967) 48 Lab Arb 705) although income from part-time work that could have been earned in addition to regular employment is not an offset to back pay (*Wise v Southern Pac. Co., supra*). Income from other sources such as social security and retirement plan benefits are also deductible. *United Protective Workers Local 2 v Ford Motor Co.* (7th Cir 1955) 223 F2d 49. Although unemployment compensation is not an offset to back pay under the LMRA (*NLRB v Gullett Gin Co.* (1951) 340 US 361, 95 L Ed 337, 71 S Ct 337; see §3.9), some arbitrators have treated it as an offset in awarding back pay, although the cases are split. *Universal Producing Co.* (1971) 57 Lab Arb 1072 (offset); *General Tine Corp.* (1969) 53 Lab Arb 867 (no offset); *Continental Can Co.* (1962) 39 Lab Arb 821 (offset).

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§3.108 C. Union or Employee Grievances

Generally, labor contracts are written in such a manner and a business operates in such a way that the employer is responsible for administering the provisions of the agreement (*e.g.,* payment of wages and benefits, promotions, transfers, and discharges of employees), and the union monitors compliance with the contract by filing a grievance if a contract violation is alleged. If the grievance cannot be resolved by the parties themselves, most collective bargaining contracts provide for binding arbitration by a single impartial arbitrator or a panel of arbitrators with at least one impartial member. Under such an arrangement, the union is normally the complainant and the employer is the respondent. Potential damages, if due, are therefore generally awarded against the employer. But see §3.19.

The range of union or employee grievances for which damages are obtainable through arbitration is extremely broad. Back pay awards have been made for

- Improper discharge (*Kroger Co. v Teamsters Local 661* (6th Cir 1967) 380 F2d 728);
- Layoff (*Minute Maid Co. v Citrus Workers Local 444* (5th Cir 1964) 331 F2d 280);
- Demotion and transfers (*Retail Shoe & Textile Salesmen Local 410 v Sears, Roebuck & Co.* (ND Cal 1960) 185 F Supp 558); and
- Subcontracting work (*Selb Mfg. Co. v Machinists, Dist. 9* (8th Cir 1962) 305 F2d 177).

Other cases have resulted in broader relief, *e.g.,*

- Assessing general damages for operating on a holiday in violation of contractual restrictions (*Retail Clerks Local 1207 v Seattle Dep't Stores Ass'n* (WD Wash 1966) 62 LRRM 2706);
- Awarding pay for time lost when a plant was shut down and the employees locked out in violation of the contract (*Ryan Aeronautical Co. v UAW Local 506* (SD Cal 1959) 179 F Supp 1);
- Requiring payment for accrued vacation pay after termination of a collective bargaining contract (*Paud v Alco Plating Corp.* (1971) 21 CA3d 362, 98 CR 706);
- Awarding compensation for costs of arbitration and weakening a union's bargaining power (*Asbestos Workers Local 66 v Leona Lee Corp.* (WD Tex 1973) 84 LRRM 2165, aff'd (5th Cir 1974) 489 F2d 1032); and
- Assessing liquidated damages and interest when an arbitrator found a runaway shop in violation of a labor agreement (*Cloak, Skirt & Dressmakers Union v Senco, Inc.* (D Mass 1968) 289 F Supp 513).

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§3.109 D. Employer Grievance: Violation of Express or Implied No-Strike Commitment

In the absence of an express no-strike commitment in a collective bargaining agreement, the courts usually imply the existence of one if the contract contains an arbitration clause. See *Teamsters Local 174 v Lucas Flour Co.* (1962) 369 US 95, 7 L Ed 2d 593, 82 S Ct 571.

A violation of the no-strike clause normally causes damages since the employer's business is usually shut down or curtailed as a result. Frequently employers seek injunctive relief, and in some cases damages, in a civil action for violations of a no-strike clause. Traditionally employers have not sought damages through arbitration, either because they felt that arbitration was not a proper forum to seek damages or because they believed that, due to lack of prior experience or fear of alienating the losing party, arbitrators would not award sufficient damages to compensate for the actual loss suffered. In addition, many arbitration clauses in contracts do not provide for employer grievances.

However, it is becoming more established both in the California and federal courts that arbitration is the proper means to secure money damages for illegal strikes, or at least that the willingness of the employer to submit a dispute to arbitration is a precondition to obtaining money damages in the courts. See, *e.g., Drake Bakeries, Inc. v Bakery Workers Local 50* (1962) 370 US 254, 8 L Ed 2d 474, 82 S Ct 1346; *Charles J. Rounds Co. v Teamsters No. 42* (1971) 4 C3d 888, 95 CR 53. There appears to be a split of authority between cases requiring arbitration (*Drake Bakeries, Inc. v Bakery Workers Local 50, supra*; *Charles J. Rounds Co. v Teamsters No. 42, supra; Hearst Corp. v Pressmen* (SD Cal 1966) 61 LRRM 2702) and those allowing direct access to the courts to obtain damages (*Atkinson v Sinclair Ref. Co.* (1962) 370 US 238, 8 L Ed 2d 462, 82 S Ct 1318; *G.T. Schieldahl Co. v Machinists Local 1680* (1st Cir 1968) 393 F2d 502; *Boeing Co. v UAW* (3d Cir 1967) 370 F2d 969). However, the seeming disparity is usually explainable in terms of the breadth of the applicable arbitration clause. In other words, if the clause allows arbitration for employer grievances, the courts will normally require the employer to resort to arbitration. Conversely a contract restricted solely to arbitration of employee grievances will usually permit an employer to seek direct judicial relief.

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4

Landlord/Tenant

Myron Moskovitz
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I. SCOPE OF CHAPTER §4.1

II. AGREEMENT TO EXECUTE LEASE
- A. Prospective Landlord's Breach
  - 1. Measure of Damages
    - a. General Damages §4.2
    - b. Special Damages §4.3
    - c. Attorney Fees §4.4
    - d. Exemplary Damages §4.5
    - e. Interest §4.6
  - 2. Burden of Proof §4.7
  - 3. Statute of Limitations §4.8
- B. Prospective Tenant's Breach §4.9

III. LANDLORD'S BREACH
- A. Measure of Damages for Breach of Duty to Deliver Possession
  - 1. General Damages §4.10
  - 2. Proof of Rental Value §4.11
  - 3. Special Damages §4.12
  - 4. Attorney Fees; Interest; Exemplary Damages §4.13
- B. Breach of Covenant of Quiet Enjoyment
  - 1. What Constitutes Breach §4.14
  - 2. Measure of Damages
    - a. General Damages
      - (1) Actual or Constructive Eviction §4.15
      - (2) Interruption of Tenant's Beneficial Enjoyment §4.16
    - b. Special Damages §4.17
    - c. Attorney Fees and Interest §4.18
    - d. Exemplary Damages §4.19
  - 3. Breach of Quiet Enjoyment as Tort §4.20
  - 4. Statute of Limitations §4.21
- C. Forcible Entry or Detainer
  - 1. Nature of Action §4.22
  - 2. Measure of Damages
    - a. General Damages §4.23
    - b. Special Damages §4.24
    - c. Exemplary Damages §4.25
    - d. Attorney Fees; Interest; Nominal Damages §4.26
  - 3. Statute of Limitations §4.27
- D. Breach of Lease Covenants
  - 1. Award of General and Special Damages §4.28
  - 2. Covenant Against Competition §4.29
  - 3. Covenant to Repair §4.30
  - 4. Covenant to Build §4.31
  - 5. Covenant to Pay for Improvements §4.32
  - 6. Attorney Fees; Exemplary Damages; Interest §4.33
  - 7. Landlord's Defenses §4.34
- E. Breach of Statutory Duty to Repair
  - 1. Civil Code §§1941-1942 §4.35
  - 2. Retaliatory Eviction §4.36
  - 3. Housing Codes §4.37

F. Breach of Warranty of Habitability
1. Availability of Damages §4.38
2. Statutory Damages; Abatement §4.39
3. General Damages
a. Difference in Value or Percentage Reduction §4.40
b. Discomfort and Annoyance §4.41
4. Special Damages §4.42
5. Punitive Damages §4.43
6. Costs and Attorney Fees §4.44
G. Disconnecting Utility Services §4.45
H. Wrongful Withholding of Tenant's Personal Property
1. Tenant's Remedies §4.46
2. Statute of Limitations §4.47
I. Landlord's Violation of Local Rent Control Ordinance
1. Damages for Rent Overcharges §4.48
2. Damages for Unlawful Evictions §4.49
3. Attorney Fees §4.50
4. Liability of New Owner §4.51
J. Security Deposits
1. In General §4.52
2. Landlord's or Landlord Successor's Retention of Deposit §4.53
3. Attorney Fees and Interest §4.54
4. Statute of Limitations §4.55

IV. TENANT'S BREACH
A. Use of Property for Illegal Purposes
1. Damages §4.56
2. Statute of Limitations §4.57
B. Use for Other Than Intended Purpose
1. Obligation and Damages §4.58
2. Statute of Limitations §4.59
C. Waste
1. Damages §4.60
2. Statute of Limitations §4.61
D. Breach of Statutory Duty to Repair §4.62
E. Breach of Lease Covenants
1. Damages for Breach §4.63
2. Statute of Limitations §4.64
3. Rent Covenant
a. Obligation and Damages §4.65
b. Interest §4.66
4. Covenant to Remain in Business §4.67
5. Covenant to Improve §4.68
6. Covenant to Repair §4.69
7. Covenant Against Assignment or Subletting §4.70
8. Covenant to Surrender §4.71
9. Covenant to Surrender in as Good Condition as Received §4.72
10. Covenant to Pay Taxes §4.73
11. Covenant to Insure §4.74
F. Wrongful Removal of Fixtures
1. General Damages §4.75
2. Exemplary Damages §4.76
3. Statute of Limitations §4.77
G. Termination for Tenant's Breach or Abandonment
1. Definition of Abandonment §4.78
2. Measure of Damages
a. Termination of Lease (CC §1951.2) §4.79
b. Continuation of Lease (CC §1951.4) §4.80
c. Liquidated Damages; Equitable Relief; Nonexclusivity of Remedies §4.81
d. Statute of Limitations §4.82
H. Holding Over After Lease Expiration
1. Election to Treat Tenant as Trespasser §4.83
2. Holdover Tenant's Liability to New Tenant §4.84
3. Statute of Limitations §4.85

I. Unlawful Detainer
1. Back Rent §4.86
2. Damages Caused by Unlawful Detainer §4.87
3. Prejudgment Interest §4.88
4. Costs
a. Awarded to Prevailing Party §4.89
b. Allowable Costs and Expenses §4.90
c. Procedure for Claiming Costs §4.91
d. Limitations on Costs §4.92
5. Attorney Fees
a. Basis for Recovery §4.93
b. Determining Who Is Prevailing Party
(1) Party Recovering "Greater Relief" §4.94
(2) Effect of Dismissal §4.95
c. Limits on Recovery by Prevailing Party §4.96
d. Determining Amount of Fees §4.97
e. Fees for Services Before Complaint Filed §4.98
f. Award of Fees Against Successors in Interest §4.99
g. Attorney Fees on Appeal §4.100
h. Procedure for Claiming Fees §4.101
(1) Basis of Award Governs Procedure
(a) Contractual Attorney Fees §4.102
(b) Statutory Attorney Fees §4.103
(2) Time Limits for Claiming Attorney Fees §4.104
i. Statute of Limitations §4.105

V. MISCELLANEOUS DAMAGE FACTORS
A. Liquidated Damages §4.106
B. Proof of Damages §4.107
C. Mitigation §4.108
D. Attorney Fees §4.109
E. Expert Witness Fees §4.110
F. Costs §4.111
G. Certainty of Damages §4.112
H. Nominal Damages §4.113
I. Damages Nondischargeable in Bankruptcy §4.114

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§4.1 I. SCOPE OF CHAPTER

This chapter discusses damages available to both landlords and tenants for the breach of obligations under the lease, as well as remedies when relevant to the discussion of damages. The rights of landlords and tenants to recover damages from each other will be discussed in this chapter only in terms of original parties to a lease and not in terms of subtenants and assignees. Under CC §§822-823, with the few exceptions noted in those sections, the assignee of either a landlord or a tenant has the same rights as the assignor, and a tenant-subtenant relationship for all practical purposes is a landlord-tenant relationship. For a comprehensive discussion of the substantive law of the landlord-tenant relationship, see California Landlord-Tenant Practice (2d ed Cal CEB 1997) and California Eviction Defense Manual (2d ed Cal CEB 1993).

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II. AGREEMENT TO EXECUTE LEASE

A. Prospective Landlord's Breach

1. Measure of Damages

§4.2 a. General Damages

When the prospective landlord breaches an agreement to execute a lease, the prospective tenant may recover damages as well as any deposit made. *McCulloch v Liguori* (1948) 88 CA2d 366, 199 P2d 25. Under CC §3300, the prospective tenant may recover as damages the amount that would compensate for the detriment proximately caused by such breach or that is likely to result from it. *Martinez v Yancy* (1919) 40 CA 503, 180 P 945. Also, general damages for breach of an agreement to lease under CC §3300 is the difference between the agreed rent and the rental value of the property for the term of the lease at the time of the breach. *McCulloch v Liguori, supra*; *Peterson v Larquier* (1927) 84 CA 174, 257 P 873. This is sometimes referred to as the fair-value use of the premises. *Handley v Guasco* (1958) 165 CA2d 703, 332 P2d 354.

When the prospective tenant's damages derive solely from a breach of an agreement to execute a lease, he or she may not recover damages for emotional distress. Framing the cause of action in terms of negligence does not avoid this rule. See *Butler-Rupp v Lourdeaux* (2005) 134 CA4th 1220, 1227, 36 CR3d 685. For further discussion of this rule, see §1.38.

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§4.3 b. Special Damages

In addition to general damages (see §4.2), the prospective tenant is entitled to recover special damages that are the natural consequence of the breach of the agreement to lease and that may reasonably be supposed to have been within the parties' contemplation at the time of the making of the contract. *McCulloch v Liguori* (1948) 88 CA2d 366, 199 P2d 25; *Schnierow v Boutagy* (1917) 33 CA 336, 164 P 1132. For example, in *Schnierow* the prospective tenant recovered damages for loss of time in securing another storeroom after the prospective landlord breached an agreement to lease a storeroom then under construction. Similarly, the prospective tenant was compensated for loss of time in *Douglass v Guardian Holding Corp.* (1933) 132 CA 585, 23 P2d 80. In *McCulloch v Liguori, supra,* the prospective tenant recovered the storage cost of materials that were to be used at the proposed lease site. It may also be possible for a prospective tenant to recover for loss of anticipated profits of an established business that is to be relocated at the proposed lease site, although the court in *Handley v Guasco* (1958) 165 CA2d 703, 332 P2d 354, suggests that the right to recover future profits applies only to contracts other than agreements to lease.

Under CC §3301, a prospective tenant cannot recover damages for injuries that are remote, speculative, or uncertain. A prospective lessee therefore cannot collect special damages for either the sacrifice sale of his present business or for the loss of anticipated profits from a new business to be established at the proposed lease site. See *Handley v Guasco, supra*.

Special damages must be set forth specifically and with particularity in the complaint; otherwise the prospective lessee will not be permitted to prove such damages. *Shook v Pearson* (1950) 99 CA2d 348, 221 P2d 757.

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§4.4 c. Attorney Fees

Code of Civil Procedure §1021 provides:

> Except as attorney's fees are specifically provided for by statute, the measure and mode of compensation of attorneys and counselors at law is left to the agreement, express or implied, of the parties….

Because no statute provides for attorney fees for the party that prevails in a contract action, the prospective tenant cannot recover attorney fees in a suit against the prospective landlord in the absence of an agreement between the parties. See §§1.21, 4.93.

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§4.5 d. Exemplary Damages

The prospective lessee is not entitled to exemplary (punitive) damages. Under CC §3294 exemplary damages may only be awarded in an action not arising in contract. This is true even though the breach of contract is willful. See *Mahon v Berg* (1968) 267 CA2d 588, 73 CR 356. See, however, §§1.34-1.39.

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§4.6 e. Interest

The prospective lessee cannot recover interest on damages from the date of breach because the claim is unliquidated. See CC §3287(a); *Peterson v Larquier* (1927) 84 CA 174, 257 P 873. However, the prospective lessee may be able to collect some interest under CC §3287(b), which provides:

> Every person who is entitled under any judgment to receive damages based upon a cause of action in contract where the claim was unliquidated, may also recover interest thereon from a date prior to the entry of judgment as the court may, in its discretion, fix, but in no event earlier than the date the action was filed.

See §1.20.

When available, interest may be awarded even though there is no specific prayer for it. *Benson v City of Los Angeles* (1963) 60 C2d 355, 33 CR 257.

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§4.7 2. Burden of Proof

Although there is little case law on the subject, it appears that to recover damages for failure to perform an agreement to execute a lease, one must show that he placed himself in a position to exact performance. *Loeffler v Wright* (1910) 13 CA 224, 109 P 269.

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§4.8 3. Statute of Limitations

The statute of limitations on a breach of contract founded on an instrument in writing is four years under CCP §337(1). Under CCP §339(1), the statute of limitations on a breach of an oral contract is two years. Although there are no cases in point, an action on an agreement to execute a lease should fall under one of the above two sections.

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§4.9 B. Prospective Tenant's Breach

Although there are no cases on the subject, the prospective landlord's damages would appear to be the same as the prospective tenant's when the latter breaches an agreement to execute a lease. See CC §3300; *McCulloch v Liguori* (1948) 88 CA2d 366, 199 P2d 25; §§4.2-4.8.

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III. LANDLORD'S BREACH

A. Measure of Damages for Breach of Duty to Deliver Possession

§4.10 1. General Damages

A landlord has a duty to put a tenant in possession of the premises. The measure of general damages for failure to do so is the difference between the agreed rent and the rental value of the premises for the lease term. *Foreman & Clark Corp. v Fallon* (1971) 3 C3d 875, 92 CR 162. See *Kaye v Melzer* (1948) 87 CA2d 299, 197 P2d 50. The more restrictive measure of damages set forth in CC §3306, relating to breaches of agreements to convey estates in real property, does not apply to leases of real property. *Foreman & Clark Corp. v Fallon, supra*. Under *Foreman,* the lessee is not required to prove that the lease rental was fair in order to recover general damages from the landlord.

When the tenant's damages derive solely from a breach of the rental agreement—*e.g.*, breach of the duty to deliver possession—he or she may not recover damages for emotional distress. Framing the cause of action in terms of negligence does not avoid this rule. See *Butler-Rupp v Lourdeaux* (2005) 134 CA4th 1220, 1227, 36 CR3d 685. For further discussion of this rule, see §1.38.

For a comprehensive overview of damages for breach of landlord duties, see California Real Property Remedies and Damages (2d ed Cal CEB 2002).

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§4.11 2. Proof of Rental Value

Rental value may be established by expert testimony. However, it may also be established by other evidence such as the rent actually agreed on after negotiations between experienced business people or by the rent agreed on in prior leases. *Foreman & Clark Corp. v Fallon* (1971) 3 C3d 875, 92 CR 162. The court in *Foreman* also held that if both expert testimony and other evidence of rental value are introduced, the trier of fact is not limited to finding a rental value within the range established by the expert testimony. Rather, it is free to reject the expert testimony and follow the other evidence in the case.

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§4.12 3. Special Damages

The tenant may also recover special damages, *e.g.,* lost profits, loss of earnings and moving expenses, from the landlord that are proximately caused by the landlord's failure to deliver possession. *S. Jon Kreedman & Co. v Meyers Bros. Parking-W. Corp.* (1976) 58 CA3d 173, 130 CR 41; *Kaye v Melzer* (1948) 87 CA2d 299, 197 P2d 50. The tenant's special damages may also include potential lost profits.

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§4.13 4. Attorney Fees; Interest; Exemplary Damages

The tenant cannot recover attorney fees unless there is an agreement to that effect with the landlord. See CCP §1021; §§4.4, 4.109. The tenant cannot collect interest on damages from the date of the breach because the claim is unliquidated (see CC §3287; §4.6), and he or she is not entitled to recover exemplary damages because his or her cause of action is contractual in nature (see CC §3294; §4.5).

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B. Breach of Covenant of Quiet Enjoyment

§4.14 1. What Constitutes Breach

A lease contains an implied covenant by the landlord for quiet enjoyment. See CC §1927; *Pierce v Nash* (1954) 126 CA2d 606, 272 P2d 938. If the landlord commits an act (*e.g.,* giving an invalid termination notice) that interrupts the tenant's beneficial enjoyment of the premises, a breach occurs even though the tenant remains in possession. *Guntert v City of Stockton* (1976) 55 CA3d 131, 126 CR 690.

In addition, the covenant, whether express or implied, is breached when the tenant is evicted either actually or constructively. *Levitzky v Canning* (1867) 33 C 299. Constructive eviction occurs if the landlord wrongfully disturbs the tenant in the possession of the premises in a way that results in the tenant's being deprived of the beneficial enjoyment of the premises. *Black v Knight* (1917) 176 C 722, 169 P 382. For example, a landlord could breach a covenant of quiet enjoyment by breaching a covenant against competition (*Kulawitz v Pacific Woodenware & Paper Co.* (1944) 25 C2d 664, 155 P2d 24) or by refusing possession of the premises to the tenant (see *Saferian v Baer* (1930) 105 CA 238, 287 P 142). However, there can be no constructive eviction unless the tenant vacates the premises within a reasonable time. *Clark v Spiegel* (1971) 22 CA3d 74, 99 CR 86; *Halbert v Jones* (1949) 93 CA2d 783, 209 P2d 812; *Bakersfield Laundry Ass'n v Rubin* (1955) 131 CA2d Supp 862, 280 P2d 921.

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2. Measure of Damages

a. General Damages

§4.15 (1) Actual or Constructive Eviction

When a tenant is evicted, he or she may stop paying rent, and, under *Kulawitz v Pacific Woodenware & Paper Co.* (1944) 25 C2d 664, 155 P2d 24, he or she may also sue for damages. The rent obligation ceases because the tenant chooses to treat the lease obligation as terminated. *Kulawitz v Pacific Woodenware & Paper Co., supra*. The measure of the tenant's damages is not controlled by CC §3304, which is concerned only with the covenant of quiet enjoyment in conveyances of real estate other than leases. Rather, the measure of the tenant's damages is that set forth in CC §3300, which provides that for breach of an obligation arising in contract the aggrieved party may recover the amount that will compensate him or her for all the detriment proximately caused by it or that in the ordinary course of things would be likely to result from the breach. *Standard Livestock Co. v Pentz* (1928) 204 C 618, 269 P 645. Under CC §3300 the tenant may recover as general damages the value of the unexpired term of the lease, *i.e.,* the difference between the agreed rent and the fair market value of the balance of the term. *Stillwell Hotel Co. v Anderson* (1935) 4 C2d 463, 50 P2d 441; *Landon v Hill* (1934) 136 CA 560, 29 P2d 281. If a tenant is wrongfully evicted from agricultural land, the measure of damages is ordinarily the value of the crop that might be grown on the leased land during the term of the lease less the cost of raising and harvesting it. *Wells v B. F. Porter Estate* (1928) 205 C 776, 272 P 1039.

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§4.16 (2) Interruption of Tenant's Beneficial Enjoyment

If a tenant is not actually or constructively evicted by the landlord's breach, he or she may either (1) surrender possession, be relieved of any further rent obligation, and possibly seek damages, or (2) remain in possession and seek damages, injunctive relief, or both. *Guntert v City of Stockton* (1976) 55 CA3d 131, 126 CR 690. The right to vacate the premises and terminate the lease is waived if not exercised within a reasonable time after the interference. A tenant who retains possession may assert damages as an offset in the landlord's action for unpaid rent, but the rental obligation itself continues. *Petroleum Collections, Inc. v Swords* (1975) 48 CA3d 841, 122 CR 114. (Note that the holding in *Petroleum Collections*—that the covenant of quiet enjoyment is not breached until there has been an actual or constructive eviction—was disapproved in *Guntert v City of Stockton, supra*.)

If the tenant elects to vacate in response to a wrongful notice to quit or other notice of termination without physical interference with possession, he or she may sue for wrongful eviction only if the landlord acted with malice and without probable cause in giving notice. *Asell v Rodrigues* (1973) 32 CA3d 817, 108 CR 566. If the landlord acted with malice, the measure of damages under CC §3300 is the amount that will compensate the tenant for all detriment proximately caused by the breach or that would be likely to result from it. *Asell v Rodrigues, supra*.

If the tenant elects to remain in possession and to stand on the lease in response to a wrongful notice of termination, CC §3300 again provides the measure of damages. In *Guntert v City of Stockton, supra,* the notice of termination created uncertainty that the tenant could continue to do business. Therefore, the tenant, who ran a heavy equipment manufacturing plant, stopped entering bids on large, long-term contracts—his company's main source of revenue. The tenant was able to recover lost profits from the time of breach (the date notice was given) to the time of trial. Because the tenant's income on long-term projects was deferred until their completion, losses did not appear on current profit-and-loss statements; the court therefore allowed use of the tenant's record of net worth and profit history to arrive at lost profits, with allowance made for dividends, distribution of profits, property revaluation, and other accounting factors. The court repeated the rule that the "law will allow reasonably calculated damages even if the result is only an approximation; the wrongdoer cannot complain if his own condition creates a situation in which the court must estimate rather than compute." 55 CA3d at 143.

The court cannot award overhead costs in addition to lost profits, because that would constitute a double recovery. The tenant in *Guntert* attempted to recover excessive overhead costs during a disorderly "wind-down" period following the wrongful notice; the court found that the overhead was either not proximately caused by the landlord's breach, not within the contemplation of the lease under the rule of *Hadley v Baxendale* (see §1.18), or already included in the calculation of net profits.

Future lost profits may be awarded only in a total breach. If, as in *Guntert,* the tenant chooses to remain in possession, or if the tenant seeks injunctive relief to remain in possession, the contract survives and the breach is only partial. The tenant cannot recover prospective loss of profits at this time, but can sue in the future when the losses are realized. 55 CA3d at 153. The court noted in passing that such an action must be filed within the limitations period (which in this case would have expired within two months of filing of the court's opinion). The award of future profits was also denied as speculative, because the tenant had closed one of its main divisions and not reopened it even after obtaining the injunction ensuring possession under the terms of the lease. It was unclear that future loss would be the proximate result of the breach rather than of the plaintiff's decision to cease production.

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§4.17 b. Special Damages

In addition to general damages for breach of the covenant of quiet enjoyment (see §§4.14-4.16), a tenant may also recover any special damages that are the natural result of the eviction. *London v Hill* (1934) 136 CA 560, 29 P2d 281. See also CC §3300. The kinds of special damages that have been recovered include prepaid rent (*Johnson v Snyder* (1950) 99 CA2d 86, 221 P2d 164), moving expenses (*Klein v Lewis* (1919) 41 CA 463, 182 P 789), loss of goodwill (see *Beckett v City of Paris Dry Goods Co.* (1939) 14 C2d 633, 96 P2d 122), and loss of future profits (*Homer v Ellis* (1919) 40 CA 57, 180 P 30). A tenant may also recover as special damages expenses incurred in defending possession against assertion of a superior title. *Standard Livestock Co. v Pentz* (1928) 204 C 618, 269 P 645. This case also indicates that a tenant is entitled to substantial damages when there is bad faith on the landlord's part in connection with a breach of the covenant of quiet enjoyment.

NOTE: Lost future profits may not be recovered when such losses are speculative, nor may they be recovered in a partial breach that leaves the tenant in possession and able to use the premises. *Guntert v City of Stockton* (1976) 55 CA3d 131, 126 CR 690. In the former situation, the plaintiff has not proved that he or she has suffered any loss. In the latter, the plaintiff may continue to earn profits at the location and thus mitigate potential damages. If losses accrue despite the plaintiff's efforts, the proper time for an action for damages is after the losses have occurred.

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§4.18 c. Attorney Fees and Interest

As indicated in §§4.4 and 4.109, attorney fees are not recoverable in the absence of express statutory authority or contractual agreement. The early case of *Levitzky v Canning* (1867) 33 C 299, which held to the contrary, has been overruled. *Lee C. Hess Co. v Susanville* (1959) 176 CA2d 594, 1 CR 586. See *Lefave v Dimond* (1956) 46 C2d 868, 299 P2d 858. Nor can a tenant recover attorney fees incurred in consulting an attorney on breach of the covenant of quiet enjoyment by the landlord. *Scurich v Ryan* (1910) 14 CA 750, 113 P 123.

Because the tenant's claim is unliquidated, the tenant cannot recover interest on the damages from the date of breach. See CC §3287; §4.6.

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§4.19 d. Exemplary Damages

Under CC §3294, exemplary damages are not allowable in an action arising in contract (see §4.5), and eviction of a tenant is ordinarily viewed as a breach of contract (see *Richardson v Pridmore* (1950) 97 CA2d 124, 217 P2d 113). But see §4.22 discussing unlawful eviction as a tort. If, however, a landlord forcibly and actually evicts a tenant within the meaning of CCP §§1159-1160, and the tenant chooses to sue for damages (and does not seek to regain possession of the leased premises), the tenant may recover exemplary damages in addition to other damages. See CC §3294; *Wilkinson v Singh* (1928) 93 CA 337, 269 P 705. For the view that a tenant cannot both recover a statutory penalty and common law punitive damages for the same wrongful eviction, see *Wagoner v Bennett* (Okla 1991) 814 P2d 476.

When recoverable, the amount of exemplary damages is within the discretion of the trier of fact; however, such damages should bear a reasonable relationship to the actual damages sustained. *Wilkinson v Singh, supra*.

Although in determining the reprehensibility of a defendant's conduct a jury might consider that the defendant harmed non-parties, it may not consider the injuries to non-parties in setting the amount of punitive damages. Because non-parties are not before the court, their injuries are speculative, and to allow the jury to consider them would deny the defendant due process of law. *Philip Morris USA v Williams* (2007) 549 US 346, 166 L Ed 2d 940, 948, 127 S Ct 1057.

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§4.20 3. Breach of Quiet Enjoyment as Tort

Although eviction of a tenant is ordinarily viewed as a breach of contract (see §4.22), the tenant instead may elect to sue in tort for injury to his or her rights under the lease. See *Bessho v General Petroleum Corp.* (1921) 186 C 133, 199 P 22. The tenant may also sue for mental anguish and pain or physical injury suffered as a proximate result of the eviction. *Richardson v Pridmore* (1950) 97 CA2d 124, 217 P2d 113. See CC §3333. For discussion of personal injury damages, see California Tort Damages (2d ed Cal CEB 2002). If the tenant sues in tort, he may recover special damages, *e.g.,* loss of income, in addition to actual damages. See also discussion of *Daluiso v Boone* (1969) 71 C2d 484, 78 CR 707, in §4.24. Special damages should be specifically pleaded. *Tooke v Allen* (1948) 85 CA2d 230, 192 P2d 804. The tenant may also recover exemplary damages if the landlord is guilty of oppression, fraud, or malice. CC §3294; *Farvour v Gelds* (1949) 91 CA2d 603, 205 P2d 424.

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§4.21 4. Statute of Limitations

If the tenant sues for breach of the covenant of quiet enjoyment in a written lease, the statute of limitations under CCP §337(1) is 4 years. If the lease is oral, the statute of limitations under CCP §339(1) is 2 years. If the tenant elects to sue in tort, the 1-year statute of limitations under CCP §340 should apply.

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C. Forcible Entry or Detainer

§4.22 1. Nature of Action

If a tenant has been actually and forcibly evicted from the leased premises, he or she may bring an action for forcible entry or detainer to recover possession instead of remaining out of possession and suing for damages (see §§4.15-4.16). CCP §§1159-1179a. Under CCP §1166a, the tenant in a forcible entry or detainer action may obtain an immediate writ of possession under some circumstances. If the tenant does so, however, and subsequently fails to recover a judgment against the landlord, or if the suit is dismissed, the tenant is liable to the landlord for damages caused by the latter's dispossession under the writ. CCP §1166a. Under this section, the landlord has one year from the date of entry of dismissal or of final judgment in his or her favor to recover such damages.

Because the essence of a forcible entry or detainer action is restitution of the premises and damages are incidental to that, the general rule is that the tenant may not recover damages unless he or she recovers possession of the premises. *Brawley v Risdon Iron Works* (1869) 38 C 676; *Edwards v Bodkin* (1919) 43 CA 405, 185 P 423. Under CCP §1174, damages are to be assessed by the jury or by the court if the proceedings are tried without a jury. Although CCP §1172 requires that the tenant show, in addition to the forcible entry or detainer, that he or she was peaceably in actual possession at the time of the forcible entry or was entitled to possession at the time of the forcible detainer, this does not mean that, in addition to being put back in possession, the tenant is entitled to substantial damages without proof of the damages. *Karp v Margolis* (1958) 159 CA2d 69, 323 P2d 557.

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2. Measure of Damages

§4.23 a. General Damages

The tenant is entitled to recover any damages that are the natural and proximate consequence of a forcible entry or detainer. *Karp v Margolis* (1958) 159 CA2d 69, 323 P2d 557. The measure of general damages to the evicted tenant is the value of the lease. To determine this value, the amount required to be paid as rent is subtracted from the gross or fair market value of possession of the premises during the period the tenant is evicted. If the rent owed were not subtracted from the gross value, the evicted tenant would get a windfall, and the landlord would be penalized the amount of the rent. *Karp v Margolis, supra*.

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§4.24 b. Special Damages

In addition to general damages (see §4.23), the tenant is entitled to recover in forcible entry or detainer proceedings any special damages that can be proved. *Karp v Margolis* (1958) 159 CA2d 69, 323 P2d 557; *San Francisco & Suburban Home Bldg. Soc'y v Leonard (*1911) 17 CA 254, 119 P 405. For example, in *Leonard,* a non-landlord-tenant case, the court said that a plaintiff in a forcible detainer case could recover expenses incurred in protecting his or her property as well as business losses sustained during the period of wrongful detention. A tenant can also recover damages to his or her person or goods that are the natural and proximate result of a forcible entry. *Daluiso v Boone* (1969) 71 C2d 484, 78 CR 707. *Daluiso* holds that a person may recover such damages in a separate action in tort apart from any remedy available in a summary action for forcible entry or detainer. This is so notwithstanding the entering party's right to possession, *e.g.,* after expiration of the lease term. *Daluiso* also holds that to the extent that prior cases (*Walker v Chanslor* (1908) 153 C 118, 94 P 606; *Canavan v Gray* (1883) 64 C 5, 27 P 788) are inconsistent, they are overruled.

While *Daluiso* holds that tort damages are recoverable in a separate suit, it is not clear whether such damages can be recovered in a forcible entry or detainer suit, which is a summary action designed to resolve the issue of who is entitled to possession.

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§4.25 c. Exemplary Damages

Code of Civil Procedure §1174 no longer authorizes an award of punitive damages on a showing of malice in a forcible entry or detainer proceeding. Code of Civil Procedure §1174(b) now provides instead that the plaintiff may be awarded, on a showing of malice, statutory damages of up to $600, or actual damages, including rent found due, or both.

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§4.26 d. Attorney Fees; Interest; Nominal Damages

Attorney fees are not provided for in forcible entry or detainer proceedings. Therefore attorney fees are not recoverable in the absence of an agreement between the parties. CCP §1021. See §§4.4, 4.109. Because the tenant's claim is unliquidated, he or she cannot recover interest from the date of the breach. See CC §3287; §4.6.

If, however, the tenant proves forcible entry or detainer but fails to prove actual damages, the court can award the tenant nominal damages. *Karp v Margolis* (1958) 159 CA2d 69, 323 P2d 557.

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§4.27 3. Statute of Limitations

It is not clear which statute of limitations applies to an action for forcible entry or detainer. It is probably CCP §318, which provides that no action for the recovery of possession of real property can be maintained unless it appears that plaintiff or his ancestor, predecessor, or grantor was possessed of the property in question within five years before commencement of the action. This five-year period may be reduced under CCP §1172, which provides that the forcible entry or detainer proceeding is barred if the landlord shows in his or her defense that he or she has been in the quiet possession of the premises for one year before commencement of the proceedings and that his or her interest in the premises is not then ended or determined.

The fact that the lease under which the tenant took possession of the premises expired before or after the forcible entry or detainer by the landlord should have no bearing on how long the tenant has to bring an action because, as indicated above, the landlord's right to possession is not a defense.

Notwithstanding the enactment of CC §§1951-1951.8, which have brought about significant changes in the area of landlord-tenant remedies, CC §1952 provides that nothing in those sections affects forcible entry or detainer proceedings.

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D. Breach of Lease Covenants

§4.28 1. Award of General and Special Damages

Discussion in §§4.28-4.34 is limited to situations in which, after breach of a lease covenant by the landlord, the tenant, who may have a choice of remedies, remains on the leased premises and sues for damages. A tenant should be able to recover damages for breach of any covenant made by the landlord for the tenant's benefit. Because a lease covenant is contractual in nature, damages are controlled by CC §3300 (*Scott v TraveLodge Corp.* (1968) 265 CA2d 881, 71 CR 547), which provides that for breach of an obligation arising from contract, the measure of damages, except where otherwise provided, is the amount that will compensate the party aggrieved for all the detriment proximately caused by it or that in the ordinary course of things would be likely to result from it. This, of course, includes the right to recover special damages suffered by reason of the breach of any lease covenant. However, special damages as they relate to breaches of specific lease covenants are discussed in §§4.28-4.34 only when there is relevant case law. In addition, when the tenant's damages derive solely from a breach of contract, he or she may not recover damages for emotional distress. Framing the cause of action in terms of negligence does not avoid this rule. See *Butler-Rupp v Lourdeaux* (2005) 134 CA4th 1220, 1227, 36 CR3d 685. For further discussion of this rule, see §1.38.

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§4.29 2. Covenant Against Competition

When a landlord breaches a covenant not to lease other parts of his property to a competing business, the tenant may continue under the lease and sue for loss of profits. *Kulawitz v Pacific Woodenware & Paper Co.* (1944) 25 C2d 664, 155 P2d 24. See *Hildebrand v Stonecrest Corp.* (1959) 174 CA2d 158, 344 P2d 378.

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§4.30 3. Covenant to Repair

The measure of general damages for the landlord's breach of a covenant to repair is the difference between the rental value of the premises if the covenant had been performed and its value under existing conditions, *i.e.,* the difference in value with and without the repairs. *Ng v Warren* (1947) 79 CA2d 54, 179 P2d 41. The amount recoverable for breach of a landlord's covenant to construct or repair does not necessarily bear a relationship to the amount of the rent agreed on (*Noble v Tweedy* (1949) 90 CA2d 738, 203 P2d 778), and, as is pointed out in *Noble,* if the covenant is "to keep" rather than "to put" in repair, it is subject to successive breaches for each of which the tenant may sue.

WARNING: If a lease requires the landlord to make repairs but requires the tenant to give notice that repairs are needed, the tenant may not recover if he or she contracts for repairs without notifying the landlord. *Wal-Noon Corp. v Hill* (1975) 45 CA3d 605, 119 CR 646.

As special damages occasioned by the breach, the tenant may recover such items as the market value of a destroyed crop (*Seid Pak Sing v Barker* (1925) 197 C 321, 240 P 765), future profits (*Seid Pak Sing v Barker, supra*; *Feder v Bryson* (1931) 111 CA 448, 295 P 546), lost rentals on a leased motel that decreased in value while out of repair (*Mills v Ruppert* (1959) 167 CA2d 58, 333 P2d 818), and expenditures on items that cannot be used because of the breach (*Seid Pak Sing v Barker, supra*).

The landlord is also liable in tort for injuries to his tenant or invitees if his breach of a covenant to repair creates an unreasonable risk that performance of the covenant would have prevented. *Mariotti v Berns* (1952) 114 CA2d 666, 251 P2d 72; *Singer v Eastern Columbia, Inc.* (1945) 72 CA2d 402, 164 P2d 531; *Scholey v Steele* (1943) 59 CA2d 402, 138 P2d 733. A conflict with this view may at first glance appear to exist in the decisions in *Daulton v Williams* (1947) 81 CA2d 70, 183 P2d 325, and *Dorswitt v Wilson* (1942) 51 CA2d 623, 125 P2d 626, both of which state that a landlord who fails to make promised repairs is guilty of mere nonfeasance for which he is not liable if injury occurs. However, in *Daulton* the defect was patently obvious to the tenants, and there was no evidence that the landlord knew of the defect or that he had made any promise to make repairs, and in *Dorswitt* the court found that notwithstanding an oral promise to repair the defect after letting the premises, the landlord was not liable because the tenant had assumed the risk of a dangerous condition fully known to her. Note that in *Lee v Giosso* (1965) 237 CA2d 246, 46 CR 803, the court points out that a promise to repair after the premises have been rented requires independent consideration to be effective.

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§4.31 4. Covenant to Build

For breach of a covenant to construct or build, the tenant's measure of damages is the difference between the reasonable rental value of the premises "as is" and "as contracted to be," the latter being an amount that bears no necessary relationship to the rental agreed on. *Noble v Tweedy* (1949) 90 CA2d 738, 203 P2d 778. Because a covenant to build is like a covenant to "put in repair" rather than "to keep in repair," it is entire and subject to only one breach. Thus, the tenant is entitled to recover in one action all his damages for the entire term. *Noble v Tweedy, supra*.

In addition to damages caused before filing suit, the tenant may recover damages that accrue before judgment as well as damages for detriment certain to result in the future. CC §3283. For example, a tenant may recover loss of future profits of an established business. *Hoag v Jenan* (1948) 86 CA2d 556, 195 P2d 451. To recover future damages, the plaintiff must show with reasonable certainty that future damages will result, but the fact that the amount of damages may be difficult to measure exactly or is subject to various contingencies does not bar recovery. Generally, in estimating future damages the court is entitled to consider only those contingencies that are reasonably probable of occurrence and are reducible to a present money value. *Noble v Tweedy, supra*.

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§4.32 5. Covenant to Pay for Improvements

If the landlord breaches a covenant to pay for improvements, the tenant may sue the landlord for their value. *Diepenbrock v Luiz* (1911) 159 C 716, 115 P 743.

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§4.33 6. Attorney Fees; Exemplary Damages; Interest

A tenant may not recover attorney fees, exemplary damage, or interest (except under CC §3287(b)) on the landlord's breach of a lease covenant. See also §§4.4-4.6, 4.109.

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§4.34 7. Landlord's Defenses

The statute of limitations on a breach of a lease covenant should be 4 years if the agreement is in writing and 2 years if the agreement is oral. See CCP §§337(1), 339(1).

If the landlord breaches a lease covenant and the parties agree to reduce the rent until the landlord complies with his obligation, the court may conclude that this agreement constitutes a settlement of the damages between the parties. *Scott v TraveLodge Corp.* (1968) 265 CA2d 881, 71 CR 547. Civil Code §1942.4 allows an award of "actual damages," which includes damages for emotional distress. *McNairy v C.K. Realty* (2007) 150 CA4th 1500, 1505, 59 CR3d 429.

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E. Breach of Statutory Duty to Repair

§4.35 1. Civil Code §§1941-1942

For rental agreements or leases entered into or renewed before January 1, 1986, the landlord, in the absence of an agreement to the contrary, must put the leased premises into a condition fit for occupancy and repair all subsequent dilapidations that render it "untenantable." CC §1941. This term is defined in CC §1941.1. The only exceptions are deteriorations or injuries caused by the tenant's lack of ordinary care. See CC §1929. The tenant's remedies for the landlord's breach of these duties are set forth in CC §1942, which provides that the lessee may either vacate the premises or, after notice and failure to repair by the landlord, spend once during each 12-month period not more than 1 month's rent for repairs. The tenant may not sue for damages for breach of the landlord's duty to repair under CC §1941. *Farber v Greenberg* (1929) 98 CA 675, 277 P 534; *Priver v Young* (1923) 62 CA 405, 216 P 966.

For rental agreements or leases entered into or renewed on or after January 1, 1986, a landlord who demands or collects rent on an untenantable dwelling is liable to the tenant or lessee under CC §1942.4 for the tenant's or lessee's actual damages, special damages of not less than $100 nor more than $1000, and costs of suit and reasonable attorney fees, if all of the following conditions exist:

(1) "The rental dwelling substantially lacks any of the affirmative standard characteristics listed in" CC §1941.1;

(2) A public officer or employee responsible for the enforcement of any housing law, after inspection of the premises, has given the landlord or the landlord's agent written notice of the landlord's obligation to abate the nuisance or repair the substandard conditions;

(3) The conditions have existed and have not been abated 60 days after the date of issuance of the above notice and the delay is without good cause; and

(4) The conditions were not caused by the tenant's or lessee's act or omission in violation of CC §§1929, 1941.2.

The remedy provided by CC §1942.4 may be used in addition to any other remedy provided by CC §§1940-1954.1, "the rental agreement, lease, or other applicable statutory or common law." CC §1942.4(f). An action under CC §1942.4 may be filed in small claims court if the claim does not exceed the monetary jurisdiction of that court and if the plaintiff does not seek injunctive relief. CC §1942.4(e).

Civil Code §1942.4(c) provides that a court that awards damages under CC §1942.4 may also order the landlord to abate the nuisance and repair substandard conditions. In addition, the court retains jurisdiction to ensure compliance.

CAUTION: A landlord who institutes an unlawful detainer action based on the tenant's nonpayment of rent, but who is later found to have violated CC §1942.4, is liable to the tenant for reasonable attorney fees and costs. CCP §1174.21.

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§4.36 2. Retaliatory Eviction

If a tenant exercises his rights under CC §1942 or complains to an appropriate government agency concerning the tenantability of a dwelling, the landlord may not in retaliation evict the tenant, increase rent, or decrease services for 60 days after the events set forth in CC §1942.5. A tenant who is a victim of retaliatory eviction is entitled to seek consequential damages and, if the act is malicious, exemplary damages under CC §3294; this is so even though actual damages are nominal. Generally, punitive damages may be not less than $100 nor more than $1000. CC §1942.5(f). Attorneys fees are also available. CC §1942.5(g). Under CC §1942.5(h), remedies allowed by case law still apply, so it appears possible to seek punitive damages in excess of $1000 in an appropriate case. See *Aweeka v Bonds* (1971) 20 CA3d 278, 97 CR 650. (The court in *Aweeka* also stated that it is possible that retaliatory eviction might give rise to a cause of action for intentional infliction of emotional distress.)

For discussion of other remedies and protections available to tenants exposed to retaliatory eviction, see California Eviction Defense Manual, chap 16 (2d ed Cal CEB 1993); California Landlord-Tenant Practice §§8.109-8.136 (2d ed Cal CEB 1997).

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§4.37 3. Housing Codes

Under some circumstances, housing codes that impose a duty on a landlord to maintain property, but provide only criminal penalties for their breach, have been held to impose greater liability on a landlord if the tenant is in the class that the legislation was designed to protect. See *McNally v Ward* (1961) 192 CA2d 871, 14 CR 260. Although the court in *McNally* concluded that a landlord is liable in tort for breach of the legislative duty, it is at least arguable that the tenant might also have a cause of action against the landlord for damages for failure to make repairs. There is perhaps additional support for this view in light of the recognition of an implied warranty of habitability in the landlord-tenant relationship. For discussion of this warranty, see §§4.38-4.44. If the tenant has a cause of action against the landlord, the measure of recovery would probably be the same as in the case of a breach of an express covenant to repair. See §4.30.

See also CC §789.3, discussed in §4.45, which provides for damages to a tenant when a landlord cuts off utility service.

For a discussion of the implied warranty of habitability and housing code violations, see California Eviction Defense Manual, chap 15 (2d ed Cal CEB 1993); California Landlord-Tenant Practice (2d ed Cal CEB 1997).

For a decision discussing the size of appropriate civil penalties for housing code violations, see *City & County of San Francisco v Sainez* (2000) 77 CA4th 1302, 92 CR2d 418.

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F. Breach of Warranty of Habitability

§4.38 1. Availability of Damages

In California, there is a common law implied warranty of habitability in residential leases. Under this warranty, a landlord covenants that premises he or she leases for living quarters will be maintained in a habitable state for the duration of the lease. *Green v Superior Court* (1974) 10 C3d 616, 111 CR 704; *Hinson v Delis* (1972) 26 CA3d 62, 102 CR 661, disapproved on other grounds in *Knight v Hallsthammar* (1981) 29 C3d 46, 55 n7, 171 CR 707.

In *Green v Superior Court, supra,* 10 C3d at 624, the court treated leases and rental agreements as contracts, not merely as conveyances of estates in land. Therefore, all normal remedies for breach of contract should apply, including an action for damages. Thus, a tenant may bring a suit for damages against the landlord for breach of the warranty of habitability. See *Fairchild v Park* (2001) 90 CA4th 919, 109 CR2d 442; *Stoiber v Honeychuck* (1980) 101 CA3d 903, 162 CR 194. See also *Smith v David* (1981) 120 CA3d 101, 176 CR 112.

In a suit by the tenant for damages for breach of the implied warranty of habitability, special damages should be recoverable (as discussed in §4.42), and general damages should be recoverable on one of the theories discussed in §§4.40-4.41. Note, however, that in *Stoiber v Honeychuck, supra,* the court held that the tenant could claim general damages for discomfort and annoyance by framing a cause of action in terms of the tort of failure to provide habitable premises. See §4.43. The landlord's management company also might be liable under this theory if the company was responsible for maintaining the premises. 101 CA3d at 929.

Damages based on the theories of nuisance and intentional infliction of mental distress might also be claimed in an action based on breach of the implied warranty. See *Stoiber v Honeychuck, supra*; *Smith v David, supra*. Each of these theories will support a claim for punitive damages under appropriate facts. *Stoiber v Honeychuck, supra*. The *Stoiber* court also approved a negligence theory (101 CA3d at 922), but it does not appear that much is gained by adding this theory in a complaint pleading causes of action under the intentional tort and warranty theories, except that negligence is an insurable risk while intentional torts are not.

Breach of warranty and various tort theories are alternative remedies and cannot be used to give the tenant double recovery. 101 CA3d at 931. See also *Fairchild v Park* (2001) 90 CA4th 919, 109 CR2d 442.

A tenant may bring an affirmative suit for breach of the implied warranty of habitability even after stipulating to give up possession in an unlawful detainer action. In *Landeros v Pankey* (1995) 39 CA4th 1167, 46 CR2d 165, the court held that a settlement of an unlawful detainer action between landlord and tenant did not collaterally estop the tenant's later action for damages for breach of the implied warranty; the settlement neither referred to the breach of warranty claim nor provided that the settlement resolved all disputes between the parties.

PRACTICE TIP: Because settlements are common in unlawful detainer actions, it is important for both parties to consider whether or not to include a release of all claims in the stipulated judgment.

The statute of limitations might restrict recovery under some theories more than under others. Nuisance and intentional infliction of mental distress are torts, as is intentionally failing to provide habitable premises, outlined in *Stoiber v Honeychuck, supra*. Under these theories, the tenant can recover personal injury damages only for 2 years preceding the filing of the action under CCP §335.1 and property losses for the preceding 3 years under CCP §338. The implied warranty, however, is inserted by law into the lease or rental agreement. Under an oral agreement, the tenant can claim economic (*i.e.,* rent reduction, property damage, and other out-of-pocket) damages for up to 2 years (CCP §339); if the agreement is in writing, the limitation period is 4 years (CCP §337).

In addition to the sections that follow, on recoverable damages for breach of the warranty of habitability, see California Eviction Defense Manual §§15.38-15.50 (2d ed Cal CEB 1993).

NOTE: The implied warranty of habitability in residential real estate contracts may be raised as a defense in an unlawful detainer action. *Green v Superior Court, supra*. Because a landlord's breach of the warranty directly relates to whether any rent is owed by the tenant, the breach may be determinative of whether the landlord or

tenant is entitled to possession of the premises on nonpayment of rent. Consequently, instead of suing for damages for breach of the covenant, the tenant may withhold rent. But see *Underwood v Corsino* (2005) 133 CA4th 132, 136, 34 CR3d 542 (because no statute permits rent abatement for commercial tenants, remedy is unavailable in commercial context). For further discussion of the breach of the warranty as a defense in an unlawful detainer action, see California Landlord-Tenant Practice §§12.36-12.37 (2d ed Cal CEB 1997).

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§4.39 2. Statutory Damages; Abatement

In addition to the affirmative remedies discussed in §4.38, CC §1942.4 provides that a residential landlord who demands or collects rent after being notified of a substandard condition by a housing code enforcement official may be required to abate the condition and may be liable to the tenant for actual damages, "special" damages of $100 to $1000, costs, and reasonable attorney fees. An action under §1942.4 may be preferable to one for breach of the implied warranty of habitability if the lease or rental agreement does not have an attorney fee clause, but certain prerequisites must be met for a §1942.4 action.

A landlord may also face liability, and potentially even a forced sale of the property, under the Narcotics Nuisance Abatement Act (Health & S C §§11570-11587), which may be considered as a potential cause of action in an implied warranty of habitability affirmative suit.

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3. General Damages

§4.40 a. Difference in Value or Percentage Reduction

A tenant who establishes a breach of warranty still must pay a "reasonable rent" for the period of the breach. The amount of "reasonable rent" depends on the damages caused by the breach of warranty (*i.e.,* contract rent minus damages equals "reasonable rent"). *Green v Superior Court* (1974) 10 C3d 616, 638, 111 CR 704. The *Green* court mentioned two approaches to the damages problem. The first bases damages on the difference between the fair rental value of the premises as warranted and the actual market value during the breach. *Green v Superior Court, supra*. See *Quevedo v Braga* (1977) 72 CA3d Supp 1, 8, 140 CR 143. The second approach estimates the percentage reduction in use caused by the landlord's breach and applies the reduction to the agreed-on rent. *Green v Superior Court* (1974) 10 C3d 616, 639 n24, 111 CR 704. See *Cazares v Ortiz* (1980) 109 CA3d Supp 23, 168 CR 108 (percentage reduction of one third).

The difference-in-value approach, which depends on proving the fair market value of the premises under different conditions of repair (one of which is hypothetical) could require expensive expert testimony. See *Cazares v Ortiz, supra*. The percentage-reduction-in-use test seems to invite an overall estimate of the impact of the defects.

In *Green,* the court did not endorse either method of determining damages. The only reported cases (*Quevedo* and *Cazares*) were decided by superior court appellate departments. Logically, it seems that neither approach can reduce the rent to zero. *Green* mentions the possibility, however, that the landlord's breach may be total, and that the tenant may owe no rent at all. 10 C3d at 639. See also *Smith v David* (1981) 120 CA3d 101, 112, 176 CR 112; *Acadia, Cal., Ltd. v Herbert* (1960) 54 C2d 328, 337, 5 CR 686.

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§4.41 b. Discomfort and Annoyance

Discomfort and annoyance have been rejected as compensable damages for breach of implied warranty by the California courts. See *Quevedo v Braga* (1977) 72 CA3d Supp 1, 9, 140 CR 143; *Cazares v Ortiz* (1980) 109 CA3d Supp 23, 168 CR 108. See also *Golden Gateway Ctr. v San Francisco Residential Rent Stabilization & Arbitration Bd.* (1999) 73 CA4th 1204, 87 CR2d 332 (discomfort does not entitle tenant to reduction under rent control law). In *Stoiber v Honeychuck* (1980) 101 CA3d 903, 916, 162 CR 194, however, the court approved damages for discomfort and annoyance caused by the landlord's failure to make repairs, when one of the tenant's causes of action was based on the tort of failing to provide habitable premises. The *Stoiber* court distinguished *Quevedo v Braga, supra,* on the ground that "no cause of action in tort was pleaded" in that case. 101 CA3d at 916.

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§4.42 4. Special Damages

The tenant should be able to recover, as special damages, various expenses actually incurred as a result of the landlord's breach of the warranty of habitability. In *Stoiber v Honeychuck* (1980) 101 CA3d 903, 913, 162 CR 194, the court held that a complaint for damages for breach of the implied warranty stated a cause of action by alleging "property damage and economic loss including but not limited to water damage to furniture, mattress and curtains." See also Moskovitz, *The Implied Warranty of Habitability*: *A New Doctrine Raising New Issues*, 62 Calif L Rev 1444, 1488 n196 (1974).

In *Fair v Negley* (Pa Super Ct 1978) 390 A2d 240, 242, the court held that, when the implied warranty of habitability is breached, the tenant may sue and recover:

- The difference between the rent paid and the reasonable rental value;
- Any amounts the tenant spent to try to make the premises habitable; and
- Any increase in the tenant's utility bills due to the uninhabitable condition of the premises.

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§4.43 5. Punitive Damages

The tenant may be able to recover punitive damages in an action for breach of the implied warranty of habitability if the landlord's conduct was willful, oppressive, or malicious. See CC §3294.

In *Stoiber v Honeychuck* (1980) 101 CA3d 903, 162 CR 194, the tenant alleged causes of action based on theories of breach of the warranty of habitability, nuisance, intentional infliction of emotional distress, negligent violation of statutory duty, constructive eviction, and injunctive relief from unlawful business practices. The court held that (1) the tenant can sue in tort for damages resulting from a breach of the implied warranty of habitability (101 CA3d at 918); and (2) the plaintiff's prayer for punitive damages was proper because she had alleged that the landlord's conduct was willful, oppressive, and malicious (101 CA3d at 920).

Thus, it appears that a cause of action for breach of the warranty may support a prayer for punitive damages under CC §3294. In any event, a tort cause of action can often be joined with a cause of action for breach of the implied warranty. 101 CA3d at 913.

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§4.44 6. Costs and Attorney Fees

When a lease or rental agreement provides for an award of attorney fees to the prevailing party in an action on the contract, and the tenant brings an affirmative action for breach of an express or implied warranty of habitability, attorney fees and costs are governed by CC §1717. See *Fairchild v Park* (2001) 90 CA4th 919, 109 CR2d 442. The prevailing party is generally the party who recovered a greater relief in the action on the contract. The court may determine, however, that there is no prevailing party on the contract for the purpose of CC §1717. CC §1717(b)(1).

A voluntary dismissal entitles the prevailing party to costs under CCP §1032, but precludes an award of attorney fees. CC §1717(b)(2); *Mitchell Land & Improvement Co. v Ristorante Ferrantelli, Inc.* (2007) 158 CA4th 479, 485, 70 CR3d 9.

If a prevailing tenant wins exclusively on a tort theory, *i.e.,* is awarded punitive damages based on the landlord's tortious failure to provide habitable premises (see §4.43), attorney fees would not be recoverable, unless the contract expressly provides for recovery of fees by the prevailing party in a related tort action. See *Santisas v Goodin* (1998) 17 C4th 599, 71 CR2d 830; *Fairchild v Park, supra*. For specific analysis of tort versus contract theories for awarding attorney fees and costs in an affirmative suit for breach of the implied warranty of habitability, see *Fairchild v Park, supra*.

In a statutory action under CC §1942.4 (see §4.39), available in certain circumstances when the premises are untenantable, the prevailing party is entitled to reasonable attorney fees and costs. CC §1942.4(b). See *Galan v Wolfriver Holding Corp.* (2000) 80 CA4th 1124, 96 CR2d 112 (court exercised discretion and found that defendant was not prevailing party after plaintiff voluntarily dismissed statutory untenantability action).

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§4.45 G. Disconnecting Utility Services

Under CC §789.3, a landlord may not interrupt or terminate any utility service to the tenant, including water, heat, light, electricity, gas, telephone, elevator, or refrigeration, with the intent to terminate the lease. For each violation, the landlord is liable in a civil action for actual damages, and $100 for each day or part of each day that the landlord remains in violation. The trial court may not award less than $250 for each separate cause of action. Subsequent or repeated violation will be treated as separate causes of action. CC §789.3(c). The court must award reasonable attorney fees to the prevailing party in any action under CC §789.3(c). CC §789.3(d).

In *Hale v Morgan* (1978) 22 C3d 388, 149 CR 375, the court held that the $100-a-day penalty provision of CC §789.3 does not deny a landlord equal protection, but it might deny him or her due process in a particular case. *Hale* was such a case because (1) the landlord's trailer park was "a modest operation by a relatively unsophisticated landlord" (22 C3d at 405), and (2) the penalty of $17,300 ($100 for each of 173 days the water and electricity were cut off) was confiscatory in relation to the $65-a-month rent (22 C3d at 405). In its opinion, the court made several other holdings regarding §789.3:

(1) Not all applications of the penalty would deny due process. "[T]here are doubtless some situations in which very large punitive assessments are both proportionate to the landlord's misconduct and necessary to achieve the penalty's deterrent purposes." 22 C3d at 404.

(2) The $100-a-day penalty is presumed to be constitutional and it must be applied, unless in a given case its unconstitutionality "clearly, positively, and unmistakably appears." 22 C3d at 404.

(3) The landlord's ignorance of the statute is irrelevant to the question of whether the penalty will be imposed. 22 C3d at 396.

(4) The tenant is "deprived" of the utility (and therefore entitled to the daily penalty) only during the time he or she "lacks practical access to any residential utility because the landlord has terminated service." 22 C3d at 406. Thus, "deprivation" ends when the tenant restores the utility or by a reasonable effort could have done so, abandons or is absent from the premises, or is lawfully evicted.

In *Kinney v Vaccari* (1980) 27 C3d 348, 165 CR 787, the court upheld an award of $100 a day (totaling $36,000) under CC §789.3 plus compensatory damages, attorney fees, and punitive damages. The court distinguished *Hale,* in that "unlike *Hale,* the landlord had little or no provocation for his conduct," the tenants later attempted to pay rent and restore the utilities, and the utilities were terminated during a harsh winter, causing families with small children to be without adequate heat, hot water, and cooking facilities for 60 days. 27 C3d at 351. The court also held that (1) the landlord was bound by the acts of his managing agent who terminated the utilities (27 C3d at 354 n2), and (2) the word "tenant" in §789.3 means the group of occupants in a rental unit, not each occupant (so that a family of four might recover $100 a day, not $400) (27 C3d at 357). In addition, the court held that §789.3 was violated even though the utilities were terminated through the landlord's nonpayment of the utility bill, rather than by his physically disconnecting the service. See also *Camacho v Schaefer* (1987) 193 CA3d 718, 238 CR 609 (1979 amendment to CC §789.3 was not intended to change ruling in *Kinney* that $100-per-day penalty is available only to each tenant-family and not to each individual tenant).

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H. Wrongful Withholding of Tenant's Personal Property

§4.46 1. Tenant's Remedies

If a landlord wrongfully detains a tenant's trade fixtures or personalty, the tenant may bring an action to recover them and seek damages for their detention, *e.g.,* lost earnings if deprived of use of trade fixtures. *Beebe v Richards* (1953) 115 CA2d 589, 252 P2d 688. By analogy to non-landlord-tenant situations (see *P. J. Freiermuth Co. v Faustino* (1932) 120 CA 136, 7 P2d 370), a demand for property wrongfully withheld should probably be made before the action, and damages for detention and depreciation should date from the time of the demand.

Instead of suing to recover the property, the tenant may bring an action in tort for conversion and recover damages for it. See *Gosliner v Briones* (1921) 187 C 557, 204 P 19; *Pearl v Figoni* (1942) 49 CA2d 662, 122 P2d 385. The measure of damages for conversion is set forth in CC §3336, which provides that the detriment caused by the wrongful conversion of personal property is presumed to be:

- The value of the property at the time of the conversion, with the interest from that time, or, an amount sufficient to indemnify the party injured for the loss which is the natural, reasonable, and proximate result of the wrongful act complained of and which a proper degree of prudence on his part would not have averted; and
- A fair compensation for the time and money properly expended in pursuit of the property.

A tenant may be able to recover damages for emotional distress caused by the landlord's conversion of the tenant's personal property. See *Gonzales v Personal Storage, Inc.* (1997) 56 CA4th 464, 480, 65 CR2d 473.

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Source: Civil Litigation/California Attorney's Guide to Damages/4 Landlord/Tenant/§4.47 2. Statute of Limitations

§4.47 2. Statute of Limitations

Under CCP §338(c), the statute of limitations on actions for detaining or injuring personal property is 3 years.

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I. Landlord's Violation of Local Rent Control Ordinance

§4.48 1. Damages for Rent Overcharges

Rent control ordinances commonly authorize damages for rent overcharges (up to three times the amount of the overcharge). Some ordinances set a minimum level of damages (usually $500) for rent overcharges.

A successor landlord may be liable to the tenant for rent increases charged by the predecessor landlord, when the rent increases exceeded the limitations of a rent control ordinance. *Baychester Shopping Ctr., Inc. v San Francisco Residential Rent Stabilization & Arbitration Bd.* (2008) 165 CA4th 1000, 1006, 81 CR3d 341.

PRACTICE TIP: The court in *Baychester* noted that the rent control ordinance at issue specifically defined landlord to include successor landlords and contained a provision benefitting successor landlords if the former landlord had failed to take advantage of allowable rent increases. The absence of one or both of these factors may allow counsel for landlords to distinguish their case.

Many ordinances contain no provision for an administrative determination of the correct rent. In these jurisdictions, a tenant faced with what may be an unlawful rent increase must contest the amount in an unlawful detainer proceeding or pay the amount demanded and then seek a judicial determination in a declaratory relief action.

Under CC §1947.7, in a jurisdiction that requires registration of rent, restitution of overcharges to the tenant and recovery of registration or filing fees are the exclusive remedies for a landlord's failure to register when a landlord is in "substantial compliance" with the ordinance. No other penalties may be assessed against such a landlord. In *Richman v Santa Monica Rent Control Bd.* (1992) 7 CA4th 1457, 9 CR2d 690, the court held that CC §1947.7 does not prevent a rent board from determining whether parking was included in the landlord's base rent, when the board did not assess any excess rent penalty against the landlord.

In rent-controlled jurisdictions that require registration of rent, once a certified rent has been established (see CC §1947.8), any landlord who charges rent to a tenant in excess of the certified rent ceiling must refund the excess rent to the tenant on demand. CC §1947.11(a). If the landlord refuses to refund the excess rent and a court finds the landlord willfully charged the tenant rent in excess of the certified lawful rent ceiling, the court must award the tenant a judgment for the excess amount of rent and *may* treble that amount. The prevailing party is entitled to attorney fees and costs. CC §1947.11(a). The remedy under CC §1947.11 does not prohibit any other remedy that might be available to a party aggrieved by rent in excess of a certified level. CC §1947.11(b).

A rent control board may not issue an order allowing a tenant to withhold a portion of the monthly rent as restitution for past overcharges, nor may it declare that such withholding may not form the basis of an unlawful detainer action. Such orders represent "an unwarranted intrusion into the power of the courts to 'check' administrative adjudications." *McHugh v Santa Monica Rent Control Bd.* (1989) 49 C3d 348, 377, 261 CR 318. The supreme court also held that, although an administrative agency may assess certain penalties, a local rent board's award of treble damages is invalid. Such penalties are not reasonably necessary to effect the board's primary, legitimate regulatory purposes. Moreover, a rent board's power to award treble damages "poses a risk of producing arbitrary, disproportionate results that magnify, beyond acceptable risks, the possibility of arbitrariness inherent in any scheme of administrative adjudications." 49 C3d at 379. In addition, the court upheld the power of local rent boards to adjudicate excess rent claims, rejecting the arguments that such adjudications violate the judicial powers clause (Cal Const art VI, §1) or the right to a jury trial (Cal Const art I, §16).

Whether an administrative body may make a monetary award for past rent overcharges, or impose penalties for the violations, is an unsettled issue. In the absence of any special administrative remedies for rent overcharges, a tenant must pursue the usual civil remedies of actions for a refund of the overcharges, for declaratory relief concerning the proper rent, or both.

A treble damage award for fraudulent collection of rents in excess of those allowed by a local rent control ordinance is not dischargeable in bankruptcy. *Cohen v de la Cruz* (1998) 523 US 213, 140 L Ed 2d 341, 118 S Ct 1212.

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§4.49 2. Damages for Unlawful Evictions

Most rent control ordinances authorize civil actions for damages arising from eviction attempts or actual evictions that violate the eviction control ordinance. Some ordinances authorize treble damages for unlawful evictions or eviction attempts. A private cause of action for damages exists when a landlord terminates a tenancy in bad faith in violation of a local rent control ordinance, even if the ordinance does not provide for such an action and the ordinance makes the landlord's action a crime. *Castillo v Friedman* (1987) 197 CA3d Supp 6, 243 CR 206.

In *Kelly v Yee* (1989) 213 CA3d 336, 261 CR 568, the court of appeal held that an award of treble damages for unlawful eviction is mandatory under the San Francisco rent control ordinance, which authorizes the tenant or the rent board to institute a civil proceeding for "not less than" treble damages. Although the language of the ordinance appears to authorize a higher award, the opinion states in dicta that it is "an obviously absurd interpretation" to contemplate that more than three times actual damages might be awarded. 213 CA3d at 340. In addition, the court held that the ordinance was not preempted by CC §3294 (which authorizes awards of punitive damages in civil actions generally) because the treble damages provision was created to encourage private enforcement of the ordinance rather than to punish extreme and outrageous conduct. The court summarily rejected the landlords' argument that the ordinance violated due process by imposing treble damages without regard to fault or magnitude of violation. 213 CA3d at 341. See also *Beeman v Burling* (1990) 216 CA3d 1586, 265 CR 719, in which the court upheld the trebling of an award of $20,000 for mental anguish in an unlawful eviction action brought under the San Francisco ordinance. The court also awarded the tenant attorney fees incurred in the appeal under CC §1717.

In *Balmoral Hotel Tenants Ass'n v Lee* (1990) 226 CA3d 686, 276 CR 640, the court held that mental anguish was a proper element of damages in a wrongful eviction action under the San Francisco rent control ordinance. The court of appeal refused to treble the portion of the damages attributable to mental anguish, however, and it limited treble damages to out-of-pocket expenses. The court held that the dominant motive of the board of supervisors in providing for treble damages was to encourage suits to protect tenants' rights, when the stakes would otherwise be too small to make litigation worthwhile. The amount of damages for mental suffering might easily be large enough to support litigation without trebling them. Interpreting the ordinance to authorize trebling only of economic damages avoided the substantive due process problems that might arise if a mandatory formula results in an excessive penalty. See *Hale v Morgan* (1978) 22 C3d 388, 149 CR 375.

After the *Balmoral* decision, the San Francisco Board of Supervisors amended its ordinance to provide that damages for mental or emotional distress should be trebled, but only if the trier of fact finds that the landlord acted in knowing violation or reckless disregard of the eviction control ordinance.

Damages for breach of an ordinance typically are calculated under CC §3333. Damages designed to compensate the tenant for actual losses are typically awarded, such as the difference between what the tenant was paying in the rent-controlled property and what the tenant was forced to pay for rent in a new apartment. On one occasion, even in the absence of pleading a contract-based cause of action, one court has employed a contract measure of damages and awarded the tenant the benefit of the tenant's bargain (*i.e.,* the difference between what the tenant was paying for rent in the rent-controlled apartment and the amount of rent the landlord obtained for the unit after the tenant left) if no other means of compensation for the wrong existed. *Castillo v Friedman, supra*. In *Castillo,* the tenant who was wrongfully evicted had moved to a smaller apartment and in fact had paid significantly less rent than had been paid in the rent-controlled apartment, thus rendering inappropriate the more traditional measure of damages for the wrong.

For practical tips on how to prosecute or defend a lawsuit for an eviction that violates a local rent control ordinance, see Souza, *The Wrongful Eviction Lawsuit*, 10 CEB Civ Litigation Rep 52 (Mar. 1988); Souza, *The Wrongful Eviction Lawsuit: Update*, 12 CEB Civ Litigation Rep 63 (Mar. 1990); Souza, *Wrongful Eviction Update and Introduction to Habitability Litigation*, 15 CEB Civ Litigation Rep 100 (Mar. 1993).

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§4.50 3. Attorney Fees

Some rent control ordinances provide for an award of attorney fees to the prevailing party in eviction cases and in civil actions for violation of the ordinance. They do not provide for attorney fees for hearings on individual-adjustment petitions. For discussion of attorney fee awards in unlawful detainer actions, see California Landlord-Tenant Practice §§13.25-13.33 (2d ed Cal CEB 1997).

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§4.51 4. Liability of New Owner

It is unsettled whether a new owner may be held liable for rent overcharges collected by a previous owner. If this were so, and a previous owner had set rents in violation of the rent control ordinance, a new owner could be forced to lower rents prospectively and to refund any overcharges he or she has collected. Therefore, potential buyers should explore compliance and registration issues before buying property. They may wish to consider requiring that funds be held in escrow pending potential resolution of liability issues.

In certain situations, a new owner has been held liable for excess rents charged by a previous owner because the tenant is permitted to offset previously paid excess rent against future months' rent. See *Minelian v Manzella* (1989) 215 CA3d 457, 263 CR 597; *Nourafchan v Miner* (1985) 169 CA3d 746, 215 CR 450.

New owners of property may have the rents of current tenants reduced to amounts that comply with local rent control ordinances. Therefore, buyers of apartment buildings in jurisdictions that have controls on rents should be very careful in determining what prior rent increases were imposed. The task of ascertaining correct rent levels may be easier in jurisdictions where the locality requires registration of rents. Where there is no rent registration, adequate disclosures and, perhaps, hold harmless agreements should be obtained from sellers.

Although some trial courts have allowed tenants to offset past overcharges in rent against current rents, when a single owner has owned the property from the commencement of rent controls, it is unlikely that a new owner with no connection to the past wrongful collection will be compelled to refund rents or suffer an offset to the injured tenant. See CC §1466. Tenant advocates have argued that the offset rationale of *Minelian v Manzella, supra,* and *Nourafchan v Miner, supra,* would allow such an offset. However, no court has ruled that such an offset would be proper against a new owner who had no relationship to the owner who made the illegal rent charges.

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J. Security Deposits

§4.52 1. In General

Civil Code §1950.5, applicable to leases of residential property, governs the law on the retention of security deposits and the landlord's liability for wrongfully withholding them at the end of the tenancy. A similar provision, CC §1950.7, covers security deposits on commercial property. Under CC §1950.5(b), security is defined as "any payment, fee, deposit or charge, including, but not limited to, any fee, payment, deposit, or charge, except as provided in Section 1950.6, that is imposed at the beginning of the tenancy to be used to reimburse the landlord for costs associated with processing a new tenant or that is imposed as an advance payment of rent, used or to be used for any purpose, including, but not limited to, any of the following:" (1) to compensate a landlord for a tenant's default in paying rent; (2) to repair damages (exclusive of wear and tear) to the premises caused by the tenant or the tenant's guest or licensee; (3) to clean the premises when the tenant leaves; and (4) to remedy future tenant defaults, and to restore, replace, or return personal property if the rental agreement so authorizes. For a thorough discussion of the landlord's and tenant's duties concerning security deposits, see California Landlord-Tenant Practice §§4.23-4.29, 8.167-8.176 (2d ed Cal CEB 1997). See also California Eviction Defense Manual, chap 31 (2d ed Cal CEB 1993).

NOTE: Civil Code §1947.3 provides that a landlord or landlord's agent may not require cash as the exclusive form of payment of rent or security deposit, *unless* the tenant has previously attempted to pay with a check drawn on insufficient funds or stopped payment. In that case, the landlord may demand cash for up to the next three months. Any waiver of the tenant's rights under this section is void.

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§4.53 2. Landlord's or Landlord Successor's Retention of Deposit

A residential landlord's or landlord successor's "bad faith claim or retention" of any part of a security deposit or a landlord successor's bad faith demand of replacement of security in violation of CC §1950.5(j) may subject the landlord or landlord's successor to statutory damages of up to twice the amount of security, in addition to actual damages. The court can award damages for bad faith whenever the facts warrant such an award, regardless of whether the injured party has specifically requested relief. CC §1950.5(*l*). In such an action, the landlord or landlord's successor has the burden of proving the reasonableness of the amounts claimed or the authority under CC §1950.5 to demand additional security deposits. CC §1950.5(*l*). For commercial tenancies, the same right to claim punitive damages is given, but the statute has no language concerning burden of proof. CC §1950.7(f).

Under CC §1950.5(n), a tenant may seek statutory damages in small claims court. Civil Code §1950.7 contains no comparable language for commercial tenancies, but small claims courts seem to have jurisdiction over these claims under their general jurisdictional powers. See 59 Ops Cal Atty Gen 321 (1976).

Civil Code §1950.7 prohibits a landlord of commercial premises from retaining a security deposit to cover damages for *future* rent, *i.e.,* rent accruing after the date on which the landlord is required by statute to return the deposit to the tenant. However, the parties may waive this aspect of the statute in their lease. The amount of a security deposit wrongly retained may not be offset against future damages actually incurred by the landlord before return of the deposit. *250 LLC v Photopoint Corp.* (2005) 131 CA4th 703, 713, 32 CR3d 296.

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§4.54 3. Attorney Fees and Interest

Although attorney fees are not recoverable (see §§4.4, 4.109), the tenant ought to be able to recover interest on a security deposit wrongfully retained because the claim is liquidated. See CC §3287. There are no cases on this particular point, however.

In *Korens v R.W. Zukin Corp.* (1989) 212 CA3d 1054, 1058, 261 CR 137, the court held that a tenant security deposit creates only a debtor-creditor relationship between the landlord and the tenant, not a trust relationship. Therefore, in the absence of an agreement or legislative enactment providing for interest on the security deposit, the tenant is not entitled to recover interest on it. See *Small Prop. Owners v City & County of San Francisco* (2006) 141 CA4th 1388, 1395, 47 CR3d 121 (local ordinance requiring landlords to pay 5 percent interest on security deposits did not effect taking of landlords' property); *National Corp. for Hous. Partnership v Liberty State Bank* (8th Cir 1988) 836 F2d 433 (no trust relationship was established).

If a tenant tries to discharge a rent obligation by filing for bankruptcy, and the landlord successfully moves to dismiss the filing, the landlord may recover the attorney fees incurred in the bankruptcy proceedings if the lease contains an attorney fees provision. *Circle Star Ctr. Assocs., L.P. v Liberate Technols.* (2007) 147 CA4th 1203, 1209, 55 CR3d 232.

On who is the prevailing party for the purpose of recovering attorney fees, see *Public Employees' Retirement Sys. v Winston* (1989) 209 CA3d 205, 258 CR 612, discussed in §4.94.

On California attorney fees generally, see California Attorney Fee Awards (2d ed Cal CEB 1994).

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§4.55 4. Statute of Limitations

Before enactment of CC §1950.5 (see §4.52), a landlord's obligation to return a security deposit was viewed as a personal one arising in contract. See *Gallagher v McMann* (1932) 119 CA 688, 7 P2d 204. As such, CCP §§337(1) and 339(1) provide respectively that a 4-year statute of limitations for breaches of written contracts and a 2-year statute of limitations for oral contracts apply to breaches of the landlord's duty to return security deposits. Nothing in CC §1950.5 indicates any intent to change the applicability of these statutes of limitations as they relate to security deposits.

For further discussion on security deposits and last month's rent, see California Eviction Defense Manual, chap 31 (2d ed Cal CEB 1993) and California Landlord-Tenant Practice (2d ed Cal CEB 1997).

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IV. TENANT'S BREACH

A. Use of Property for Illegal Purposes

§4.56 1. Damages

When a landlord knowingly rents property to a tenant for use for illegal purposes (defined in CC §1667), the lease is void and the law will not aid the landlord or the tenant in enforcing it. *Demartini v Anderson* (1899) 127 C 33, 59 P 207. Therefore the landlord cannot recover damages for breach of a lease made under such circumstances. Nor can the landlord recover damages from the tenant for injuring the reputation of the leased premises. *Pratt v Padgett* (1920) 47 CA 563, 191 P 39.

But if the lease is valid and the tenant on his own uses the premises for illegal purposes, the landlord may recover damages. See *Keating v Preston* (1940) 42 CA2d 110, 108 P2d 479. The cause of action appears to arise from breach of an implied covenant not to use the property for a purpose prohibited by statute. See *Keating v Preston, supra*. To date, there have been no cases in which a landlord has been awarded damages for the tenant's illegal use of the premises. However, the measure of damages should be controlled by CC §3300, which concerns breach of an obligation arising in contract. The nature of the damage suffered by the landlord would probably be the injury to the reputation of the premises.

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§4.57 2. Statute of Limitations

The statute of limitations on breach of a lease covenant express or implied should be 4 years if the lease is in writing and 2 years if the lease is oral. See CCP §§337(1), 339(1). There are no cases on this point, however.

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B. Use for Other Than Intended Purpose

§4.58 1. Obligation and Damages

When real property is leased for a particular purpose, the tenant who uses it for a different purpose is liable to the landlord for all damages resulting from such use. See CC §1930; *Isom v Rex Crude Oil Co.* (1905) 147 C 659, 82 P 317; *Keating v Preston* (1940) 42 CA2d 110, 108 P2d 479. Under CC §1930, damages appear to be those that the landlord suffered because his or her property was injured by depreciation in value or by some other injury naturally occurring because of the nonpermitted use. It should be noted, however, that the measure of the landlord's damages under CC §1930 is not the value of the nonpermitted use to the tenant during wrongful occupation, as is the case under CC §3334. See *Lineberger v Delaney Petroleum Corp.* (1935) 8 CA2d 153, 47 P2d 326. To hold that the landlord is entitled to the value of the nonpermitted use when he or she has reserved no right to use the property during the time the tenant is in possession under the lease would be to allow the landlord to recover for something to which he or she is not entitled, *e.g.,* profits from unauthorized commercial use of the property. *Smith v United Crude Oil Co.* (1920) 50 CA 466, 195 P 434.

If in a suit based on CC §1930 the landlord is unable to show actual damages due to the tenant's unauthorized use, the landlord is nevertheless entitled to recover nominal damages for breach of the lease. CC §3360; *Sill Prop., Inc. v CMAG, Inc.* (1963) 219 CA2d 42, 33 CR 155; *Bromberg v Signal Gasoline Corp.* (1933) 130 CA 469, 20 P2d 83.

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§4.59 2. Statute of Limitations

There are no cases on the statute of limitations that apply to a landlord's damage action against the tenant for a use other than that for which the property was let. It is possible that such an action could be viewed as either an action on a liability created by statute, *i.e.,* by CC §1930, or as an action for injury to real property under CCP §338. In either case, the statute of limitations would be three years. If, however, CC §1930 is viewed as an implied lease covenant by the tenant, the statute of limitations would be either two or four years, depending on whether the lease is oral or written. See §4.57.

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C. Waste

§4.60 1. Damages

Under CC §826 and CCP §732, a landlord may recover not only actual damages but treble damages for waste committed by a tenant for years. (A tenant at will is not included among the possible defendants under CCP §732 and is probably liable for waste-like injury to leased premises not as a tenant but as a trespasser. See *Parrott v Barney* (D Cal 1868) 18 F Cas 1249 (No. 10,773a).) Because of the nature of waste (see *Southern Pac. Land Co. v Kiggins* (1930) 110 CA 56, 293 P 708), it must ordinarily be proved by evidence of acts that injuriously affect the market value of the leased premises. *Sallee v Daneri* (1942) 49 CA2d 324, 121 P2d 781; *Richards v Silveria* (1929) 97 CA 166, 275 P 478. Of course, the measure of actual damages will probably be the difference between the value of the property before the waste was committed and the present value of the property. However, damages could also be measured by the cost of restoring the property to its original condition if it is possible to do so.

Whether treble damages will be awarded is discretionary with the court. *Isom v Book* (1904) 142 C 666, 76 P 506. Code of Civil Procedure §732, which provides for treble damages, contemplates a showing of willfulness and maliciousness to recover such damages. *Kanner v Globe Bottling Co.* (1969) 273 CA2d 559, 78 CR 25. If treble damages are sought, the complaint must expressly request them. *Chipman v Emeric* (1855) 5 C 239. But see *Parrott v Barney, supra,* for a conflicting view.

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§4.61 2. Statute of Limitations

The statute of limitations for waste should be three years under CCP §338.

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§4.62 D. Breach of Statutory Duty to Repair

In the absence of an express covenant to repair, the tenant has a statutory duty to use ordinary care for the preservation of the premises and a duty to repair all deteriorations caused by his or her want of ordinary care. CC §§1928-1929. The measure of damages (and probably the statute of limitations (see §4.55)) should be the same as for breach of an express covenant to repair. See §4.69. The tenant's breach of his or her statutory duties may, of course, amount to waste, in which case the landlord may recover not only actual but treble damages. See §4.60.

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E. Breach of Lease Covenants

§4.63 1. Damages for Breach

Discussion in §§4.63-4.74 is limited to the landlord's cause of action for damages for breach of a lease covenant without regard to whether the breach also gives the landlord a right to terminate the lease. See §§4.79-4.82 for discussion of termination plus damages.

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§4.64 2. Statute of Limitations

The statute of limitations on all lease covenants that are contractual in nature should be 4 years if the lease is in writing and 2 years if it is oral. See CCP §§337(1) and 339(1), respectively.

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3. Rent Covenant

§4.65 a. Obligation and Damages

A tenant's covenant to pay rent is almost invariably express and specifies the amount owed. In the absence of an express covenant, however, the law implies an obligation to pay reasonable rent (rental value). *Ross v Long Beach* (1944) 24 C2d 258, 148 P2d 649. Breach of the rent covenant will, of course, subject the tenant to an action for the specified amount owed if the covenant is express or for the reasonable rental value of the premises if the covenant is implied.

Regardless of whether the rent covenant is express or implied, the landlord may sue to recover either each rent installment, or the entire amount, when it becomes due. *Associates Discount Corp. v Tobb Co.* (1966) 241 CA2d 541, 50 CR 738. A limit on this right, however, exists insofar as the cause of action accrues on each rent installment as it comes due and the statute of limitations begins to run from each due date. *Lee v DeForest* (1937) 22 CA2d 351, 71 P2d 285.

If the lessee contracts to drill or mine the property and the rent is contingent on the quantity or value of the minerals produced, the measure of damages for breach of the covenant is the amount of royalties lost by reason of the breach. *Fisher v Hampton* (1975) 44 CA3d 741, 118 CR 811. The lessor's difficult task is to establish the amount of damages with reasonable certainty.

A jury can consider that the defendant harmed non-parties in determining the reprehensibility of defendant's conduct, but may not consider the injuries to non-parties in setting the amount of punitive damages. Because non-parties are not before the court, their injuries are speculative, and to allow the jury to consider them would deny the defendant due process of law. *Philip Morris USA v Williams* (2007) 549 US 346, 166 L Ed 2d 940, 948, 127 S Ct 1057.

For a case in which a charge for the late payment of rate was held to be an unenforceable penalty, see *Highgate Assocs., Ltd. v Merryfield* (Vt 1991) 597 A2d 1280.

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§4.66 b. Interest

Civil Code §3287, which permits interest to be recovered on "damages certain, or capable of being made certain by calculation," is ordinarily applicable to actions for recovery of rent. *Rabinowitch v California W. Gas Co.* (1967) 257 CA2d 150, 65 CR 1. The court in *Rabinowitch* also stated that a plaintiff is entitled to interest as a matter of right in an action at law based on a contract obligation if the requirements of CC §3287 are met and held that an action for rent is an action at law. See *Canal-Randolph Anaheim, Inc. v Wilkoski* (1978) 78 CA3d 477, 492, 144 CR 474 (court upheld lease provision specifying that tenant would owe 10-percent interest on past-due rent). It is unclear whether interest can be recovered on rent owed under an implied covenant to pay rent (see §4.54).

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§4.67 4. Covenant to Remain in Business

If a lease contains either an express or an implied covenant to remain in business, the landlord may recover damages for its breach. *Lippman v Sears Roebuck & Co.* (1955) 44 C2d 136, 280 P2d 775. Although there are no cases on the subject, a bare covenant to remain in business might give rise to some kind of damage for diminution of value of the property as commercial property. However, it is more likely that the damages suffered by the landlord would be nominal damages. But, in most cases, a covenant to remain in business is tied to rent based on a percentage of the proceeds from the business to be conducted on the leased premises, *i.e.,* the so-called percentage lease. When this is so, the measure of damages for breach of an implied covenant to remain in business is the amount the landlord would have received from his or her share of the proceeds had the tenant continued to operate the business. *Lippman v Sears, Roebuck & Co., supra*. The measure of damages should be the same if the lease covenant is express. The decision in *Lippman* also states that if the lease contains a liquidated damages clause, it might well be applied to measure damages for breach of a covenant to remain in business.

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§4.68 5. Covenant to Improve

If a landlord exercises his or her right to seek damages for breach of a covenant to improve (see *Simen v Sam Aftergut Co.* (1915) 26 CA 361, 146 P 1058), the landlord may recover the reasonable cost of making or completing such improvements. *Sprague v Fauver* (1945) 71 CA2d 333, 162 P2d 865. Although there are no cases in California on the subject, if the landlord sues for breach before the end of the lease term, instead of recovering the cost of making the improvements, the landlord ought to recover the difference between the value of the premises with and without the improvements. To let the landlord recover the cost of making the improvements before the end of the term is unfair to the tenant because the landlord is not bound to expend the awarded damages in making the agreed improvements.

If the tenant makes the agreed improvements but does so improperly, the landlord may recover damages for inadequate performance. See *Leslie v Brown Bros.* (1929) 208 C 606, 283 P 936. Although CC §3300 would control the general measure of damages recoverable for breach as it does in all contract actions, no case has ruled on how damages are to be computed. It would probably be in the same way they are computed on breach of a non-landlord-tenant construction contract. See §1.17.

On breach of an agreement to drill or mine rented property, see *Fisher v Hampton* (1975) 44 CA3d 741, 118 CR 811, discussed in §4.65.

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§4.69 6. Covenant to Repair

When a tenant breaches a covenant to repair, the landlord's measure of damages is governed by CC §3300, which covers damages for breach of contract. See §§1.17-1.18.

If breach of the covenant to repair occurs before the lease expires, the damages should probably be the difference between the value of the premises with and without the repairs rather than the amount necessary to put the premises in repair. The reason for this is that if the landlord is permitted to recover the cost of repairs without being obligated to spend the award on repairing the premises, the tenant has been dealt with unfairly. If the action is brought after the end of the lease term, the damages recoverable are the cost of putting the leased premises in the state of repair contemplated by the covenant. See *Markowitz v Ikemoto* (1958) 159 CA2d 242, 323 P2d 513. The landlord should also be entitled to recover special damages for loss of use of the premises suffered while repairs are being made, *e.g.,* loss of rentals. See *Gold Mining & Water Co. v Swinerton* (1943) 23 C2d 19, 142 P2d 22. In *Iverson v Spang Indus.* (1975) 45 CA3d 303, 119 CR 399, the court restated the California rule that, on breach of the covenant to restore the premises, the proper measure of the landlord's damages is "the reasonable cost of putting the demised premises into the required state of repair or the condition contemplated by the covenant," as well as damages for loss of rental during the time required for restoration. The court, however, refused to grant an additional claim for loss of rental value under the new tenant's lease (which apparently provided for less rent) on the ground that such an award would constitute double recovery.

Under some circumstances, a tenant's failure to make repairs may constitute waste. For a discussion of waste, see §§4.60-4.61.

For the landlord to recover for breach of the covenant to repair, the condition of the premises at the beginning and at the end of the lease must be shown; otherwise recovery will be denied. *Markowitz v Ikemoto, supra*. However, *Markowitz* held that if the premises are surrendered in a damaged condition, the landlord has proved a prima facie case, and the tenant must prove that the damage was due to an excepted cause, *e.g.,* normal wear and tear, in order to avoid liability.

If there is a covenant to repair and replace the landlord's personal property, the detriment caused by injury to such property is the difference in its value immediately before and after the injury; but if repairs can be made for a smaller sum, that sum becomes the measure of recovery. If the property is destroyed, the measure of recovery is its value at the time of destruction. In neither instance is the measure of damages the original cost or the replacement cost of the property. *Lane v Spurgeon* (1950) 100 CA2d 460, 223 P2d 889.

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§4.70 7. Covenant Against Assignment or Subletting

Although a landlord can terminate the lease if the tenant breaches a covenant to assign or sublet, if the landlord elects not to do so, the assignment or sublet is valid and the landlord's only remedy is a suit for damages for breach of the covenant. *Licht v Gallatin* (1927) 84 CA 240, 257 P 914. Although the landlord is entitled to recover all damages proximately caused by the breach under CC §3300, in most cases the landlord will probably not suffer anything but nominal damages. No cases have been reported awarding damages to a landlord against a tenant for breach of a covenant not to assign or sublet when the landlord did not terminate the lease.

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§4.71 8. Covenant to Surrender

There are no cases concerning the measure of damages for breach of a covenant to surrender the premises at the end of the lease term, though they should be controlled by CC §3300. Damages allowable for such breach will probably overlap those awardable to the landlord in any case in which a tenant holds over after expiration of the lease (see §§4.83-4.85), regardless of the existence of a covenant to surrender. In any case, the landlord should be entitled to the value of the use of the property for its wrongful occupation by the tenant. See CC §3334.

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§4.72 9. Covenant to Surrender in as Good Condition as Received

By its very terms, the covenant to surrender in as good condition as when received cannot be breached until the end of the lease term because the property may be repaired before that time. *Fratt v Hunt* (1895) 108 C 288, 41 P 12, overruled on other grounds in *Morse v Steele* (1901) 132 C 456, 64 P 690. When the tenant does breach the covenant, however, the landlord may recover for all damage to the property regardless of the nature of the cause. *Caldwell v Western Dev. Co.* (1921) 54 CA 776, 203 P 158. Most of such covenants, however, except normal wear and tear from its coverage. But even if the covenant does except wear and tear, the landlord can still recover such items as the cost of removing signs painted on the leased premises, repairing elevators, patching plaster carelessly broken by the tenant, painting discolored walls, and painting metal parts of the building's exterior that had not been painted in 10 years. *Connell v Brownstein-Louis Co.* (1927) 86 CA 610, 261 P 331. A tenant is also liable for the cost of restoring the premises to their original condition when he or she has remodeled them for his or her own purposes. *Worthington v Kaiser Found. Health Plan, Inc.* (1970) 8 CA3d 435, 87 CR 272; *Masonic Temple Ass'n v Stockholders Auxiliary Corp.* (1933) 130 CA 234, 19 P2d 865. The landlord may also recover for loss of use of the premises, *e.g.,* rent, for the time reasonably required to restore them if the tenant surrenders them at the end of the term in either a state of disrepair or in an altered condition. *Worthington v Kaiser Found. Health Plan, Inc., supra*. However, unless the covenant specifically so provides, it does not require the tenant to rebuild buildings destroyed by fire if the tenant is not responsible for the fire. *Realty & Rebuilding Co. v Rea* (1920) 184 C 565, 194 P 1024. In *Caldwell v Western Dev. Co., supra,* the court stated that under the covenant, absent an exception to that effect, a tenant is liable for injury to the leased property even if it is not caused by him. 54 CA at 781, 203 P at 160. (It is worth noting that both cases make no real distinction between a covenant to repair (see §4.69) and a covenant to return the property in as good condition as received.) The obvious and simple solution to the problem of what the parties' rights and obligations in this regard are is to spell out their intent in precise language in the lease.

As indicated in §4.57, the statute of limitations for a cause of action on a lease covenant is two or four years, depending on whether the lease is oral or written. Assuming the lease is written, the four-year statute of limitations is not reduced to two years merely because the landlord orally consents to alteration of the building on the condition that the tenant will restore the premises to their original condition at the end of the term. See *Worthington v Kaiser Found. Health Plan, Inc., supra*.

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§4.73 10. Covenant to Pay Taxes

Breach of a covenant to pay taxes renders the tenant liable to the landlord for the amount of the taxes due. *Ellis v Bradbury* (1888) 75 C 234, 17 P 3. The court in this case also held that to recover damages, the landlord need not allege in the complaint all the facts necessary to show that a valid assessment has been made. Rather, a general allegation that the property has been assessed and that the taxes are unpaid is sufficient.

Because the amount owed is certain, the landlord should be able to recover interest on it from the date of breach. See CC §3287.

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§4.74 11. Covenant to Insure

When the tenant breaches a covenant to insure against a particular risk for the landlord's benefit, the tenant is liable for all the damage suffered from failure to obtain insurance. *Davidson v Welch* (1969) 270 CA2d 220, 75 CR 676. For example, when the tenant breached its duty to maintain public liability insurance covering the landlord, the landlord was allowed to recover the costs, expenses, and fees reasonably incurred in defending an action brought against it because if the tenant had not breached its obligation, the landlord would have been entitled to defense under the insurance policy. *American Trust Co. v Truck Ins. Exch.* (1957) 147 CA2d 395, 305 P2d 73. Another kind of damage that might typically be suffered by the landlord arises from the destruction of improvements by fire.

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F. Wrongful Removal of Fixtures

§4.75 1. General Damages

If fixtures are severed from realty they become personalty. *Stowell v Waddingham* (1893) 100 C 7, 34 P 436. Instead of suing to recover possession of the personalty, the landlord may bring an action for damages to the realty due to the removal. See *O. L. Shafter Estate Co. v Alvord* (1906) 2 CA 602, 84 P 279. The landlord may recover such damages as will compensate him or her for the injury or loss sustained. *Menzies v Geophysical Serv., Inc.* (1953) 116 CA2d 419, 254 P2d 51. The measure of damages for the injury or destruction of real property is ordinarily the difference between the value of the property before and after the wrongful acts. However, in the case of removal of a fixture that, although once a part of the realty, has a value that can be determined without reference to the land of which it was once a part, damages may be measured by the value of the fixture itself. See *Menzies v Geophysical Serv., Inc., supra*; *Wilmerton v Morton* (1946) 74 CA2d 891, 169 P2d 992; *Givens v Markall* (1942) 51 CA2d 374, 124 P2d 839. In determining the value of the fixture, however, the proper measure of damages for its wrongful removal is the value of the fixture in place as part of the realty and not what it would sell for on the open market removed from the soil or building to which it was attached. *Wilmerton v Morton, supra*. If a tenant returns the wrongfully removed fixtures after he or she has been sued, the measure of damages is the injury (if any) to the fixtures plus the reasonable cost of restoring them to their original place and condition. *Givens v Markall, supra*.

The foregoing case law was modified by enactment of CC §1013.5, which provides that if a tenant acting in good faith and erroneously believing because of a mistake of law or fact that the tenant has a right to affix his or her own improvements to the land of another, the tenant has the right to remove them, and damages are limited to those resulting from the affixing and removal of the chattel. If either of the two elements, good faith or erroneous belief, is missing, the measure of damages is that set out in *Wilmerton v Morton, supra*. See *Cornell v Sennes* (1971) 18 CA3d 126, 95 CR 728.

The landlord's right to recover for fixtures may depend on the nature of the fixtures and terms of the lease. Trade fixtures normally remain personalty, even if attached to the real property, under CC §1019. But in *Goldie v Bauchet Prop.* (1975) 15 C3d 307, 124 CR 161, a different result was reached. An unrecorded lease contained a clause prohibiting removal of the trade fixtures if the tenant was in default at termination of the lease. Moreover, the lease contained a clause granting the landlord a security interest in the trade fixtures to secure performance by the tenant. This security interest was expressly subordinate to a chattel mortgage executed and filed shortly thereafter with the Secretary of State under the Commercial Code. Under the Commercial Code provisions for security interests in personal property, the chattel mortgagee would have prevailed.

However, the court remanded for a determination of whether the fixtures had lost their character as personal property and become part of the real property because of the default clause. In doing so, the court ruled that competing claims, one based on real property law and one based on the Commercial Code, should be resolved under the real property law. The tenant could grant the chattel mortgagee no more right in the fixtures than he had himself; when the tenant lost the right to remove them, the mortgagee did also.

If the lease had not contained the clause forfeiting the tenant's right to remove the fixtures on his default, they would have remained "trade fixtures" and not fixtures within the law of real property. Not only would the landlord have lost the race for the security, but he would not have had any action against the tenant for loss caused by removal of the fixtures. This opinion is criticized in the context of the Uniform Commercial Code in Burke, *Secured Transactions*, 31 Bus Law 1583, 1584 (1976). The author contends that the default clause created only another form of security interest, not an "ownership" interest that changed the property's character.

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§4.76 2. Exemplary Damages

Because the cause of action for wrongful removal does not arise out of contract, the landlord may recover exemplary damages under CC §3294 if the tenant was guilty of oppression, fraud, or malice. *Menzies v Geophysical Serv., Inc.* (1953) 116 CA2d 419, 254 P2d 51. The landlord must prove oppression, fraud, or malice "by clear and convincing evidence." CC §3294(a).

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§4.77 3. Statute of Limitations

There are no cases on which statute of limitations applies to an action for wrongful removal of fixtures. Because fixtures become personalty when they are severed from the leased premises, it is doubtful that the five-year statute of limitations (CCP §318) for recovery of real property applies. It is more likely that the three-year statute of limitations governing actions for injury to real property controls. See CCP §338.

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G. Termination for Tenant's Breach or Abandonment

§4.78 1. Definition of Abandonment

Abandonment is the unilateral, voluntary relinquishment of the premises by a tenant who does not intend to perform the future obligations of the lease. *Martin v Cassidy* (1957) 149 CA2d 106, 307 P2d 981; *Pickens v Johnson* (1951) 107 CA2d 778, 238 P2d 40. Abandonment is distinguishable from surrender, which is the tenant's relinquishment of the premises with the landlord's express or implied consent. *Scott v Mullins* (1962) 211 CA2d 51, 27 CR 269; *Dorcich v Time Oil Co.* (1951) 103 CA2d 677, 230 P2d 10. Before 1971, California law held that when the tenant's estate is terminated by surrender, the tenant owes no further obligation to the landlord. Since the adoption of CC §1951.2, despite the method of termination of the tenancy, the landlord retains his contract remedies. *Millikan v American Spectrum Real Estate Servs. Cal., Inc.* (2004) 117 CA4th 1094, 1103, 12 CR3d 459.

Establishing both the tenant's breach of the lease and abandonment of the premises has the important consequence of terminating the lease and the tenant's obligations under it.

For discussion of methods to establish abandonment and further discussion of surrender, see California Landlord-Tenant Practice (2d ed Cal CEB 1997).

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2. Measure of Damages

§4.79 a. Termination of Lease (CC §1951.2)

Unless the lease specifically provides to the contrary, the tenant's breach of the lease and abandonment of the premises terminates the lease and the rights and obligations of the parties under it. CC §1951.2(a). On lease termination, the landlord is entitled to recover the following:

- Unpaid rent earned to the time of termination (CC §1951.2(a)(1)), with interest (CC §1951.2(b));
- The amount by which the unpaid rent from the time of termination to the time of the award exceeds the amount that the landlord could have obtained by acting reasonably in reletting the property (*i.e.,* "the amount of such rental loss that the lessee proves could have been reasonably avoided" (CC §1951.2(a)(2)); and
- Any other amount necessary to compensate the landlord for any loss proximately caused by the tenant's failure to perform, or that reasonably could have been foreseen to be a likely result of the tenant's breach (CC §1951.2(a)(4)).

The landlord may also be able to recover the amount by which the unpaid rent for the balance of the term exceeds the amount that the landlord reasonably could have obtained by reletting the premises (CC §1951.2(a)(3)), but only if the lease so provides or if the landlord relets the premises and the reletting constitutes a reasonable, good faith effort to mitigate damages (CC §1951.2(c)). If either of these conditions is met, the landlord may then recover the amount by which the unpaid rent for the balance of the term exceeds the amount of rent loss that the tenant proves could reasonably have been avoided (discounted at the Federal Reserve Bank of San Francisco discount rate at the time of the award, plus 1 percent). CC §1951.2(b).

An obvious purpose of CC §1951.2 is to induce the landlord to relet the premises in order to mitigate damages. The statute expressly provides that the landlord's efforts to mitigate damages do not constitute a waiver of the right to recover damages. CC §1951.2(d). In the somewhat curious wording of CC §1951.2(a)(2)-(3) ("the amount of such rental loss that the lessee proves could have been reasonably avoided"), the legislature permits the tenant to offset against unpaid rent not only amounts actually received by the landlord as a result of the reletting, but also any amounts that the tenant can prove that the landlord should have obtained by making reasonable efforts to relet the property. If the landlord relets the abandoned premises for a higher rent, the breaching tenant can offset the increase against the amounts due under the old lease. The landlord is not entitled to recover a windfall, and the tenant may owe nothing or a reduced amount. *Willis v Soda Shoppes* (1982) 134 CA3d 899, 184 CR 761.

The tenant may defend against a claim for future rent by proving acts or statements by the landlord that constitute cancellation, waiver, or estoppel. *Desert Plaza Partnership v Waddell* (1986) 180 CA3d 805, 225 CR 775. See also CCP §1161.5. Efforts to mitigate damages, however, *e.g.,* discussions with the tenant concerning a sublet, do not waive the lessor's right to recover damages under CC §1951.2. *Walt v Superior Court* (1992) 8 CA4th 1667, 1678, 11 CR2d 278 (distinguishing *Desert Plaza*).

An action for damages under CC §1951.2 may be maintained even when the tenant has been allowed to remain in possession of the premises. *Walt v Superior Court, supra*.

NOTE: A lease may reserve landlord's rights under both CC §§1951.2 and 1951.4, allowing the landlord to elect between them after the tenant defaults. For further discussion in a commercial leasing context, see Office Leasing: Drafting and Negotiating the Lease, chap 29 (Cal CEB 1996).

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Source: Civil Litigation/California Attorney's Guide to Damages/4 Landlord/Tenant/§4.80 b. Continuation of Lease (CC §1951.4)

§4.80 b. Continuation of Lease (CC §1951.4)

The landlord may continue the lease in force and collect the rent as it becomes due, on the tenant's breach of the lease and abandonment of the property, but only if the lease so provides and the landlord does not terminate the tenant's right to possession of the property. CC §1951.4(a)-(b). For this remedy to be available to the landlord, not only must the lease provide for it (CC §1951.4(a)), but the lease must also permit the tenant, subject only to reasonable limitations, to assign or sublet the leasehold estate (CC §1951.4(b)). Under CC §1951.4(a), a lease provision in substantially the following form satisfies the requirements of that subsection:

The lessor has the remedy described in California Civil Code §1951.4 (lessor may continue lease in effect after lessee's breach and abandonment and recover rent as it becomes due, if lessee has right to sublet or assign, subject only to reasonable limitations).

This provision is not the exclusive method of providing for the remedy of CC §1951.4 in the lease (CC §1951.4(a)), but it is a clear and useful method that lessors should consider incorporating in their leases if they intend to avail themselves of the remedy under the statute.

Thus, it is the tenant's duty to relet the premises in order to mitigate damages under such a lease provision. The landlord's actions to maintain or preserve the property, to relet it, to appoint a receiver to protect the landlord's interest, or to withhold consent to or terminate a subletting or assignment (provided the action does not violate the lessee's rights under CC §1951.4(b)) do not constitute a termination of the tenant's right to possession under this section. CC §1951.4(c).

PRACTICE TIP: In an inflationary market, the landlord might be better off terminating the tenancy under CC §1951.2 rather than continuing the lease. This is so because the tenant is entitled to offset any increase in rent on reletting against the rent owed under the original lease. See *Willis v Soda Shoppes* (1982) 134 CA3d 899, 184 CR 761.

The landlord's duty to mitigate damages does not require him to run the business that was operated by the tenant, or to sell the property. Profits made from the landlord's running the business or selling the property will not be deducted from recoverable damages. *Lu v Grewal* (2005) 130 CA4th 841, 850, 30 CR3d 623.

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§4.81 c. Liquidated Damages; Equitable Relief; Nonexclusivity of Remedies

A lease executed on or after July 1, 1971, may contain a liquidated damages provision (see CC §1671), and the provision is enforceable. CC §§1951.5, 1952.2.

The statutory remedies for recovering damages on abandonment (CC §§1951.2, 1951.4; see §§4.79-4.81) are not exclusive. Thus, the landlord is entitled to obtain equitable relief in addition to the statutory remedies when such relief is otherwise appropriate. CC §1951.8. For example, the landlord may have a receiver appointed without being held to have terminated the tenant's rights under the lease. CC §1951.4(c)(2). Moreover, nothing in the abandonment sections affects the parties' rights to proceed with actions for unlawful detainer or forcible entry or detainer. CC §1952(a). Bringing such an action does not affect the landlord's ability to obtain relief under the abandonment provisions, but no damages may be recovered in the subsequent action for detriment for which a claim for damages was made and determined in the previous action. CC §1952(b).

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§4.82 d. Statute of Limitations

Depending on whether the lease is oral or written, the statute of limitations on an action under CC §1951.2 is either two years or four years from the breach of the lease and abandonment of the property, or two years or four years from the termination of the tenant's right to possession of the property, whichever is earlier. CCP §§337.2, 339.5.

The statute of limitations on actions under CC §1951.4 should also be either two or four years, depending on whether the lease is oral or written, under CCP §§337 and 339, because of the contractual nature of the lease covenant involved.

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H. Holding Over After Lease Expiration

§4.83 1. Election to Treat Tenant as Trespasser

A landlord may elect to treat a tenant who holds over after expiration of the lease term as a trespasser. As such, a tenant is liable for the value of the use and occupation of the land. CC §3334; *Cowell v Snyder* (1911) 15 CA 634, 115 P 961.

NOTE: *Cowell* does not hold or imply that the landlord may remove such a tenant through self-help measures. Rather, an unlawful detainer action is the proper method to remove a holdover tenant. On unlawful detainer actions, see California Landlord-Tenant Practice, chaps 9-13 (2d ed Cal CEB 1997).

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§4.84 2. Holdover Tenant's Liability to New Tenant

A commercial tenant who wrongfully refuses to vacate on expiration of its lease may be held liable to the replacing tenant for intentional interference with contractual relations, including lost profits and punitive damages. *Ramona Manor Convalescent Hosp. v Care Enter.* (1986) 177 CA3d 1120, 225 CR 120.

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Source: Civil Litigation/California Attorney's Guide to Damages/4 Landlord/Tenant/§4.85 3. Statute of Limitations

§4.85 3. Statute of Limitations

Although the landlord has a total of 10 years to recover possession of the property from the tenant (CCP §§318, 326), he or she can only recover damages for the value of use and occupation for the 5 years before commencement of the suit plus costs of recovering possession (CC §3334).

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I. Unlawful Detainer

§4.86 1. Back Rent

Rent as a form of actual damages may be recoverable along with possession in an unlawful detainer judgment. Back rent (delinquent rent through the expiration of the tenancy) is recoverable only when the action is based on nonpayment of rent. CCP §1174(b); *Saberi v Bakhtiari* (1985) 169 CA3d 509, 215 CR 359; *Castle Park No. 5 v Katherine* (1979) 91 CA3d Supp 6, 154 CR 498. See also *Harris v Bissell* (1921) 54 CA 307, 202 P 453. The amount found due, if any, is determined by the contract or the agreed-on rent and is recoverable only for the period of delinquency through expiration of the 3-day notice to pay rent or quit. See CCP §1174. A landlord is not permitted, however, to recover rent due for more than 1 year preceding service of the notice. In commercial tenancies, a landlord may seek rent more than 1 year old if the sum prayed for is listed as an estimate and is no more than 20 percent above the amount due within the 1-year period before service of the notice. *Levitz Furniture Co. v Wingtip Communications, Inc.* (2001) 86 CA4th 1035, 103 CR2d 656. The landlord may consider suing for all past-due rent in another action, separately from the unlawful detainer. Otherwise, the landlord may be precluded from obtaining a judgment for rent in a second action because that would constitute splitting a cause of action. See *Lekse v Municipal Court* (1982) 138 CA3d 188, 193, 187 CR 698.

Unless the lease is terminated through the landlord's fault (*e.g.,* when there is a constructive eviction), rent paid by the tenant in advance will not be apportioned in the absence of a qualifying provision in the lease, even though the tenant lawfully surrenders the premises during the prepaid period. *Friedman v Isenbruck* (1952) 111 CA2d 326, 335, 244 P2d 718.

If a landlord fails to obtain a certificate of occupancy, the lease is illegal. This prevents the landlord from recovering back rent, but does not prevent the landlord from obtaining a judgment for possession in an unlawful detainer action based on nonpayment of rent. *Gruzen v Henry* (1978) 84 CA3d 515, 148 CR 573. *Gruzen* was based on an ordinance that expressly imposed criminal sanctions for the failure to obtain a certificate of occupancy. 84 CA3d at 517. *Espinoza v Calva* (2008) 169 CA4th 1393, 87 CR3d 492, broadened *Gruzen,* holding that the tenant owed no rent when the landlord had no certificate of occupancy, even though the opinion did not indicate whether the ordinance at issue expressly imposed criminal sanctions.

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§4.87 2. Damages Caused by Unlawful Detainer

Code of Civil Procedure §1174(b) allows the court to award only those damages occasioned to the plaintiff by the unlawful detainer. Unless the tenant used fraud, force, or violence to remain in possession, the court may award only those damages resulting from the detainer itself, *i.e.,* reasonable rental value, calculated daily from the date of expiration of the termination notice up through the date of judgment. See *Roberts v Redlich* (1952) 111 CA2d 566, 244 P2d 933. See also *Hudec v Robertson* (1989) 210 CA3d 1156, 258 CR 868 (trial court lacked jurisdiction to award landlord back rent in unlawful detainer based on alleged expiration of lease, an issue on which tenant prevailed).

Code of Civil Procedure §1174(b) also authorizes an award of additional "statutory" damages of up to $600 for a malicious holding over, in place of the former provision for treble damages.

Any sums claimed by the landlord for the tenant's breaches before the unlawful detainer are characterized as back rent (for which the landlord must have served a 3-day notice to *pay rent* or quit; see CCP §1174(b)) or as "non-allowable" damages. See *Vasey v California Dance Co.* (1977) 70 CA3d 742, 139 CR 72 (separate action required for damages from tenant's unauthorized alteration of premises).

Damages are measured by the premises' reasonable rental value, usually at a per diem rate, during the period of unlawful detainer. See *Flournoy v Everett* (1921) 51 CA 406, 196 P 916. Although the agreed-on rent is evidence of the rental value (*Lehr v Crosby* (1981) 123 CA3d Supp 1, 9, 177 CR 96; *Harris v Bissell* (1921) 54 CA 307, 312, 202 P 453), the reasonable rental value may be found to be higher or lower (*Harris v Bissell, supra*). See also *Gill Petrolium, Inc. v Hayer* (2006) 137 CA4th 826, 832, 40 CR3d 648 (in granting relief from forfeiture, trial court ordered tenant to pay contract amount of rent, not higher per diem rate).

The measure of rental value for assessing unlawful detainer damages is not simply "all rents, issues and profits" of a leasehold. *Superior Motels, Inc. v Rinn Motor Hotels, Inc.* (1987) 195 CA3d 1032, 1069, 241 CR 487. Damages for wrongful possession are not limited to the rent set by a local rent control ordinance. See *Adler v Elphick* (1986) 184 CA3d 642, 229 CR 254.

PRACTICE TIP: Following the full impact of the Costa-Hawkins Rental Housing Act (CC §§1954.50-1954.535), on January 1, 1999, rent-controlled cities that had either no vacancy decontrol or limited vacancy decontrol (*e.g.,* Santa Monica, Berkeley, West Hollywood) have seen a dramatic escalation in rents. As a result, the damages for unlawful detention may far exceed the rent-controlled rent. Counsel for tenants need to consider this fact when taking a weak unlawful detainer case to trial.

It has been held proper for the trial court to award damages in the absence of a prayer for them in the complaint. *Flournoy v Everett* (1921) 51 CA 406, 408, 196 P 916; *Holland v Eastern Outfitting Co.* (1911) 16 CA 441, 117 P 562. Such an award appears questionable in light of CCP §1174(b), which authorizes the trier of fact to assess damages alleged in the complaint and proved at trial. However, a lack of allegations or prayer could be cured by seeking leave to amend under CCP §1173. The court may not award future damages, *i.e.,* a specified sum for each day of the tenant's continued possession after entry of judgment. *Lehr v Crosby* (1981) 123 CA3d Supp 1, 10, 177 CR 96; *Cavanaugh v High* (1960) 182 CA2d 714, 722, 6 CR 525.

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§4.88 3. Prejudgment Interest

Code of Civil Procedure §1174(c) authorizes interest on the rent found due if a tenant is awarded possession on curing the default because the landlord did not elect a forfeiture (see California Landlord-Tenant Practice §13.49 (2d ed Cal CEB 1997)). When the unlawful detainer action is based on nonpayment of rent, and rent is found due, interest on the rent from the date each installment was due may be awarded also under CC §3287(a). *Chambers v Security Commercial & Sav. Bank* (1920) 46 CA 32, 188 P 818.

In *Tripp v Swoap* (1976) 17 C3d 671, 682, 131 CR 789, overruled on other grounds in 31 C3d at 180, the court listed the following three conditions for an award of prejudgment interest under CC §3287(a):

- An underlying monetary obligation must exist;
- Recovery must be certain or capable of being made certain by calculation; and
- Right to recovery must vest on a particular day.

See also CC §1951.2(b) regarding interest on the "worth at the time of award" in a breach-of-lease case.

Interest is not recoverable, however, on damages occasioned by an unlawful detainer. Such damages, as distinguished from rent, are not a liquidated sum, capable of being made certain by calculation. *Stockton Morris Plan Co. v Carpenter* (1936) 18 CA2d 205, 213, 63 P2d 859; *Samuels v Singer* (1934) 1 CA2d 545, 555, 36 P2d 1098. See also *Superior Motels, Inc. v Rinn Motor Hotels, Inc.* (1987) 195 CA3d 1032, 1072, 241 CR 487. The tenant's tender of the rent due during the notice's period precludes an award of interest on the amount tendered (see CC §1504), although interest would be allowable for the period up to the date of tender. *Webb v Jones* (1927) 88 CA 20, 30, 263 P 538.

A trial court may award prejudgment interest when it is otherwise allowable, even though it was not requested in the complaint. *Chambers v Security Commercial & Sav. Bank, supra*. The trial court's failure to award interest cannot be claimed as error on appeal when interest was not requested in the complaint or at trial. *Garfinkle v Montgomery* (1952) 113 CA2d 149, 159, 248 P2d 52.

If allowable, prejudgment interest on back rent would be awarded at the legal rate, which is 7 percent per year under Cal Const art XV, §1, unless the parties agree in the lease or rental agreement to a higher rate, in which case the prejudgment interest may not exceed 10 percent per year under Cal Const art XV, §1(1). See also CC §3289(b). The landlord is also entitled to recover interest at the rate of 10 percent per year on the principal amount of the money judgment remaining unsatisfied, as distinct from the prejudgment interest discussed above. CCP §685.010(a). See California Trial Practice: Civil Procedure During Trial §27.114 (3d ed Cal CEB 1995).

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4. Costs

§4.89 a. Awarded to Prevailing Party

The party in whose favor judgment is ordered is entitled to claim his or her costs in the action. CCP §1032(b). Although this proposition is straightforward enough, it may not always be clear in an unlawful detainer action who is the prevailing party for purposes of recovering costs. Confusion formerly arose when a tenant succeeded on an implied warranty of habitability defense, because the landlord might still obtain a conditional judgment for possession of the premises if the tenant did not pay the amount of "reasonable rent." Currently, under CCP §1174.2, the landlord is the prevailing party when a tenant who successfully establishes the defense of breach of any warranty of habitability fails to pay the reasonable rental value, as determined by the court in a conditional judgment, within a 5-day period.

When a party recovers relief other than a monetary judgment, the court has discretion to award costs. CCP §1032(a)(4). Therefore, an award of purely equitable relief (*e.g.,* possession or an injunction) or a plaintiff's dismissal of monetary damage claims on the eve of trial may result in a court awarding no costs to either party. See *United States Golf Ass'n v Arroyo Software Corp.* (1999) 69 CA4th 607, 615, 81 CR2d 708. This discretionary standard differs from the standards applied in attorney fee disputes.

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§4.90 b. Allowable Costs and Expenses

Allowable costs are governed by CCP §§1032-1034.5. They include:

- Filing (appearance), motion, and jury fees and jury expenses (CCP §1033.5(a)(1)-(2));
- Actual cost of service of process (CCP §1033.5(a)(4)(B)-(D));
- Deposition costs, including travel expenses (CCP §1033.5(a)(3));
- Court reporter fees (CCP §1033.5(a)(11); Govt C §69953);
- Transcripts of court proceedings ordered by the court (CCP §1033.5(a)(9));
- Models, blowups, and photocopies of exhibits, if reasonably helpful to the trier of fact (CCP §1033.5(a)(12));
- Costs on appeal (CCP §1034(b)); and
- Costs advanced to the sheriff or marshal for an eviction (CCP §1034.5).

Ordinary witness fees are recoverable. CCP §1033.5(a)(7); Govt C §§68093, 68097. See *Fay v Fay* (1913) 165 C 469, 132 P 1040. Expert witness fees, however, are not recoverable as costs, unless the use of the expert is ordered by the court. CCP §1033.5(a)(8), (b)(1); *Sanchez v Bay Shores Med. Group* (1999) 75 CA4th 946, 89 CR2d 634. See *Fairchild v Park* (2001) 90 CA4th 919, 109 CR2d 442 (parties to contract cannot change meaning of statutory law excluding award of expert witness fees). On recovery of costs generally, see California Trial Practice: Civil Procedure During Trial, chap 27 (3d ed Cal CEB 1995).

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§4.91 c. Procedure for Claiming Costs

If a judgment includes an award of costs, the party claiming costs must file and serve an appropriate memorandum of costs within 15 days after the mailing date of the notice of entry of judgment or within 180 days after entry of judgment, whichever is earlier. Cal Rules of Ct 3.1700(a)(1). The party against whom costs are sought may challenge the costs by filing a motion to strike the cost bill or a motion to tax costs, no later than 15 days after service of the cost memorandum. Cal Rules of Ct 3.1700(b)(1). See California Trial Practice: Civil Procedure During Trial §§27.88-27.111 (3d ed Cal CEB 1995).

Under Cal Rules of Ct 3.2000, a plaintiff in an unlawful detainer proceeding who has complied with CCP §1034.5 may file a supplemental cost memorandum for costs of eviction by a sheriff or marshal within 10 days after being advised by the sheriff or marshal of the exact amount of the costs. The defendant may move to tax those costs within 10 days after service of the supplemental cost memorandum.

Because the costs of eviction are generally limited to the statutory eviction fee (currently $75; see Govt C §26733.5) plus the writ of execution fee (set by the county clerk; see Govt C §26820), such supplemental cost bills are often more expensive to prepare than their recovery amount. A landlord who waits, however, to include such costs in a later postjudgment filing (*e.g.,* for accrued postjudgment interest or for wage garnishment expenses) may not be allowed eviction expenses on the ground that they were not claimed within 10 days of having been ascertained.

Attorney fees are defined by statute as a cost item (CCP §1033.5(a)(10)) but are claimed in the memorandum of costs (without a noticed motion after judgment) only if the party claiming them is awarded either statutory or contractual attorney fees that are fixed without the necessity of a court hearing. CCP §1033.5(c)(5); Cal Rules of Ct 3.1702(e). Examples of this are fees fixed in a certain amount by contract or statute, schedules in local rules that prescribe a fixed amount of attorney fees on default, or a stipulation by the parties to accept the amount set by local jurisdictions for contested actions (usually based on the principal amount claimed as damages or the nature of the action). Otherwise, if attorney fees are awarded to the prevailing party by the trial court, the amount is generally determined on a motion filed after judgment (CCP §1033.5(c)(5); Cal Rules of Ct 3.1702).

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Source: Civil Litigation/California Attorney's Guide to Damages/4 Landlord/Tenant/§4.92 d. Limitations on Costs

§4.92 d. Limitations on Costs

Unlawful detainer actions are not within the jurisdiction of small claims court. See CCP §116.220. Consequently, under CCP §1033(b)(2), because a prevailing landlord could not have brought the unlawful detainer action in small claims court, if the recovery in a superior court limited civil case is less than the small claims court's jurisdictional maximum, the landlord's costs are limited to the actual filing fee for the action, the actual costs for service of process, and, if applicable, reasonable attorney fees. These may be awarded only if the plaintiff advised the defendant in writing before the action was brought that legal action was contemplated and that such action could result in the award of these costs against the defendant.

Code of Civil Procedure §1033(b)(2) may prove to be troublesome to landlords. Small recoveries are common in unlawful detainer actions, particularly when the judgment is recovered quickly and the monthly rent is low. In such cases, the amount of rent or damages awarded could easily be less than the small claims court's jurisdictional limit ($5000; see CCP §116.220). On the other hand, the recovery of "possession" is a recovery in excess of the jurisdiction of the small claims court. The small claims court no longer has jurisdiction to award possession. Arguably, CCP §1033(b) should not apply in cases where possession has been awarded to the landlord.

PRACTICE TIP: Notices to quit or to terminate tenancies should include the warning prescribed in CCP §1033(b)(2) when the monetary relief (back rent and damages) is expected to be less than $5000. Furthermore, the notices should closely follow the wording of the statute to avoid claims of intimidation and harassment, and may state that the warning is given without a waiver of the right to argue the inapplicability of CCP §1033(b) altogether.

In superior court, when a prevailing plaintiff recovers a judgment that could have been recovered in a court of lesser jurisdiction, an award of costs is within the court's discretion as governed by CCP §1034. CCP §1033(a).

There is no statutory language limiting the amount of the costs that a prevailing defendant may claim.

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5. Attorney Fees

§4.93 a. Basis for Recovery

Except as expressly provided by statute, the "measure and mode" of compensating attorneys are left to the agreement of the parties. CCP §1021. The parties may, and often do, provide in the lease or rental agreement for recovery of attorney fees incurred in enforcing the provisions of that agreement. A party may recover attorney fees under a contractual provision even if neither party has *pleaded* entitlement to the fees as an item of damages, because such fees are recovered as costs. *Allstate Ins. Co. v Loo* (1996) 46 CA4th 1794, 54 CR2d 541. The better practice is to plead for attorney fees at least in the prayer of the complaint.

Some leases are one-sided and provide only for recovery of attorney fees when the landlord enforces its terms. Under California law, however, such a provision is interpreted to provide for recovery of attorney fees by the prevailing party, regardless of language limiting the right to one party. CC §1717(a). In other words, a unilateral contractual provision for attorney fees is transformed into a reciprocal provision by authorizing an award of fees to the prevailing party, "whether he or she is the party specified in the contract or not." CC §1717(a). Thus, if the lease provides for attorney fees at all, the party prevailing at trial in an unlawful detainer action may recover attorney fees. Moreover, if the contract provides for attorney fees, the prevailing party is entitled to fees regardless of which party initiated the action. *Pacific Custom Pools, Inc. v Turner Constr. Co.* (2000) 79 CA4th 1254, 94 CR2d 756.

A commercial lease provision that allowed the lessor to recover attorney fees in an enforcement action that "determined" that the tenant was in default entitled the landlord to attorney fees after accepting the tenant's CCP §998 offer. *Wong v Thrifty Corp.* (2002) 97 CA4th 261, 264, 118 CR2d 276. The court of appeal held that a party that accepts a §998 offer may recover attorney fees under §1717 when the compromise agreement was silent on costs and fees.

When there is no contractual provision for attorney fees, there is no general statutory authorization for attorney fees in unlawful detainer proceedings except for CC §798.85, which entitles the prevailing party in an action regarding a mobilehome tenancy to an award of reasonable attorney fees and costs. Other statutes that authorize an award of attorney fees in related contexts include:

- CC §52(a) (enforcement of Unruh Act (CC §§51-52));
- CC §789.3(d) (unlawful termination of utility services);
- CC §1940.1(b) (violation of residential hotel tenancy rights);
- CC §1942.4(b) (breach of statutory habitability requirements);
- CC §1942.5(g) (action for damages for retaliatory eviction);
- CCP §527.6(i) (action to enjoin harassment);
- CCP §1021.5 (private attorney general); and
- CCP §1174.21 (in unlawful detainer action, when landlord has violated CC §1942.4).

For a complete listing of statutes authorizing awards of attorney fees, see California Attorney Fee Awards, chaps 3, 9, 12-13 (2d ed Cal CEB 1994).

An award of attorney fees may also be authorized by a city or county ordinance. *City of Santa Paula v Narula* (2003) 114 CA4th 485, 8 CR3d 75.

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b. Determining Who Is Prevailing Party

§4.94 (1) Party Recovering "Greater Relief"

Attorney fees in routine unlawful detainer actions usually turn on the presence or absence of an attorney fee provision in the lease. Civil Code §1717(a) authorizes an award of attorney fees to the prevailing party, who is defined in CC §1717(b)(1) as the party who recovered a greater relief in the action on the contract. Civil Code §1717 was amended (in piecemeal fashion) several times between 1980 and 1988. In its current version, a court has the authority to decide that neither party is the prevailing party for purposes of awarding attorney fees under CC §1717(b)(1) even though it may make an award of costs to one of the parties. See *Nasser v Superior Court* (1984) 156 CA3d 52, 202 CR 552. If the tenant defeats the plaintiff's claim for possession in the unlawful detainer action, the tenant is the party prevailing on the contract as a matter of law and may not be denied reasonable attorney fees under CC §1717. See *Hsu v Abbara* (1995) 9 C4th 863, 39 CR2d 824. Because the primary objective of an unlawful detainer action is recovery of possession of the premises (see *Gray v Whitmore* (1971) 17 CA3d 1, 17, 94 CR 904), the tenant must be considered to have prevailed in the action if the landlord for any reason is denied recovery of the premises. If a tenant successfully defeats the claim for possession by proving at trial the defense of breach of warranty of habitability, however, and thereafter fails to pay the reasonable rental value as determined by the court within a 5-day period, and, if a statute or a contract (*i.e.,* rental agreement, lease) provides for attorney fees to the prevailing party, then the landlord will be awarded costs and attorney fees. CCP §1174.2.

In *Public Employees' Retirement Sys. v Winston* (1989) 209 CA3d 205, 258 CR 612, the court held that the tenant, who was entitled to return of the security deposit, which exceeded the amount of unpaid rent, was the prevailing party. A tenant was held to be the prevailing party in *Haire v Stevenson* (1987) 196 CA3d 1249, 242 CR 433, although the landlord prevailed in the unlawful detainer action. Because the tenant's judgment for damages in his action for breach of the lease exceeded the landlord's judgment in the unlawful detainer action, the tenant was the prevailing party. Both of these cases are consistent with the current version of CC §1717(b)(1), which provides that the prevailing party is the one who recovered greater relief.

A commercial landlord recovered attorney fees in *North Assocs. v Bell* (1986) 184 CA3d 860, 229 CR 305. The landlord filed an unlawful detainer action based on a 30-day notice terminating a month-to-month tenancy. The tenant defended the action on the ground that he had exercised an option to extend the expired lease, which contained an attorney fees provision. The trial court ruled in the landlord's favor. The court of appeal affirmed the trial court's award of attorney fees under CC §1717, even though the trial court found that the lease containing the attorney fee provision had expired and had not been extended. Had the tenant prevailed in his defense, he would have been allowed to recover attorney fees based on the lease. The court thus found that it would be inequitable to deny attorney fees to the landlord.

Similarly, in *Real Prop. Servs. Corp. v City of Pasadena* (1994) 25 CA4th 375, 30 CR2d 536, the court held that the prevailing signatory defendant was entitled to fees against the losing nonsignatory plaintiff because the plaintiff would have been entitled to an attorney fees award had it prevailed.

WARNING: There are many other appellate court decisions on whether attorney fees may be awarded to or against persons who were not signatories to the agreement in dispute. For further discussion, see California Attorney Fee Awards §§6.10-6.12 (2d ed Cal CEB 1994). Many of the opinions on this issue appear to be in conflict because they were decided on factually driven analyses, or because the court applied equitable principles that appear to be inconsistent with the language of CC §1717. Because of the apparent conflicts among the appellate districts, counsel should review carefully the facts of the reported cases and check to see which cases are binding in his or her district, or be prepared to argue the view most favorable to one's client for an action pending in a district where there is no published opinion on this issue.

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§4.95 (2) Effect of Dismissal

If the plaintiff dismisses the contract action voluntarily, or the action is dismissed as part of a settlement, there is no party prevailing on the contract. CC §1717(b)(2). Consequently, the defendant may not recover attorney fees incurred in defending a contract action that is voluntarily dismissed before trial, even if the contract expressly authorizes recovery of those fees. *Santisas v Goodin* (1998) 17 C4th 599, 617, 71 CR2d 830 (real estate purchase contract); *Exxess Electronixx v Heger Realty Corp.* (1998) 64 CA4th 698, 75 CR2d 376 (commercial lease). Even if the plaintiff voluntarily dismisses the case after trial begins but before a ruling dispositive of the case is made, there is no prevailing party on the contract. *Marina Glencoe, L.P. v Neue Sentimental Film AG* (2008) 168 CA4th 874, 85 CR3d 800.

For example, in *Honey Baked Hams, Inc. v Dickens* (1995) 37 CA4th 421, 424, 43 CR2d 595, disapproved on other grounds in 17 C4th at 614 n8, a commercial lease required that "the losing party" in any action for possession pay "the successful party" a reasonable attorney fee, "whether or not such action is prosecuted to judgment." The landlord sued to evict for nonpayment of rent, but voluntarily dismissed the action when it learned of a weakness in its evidence. The trial court granted the tenant's motion for attorney fees, and the court of appeal affirmed. The ruling in *Honey Baked Hams* was expressly disapproved in *Santisas v Goodin, supra,* because CCP §1717(b), not CCP §1021, governs the award of fees after a voluntary dismissal.

In an action on a contract that is ultimately settled, however, the parties may in their settlement agreement waive rights under §1717(b)(2). See, *e.g., Jackson v Homeowners Ass'n Monte Vista Estates-East* (2001) 93 CA4th 773, 113 CR2d 363, in which the parties entered into a pretrial settlement agreement and inserted a clause providing that the trial court would determine the prevailing party and the amount of the attorney fee award. The court of appeal held the agreement to be valid and enforceable because the parties contemplated that the case would not be dismissed until the trial court had decided the attorney fee issue.

Note also that the *Santisas* decision arose from a contract that contained an attorney fee clause awarding fees to the prevailing party and does not apply to attorney fee awards authorized by statute. The ruling in *Santisas* was distinguished in *Damian v Tamondong* (1998) 65 CA4th 1115, 77 CR2d 262, which held that CC §1717(b)(2) does not bar a statutory attorney fee award under CC §2983.4 for a defendant in whose favor a dismissal has been entered in an action on a contract subject to the Rees-Levering Automobile Sales Finance Act. See also *Del Cerro Mobile Estates v Proffer* (2001) 87 CA4th 943, 105 CR2d 5 (mobilehome tenant in whose favor dismissal was entered was entitled to recover attorney fees under CC §798.85 of Mobilehome Residency Law (CC §§798-799.10), independent of cost statutes and CC §1717); *Galan v Wolfriver Holding Corp.* (2000) 80 CA4th 1124, 96 CR2d 112 (trial court had discretion to rule that defendant was not prevailing party for purposes of recovering attorney fees under CC §1942.4 after plaintiff voluntarily dismissed suit for untenantable unit).

Civil Code §1717 does not bar an award of attorney fees arising from a tort claim, as long as the attorney fees provision in the lease is broad enough to include tort claims. *Drybread v Chipain Chiropractic Corp.* (2007) 151 CA4th 1063, 60 CR3d 580 (unlawful detainer action against sublessee for holding over after expiration of lease sounded in tort).

A defendant is not entitled to fees under CC §1717 if the plaintiff voluntarily dismisses the case after a judgment for the plaintiff is reversed on appeal, but before retrial. *Investors Capital Mgmt. v Reiff* (1979) 96 CA3d Supp 26, 158 CR 272. But see *Wells v Marina City Props.* (1981) 29 C3d 781, 176 CR 104 (plaintiff lost right to dismiss voluntarily when demurrer sustained and plaintiff failed to amend complaint); *Groth Bros. Oldsmobile, Inc. v Gallagher* (2002) 97 CA4th 60, 118 CR2d 405 (absolute right to voluntarily dismiss case before trial did not apply when previous court order (by tentative ruling) sustained defendant's demurrer without leave to amend; defendant allowed to seek reasonable attorney fees under §1717).

A voluntary dismissal does not always exculpate a plaintiff from liability for attorney fees. See, *e.g., Santisas v Goodin, supra*; *Del Cerro Mobile Estates v Proffer, supra* (when plaintiff joins noncontract claim with contract action and dismisses entire action, defendant might recover attorney fees if contract or statute permits fee award in noncontract claim); *Kelley v Bredelis* (1996) 45 CA4th 1819, 53 CR2d 536 (when voluntary dismissal is set aside, defendant may be awarded attorney fees).

Also, under CCP §581(i), a plaintiff may not dismiss the entire *action* voluntarily if a defendant has sought relief in a cross-complaint, but a plaintiff may dismiss the *complaint* or any part of it under CCP §581(c), despite a cross-complaint.

PRACTICE TIP: Before voluntarily dismissing an action prior to trial, a landlord's attorney should scrutinize the complaint to make sure all causes of action pleaded arise from the contract.

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§4.96 c. Limits on Recovery by Prevailing Party

An attorney who represents himself or herself in propria persona may not recover attorney fees under CC §1717. *Trope v Katz* (1995) 11 C4th 274, 292, 45 CR2d 241. Nor may a pro per attorney recover attorney fees as a discovery sanction (*Argaman v Ratan* (1999) 73 CA4th 1173, 86 CR2d 917) or as a sanction under CCP §128.7 (*Musaelian v Adams* (2009) 45 C4th 512, 87 CR3d 475). A pro se litigant, including an attorney, may recover as a discovery sanction reasonable expenses incurred, even though he or she may not recover attorney fees. *Kravitz v Superior Court* (2001) 91 CA4th 1015, 111 CR2d 385. An entity that is represented by in-house counsel may recover attorney fees under CC §1717. *PLCM Group, Inc. v Drexler* (2000) 22 C4th 1084, 95 CR2d 198.

Under CC §1717(b)(2), a tenant may argue that the landlord cannot be the prevailing party for purposes of CC §1717 if:

(1) The court finds that the tenant truthfully alleged in the answer that the tenant tendered to the landlord the full amount to which the landlord was entitled; and

(2) The tenant deposits that amount into court for the landlord.

The landlord may argue in response that the failure to tender the rent during the 3-day notice period terminates the tenancy irrespective of CC §1717(b)(2). If the court accepts the tenant's view of CC §1717 and finds the allegation to be true, the tenant would be the prevailing party and thus would be entitled to recover attorney fees under CC §1717. If the tenant tendered the rent due before or during the 3-day notice period, of course, he or she should prevail and would not need the benefit of this provision. See California Landlord-Tenant Practice §§8.43-8.44 (2d ed Cal CEB 1997).

Attorney fees may be denied or reduced if a landlord who is otherwise the prevailing party sues in the wrong jurisdictional level of the courts. In *Dorman v DWLC Corp.* (1995) 35 CA4th 1808, 42 CR2d 459, a landlord sued his tenant in superior court for $50,000 for damage to the leased commercial premises, but the court awarded the landlord only $22,910. Because this amount was within the jurisdiction of the municipal court, the court exercised its discretion under CCP §1033 to deny the landlord an award of attorney fees and costs, although the lease provided for attorney fees and costs to the prevailing party, and the landlord had prevailed. On appeal, the landlord argued that CC §1717 requires the trial court to award attorneys fees to the prevailing party if the lease so provides. The court of appeal held that CCP §1033, not CC §1717, controlled, but that the trial court had abused its discretion by failing to award any fees.

In *Artesia Med. Dev. Co. v Regency Assocs.* (1989) 214 CA3d 957, 266 CR 657, the court held that a subtenant could not be the prevailing party, although it was awarded relief from forfeiture of the lease in an unlawful detainer action. Although the lease provided for attorney fees, there was no privity of contract between the landlord and the subtenant. Therefore, CC §1717 did not authorize an award of attorney fees for *either* party. In any event, the subtenant could not be the prevailing party under CC §1717, because it actually lost the unlawful detainer action and was allowed relief from forfeiture only as "an act of grace."

In *McCulloch v M & C Beauty Colleges, Inc.* (1987) 194 CA3d 1338, 1347, 240 CR 189, the tenant argued that attorney fees should not be awarded under the lease because the issues actually litigated in the suit were "entirely outside of the lease." In defense to an unlawful detainer action, the tenant raised complicated questions of title in an effort to prove that he had exercised a right of first refusal. The court rejected this argument on the ground that the tenant, and not the landlord, was responsible for introducing those issues into the case. Thus, the case essentially remained an unlawful detainer action. But see CC §1717(c) (allows for setoff in a case between contract and noncontract awards to ascertain prevailing party).

For further discussion of attorney fees under CC §1717, see California Attorney Fee Awards, chap 6 (2d ed Cal CEB 1994).

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Source: Civil Litigation/California Attorney's Guide to Damages/4 Landlord/Tenant/§4.97 d. Determining Amount of Fees

§4.97 d. Determining Amount of Fees

Attorney fees actually awarded to the prevailing party are often based on the amount in controversy, and they may not accurately reflect the actual amount of time expended by counsel on the case. This problem may arise especially in unlawful detainer actions, in which counsel for both parties may expend much time litigating complicated issues such as habitability and retaliation, but in which the actual dollar amounts in dispute (basically back rent and damages) may be small.

The court in *Stokus v Marsh* (1990) 217 CA3d 647, 266 CR 90, however, upheld an award of $75,000 in attorney fees to a landlord because of the extremely vigorous, but unsuccessful, defense attempted by counsel for the tenants. Similarly, in *Honey Baked Hams, Inc. v Dickens* (1995) 37 CA4th 421, 43 CR2d 595, disapproved on other grounds in 17 C4th at 614 n8, a court of appeal allowed an attorney fee award of over $5000 to the tenant's attorney, citing the facts that the landlord served the 3-day notice on the Friday of the 3-day New Year's weekend (although it had prepared the notice a month earlier), the tenant had submitted detailed billings to support the award, and a 5-year tenancy was at stake.

To assess attorney fees, trial courts frequently refer to local fee schedule tables. See *Bakkebo v Municipal Court* (1981) 124 CA3d 229, 236, 177 CR 239. For further discussion of fixing the amount of attorney fees, see California Attorney Fee Awards, chaps 11-13 (2d ed Cal CEB 1994).

An attorney fee award may be immunized from appellate review under the well-established rule that the trial court's decision "cannot be reversed in the absence of an abuse of discretion." *Melnyk v Robledo* (1976) 64 CA3d 618, 623, 134 CR 602. In *Hadley v Krepel* (1985) 167 CA3d 677, 214 CR 461, however, the court held that the trial court had abused its discretion in awarding the prevailing party only 20 percent of the attorney fees requested. Particularly in cases of unusual complexity or duration, the trial court should consider many factors in determining the amount of the award, "including the nature of the litigation, its difficulty, the amount involved, the skill required in its handling, the skill employed, the attention given, the success or failure," and other circumstances. *Melnyk v Robledo, supra.*

The trial court may consider, but need not follow, the fee arrangement between the prevailing party and his or her counsel. *Vella v Hudgins* (1984) 151 CA3d 515, 198 CR 725. A court may consider the attorney's "age and experience in the particular type of work demanded." *La Mesa-Spring Valley Sch. Dist. v Otsuka* (1962) 57 C2d 309, 316, 19 CR 479. The determination should focus on reasonably necessary services and not on the mere total of hours expended. *Cirimele v Shinazy* (1955) 134 CA2d 50, 52, 285 P2d 311. The trial court may also need to decide who gets the fees awarded—the attorney or the party. In *Flannery v Prentice* (2001) 26 C4th 572, 110 CR2d 809, *e.g.,* the supreme court held that attorney fees awarded under Govt C §12965 (exceeding the fees already paid) belong to the attorney and not the client, unless their agreement provides otherwise.

PRACTICE TIP: When attorney fees might be awarded in a case, counsel should document the need for each expenditure of time as the case proceeds and be prepared to submit a detailed declaration stating (1) the hours worked and a justification for them, (2) material concerning his or her background and experience, (3) the complexity and importance of the case, and (4) any other facts that might support an award of fees in the amount requested. See California Attorney Fee Awards, chap 12, apps A-L (2d ed Cal CEB 1994); California Eviction Defense Manual §26.24 (2d ed Cal CEB 1993).

A $500 limit on attorney fees in a rental agreement does not preclude an award of a higher amount under CCP §128.5, which authorizes sanctions for frivolous litigation tactics. *Park Magnolia v Fields* (1987) 191 CA3d Supp 1, 236 CR 900. Sanctions for frivolous litigation actions are governed by CCP §128.7, for actions initiated on or after January 1, 1995.

In awarding attorney fees, a court hearing a limited civil case is not limited to its $25,000 jurisdictional limit, as long as the fees are reasonable and bear a rational relationship to the substantive recovery. *Stokus v Marsh* (1990) 217 CA3d 647, 266 CR 90. Upholding a $75,000 fee award in an unlawful detainer action in which actual damages were $6,166, the court in *Stokus* rejected dicta in *Bakkebo v Municipal Court, supra,* which suggested that a fee award could not exceed a court's jurisdictional limit.

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§4.98 e. Fees for Services Before Complaint Filed

If counsel for the prevailing party can establish that significant services were performed before the action was filed, and that such services were necessary to prosecute or defend the action successfully, fees for such services may be awarded within the court's discretion. In *La Mesa-Spring Valley Sch. Dist. v Otsuka* (1962) 57 C2d 309, 316, 19 CR 479, the supreme court held that the fees must proximately and directly result from the action, but not be disallowed merely because the services were rendered before the action was filed. Thus, counsel might be able to recover for time spent preparing and serving the termination notice, investigating the facts of the case, or even attempting to persuade the parties to resolve their dispute.

Upholding an award of prefiling attorney fees, the court in *Stokus v Marsh* (1990) 217 CA3d 647, 266 CR 90, extended the reasoning of *La Mesa-Spring Valley Sch. Dist. v Otsuka, supra,* to all civil actions in municipal court.

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§4.99 f. Award of Fees Against Successors in Interest

Although the prevailing party is entitled to attorney fees under CC §1717 if they are expressly authorized in a lease or rental agreement, it is less certain whether such a contractual provision is enforceable between a landlord's successor in interest and the tenant or the tenant's assignee. This question is significant because parties to the litigation often succeed to the interests of either the landlord or the tenant, without having executed an assignment of an existing lease or rental agreement.

Under CC §821, a person to whom any real property is conveyed is entitled to the same remedies for breach of any of the terms of the lease as the grantor might have had. This provision is complemented by CC §823, which states:

> Whatever remedies the lessee of any real property may have against his immediate lessor, for the breach of any agreement in the lease, he may have against the assigns of the lessor, and the assigns of the lessee may have against the lessor and his assigns, except upon covenants against encumbrances or relating to the title or possession of the premises.

Those two statutes preserve the reciprocal rights of both parties to the lease or rental agreement to enforce a contractual attorney fee provision when there are successors in interest to one or both parties who have not executed a new lease. *Upton v Toth* (1940) 36 CA2d 679, 684, 98 P2d 515; *Rosenkranz v Pellin* (1950) 99 CA2d 650, 652, 222 P2d 249.

Civil Code §§821 and 823 apply, however, only when the lease does not provide to the contrary. *Commonwealth Mem., Inc. v Telophase Soc'y* (1976) 63 CA3d 867, 871, 134 CR 58 (sales agreement between landlord and successor reserved rights under lease to landlord; court held that successor did not become tenant's landlord). Similarly, a tenant is not bound by a preexisting lease that the tenant neither signed nor agreed to be bound by. See *Canal-Randolph Anaheim, Inc. v Wilkoski* (1978) 78 CA3d 477, 485, 144 CR 474 (attorney-tenant, who moved into suite occupied by law firm under lease with owner, not entitled to attorney fees under CC §1717 after successfully defending unlawful detainer action).

When a party did not execute the lease or rental agreement, or agree to be bound by it, the test for applicability of CC §1717 appears to be whether the plaintiff claims that the nonsignatory party is bound to the contract by principles of agency or "coventureship." If such a relationship is established, a prevailing plaintiff is entitled to attorney fees against both a signatory and a nonsignatory defendant. A nonsignatory defendant who successfully defends against such a claim should also be entitled to attorney fees under CC §1717. See *Reynolds Metals Co. v Alperson* (1979) 25 C3d 124, 128, 158 CR 1.

When a nonsignatory plaintiff sues a signatory defendant in an action on a contract and the signatory defendant prevails, the signatory defendant is entitled to attorney fees only if the nonsignatory plaintiff would have been entitled to its fees had the plaintiff prevailed. *Real Prop. Servs. Corp. v City of Pasadena* (1994) 25 CA4th 375, 30 CR2d 536.

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§4.100 g. Attorney Fees on Appeal

Attorney fees may be awarded for services rendered in successfully prosecuting or opposing an appeal. *Erbe Corp. v W & B Realty Co.* (1967) 255 CA2d 773, 63 CR 462; *Care Constr., Inc. v Century Convalescent Ctrs.* (1976) 54 CA3d 701, 126 CR 761. Attorney fees are generally determined by the trial court, following remand, when it determines costs on appeal under CCP §1034(b). See *Genis v Krasne* (1956) 47 C2d 241, 302 P2d 289). If an appellate court rules that "each party shall bear its own costs" on appeal, the trial court may still award the party that prevailed on appeal the attorney fees incurred on appeal, under an attorney fees provision broad enough to encompass such fees. *Butler-Rupp v Lourdeaux* (2007) 154 CA4th 918, 65 CR3d 242.

Fees on appeal may be fixed by the appellate court, although the trial court is normally considered to be in a better position to determine the amount. *Beverly Hills Nat'l Bank v Glynn* (1968) 267 CA2d 859, 870, 73 CR 808. See Cal Rules of Ct 3.1702(c); California Attorney Fee Awards, chap 15 (2d ed Cal CEB 1994).

See Cal Rules of Ct 8.278(c) and 8.891(c), which respectively govern the procedure for claiming costs awarded on appeal to an appellate court and to the superior court from limited civil cases.

On the timing of a motion for attorney fees after a postjudgment appeal, see Cal Rules of Ct 3.1702(c). Note that a party may postpone seeking attorney fees for a prejudgment appeal until after entry of judgment in the trial court. The parties may stipulate to extend the time for filing a motion for attorney fees on appeal as well as at trial or may seek an order of court to extend the time for filing the motion. Cal Rules of Ct 3.1702(b)(2), (c)(2), (d).

If the underlying judgment is reversed, but the losing party has already paid the attorney fees of the prevailing party, the party that paid the fees may be able to petition for relief from the fee judgment. See, *e.g., California Med. Ass'n v Shalala* (9th Cir 2000) 207 F3d 575.

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§4.101 h. Procedure for Claiming Fees

Attorney fee awards in unlawful detainer actions are frequently based on contractual provisions for such awards to the prevailing party (found in many leases and rental agreements). Occasionally, attorney fees are granted to the prevailing party under a statute (*e.g.,* a successful defense to an unlawful detainer action based on a landlord's violation of fair housing laws). For further examples and additional grounds for attorney fees, see California Attorney Fee Awards, chaps 4-8 (2d ed Cal CEB 1994).

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(1) Basis of Award Governs Procedure

§4.102 (a) Contractual Attorney Fees

When the basis of the award is contractual, attorney fees are adjudicated during or after trial in one of the following three ways:

- Fixed by a noticed motion after entry of judgment;
- Awarded on entry of default judgment; or
- Claimed in a memorandum of costs after entry of judgment.

See CC §1717(a); CCP §1033.5(a)(10)(A), (c)(5); Cal Rules of Ct 3.1702(a), (e). See also *Santisas v Goodin* (1998) 17 C4th 599, 618, 71 CR2d 830.

A voluntary dismissal entitles the prevailing party to costs under CCP §1032, but precludes an award of attorney fees. CC §1717(b)(2); *Mitchell Land & Improvement Co. v Ristorante Ferrantelli, Inc.* (2007) 158 CA4th 479, 485, 70 CR3d 9.

A noticed motion after judgment is the most common method, although attorney fees are claimed in the memorandum of costs without a motion when "a party is entitled to statutory or contractual attorney fees that are fixed without the necessity of a court determination." Cal Rules of Ct 3.1702(a), (e).

The noticed motion procedure is based on a combination of statutes, decisional law, and rules of court. Civil Code §1717(a) provides: "Reasonable attorney's fees shall be fixed by the court, and shall be an element of the costs of suit." See also CCP §1033.5(c)(5); Stats 1990, ch 804, §2. Under CC §1717(b)(1), on notice and motion, the court must first determine the party prevailing on the contract for the purpose of awarding fees under CC §1717. The motion can and should also request that the court fix the amount of the award. See Cal Rules of Ct 3.1702(a). See also California Attorney Fee Awards, chaps 6, 14 (2d ed Cal CEB 1994).

A question of how to proceed may arise when a court has adopted a local rule fixing attorney fees in a schedule that is based on the amount in controversy or some other standard. Some courts have a sliding scale system and vary the fees, depending on whether the case is contested or defaulted. Other jurisdictions have a policy (if not a local rule) for contested unlawful detainer actions (*e.g.,* in several divisions of the Los Angeles courts a standard attorney fee of $350 is set for contested cases). Under CCP §1033.5(c)(5), attorney fees are awarded only on a noticed motion unless the parties stipulate otherwise or the judgment is entered by default (see Stats 1990, ch 804, §2). Therefore, a motion apparently may be avoided in a contested case only if the parties stipulate to an award consistent with the fee schedule or local policy, or if the parties have agreed on a fixed fee in the rental agreement. Despite the lack of authority, a few courts award attorney fees at the end of trial under the local fee schedule without a fee stipulation to expedite entry of judgment in unlawful detainer actions.

PRACTICE TIP: Most judges try to resolve attorney fees at the end of trial, if judgment is announced at that time, by asking the parties to stipulate to an award based on the local policy or rule of court. This is generally a good idea. The fixed fee is usually low enough to reward a stipulation from the losing party, who would have to pay more attorney fees to oppose a motion after trial. Many courts will not deviate from the local policy or rule unless there are extraordinary circumstances, such as a lengthy trial or a bankruptcy. In such courts, or if a prevailing landlord knows that the tenant is judgment-proof, the prevailing party may also benefit from stipulating in lieu of a motion.

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Source: Civil Litigation/California Attorney's Guide to Damages/4 Landlord/Tenant/§4.103 (b) Statutory Attorney Fees

§4.103 (b) Statutory Attorney Fees

When the basis of an attorney fee award is statutory, the fee amount may be fixed as follows:

- On a noticed motion after entry of judgment;
- At the time a statement of decision is rendered;
- On application (supported by a declaration) accompanying the filing of the memorandum of costs; or
- On entry of a default judgment.

See CCP §1033.5(a)(10)(B), (c)(5); Cal Rules of Ct 3.1702(a), (e). See also California Attorney Fee Awards, chaps 4-5, 11-14 (2d ed Cal CEB 1994) for a thorough discussion of statutory fees.

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Source: Civil Litigation/California Attorney's Guide to Damages/4 Landlord/Tenant/§4.104 (2) Time Limits for Claiming Attorney Fees

§4.104 (2) Time Limits for Claiming Attorney Fees

If attorney fees are allowed to be claimed along with or in the memorandum of costs, the memorandum and supporting documents must be served and filed within the time prescribed by Cal Rules of Ct 3.1700. See Cal Rules of Ct 3.1702(e).

If the attorney fees must be claimed in a motion filed after entry of judgment in the trial court, the motion to determine the prevailing party or the amount of attorney fees, or both, must be served and filed within the time for filing a notice of appeal. Cal Rules of Ct 3.1702(b)(1). In a limited civil case, this is within 30 days after the mailing by the court clerk (or service by a party) of a "notice of entry" of judgment, or within 90 days after the entry of judgment, whichever is earlier. Cal Rules of Ct 8.822(a). In an unlimited civil case, the motion must be served and filed within 60 days after the mailing by the court clerk (or service by a party) of a "notice of entry" of judgment, or within 180 days after the entry of judgment, whichever is earlier. Cal Rules of Ct 8.104(a). See Cal Rules of Ct 8.104(d) and 8.822(b) on what constitutes entry of judgment. The notice of entry of judgment (or copy of the judgment) must show the date on which the clerk mailed the document in order to establish the date on which the time period begins to run. Cal Rules of Ct 8.104(a)(1).

PRACTICE TIP: Because Cal Rules of Ct 3.1702(b)(1) only expressly refers to Cal Rules of Ct 8.104 and 8.108, an attorney who misses the statutory time limit for filing an attorney fee motion in a limited civil case has a plausible argument that the 60/180 day rule applies to such motions in both limited and unlimited civil cases tried in superior courts.

A party may postpone seeking attorney fees for an appeal that occurred "before the rendition of judgment in the trial court" until after the entry of judgment, and then seek both the attorney fees on that appeal and the attorney fees for trial in the same motion. Cal Rules of Ct 3.1702(b)(1).

The time for making the motion is automatically extended when certain posttrial motions are made. For example, under Cal Rules of Ct 8.108(b) and 8.823(b), when a notice of intention to move for a new trial is served and filed and the motion is denied, the appeal time (and the time for an attorney fee motion) is increased until 30 days (15 days in a limited civil case) after either the superior court clerk mails, or a party serves, an order denying the motion or a notice of entry of that order or denial by operation of law, but in no event later than 180 days (90 days in a limited civil case) after the date of entry of judgment. This filing time is also automatically extended by various formulae for other posttrial procedures: under Cal Rules of Ct 8.108(c) and 8.823(c) when a notice of intention to move to vacate a judgment, or to vacate a judgment and enter a different judgment, is made; and under Cal Rules of Ct 8.108(d) and 8.823(d) when a motion for judgment notwithstanding the verdict is made.

Under Cal Rules of Ct 3.1702(b)(2), the time for an attorney fee motion may be extended further by stipulation (a) until 60 days after the expiration of the time for filing a notice of appeal, or (b) if a notice of appeal has been filed, until the time in which a memorandum of costs must be filed as required in Cal Rules of Ct 8.278(c). For good cause, the trial judge may extend the time for a period that is the same as (or longer than) that allowed by stipulation. Cal Rules of Ct 3.1702(d).

In *California Rec. Indus. v Kierstead* (1988) 199 CA3d 203, 209, 244 CR 632, the court held that failure to file a noticed motion under the former version of CC §1717 did not deprive the court of jurisdiction to award attorney fees when the party seeking fees filed and served only a memorandum of costs and the party opposing fees was not prejudiced by the lack of a noticed motion. See also *M.C. & D. Capital Corp. v Gilmaker* (1988) 204 CA3d 671, 678, 251 CR 178 (following *Kierstead* concerning attorney fees on appeal). Although these cases were decided before amendments to CCP §1033.5(c)(5) (see Stats 1990, ch 804, §2), they may be relevant to an argument about whether a court may proceed on an attorney fee motion that is filed later than currently allowed by Cal Rules of Ct 3.1702(b). See, *e.g., Russell v Trans Pac. Group* (1993) 19 CA4th 1717, 1725, 24 CR2d 274 (trial court has no discretion to disregard compliance with noticed motion requirement, although it has discretion to grant relief for excusable neglect under CCP §473). Compare *Russell* with *Gunlock Corp. v Walk on Water, Inc.* (1993) 15 CA4th 1301, 19 CR2d 197 (filing

memorandum of costs within statutory time period constitutes substantial compliance with "notice and motion" requirement).

PRACTICE TIP: The safest practice is to file a timely and properly noticed motion within the time frame established in Cal Rules of Ct 3.1702(b). The opinion in *Gunlock* is questionable in view of the legislative intent stated in Stats 1990, ch 804, §2. See *Russell v Trans Pac. Group* (1993) 19 CA4th 1717, 1724, 24 CR2d 274.

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§4.105 i. Statute of Limitations

There are no cases concerning the time period within which an unlawful detainer action must be brought. When it is brought on grounds other than rent default, the action is probably controlled by CCP §318, which provides five years for the recovery of possession of real property. In this regard, it is important to be aware that this five-year period of limitation is extended under some circumstances by CCP §326, which provides that the tenant's possession is deemed the landlord's possession until the expiration of five years from the termination of tenancy.

When a tenant breaches the rent covenant, however, CCP §1161 provides that the tenant is not guilty of unlawful detainer until after the landlord has given him or her three days' written notice requiring payment or possession of the property. Such notice is to be served within one year after the rent becomes due. In effect, this code provision appears to bar an unlawful detainer action for rent default after one year.

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V. MISCELLANEOUS DAMAGE FACTORS

§4.106 A. Liquidated Damages

There are different standards for liquidated damages provisions in residential and nonresidential leases. If a party to a real property lease intends to reside on the property, or to have its dependents reside there, the traditional rule will apply, *i.e.,* a liquidated damages clause in such a lease is void, unless actual damages would be impracticable or extremely difficult to fix. CC §1671(d). In a nonresidential lease, the liquidated damages provision in the lease will be valid unless the breaching party can show that the provision was unreasonable when the lease was made. CC §1671(b). Because of this, the liquidated damages provisions of leases for commercial property are more likely to be enforced.

Several cases have held that when a tenant breaches his rent covenant, a liquidated damages clause is void because the landlord's damages are not impracticable or extremely difficult to fix. *Knight v Marks* (1920) 183 C 354, 191 P 531; *Jack v Sinsheimer* (1899) 125 C 563, 58 P 130. See also *McCarthy v Tally* (1956) 46 C2d 577, 297 P2d 981. As pointed out in the Law Revision Commission Comment to CC §1951.5, this rule was based on the theory that a landlord's cause of action on abandonment was either for rent as it became due or for the rental deficiency at the end of the term. But, under CC §1951.2, which gives the landlord the right to sue immediately for both present and future damages (see §4.79), damages may well be impracticable or extremely difficult to fix, and a liquidated damages provision may therefore be valid.

When breach of a lease involves a covenant to surrender the property, the status of the liquidated damages provision is not altogether clear. In one case, involving the rental of a ship, the court found that damages for its loss were not difficult to fix and held the liquidated damages provision void. *Wilmington Transp. Co. v O'Neil* (1893) 98 C 1, 32 P 705. In another case when the tenant remained on the real property after expiration of the lease, the court found valid a lease clause that provided that if the tenant held over, he would pay a greatly increased amount per month. *Vucinich v Gordon* (1942) 51 CA2d 434, 124 P2d 868. However, in *Vucinich,* the court said that the provision was not a liquidated damages clause but rather a negotiated rent covenant.

See also *Western Camps, Inc. v Riverway Ranch Enters.* (1977) 70 CA3d 714, 138 CR 918, in which a clause requiring the sublessor to pay $60,000 on early termination of the sublease was construed as an alternative means of performance rather than a liquidated damages provision.

A late fee in a rental agreement is normally void, unless the landlord both alleges in his complaint and proves at trial (1) that it was impracticable or extremely difficult to fix the actual damage (normally interest and administrative expenses), and (2) that the fee set was a reasonable estimate of actual damage. *Orozco v Casimiro* (2004) 121 CA4th Supp 7, 17 CR3d 175 (3-day notice to pay or quit that demanded a $50 late fee held invalid). See *Highgate Assocs., Ltd. v Merryfield* (Vt 1991) 597 A2d 1280.

See §§1.42-1.44 on liquidated damages generally.

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§4.107 B. Proof of Damages

There is little case law on how either a landlord or a tenant must prove damages. See chap 1 on contract damages generally. See *Foreman & Clark Corp. v Fallon* (1971) 3 C3d 875, 92 CR 162, for discussion of proof of rental value. But there is no question that to recover damages, the plaintiff must show facts and figures by which damages can be legally and correctly ascertained and cannot merely rely on general statements of injury. *Scurich v Ryan* (1910) 14 CA 750, 113 P 123. See also §4.87.

A lessee whose business is injured may prove lost profits by showing "the working experience of the business… its past volume and… other data reflecting probable future volume." *Guntert v City of Stockton* (1976) 55 CA3d 131, 143, 126 CR 690.

See Anno, What Constitutes Willfulness or Malice Justifying Landlord's *Collection of Statutory Multiple Damages for Tenant's Wrongful Retention of Possession*, 7 ALR4th 589 (1981).

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§4.108 C. Mitigation

Generally, one who is injured by a breach of contract has the duty to mitigate damages. *Rebel v Peckham* (1949) 94 CA2d 834, 211 P2d 883. See §1.41.

If a tenant remains in possession after the landlord's breach of the covenant of quiet possession, the tenant must mitigate damages before it can recover for future losses from the landlord for the same breach. *Guntert v City of Stockton* (1976) 55 CA3d 131, 153, 126 CR 690, 703. Until the tenant performs this duty, its future damages are too speculative. This is the reason for the rule, cited in §4.17, that a tenant cannot recover prospective damages when a landlord's breach is only partial.

When the tenant has wrongfully abandoned the premises, it might be appropriate in some circumstances for the landlord to mitigate damages by selling the property rather than reletting it. If the landlord does so, he or she may recover the reasonable selling expenses. The tenant is free to prove that a greater rental loss could have been avoided by retaining the property, or that the sale price was unreasonably low. *Millikan v American Spectrum Real Estate Servs. Cal., Inc.* (2004) 117 CA4th 1094, 12 CR3d 459.

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Source: Civil Litigation/California Attorney's Guide to Damages/4 Landlord/Tenant/§4.109 D. Attorney Fees

§4.109 D. Attorney Fees

As indicated in §4.4, except when attorney fees are provided for by statute, the question of whether they can be obtained is left to the parties' agreement. CCP §1021; *Martin v Pacific Southwest Royalties, Inc.* (1940) 41 CA2d 161, 106 P2d 443. There are no statutes providing for attorney fees in actions between landlords and tenants. *Bank of America Nat'l Trust & Sav. Ass'n v Moore* (1937) 18 CA2d 522, 64 P2d 460. When recoverable, they have been held to be in the nature of special damages that must be pleaded as such. *City Inv. Co. v Pringle* (1920) 49 CA 353, 193 P 504. However, a later case holds that lack of a prayer for attorney fees when the lease provides for them is immaterial if the complaint contains a prayer for general relief and if the matter is placed in issue by defendant. *Martin v Pacific Southwest Royalties, Inc., supra*.

When attorney fees are recoverable under the parties' agreement, the amount that may be awarded is a question of fact within the trial court's discretion. *Scott v TraveLodge Corp.* (1968) 265 CA2d 881, 71 CR 547. Considerable leeway must be allowed the trial court in fixing fees because legal fees are not standardized. *Newbauer v Newbauer* (1949) 95 CA2d 36, 212 P2d 240. Involved in this determination are such factors as the necessity for and the nature of the litigation, the amount involved, and the success or failure of the attorney's efforts, including the amount of recovery. *Kanner v Globe Bottling Co.* (1969) 273 CA2d 559, 78 CR 25.

According to the court in *Stokus v Marsh* (1990) 217 CA3d 647, 266 CR 90, when awarding attorney fees the municipal court is not limited to its $25,000 jurisdictional limit. A prevailing party entitled to recover attorney fees as costs is entitled to recover all such fees as are reasonable and that bear a rational relationship to the substantive recovery. In addition, the award can include fees for services rendered before the filing of the complaint. Upholding a $75,000 fee award in an unlawful detainer action in which actual damages were $6166, the court in *Stokus* rejected dicta in *Bakkebo v Municipal Court* (1981) 124 CA3d 229, 177 CR 239, which suggested that a fee award could not exceed the municipal court's jurisdictional limit.

Effective January 1, 1991, CCP §1033.5 was enacted, allowing recovery of attorney fees as costs when authorized by contract. See CCP §1033.5(a)(10)(A). Thus, a party may recover attorney fees under a contractual provision even if neither party has pleaded such entitlement. *Allstate Ins. Co. v Loo* (1996) 46 CA4th 1794, 54 CR2d 541. Note that attorney fees recoverable as costs authorized by contract may be fixed on a noticed motion or on entry of default, unless otherwise provided by stipulation of the parties. CCP §1033.5(c)(5). See Cal Rules of Ct 3.1702.

In 1977, CCP §1021.5 was added. It provides that attorney fees may be awarded to the successful party "in any action which has resulted in the enforcement of an important right affecting the public interest," if (1) a significant benefit has been conferred on the general public or a large class of persons, (2) the necessity and financial burden of private enforcement are such as to make the award appropriate, and (3) such fees, in the interest of justice, should not be paid out of any recovery.

A provision in an agreement for attorney fees also covers fees on appeal. The appellate court may fix the fees on appeal, or they may be determined by the trial court when costs are determined. *Rabinowitch v California W. Gas Co.* (1967) 257 CA2d 150, 65 CR 1.

When the appellant challenges an attorney fee award, the appellant has the burden of furnishing the appellate court an adequate record. *Vo v Las Virgenes Mun. Water Dist.* (2000) 79 CA4th 440, 447, 94 CR2d 143. As the court stated (79 CA4th at 447):

> The judgment must be affirmed because the record provided by defendant is inadequate to conclude the trial court abused its discretion in determining the fee was reasonable. As the party challenging a fee award, defendant has an affirmative obligation to provide an adequate record so that we may assess whether the trial court abused its discretion.

A postjudgment award of attorney fees is separately appealable. A notice of an appeal from the original judgment alone does not give the appellate court jurisdiction to hear a challenge to the award of attorney fees. *DeZerega v Meggs* (2000) 83 CA4th 28, 99 CR2d 366.

The procedure for obtaining attorney fees *on appeal* was discussed in *Plumbing, Heating & Piping Employers Council v Quillin* (1976) 64 CA3d 215, 134 CR 332. The court noted authority for proceeding by way of a *motion* for

attorney fees in the trial court, as well as authority for having attorney fees taxed as costs. The court concluded (64 CA3d at 220):

> We deem irrelevant the procedure a party uses to assert a claim of attorney fees incurred on appeal, whether by memorandum or motion, as long as the allegation has been properly placed before the trial court in some fashion.

In *Committee for Sewer Referendum v Humboldt Bay Wastewater Auth.* (1978) 77 CA3d 117, 125 n7, 143 CR 463, the court held that when attorney fees on appeal are awarded under statute rather than contract, they may be awarded as costs, even though the complaint included no special demand for attorney fees. The court cited *T.E.D. Bearing Co. v Walter E. Heller & Co.* (1974) 38 CA3d 59, 112 CR 910.

Dicta by the court in *Committee for Sewer Referendum* that attorney fees cannot be sought on appeal for work done in the lower court unless the issue is raised in the trial court was disapproved in *Citizens Against Rent Control v City of Berkeley* (1986) 181 CA3d 213, 227 n10, 226 CR 265. A city or county ordinance may provide authority for an award of attorney fees. *City of Santa Paula v Narula* (2003) 114 CA4th 485, 493, 8 CR3d 75.

For further discussion of attorney fees and CC §1717, see §§1.21-1.32. See also California Attorney Fee Awards (2d ed Cal CEB 1994).

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§4.110 E. Expert Witness Fees

Expert witness fees may be recovered as damages in a tort action. See *Stearman v Centex Homes* (2000) 78 CA4th 611, 625, 92 CR2d 761 ("[p]laintiffs were entitled to be made whole").

Expert witness fees may be recovered in a contract action, if the contract provides for such fees, but they must be pleaded and proved as damages, and may not be recovered postjudgment as costs. *First Nationwide Bank v Mountain Cascade, Inc.* (2000) 77 CA4th 871, 92 CR2d 145 (First District Court of Appeal disagreed with *Bussey v Affleck* (1990) 225 CA3d 1162, 275 CR 646, which held that such fees may be recovered as costs).

In *Ripley v Pappadopoulos* (1994) 23 CA4th 1616, 1619, 28 CR2d 878, the Third District Court of Appeal declined to follow *Bussey,* holding that a general contractual provision allowing recovery of "attorneys fees and costs" does not include expert witness fees. In *Fairchild v Park* (2001) 90 CA4th 919, 930, 109 CR2d 442, the Second District Court of Appeal followed *Ripley,* but also refused to follow *Bussey,* holding that parties may not expand the definition of "costs" in CC §1717 to include expert witness fees. See also *United States Fid. & Guar. Co. v Scott Cos.* (ND Cal, Sept. 18, 2007, No. C-03-5376 SBA (EMC)) 2007 US Dist Lexis 71100 (court found *Ripley* dispositive on issue of expert witness fees).

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§4.111 F. Costs

Under the Code of Civil Procedure, the prevailing party in an action is ordinarily entitled to recover costs. CCP §§1021-1038. Recoverable costs are set out in CCP §1033.5(a). The term "costs" has also been held to encompass fees and charges required by law to be paid to the courts or their officers or amounts specifically fixed by law as recoverable. *Rabinowitch v California W. Gas Co.* (1967) 257 CA2d 150, 65 CR 1. One example of such fees and charges is jury expenses, covered in CCP §1033.5(a). Code of Civil Procedure §1141.21(a)(1)(C) provides for the recovery of "the reasonable costs of the services of expert witnesses," not limited to court-appointed experts. See *Boyd v Oscar Fisher Co.* (1989) 210 CA3d 368, 382, 258 CR 473.

For discussion of who is a prevailing party for the purpose of recovery of costs, see *Public Employees' Retirement Sys. v Winston* (1989) 209 CA3d 205, 258 CR 612. Code of Civil Procedure §1033(b) now provides that when a prevailing plaintiff in a limited civil case recovers less than the amount prescribed by law as the maximum limitation on the jurisdiction of the small claims court, the following applies: (1) When the party could have brought the action in the small claims division but did not do so, the court may, in its discretion, allow or deny costs to the prevailing party, or may allow costs in part in any amount it deems proper, and (2) when the party could not have brought the action in the small claims court, costs and necessary disbursements are limited to the actual costs of the filing fee and service of process, subject to specified requirements.

An appellant might avoid imposition of costs by dismissing a nonmeritorious appeal early in the process. See *Small v Hall's Furniture Defined Benefit Pension Plan* (2000) 79 CA4th 648, 94 CR2d 313.

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§4.112 G. Certainty of Damages

Civil Code §3301 provides that "no damages can be recovered for a breach of contract which are not clearly ascertainable in both their nature and origin." The fact that the amount of damage may not be susceptible of exact proof, or may be uncertain, contingent, or difficult of ascertainment does not bar recovery. *California Lettuce Growers, Inc. v Union Sugar Co.* (1955) 45 C2d 474, 289 P2d 785; *Hartman Ranch Co. v Associated Oil Co.* (1937) 10 C2d 232, 73 P2d 1163. This rule applies to both special and general damages. *Tooke v Allen* (1948) 85 CA2d 230, 192 P2d 804. See generally §§1.17-1.18.

Proving future lost profits can be difficult. Uncertainty of amount will not necessarily bar their recovery, but uncertainty whether such losses will actually occur as a proximate result of the defendant's conduct will bar recovery. See *Guntert v City of Stockton* (1976) 55 CA3d 131, 153, 126 CR 690.

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§4.113 H. Nominal Damages

Under CC §3360, if either the landlord or tenant has breached a duty to the other under the lease, but the breach has caused no appreciable detriment to the other party, the latter may still recover nominal damages. When a lease is breached and because of an error there is no award of nominal damages, such an error does not constitute reversible error. *Sill Prop., Inc. v CMAG, Inc.* (1963) 219 CA2d 42, 33 CR 155.

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§4.114 I. Damages Nondischargeable in Bankruptcy

When a landlord's overcharges were found to have been obtained by actual fraud in violation of local rent control laws, they were held to be nondischargeable in bankruptcy in *Cohen v de la Cruz* (1998) 523 US 213, 140 L Ed 2d 341, 118 S Ct 1212. A local rent control administrator found that a landlord had charged tenants more than $31,000 in rents that were above levels allowed by the rent control ordinance, and ordered those amounts returned to the tenants. The landlord then filed for bankruptcy. In the bankruptcy action, the tenants sought a judgment that the excess rents were obtained by "actual fraud," and therefore were nondischargeable. The tenants also sought a judgment for treble damages, attorney fees, and costs under New Jersey's consumer fraud act, and a determination that those amounts also were nondischargeable. The trial court ruled for the tenants on all these matters, and the Supreme Court affirmed, holding that the entire amount (excess rents, treble damages, attorney fees, and costs) constituted a debt obtained by "actual fraud" and was thus nondischargeable.

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5

Injury to Property

Stephen L. R. McNichols

I. SCOPE OF CHAPTER §5.1

II. NUISANCE
- A. General Definition §5.2
- B. Nuisance Per Se §5.3
- C. Categories of Nuisance Under CC §3479 §5.4
  - 1. Objective Standard Under CC §3479 §5.5
  - 2. Balancing Equities Required Under CC §3479 §5.6
- D. Public Nuisance
  - 1. Definition §5.7
  - 2. Standing §5.8
- E. Private Nuisance
  - 1. Definition §5.9
  - 2. Threat of Future Injury §5.10
  - 3. Blockage of Air, Light, or View §5.11
- F. Nuisance That Is Both Public and Private §5.12
- G. Distinction Between Temporary or Continuing Nuisances and Permanent Nuisances
  - 1. Importance of Classification for Selection of Remedies §5.13
  - 2. Factors §5.14
  - 3. Election by Plaintiff §5.15
  - 4. Courts' Preference for Continuing Nuisance §5.16

III. TRESPASS
- A. Definition §5.17
- B. Distinction Between Nuisance and Trespass §5.18

IV. ENCROACHMENT §5.19

V. REMEDIES AND DAMAGES FOR PUBLIC NUISANCE §5.20

VI. DAMAGES AND OTHER REMEDIES FOR PRIVATE NUISANCE AND TRESPASS §5.21
- A. Equitable or Legal Action? §5.22
- B. Jurisdiction §5.23
- C. Venue §5.24
- D. Right to Self-Help §5.25
- E. Injunction §5.26
- F. Tort Measure of Damages §5.27
  - 1. Continuing Nuisance §5.28
  - 2. Permanent Nuisance §5.29
  - 3. Continuing Trespass §5.30
  - 4. Permanent Trespass §5.31
- G. Injury to Products of Real Property §5.32
- H. Damage, Destruction, or Removal of Fixtures or Personal Property §5.33
- I. Injury to Persons §5.34
- J. Lost Profits §5.35
- K. Attorney Fees §5.36
- L. Prejudgment Interest §5.37
- M. Punitive Damages §5.38
- N. Statutory Limitations on Recovery §5.39

VII. DEFENSES
- A. Comparative Fault §5.40

B. Statutes of Limitations and Repose
1. Public Nuisance and Trespass §5.41
2. Private Nuisance and Trespass §5.42
a. Permanent Nuisance and Trespass §5.43
b. Continuing Nuisance and Trespass §5.44
c. "Improvement" as Continuing Nuisance §5.44A
d. Special Rules for Pollution Cases §5.45
C. Laches §5.46
D. Coming to Nuisance §5.47
E. Consent §5.48
F. Balancing Equities §5.49
G. Due Care §5.50
H. Use Consistent With Applicable Zoning §5.51
I. Separation of Powers §5.52
J. Scope of Injunction §5.53

VIII. RELATED ACTIONS §5.54

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§5.1 I. SCOPE OF CHAPTER

This chapter discusses damages for trespass and nuisance. Damages for related causes of action are briefly discussed in §5.54. Because the right to damages can be defeated by affirmative defenses, various defenses are also discussed in that section.

The focus of this chapter is on damages. However, one of the unique features of nuisance and trespass law is that the remedies cannot be separated from the substantive law. The historical growth of these two torts have produced an unusually tight bond between substantive law and the determination of the remedies available. The remedies and defenses applicable to a particular situation involving nuisance or trespass depend on the classification of the underlying claim as "per se" (see §5.3), "public" or "private" (see §§5.7-5.11), and "temporary/continuing" or "permanent" (see §§5.13-5.16). The result is that remedies, including damages, can be meaningfully discussed only in the context of the substantive law. Therefore, practitioners must review the elements of the causes of action for nuisance and trespass in order to possess sufficient information to evaluate the damage options available in a particular case.

Also, there are devastating traps for the unwary inherent in these classifications (*e.g.,* "public/private," "continuing/permanent"). The classifications are often artificial and extremely difficult to predict with accuracy. These classifications not only control what remedies are available but also determine whether the plaintiff has any viable claim at all. Practitioners must be aware of the implications of these classifications in their cases. See, *e.g.,* §§5.7-5.12 concerning public and private nuisance and §§5.13-5.16 discussing temporary or continuing versus permanent nuisance.

This chapter does not provide a complete treatment of the substantive law of nuisance and trespass. For a discussion of nuisance, see 13 Witkin, Summary of California Law, *Equity* §§133-173 (10th ed 2005), and of trespass, see 5 Witkin, Summary, *Torts* §§693-698. For a review of insurance issues concerning damage to real property, see California Liability Insurance Practice: Claims and Litigation (Cal CEB 1991).

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II. NUISANCE

§5.2 A. General Definition

The word "nuisance" is derived from Latin by way of the French and means hurt, annoyance, or inconvenience. Nuisance theory has provided an effective means for redress to a wide range of wrongs. The tort of nuisance, however, is incapable of an exact or comprehensive definition. Most of the uncertainty regarding this term derives from the fact that nuisance law has been used to cover the invasion of many different interests caused by various kinds of conduct that inconveniences someone. For an absorbing history of the development of the law of nuisance, see McRae, *Development of Nuisance in The Early Common Law*, 1 U Fla L Rev 27 (1948).

Nuisance results from conduct or conditions that unreasonably interfere with, or create a condition that interferes with, the use or enjoyment of land. Nuisance is a species of tort liability rather than a type of tortious conduct. Although nuisance is primarily created and defined by the interests invaded and the damage or harm caused, and not by the conduct that has created the condition (see CC §3479), it usually requires proof of negligence, recklessness, or intent. See *Lussier v San Lorenzo Valley Water Dist.* (1988) 206 CA3d 92, 100, 253 CR 470.

Nuisance is a civil wrong based on disturbance of rights in land. The cause of action is based on the idea that owners or possessors of land are entitled to the full use and enjoyment of their land, but they must use their property in a way that does not unreasonably interfere with either the general welfare of the community or others' right to the full enjoyment of their property. *County of Contra Costa v Cowell Portland Cement Co.* (1932) 126 CA 267, 271, 14 P2d 606; *Wolford v Thomas* (1987) 190 CA3d 347, 358, 235 CR 422. The public policy underlying nuisance law and its purpose is to provide a means of recovery for harm suffered and to facilitate a just and equitable recovery. *Baker v Burbank-Glendale-Pasadena Airport Auth.* (1985) 39 C3d 862, 871, 218 CR 293.

PRACTICE TIP: Nuisance law works well when the nuisance creates an immediate, perceptible condition that can be seen, heard, smelled, felt, and so forth. It does not function as well when dealing with "stealth" conditions such as toxic contamination or other hidden conditions affecting the use of property.

The overall policy of providing a remedy for recovery for harm suffered has been eroded in practice by the mechanical, and sometimes convoluted, application of the technical rules based on the classification of the nuisance, such as temporary (or continuing) versus permanent. See §§5.13-5.16. These classifications often result in the denial of recovery to landowners for conduct that is obviously tortious because it interferes with the use of land. See, *e.g., Mangini v Aerojet-General Corp.* (1996) 12 C4th 1087, 51 CR2d 272 (*Mangini II*), discussed in §5.45. Contemporary situations that were not contemplated at the time these classifications and rules were developed are fertile fields for reexamination and reformulation of nuisance law.

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§5.3 B. Nuisance Per Se

Nuisance per se arises when a legislative body, in exercising its police power, expressly declares a particular object, substance, activity, or circumstance to be a nuisance. *Beck Dev. Co. v Southern Pac. Transp. Co.* (1996) 44 CA4th 1160, 1206, 52 CR2d 518. A nuisance per se can be declared by statute or ordinance. See, *e.g.,* Govt C §38771; *City of Bakersfield v Miller* (1966) 64 C2d 93, 48 CR 889 (discussing preemption issues and authority of legislature and cities); *Flahive v City of Dana Point* (1999) 72 CA4th 241, 244, 85 CR2d 51; *People ex rel Dep't of Transp. v Outdoor Media Group* (1993) 13 CA4th 1067, 17 CR2d 19; *City of Costa Mesa v Soffer* (1992) 11 CA4th 378, 13 CR2d 735; *Amusing Sandwich, Inc. v City of Palm Springs* (1985) 165 CA3d 1116, 211 CR 911; *City & County of San Francisco v Padilla* (1972) 23 CA3d 388, 401, 100 CR 223 (violation of ordinance). A nuisance per se can also be declared by administrative or judicial procedures taken by a governmental agency. *Beck Dev. Co. v Southern Pac. Transp. Co., supra.*

If an activity is a nuisance per se, the court does not go beyond the legislative determination that the activity is a nuisance. The court does not balance the equities. *City of Costa Mesa v Soffer* (1992) 11 CA4th 378, 382, 13 CR2d 735. Although the plaintiff has the burden of proving the essential factual elements of nuisance (*Beck Dev. Co. v Southern Pac. Transp. Co., supra*), a nuisance per se can be enjoined without proof of injury (*City & County of San Francisco v Padilla, supra* (enjoined violation of ordinance)). Finally, for a nuisance per se to exist, the statute in question must have been in effect at the time the nuisance occurred (these statutes are not applied retroactively), and the statute must apply to the condition on the property. *Beck Dev. Co. v Southern Pac. Transp. Co., supra*.

PRACTICE TIP: There are numerous statutes and ordinances that a plaintiff can use to classify the condition or conduct as a nuisance per se, and plaintiff's counsel should research them at the outset of the case. See, *e.g., Beck Dev. Co. v Southern Pac. Transp. Co., supra*. In view of the lighter burden a plaintiff must carry on a nuisance per se action, the defendant's best defense is usually to argue that the statutes are inapplicable. For a comprehensive list of defense arguments, see *Beck Dev. Co. v Southern Pac. Transp. Co., supra*.

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§5.4 C. Categories of Nuisance Under CC §3479

If an activity has not been declared to be a nuisance by law (see, *e.g.,* §5.3), a court may find it to be a nuisance under CC §3479 if it meets any of these descriptions:

- Anything injurious to health, including "the illegal sale of controlled substances";
- Anything "indecent or offensive to the senses";
- Any obstruction to the free use of property, "so as to interfere with the comfortable enjoyment of life or property"; or
- Anything that "unlawfully obstructs the free passage or use, in the customary manner, of any navigable lake, or river, bay, stream, canal, or basin, or any public park, square, street, or highway."

These definitions are broad and may include virtually any type of interference with the enjoyment or use of land. *Tint v Sanborn* (1989) 211 CA3d 1225, 1227, 259 CR 902. Any activity done or maintained under the express authority of a statute, however, cannot be deemed a nuisance. CC §3482. For examples of the interplay between CC §§3479 and 3482, see *Jones v Union Pac. R.R.* (2000) 79 CA4th 1053, 94 CR2d 661; *Paterno v State* (1999) 74 CA4th 68, 87 CR2d 754.

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§5.5 1. Objective Standard Under CC §3479

An activity or conduct that merely offends the esthetic senses or produces only personal discomfort will not be enjoined as a nuisance. To be actionable under CC §3479, the interference with the enjoyment of property rights must be "substantial and unreasonable" and affect the sensibilities of a "normal" person. *Oliver v AT&T Wireless Servs.* (1999) 76 CA4th 521, 533, 90 CR2d 491.

EXAMPLE: A 130-foot cellular telephone transmission tower on adjacent property was ruled not a nuisance despite its unpleasant appearance. The height and shape of the tower, even combined with intermittent noises and the requirement that the complaining landowner keep weeds low for fire clearance, did not make it a nuisance. *Oliver v AT&T Wireless Servs., supra*.

See also *City of San Diego v U.S. Gypsum Co.* (1994) 30 CA4th 575, 35 CR2d 876 (installation of defective product (asbestos) not a nuisance); *Hellman v La Cumbre Golf & Country Club* (1992) 6 CA4th 1224, 8 CR2d 293 (operation of golf course with balls landing on plaintiff's property adjacent to course not a nuisance).

The operation of a mortuary, however, was enjoined because the court found that its presence in the neighborhood would lower property values and affect the happiness of residents by causing people to be depressed and suffer physical disturbances. *Brown v Arbuckle* (1948) 88 CA2d 258, 261, 198 P2d 550. See also *Mangini v Aerojet-General Corp.* (1991) 230 CA3d 1125, 281 CR 827 (*Mangini I*) (owner can sue former owner or lessee of former owner on nuisance theory for damages caused by hazardous waste on property).

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§5.6 2. Balancing Equities Required Under CC §3479

If an activity is not a nuisance per se (see §5.3) and was not willfully created (see, *e.g., McIvor v Mercer-Fraser Co.* (1946) 76 CA2d 247, 172 P2d 758), it is difficult to generalize about what is and is not a nuisance under CC §3479 because this determination is a matter of degree. The issue is decided on the facts of each case and requires balancing the harm suffered by the plaintiff against the utility of the defendant's conduct. See *Hellman v La Cumbre Golf & Country Club* (1992) 6 CA4th 1224, 1231, 8 CR2d 293; Restatement (Second) of Torts §§826-831 (1979). Courts consider all factors, such as the nature of the activity, the extent and frequency of the harm caused by the activity, the effects of the activity on the owners' health and enjoyment of the property, the harm that would be caused by discontinuing the activity, the manner in which the activity is conducted, the location of the activity, and the nature of the surroundings. See, *e.g., Hellman v La Cumbre Golf & Country Club, supra;* 11 Witkin, Summary of California Law, *Equity* §169 (10th ed 2005).

For example, the rule that there is no duty to control natural conditions on property (see *Boarts v Imperial Irrig. Dist.* (1947) 80 CA2d 574, 182 P2d 246) was abolished in California (see *Sprecher v Adamson Cos.* (1981) 30 C3d 358, 178 CR 783; *Locklin v City of Lafayette* (1994) 7 C4th 327, 27 CR2d 613). All property owners now have a duty to exercise reasonable care to control all conditions on their property, including natural ones. If a natural condition unreasonably interferes with the use and enjoyment of another's property and causes material injury, the court will balance the equities to decide whether a nuisance exists. *Lussier v San Lorenzo Valley Water Dist.* (1988) 206 CA3d 92, 253 CR 470.

PRACTICE TIP: In a typical case, it is evident that the defendant's activity to some extent meets the definition of nuisance under CC §3479. The initial battle over whether there is an *actionable* nuisance is won or lost in the balancing process. As a result, despite the general rules, the reported cases often appear contradictory and irreconcilable because a court decides the equitable issues in each case under the particular facts. Both sides of a dispute can usually find authority to support almost any reasonable position, at least by analogy. From there, it is up to the judge to "balance the equities." This lack of predictability is of little comfort to an attorney who is trying to explain the chances of success to a client, who should be advised that decisions dealing with nuisance can be highly subjective.

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D. Public Nuisance

§5.7 1. Definition

A public nuisance is a nuisance that "affects at the same time an entire community or neighborhood, or any considerable number of persons, although the extent of the annoyance or damage inflicted upon individuals may be unequal." CC §3480. See *Wade v Campbell* (1962) 200 CA2d 54, 19 CR 173 (nuisance need not affect every member of community before it can be deemed a public nuisance); Restatement (Second) of Torts §§821B, 821D (1979).

Some acts are specifically declared by law to be a public nuisance. See, *e.g.,* Pen C §370 (obstructing a highway); Pub Res C §§4170 (uncontrolled fire), 4171 (fire hazard); Govt C §39561 (weeds); Health & S C §17980.6 (violation of building codes). See also *Golden Gate Water Ski Club v County of Contra Costa* (2008) 165 CA4th 249, 255, 80 CR3d 876 (violations of public planning code constitute public nuisance).

Some local jurisdictions use public nuisance ordinances to enjoin gang-related activity. See, *e.g., People ex rel Gallo v Acuna* (1997) 14 C4th 1090, 60 CR2d 277; *In re Englebrecht* (1998) 67 CA4th 486, 79 CR2d 89. The purpose of public nuisance law is to protect public order. *People ex rel Gallo v Acuna, supra*.

PRACTICE TIP: If no specific legislation declares an act to be a public nuisance, the courts focus on the number of persons that are specifically affected by the factors that make the activity or condition a nuisance in order to determine whether it is a public nuisance.

EXAMPLES: Emissions from a factory that caused allergies and respiratory problems for neighbors were found to constitute a public nuisance in *Venuto v Owens-Corning Fiberglas Corp.* (1971) 22 CA3d 116, 99 CR 350. Obstruction of traffic, even if not done for the purpose of obstructing traffic, was held to be a public nuisance in *People v Jones* (1988) 205 CA3d Supp 1, 252 CR 216. Similarly, obstruction of the ingress and egress to and from public streets and roads constitutes a public nuisance. *Kempton v City of Los Angeles* (2008) 165 CA4th 1344, 1348, 81 CR3d 852. Secondhand smoke in the common areas of a private apartment complex that plaintiff alleged increased the risk of heart disease and lung cancer to the public in general and exacerbated plaintiff's allergies and asthma was found to constitute a public nuisance. *Birke v Oakwood Worldwide* (2009) 169 CA4th 1540, 87 CR3d 602. Loss of development fees by the public entity is not sufficient to render the condition a public nuisance. A private nuisance does not become a public nuisance merely because the public is tangentially affected. See *Beck Dev. Co. v Southern Pac. Transp. Co.* (1996) 44 CA4th 1160, 1209, 52 CR2d 518.

What constitutes a "considerable number of persons" is another fact-specific issue. A dairy farm was held to be a public nuisance when it affected 11 persons owning property near the farm. *Wade v Campbell* (1962) 200 CA2d 54, 59, 19 CR 173. A bar and restaurant that played loud amplified music, disturbing a rural neighborhood of about 33 homes, was found to be a public nuisance. *People v Mason* (1981) 124 CA3d 348, 354, 177 CR 284.

Ordinances declaring activities to be a nuisance must, however, meet due process standards. For instance, a city ordinance obliging landlords to undertake eviction proceedings against all occupants of a rental unit when the chief of police suspects the tenant is engaged in or permits illegal drug activity, gang-related crime, or drug-related nuisance in or near the rental property violates procedural due process by requiring a landlord to prevail in an unlawful detainer action. *Cook v City of Buena Park* (2005) 126 CA4th 1, 9, 23 CR3d 700. The *Cook* court pointed out that whether the rental property is a nuisance is precisely the question to be determined in the unlawful detainer proceeding required by the ordinance. The ordinance, in effect, required the landlord to prevail in the unlawful detainer action or face fines, misdemeanor punishment, a lien against the property, and/or a civil penalty.

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§5.8 2. Standing

Any public body, through the Attorney General, District Attorney, or city attorney, can bring an action to abate a public nuisance. CC §3494; Pen C §11226. A private citizen may seek to enjoin a public nuisance if it is specifically injurious to him or her. CC §3493. See *Frost v City of Los Angeles* (1919) 181 C 22, 183 P 342; *Brown v Petrolane, Inc.* (1980) 102 CA3d 720, 726, 162 CR 551; *Wilson v Edwards* (1927) 82 CA 564, 567, 256 P 239. And a private citizen may sue a public entity to abate a nuisance that the public entity itself maintains. *Kempton v City of Los Angeles* (2008) 165 CA4th 1344, 1349, 81 CR3d 852. However, a private party who brings an action for a public nuisance cannot recover damages on that theory; the only remedy is an injunction. *Jordan v City of Santa Barbara* (1996) 46 CA4th 1245, 54 CR2d 340. Some statutes specifically provide that any resident citizen can bring an action to abate certain public nuisances. In these instances, no showing of specific injury is required. Health & S C §11571; Pen C §§11201, 11226.

NOTE: If a public entity declares a use to be a nuisance without obtaining a judicial determination of this status, and then proceeds to physically take the property, the property owner may sue for damages even if he or she did not fulfill the usual common law requirement of first filing an administrative mandamus action. See, *e.g.*, *Hurwitz v City of Orange* (2004) 122 CA4th 835, 19 CR3d 213 (owner obtained injunction preventing city from blocking parking space, but city ignored injunction, built a permanent curb blocking the space, and brought condemnation action against owner); *Leppo v City of Petaluma* (1971) 20 CA3d 711, 97 CR 840 (city knocked down one wall of property owner's building, then declared building a nuisance and knocked the entire building down). See also *Hensler v City of Glendale* (1994) 8 C4th 1, 13, 32 CR2d 244 (when property is damaged or physical invasion has taken place, property owner may bring inverse condemnation action immediately).

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E. Private Nuisance

§5.9 1. Definition

Every nuisance not included in the definition of a public nuisance under CC §3480 is a private nuisance. CC §3481; *Koll-Irvine Ctr. Prop. Owners Ass'n v County of Orange* (1994) 24 CA4th 1036, 1040, 29 CR2d 664. For example, soil contamination was held to be a private nuisance because it interfered with the free use of the property in a manner the owner wished (residential development). This condition was held to be a nuisance even though it did not pose a risk to health and was not indecent or offensive to the senses and even though the trial court had concluded that the site had not been adequately tested by either side to establish that it was hazardous. Interference with the use of the property for residential development was sufficient to render the condition a private nuisance. See *Beck Dev. Co. v Southern Pac. Transp. Co.* (1996) 44 CA4th 1160, 52 CR2d 518. Violation of CC&Rs may also be a private nuisance if the CC&Rs declare violations to be a nuisance. *Woodridge Escondido Prop. Owners Ass'n v Nielsen* (2005) 130 CA4th 559, 570, 30 CR3d 15.

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§5.10 2. Threat of Future Injury

California courts have stated a general rule that a private nuisance action cannot be maintained for interference with the use and enjoyment of land caused solely by fear of future injury. See, *e.g.,* authorities cited in *Jordan v City of Santa Barbara* (1996) 46 CA4th 1245, 54 CR2d 340.

Other California courts have allowed actions for nuisance when the plaintiff established an actual and unnecessary harmful condition even though there was no physical damage. See, *e.g., San Diego Gas & Elec. Co. v Superior Court* (1996) 13 C4th 893, 55 CR2d 724; *Beck Dev. Co. v Southern Pac. Transp. Co.* (1996) 44 CA4th 1160, 1213, 52 CR2d 518. These cases established elaborate tests that should be examined carefully. In general, the plaintiff has the burden of showing the likelihood and magnitude of the potential for future injury and that the apprehension of future injury is well founded and based on an objective standard.

For cases dealing with the threat of future illness, see *Potter v Firestone Tire & Rubber Co.* (1993) 6 C4th 965, 997, 25 CR2d 550 (exposure to toxic emissions); *Macy's Cal., Inc. v Superior Court* (1995) 41 CA4th 744, 48 CR2d 496 (scratch from hypodermic needle possibly contaminated with AIDS virus); *Koll-Irvine Ctr. Prop. Owners Ass'n v County of Orange* (1994) 24 CA4th 1036, 1041, 29 CR2d 664; *Akins v Sacramento Mun. Util. Dist.* (1992) 18 CA4th 208, 8 CR2d 785 (damages for exposure to radioactive materials discharged into air) (CAVEAT: This case was depublished and is not citable).

For cases dealing with the threat of property damage as a nuisance, see *County of San Diego v Carlstrom* (1961) 196 CA2d 485, 16 CR 667 (dilapidated housing unit structure temporarily stored with and surrounded by combustible debris); *People v Oliver* (1948) 86 CA2d 885, 195 P2d 926 (uncompleted skeleton wooden building surrounded by flammable debris in built-up residential area). In *City of Malibu v California Coastal Comm'n* (2005) 128 CA4th 897, 27 CR3d 501, the trial court did not abuse its discretion in denying a beachfront property owner leave to intervene in an adjacent owner's action challenging a proposed opening of a public access easement to the beach. Intervener could only speculate that the public would trespass and litter on its property. "But the possibility of what some ill-mannered citizens might do cannot create an entitlement for landowners up and down the Malibu Coast to interject themselves into every dispute regarding the right of public access to the beach." 128 CA4th at 905.

PRACTICE TIP: In *Aas v Superior Court* (2000) 24 C4th 627, 101 CR2d 718, the California Supreme Court decided that homeowners cannot recover in tort for negligent construction when the condition has not yet resulted in damage. The court held that such negligence claims are limited to damages for physical injuries, and there is no recovery for economic loss alone. Although *Aas* dealt with construction defects, the rationale of this case appears to apply to economic loss caused by nuisance or trespass as well. See *Braun v Agri-Systems* (ED Cal, May 16, 2006, No. CV-F-02-6482) 2006 US Dist Lexis 29947 (confirming rule of *Aas* and noting that purely economic damages can be recovered under breach of warranty theory). But see CC §§895-945.5 (providing cause of action against builders of new homes for violations of specified building standards).

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§5.11 3. Blockage of Air, Light, or View

California does not recognize an easement for air, light, or view. As a result, the blockage of light to a neighbor's property, unless malice is the motive, does not constitute an actionable nuisance, even if a showing is made of material injury. *Sher v Leiderman* (1986) 181 CA3d 867, 876, 226 CR 698. For example, a penthouse apartment on adjacent property, blocking the plaintiffs' light, air, and view, and infringing on their privacy, was held not a nuisance. *Wolford v Thomas* (1987) 190 CA3d 347, 235 CR 422.

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§5.12 F. Nuisance That Is Both Public and Private

An activity can be a public nuisance, a private nuisance, or both. Unless a public nuisance also constitutes a private nuisance as to the plaintiff, the plaintiff cannot bring a private nuisance action. CC §3493. When a public nuisance does exist and a private party wishes to proceed on a private nuisance theory, the plaintiff must plead and prove an injury, specifically related to the use and enjoyment of its land, that is different from the injury suffered by the public in general. *Buchanan v Los Angeles County Flood Control Dist.* (1976) 56 CA3d 757, 768, 128 CR 770. Merely showing that the injury is of a different degree or intensity is not sufficient. For example, the court denied recovery for emotional distress damages based on a private nuisance theory to owners whose property was subjected to airport-generated noise levels that were higher than the noise level to which the general public was exposed because their injury did not differ in kind but only in degree. *Institoris v City of Los Angeles* (1989) 210 CA3d 10, 258 CR 418; *Venuto v Owens-Corning Fiberglas Corp.* (1971) 22 CA3d 116, 99 CR 350 (allegation of special health injury is not sufficient in emission of air pollutants); *Roark v State* (1971) 20 CA3d 155, 158, 97 CR 552; *Kitzman v Newman* (1964) 230 CA2d 715, 726, 41 CR 182; *Wilson v Edwards* (1927) 82 CA 564, 567, 256 P 239.

In *Newhall Land & Farming Co. v Superior Court* (1993) 19 CA4th 334, 342, 23 CR2d 377, however, the court held that if there is actual, specific damage to the plaintiff's private property rights, the plaintiff need not show that it suffered damage of a different kind. In *Newhall,* the plaintiff alleged that it was unable to sell the property because of the pollution of soil and groundwater and that it spent money on investigation of the pollution. See *Birke v Oakwood Worldwide* (2009) 169 CA4th 1540, 87 CR3d 602 (when conduct constitutes both private and public nuisance, plaintiff does not need to demonstrate injury of different kind or degree to establish cause of action for public nuisance); *Mangini v Aerojet-General Corp.* (1991) 230 CA3d 1125, 1138, 281 CR 827 (*Mangini I*) (toxic testing costs are sufficient to constitute a "special injury").

PRACTICE TIP: Defendants should consider whether they can successfully contend that the nuisance claimed by the plaintiff is solely a public nuisance. If the court agrees that the nuisance is public and further finds that it is not specifically injurious to the plaintiff, the plaintiff generally lacks standing to bring either a public or private action, and the action should be dismissed. See CC §3493, cited in §5.9.

When the plaintiff alleges that an activity is a nuisance solely because it violates a statute, ordinance, or regulation and the determination of whether the activity constitutes a nuisance turns on an interpretation of the statute, ordinance, or regulation, the courts may properly defer to an interpretation of the governmental entity charged with enforcing the enactment. *Pallco Enters., Inc. v Beam* (2005) 132 CA4th 1482, 1499, 34 CR3d 490. This deference to the determination by an agency is appropriate only when the plaintiff does not claim that the activity is unsafe or otherwise threatens adjacent property or the public. 132 CA4th at 1490. Courts will ordinarily give great weight to the interpretation of a statute by an administrative agency empowered to promulgate regulations to advance its purpose, however, unless the interpretation is clearly erroneous. *Norman v Unemployment Ins. Appeals Bd.* (1983) 34 C3d 1, 8, 192 CR 134.

If the court finds that the nuisance is public and that it is specifically injurious to the plaintiff, but also finds that the plaintiff has failed to plead or prove harm to its specific property rights that is different in kind from that suffered by the general public, the defendant can contend that the plaintiff cannot recover damages and is limited to the remedy of injunction. See *Koll-Irvine Ctr. Prop. Owners Ass'n v County of Orange* (1994) 24 CA4th 1036, 29 CR2d 664.

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Source: Civil Litigation/California Attorney's Guide to Damages/5 Injury to Property/ G. Distinction Between Temporary or Continuing Nuisances and Permanent Nuisances/§5.13 1. Importance of Classification for Selection of Remedies

G. Distinction Between Temporary or Continuing Nuisances and Permanent Nuisances

§5.13 1. Importance of Classification for Selection of Remedies

The classification of a nuisance or trespass as temporary or continuing versus permanent is the most difficult and probably the most frequently contested issue in this area of the law. The resolution of this issue is crucial and often determines the outcome of the case because it controls both the remedy available and the application of the defense of the statute of limitations.

If the nuisance or trespass is permanent:

- The plaintiff must bring one action for all past, present, and future damage within three years after the permanent nuisance arises; if the plaintiff does not, the claim is barred by the statute of limitations;
- An injunction is not available; and
- The plaintiff can recover damages for diminution in value and stigma but not for loss of use.

See, *e.g.,* authorities cited in *Baker v Burbank-Glendale-Pasadena Airport Auth.* (1985) 39 C3d 862, 868, 218 CR 293. See also *Beck Dev. Co. v Southern Pac. Transp. Co.* (1996) 44 CA4th 1160, 1216, 52 CR2d 518.

If the nuisance or trespass is considered temporary or continuing:

- The person harmed may bring successive actions for damages until the nuisance is abated but recover only actual damages suffered in the three years before commencement of the action;
- An injunction is usually available; and
- The plaintiff can recover for loss of use, but prospective damages (such as diminution in value and stigma) are not recoverable.

Each repetition of a continuing nuisance or trespass is considered a separate wrong that commences a new period in which to bring an action for recovery based on the new injury. See *Baker v Burbank-Glendale-Pasadena Airport Auth., supra; Capogeannis v Superior Court* (1993) 12 CA4th 668, 676, 15 CR2d 796.

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§5.14 2. Factors

The factors the court considers in determining whether a nuisance or trespass is permanent or continuing are whether:

- It can be substantially abated in a reasonably feasible manner and at a reasonable cost (*Mangini v Aerojet-General Corp.* (1996) 12 C4th 1087, 1097, 51 CR2d 272 (*Mangini II*); *Wilshire Westwood Assocs. v Atlantic Richfield Co.* (1993) 20 CA4th 732, 744, 24 CR2d 562);
- It is the result of continuing activity (*Beck Dev. Co. v Southern Pac. Transp. Co.* (1996) 44 CA4th 1160, 1218, 52 CR2d 518); and
- The impact of the condition varies over time (*Mangini v Aerojet-General Corp.* (1991) 230 CA3d 1125, 1147, 281 CR 827 (*Mangini I*); *Field-Escandon v DeMann* (1988) 204 CA3d 228, 234, 251 CR 49).

The most important test is whether the nuisance or trespass can be substantially and feasibly abated without unreasonable burden. The question of whether a nuisance is abatable is a question of fact. *Mangini v Aerojet-General Corp.* (*Mangini II*), *supra*; *Kornoff v Kingsburg Cotton Oil Co.* (1955) 45 C2d 265, 288 P2d 507; *Newhall Land & Farming Co. v Superior Court* (1993) 19 CA4th 334, 343, 23 CR2d 377; *Mangini v Aerojet-General Corp.* (*Mangini I*), *supra*. The requirement of "substantial" abatement means that, even if a nuisance cannot be totally abated, partial abatement may be sufficient to classify the nuisance as temporary.

Abatement does not require proof that the condition can be entirely eradicated. Even if the abatement will take considerable time and may never be wholly successful, the nuisance may not be permanent as long as it can be reduced to acceptable levels. If there is no legitimate interest in permitting the condition to persist, the policy of the law should be to encourage discontinuance of the nuisance or trespass promptly and as thoroughly as possible. The court should not require absolutes. *Capogeannis v Superior Court* (1993) 12 CA4th 668, 680, 15 CR2d 796.

The "feasibility" and "without unreasonable burden" tests overlap and are often blended. These tests deal with two different concepts: (1) whether the means exist to abate, and (2) whether abatement is possible without unreasonable hardship or cost. *Mangini v Aerojet-General Corp.* (*Mangini II*), *supra; Beck Dev. Co. v Southern Pac. Transp. Co., supra*. "Abatable" depends on whether the contamination can be cleaned up to sufficient levels at a reasonable cost by reasonable means. The factors that should be considered in that determination are (1) feasibility of the means, (2) the alternatives to abatement, (3) the time and expense involved, (4) the legitimate competing interest, and (5) the benefits to be gained by abatement versus the detriments to be suffered if abatement is denied. This determination must be made on the facts and circumstances of each case. The burden of proof is on the plaintiff to prove that all these conditions are present. *Beck Dev. Co. v Southern Pac. Transp. Co, supra*.

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§5.15 3. Election by Plaintiff

The seminal case dealing with continuing and permanent nuisance is *Spaulding v Cameron* (1952) 38 C2d 265, 267, 239 P2d 625. The rationale behind the establishment of permanent nuisance is to allow one action to recover for all damages inflicted when it would be unfair to the defendant to be subjected to successive suits and unfair to the plaintiff if they were not allowed to recover all damages in one action. *Spaulding v Cameron, supra*.

The clearest example of a permanent nuisance is the operation of a public utility, which is privileged and will continue for indefinite duration because the utility is entitled to continue its operation. A more difficult situation exists when a nuisance or trespass is not privileged, but abandonment is impracticable or the plaintiff is willing to allow it to continue if he or she can be compensated for it. In that event, the plaintiff may elect to treat the nuisance as either permanent or continuing. A defendant who is not privileged to continue the nuisance and is able to abate it cannot complain about the classification selected by the plaintiff. 38 C2d at 268. This rule has been universally acknowledged since the *Spaulding* decision. *Beck Dev. Co. v Southern Pac. Transp. Co.* (1996) 44 CA4th 1160, 52 CR2d 518; *Wilshire Westwood Assocs. v Atlantic Richfield Co.* (1993) 20 CA4th 732, 24 CR2d 562; *Capogeannis v Superior Court* (1993) 12 CA4th 668, 15 CR2d 796.

The rule allowing a plaintiff to elect to treat the nuisance as either permanent or continuing applies when the nuisance cannot be abated or is operated by a public entity that has the discretion to terminate a nuisance at any time. *Baker v Burbank-Glendale-Pasadena Airport Auth.* (1985) 39 C3d 862, 871, 218 CR 293; *Kornoff v Kingsburg Cotton Oil Co.* (1955) 45 C2d 265, 268, 288 P2d 507; *Phillips v City of Pasadena* (1945) 27 C2d 104, 162 P2d 625 (barricade of public street cutting off access to a resort). See also *Bartleson v U.S.* (9th Cir 1996) 96 F3d 1270; *Reynolds Metals Co. v Wand* (9th Cir 1962) 308 F2d 504 (fumes from plant that could not be abated can be treated as permanent nuisance).

PRACTICE TIP: Some courts have not permitted the plaintiff to elect in doubtful cases, using the rubric of *Beck Dev. Co. v Southern Pac. Transp. Co.* (1996) 44 CA4th 1160, 1217, 52 CR2d 518. The *Beck* court recognized the plaintiffs' right to elect to treat a nuisance as permanent or continuing in doubtful cases, but it stated that the choice must be supported by evidence that would reasonably support either classification and concluded that the court should uphold the plaintiff's characterization only "if it is reasonable to do so under a given formulation." *Beck Dev. Co. v Southern Pac. Transp. Co., supra*. See also *Spar v Pacific Bell* (1991) 235 CA3d 1480, 1 CR2d 480 (court denied plaintiff right to elect by ruling that there was no reasonable doubt that nuisance was permanent).

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§5.16 4. Courts' Preference for Continuing Nuisance

Courts have expressed, as a matter of policy, a preference for finding a continuing nuisance to (1) protect the plaintiff from contingencies, such as unforeseen future injuries, (2) prevent the plaintiff's claim from being barred by the statute of limitations, and (3) encourage termination of the condition causing the nuisance. *Baker v Burbank-Glendale-Pasadena Airport Auth.* (1985) 39 C3d 862, 870, 218 CR 293; *Mangini v Aerojet-General Corp.* (1991) 230 CA3d 1125, 1148, 281 CR 827 (*Mangini I*); *Starrh & Starrh Cotton Growers v AERA Energy LLC* (2007) 153 CA4th 583, 596, 63 CR3d 165 (following *Mangini I* and refusing to enlarge category of permanent trespass to include ongoing ground water contamination caused by neighboring landowner's oil production activities).

A continuing nuisance may exist even if the offensive conduct that has caused it has ended. A nuisance is defined by the condition created and the damage or harm inflicted, not by the conduct that created it. Therefore, the court will find a continuing nuisance if the harm continues or if there is a continuing threat of future injury. *Arcade Water Dist. v U.S.* (9th Cir 1991) 940 F2d 1265; *Capogeannis v Superior Court* (1993) 12 CA4th 668, 681, 15 CR2d 796 (continuing nature of nuisance refers to continuing (but abatable) damage caused by offensive condition, not to acts causing offensive conditions to occur); *Starrh & Starrh Cotton Growers*, 153 CA4th at 593.

In *Beck Dev. Co. v Southern Pac. Transp. Co.* (1996) 44 CA4th 1160, 52 CR2d 518, the court applied a restricted view of the continuing damage rule in a case involving groundwater contamination. The court held that the contamination must continue to migrate through land or water and cause new and additional damages on a continuous basis before it will be considered a continuing nuisance or trespass. The continuing location of the contamination under the property without continuing migration or leaching "indicates a permanent rather than continuing nuisance." The court considered this condition to be more like a permanent encroachment that a court, after balancing the equities, will not abate. *Beck Dev. Co.,* 44 CA4th at 1218.

NOTE: The *Beck* court seemed to confuse the conduct that created the condition with the continuing invasion of property interests and continuing damage caused by the condition after it was created. Arguably, the fact that the activity creating the nuisance has stopped is not relevant and certainly should not be determinative. As long as the condition exists and is abatable, the crucial factor should be the continuing nature of the interference compared with the plaintiff's full use and enjoyment of the property, regardless of whether the contamination is moving or not. See *Newhall Land & Farming Co. v Superior Court* (1993) 19 CA4th 334, 345, 23 CR2d 377; *Capogeannis v Superior Court* (1993) 12 CA4th 668, 682, 15 CR2d 796. In cases involving toxic contamination, the policy of the law ought to be to get the contamination cleaned up. This policy would be supported by a finding of continuing nuisance, which encourages and facilitates cleanup and payments by the responsible parties.

In *Starrh & Starrh Cotton Growers,* 153 CA4th at 597, the court came to the opposite result in a case involving contamination of ground water caused by a neighboring landowner's oil production activities. The court followed *Mangini I* and held that the case presented a "classic continuing trespass situation" because defendant's oil producing activities were ongoing and would contribute to deteriorating water quality condition as long as they continued. Although the court cited *Beck*, it did not directly address the factual similarities of the case, and based its analysis on *Mangini I*.

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III. TRESPASS

§5.17 A. Definition

Trespass to property is defined as an unlawful interference with possession. *Staples v Hoefke* (1987) 189 CA3d 1397, 235 CR 165; Restatement (Second) of Torts §158 (1965). In general, every unwarranted entry onto the land of another, sometimes called "breaking the close," is a trespass. Trespass may result from an act that is intentional, reckless, or negligent or that is the result of ultrahazardous activity. The only intent required is the intent to enter the property, regardless of the actor's motivation. *Miller v National Broad. Co.* (1986) 187 CA3d 1463, 1480, 232 CR 668. Trespass does not require personal entry onto the property; it can occur by causing the entry of material objects or inanimate substances. *Wilson v Interlake Steel Co.* (1982) 32 C3d 229, 185 CR 280 (damage from noise, vibrations, and deposit of particulates; see §5.18); *Roberts v Permanente Corp.* (1961) 188 CA2d 526, 10 CR 519 (dust).

A party is generally liable for the entry of instrumentalities under his control on the land of another, regardless of whether the land is enclosed or unenclosed. *Blevins v Mullally* (1913) 22 CA 519, 523, 135 P 307. However, California has unique rules that apply to trespass by cattle. Throughout most of California the common law "fencing in" rule applies. Under this rule "the cattle owner builds a fence to keep his cattle in," and the owner of the cattle is responsible if they stray onto the property of others. In some of California's northernmost counties, however, the "fencing out" rule applies. Under this rule, the neighboring land owners must build the fences to keep the cattle out. Even under this rule, the owner of the cattle is still liable for deliberate incursions onto another's property. *Herzberg v County of Plumas* (2005) 133 CA4th 1, 8, 34 CR3d 588.

The performance of an act, without negligence or intent to harm, that will result with substantial certainty in the entry of foreign matter on another's land is sufficient for an intentional trespass. *Roberts v Permanente Corp., supra*. Trespass must cause actual damage to the property. *Elton v Anheuser-Busch Beverage Group* (1996) 50 CA4th 1301, 58 CR2d 303.

Trespass may result from physical intrusion, failure to leave, or failure to remove foreign material. It can also occur when a party exceeds the scope of the permission or purpose of consent to enter the property. *Mangini v Aerojet-General Corp.* (1991) 230 CA3d 1125, 1141, 281 CR 827 (*Mangini I*). The scope of permitted uses under a public right-of-way, particularly one located in an urban area, may not be limited to the express language of the right-of-way, but may be subject to a wide range of uses that go beyond the express grant of the right-of-way. *Bello v ABA Energy Corp.* (2004) 121 CA4th 301, 16 CR3d 818. It may result from the entry of foreign matter or causing the entry of other persons. Restatement §§158-159. Trespass may result in an invasion on the surface of the land, over the land, or below the land. 5 Witkin, Summary of California Law, *Torts* §§693-698 (10th ed 2005). One court held that contamination left on the property by a previous owner was not a trespass against the interests of the present owner but was, however, a nuisance. *Capogeannis v Superior Court* (1993) 12 CA4th 668, 674, 15 CR2d 796.

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§5.18 B. Distinction Between Nuisance and Trespass

The line between trespass and nuisance is wavering and uncertain. An action may be a trespass, a nuisance, or both. The primary distinctions between a claim for trespass and one for nuisance are found in the rights invaded and the proof of damages. Trespass requires physical invasion of the land and interference with the plaintiff's exclusive possession. See *Elton v Anheuser-Busch Beverage Group* (1996) 50 CA4th 1301, 58 CR2d 303 (fire spreading from defendant's property to plaintiff's constituted trespass); *Posey v Leavitt* (1991) 229 CA3d 1236, 1243, 280 CR 568. A nuisance is an interference with the plaintiff's use and enjoyment of property. *Lussier v San Lorenzo Valley Water Dist.* (1988) 206 CA3d 92, 253 CR 470.

Wilson v Interlake Steel Co. (1982) 32 C3d 229, 185 CR 280, illustrates the difference between the two torts. In *Wilson,* the court held that loud noise from a 24-hour steel mill could not be abated on the theory of trespass. The court distinguished between noise that caused vibrations resulting in damage or injury to the property (trespass) and noise waves that are merely bothersome and not physically damaging (nuisance). Intangible intrusion, such as noise, odor, or light with physical damage, is a nuisance and not a trespass. *San Diego Gas & Elec. Co. v Superior Court* (1996) 13 C4th 893, 935, 55 CR2d 724; *Newhall Land & Farming Co. v Superior Court* (1993) 19 CA4th 334, 345, 23 CR2d 377; *Capogeannis v Superior Court* (1993) 12 CA4th 668, 674, 15 CR2d 796. Many types of conduct and conditions will interfere with both of these interests.

The second distinction between these two torts is that a cause of action for trespass requires proof of the deposit of particulate matter on the plaintiffs' property or of actual physical damage to the property; nuisance does not. *San Diego Gas & Elec. Co. v Superior Court, supra*. Proof of interference with the beneficial use and enjoyment of property is sufficient for nuisance. Liability for a private nuisance, however, requires proof that the invasion of the plaintiff's interest in the use and enjoyment of the land is substantial and that the substantial interference is unreasonable. 13 C4th at 937. Note that a continuing trespass creates a continuing cause of action that is virtually the same as a continuing nuisance claim. *Newhall Land & Farming Co. v Superior Court, supra*.

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§5.19 IV. ENCROACHMENT

An encroachment (*i.e.,* an unconsented intrusion by a building or other structure onto adjacent property) is usually treated as a nuisance or a trespass in California, depending on the nature of the encroachment. An encroachment may be both a nuisance and a trespass. An encroachment such as a building that rests on adjoining land is a permanent trespass (see *Rankin v DeBare* (1928) 205 C 639, 271 P 1050) and may be remedied by an action for damages (see §5.31) or for an injunction (see §5.26). If an encroachment substantially interferes with the adjoining owner's use and enjoyment of the land, it is a nuisance under CC §3479. *Kafka v Bozio* (1923) 191 C 746, 218 P 753.

When a structure encroaches only into the airspace of the adjacent land, it is not a trespass, but it may be a nuisance if it affects the adjacent owner's use and enjoyment. *Case v Sisich* (1929) 97 CA 106, 275 P 492. If it does, remedies applicable to nuisance apply. See §§5.25-5.29.

A court will not usually order the removal of an encroachment if there is no direct evidence of actual damage and the encroachment is minor (see, *e.g., McKean v Alliance Land Co.* (1927) 200 C 396, 253 P 134) or if the expense of removal will far exceed the damage caused (see *Case v Sisich, supra*); the court will instead award damages.

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§5.20 V. REMEDIES AND DAMAGES FOR PUBLIC NUISANCE

The remedies against a public nuisance are (1) criminal indictment or information, (2) a civil action for abatement, or (3) summary abatement. CC §§3491-3496; *People ex rel Gallo v Acuna* (1997) 14 C4th 1090, 60 CR2d 277. Cities and counties can establish procedures for abatement, but an offending property owner must be given a choice of repairing or demolishing a condemned building and must be given a reasonable time to do so. The owner is liable for all costs of abatement and, if the county ordinance requires it, attorney fees as well. Ordinances may also provide that entry of a second or subsequent civil or criminal judgment within 2 years will put the owner at risk of being ordered to pay treble the costs of the abatement. Govt C §§25845, 38773.1-38773.7; Health & S C §17980(b).

Damages are not recoverable for a public nuisance unless they are specifically provided for by statute. *People ex rel Gow v Mitchell Bros. Santa Ana Theatre* (1981) 114 CA3d 923, 930, 171 CR 85, rev'd on other grounds in 454 US at 94. Some statutes specifically authorize damages for public nuisances. See Pen C §11225(b). Note, however, that if a public entity has a property interest that is injuriously affected by the nuisance, it can recover the same type of damages available to private property holders. *Selma Pressure Treating Co. v Osmose Wood Preserving Co. (*1990) 221 CA3d 1601, 1614, 271 CR 596, disapproved on other grounds in *Johnson v American Standard, Inc.* (2008) 43 C4th 56, 70, 74 CR3d 108.

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§5.21 VI. DAMAGES AND OTHER REMEDIES FOR PRIVATE NUISANCE AND TRESPASS

Private nuisance and trespass give rise to alternative and concurrent remedies at law and in equity. 11 Witkin, Summary of California Law, *Equity* §71 (10th ed 2005). The remedies available for a private nuisance are self-help abatement at the party's own risk or a civil action for injunction, damages, or both. CC §§3501-3503. See §§5.25-5.29.

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§5.22 A. Equitable or Legal Action?

Counsel evaluating a claim for nuisance or trespass must initially consider whether or not to classify the action as legal, equitable, or both legal and equitable (hybrid action). This characterization will determine whether or not the party is entitled to a jury. Whether an action is legal or equitable depends on the "gist of the action," as formed by the pleadings and facts, and the type of relief sought. *Paularena v Superior Court* (1965) 231 CA2d 906, 911, 42 CR 366. In general, if the action seeks only equitable relief, there is no right to a jury. See *Baugh v Garl* (2006) 137 CA4th 737, 740, 40 CR3d 539 (defendant properly denied jury trial when "gist" of action was specific performance of settlement agreement and to prevent interference with easement rights). On the other hand, if the action seeks only damages, there is a right to a jury. Cal Const art I, §16; CCP §592. There are, however, numerous qualifications and exceptions to this rule. For a more detailed discussion of the matter, see California Civil Procedure Before Trial §§41.3-41.6 (4th ed Cal CEB 2004); 7 Witkin, California Procedure, *Trial* §§79-97 (5th ed 2008).

The most common kinds of relief sought in nuisance and trespass actions are damages and/or injunctions. Actions for damages for injuries to property are legal actions. CCP §592; 7 Witkin, Procedure, *Trial* §80. Actions for an injunction are equitable. *Baugh v Garl* (2006) 137 CA4th 737, 740, 40 CR3d 539; *Arciero Ranches v Meza* (1993) 17 CA4th 114, 125, 21 CR2d 127.

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§5.23 B. Jurisdiction

In a pure action for damages, subject matter jurisdiction is governed by the amount in controversy exclusive of attorney fees, interest, and costs. If the amount in controversy does not exceed $25,000, the action is considered a limited civil case subject to certain rules intended to reduce litigation expenses. CCP §§85-86.1, 90-100. If the amount in controversy is higher than $25,000, the case is an unlimited civil case. CCP §88. Both such cases are filed in superior court. CCP §§85-89. Matters below $5000 are filed as limited civil cases in the small claims division of the superior court. CCP §116.220. Equitable actions for injunction can be filed as limited or unlimited civil cases. CCP §86. For a comprehensive discussion of this matter, see California Civil Procedure Before Trial §§6.4-6.57 (4th ed Cal CEB 2004).

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§5.24 C. Venue

Venue in trespass and nuisance actions is based on a classification of the action as transitory or local. These classifications are generally based on the plaintiffs' theory of the action set forth in the complaint and the scope of the judgment that might be entered on default. *Brown v Superior Court* (1984) 37 C3d 477, 482, 208 CR 724. See California Civil Procedure Before Trial §§8.4-8.9 (4th ed Cal CEB 2004).

The actions for injury to real property are local actions and must be tried in the particular locality of the property regardless of the defendant's county of residence. CCP §392(a)(1); Civ Proc Before Trial §§15.30-15.34. An action for injunctive relief is ordinarily personal or transitory. It is usually triable in the defendant's county of residence unless otherwise provided by law. CCP §395(a); Civ Proc Before Trial §39.12. In a mixed action involving a demand for relief that is local and another that is transitory, the court determines the venue by determining the main relief sought or the "principal object" of the action. Civ Proc Before Trial §§8.48-8.51.

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§5.25 D. Right to Self-Help

Anyone injured by a private nuisance may abate it by removing, or, if necessary, destroying, whatever constitutes the nuisance, if this is done without committing a breach of the peace or doing unnecessary injury. CC §3502. If the nuisance results from a mere omission of the wrongdoer and cannot be abated without entering onto the land of another, reasonable notice must be given before the entry can be made. CC §3503. A person who has the right to self-help may forgo this option and elect to resort to judicial remedies, such as an abatement order. See *Parsons v Luhr* (1928) 205 C 193, 270 P 443; *Bonde v Bishop* (1952) 112 CA2d 1, 6, 245 P2d 617.

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§5.26 E. Injunction

The most common remedies used against a private nuisance are an injunction, damages, or both. CC §3501; CCP §731. The plaintiff can elect to prosecute separate actions concurrently or combine an action for injunction and damages. *Katenkamp v Union Realty Co.* (1936) 6 C2d 765, 776, 59 P2d 473.

Civil Code §3533 states that "[t]he law disregards trifles." In deciding whether to grant an injunction, the court must balance the hardships and the equities by measuring the harm that will result to the plaintiff by a continuance of a nuisance against the harm that would be caused to the defendant if it is abated. This is a different balancing from that done by the court to decide whether a nuisance exists (see §5.6). The court may find that a condition or an activity is a nuisance and still deny an injunction if damages are an adequate remedy. Also, if the injury to the plaintiff is trivial or the damage to the defendant is greater than the damage to the plaintiff, the court may refuse an injunction and limit the plaintiff's relief to damages. See *Remmer v Glens Falls Indem. Co.* (1956) 140 CA2d 84, 87, 295 P2d 19 (in underlying nuisance action, court limited award to diminution in value because cost of abating nuisance exceeded diminution caused by nuisance). However, an injunction will not be refused merely because the offending activity or condition is highly beneficial to the defendant. CC §3533; *Rothaermel v Amerige* (1921) 55 CA 273, 203 P 833. The public interest may also justify denying an injunction. *Mountain Copper Co. v U.S.* (9th Cir 1906) 142 F 625, 638. The courts will, however, refuse to balance a hardship if a nuisance is created willfully. *Morgan v Veach* (1943) 59 CA2d 682, 689, 139 P2d 976.

As a practical matter, in the absence of extreme circumstances, the courts usually grant injunctive relief when a nuisance or trespass invades a substantial property right or unreasonably interferes with the plaintiff's use and enjoyment of its property. See *Sierra Screw Prods. v Azusa Greens, Inc.* (1979) 88 CA3d 358, 151 CR 799. Most courts require a showing of proof of irreparable injury to the defendant before they will deny an injunction based on a balancing test, because a refusal to grant the injunction (allowing instead damages for a permanent nuisance) may effectively result in a condemnation award to a private party. *Fairington v Dyke Water Co.* (1958) 50 C2d 198, 323 P2d 1001.

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§5.27 F. Tort Measure of Damages

The general tort measure of damages for trespass and nuisance is prescribed by CC §3333, which allows the plaintiff to recover the amount that will compensate the plaintiff for all detriment proximately caused by the tort, whether or not it could have been anticipated. *Coats v Atchison, T. & S. F. Ry.* (1905) 1 CA 441, 444, 82 P 640. But see *Bailey v Outdoor Media Group* (2007) 155 CA4th 778, 789, 66 CR3d 322 (real property owner not entitled to recover proceeds from sale by owner's lessee where no causal connection was established between lessee's wrongful occupation of property and purchaser's willingness to buy property).

A plaintiff, in a suit for damage to real property, may recover either the cost to repair or the diminution in value, but not both. The plaintiff can recover the costs of repair even if that amount exceeds the diminution in value. The plaintiff cannot recover diminution in value if that amount exceeds the cost of repair. *Safeco Ins. Co. v J & D Painting* (1993) 17 CA4th 1199, 21 CR2d 903. Also, the plaintiff cannot recover diminution in market value that occurred while the repairs were taking place. *Safeco Ins. Co. v J & D Painting, supra*.

Civil Code §3334 sets out the measure of damages of a trespass resulting in wrongful occupation of real property. The detriment includes the value of the use of the property during the wrongful occupation, the reasonable cost of repair or restoration of the property to its original condition, and the reasonable costs of recovering possession of the property. CC §3334(a). Two decisions interpreting and applying this measure of recovery are *Bailey v Outdoor Media Group, supra* and *Starrh & Starrh Cotton Growers v AERA Energy LLC* (2007) 153 CA4th 583, 63 CR3d 165. In *Bailey,* the court held that the net benefit obtained by a defendant wrongfully occupying plaintiff's advertising billboards was the net profit obtained by the defendant in operating the billboards. 155 CA4th 789. In *Starrh & Starrh Cotton Growers,* the court found that damages for ground water contamination could be measured by the reasonable restoration cost, but if the restoration costs are not reasonable, then the diminution in value is the alternative measure of recovery. 153 CA4th at 601.

Nominal damages may be recovered for a nuisance even if the plaintiff suffers no appreciable detriment. CC §3360; *Davidson v Devine* (1886) 70 C 519, 11 P 664. As long as the plaintiff has incurred some actual damages, an action for trespass can support an award of nominal damages. Nominal damages must be awarded if the matter decides a question of permanent right or entitles the plaintiff to costs. *Staples v Hoefke* (1987) 189 CA3d 1397, 235 CR 165.

It is not necessary that a nuisance have its origin on neighboring property. A property owner can sue for damages caused by a nuisance created on its own property by a former owner or others. The party claiming a nuisance need not have a possessory or ownership interest in the property at the time the nuisance was created, and the defendant need not have a possessory or ownership interest in the property at the time the action is brought. See *Newhall Land & Farming Co. v Superior Court* (1993) 19 CA4th 334, 343, 23 CR2d 377; *Mangini v Aerojet-General Corp.* (1991) 230 CA3d 1125, 281 CR 827 (*Mangini I*). A nuisance that obstructs the free use of the property is actionable. *Wilshire Westwood Assocs. v Atlantic Richfield Co.* (1993) 20 CA4th 732, 746, 24 CR2d 562 (allowed subsequent owner to recover for nuisance created by former lessee). Any party who creates, assists, or maintains a nuisance is liable for it. *Newhall Land & Farming Co. v Superior Court, supra*.

A person who was the owner of real property at the time an injury to the property occurred and is discovered does not lose the right to recover damages when the property is sold to a third party. *Vaughn v Dame Constr. Co.* (1990) 223 CA3d 144, 147, 272 CR 261. The subsequent owner, however, will not have standing to sue for the injury to the property if possession was taken after the damage to the property occurred and with full knowledge of the damage. *Keru Invs., Inc. v Cube Co.* (1998) 63 CA4th 1412, 1423, 74 CR2d 744. A subsequent owner will only have standing to sue if either an assignment is secured from the person in possession when the injury to the property occurred (*Krusi v S.J. Amoroso Constr. Co.* (2000) 81 CA4th 995, 1005, 97 CR2d 294) or possession was taken after damage to the property occurred but was, as of the time of the sale, undiscovered (*Siegel v Anderson Homes, Inc.* (2004) 118 CA4th 994, 1000, 13 CR3d 462). See also *Standard Fire Ins. Co. v Spectrum Community Ass'n* (2006) 141 CA4th 1117, 1144, 46 CR3d 804 (condominium homeowners association had standing to sue developer even though damage to common areas occurred before association's creation).

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§5.28 1. Continuing Nuisance

If the nuisance is continuing (see §§5.13-5.16), the remedy is either abatement and damages for past injury or successive actions for damages as new injuries occur until the nuisance is abated. *Spaulding v Cameron* (1952) 38 C2d 265, 239 P2d 625; *Rhodes v San Mateo Inv. Co.* (1955) 130 CA2d 116, 278 P2d 447. Prospective damages are not recoverable. *Baker v Burbank-Glendale-Pasadena Airport Auth.* (1985) 39 C3d 862, 869, 218 CR 293. Nonetheless, damages suffered between commencement and conclusion of a continuing nuisance action are recoverable in that action. *Renz v 33rd Dist. Agric. Ass'n* (1995) 39 CA4th 61, 46 CR2d 67. Language in *Baker v Burbank-Glendale-Pasadena Airport Auth.,* 39 C3d at 869, suggesting that damages incurred after commencement of the action were not recoverable in that action, was dismissed as dicta. 39 CA4th at 67. A person who obtains an injunction against a nuisance cannot recover damages for diminution in value but can bring a subsequent action for the damage that resulted during the period of the nuisance prior to abatement or for damages if the abatement is inadequate. *Alexander v McKnight* (1992) 7 CA4th 973, 9 CR2d 453; *Guttinger v Calaveras Cement Co.* (1958) 160 CA2d 460, 325 P2d 145.

Diminution of value damages and stigma damages are not recoverable in continuing trespass or continuing nuisance cases; damages are limited to abatement and to damages for loss of use. *Gehr v Baker Hughes Oil Fields Operations, Inc.* (2008) 165 CA4th 660, 666, 81 CR3d 219; *Santa Fe Partnership v ARCO Prods. Co.* (1996) 46 CA4th 967, 977, 54 CR2d 214. Damages for diminution in value caused by a nuisance are inappropriate when equitable relief is granted requiring abatement of the nuisance because the defendant is presumed to comply with the order. But see *Rhodes v San Mateo Inv. Co., supra* (although plaintiff obtained injunction requiring defendant to stabilize hill to prevent slides, plaintiff was also entitled to damages for fear and worry caused by future threatened damage).

If dirt, gravel, or other physical substances are deposited on the property, however, the injured party may recover the cost of removal and restoration or loss of market value, whichever is more appropriate to compensate the injured party, usually the lesser of the two amounts. After a plaintiff establishes decreased market value, the defendant has the burden of proving that restoration costs would be less. *Armitage v Decker* (1990) 218 CA3d 887, 904, 267 CR 399. The cost of testing property allegedly polluted with hazardous waste by a former tenant is a compensable injury for a continuing nuisance to the owners under CC §3493. *Mangini v Aerojet-General Corp.* (1991) 230 CA3d 1125, 1138, 281 CR 827 (*Mangini I*).

The mechanical rule that diminution in value and stigma damages are not recoverable under any circumstances in a continuing nuisance or trespass action is arguably unnecessary and in certain circumstances results in injustice. See, *e.g., FDIC v Jackson-Shaw Partners No. 46, Ltd., supra* (court refused to grant damages for loss of use or diminution in value of property). The purpose of the rule is to avoid a double recovery (*i.e.,* if a nuisance is continuing, an owner or a series of owners should not be able to recover more than once for the same diminution in value). The rule incorrectly assumes that diminution in value will never occur when an injunction against the offending activity is granted. See, *e.g., Alexander v McKnight* (1992) 7 CA4th 973, 978, 9 CR2d 453 (suggested that damaged party might be able to recover actual diminution in value caused by unabated continuing nuisance, but reversed award of diminution damages because trial court had granted injunctive relief). See also *Santa Fe Partnership v ARCO Prods. Co., supra*. Arguably, this rule is not necessary to prevent double recovery and should be reexamined.

For example, if a party sells a parcel of real property that contains or is affected by a continuing nuisance and receives less than the fair market value for the property because of that nuisance, that party should be able to recover damages for lost value. This result would not constitute a double recovery. First, these damages, once incurred, belong to the owner at the time the damages were inflicted and are not being passed on to future owners. *Vaughn v Dame Constr. Co.* (1990) 223 CA3d 144, 272 CR 261. Second, the owner/seller is legally obligated to disclose this condition to the buyer. As a result, the buyer will presumably pay less for the property than it would have without the disclosure of the nuisance. This is the difference the seller would be entitled to recover as diminution in value. A buyer who pays a reduced price based on the disclosure will not suffer the same damages during its ownership and would have no basis on which to recover them. See extended discussion of seller's duty to disclose known property conditions in *Newhall Land & Farming Co. v Superior Court* (1993) 19 CA4th 334, 23 CR2d 377.

Finally, even if the nuisance is abated by compliance with a court order or statutory mandate, a seller must disclose some types of neighborhood problems even if they occurred in the past, such as noise and other nuisances. See, ***e.g.,*** *Alexander v McKnight* (1992) 7 CA4th 973, 977, 9 CR2d 453, in which the court characterized the noise as primarily psychological, with "no guaranteed physical solution" to prevent the offending neighbors from reverting to their illegal behavior. 7 CA4th at 980. See also *Santa Fe Partnership v ARCO Prods. Co., supra,* in which the court acknowledged that the nature of the nuisance was contaminated soil that might take a long time to clean up, and during that time the owner would suffer stigma damages. Arguably, the reality of the marketplace is that often, even after remediation, the property will remain stigmatized. If a buyer offers less than the market value for the property because of the seller's disclosure of a prior nuisance, arguably that is damage the seller should be able to recover. For further discussion of the seller's and broker's duties to disclose, see California Real Property Sales Transactions §§6.34-6.70 (4th ed Cal CEB 2007); Handling Real Property Sales Transactions, steps 4-16 (Cal CEB Action Guide April 2007).

Moreover, even when the damages were not incurred, the courts should not apply a mechanical rule. There are better ways to prevent double recovery and, at the same time, compensate injured parties. Rather than using a mechanical rule that all prospective damages are not recoverable under any circumstances when the nuisance or trespass is continuing, the courts should adopt a more flexible test such as the six-prong test used by the California Supreme Court in *Biakanja v Irving* (1958) 49 C2d 647, 320 P2d 16. This type of approach was discussed in *Beck Dev. Co. v Southern Pac. Transp. Co.* (1996) 44 CA4th 1160, 52 CR2d 518.

PRACTICE TIP: In furtherance of equity to all parties, the California Supreme Court could unbundle the concept of damages from the classification of the nuisance as permanent or continuing. These classifications could still be used for determining the statute of limitations. As the dissent in *Mangini v Aerojet-General Corp.* (1996) 12 C4th 1087, 51 CR2d 272 (*Mangini II*), pointed out, it may be appropriate for the court to use a different rule for damages from that used to calculate the statute of limitations. The dissent suggested that the unabated nuisance in *Mangini* could be treated as continuing for purposes of the statute of limitations and permanent or continuing for purposes of damages at the option of the plaintiff.

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§5.29 2. Permanent Nuisance

In an action for permanent nuisance, the plaintiff can recover for both past and future damages. *Baker v Burbank-Glendale-Pasadena Airport Auth.* (1985) 39 C3d 862, 869, 218 CR 293; *Razzano v Kent* (1947) 78 CA2d 254, 177 P2d 612; *Williams v Southern Pac. R.R.* (1907) 150 C 624, 89 P 599.

The damage for a permanent nuisance is measured by the loss of the market value caused by the nuisance. CC §3333; *Spaulding v Cameron* (1954) 127 CA2d 698, 704, 274 P2d 177; *Guttinger v Calaveras Cement Co.* (1951) 105 CA2d 382, 233 P2d 914. Although there are no California cases on point, it appears that the valuation is set on the date that the nuisance became permanent. *Bartleson v U.S.* (9th Cir 1996) 96 F3d 1270; Restatement (Second) of Torts §930(3)(b) (1979).

A plaintiff may recover for diminution in property value due to a stigma caused by a permanent nuisance. *Bartleson v U.S.* (9th Cir 1996) 96 F3d 1270 (applying California law, court upheld damages to plaintiffs due to stigma caused by past shelling of their properties adjacent to artillery range). Stigma damages are not allowed in a continuing nuisance action. *Santa Fe Partnership v ARCO Prods. Co*. (1996) 46 CA4th 967, 977, 54 CR2d 214. See also *FDIC v Jackson-Shaw Partners No. 46, Ltd*. (ND Cal 1994) 850 F Supp 839, 844 (diminution of value damages are not compensable in continuing trespass or continuing nuisance cases; damages are limited to abatement and loss of use).

For a discussion of the evidence a jury may consider in arriving at the property's value, see *Los Angeles County Flood Control Dist. v Abbot* (1938) 24 CA2d 728, 76 P2d 188. The court held that, in determining value for eminent domain purposes, the jury could consider the condition of the property, the use to which it had been put, advantages of making practical use of the property, and the reasonable expectation of such advantages. *Los Angeles County Flood Control Dist. v Abbot, supra*.

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§5.30 3. Continuing Trespass

If a trespass can be enjoined or if it causes only temporary injury, the injured party can recover damages resulting from the original wrong. It can bring separate and successive actions for continuing damages caused by the trespass. *Kafka v Bozio* (1923) 191 C 746, 218 P 753; *Bertram v Orlando* (1951) 102 CA2d 506, 227 P2d 894.

Civil Code §3334 allows the plaintiff to recover the value of the loss of use of the property resulting from the trespass. The value is defined as the greater of the reasonable rental value or the benefit obtained by the trespasser (CC §3334(b)(1)), as well as the reasonable cost of restoration or repair and the cost of recovering possession (CC §3334(a)).

In order to meet the "benefits obtained" tests, the trespass must result in something advantageous for the trespasser. That is, the trespass itself must provide the trespasser with a financial or business advantage. *Watson Land Co. v Shell Oil Co.* (2005) 130 CA4th 69, 77, 29 CR3d 343. In *Watson* the court held that a gas line leak from a pipeline on the plaintiff's property did not constitute "benefits" within the meaning of CC §3334. The court rejected the plaintiff's contention that "benefits" included the avoidance of remediation costs. In dicta, the court stated that a polluter who dumped toxic waste in the desert instead of paying to properly dispose of toxic waste does gain the financial advantage of getting either free disposal or cheaper disposal. The court found no such financial advantage accruing to the owner of a leaking pipeline. 130 CA4th at 78.

The owner of land can recover damages for the value of the use of the property by a trespasser, even if the owner suffered no actual loss of rents. CC §3334; *Don v Trojan Constr. Co.* (1960) 178 CA2d 135, 2 CR 626. If the wrongful occupation of the real property is the result of mistake of fact by the wrongful occupier, the value of the use of the property is the reasonable rental value. CC §3334(b)(2).

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§5.31 4. Permanent Trespass

When the trespass is of a permanent nature, all damages past and prospective are recoverable in one action. *Kafka v Bozio* (1923) 191 C 746, 750, 218 P 753; *Bertram v Orlando* (1951) 102 CA2d 506, 227 P2d 894. When injury to real property from trespass is permanent, the measure of damages is the difference between the market value of the property before and after the injury. *Perkins v Blauth* (1912) 163 C 782, 127 P 50; *Revis v I. S. Chapman & Co.* (1933) 130 CA 109, 19 P2d 511; *Hancock v George R. Curtis Paving Co.* (1931) 114 CA 624, 300 P 65. On permanent injury, see *Guttinger v Calaveras Cement Co.* (1951) 105 CA2d 382, 233 P2d 914. For a description of various kinds of permanent injuries and applicable cases, see 6 Witkin, Summary of California Law, *Torts* §1727 (10th ed 2005).

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§5.32 G. Injury to Products of Real Property

The measure of damages for injury to or removal of mature, non-fruit-bearing trees, *i.e.,* timber, without injury to the real property, is the value of the trees without consideration of the value of the real property. *Doak v Mammoth Copper Mining Co.* (ND Cal 1911) 192 F 748. The destruction of growing forest trees is treated as an injury to the land, and the measure of damages is the difference between the value of the land before destruction of the trees and its value after such destruction. *Doak v Mammoth Copper Mining Co., supra.* This is also the measure of damages in the case of injury to or destruction of fruit trees. *Montgomery v Locke* (1887) 72 C 75, 13 P 401. See *Hill v Morrison* (1928) 88 CA 405, 263 P 573.

On the possibility of recovery of damages in the amount of twice or three times the actual detriment from injury to or removal of timber, trees, or underwood, see CC §3346; *Drewry v Welch* (1965) 236 CA2d 159, 46 CR 65; *Caldwell v Walker* (1963) 211 CA2d 758, 27 CR 675. For a detailed discussion of CC §3346, see 6 Witkin, Summary of California Law, *Torts* §§1732-1734 (10th ed 2005).

The measure of damages for injury to or destruction of a growing crop is the value of the crop on the date of and at the place of destruction, *i.e.,* the market value of the estimated crop, less the harvesting, production, and marketing costs. *Teller v Bay & River Dredging Co.* (1907) 151 C 209, 90 P 942. These costs are not deducted if the crop was fully matured at the time of injury and the plaintiff has paid them. If the crop has been completely destroyed, however, harvesting costs are deductible from market value. See *Dutra v Cabral* (1947) 80 CA2d 114, 181 P2d 26. For a more detailed discussion of measure of damages in a pollution situation, see §5.54.

If nursery stock is proved to have been diseased when purchased, the injured purchaser is not limited to damages specified under *Posz v Burchell* (1962) 209 CA2d 324, 25 CR 896, *i.e.,* the difference between the value of the land as planted with the trees or nursery stock as delivered and the value the land would have had if it had been planted with nursery stock of the kind warranted. Rather, the grower may also seek to recover lost profits as well as other incidental and consequential damages. *Serian Bros., Inc. v Agri-Sun Nursery* (1994) 25 CA4th 306, 30 CR2d 382. See also *Santa Barbara Pistachio Ranch v Chowchilla Water Dist.* (2001) 88 CA4th 439, 105 CR2d 856 (discussing *Posz* and *Serian Bros.*).

On the various measures of damages for destruction of a crop without market value, see *Murphy v Nielsen* (1955) 132 CA2d 396, 282 P2d 126; *Zuolanek v Bodger Seeds* (1935) 5 CA2d 106, 42 P2d 92; *Miller & Lux v Pinelli* (1927) 84 CA 42, 257 P 573.

The measure of damages for destruction of a perennial crop, such as grazing land or alfalfa, is the difference between rental value of the real property with and without the crop. If the crop is not totally destroyed, the measure is the local market value of the crop less production and marketing costs. *Staub v Muller* (1936) 7 C2d 221, 60 P2d 283. But see *Lowe v Yolo County Consol. Water Co.* (1910) 157 C 503, 108 P 297 (measure for total destruction was cost of reseeding plus loss of profits).

When a trespass due to inadvertence or honest mistake results in the severance and appropriation of raw materials, such as coal, oil, or gas, the measure of damages is the value of the removed product at the time of taking less the cost of extraction. *Maye v Yappen* (1863) 23 C 306. See *Whittaker v Otto* (1967) 248 CA2d 666, 56 CR 836; *Daly v Smith* (1963) 220 CA2d 592, 33 CR 920; *Union Oil Co. v Mutual Oil Co.* (1937) 19 CA2d 409, 65 P2d 896. For a discussion of the test of innocent trespass, see 6 Witkin, Summary, *Torts* §§1726, 1736. If the trespass is intentional, the measure of damages is the value of the product after removal without deduction for the expense of removal. *Lightner Mining Co. v Lane* (1911) 161 C 689, 120 P 771; *Dolch v Ramsey* (1943) 57 CA2d 99, 134 P2d 19; *Union Oil Co. v Reconstruction Oil Co*. (1937) 20 CA2d 170, 66 P2d 1215.

If a demand is made for the extracted product and an action is later brought for its conversion, the measure of damages is its value at the time of the conversion, without deduction of extraction expenses. *Maye v Yappen, supra.*

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§5.33 H. Damage, Destruction, or Removal of Fixtures or Personal Property

If a fixture is removed or destroyed, the measure of damages is the difference between the value of the real property before and after removal or destruction of the fixture. *Rhoda v Alameda County* (1881) 58 C 357; *Wilmerton v Morton* (1946) 74 CA2d 891, 169 P2d 992; *Givens v Markall* (1942) 51 CA2d 374, 124 P2d 839. In addition, CC §1013.5, allowing removal of improvements erroneously placed on another's land in good faith, may apply if its conditions are met.

For the total destruction of a building or other structures on real property, the measure of damages is the difference between fair market value of the property immediately before destruction and the value immediately after. Loss of use is not recoverable. *Ferraro v Southern Cal. Gas Co.* (1980) 102 CA3d 33, 162 CR 238. Conversely, the measure of damages that may be used for injury to a building is the reasonable cost of repair plus loss of rent if the building was leased. *Linforth v San Francisco Gas & Elec. Co.* (1909) 156 C 58, 103 P 320.

If the property removed or damaged is not affixed and remains personal property, the measure of damages for harm to the real property is the difference in the real property's value immediately before the injury and immediately after, unless the cost of restoration is less than the difference, in which event the proper measure of damages is the cost of repair. *Cornell v Sennes* (1971) 18 CA3d 126, 136, 95 CR 728. See also remedies for conversion in §4.46.

Under CC §987, an artist may recover damages for injury to his or her reputation as the result of the destruction or physical alteration of the artist's work of art. In *Lubner v City of Los Angeles* (1996) 45 CA4th 525, 53 CR2d 24, the court held that CC §987 does not authorize the recovery of damages for the *negligent* destruction or alteration of art. In addition, the court held that the enactment of the federal Visual Artists Rights Act of 1990 (Pub L 101-650 §§601-610, 104 Stat 5128) preempts the creation of a common law right of recovery for such injury. The court also rejected the plaintiffs' attempts to recover damages for emotional distress suffered as a result of the destruction to their artwork, citing *Cooper v Superior Court* (1984) 153 CA3d 1008, 1012, 200 CR 746, which held that recovery for emotional distress caused by injury to property is permitted only when there is a preexisting relationship between the parties or an intentional tort.

The *value to the owner* might be the measure of damages if the property has little value as compared with special value to the owner. See *Willard v Valley Gas & Fuel Co.* (1915) 171 C 9, 151 P 286. For example, this measure of damages might be applied to a painting, and the time it took to produce it might be evidence of the amount of special value.

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§5.34 I. Injury to Persons

Damages may be recovered for annoyance and discomfort and for mental suffering, without physical injury, resulting from a nuisance or trespass. *Acadia, Cal., Ltd. v Herbert* (1960) 54 C2d 328, 337, 5 CR 686 (plaintiff could recover for loss of wife's services when she received extensive medical treatment and hospitalization because of defendant's willful conduct); *Kornoff v Kingsburg Cotton Oil Co.* (1955) 45 C2d 265, 272, 288 P2d 507; *Lew v Superior Court* (1993) 20 CA4th 866, 873, 25 CR2d 42.

The plaintiff need not prove impairment of health. *Bartleson v U.S.* (9th Cir 1996) 96 F3d 1270; *Judson v Los Angeles Suburban Gas Co.* (1910) 157 C 168, 106 P 581. In some instances, an owner may recover damages for mental suffering caused by fear for his or her safety or that of family members and guests. *Potter v Firestone Tire & Rubber Co.* (1993) 6 C4th 965, 997, 25 CR2d 550 (exposure to toxic emissions); *Herzog v Grosso* (1953) 41 C2d 219, 259 P2d 429; *Macy's Cal., Inc. v Superior Court* (1995) 41 CA4th 744, 48 CR2d 496 (scratch from hypodermic needle possibly contaminated with AIDS virus); *Koll-Irvine Ctr. Prop. Owners Ass'n v County of Orange* (1994) 24 CA4th 1036, 1041, 29 CR2d 664; *Alexander v McKnight* (1992) 7 CA4th 973, 9 CR2d 453 (negligently and intentionally caused emotional distress by problem neighbors).

Damages for mental suffering can be recovered even if the nuisance does not injure or decrease the value of the property. *Coats v Atchison, T. & S. F. Ry. (*1905) 1 CA 441, 82 P 640. Damages for discomfort flowing from a nuisance are recoverable in addition to damages for injury to real property caused by the nuisance. *Kornoff v Kingsburg Cotton Oil Co.* (1955) 45 C2d 265, 288 P2d 507; *Spaulding v Cameron* (1954) 127 CA2d 698, 274 P2d 177; *Ingram v City of Gridley* (1950) 100 CA2d 815, 224 P2d 798; *Bartleson v U.S., supra*.

For discussion of the independent tort of intentional infliction of emotional distress, see California Tort Damages, chap 6 (2d ed Cal CEB 2002).

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§5.35 J. Lost Profits

Lost profits may be a proper measure of damages for a trespass and nuisance. CC §3334(b)(1); *Natural Soda Prods. Co. v City of Los Angeles* (1943) 23 C2d 193, 143 P2d 12; *Bailey v Outdoor Media Group* (2007) 155 CA4th 778, 787, 66 CR3d 322. To recover lost profits, the plaintiff must show probable income and expense of the business as a whole, based on operating experience, sufficient to permit a reasonable estimate to be made. *Guttinger v Calaveras Cement Co.* (1951) 105 CA2d 382, 233 P2d 914; *Bailey,* 155 CA4th at 789 (net profit, not gross revenue, is appropriate measure of damages for wrongful occupation of property under CC §3334 "benefits obtained" measure of damages).

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§5.36 K. Attorney Fees

Attorney fees are not recoverable in California unless authorized by statute or contract. CCP §1021. There is no general statutory provision for attorney fees in tort actions (*Falk v Waterman* (1874) 49 C 224), but attorney fees may be awarded in a tort action between contracting parties if their contract so provides (*Xuereb v Marcus & Millichap, Inc.* (1992) 3 CA4th 1338, 1342, 5 CR2d 154).

Civil Code §3496 provides for recovery of costs, including costs of investigation, discovery, and attorney fees, in certain public nuisance cases brought by a governmental agency. Under Govt C §38733.5(b), any ordinance that allows recovery of attorney fees in a public nuisance abatement action must allow recovery of attorney fees by the prevailing party and not just the prevailing municipality. See *City of Monte Sereno v Padgett* (2007) 149 CA4th 1530, 1536, 58 CR3d 218 (reversing trial court's award of attorney fees where local ordinance limited recovery of attorney fees to city). In addition, attorney fees may be awarded under the private attorney general theory codified in CCP §1021.5 or under the nonstatutory substantial benefit rule for litigation that effectuates state environmental policies. See California Attorney Fee Awards, chap 3 (2d ed Cal CEB 1994).

Code of Civil Procedure §1021.9 authorizes an award of attorney fees when a trespass occurs on land under cultivation or used for grazing. A back yard or an urban garden does not qualify. *Quarterman v Kefauver* (1997) 55 CA4th 1366, 64 CR2d 741. It is unnecessary, however, that the cultivation or grazing be conducted for commercial purposes. *Haworth v Lira* (1991) 232 CA3d 1362, 284 CR 62.

A prevailing party in environmental litigation may be entitled to an award of attorney fees under federal law. A fee award may be available under the Equal Access to Justice Act (28 USC §2412) to an environmental litigant who prevails against the United States or a federal government agency. See, *e.g., Environmental Defense Fund, Inc. v Environmental Protection Agency* (DC Cir 1983) 716 F2d 915 (attorney fees awarded despite agency action in response to suit that rendered petition for review moot). See also *Environmental Defense Fund v Watt* (ED NY 1982) 554 F Supp 36 (unnecessary to prevail on all claims or to secure final judgment in order to prevail for fee purposes; party who obtains beneficial settlement may be deemed "prevailing party"). Attorney fees may also be awarded under the following federal statutes: the Clean Air Act (42 USC §7607(f)); the Federal Water Pollution Control Act (33 USC §1365(d)); the Marine Protection, Research, and Sanctuaries Act of 1972 (33 USC §1415(g)(4)); the Noise Control Act of 1972 (42 USC §4911(d)); and the Resource Conservation and Recovery Act (42 USC §6972(e)). For a discussion of attorney fees under the Comprehensive Environmental Response, Compensation, and Liability Act of 1980 (CERCLA) (42 USC §§9601-9675), see *Key Tronic Corp. v U.S.* (1994) 511 US 809, 128 L Ed 2d 797, 114 S Ct 1960. An attorney litigating a case in propria persona may not recover attorney fees because actual attorney fees were not incurred. *Trope v Katz* (1995) 11 C4th 274, 45 CR2d 241.

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§5.37 L. Prejudgment Interest

Prejudgment interest from the date of injury is generally not recoverable in nuisance and trespass actions, because the damages are unliquidated. CC §§3287-3288; *Perkins v Blauth* (1912) 163 C 782, 127 P 50. But if the damages sought are liquidated or are sufficiently capable of calculation, they may qualify for an award under CC §3287(a). *Amador Valley Investors v City of Livermore* (1974) 43 CA3d 483, 117 CR 749 (interest allowed on damages for wrongful discharge of sewage onto plaintiff's property in inverse condemnation action). Prejudgment interest may also be recovered as a cost in contribution actions under the Comprehensive Environmental Response, Compensation, and Liability Act of 1980 (CERCLA) (42 USC §§9601-9675). 42 USC §§9607(a), 9613(f).

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§5.38 M. Punitive Damages

Civil Code §3294(a) provides that, in an action for breach of an obligation not arising from contract, exemplary and punitive damages are recoverable when clear and convincing evidence proves that the defendant is guilty of oppression, fraud, or malice. Malice includes not only conduct that the defendant intended to cause injury to the plaintiff, but also despicable conduct carried on with a willful and conscious disregard of the rights or safety of others. CC §3294(c)(1).

Under older case law, punitive damages were recoverable when a nuisance was willfully created, was dangerous, and substantially impaired the use and enjoyment of the property (*McIvor v Mercer-Fraser Co.* (1946) 76 CA2d 247, 254, 172 P2d 758), but recovery would be governed by the current standards created under more recent amendments to CC §3294. Punitive damages have also been allowed for encroachment. *Goshgarian v George* (1984) 161 CA3d 1214, 208 CR 321. Punitive damages, however, are not recoverable when the defendant has made a good faith effort to control the nuisance or trespass. See 13 Witkin, Summary of California Law, *Equity* §153 (10th ed 2005).

In addition, punitive damages may not be used to punish a defendant for injuries to nonparties. *Philip Morris USA v Williams* (2007) 549 US 346, 166 L Ed 2d 940, 948, 127 S Ct 1057; *Bullock v Philip Morris USA* (2008) 159 CA4th 655, 693, 71 CR3d 775. Further, dissimilar acts, independent of the conduct on which liability is premised, cannot serve as the basis either for the defendant's liability for punitive damages or for a determination of the amount of punitive damages. *Holdgrafer v Unocal Corp.* (2008) 160 CA4th 907, 928, 73 CR3d 216. On appealing excessive punitive damage awards, see §1.34.

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Source: Civil Litigation/California Attorney's Guide to Damages/5 Injury to Property/§5.39 N. Statutory Limitations on Recovery

§5.39 N. Statutory Limitations on Recovery

The California legislature has enacted statutes that limit the recovery of damages arising from certain types of activities. Parties must research this subject as it applies to the facts of their case. These limitations apply if the conduct or condition alleged to be a nuisance is expressly authorized or so clearly implied that it is apparent that the legislative body contemplated protection of the acts causing the nuisance. See *Greater Westchester Homeowners Ass'n v City of Los Angeles* (1979) 26 C3d 86, 160 CR 733. Some examples of these statutes are:

- Outdoor shooting ranges (CC §3482.1);
- Preexisting agricultural activities, operations, or facilities (CC §3482.5); and
- Preexisting agricultural processing activities, operations, and facilities involving dairy products, meat, rendering plants, eggs, fruits, grains, beer and wine, and collection centers (CC §3482.6).

It is the court's decision whether the plaintiff's claim is contrary to the legislative policy in a particular statute or regulation. For example, the California Supreme Court held that property owners may not seek damages against a public utility for diminution in property value caused by fear of electromagnetic fields, because such a recovery would interfere with Public Utilities Commission policies as adopted in public utilities regulations. *San Diego Gas & Elec. Co. v Superior Court* (1996) 13 C4th 893, 55 CR2d 724. See also Coon, *Case Comment: San Diego Gas & Electric Co*., 19 CEB Real Prop L Rep 209 (Oct 1996).

For a case giving a narrower application of statutory limitations, see *Jones v Union Pac. R.R.* (2000) 79 CA4th 1053, 94 CR2d 661.

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VII. DEFENSES

§5.40 A. Comparative Fault

Proposition 51 (CC §§1431-1431.5) limits liability for noneconomic damages to the amount allocated to the defendant in direct proportion to that defendant's percentage of fault. Noneconomic damages are defined as subjective, nonmonetary losses, including, but not limited to, pain, suffering, inconvenience, mental suffering, emotional distress, loss of society and companionship, loss of consortium, injury to reputation, and humiliation. CC §1431.2(b)(2). A defendant's liability for noneconomic damages is limited to its proportionate share of fault relative to all those responsible for the injuries, whether or not they are parties to the lawsuit.

Comparative negligence is a defense when the nuisance action seeks personal injury, property, or wrongful death damages resulting from negligent conduct. It is not a defense when the harm is intentional or the result of recklessness. *Tint v Sanborn* (1989) 211 CA3d 1225, 1229, 259 CR 902. When the nuisance is the result of an abnormally dangerous condition or activity, contributory negligence is a defense only if the plaintiff has voluntarily and unreasonably subjected him- or herself to the risk of harm. *Tint v Sanborn, supra;* Restatement (Second) of Torts §840B (1979). Comparative fault is not a defense when the plaintiff seeks an injunction as the remedy. *Kafka v Bozio* (1923) 191 C 746, 749, 218 P 753.

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B. Statutes of Limitations and Repose

§5.41 1. Public Nuisance and Trespass

There is no statute of limitations for a public nuisance. CC §3490; *People v Mason* (1981) 124 CA3d 348, 353, 177 CR 284. A public nuisance cannot be legalized by lapse of time. CC §3490. Therefore, the statute of limitations and consent are not a defense to public nuisance, and there can be no prescriptive rights to maintain a public nuisance. This rule does not apply to a private nuisance action for damages or a private action to abate an unlawful condition. *Mangini v Aerojet-General Corp.* (1991) 230 CA3d 1125, 1142, 281 CR 827 (*Mangini I*). In spite of the general rule, laches may apply to a public nuisance when the delay results in prejudice and there is no reasonable explanation for the delay. The same result may follow on the theory of estoppel. See *City & County of San Francisco v Pacello* (1978) 85 CA3d 637, 645, 149 CR 705.

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§5.42 2. Private Nuisance and Trespass

Applicable statutes of limitations for a private nuisance are three years for property damage and one year for bodily injury. CCP §§338(b), 340(3). In private nuisance and trespass cases, it is necessary to consider both the harm and the discovery of the harm in order to determine when the limitation period commences. See *Camsi IV v Hunter Technology Corp.* (1991) 230 CA3d 1525, 282 CR 80. In actions involving trespass or nuisance, the injury is considered to be to the property itself, not to the owner. 230 CA3d at 1534. Thus, as soon as the defendant's acts cause immediate and permanent injury to the property (unless the discovery rule applies), the statute of limitations begins to run. 230 CA4th at 1535. If the defendant has caused injury by a series of acts, the cause of action can generally be brought within the limitation period running from the last act. 230 CA4th at 1534.

However, there is a distinction between harm to the real property and harm to the owner's interest in the property and the two do not necessarily occur at the same time. 230 CA4th at 1535. Thus, an owner who took title to property after an immediate and permanent injury had occurred may be entitled to maintain a tort action based on that injury if the previous owner had not discovered the damage. 230 CA4th at 1536. Under the discovery rule, a cause of action belongs to the owner who first discovered or ought to have discovered the property damage. *Siegel v Anderson Homes, Inc.* (2004) 118 CA4th 994, 1009, 13 CR3d 462.

The *Camsi IV* property had been damaged prior to sale and the prior owner knew or should have known about the damage. Under those facts, the new owner's cause of action most likely would be a claim against the prior owner for failure to disclose. 118 CA4th at 1009. On the other hand, if the property had been damaged prior to sale, but the prior owner sold it in good faith without knowledge of the damage, at a price that did not reflect the damage, then the prior owner would have suffered no damage. The new owner, however, who discovers the damage after purchase has a claim against the person or entity that caused the damage because the new owner is the only party capable of maintaining a legal claim who has also suffered a compensable injury. 118 CA4th at 1009.

An owner who is aware of damage to his property may deliberately transfer the cause of action to another. 118 CA4th at 1005. Without some clear manifestation of such intent, however, the cause of action is not transferred to the subsequent owner. 118 CA4th at 1005. Once the statute of limitations bars a claim, all subsequent owners are also barred unless the damage suffered by the subsequent owner is fundamentally different from the earlier damage. 118 CA4th at 1006. In the usual case, a subsequent owner will not be personally harmed by the tort until he or she becomes owner of the property.

The statute does not commence to run anew every time ownership of the property changes hands. *Beck Dev. Co. v Southern Pac. Transp. Co.* (1996) 44 CA4th 1160, 1215, 52 CR2d 518. See also *CAMSI IV v Hunter Technol. Corp.* (1991) 230 CA3d 1525, 1534, 282 CR 80. The expiration of the limitation period bars an action by all successors in interest. *Beck Dev. Co. v Southern Pac. Transport Co., supra; Camsi IV v Hunter Technol. Corp., supra*. This rule means that a party can acquire a prescriptive right to maintain a private nuisance.

In a nuisance action, the plaintiff can recover damages that accrue between the commencement and the conclusion of the action. CC §3283; *Renz v 33rd Dist. Agric. Ass'n* (1995) 39 CA4th 61, 68, 46 CR2d 67. (Note, however, that *Baker v Burbank-Glendale-Pasadena Airport Auth.* (1985) 39 C3d 862, 218 CR 293, suggests the contrary in dicta at 39 C3d at 869.)

To calculate when the statute of limitations begins to run in a nuisance action, counsel must ascertain whether the nuisance is permanent or continuing. See §§5.43-5.44.

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§5.43 a. Permanent Nuisance and Trespass

The statute of limitations for permanent nuisance commences from the time that (1) the permanent nuisance is created, (2) the property suffers actual and appreciable harm, and (3) the plaintiff discovers or should have discovered the injury and its cause through reasonable diligence. *Wilshire Westwood Assocs. v Atlantic Richfield Co.* (1993) 20 CA4th 732, 739, 24 CR2d 562; *Lyles v State* (2007) 153 CA4th 281, 291, 62 CR3d 696. The cause of action for nuisance accrues when the consequential damages are sufficiently apparent to give a reasonable person notice that he or she has a duty to pursue legal remedies. In contamination cases, the actual and appreciable harm is the placing of hazardous material in the soil or groundwater and not the order to clean up the property. In contrast, a cause of action for trespass accrues when the land is entered. *CAMSI IV v Hunter Technol. Corp.* (1991) 230 CA3d 1525, 1534, 282 CR 80.

The fact that the plaintiff is not aware of the cause of action or the wrongdoer does not necessarily toll the statute. *Angeles Chem. Co. v Spencer & Jones* (1996) 44 CA4th 112, 51 CR2d 594 (federal environmental cleanup "discovery rule" supersedes state limitation period). California's late discovery rule postpones the running of the statute of limitations until the plaintiff discovers or should have discovered all facts essential to its cause of action. A plaintiff is charged with presumptive knowledge when it has notice or information of circumstances to put a reasonable person on inquiry or has the opportunity to obtain knowledge from sources open to its investigation. This is an objective test based on whether the facts would make a reasonably prudent person suspicious. *Wilshire Westwood Assocs. v Atlantic Richfield Co., supra*.

When the complaint demonstrates on its face that the cause of action is barred by the statute of limitations, the plaintiff has the burden to plead the reasons for the late discovery. The plaintiff must specifically plead facts that show the time and manner of discovery and the inability to have made an earlier discovery despite reasonable diligence. *CAMSI IV v Hunter Technol. Corp., supra*. Whether a plaintiff's late discovery is justified is a factual question that may be decided by a jury. See *Smith v County of Los Angeles* (1989) 214 CA3d 266, 281, 262 CR 754 (noting determination of when statute of limitations on cause of action began to run is question of fact).

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Source: Civil Litigation/California Attorney's Guide to Damages/5 Injury to Property/§5.44 b. Continuing Nuisance and Trespass

§5.44 b. Continuing Nuisance and Trespass

Because plaintiffs may bring successive actions for damages until the nuisance or trespass is abated, a continuing nuisance or trespass effectively has no statute of limitations. If the nuisance is continuing, every continuation or repetition of the nuisance gives rise to a separate claim for damages caused by the nuisance. If the nuisance is continuing, the person harmed may bring successive actions for damage until the nuisance is abated. *Baker v Burbank-Glendale-Pasadena Airport Auth.* (1985) 39 C3d 862, 218 CR 293; *Wilshire Westwood Assocs. v Atlantic Richfield Co.* (1993) 20 CA4th 732, 24 CR2d 562.

The continuing nature of the nuisance refers to continuing damage caused by the offensive conduct, not to the acts causing the offensive conditions to occur. *Mangini v Aerojet-General Corp.* (1991) 230 CA3d 1125, 1147, 281 CR 827 (*Mangini I*). When continuing or recurring injury results from a wrongful act or from a condition wrongfully created and maintained, there is not only a cause of action for the original wrong arising when the wrong is committed, but separate and successive causes of action for the consequential damages that arise as and when such damages are sustained. Therefore, as long as the cause of action exists and damage continues, the plaintiff may recover for the damages that have occurred within the statutory period, even if the cause of action based solely on the original wrong is barred. *Phillips v City of Pasadena* (1945) 27 C2d 104, 162 P2d 625; *Kafka v Bozio* (1923) 191 C 746, 751, 218 P 753.

The policy of the law is to construe a nuisance as continuing rather than permanent. See §5.16. Therefore, if the permanency of an injury caused by a nuisance is in doubt, the courts favor the right to successive actions. See, *e.g., Kafka v Bozio, supra*. The courts should be reluctant to enlarge the category of permanent nuisance. See *Baker v Burbank-Glendale-Pasadena Airport Auth.* (1985) 39 C3d 862, 872, 218 CR 293. Otherwise the effect would be to give the defendant, because of its wrongful act, the right to continue the wrong. *Kafka v Bozio, supra*.

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Source: Civil Litigation/California Attorney's Guide to Damages/5 Injury to Property/§5.44A c. 'Improvement' as Continuing Nuisance

§5.44A c. "Improvement" as Continuing Nuisance

If the construction or operation of a mechanism that constitutes the nuisance is an "improvement" as defined in the 10-year statute of repose (CCP §337.15), the continuing nature of the nuisance does not extend the 10-year limit imposed by that statute. *Gaggero v County of San Diego* (2004) 124 CA4th 609, 618, 21 CR3d 388. In *Gaggero,* plaintiffs purchased a landfill in 1974 that had been operated by the county from 1959 to 1967. In 1998 and 1999, severe subsidence occurred at the landfill, causing major damage to plaintiffs' improvements on the property. The plaintiffs contended that the subsidence was the result of defective design and operation of the landfill. They alleged that decomposition of material placed in the landfill produced methane gas, which in turn created void pockets in areas beneath the landfill covering. Plaintiffs contended that the landfill was a continuing nuisance because it continued to produce the methane gas that in turn created the soil subsidence. The court found that the landfill was an "improvement" within the meaning of CCP §§337.15. The court further found that the continuing nature of the nuisance did not extend the 10-year statute of repose.

The statute has also been interpreted to apply to claims against governmental and public entities. *Magnuson-Hoyt v County of Contra Costa* (1991) 228 CA3d 139, 144, 278 CR 770. In *Magnuson,* a home owner brought an action against the City of Lafayette and Contra Costa County, alleging that landslide damage to her property was caused by the manner in which an adjoining public street was constructed. The street had been constructed in 1968 by Contra Costa County. The City of Lafayette became the owner of the street shortly after the street was completed and had exclusive title to the street since July of 1968. The county provided maintenance services for the street until 1977 and had no involvement in the street after that date. The property was damaged in 1987. The plaintiff brought an action for inverse condemnation. The court held that the action was one involving latent deficiency in the design specification or construction of an improvement to real property. It found that these activities are covered by the statute. It further held that the provisions of CCP §337.15 are applicable to governmental and public entities.

NOTE: Code of Civil Procedure §337.15 was drafted by, and passed at the behest of, real estate developers and the construction industry. The statute is an economic regulation designed to protect developers, design professionals, consultants, contractors, and land developers and promote the construction business in general. The legislature found that liability for an indefinite period could seriously impinge on the conduct of the construction industry. *Tomko Woll Group Architects, Inc. v Superior Court* (1996) 46 CA4th 1326, 1334, 54 CR2d 300.

Before its enactment, claims for negligence or breach of warranty for defective construction were controlled by a 3-year (CCP §338(2)) or 4-year (CCP §337) statute of limitations. However, the 3- or 4-year period did not begin to run until consequential damage caused by the construction defect was sufficiently appreciable to a reasonable man so that he had a duty to pursue his remedies with reasonable diligence. The legislature intended §337.15 to cap the time to bring a claim. It imposed an absolute requirement that claims arising from defective construction of "improvements" be filed within 10 years of substantial completion of the "development or construction." The language of §337.15 is broad and susceptible to the interpretation in *Gaggero* and *Magnuson*.

There are exceptions to the application of CCP §337.15. The statute does not apply to personal injury or wrongful death actions. Also, it cannot be used by "any person in actual possession or the control, as owner, tenant or otherwise, of such an improvement, at the time any deficiency in such improvement constitutes the proximate cause for which it is proposed to bring an action." This exception renders the statute inapplicable in nearly all nuisance, trespass, and inverse condemnation actions. *Leaf v City of San Mateo* (1980) 104 CA3d 398, 405, 163 CR 711. In *Leaf,* the court held that the city could not assert a defense based on §337.15 because it was the owner in possession of the offending improvements. In *Gundogdu v King Mai, Inc.* (2009) 171 CA4th 310, 89 CR3d 489, however, the court held that the fact that the builder of a home owned it for approximately 16 months after its completion did not bar the application of §337.15 or toll or extend the statute because the defects plaintiffs complained of occurred during the original construction of the home and not while the defendant-builder was, arguably, in possession and control of the home before its sale to the plaintiffs. In *Magnuson,* the plaintiff raised the issue that §337.15 conflicted with the

fundamental policy underlying inverse condemnation actions, which is to distribute throughout the relevant community the loss inflicted on the individual by a public improvement. See McNichols, *From Sovereign Immunity to Strict Liability: Using Inverse Condemnation in Water Damage Actions,* 27 CEB Real Prop L Rep 93 (July 2004). The *Magnuson* court held there was no such conflict because one government entity had ceded possession and control of the public improvement to another. If that were not the case, the court may have reached a different result. That is, the constitutional policy underlying inverse condemnation may have trumped the statutory policy of §337.15.

The holding of *Gaggero* appears to conflict with the long-standing rationale for accrual of a cause of action for continuing nuisance. *Gaggero* relied on an earlier case, *Chevron USA, Inc. v Superior Court* (1994) 44 CA4th 1009, 1017, 54 CR2d 324, which stated that the rule regarding accrual of the statute of limitations for a continuing nuisance and continuing trespass was overridden by the 10-year statute of repose. The *Chevron* court relied on the broad terms "no action" in CCP §337.15(a) and on the legislative goal of setting an outside limit to protect contractors from extended liability. 44 CA4th at 1018. However, it is unclear that the legislature intended, or even considered, the effect of CCP §337.15 on the established rule of accrual of a cause of action for continuing nuisance. The result in *Chevron* is that the party that caused the contamination was exempted by the statute of limitations, while an innocent possessor of the property at the time of contamination was held accountable for cleanup costs. The outside limit, which protects contractors, overrides both the public interest in cleaning up the environment and the state policy favoring accountability for those who cause pollution. It is doubtful that the legislature intended this result in enacting §337.15. The *Chevron* court noted, however, that the creation of a pollution exception to the statute of limitations for latent construction defects would be better left to the legislature. 44 CA4th at 1019.

Equitable tolling does not apply to CCP §337.15. *Lantzy v Centex Homes* (2003) 31 C4th 363, 370, 2 CR3d 655. However, equitable estoppel may apply if (1) while the limitations period is still running, the tortfeasor represents that all actionable damage has been or will be repaired, thus making it unnecessary to sue; (2) the plaintiff reasonably relies on this representation to refrain from bringing a timely action; (3) the representation proves false after the limitations period has expired; and (4) the plaintiff proceeds diligently once the truth is discovered. 31 C4th at 383. For further discussion, see California Construction Contracts, Defects, and Litigation, chap 11 (Cal CEB 2008).

There are exceptions to the application of CCP §337.15. Nuisance actions covered by the Comprehensive Environmental Response, Compensation, and Liability Act of 1980 (CERCLA) (42 USC §§9601-9675) are not triggered until discovery of the contamination. *Angeles Chem. Co. v Spencer & Jones* (1996) 44 CA4th 112, 51 CR2d 594. CERCLA creates a federally mandated discovery rule that preempts state law. The 10-year California statute of repose applies if the nuisance or trespass is the result of a latent construction defect unless the nuisance or trespass involves CERCLA chemicals (42 USC §9658) or unless the defendant is in possession and control of the property (*Leaf v City of San Mateo* (1980) 104 CA3d 398, 405, 163 CR 711). In *San Diego Unified Sch. Dist. v County of San Diego* (2009) 170 CA4th 288, 87 CR3d 796, the court held that an action based on damages caused by a landfill constructed and operated by the defendant more than 10 years before suit was commenced was not barred by CCP §337.15 when plaintiff also alleged breaches of a hold harmless agreement and side agreement governing the parties' responsibilities for environmental compliance.

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§5.45 c. Special Rules for Pollution Cases

The distinction between continuing and permanent nuisance on one hand and trespass on the other presents particularly important and complex issues in cases involving soil and groundwater contamination. The key case on this subject is *Mangini v Aerojet-General Corp.* (1996) 12 C4th 1087, 51 CR2d 272 (*Mangini II*). This case held that, in order to treat soil contamination as a continuing rather than a permanent nuisance, the plaintiff must present substantial evidence that the contaminated condition is subject to remediation or cleanup and that cleanup costs are reasonable. The supreme court also held that the claim for permanent nuisance was barred by the statute of limitations.

Whether regarded from a practical, equitable, public policy, or legal point of view, *Mangini II* presents many problems for innocent owners who discover pollution on their property. The result of the case was that the defendant, which had created severe contamination that would be very expensive to remediate, was not required to compensate the plaintiff for the loss of use of the property and other damages while the property was under remediation. This result can be expected to be duplicated in similar situations.

Before *Mangini II,* the courts had consistently stated that, when there is doubt about whether a nuisance is continuing or permanent, the court should opt for a continuing nuisance to protect the plaintiff from contingencies such as unforeseen future injury, to prevent the plaintiff from being barred by the statute of limitations, and to encourage termination of the condition causing the nuisance. *Baker v Burbank-Glendale-Pasadena Airport Auth.* (1985) 39 C3d 862, 870, 218 CR 293; *Capogeannis v Superior Court* (1993) 12 CA4th 668, 678, 15 CR2d 796; *Mangini v Aerojet-General Corp.* (1991) 230 CA3d 1125, 1148, 281 CR 827 (*Mangini I*). See §5.16. *Mangini II* appears to make permanent nuisance a preferred option in doubtful cases—at least for purposes of the statute of limitations in contamination cases. Also, before *Mangini II,* the courts had consistently held that in doubtful cases the plaintiff had the option to elect to treat the nuisance as permanent or continuing. See §5.15. The court in *Mangini II* ignored this rule and denied the plaintiff the option to elect.

Mangini II leaves landowners in a precarious position for many reasons and creates much confusion and uncertainty in the law of nuisance. First, the court expressly left open the issue of whether a plaintiff who has filed a timely nuisance action must prove that the abatement can be accomplished at a reasonable cost in order to be entitled to an injunction or damages. The holding is expressly limited to the statute of limitations. Second, it is unclear whether continuing nuisance will remain the default holding when there is doubt about whether the nuisance is continuing or permanent for purposes of injunction and damages. It is apparently not the rule for purposes of the statute of limitations. It is equally unclear whether plaintiffs can elect to characterize the nuisance as continuing or permanent for purposes of damages and injunction. Again, for the statute of limitations, this rule no longer seems to apply.

Finally, it is uncertain whether characterizing the nuisance as continuing or permanent for statute of limitations purposes will apply on the issue of remedy. If the plaintiff needs to show that the nuisance can be abated at a reasonable cost in order to prove a continuing nuisance for statute of limitations purposes and is not required to make the same showing to prove that a nuisance is continuing for other purposes, such as the remedy, the same situation could be a permanent nuisance for statute of limitations purposes and continuing for damages or injunction purposes.

To extend the statute of limitations, the plaintiff may be able to argue that a nuisance was continuing for a period of time and became permanent at a later time. This argument was accepted by the court in *Bartleson v U.S.* (9th Cir 1996) 96 F3d 1270.

For further analysis and criticism of *Mangini II,* including its effects on future land contamination cases, as well as owner strategies for coping with uncertainty about the feasibility and cost of remediation, see McNichols, *Revisiting Mangini II: Should the Burden of Proof in Contamination-Nuisance Cases Be Re-examined?* 25 CEB Real Prop L Rep (Apr. 2002).

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§5.46 C. Laches

A public nuisance cannot be legalized by the passage of time. CC §3490. Although laches is an available defense in public nuisance actions if the delay results in prejudice and there is no reasonable explanation for the delay (*City & County of San Francisco v Pacello* (1978) 85 CA3d 637, 645, 149 CR 705), it cannot be invoked when doing so would nullify an important policy adopted for the public benefit (*Golden Gate Water Ski Club v County of Contra Costa* (2008) 165 CA4th 249, 263, 80 CR3d 876). Laches may be raised as a defense to a private nuisance or trespass action.

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§5.47 D. Coming to Nuisance

The defense of coming to the nuisance does not apply to the current law of nuisance. The rule formerly stated that, if a noxious trade were established in a place remote from habitation, those who afterward acquired property in the vicinity were barred from obtaining either damages or an injunction, having assumed the risk of the nuisance by purchasing property with knowledge of the conditions. See *Williams v Blue Bird Laundry Co.* (1927) 85 CA 388, 392, 259 P 484.

This doctrine has generally been repudiated, *i.e.,* the plaintiff may obtain injunctive relief or damages even if the nuisance was in operation when it acquired the property. See, *e.g., Mangini v Aerojet-General Corp.* (1996) 12 C4th 1087, 51 CR2d 272 (*Mangini II*) (proving temporary nuisance and reasonable cleanup costs entitles plaintiff to damages for loss of use). See also 13 Witkin, Summary of California Law, *Equity* §166 (10th ed 2005). In addition, even though a business was entirely unobjectionable when established, it may become objectionable because of the growth in the area or change in the surroundings. *Ex Parte Hadacheck* (1913) 165 C 416, 420, 132 P 584; *Friedman v Pacific Outdoor Advert. Co.* (1946) 74 CA2d 946, 952, 170 P2d 67. That the owner acquired and improved the property with knowledge of the nuisance is a factor to consider. See *Hellman v La Cumbre Golf & Country Club* (1992) 6 CA4th 1224, 8 CR2d 293 (errant golf balls from country club).

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§5.48 E. Consent

Although consent is not a defense to a public nuisance (*Friedman v Pacific Outdoor Advert. Co.* (1946) 74 CA2d 946, 170 P2d 67), consent may be a defense to a private nuisance claim (*Mangini v Aerojet-General Corp.* (1991) 230 CA3d 1125, 281 CR 827 (*Mangini I*)). Consent is a factual defense and cannot generally be resolved on the basis of demurrer. 230 CA3d at 1140. For the defense of consent to apply, the activity must have been lawful when it was done. *Newhall Land & Farming Co. v Superior Court* (1993) 19 CA4th 334, 344, 23 CR2d 377. Applying this test, one court found that the activity (fuel storage) was lawful when it was operated and done in an open and notorious manner. Because a former owner was also the operator of the reservoir, the activity was conducted with the owner's consent. The court found that the developer purchased the property with full knowledge of its past use and was barred by the statute of limitations from claiming damages. See *Beck Dev. Co. v Southern Pac. Transp. Co.* (1996) 44 CA4th 1160, 52 CR2d 518. See also *Mangini v Aerojet-General Corp.* (1991) 230 CA3d 1125, 1139, 281 CR 827 (*Mangini I*).

Consent can also be shown by the terms of a lease; *i.e.,* an owner's action against a lessee for nuisance cannot be sustained if the owner contractually consented to the lessee's specific use of the property that caused the nuisance. 230 CA3d at 1138. The defense is not applicable, however, if the current owner sues a prior owner and the condition causing the nuisance was caused but not disclosed by a prior owner. *Newhall Land & Farming Co., supra*. In *Capogeannis v Superior Court* (1993) 12 CA4th 668, 15 CR2d 796, the court allowed a new owner of the property to sue the prior owner and a long-term tenant because the new owner was unaware of the property's contamination at the time of purchase.

Consent can be a valid defense in nuisance actions involving easements over private land for public works. *Sutro Heights Land Co. v Merced Irrig. Dist.* (1931) 211 C 670, 690, 296 P 1088.

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§5.49 F. Balancing Equities

When an injunction is sought, the court must first balance the conflicting interests to determine whether a nuisance exists. See §5.6. Then there is a further balancing to decide whether to grant an injunction. See §5.26. See also California Civil Procedure Before Trial, chap 32 (4th ed Cal CEB 2004); 13 Witkin, Summary of California Law, *Equity* §§169-173 (10th ed 2005). The defendant can argue that, even if the court found the activity or condition to be a nuisance, it should deny injunctive relief. The courts, however, will refuse to balance a hardship in favor of a defendant who willfully created the nuisance. See *Morgan v Veach* (1943) 59 CA2d 682, 689, 139 P2d 976.

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§5.50 G. Due Care

Due care is not a defense to a nuisance or trespass action. It is the effect of the nuisance, not whether the act or omission that causes it is intentional, negligent, or careless in the way it is performed, that determines whether it is a nuisance. *People ex rel Robarts v Russ* (1901) 132 C 102, 64 P 111.

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§5.51 H. Use Consistent With Applicable Zoning

Some courts have held that a plaintiff cannot obtain an injunction against a business that is operated in accordance with applicable zoning laws unless the methods used are unnecessary and injurious. CCP §731a; *Kornoff v Kingsburg Cotton Oil Co.* (1955) 45 C2d 265, 271, 288 P2d 507 (holding that ginning mill, lawfully operated in properly zoned location, could not be abated under §731a); *Sierra Screw Prods. v Azusa Greens, Inc.* (1979) 88 CA3d 358, 366, 151 CR 799.

The plaintiff has the burden of showing unnecessary and injurious methods of operation. *Christopher v Jones* (1964) 231 CA2d 408, 411, 41 CR 828. A person may not use his or her own property, even in and about a business that is itself lawful, in a manner that seriously interferes with a neighbor's enjoyment of its rights and the use of its property. That a business operation is conducted with the government's consent, is legal, and is conducted in a district zoned for industry may not be a defense. *Vowinckel v N. Clark & Sons* (1932) 216 C 156, 13 P2d 733 (court required pipe, tile, and pottery factory adjacent to residential area to abate nuisance by discontinuing use of some areas and erecting firewall).

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§5.52 I. Separation of Powers

In rare instances, the separation of powers may provide a defense in a nuisance or trespass action. For example, one court held that it could not provide a remedy for a city's failure to remedy traffic conditions in a neighborhood, because that power is delegated to the city by the legislature. Court interference would violate the separation of powers. *Friends of H St. v City of Sacramento* (1993) 20 CA4th 152, 24 CR2d 607. See CC §3482 (nothing done or maintained under express authority of statute can be deemed a nuisance); *Farmers Ins. Exch. v State* (1985) 175 CA3d 494, 221 CR 225; but see *Varjabedian v City of Madera* (1977) 20 C3d 285, 142 CR 429.

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§5.53 J. Scope of Injunction

An injunction (see §5.26) should not impose burdens beyond the necessities of the case. *Anderson v Souza* (1952) 38 C2d 825, 841, 243 P2d 497; *People v Mason* (1981) 124 CA3d 348, 177 CR 284. The defendant may apply for a modification or dissolution of an injunction if there is "a material change in the facts" (or a change in the law) on which the injunction was based, or if "the ends of justice would be served." CCP §533. See also CCP §532 (modifying or dissolving injunction against water diversion). An injunction will be reversed on appeal if it causes unnecessary hardship or goes beyond what is reasonably necessary. See *Anderson v Souza, supra*. If the injunction is broad in scope, the court may refuse (or adjust) a request for compensatory damages. See *Farmy v College Hous., Inc.* (1975) 48 CA3d 166, 121 CR 658. The court will not enjoin the conduct of the defendant's entire business when the business is not a nuisance per se, if a lesser restriction will give the plaintiff relief. *Vowinckel v N. Clark & Sons* (1932) 216 C 156, 13 P2d 733.

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Source: Civil Litigation/California Attorney's Guide to Damages/5 Injury to Property/§5.54 VIII. RELATED ACTIONS

§5.54 VIII. RELATED ACTIONS

The following are torts and other actions that are related to nuisance and trespass:

- **Violation of seller's duty to disclose.** Under CC §1102.6, a seller of residential property must disclose any neighborhood noise problems and other nuisances to a potential buyer. Under CC §1102.6(c), the seller must give notice to a prospective buyer of the buyer's responsibility to pay any supplemental tax bills after closing. A violation subjects the seller to damages. CC §1102.13. See *Alexander v McKnight* (1992) 7 CA4th 973, 9 CR2d 453 (disclosure requirement justified award of diminution in value damages to plaintiff in nuisance action). Under the common law, when a seller knows facts materially affecting the value or desirability of the property, and knows that these facts are not known to or within the reach of the diligent attention and observation by the buyer, the seller has a duty to disclose them to the buyer. *Preston v Goldman* (1986) 42 C3d 108, 227 CR 817. A breach of that duty allows the buyer to obtain either rescission or damages. *Karoutas v HomeFed Bank* (1991) 232 CA3d 767, 771, 283 CR 809. See California Real Property Remedies and Damages, chaps 1, 3-4 (2d ed Cal CEB 2002). For further discussion of disclosure obligations, see California Real Property Sales Transactions §§6.34-6.70 (4th ed Cal CEB 2007) and Handling Real Property Sales Transactions, steps 4-16 (Cal CEB Action Guide April 2007).
- **Violation of federal contamination statutes**
- The Comprehensive Environmental Response, Compensation, and Liability Act of 1980 (CERCLA) (42 USC §§9601-9675) provides for recovery of cleanup costs and natural resource damages. 42 USC §9601. Responsible parties may bring an action for contribution under 42 USC §9613(f)(1), which provides that anyone who incurs cleanup costs or is required to reimburse the government for cleanup costs may seek appropriate contribution from other responsible parties. Innocent parties (*i.e.,* federal, state, or local government), can bring cost recovery actions. See 42 USC §9607.
- Under the Resource Conservation and Recovery Act of 1976 (RCRA) (42 USC §§6901-6992k), a private party cannot recover the cost of past cleanup efforts but may bring suit against certain responsible persons, including former owners who contributed to the contamination. See 42 USC §6972(a); *Meghrig v KFC W., Inc.* (1996) 516 US 479, 134 L Ed 2d 121, 116 S Ct 1251.
- Claims can be brought by individuals or groups alleging violations of the federal Clean Water Act (33 USC §§1251-1387) if the person or group has "an interest which is or may be adversely affected." See 33 USC §1365. The U.S. Supreme Court has allowed Clean Water Act claims by environmental groups even when the group would not directly benefit from a favorable decision and when the defendant had already stopped the claimed pollution. *Friends of the Earth, Inc. v Laidlaw Envt'l Servs. (TOC), Inc.* (2000) 528 US 167, 145 L Ed 2d 610, 120 S Ct 693. See also *Ecological Rights Found. v Pac. Lumber Co.* (9th Cir 2000) 230 F3d 1141.
- **Violation of California contamination statutes**
- California has its own version of CERCLA. The Carpenter-Presley-Tanner Hazardous Substance Account Act (HSAA) (Health & S C §§25300-25395.15) is similar to CERCLA in many respects, including the fact that neither act applies to petroleum contamination. See *KFC W., Inc. v Meghrig* (1994) 23 CA4th 1167, 1173, 28 CR2d 676 (cost recovery action barred by statutory petroleum exclusion).
- Other California statutes also provide for private claims against alleged polluters. For example, Health & S C §§25249.5-25249.13, commonly known as Proposition 65, allows claims for injunction and penalties when a business knowingly discharges certain chemicals where they can pass into a source of drinking water or when the business exposes a person to such chemicals without an adequate warning.
- Water Code §13350(b)(1) provides for a private right of action for contribution against a person who, with certain exceptions, "causes or permits any hazardous substance to be discharged in or on any of the waters of the state where it creates a condition of pollution or nuisance." Regulatory statutes may also provide the basis for damage claims under a negligence per se theory.
- While many environmental statutes are of fairly recent vintage, some were enacted several decades ago. See, *e.g.,* Fish & G C §5650 and Health & S C §§5410-5416. Thus, acts done long before environmental concerns

came to the forefront may still provide a basis for a damages claim.

PRACTICE TIP: State common law actions, such as nuisance and trespass, are necessary supplements to a landowner dealing with contaminated property. Under federal law, plaintiffs can recover only costs of response, such as the cost of a health assessment study. Also under federal law, plaintiffs cannot recover other damages or economic losses, personal injury, or punitive damages. The plaintiff can generally obtain injunctions more easily under state common law claims.

- **Actions by secured lenders.** In limited situations, a secured lender may bring an action for breach of contract against a borrower for breach of any environmental covenant made by the borrower relating to the real property security, for the recovery of damages, and for enforcement of the covenant; that action or failure to foreclose against collateral does not violate the one-form-of-action rule. CCP §736(a). This remedy does not apply to the parties' obligations contracted for before January 1, 1992. CCP §736(e). Damages are limited to reimbursement or indemnification of costs relating to a reasonable and good faith cleanup, remediation, or other response action concerning a release, plus attorney fees and costs incurred by the secured lender relating to the breach. See CCP §736(b)-(c). See also California Mortgages, Deeds of Trust, and Foreclosure Litigation §§4.54-4.57 (4th ed Cal CEB 2009).

PRACTICE TIP: If a landlord is held liable for its tenant's conduct in an action to enforce contamination statutes or environmental covenants, the landlord can seek indemnity from the tenant. The landlord should look to the express indemnity provisions in the lease and remedies for implied indemnity.

- **Wrongful occupancy.** The measure of damages for the wrongful occupation of real property resulting from a trespass is the value of the use of the property during the time of the occupancy (not to exceed five years before the start of the action for damages), the reasonable cost of repair or restoration of the property, plus costs of recovering possession. CC §3334. The landowner can recover damages under §3334 even if the owner is not using the land. See *Don v Trojan Constr. Co.* (1960) 178 CA2d 135, 2 CR 626. The value under §3334 is reasonable rental value. But if the benefit to the defendant exceeded reasonable rental value, the plaintiff may recover the greater amount. CC §3334(b)(1); *Bourdieu v Seaboard Oil Corp.* (1941) 48 CA2d 429, 438, 119 P2d 973.
- **Wrongful holding over.** The measure of damages for a wrongful holding over of real property "by a person who entered upon the same, as guardian or trustee for an infant, or by right of an estate terminable with any life or lives, after the termination of the trust or particular estate, without the consent of the party immediately entitled after such termination," is the value of the profits received during the holding over. CC §3335. See §§4.83-4.85.
- **Waste.** A landlord can file an action against a tenant for waste, seeking damages or injunctive relief restraining the tenant from practices that are damaging to the property. See §§4.60-4.61. Generally, the measure of damages for a tenant's waste is the diminution in value of the estate. Any aggrieved person, presumably including a lender holding a security interest, may bring an action against the tenant for treble damages. CCP §732. See also CC §2929; Mortgage Deed of Trust Foreclosure, chap 6.
- **Tenant's breach of lease.** When a tenant commits a nuisance, the landlord may bring an action for damages for breach of the lease, whether the tenant is in possession of the property or has abandoned it. See California Landlord-Tenant Practice, chaps 8-9 (2d ed Cal CEB 1997). The landlord may evict the tenant, using the unlawful detainer procedure, and in a separate action recover the value of the past and future rent that is not paid, plus any other amount necessary to compensate the landlord for all damages caused by the breach. This amount can include a brokerage commission, tenant improvements, and cleanup costs of the premises. The tenant, however, is entitled to a credit for the amount of rent or other damages that the tenant can prove could have been reasonably avoided. Thus, the landlord has a duty to mitigate its damages. CC §1951.2; *Danner v Jarrett* (1983) 144 CA3d 164, 192 CR 535; *Sanders Constr. Co. v San Joaquin First Fed. Sav. & Loan Ass'n* (1982) 136 CA3d 387, 401, 186 CR 218; see Landlord-Tenant §§8.46-8.54.
- **Forcible entry or unlawful detainer.** In an action for forcible entry on, or forcible or unlawful detainer of, real property, on a showing of malice the plaintiff may be awarded statutory damages of up to $600, in addition to actual damages, including rent found due. CCP §1174(b). See CCP §735 on treble damages for forcible or unlawful entry with regard to a building or cultivated real property. On forcible entry and forcible or unlawful

detainer, see CCP §§1159-1161; §§4.22-4.26. For a comprehensive discussion of unlawful detainer procedure, see California Eviction Defense Manual, chap 4 (2d ed Cal CEB 1993); Landlord-Tenant, chaps 9-13.

- **Intrusion.** The tort of intrusion requires the invasion, physical or otherwise, of a private place, conversation, or matter with the intent to capture any type of visual image, sound recording, or other physical impression of plaintiff engaging in a personal or familial activity in a manner that is offensive to a reasonable person. See CC §1708.8; Restatement (Second) of Torts §652B (1977); California Tort Damages §9.6 (2d ed Cal CEB 2002).
- **Breach of the covenant of quiet enjoyment.** In the absence of language to the contrary, every lease contains an implied covenant of quiet enjoyment, whereby the landlord impliedly covenants that the tenant shall have quiet enjoyment and possession of the premises. If an interference is caused by the landlord or by a neighbor or tenant claiming under the landlord, the tenant has an actionable breach of the covenant of quiet enjoyment. Activities on neighboring premises not owned or controlled by the aggrieved tenant's landlord may also interfere with the tenant's quiet enjoyment. However, that conduct does not amount to a breach of the covenant of quiet enjoyment as between the tenant and the landlord. *Andrews v Mobile Aire Estates* (2005) 125 CA4th 578, 590, 22 CR3d 832.

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6

Intellectual Property Infringement and Misappropriation

Surjit P. Soni
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I. PATENT INFRINGEMENT
- A. Statutory Basis for Damages and Statute of Limitations §6.1
- B. Lost Profits §6.2
  - 1. Requirement of Causation in Fact §6.3
  - 2. *Panduit* Causation Test §6.4
  - 3. Measure of Lost Profits §6.5
  - 4. Lost Profits for Patented Products §6.6
  - 5. Lost Profits for Unpatented Products §6.7
  - 6. Entire Market Value Rule §6.8
  - 7. Price Erosion Damages §6.9
  - 8. Absence of Established Royalty Rate §6.10
  - 9. Factors That Serve as Basis for Reasonable Royalty Rate §6.11
  - 10. *Georgia-Pacific* Factors §6.12
- C. Willful Infringement Damages §6.13
- D. Prejudgment Interest §6.14

II. COPYRIGHT INFRINGEMENT
- A. Statutory Basis for Damages and Statute of Limitations §6.15
- B. Actual Damages §6.16
  - 1. Loss in Value of Copyrighted Material §6.17
  - 2. Value of Use §6.18
  - 3. Plaintiff's Lost Profits
    - a. Lost Revenue as Result of Infringement §6.19
    - b. Plaintiff's Costs Must Be Deducted to Determine Lost Profits §6.20
- C. Defendant's Profits §6.21
  - 1. Gross Revenues Attributable to Infringement §6.22
  - 2. Deductible Expenses §6.23
  - 3. Apportionment of Profits Between Infringing and Noninfringing Elements §6.24
- D. Statutory Damages §6.25
- E. Costs and Attorney Fees §6.26
- F. Prejudgment Interest §6.26A
- G. Damages Under Digital Millennium Copyright Act (DMCA) §6.27
- H. Illegality No Defense to Damages §6.27A

III. TRADEMARK INFRINGEMENT
- A. Lanham Act and Statute of Limitations §6.28
  - 1. Defendant's Profits §6.29
  - 2. Plaintiff's Damages §6.30
    - a. Treble Damages and Punitive Damages §6.31
    - b. Statutory Damages for Counterfeit Marks and for Violation of 15 USC §1125(d)(1) §6.31A
    - c. Prejudgment Interest and Attorney Fees §6.32
- B. California Trademark Law §6.33

IV. TRADE SECRET MISAPPROPRIATION AND STATUTE OF LIMITATIONS §6.34
- A. Actual Damages §6.35
- B. Unjust Enrichment §6.36
- C. Reasonable Royalty §6.37
- D. Punitive Damages §6.38

E. Attorney Fees §6.39

V. REMEDIES FOR MISAPPROPRIATION UNDER OTHER COMMON LAW THEORIES
A. Fraud (Deceit) Damages and Statute of Limitations §6.40
1. Lost Profits as Additional or Consequential Damages for Nonfiduciary Claims §6.41
2. Lost Profits for Claims Against Fiduciaries §6.42
B. Conversion Damages and Statute of Limitations §6.43
C. Restitution Based on Quasi-Contract/Unjust Enrichment §6.44
1. General Measure of Restitution for Quasi-Contract/Unjust Enrichment §6.45
2. Restitution for Lost Profits Attributable to Property §6.46
3. Constructive Trust Remedy
a. Nature of Constructive Trust Remedy §6.47
b. Constructive Trust and Quasi-Contract Claims Based on Unjust Enrichment §6.48
c. Property Subject to Constructive Trust §6.49

VI. CHECKLIST: SUGGESTED DISCOVERY §6.50

VII. REQUIRED FACTUAL BASIS FOR OPINIONS OF EXPERTS
A. Federal Rules of Evidence
1. Permitted Basis for Expert's Opinion §6.51
2. Procedure for Establishing Foundation of Expert Testimony §6.52
3. Application of Reliable Data Requirement §6.53
B. California Evidence Code
1. Permitted Basis for Expert's Opinion §6.54
2. Need to Establish Foundation §6.55
3. Procedure for Establishing Foundation §6.56
4. Application of Reliable Data Requirement §6.57

VIII. INSURANCE AS SOURCE FOR COLLECTION OF DAMAGES §6.57A

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Source: Civil Litigation/California Attorney's Guide to Damages/6 Intellectual Property Infringement and Misappropriation/ I. PATENT INFRINGEMENT/§6.1 A. Statutory Basis for Damages and Statute of Limitations

I. PATENT INFRINGEMENT

§6.1 A. Statutory Basis for Damages and Statute of Limitations

Damages are available for patent infringement under statute (35 USC §284):

> Upon finding for the claimant the court shall award the claimant damages adequate to compensate for the infringement, but in no event less than a reasonable royalty for the use made of the invention by the infringer, together with interest and costs as fixed by the court.

When the infringement involves a design patent, the infringer's profits are also available under statute (35 USC §289):

> Whoever during the term of a patent for a design, without license of the owner, (1) applies the patented design, or any colorable imitation thereof, to any article of manufacture for the purpose of sale, or (2) sells or exposes for sale any article of manufacture to which such design or colorable imitation has been applied shall be liable to the owner to the extent of his total profit, but not less than $250, recoverable in any United States district court having jurisdiction of the parties.
> Nothing in this section shall prevent, lessen, or impeach any other remedy which an owner of an infringed patent has under the provisions of this title, but he shall not twice recover the profit made from the infringement.

The patent statute provides that damages may only be recovered for the 6-year period preceding the filing of suit. 35 USC §286; *Standard Oil Co. v Nippon Shokubai Kagaku Kogyo Co. Ltd.* (Fed. Cir 1985) 754 F2d 345, 347. Moreover, products that include the invention must be marked with the patent number in order to recover pre-actual notice damages. 35 USC §286; *AT&T Corp. v Microsoft Corp.* (SDNY 2003) 290 F Supp 2d 409. When the patentee owns a mixed patent that contains both method claims and apparatus claims, the marking requirement does not apply if the patentee asserts only infringement of the method claims. *Crown Packaging Technol., Inc. v Rexam Beverage Can Co.* (Fed Cir 2009) 559 F3d 1308, 1316.

The phrase "damages adequate to compensate" in 35 USC §284 means full compensation for any damages suffered as a result of the infringement. *General Motors Corp. v Devex Corp*. (1983) 461 US 648, 654, 76 L Ed 2d 211, 217, 103 S Ct 2058. Full compensation includes any foreseeable lost profits the patent owner can prove. See *Rite-Hite Corp. v Kelley Co.* (Fed Cir 1995) 56 F3d 1538, 1545. A defendant's projected revenues and costs can be used to develop a damages award. *Technologies, S.A. v Cyrano, Inc.* (D Mass 2006) 460 F Supp 2d 197, 201. For further discussion of lost profits, see §§6.2-6.12.

Thus, the reasonable royalty rate amount represents the floor for the calculation of infringement damages. Because damages attributable to the infringer may extend beyond just lost profits for lost sales of the infringed invention, in most cases, damages will exceed the reasonable royalty rate amount.

To seek damages for patent infringement, a party must have standing at the inception of the lawsuit. *Arachnid, Inc. v Merit Indus., Inc.* (Fed Cir 1991) 939 F2d 1574, 1579. A party that has been granted all substantial rights under a patent, "regardless of how the parties characterize the transaction that conveyed those rights," is considered to have legal title and, therefore, standing. *Speedplay, Inc. v Bebop, Inc.* (Fed Cir 2000) 211 F3d 1245, 1249. By statute, assignment of a patent must be in writing. 35 USC §261. The validity and terms of an assignment are usually determined by federal law, but "state law controls any transfer of patent ownership by operation of law not deemed an assignment." *Sky Technols. LLC v SAP AG* (Fed Cir 2009) 576 F3d 1374 (ownership, and therefore standing, acquired by foreclosure on lien.) See also *Akazawa v Link New Technol. Int'l, Inc.* (Fed Cir 2008) 520 F3d 1354 (ownership transferred through intestacy). A licensee generally may not sue for damages unless it has exclusive rights under a patent, including the right to sue. *Poly-America, L.P. v GSE Lining Technol., Inc.* (Fed Cir 2004) 383 F3d 1303.

A corporate entity may be disregarded if doing so will prevent fraud, illegality, injustice, a contravention of public policy, or prevent the corporation from shielding someone from criminal liability. See *Manville Sales Corp. v Paramount Sys., Inc.* (Fed Cir 1990) 917 F2d 544, 552. Officers and directors controlling day-to-day operations of a business who actively aid and abet the infringement of a patent are individually responsible for the conduct and may be held

personally liable under §271(b). *Orthokinetics, Inc. v Safety Travel Chairs, Inc.* (Fed Cir 1986) 806 F2d 1565, 1579; 35 USC §271(b) ("[w]hoever actively induces infringement of a patent shall be liable as an infringer").

In order to succeed on a claim of inducement, the patentee must show both direct infringement and a level of intent on the part of the alleged inducer that the patent be infringed. *Water Technols. Corp. v Calco, Ltd.* (Fed Cir 1988) 850 F2d 660, 668. "It must be established that the defendant possessed specific intent to encourage another's infringement and not merely that the defendant had knowledge of the acts alleged to constitute inducement. The plaintiff has the burden of showing that the alleged infringer's actions induced infringing acts *and* that he knew or should have known his actions would induce actual infringements." *DSU Med. Corp. v JMS Co.* (Fed Cir 2006) 471 F3d 1293, 1306 (quoting *Manville Sales Corp. v Paramount Sys., Inc.* (Fed Cir 1990) 917 F2d 544, 553). Intent is a factual determination particularly within the province of the trier of fact and may be inferred from all of the circumstances. *Water Technols.,* 850 F2d at 669. These principles were reaffirmed in *Insituform Technols., Inc. v Cat Contracting, Inc.* (Fed Cir 2004) 385 F3d 1360.

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§6.2 B. Lost Profits

Included within the foreseeable damages that a patent owner may recover for infringement of its patent are lost profits for sales of products covered by the patent owner's patents and, in appropriate cases, for sales of products that, though not covered by such patents, would have been sold *but for* the infringement, sometimes known as "caravan sales." In addition, a patent owner may be entitled to recover damages due to a decrease in profits resulting from the patent owner's reductions in sales price in order to compete with an infringer.

Recovery of lost profits is not limited to the situation in which the patentee is selling the patented device. However, the patentee needs to have been selling some item, the profits of which have been lost due to infringing sales, in order to claim damages consisting of lost profits. *Poly-America, L.P. v GSE Lining Technol., Inc.* (Fed Cir 2004) 383 F3d 1303. In a design patent infringement case, the statute permits a patentee to recover both the infringer's profits and the patentee's damages. 35 USC §289; *Atlas-Pacific Eng'r Co. v Geo. W. Ashlock Co.* (9th Cir 1964) 339 F2d 288, 290. A patent owner may not recover damages from a lost sale and the infringer's profits from the same transaction. *Bergstrom v Sears, Roebuck & Co.* (D Minn 1980) 496 F Supp 476, 494; *Bran, Inc. v Dynamics Corp.* (Fed Cir 1992) 975 F2d 815, 823, 824 n16.

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§6.3 1. Requirement of Causation in Fact

The patent owner has an initial burden to show a reasonable probability (not a certainty) by a preponderance of the evidence, using reliable economic evidence, that the asserted sales would have been made *but for* the infringement. See *King Instruments Corp. v Perego* (Fed Cir 1995) 65 F3d 941, 952; *Rite-Hite Corp. v Kelley Co.* (Fed Cir 1995) 56 F3d 1538, 1545. The burden then shifts to the accused infringer to show that the patent owner's claim is unreasonable for some or all of the alleged lost sales. 56 F3d at 1545. Any doubt as to the amount of damages suffered by the patentee must be resolved against the infringer. *Lam, Inc. v Johns-Manville Corp.* (Fed Cir 1983) 718 F2d 1056, 1065.

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§6.4 2. *Panduit* Causation Test

In *Panduit Corp. v Stahlin Bros. Fibre Works Inc*. (6th Cir 1978) 575 F2d 1152, 1156, the Sixth Circuit formulated a test, which is now widely followed, for determining whether a patent owner is entitled to lost profits damages. According to this test, the plaintiff must prove four things:

(1) Demand for the patented product;

(2) The absence of acceptable noninfringing product substitutes;

(3) The plaintiff's manufacturing and marketing capability to exploit the demand; and

(4) The amount of profit the plaintiff would have made.

However, the *Panduit* test, specifically the first three of the above elements, is not an exclusive causation test for lost profits. *Rite-Hite Corp. v Kelley Co.* (Fed Cir 1995) 56 F3d 1538, 1545. For example, causation may be inferred in a two-supplier market. See *Lam, Inc. v Johns-Manville Corp.* (Fed Cir 1983) 718 F2d 1056, 1065. Some courts have required a showing that the patentee had the financial capacity to produce, acquire, sell, and distribute the goods and that the allegedly diverted customers would have done business with the patentee. *Gargoyles, Inc. v U.S.* (1997) 37 Fed Cl 95, 99. Furthermore, a court may inquire whether the customers would have paid the prices the patentee was demanding if that price was different from the price charged by the infringer, whether the noninfringing substitutes proposed would have been acceptable to customers, and whether they would have been similar in characteristics and/or price. *Standard Havens Prods., Inc. v Gencor Indus., Inc.* (Fed Cir 1991) 953 F2d 1360, 1373; *Kaufman Co. v Lantech, Inc.* (Fed Cir 1991) 926 F2d 1136, 1140.

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§6.5 3. Measure of Lost Profits

The Supreme Court has explained that the statutory measure of damages is the difference between the patent owner's pecuniary condition after the infringement and what his or her condition would have been if the infringement had not occurred. *Aro Mfg. Co. v Convertible Top Replacement Co.* (1964) 377 US 476, 507, 12 L Ed 2d 457, 84 S Ct 1526. This *"but for"* inquiry requires a reconstruction of the market as it would have developed absent the infringing product to determine what the patent owner would have made. *Grain Processing Corp. v American Maize-Prods. Co.* (Fed Cir 1999) 185 F3d 1341, 1350. The reconstructed market analysis must be based on sound economic proof; however, the courts have consistently permitted patentees wide latitude to present a reconstructed market showing all of the ways in which they would have been better off in the "but for world," and accordingly to recover lost profits in a wide variety of forms. 185 F3d at 1350.

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§6.6 4. Lost Profits for Patented Products

The principal basis for the calculation of a patentee's lost profits is to compute the profits attributable to the sales of the patented product by the patent infringer which the patentee would have made. Lost profits are generally calculated by utilizing the number of units of infringing products sold by the infringer, less returns, multiplied by the patent owner's historical gross profit per unit on its own sales of the product unless some showing is made by the infringer that the patentee would not have made those sales or that consumers would not have purchased at the price that the patentee was demanding. *Golden Bount, Inc. v Robert H. Peterson Co.* (Fed Cir 2006) 438 F3d 1354, 1371.

For infringed process patents, lost profits are considered to be equal to the savings derived by the infringer attributable to its use of the patented process. *Gordon Form Lathe Co. v Ford Motor Co.* (6th Cir 1943) 133 F2d 487, 492.

NOTE: According to the general rule for computing lost profits damages for common law claims, the amount need not be proved with exact precision, even though speculation about the existence of lost profits is improper. *Bio-Rad Labs., Inc. v Nicolet Instrument Corp.* (Fed Cir 1984) 739 F2d 604, 616. A patent owner is not required to show that it would have bid on every sale that an infringer made. *Standard Havens Prods., Inc. v Gencor Indus., Inc.* (Fed Cir 1991) 953 F2d 1360, 1373. In fact, in a two-seller market, a patent owner is not precluded from recovering lost profits even if it has not marketed a product covered by the infringed patent. *Scripto-Tokai Corp. v Gillette Co.* (CD Cal 1992) 788 F Supp 439, 441.

Incremental profits, not operating profits, are to be awarded. It is generally considered improper to allocate a portion of fixed or overhead costs to the hypothetically increased sales. Fixed costs are considered to have been charged to the sales that the patent owner did make. Charging them again would leave the plaintiff less than fully compensated for the infringement. As the court in *Saf-Gard Prod., Inc. v Service Parts, Inc.* (D Ariz 1980) 491 F Supp 996, 1001 stated, "[t]hese fixed overhead expenses would have neither increased nor decreased had the plaintiff's production incorporated the defendant's additional sales. Plaintiff's fixed overhead expenses had already been amortized over and paid out of plaintiff's actual sales."

The incremental damage award, however, must be reduced by the amount of any increase in fixed capital, properly amortized, needed to expand the capacity to satisfy the infringing sale. See *Andrew Corp. v Gabriel Electronics, Inc.* (D Me 1992) 785 F Supp 1041, 1049 (rejecting plaintiff's damages expert's methodology for determining plaintiff's fixed versus variable costs).

NOTE: Incremental profits calculations do not usually take into account that the infringer's sales may have been lower priced, because the object of the statute is to make the patent owner whole for the damages it has suffered. See *Saf-Gard Prod., Inc. v Service Parts, Inc*. (D Ariz 1980) 491 F Supp 996, 1009. However, when the price disparity is significant, the court may take the difference into account in calculating the damages awarded. *BIC Leisure Prods., Inc. v Windsurfing Int'l Corp.* (Fed Cir 1993) 1 F3d 1214, 1218.

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§6.7 5. Lost Profits for Unpatented Products

A patent owner may also suffer lost sales of unpatented products because a competitor has infringed the patent. A patent owner may recover its profits for such lost sales of products not covered by the patent.

The patent owner in *Rite-Hite Corp. v Kelley Co.* (Fed Cir 1995) 56 F3d 1538, 1548, marketed unpatented "ADL-100" devices for securing vehicles to loading docks. Sales of these unpatented devices were lost to the defendant's "Truck Stop" device that was found to infringe Rite-Hite's patent. Rejecting the infringer's arguments that compensability must be restricted to profits lost on products sold by the patent owner covered by its patent, the court observed (56 F3d at 1548):

> [N]or do we find, any justification in the statute, precedent, policy, or logic to limit the compensability of lost sales of a patentee's device that directly competes with the infringing device if it is proven that those lost sales were caused in fact by the infringement. Such lost sales are reasonably foreseeable and the award of damages is necessary to provide adequate compensation for infringement under 35 USC §284.

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§6.8 6. Entire Market Value Rule

In some cases, sales of a patented product involve ancillary sales of unpatented products, sold with the patented product, which have no separate marketable value. The Federal Circuit has explained that damages are available under what is called the "Entire Market Value Rule," if the patented features are the basis of the consumer demand. *Imonex Servs., Inc. v W.H. Munzprufer Dietmar Trenner GmbH* (Fed Cir 2005) 408 F3d 1374, 1379; *Kalman v Berlyn Corp.* (Fed Cir 1990) 914 F2d 1473, 1485 (affirming award of damages for filter screens used with patented filtering device).

However, not all ancillary sales satisfy the test of the Entire Market Value Rule. In *Rite-Hite Corp. v Kelley Co.* (Fed Cir 1995) 56 F3d 1538, 1550, the court set aside an award of lost profits on "dock leveler" devices that Rite-Hite frequently sold with its ADL-100 restraint devices finding that:

> The facts of this case do not meet this requirement. The dock levelers operated to bridge the gap between a loading dock and a truck. The patented vehicle restraint operated to secure the rear of the truck to the loading dock. Although the two devices may have been used together, they did not function together to achieve one result and each could effectively have been used independently of each other. 56 F3d at 1550.

Thus, lost profits on unpatented products sold with the patented product will only be recoverable when the patented and unpatented devices together constitute a functional unit and when the unpatented device has no separate, independent utility.

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§6.9 7. Price Erosion Damages

In some cases, the patent owner was forced to reduce its prices to meet the prices charged by the infringer for the infringing product, causing lost profits because of the reduced price. This additional component of lost profits is commonly referred to as "price erosion damages." *Minnesota Mining & Mfg. Co. v Johnson & Johnson Orthopaedics, Inc.* (Fed Cir 1992) 976 F2d 1559, 1578. A patentee may even recover future price erosion losses, as long as they are not totally speculative. *Fiskars, Inc. v Hunt Mfg. Co.* (Fed Cir 2000) 221 F3d 1318, 1325; *Brooktree Corp. v Advanced Micro Devices, Inc.* (Fed Cir 1992) 977 F2d 1555, 1581. When the patentee's own sales are substantial, the lost profits damages attributable to price erosion can exceed the lost profits damages attributable to the infringer's own sales.

NOTE: Erosion of price may be inferred, much as causation may be, when a patentee lowers its prices in a two-supplier market. In *Lam, Inc. v Johns-Manville Corp.* (Fed Cir 1983) 718 F2d 1056, 1067, the Federal Circuit found that in a predominantly two-supplier market, an award based on reduced profits was proper when the patentee lowered its prices to meet the infringer's competition.

The Federal Circuit also upheld an award of lost profits based on special discounts the plaintiff had to give in order to remain competitive. *TWM Mfg. Co., Inc. v Dura Corp*. (Fed Cir 1986) 789 F2d 895, 902. The award was allowed even though there was no proof that the price reductions were directly caused by competition with the infringer, other than the patent owner's testimony.

Expert testimony can support price erosion damages showing that a patentee could have maintained a higher price. *Kalman v Berlyn Corp*. (Fed Cir 1990) 914 F2d 1473, 1485. In *Kalman,* the Federal Circuit approved an award of 15 percent above the actual sales price based on such expert testimony.

Price erosion damages are, however, often difficult to prove because the patent owner may have reduced its prices for other reasons—for example, to meet competition from noninfringing devices or from infringers other than the defendant, or because of other economic factors such as increased manufacturing efficiencies, reduction in raw material costs, or increased sales resulting in reduced overhead per unit. Exemplary cases in which price erosion damage claims failed include *BIC Leisure Prods., Inc. v Windsurfing Int'l Corp.* (Fed Cir 1993) 1 F3d 1214, 1220; *Minco, Inc. v Combustion Eng'g Inc*. (Fed Cir 1996) 95 F3d 1109, 1120 (evidence of price fluctuation, and plaintiff was leader in price-cutting in market).

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§6.10 8. Absence of Established Royalty Rate

A reasonable royalty rate is an alternate measure of recovery when evidentiary or other reasons prevent proof of lost profits or damages, the profits or damages are not significant, or there is no established royalty rate. *Hayhurst v Rosen* (ED NY, May 15, 1992, No. CV-91-4496) 1992 US Dist Lexis 7312. The reasonable royalty rate may be based on a hypothetical negotiation between the patent holder and the infringer at the time of the first infringement.

NOTE: If the evidence of actual license agreements is for agreements negotiated well after the first infringement, such evidence may be irrelevant for establishing the hypothetical negotiation royalty rate. See *Odetics, Inc. v Storage Tech. Corp*. (Fed Cir 1999) 185 F3d 1259, 1276 (licenses negotiated four and five years after first infringement date were irrelevant because of changing technology and financial conditions).

The royalty is calculated as if the parties negotiated at arm's length as a willing licensor and a willing licensee. *Rite-Hite Corp. v Kelley Co.* (Fed Cir 1995) 56 F3d 1538, 1554. The end result of the negotiation often has the character of a forced settlement in which neither party receives everything it wants. 56 F3d at 1576. Although a patentee's lost profits per unit can be considered in determining a reasonable royalty, in at least one case, the patentee was prevented from offering evidence of its lost profits as a guise of explaining hypothetical negotiations after having elected to forego a claim of lost profits and/or damages. *See Rodime PLC v Seagate Tech., Inc*. (Fed Cir 1999) 174 F3d 1294, 1307.

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§6.11 9. Factors That Serve as Basis for Reasonable Royalty Rate

The determination of a reasonable royalty rate is based on the totality of the evidence, and the fact finder is not limited to selecting one or the other of the specific royalty figures urged by counsel as reasonable. *Smithkline Diagnostics, Inc. v Helena Labs. Corp*. (Fed Cir 1991) 926 F2d 1161, 1168. The fact finder may consider certain factors, including royalties received by the patentee for the licensing of the subject patent, opinion testimony of qualified experts, and the patentee's relationship with the infringer, to assist in the determination of adequate compensation for the infringement. *Maxwell v J. Baker, Inc*. (Fed Cir 1996) 86 F3d 1098, 1109. An expert, however, must have experience in placing a value on a patent and knowledge regarding reasonable royalties for industry-related patents. *State Contracting & Eng'g Corp. v Condotte Am., Inc.* (Fed Cir 2003) 346 F3d 1057.

The court has discretion in choosing a methodology for determining a reasonable royalty or the number of infringing units. *Insituform Technols., Inc. v Cat Contracting, Inc.* (Fed Cir 2004) 385 F3d 1360. Calculation of unit profits that the patentee would forego if it had licensed the patent was a method for determining the reasonableness of a royalty rate utilized in *Rite-Hite Corp. v Kelley Co.* (Fed Cir 1995) 56 F3d 1538, 1554. There, the Federal Circuit determined that the district court's hypothetical negotiation analysis correctly concluded that a unit royalty rate equal to 50 percent of the patentee's "lost profits" was reasonable. See also *C.R. Bard v Medtronic, Inc.* (D Del, June 15, 1999) No. CA 96-589-SLR, 1999 WL 458305, 1999 US Dist Lexis 9875, aff'd and vacated in part (Fed Cir, June 29, 2000) 2000 US App Lexis ¶15,316 (rejecting defendant's claim that royalty award equal to approximately 50 percent of plaintiff's lost profits was lost profits award in disguise). "There is no rule that a royalty be no higher than the infringer's net profit margin" or the infringer's cost of manufacture of the infringing article. *Golight, Inc. v Wal-Mart Stores, Inc*. (Fed Cir 2004) 355 F3d 1327, 1338.

Evidence which establishes what the infringer might have preferred to pay is irrelevant for determining royalty. *Golight, Inc. v Wal-Mart Stores, Inc., supra; Rite-Hite Corp.,* 56 F3d at 1555 ("Moreover, what an infringer would prefer to pay is not the test for damages.")

In the absence of any record of actual profits earned by the patentee at the time of the first infringement, the infringer's projection of its own prospective profits may serve in part as a basis for determining a reasonable royalty rate. *TWM Mfg. Co., Inc. v Dura Corp*. (Fed Cir 1986) 789 F2d 895, 899. Affirming the jury's award of a royalty equal to 30 percent of the infringer's net profits, the Federal Circuit ruled that the district court's analysis based on the defendant's projections of net profits of between 37 and 42 percent was within the district court's discretion.

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§6.12 10. *Georgia-Pacific* Factors

A widely followed list of factors for determining a reasonable royalty rate is found in *Georgia-Pacific Corp. v U.S. Plywood Corp*. (SD NY 1970) 318 F Supp 1116, modified and aff'd (2d Cir 1971) 446 F2d 295. These factors are:

- The royalties received by the patentee for the licensing of the patent in suit, proving or tending to prove an established royalty;
- The rates paid by the licensee for the use of other patents comparable to the patent in suit;
- The nature and scope of the license, as exclusive or nonexclusive, or as restricted or nonrestricted in terms of territory or with respect to whom the manufactured product may be sold;
- The licensor's established policy and marketing program to maintain his patent monopoly by not licensing others to use the invention or by granting licenses under special conditions designed to preserve that monopoly;
- The commercial relationship between the licensor and licensee, such as whether they are competitors in the same territory in the same line of business or are, *e.g.,* inventor and promoter;
- The effect of selling the patented specialty in promoting sales of other products of the licensee; the existing value of the invention to the licensor as a generator of sales of his or her nonpatented items; and the extent of such derivative or convoyed sales;
- The duration of the patent and the term of the license;
- The established profitability of the product made under the patent; its commercial success; and its current popularity;
- The utility and advantages of the patent property over the old modes or devices, if any, that had been used for working out similar results;
- The nature of the patented invention; the character of the commercial embodiment of it as owned and produced by the licensor; and the benefits to those who have used the invention;
- The extent to which the infringer has made use of the invention, and any evidence probative of the value of that use;
- The portion of the profit or of the selling price that may be customary in the particular business or in comparable businesses to allow for the use of the invention or analogous inventions;
- The portion of the realizable profit that should be credited to the invention as distinguished from nonpatented elements, the manufacturing process, business risks, or significant features or improvements added by the infringer;
- The opinion testimony of qualified experts; and
- The amount that a licensor (such as the patentee) and a licensee (such as the infringer) would have agreed on (at the time the infringement began) if both had been reasonably and voluntarily trying to reach an agreement; *i.e.,* the amount that a prudent licensee, who desired, as a business proposition, to obtain a license to manufacture and sell a particular article embodying the patented invention, would have been willing to pay as a royalty and yet be able to make a reasonable profit, and which would have been acceptable by a prudent patentee who was willing to grant a license.

NOTE: A patentee is not automatically estopped from seeking a higher royalty rate than was obtained in a prior case, although evidence of prior infringements is admissible to determine the rate of reasonable royalty. *Applied Med. Resources Corp. v United States Surgical Corp.* (Fed Cir 2006) 435 F3d 1356, 1360.

A patentee's entitlement to royalties may be limited by the patent exhaustion doctrine, which provides that the initial sale of a patented item, if authorized by the patent holder, "terminates all patent rights to that item." *Quanta Computer, Inc. v LG Electronics, Inc.* (2008) 553 US ___, 170 L Ed 2d 996, 1006, 128 S Ct 2109. In *Quanta,* the doctrine was triggered when LG Electronics licensed its patents for computer components to Intel and authorized Intel to manufacture and sell microprocessors containing the patented components; Intel's sale of those components to Quanta for use in Quanta computers exhausted its patent rights in LG's components.

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§6.13 C. Willful Infringement Damages

Title 35 USC §284 provides for increased damages at the discretion of the court. The section provides: "When the damages are not found by a jury, the court shall assess them. In either event, the court may increase the damages up to three times the amount found or assessed." Although §284 does not specify the basis on which damages may be increased, case law is clear that an increase of damages may be ordered when the infringement is found to have been "willful." *Johns Hopkins Univ. v CellPro, Inc*. (Fed Cir 1998) 152 F3d 1342, 1365.

In *McLaughlin v Richland Shoe Co.* (1988) 486 US 128, 133, 100 L Ed 2d 115, 108 S Ct 1677, the Supreme Court, considering conventional definitions such as "voluntary," "deliberate," and "intentional," clarified that "willful" refers to conduct that is not merely negligent. Willful infringement requires a showing of "objective recklessness" by clear and convincing evidence. *In re Seagate Technol., LLC* (Fed Cir 2007) 497 F3d 1360, 1371. This showing requires evidence that the infringer acted despite an objectively high likelihood that the actions constituted infringement of a valid patent, and that the infringer should have known of the likelihood. 497 F3d at 1371. Determination of willfulness is made on consideration of the totality of the circumstances (see *Gustafson, Inc. v Intersystems Indus. Prods., Inc.* (Fed Cir 1990) 897 F2d 508, 510), and may include contributions of several factors, as compiled, *e.g.,* in *Read Corp. v Portec, Inc.* (Fed Cir 1992) 970 F2d 816, 826.

The Federal Circuit continues to subscribe to the factors articulated by the court in *Read Corp.* Those factors are:

- Whether the infringer deliberately copied the ideas or design of another;
- Whether the infringer, when he or she knew of the other's patent protection, investigated the scope of the patent and formed a good faith belief that it was invalid or that it was not infringed;
- The infringer's behavior as a party to the litigation;
- Defendant's size and financial condition;
- The closeness of the case;
- The duration of defendant's misconduct;
- Remedial action by the defendant;
- Defendant's motivation for harm; and
- Whether defendant attempted to conceal its misconduct.

These factors are evaluated and weighed by the trier of fact, for, as the court remarked in *Rite-Hite Corp. v Kelley Co.* (Fed Cir 1987) 819 F2d 1120, 1125, "'[w]illfulness' in infringement, as in life, is not an all-or-nothing trait, but one of degree. It recognizes that infringement may range from unknowing, or accidental, to deliberate, or reckless, disregard of a patentee's legal rights." *Knorr-Bremse Systeme Fuer Nutzfahrzeuge GmbH v Dana Corp.* (Fed Cir 2004) 383 F3d 1337.

Evidence of early receipt of legal advice may strengthen the defendant's argument that it did not willfully infringe. *Imonex Servs., Inc. v W.H. Munzprufer Dietmar Trenner GmbH* (Fed Cir 2005) 408 F3d 1374, 1378; *Rolls-Royce Ltd. v GTE Valeron Corp.* (Fed Cir 1986) 800 F2d 1101, 1110. A party's failure to obtain an exculpatory opinion of counsel does not create an inference or evidentiary presumption that the opinion would have been unfavorable. *Knorr-Bremse Systeme Fuer Nutzfahrzeuge GmbH v Dana Corp.* (Fed Cir 2004) 383 F3d 1337, 1343. In addition, the assertion of the attorney-client or work product privilege does not create an adverse inference with respect to willful infringement. 383 F3d at 1344. An adverse inference cannot be drawn from the withholding of counsel's advice, and a defendant may choose to waive the privilege and produce the advice of counsel. 383 F3d at 1345. But see *nCube Corp. v SeaChange Int'l, Inc.* (Fed Cir 2006) 436 F3d 1317, 1324 (intentionally withholding important information from opinion counsel was substantial evidence supporting jury verdict of willfulness). A patentee may prove willfulness by showing the incompetence of an opinion. See *Golden Bount, Inc. v Robert H. Peterson Co.* (Fed Cir 2006) 438 F3d 1354, 1364; *Markman v Westview Instruments, Inc.* (Fed Cir 1995) 52 F3d 967, 381.

Fundamental to the determination of willful infringement is the duty to act in accordance with the law. Reinforcement of this duty was a foundation of the formation of the Federal Circuit court, at a time when widespread disregard of

patent rights was undermining the national innovation incentive. See *Advisory Committee On Industrial Innovation Final Report*, Dep't of Commerce (Sept. 1979). Thus, in *Underwater Devices, Inc. v Morrison-Knudsen Co.* (Fed Cir 1983) 717 F2d 1380, overruled on other grounds in *In re Seagate Technol., LLC* (Fed Cir 2007) 497 F3d 1360, the court stressed the legal obligation to respect valid patent rights. There continues to be "an affirmative duty of due care to avoid infringement of the known patent rights of others." *L.A. Gear Inc. v Thom McAn Shoe Co.* (Fed Cir 1993) 988 F2d 1117, 1127. See also *Golight*, *Inc. v Wal-Mart Stores, Inc.* (Fed Cir 2004) 355 F3d 1327, 1339 (finding of willful infringement upheld when Wal-Mart took no appropriate action after receiving cease-and-desist letter to establish reasonable belief that its actions were not infringing plaintiff's patent).

"When it is found that the infringer acted without a reasonable belief that its actions would avoid infringement, the patentee has established willful infringement, which may be accompanied by enhanced damages." *Vulcan Eng'g Co. v Fata Aluminium, Inc.* (Fed Cir 2002) 278 F3d 1366, 1378. Clear and convincing evidence of actions in disregard of a cease and desist letter, and in disregard of patent rights is willful. *Golight, Inc. v Wal-Mart Stores, Inc., supra*.

Title 35 USC §284 allows the court to award attorney fees in exceptional cases. *Knorr-Bremse Systeme Fuer Nutzfahrzeuge GmbH v Dana Corp., supra.* Attorney fees are compensatory, and may provide a fair remedy in appropriate cases. "That there were not actual damages does not render the award of attorney fees punitive." *Knorr-Bremse,* 383 F3d at 1347.

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§6.14 D. Prejudgment Interest

Under 35 USC §284, the court may at its discretion award interest on the amount of damages, starting when a royalty should have been paid and accruing until the date of judgment. *General Motors Corp. v Devex Corp*. (1983) 461 US 648, 656, 76 L Ed 2d 211, 103 S Ct 2058, is the seminal case concerning prejudgment interest under §284. The court may not award prejudgment interest until it finds that the damages are liquidated or reasonably certain. See *Go Med. Indus. Pty., Ltd. v Inmed Corp.* (Fed Cir 2006) 471 F3d 1264, 1272. In *Devex*, the Supreme Court held that prejudgment interest was not limited to cases of bad faith or exceptional circumstances, stating that "prejudgment interest should ordinarily be awarded where necessary to afford the plaintiff compensation for the infringement." *General Motors Corp.,* 461 US at 654.

NOTE: There are no statutory guidelines concerning prejudgment interest. However, case law provides some guidance. For example, prejudgment interest may only be applied to the primary or actual damage portion of the judgment, and not to any enhanced or punitive portion of the judgment. *Underwater Devices, Inc. v Morrison-Knudsen Co.* (Fed Cir 1983) 717 F2d 1380, 1389, overruled on other grounds in *In re Seagate Technol., LLC* (Fed Cir 2007) 497 F3d 1360. Although there is no federal prejudgment interest rate, at least one district court applied the rate under 28 USC §1961(a) to a patent case, noting that the equities may require use of a different rate. *Excelsior College v Fyre* (SD Cal, Feb. 21, 2007, No. 04CV0535WQH) 2007 US Dist Lexis 11934.

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II. COPYRIGHT INFRINGEMENT

§6.15 A. Statutory Basis for Damages and Statute of Limitations

Damages. Damages for copyright infringement are awardable under statute. Title 17 USC §504 provides for the recovery of either (1) actual damages and the infringer's profits, or, in place of them, (2) statutory damages from $750 to $30,000 for nonwillful infringements and up to $150,000 for willful infringements. The infringer's profits cannot be recovered to the extent that they have been taken into account in computing actual damages. 17 USC §504(b). Statutory damages are only available when a registration for the copyright over the work was obtained before the time of infringement if the work was unpublished, or if registration is made within 3 months of first publication. 17 USC §412; *X-It Prods., LLC v Walter Kidde Portable Equip., Inc.* (ED Va 2001) 155 F Supp 2d 577, 614. The plaintiff's election between statutory damages and actual damages plus the infringer's profits may be made at any time before final judgment is rendered. 17 USC §504(c)(1). Willfulness can be shown by proof of reckless disregard for the rights of the copyright owner.

Injunction. A prevailing plaintiff is also entitled to an injunction if the plaintiff shows that

- It has suffered an irreparable injury;
- The remedies at law (*e.g.*, monetary damages) are inadequate compensation;
- An injunction is warranted, considering the balance of hardships between the plaintiff and defendant; and
- The public interest would not be disserved by an injunction.

eBay, Inc. v MercExchange, LLC (2006) 547 US 388, 391, 164 L Ed 2d 641, 645, 126 S Ct 1837. Moreover, an infringer's voluntary cessation of infringement does not moot the need for an injunction if there is some possibility of future infringing use and no evidence that the infringing use had ceased. *LGS Architects, Inc. v Concordia Homes of Nev.* (9th Cir 2006) 434 F3d 1150, 1153.

Statute of limitations. The statute of limitations for recovery of copyright damages is 3 years from the date of accrual of the claim. *Stone v Williams* (2d Cir 1992) 970 F2d 1043, 1049. A copyright claim accrues as of the date of discovery of the infringement. *Polar Bear Prods., Inc. v Timex Corp.* (9th Cir 2004) 384 F3d 700 (as amended on denial of rehearing and rehearing en banc). An action must be brought within 3 years thereafter or is barred. In some circuits, if the infringement is continuing, an action brought while the infringement is ongoing will allow the copyright owner to recover for infringing acts that began more than 3 years earlier. *Polar Bear Prods., Inc. v Timex Corp., supra; Taylor v Meirick* (7th Cir 1983) 712 F2d 1112, 1118. See also *MAI Basic Four, Inc. v Basis, Inc.* (10 Cir 1992) 962 F2d 978, 987 n9; *Eisenman Chemical Co. v NL Indus., Inc.* (D Nev 1984) 595 F Supp 141, 146. But see *Stone v Williams* (2d Cir 1992) 970 F2d 1043, 1050 ("[a]pplication of the continuous wrong doctrine generally has been rejected in the infringement context"); *Bridgeport Music, Inc. v Lorenzo* (MD Tenn 2003) 255 F Supp 2d 795, 798 n3 ("this Court declined to follow *Taylor* because its continuing wrong theory has been rejected by every other circuit that has considered it").

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§6.16 B. Actual Damages

"Actual damages are usually determined by the loss in the fair market value of the copyright, measured by the profits lost due to the infringement or by the value of the use of the copyrighted work to the infringer." *Polar Bear Prods., Inc. v Timex Corp.* (9th Cir 2004) 384 F3d 700, 708, quoting *McRoberts Software, Inc. v Media 100, Inc.* (7th Cir 2003) 329 F3d 557, 566. See also *Mackie v Rieser* (9th Cir 2002) 296 F3d 909, 914 (approving of recovery of reasonable license fee). A defendant's projected revenues and costs may be used to develop a damages award. *Technologies, S.A. v Cyrano, Inc.* (D Mass 2006) 460 F Supp 2d 197, 201. A plaintiff in a §504(b) action must establish the causal connection between the infringing use and the loss of profits or the value to the infringer; this requirement is akin to tort principles of causation and damages. *Mackie v Rieser, supra.*

However, because of the difficulties, in most cases, of calculating market value and the loss in value attributable to the infringement, actual damages may be calculated by reference to the amount of the plaintiff's lost profits. See *Taylor v Meirick* (7th Cir 1983) 712 F2d 1112, 1120. Section 504(b) also provides for the recovery of wrongfully obtained profits resulting from the infringement, "[t]o take away incentives for would-be infringers" and "to prevent the infringer from unfairly benefiting from a wrongful act." *Polar Bear Prods., Inc. v Timex Corp.* (9th Cir 2004) 384 F3d 700, 708.

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§6.17 1. Loss in Value of Copyrighted Material

Market value is what a willing buyer would have been reasonably required to pay to a willing seller for the copyrighted material. See *Sid & Marty Kroft Television Prods., Inc. v McDonald's Corp*. (9th Cir 1977) 562 F2d 1157, 1174. Reduction in market value is loss of value that is compensable. If the value of the copyrighted material has been entirely lost by the infringement, then such entire value is the measure of actual damages. *Golding v RKO Pictures, Inc*. (1950) 35 C2d 690, 700, 221 P2d 951. Market value may be established by the copyright owner's testimony in addition to an expert witness's testimony. *Universal Pictures Co. v Harold Lloyd Corp*. (9th Cir 1947) 162 F2d 354, 369. However, a plaintiff may demonstrate that the infringed copyrighted material has a special value to the plaintiff and claim that lost special value as damages even if that amount is in excess of lost market value. *Szekely v Eagle Lion Films, Inc*. (SD NY 1956) 140 F Supp 843, 849.

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§6.18 2. Value of Use

When the infringer did not realize any direct profits from the infringement and statutory damages are not available (*e.g.,* the copyright was not registered at the time of the infringement), the plaintiff may still recover, as actual damages, the benefit to the infringer as measured by amount normally charged for the use of the copyrighted material. *Deltak, Inc. v Advanced Sys., Inc*. (7th Cir 1985) 767 F2d 357, 360.

NOTE: The Second Circuit in *Business Trends Analysts, Inc. v Freedonia Group, Inc*. (2d Cir 1989) 887 F2d 399, 406, rejected the value of use measure of damages because it was not the equivalent of a measure of profits.

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3. Plaintiff's Lost Profits

§6.19 a. Lost Revenue as Result of Infringement

A plaintiff has the initial burden of establishing with a reasonable degree of certainty that it has suffered lost sales revenue directly as a result of the alleged infringement. *Baldwin Cooke Co. v Keith Clark, Inc*. (ND Ill 1976) 420 F Supp 404, 407. Proof of the plaintiff's lost sales revenue may be made based on opinion and probable estimate but not on mere conjecture. 420 F Supp at 407. Uncertainty regarding the amount of the plaintiff's lost revenue does not preclude an award of actual damages if there is reasonable certainty that the lost revenue is attributable to the infringement. *Universal Pictures Co. v Harold Lloyd Corp*. (9th Cir 1947) 162 F2d 354, 369.

The defendant must then show that the plaintiff's lost revenue still would have occurred despite the infringement. *Harper & Row, Publishers, Inc. v Nation Enters*. (1985) 471 US 539, 567, 85 L Ed 2d 588, 105 S Ct 2218.

When the infringer sells the copyrighted material at the same or near the same price as did the plaintiff for a similar use, lost profits damages are relatively easy to calculate because of the plausible assumption that each of the infringer's sales could have been made by the plaintiff. See *Design Resources, Inc. v John Wolf Decorative Fabrics* (SD NY 1985) 229 USPQ 418, 424. On the other hand, when the infringer sells the copyrighted material for a price below the plaintiff's sales price, courts are reluctant to find that there is a direct correlation between the amount of the defendant's sales revenue and the amount of the plaintiff's lost sales revenue. See, *e.g., Stevens Linen Assocs., Inc. v Mastercraft Corp.* (2d Cir 1981) 656 F2d 11, 14.

Other factors that may limit the plaintiff's ability to generate sales revenue from the copyrighted material, such as the plaintiff's restrictive licensing agreements with third parties, may preclude the plaintiff from basing its lost revenue amount on the infringer's revenue. See, *e.g., Abeshouse v Ultragraphics, Inc*. (2d Cir 1985) 754 F2d 467, 470.

A plaintiff's projection of lost sales must be based on supporting documentary or other evidence so that the amount of lost revenue claimed is not based on sheer speculation. See *Davis v GAP, Inc*. (2d Cir 2001) 246 F3d 152, 167 (some degree of speculation necessarily exists in determining copyright damages) (quoting *Stevens Linen Assocs., Inc. v Mastercraft Corp., supra,* 754 F2d at 14). In *Stevens Linen Assocs., Inc. v Mastercraft Corp*., *supra,* the plaintiff's copyright in an upholstery fabric was infringed. The plaintiff offered four different measures of its lost revenue for its lost profits damages, two of which were rejected by the court. The plaintiff's sales projections were rejected because they were based solely on the uncorroborated and unexplained testimony of one of its officers. Because the plaintiff charged more for its fabric than the infringer charged for its fabric, the plaintiff was precluded from recovering damages based on the entire amount of sales revenue from the fabric received by the infringer. However, because of the facts of the case—that the plaintiff's customers purchased both the copyrighted and infringing fabric—the court agreed with two of the plaintiff's theories and determined that it was proper for the plaintiff to recover damages based on either one of two measures: (1) sales revenues that the plaintiff would have realized from sales to customers who bought both the plaintiff's and the infringer's fabrics; or (2) lost sales revenue attributable to the difference between sales of the copyrighted fabric and the average sales of all other fabrics by the plaintiff, whichever sum was greater. 656 F2d at 15.

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§6.20 b. Plaintiff's Costs Must Be Deducted to Determine Lost Profits

A plaintiff cannot claim lost sales revenue as actual damages without deducting the amount of increased costs from the lost sales revenue that would have been incurred if the lost sales revenue had in fact been generated. It is the plaintiff's burden to establish that lost sales revenue would have resulted in all profit. See *Taylor v Meirick* (7th Cir 1983) 712 F2d 1112, 1121.

NOTE: A plaintiff may even be denied recovery of actual lost profits damages if it fails to offer reliable evidence of its costs. See *Key W. Hand Print Fabrics, Inc. v Serbin, Inc.* (SD Fla 1966) 269 F Supp 605, 614.

Not all courts limit the plaintiff's costs to variable costs. For example, in the Ninth and Second Circuits, overhead costs in the production, distribution, or sale of the product must be factored into the profit calculation. *Kamar Int'l, Inc. v Russ Berrie & Co*. (9th Cir 1984) 752 F2d 1326, 1332; *Sygma Photo News, Inc. v High Soc'y Magazine* (2d Cir 1985) 778 F2d 89, 93. Moreover, a plaintiff will be denied recovery of the costs to develop the copyrighted material to the extent that such costs enable the plaintiff to profit from the copyright despite the infringer's activities. *Softel, Inc. v Dragon Med. & Scientific Communications Ltd*. (SD NY 1995) 891 F Supp 935, 943.

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§6.21 C. Defendant's Profits

In addition to the copyright owner's recovery of actual damages under 17 USC §504, that section permits recovery of "any profits of the infringer that are attributable to the infringement and are not taken into account in computing the actual damages." 17 USC §504(b). "These profits can be direct or indirect. Profits indirectly gained from infringements used in promotional efforts, as is the case here, fall squarely within the rubric of wrongful profits." *Polar Bear Prods., Inc. v Timex Corp.* (9th Cir 2004) 384 F3d 700, 708. The court in *Polar Bear* went on to quote *Mackie v Rieser* (9th Cir 2002) 296 F3d 909, 911, saying: "[A]copyright infringement plaintiff seeking to recover indirect profit damages 'must proffer some evidence.… [that] the infringement at least partially caused the profits that the infringer generated as a result of the infringement.'" *Polar Bear Prods., Inc.,* 384 F3d at 711. Promotional use potentially creates liability for indirect profits. *Polar Bear Prods., Inc.,* 384 F3d at 708.

The plaintiff need only prove the infringer's gross revenue. The burden then shifts to the infringer, who must prove any allowable deductible expenses. The infringer may also try to prove that some or all of its profits are attributable to factors other than the copyrighted work. *Frank Music Corp. v Metro-Goldwyn-Mayer, Inc*. (9th Cir 1985) 772 F2d 505, 514; *X-It Prods., LLC v Walter Kidde Portable Equip., Inc.* (ED Va 2001) 155 F Supp 2d 577, 616.

The plaintiff will be entitled to recover the defendant's gross revenue from the infringement as "profits" if the infringer fails to carry its burden. *Cream Records, Inc. v Joseph Schlitz Brewing Co*. (9th Cir 1989) 864 F2d 668, 669.

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§6.22 1. Gross Revenues Attributable to Infringement

Gross revenues attributable to the infringement include, in addition to the infringer's direct sales revenue, an increase in the infringer's goodwill resulting from the infringement. *Softel, Inc. v Dragon Med. & Scientific Communications Ltd*. (SD NY 1995) 891 F Supp 935, 942. However, the defendant's saved acquisition costs attributable to the infringement are not included in calculating "profits.'" *Encyclopedia Brown Prods. v Home Box Office* (SD NY 1998) 25 F Supp 2d 395, 400. Similarly, profits attributable to the infringement do not include either wages or rent. *MCA, Inc. v Wilson* (2d Cir 1981) 677 F2d 180, 186.

A plaintiff may also recover the defendant's indirect profits attributable to the infringement as long as the plaintiff can demonstrate that the connection between such profits and the infringement are not unduly speculative. See, *e.g., Frank Music Corp. v Metro-Goldwyn-Mayer, Inc*. (9th Cir 1985) 772 F2d 505, 517 (because infringing portions of plaintiff's play, included in Las Vegas hotel casino's revue, increased casino's gaming, hotel, and restaurant revenues, plaintiff was entitled to recover percentage of profits from such revenues). See also *Cream Records, Inc. v Joseph Schlitz Brewing Co*. (9th Cir 1985) 754 F2d 826, 828 (portion of profits attributable to defendant's increased sales revenue resulting from infringement of advertisement was recoverable).

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§6.23 2. Deductible Expenses

There is no statutory guidance available concerning which of the defendant's expenses and costs are deductible from gross revenue attributable to the infringement. However, based on case law, the general rule is that only expenses or costs that were incurred by the defendant as a result of the production and sale of the infringing material are deductible. *In Design v Lauren Knitwear Corp.* (SD NY 1991) 782 F Supp 824, 832. Deductible expenses may include income taxes on the infringement profits of a nonwillful infringer but not for willful infringers. *Manufacturers Technol., Inc. v Cams, Inc*. (D Conn 1989) 728 F Supp 75, 84; *Hamil Am. Inc. v GFI* (2d Cir 1999) 193 F3d 92. Variable costs of goods, royalties, distribution expenses, and sales commissions are deductible. *Deltak, Inc. v Advanced Sys., Inc*. (ND Ill 1983) 574 F Supp 400, 412. Officers' salaries, payroll taxes, travel expenses, employee benefits, utilities, professional services, and other operating expenses are deductible to the extent that a showing is made by the infringer of the relationship between those expenses and the profits obtained on the infringing activity. *Aitken, Hazen, Hoffman, Miller, P.C. v Empire Constr. Co*. (D Neb 1982) 542 F Supp 252, 265; *Hamil Am., Inc. v GFI, supra*. Thus, in addition to its direct cost and expenses, a defendant is entitled to a deduction for any overhead that it can prove was attributable to the infringing sales based on the "incremental" method of computing profits. The incremental approach "examines whether each category of expense is 'sensitive' to the infringing sales. When it does not appear that the infringing sales significantly contributed to an increase in a given expense, no deduction is permitted for that expense." *Banff Ltd. v Express, Inc*. (SD NY 1996) 921 F Supp 1065, 1069.

NOTE: A defendant may estimate its indirect costs (overhead) attributable to the infringing sales by any reasonable method of allocating its total indirect costs. See, *e.g., Segrets, Inc. v Gillman Knitwear Co., Inc*. (D Mass 1998) 42 F Supp 2d 58, 85 (defendant's "suggested means of calculating overhead in proportion to the number of infringing sales versus the percentage of total sales is an acceptable method for estimating overhead costs").

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§6.24 3. Apportionment of Profits Between Infringing and Noninfringing Elements

When the defendant has added value to the infringed material and the profits derived from the sale of such material are attributable in part to the defendant's efforts, the defendant is permitted a deduction for such proportion of profits. *Data Gen. Corp. v Grumman Sys. Support Corp*. (1st Cir 1994) 36 F3d 1147, 1176. However, in the case of a willful infringement, the defendant may be precluded from benefiting from apportionment. *Knitwaves, Inc. v Lollytogs Ltd*. (2d Cir 1995) 71 F3d 996, 1010.

The defendant has the burden of proving apportionment. *Transgo v Ajac Transmission Parts Corp*. (9th Cir 1985) 768 F2d 1001, 1024. The defendant does not need to offer mathematical exactness to meet its burden but need only offer a reasonable approximation, which may be made by an expert witness. *Sheldon v Metro-Goldwyn-Mayer Pictures Corp*. (1940) 309 US 390, 408, 84 L Ed 825, 60 S Ct 681. In determining the apportionment, the relative value of the plaintiff's work as compared to the defendant's work cannot be measured simply based on the quantity of the infringed material. Rather, the determination should be somewhat subjective, based on qualitative factors. See, *e.g*., *Frank Music Corp. v Metro-Goldwyn-Mayer, Inc. (Frank II)* (9th Cir 1989) 886 F2d 1545, 1549.

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§6.25 D. Statutory Damages

The plaintiff may elect statutory damages even when the plaintiff cannot prove actual damages or the defendant's profits. *Harris v Emus Records Corp*. (9th Cir 1984) 734 F2d 1329, 1335. Under 17 USC §504(c)(1), "the copyright owner may elect, at any time before final judgment is rendered, to recover, instead of actual damages and profits, an award of statutory damages for all infringements involved in the action." However, plaintiff must include a demand for statutory damages in the complaint. *Elektra Entertainment Group, Inc. v Crawford* (CD Cal 2005) 226 FRD 388, 393.

Statutory damages are to be awarded in an amount that the court considers just. 17 USC §504(c)(1). However, there are minimum and maximum amounts for statutory damages, depending on whether the infringement was willful or innocent. The general range of statutory damages is between $750 and $30,000 for infringement of each work without proof of willfulness. 17 USC §504(c)(1). If the plaintiff proves that the infringement was willful, the maximum amount of statutory damages for infringement of each work may, in the court's discretion, be increased to $150,000. 17 USC §504(c)(2). If the infringer proves that it was not aware and had no reason to believe that its acts constituted copyright infringement, the court may, in its discretion, reduce statutory damages to a minimum of $200 for infringement of each work. 17 USC §504(c)(2).

Multiple statutory damages awards are permitted when multiple works are infringed, or when the infringer repeatedly infringes one work in a series of separate transactions rather than in a mere continuation of a single transaction. HR Rep No. 94-1476, 94th Cong, 2d Sess 162 (1976); *Walt Disney Co. v Powell* (DC Cir 1990) 897 F2d 565, 569. There is, however, a split of authority on whether multiple statutory damage awards are permitted when the infringement is of a registration that covers multiple works, such as a collection or a compilation. See discussion in *Costar Group, Inc. v Loopnet, Inc.* (D Md 2001) 164 F Supp 2d 688, 709.

Courts are often guided by the evidence of actual damages or profits, or both, when such evidence exists, in determining the amount of statutory damages to be awarded. For example, courts have considered the fair market value of the copyrighted work (*Quinto v Legal Times of Washington, Inc.* (D DC 1981) 511 F Supp 579, 582) and the revenues lost by the plaintiff (*Boz Scaggs Music v KND Corp*. (D Conn 1980) 491 F Supp 908, 914).

Statutory damages are not available for foreign works not registered in the United States, despite the fact that registration is not required to file a lawsuit for infringement of a foreign work under the Berne Convention. 17 USC §412; *The Football Ass'n Premier League Ltd. v YouTube, Inc.* (SD NY 2009) 633 F Supp 2d 159.

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§6.26 E. Costs and Attorney Fees

Under 17 USC §505, in a civil copyright infringement action, the court may award the full recovery of costs by or against any party other than the United States and may also award the prevailing party its reasonable attorney "fees as part of its costs." Generally, attorney fees are awarded to a prevailing plaintiff when the infringement was willful or when the defendant's defense was made in bad faith. See, *e.g., Lauratex Textile Corp. v Allton Knitting Mills, Inc*. (SD NY 1981) 517 F Supp 900, 904; *Dean v Burrows* (ED Tenn 1989) 732 F Supp 816, 827. An award of fees, however, is discretionary with the court and may be based on such factors as frivolousness, legal or factual objective unreasonableness, or improper motivation. *Fogerty v Fantasy, Inc.* (1994) 510 US 517, 534, 127 L Ed 2d 455, 469, 114 S Ct 1023.

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§6.26A F. Prejudgment Interest

Prejudgment interest is a generally available remedy that may be awarded under both the 1909 Copyright Act and the Copyright Revision Act of 1976 (17 USC §§101-914) because an award of profits or damage alone is not necessarily adequate to compensate a prevailing copyright owner. See *Polar Bear Prods., Inc. v Timex Corp.* (9th Cir 2004) 384 F3d 700, 716 (1976 Act); *Frank Music Corp. v Metro-Goldwyn-Mayer, Inc. (Frank II)* (9th Cir 1989) 886 F2d 1545, 1552 (1909 Act). Prejudgment interest is not available for statutory damages. *Excelsior College v Fyre* (SD Cal, Feb. 21, 2007, No. 04CV0535WQH) 2007 US Dist Lexis 11934.

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§6.27 G. Damages Under Digital Millennium Copyright Act (DMCA)

The Digital Millennium Copyright Act (DMCA) (17 USC §§1201-1205) pertains, among other things, to copyright infringement effected by circumvention of various copyright protections, overcoming technological barriers to the protected material, or by alteration or removal of copyright management information.

Damages available to a complaining party under the DMCA include actual damages and the infringer's profits (to the extent they are attributable to the infringing acts and are not accounted for by actual damages). 17 USC §1203(c)(2). At any time before the entry of final judgment, however, the complainant can elect to recover statutory damages in place of actual damages. 17 USC §1203(c)(3). For each violation of 17 USC §1201, statutory damages of not less than $200 and not in excess of $2500 may be awarded as the court considers just. 17 USC §1203(c)(3)(A). For each violation of 17 USC §1202, statutory damages of not less than $2500 and not in excess of $25,000 can be awarded as the court considers just. 17 USC §1203(c)(3)(B).

When an infringer proves that the infringement was innocent (*i.e.,* done without awareness that the conduct in issue constituted infringement or without reason to know that the conduct in issue was infringing), the court, in its discretion, may reduce or remit the damages award. 17 USC §1203(c)(5)(A). When a party proves that an infringer against whom a judgment was entered committed additional violations within the prior 3 years, the court, as it considers just, may award treble damages to the aggrieved party. 17 USC §1203(c)(4).

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§6.27A H. Illegality No Defense to Damages

The illegal use or operation of a work by the copyright owner does not preclude an award of actual or statutory damages for copyright infringement "unless the defendant can show that he has personally been injured by the plaintiff's conduct." *Dream Games of Arizona, Inc. v PC Onsite* (9th Cir 2009) 561 F3d 983, 990 (quoting *Mitchell Bros. Film Group v Cinema Adult Theater* (5th Cir 1979) 604 F2d 852, 863).

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III. TRADEMARK INFRINGEMENT

§6.28 A. Lanham Act and Statute of Limitations

Section 35(a) of the Lanham Act (15 USC §1117(a)) provides the federal statutory basis for the recovery of damages for infringement of marks registered in the Patent and Trademark Office as well as to unregistered marks in actions under §43(a) of the Lanham Act. The pertinent language is quoted below:

> When a violation of any right of the registrant of a mark registered in the Patent and Trademark Office, or a violation under section 43(a) of this title, shall have been established in any civil action arising under this chapter, the plaintiff shall be entitled… subject to the principles of equity, to recover (1) defendant's profits, (2) any damages sustained by the plaintiff, and (3) the costs of the action. The court shall assess such profits and damages or cause the same to be assessed under its direction. In assessing damages the court may enter judgment, according to the circumstances of the case, for any sum above the amount found as actual damages, not exceeding three times such amount. If the court shall find that the amount of the recovery based on profits is either inadequate or excessive the court may in its discretion enter judgment for such sum as the court shall find to be just, according to the circumstances of the case. Such sum in either of the above circumstances shall constitute compensation and not a penalty.

NOTE: The qualification found in 15 USC §1117(a), "subject to the principles of equity," permits a court to deny an award of damages if an injunction will suffice. However, "where trademark infringement is deliberate and willful both the trademark owner and the public are slighted if a court provides no greater remedy than an injunction." *Playboy Enters., Inc. v Baccarat Clothing Co.* (9th Cir 1982) 692 F2d 1272.

The Lanham Act does not include a statute of limitations. The courts have held that the statute should be borrowed from the comparable state statute for the same or similar law. *Lampf, Pleva, Lipkind, Prupi & Petigrow v Gilbertson* (1991) 501 US 350, 356, 1274, 115 L Ed 2d 321, 111 S Ct 2773. California law applies a 4-year statute for trademark infringement. Bus & P C §17208.

NOTE: Bad faith use of a trademark in a domain name, with intention to profit from the mark, violates the Anticybersquatting Consumer Protection Act (ACPA) (15 USC §1125(d)). See *Audi AG v D'Amato* (6th Cir 2006) 469 F3d 534, 547.

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§6.29 1. Defendant's Profits

Courts have held that the purposes of the Lanham Act are slighted and the infringer is rewarded, if the infringer is permitted to retain the profits from an infringing act. These courts have disgorged a defendant's profits under an unjust enrichment theory. *Burger King Corp. v Mason* (11th Cir 1988) 855 F2d 779, 78. Other courts have awarded an infringer's profits as an alternate method of approximating the plaintiff's lost profits. *Winterland Concessions Co. v Ferton* (ND Cal 1993) 835 F Supp 529, 532. Disgorgement of profits is also a measure for contempt sanctions. *Jerry's Famous Deli, Inc., v Papanicolaou* (9th Cir 2004) 383 F3d 998. See, *e.g., Frank Music Corp. v Metro-Goldwyn-Mayer, Inc.* (9th Cir 1985) 772 F2d 505, 514.

The theory of unjust enrichment for awarding a defendant's profits does not apply in circumstances when the subject goods were not competitive and there were no actual damages because of the infringement. *Adray v Adry-Mart, Inc*. (9th Cir 1995) 76 F3d 984, 988. It also does not apply if the award of profits would be duplicative of the award of damages. See *Aero Prods. Int'l, Inc. v Intex Recreation Corp.* (Fed Cir 2006) 466 F3d 1000, 1016 (trademark damages disallowed because they were duplicative of patent damages). Nonetheless, the defendant's profits are always awarded if the infringement was willful. *Raxton Corp. v Anania Assocs.* (1st Cir 1982) 668 F2d 622, 625.

Banjo Buddies, Inc. v Renosky (3d Cir 2005) 399 F3d 168, 174, establishes that under the post-1999 amendment to the Lanham Act, willfulness is a factor to be considered, but it is not a prerequisite, in an award of defendant's profits. See also *R & R Partners, Inc. v Tovar* (D Nev, Apr. 23, 2007, No. 03:04-CV-00145-LRH-PAL) 2007 US Dist Lexis 29819. Nevertheless, a claimant must have at least pleaded willfulness in the complaint to recover enhanced damages. *Curcio Webb, LLC, v National Benefit Programs Agency, Inc.* (SD Ohio 2005) 367 F Supp 2d 1191, 1203.

The plaintiff is required to prove only the defendant's revenue. The defendant must prove all elements of costs or expenses to be deducted. *Playboy Enters., Inc. v P.K. Sorren Export Co*. (SD Fla 1982) 546 F Supp 987, 997, aff'd (11th Cir 1984) 724 F2d 977. If the defendant fails to prove any deductible costs or expenses, the plaintiff is entitled to recover all of the defendant's revenue from the infringement. *Louis Vuitton S.A. v Spencer Handbags Corp*. (2d Cir 1985) 765 F2d 966, 973.

The defendant may try to prove that some or all of its profits resulted from something other than infringement of the plaintiff's mark, *e.g.,* that the profits are in part attributable to the defendant's own efforts. If the defendant's contributions to profits are established, the awardable profits are reduced "so that neither party will have what belongs to the other." *Holiday Inns, Inc. v Airport Holiday Corp*. (ND Tex 1980) 493 F Supp 1025, 1028. The defendant's failure to meet this burden will result in the defendant's being charged with all of its profits being attributable to the infringement. *Mishawaka Rubber & Woolen Mfg. Co. v S.S. Kresge Co*. (1942) 316 US 203, 206, 86 L Ed 1381, 62 S Ct 1022.

NOTE: Some courts have denied the defendant the right to apportion profits between infringing and noninfringing sources if the infringement was willful, under the pre-1999 amendment to the Lanham Act. *Truck Equip. Serv. Co. v Fruehauf Corp*. (8th Cir 1976) 536 F2d 1210, 1222.

The defendant may be able to deduct a portion of its fixed overhead expenses from its profits under the full absorption approach rather than only direct expenses under the incremental approach. *American Honda Motor Co. v Two Wheel Corp*. (2d Cir 1990) 918 F2d 1060, 1064. However, in order to be able to deduct overhead expenses, the defendant must offer sufficient evidence in the form of its records to establish a nexus between the expenses to be deducted and the infringing sales. *Manhattan Indus., Inc. v Sweater Bee by Banff, Ltd*. (2d Cir 1989) 885 F2d 1, 7.

Title 15 USC §1117(a) also provides that if "the amount of the recovery based on profit is either inadequate or excessive the court may in its discretion enter judgment for such sum as the court shall find to be just, according to the circumstances of the case."

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§6.30 2. Plaintiff's Damages

A plaintiff is entitled to recover all damages proximately caused by the infringement, which may include:

- The plaintiff's lost profits (*Borg-Warner Corp. v York-Shipley, Inc.* (7th Cir 1961) 293 F2d 88, 95);
- A reasonable royalty (*Playboy Enters., Inc. v Baccarat Clothing Co*. (9th Cir 1982) 692 F2d 1272, 1274);
- The defendant's profits (*FoxTrap, Inc. v FoxTrap, Inc*. (DC Cir 1982) 671 F2d 636, 641); and
- Corrective advertising costs (*Big O Tire Dealers, Inc. v Goodyear Tire & Rubber Co*. (D Colo 1976) 408 F Supp 1219, 1232, aff'd with modification (10th Cir 1977) 561 F2d 1365).

A defendant's projected revenues and costs may be used to develop a damages award. *Technologies, S.A. v Cyrano, Inc.* (D Mass 2006) 460 F Supp 2d 197, 201. Under 15 USC §1117 a trial court has no authority to downwardly adjust the damages found by a jury. *Go Med. Indus. Pty., Ltd. v Inmed Corp.* (Fed Cir 2006) 471 F3d 1264, 1274.

NOTE: An award of statutory damages under the Anticybersquatting Consumer Protection Act (ACPA) (15 USC §1125(d)) is not duplicative of damages for service mark infringement under the Lanham Act. *St. Luke's Cataract & Laser Inst., P.A. v Sanderson* (11th Cir 2009) 573 F3d 1186, 1203.

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§6.31 a. Treble Damages and Punitive Damages

According to the circumstances of the case, the plaintiff is entitled to recover up to treble damages, as additional damages and not as a penalty. *Deering, Miliken & Co. v Gilbert* (2d Cir 1959) 269 F2d 191, 194. Punitive damages are not recoverable under the Lanham Act. *Metric & Multistandard Components Corp. v Metric's, Inc*. (8th Cir 1980) 635 F2d 710, 715.

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Source: Civil Litigation/California Attorney's Guide to Damages/6 Intellectual Property Infringement and Misappropriation/§6.31A b. Statutory Damages for Counterfeit Marks and for Violation of 15 USC §1125(d)(1)

§6.31A b. Statutory Damages for Counterfeit Marks and for Violation of 15 USC §1125(d)(1)

Statutory damages for the use of counterfeit marks are governed by 15 USC §1117(c):

> In a case involving the use of a counterfeit mark (as defined in [15 USC §1116(d)]) in connection with the sale, offering for sale, or distribution of goods or services, the plaintiff may elect, at any time before final judgment is rendered by the trial court, to recover, instead of actual damages and profits under subsection (a) of this section, an award of statutory damages for any such use in connection with the sale, offering for sale, or distribution of goods or services in the amount of—
>
> (1) not less than $1,000 or more than $200,000 per counterfeit mark per type of goods or services sold, offered for sale, or distributed, as the court considers just; or
>
> (2) if the court finds that the use of the counterfeit mark was willful, not more than $2,000,000 per counterfeit mark per type of goods or services sold, offered for sale, or distributed, as the court considers just.

Statutory damages for violation of 15 USC §1125(d)(1) are governed by 15 USC §1117(d):

> In a case involving a violation of [15 USC §1125(d)(1)], the plaintiff may elect, at any time before final judgment is rendered by the trial court, to recover, instead of actual damages and profits, an award of statutory damages in the amount of not less than $1,000 and not more than $100,000 per domain name, as the court considers just.

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§6.32 c. Prejudgment Interest and Attorney Fees

Prejudgment interest on damages awards is also available to a plaintiff. *American Honda Motor Co. v Two Wheel Corp*. (2d Cir 1990) 918 F2d 1060, 1064. Attorney fees are recoverable by the prevailing party in exceptional cases, such as when the infringement was fraudulent or willful. *Quaker State Oil Ref. Corp. v Kooltone, Inc*. (2d Cir 1981) 649 F2d 94, 95. A prevailing defendant can recover attorney fees if the action was brought in bad faith or was objectively unreasonable. *Conopco, Inc. v Campbell Soup Co.* (2d Cir 1996) 95 F3d 187, 194 (requiring fraud or bad faith for award of attorney fees to prevailing defendant). But see *Stephen W. Boney, Inc. v Boney Servs., Inc.* (9th Cir 1997) 127 F3d 821, 827 (bad faith sufficient but not always necessary to award attorney fees to prevailing defendants).

NOTE: The U.S. Supreme Court in *Safeco Ins. Co. v Burr* (2007) 551 US 47, 167 L Ed 2d 1045, 127 S Ct 2201, held in a different statutory context that "willfully is a word of many meanings whose construction is often dependent on the context in which it appears, [citation] and where willfulness is a statutory condition of civil liability, we have generally taken it to cover not only knowing violations of a standard, but reckless ones as well." 551 US at 57, 167 L Ed 2d at 1058 (internal quotation marks omitted). The Supreme Court also found that "the term recklessness is not self-defining, [but] the common law has generally understood it in the sphere of civil liability as conduct violating an objective standard: action entailing an unjustifiably high risk of harm that is either known or so obvious that it should be known." 551 US at 68, 167 L Ed 2d at 1065 (internal quotation marks omitted). Thus it is arguable that the willfulness requirement of the Lanham Act should be satisfied by a recklessness standard as well.

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§6.33 B. California Trademark Law

Chapter 2 of the California Business & Professions Code (Bus & P C §§14200-14272 ("Trademark Law")) governs the registration and protection of trademarks under California law. Business and Professions Code §14250(a) provides the statutory basis for the recovery of damages for trademark infringement under the Trademark Law. Under this section, an owner of a mark registered under the Trademark Law may recover against the infringer of the mark "up to three times [the infringer's] profits from, and up to three times all damages suffered by reason of, the wrongful manufacture, use, display, or sale." Both federal and state courts have held that California trademark laws are substantially congruent with the Lanham Act. *Dreamwerks Prod. Group, Inc. v SKG Studio* (9th Cir 1998) 142 F3d 1127.

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§6.34 IV. TRADE SECRET MISAPPROPRIATION AND STATUTE OF LIMITATIONS

The statutory basis for an award of damages under the Uniform Trade Secrets Act (CC §3426-3426.11) is CC §3426.3, which provides:

> (a) A complainant may recover damages for the actual loss caused by misappropriation. A complainant also may recover for the unjust enrichment caused by the misappropriation that is not taken into account in computing damages for actual loss.
>
> (b) If neither damages nor unjust enrichment caused by misappropriation are provable, the court may order payment of a reasonable royalty for no longer than the period of time the use could have been prohibited.
>
> (c) If willful and malicious misappropriation exists, the court may award exemplary damages in an amount not exceeding twice any award made under subdivision (a) or (b).

The statute of limitations for a trade secret claim is 3 years from discovery of the violation. CC §3426.6.

The District Court for Southern District of Florida found that a plaintiff's failure to present evidence of lost profits, or that the infringement caused the lost profits, entitled the defendant to a judgment in its favor. *AlphaMed Pharms. Corp. v Arriva Pharms., Inc.* (SD Fla 2006) 432 F Supp 2d 1319, 1339. The prevailing defendant would presumably also be entitled to an award of attorney fees.

A prevailing plaintiff is entitled to an injunction against continuing misappropriation or use of its trade secrets. Such injunctive orders need not be limited in time notwithstanding the time limitations on contractual limitations on use of trade secrets. *ReadyLink Healthcare v Cotton* (2005) 126 CA4th 1006, 1021, 24 CR3d 720. No injunction will be permitted, however, if the claimed trade secret is no longer secret. *O2 Micro Int'l Ltd. v Monolithic Power Sys., Inc.* (ND Cal 2005) 399 F Supp 2d 1064, 1069. Moreover, a "production injunction" can only be imposed when the misappropriated trade secret is inextricably connected to the defendant's manufacture of the product and a "use injunction" would be ineffective because "the misappropriator cannot be relied upon to unlearn or abandon the misappropriated technology." 399 F Supp 2d at 1070.

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§6.35 A. Actual Damages

Damages for the actual losses caused by the misappropriation may be recovered by the plaintiff, including lost profits. See *Klamath-Orleans Lumber, Inc. v Miller* (1978) 87 CA3d 458, 466, 151 CR 118. In cases involving a manufacturing process, lost profits damages may include loss of profits because of a reduction in the plaintiff's sales price of the items. See *Sarkes Tarzian, Inc. v Audio Devices, Inc.* (SD Cal 1958) 166 F Supp 250, 269. If the trade secret misappropriated is a customer list, lost profits resulting from sales actually diverted from the plaintiff's business are the correct measure of actual damages. *Klamath-Orleans Lumber, Inc. v Miller,* 87 CA3d at 466. A defendant's projected revenues and costs may be used to develop a damages award. *Technologies, S.A. v Cyrano, Inc.* (D Mass 2006) 460 F Supp 2d 197, 201.

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§6.36 B. Unjust Enrichment

Any unjust enrichment by the misappropriation may also be recovered by the plaintiff to the extent not taken into account in computing damages for actual loss. CC §3426.3(a).

NOTE: The plaintiff must offer evidence of the benefit the defendant received by misappropriation of the plaintiff's trade secrets that was not taken into account in computing the plaintiff's damages for actual loss and is not simply the value of the trade secret to the plaintiff. See generally *Unilogic, Inc. v Burroughs Corp*. (1992) 10 CA4th 612, 626, 12 CR2d 741. The amount of the defendant's unjust enrichment may be calculated based on a reasonable approximation. *Morlife, Inc. v Perry* (1997) 56 CA4th 1514, 1528, 66 CR2d 731. For example, in *Morlife,* the calculation of the defendants' "unjust enrichment" was based on the percentage of business derived by the defendants from a misappropriated customer list. That percentage was applied to the defendants' earnings from their new business, which competed with their former employer.

"If the trade secret accounts for only a portion of the profits earned on the defendant's sales, such as when the trade secret relates to a single component of a product marketable without the secret, an award to the plaintiff of defendant's entire profit may be unjust." *Vermont Microsystems, Inc. v Autodesk, Inc*. (2d Cir 1998) 138 F3d 449, 450.

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§6.37 C. Reasonable Royalty

If neither damages nor unjust enrichment caused by misappropriation are provable, the court may order payment of a reasonable royalty for no longer than the period of time the use could have been prohibited. CC §3426.3(b). A royalty may not be awarded as damages when actual damages or unjust enrichment are provable. *Cacique, Inc. v Robert Reiser & Co.* (9th Cir 1999) 169 F3d 619, 623. The Ninth Circuit in *Cacique* explained that cases finding unjust enrichment unprovable under CC §3426.3 have involved unusual circumstances, citing *Unilogic, Inc. v Burroughs Corp*. (1992) 10 CA4th 612, 12 CR2d 741 (infringing product never brought to market), and *Vermont Microsystems, Inc. v Autodesk, Inc*. (2d Cir 1998) 138 F3d 449 (infringing technology was only tiny part of value of final product).

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§6.38 D. Punitive Damages

If the misappropriation was willful and malicious, the court may award exemplary damages in an amount not exceeding twice any award made under CC §3426.3(a) (damages) or §3426.3(b) (royalties). CC §3426.3(c). Despite this statutory cap on punitive damages, the rules under California law concerning the financial evidence that must be considered in awarding punitive damages are applicable under CC §3426.3(c). *Vacco Indus., Inc. v Van Den Berg* (1992) 5 CA4th 34, 46 n11, 6 CR2d 602.

NOTE: Under California law, the plaintiff has the burden of presenting evidence of the defendant's financial condition for a punitive damages claim. *Adams v Murakami* (1991) 54 C3d 105, 110, 119, 284 CR 318. As in the case of compensatory damages, punitive damages cannot be based on speculation. 54 C3d at 114. California courts have held that the defendant's net worth at the time of trial is the criterion against which an award of punitive damages is to be measured in deciding whether the award is excessive, and that evidence only of the defendant's annual income or wrongfully gained profits is not sufficiently meaningful. *Kelly v Haag* (2006) 145 CA4th 910, 915, 52 CR3d 126; *Lara v Cadag* (1993) 13 CA4th 1061, 1064, 16 CR2d 811; *Kenly v Ukegawa* (1993) 16 CA4th 49, 56, 19 CR2d 771. But see *Cummings Med. Corp. v Occupational Med. Corp*. (1992) 10 CA4th 1291, 1298, 13 CR2d 585 (punitive damages award based solely on defendant's profits). See also *State Farm Mut. Auto. Ins. Co. v Campbell* (2003) 538 US 408, 155 L Ed 2d 585, 123 S Ct 1513 (strongly suggesting that punitive-to-compensatory ratios that exceed single digits risk being considered excessive); *Simon v San Paolo U.S. Holding Co.* (2005) 35 C4th 1159, 1188, 29 CR3d 379 (reducing punitive damages award to 10 times actual damages); *Johnson v Ford Motor Co.* (2005) 135 CA4th 137, 150, 37 CR3d 283 ($10 million punitive damages award was reversed as excessive in favor of award of just under 10 times compensatory damages award). Punitive damages are not available if there was no award of compensatory damages, whether substantial or nominal, comprising only restitution, offset, or damages presumed by law. *Berkley v Dowds* (2007) 152 CA4th 518, 532, 61 CR3d 304.

"Willful" means "a purpose or willingness to commit the act or engage in the conduct in question, and the conduct was not reasonable under the circumstances then present and was not undertaken in good faith." *Ajaxo Inc. v E*Trade Group, Inc.* (2005) 135 CA4th 21, 66, 37 CR3d 221. "Malice" means (135 CA4th at 66):

> conduct which is intended by the defendant to cause injury to the plaintiff or despicable conduct which is carried on by the defendant with a willful and conscious disregard for the rights of others when the defendant is aware of the probable consequences of its conduct and willfully or deliberately fails to avoid those consequences.

Malice may be proven either expressly by direct evidence probative of the existence of hatred or ill will or by implication from indirect evidence from which the jury may draw inferences. *Neal v Farmers Ins. Exch.* (1978) 21 C3d 910, 923 n6, 148 CR 389. In *Philip Morris USA v Williams* (2007) 549 US 346, 166 L Ed 2d 940, 948, 127 S Ct 1057, the Supreme Court held that it is a violation of due process for a jury to consider injuries to non-parties in setting punitive damages, but jurors may consider harm to non-parties in determining the reprehensibility of defendant's conduct.

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§6.39 E. Attorney Fees

The court *may* award reasonable attorney fees to the prevailing party if a claim of misappropriation is made in bad faith, a motion to terminate an injunction is made or resisted in bad faith, or the misappropriation was willful and malicious. CC §3426.4; *Computer Prepared Accounts, Inc. v Katz* (1991) 235 CA3d 428, 431, 286 CR 556 (awarding sanctions and attorney fees under CC §3426.4 and CCP §128.5 for seeking injunction based on forged documents). The attorney fees provision of CC §3426.4 is a rule of substantive state law and therefore it applies to trade secret claims litigated under the federal courts' diversity jurisdiction. *CRST Van Expedited, Inc. v Werner Enters., Inc.* (9th Cir 2007) 479 F3d 1099, 1111.

The statute does not define "willful" or "malicious." However, it has been held that willfulness and maliciousness are established by a jury's determination, on clear and convincing evidence, to award punitive damages, because such a determination necessitates a finding that the defendants' acts of misappropriation were done with malice. *Vacco Indus., Inc. v Van Den Berg* (1992) 5 CA4th 34, 54, 6 CR2d 602.

Attorney fees under CC §3426.4 are governed by CCP §1033.5(a)(10), and therefore the amount of the award is fixed by the court in a posttrial noticed motion. CCP §1033.5(c)(5). The amount of the award to a successful plaintiff need not reflect the damages award alone when the most significant relief awarded the plaintiff is injunctive. *Vacco Indus., Inc.,* 5 CA4th at 55.

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V. REMEDIES FOR MISAPPROPRIATION UNDER OTHER COMMON LAW THEORIES

§6.40 A. Fraud (Deceit) Damages and Statute of Limitations

A plaintiff who claims that it was "defrauded in the purchase, sale or exchange" of its intellectual property may in certain cases have a claim for common law fraud as a defrauded seller. Under California law, "[a] complete causal relationship between the fraud or deceit and the plaintiff's damages is required" (*Small v Fritz Cos.* (2003) 30 C4th 167, 202, 132 CR2d 490). As the court said in *Viner v Sweet* (2003) 30 C4th 1232, 1242, 135 CR2d 629:

> Determining causation always requires evaluation of hypothetical situations concerning what might have happened, but did not.... This is so because the very idea of causation necessarily involves comparing historical events to a hypothetical alternative.

The Ninth Circuit has noted that because of the highly subjective nature of causation analysis, the Supreme Court of California has instructed that the question of whether a party detrimentally relied on another party's misrepresentation is properly left to a jury. See *City Solutions Inc v Clear Channel Communications, Inc*. (9th Cir 2004) 365 F3d 835.

In fraud cases, CC §3343—the out-of-pocket loss rule—governs the measure of the plaintiff's damages. *Croeni v Goldstein* (1994) 21 CA4th 754, 759, 26 CR2d 412 ("[i]n the absence of a fiduciary relationship, CC §3343 governs the measure of damages in fraudulent property transactions"). The primary damages element under CC §3343 is equal to "the difference between the actual value of that with which the defrauded person parted with and the actual value of that which he received." CC §3343(a). The valuation of the properties under §3343(a) is to be made as of the date of the fraudulent transaction. *McCue v Bruce Enters., Inc*. (1964) 228 CA2d 21, 31, 39 CR 125.

NOTE: Although CC §3343 speaks only in terms of "property," CC §§654-655 and 980 define "property" to include "intellectual property."

The statute of limitations for a fraud or deceit claim is 3 years from discovery of the violation. CCP §338(d).

NOTE: In *Robinson Helicopter Co. v Dana Corp.* (2004) 34 C4th 979, 22 CR3d 352, the California Supreme Court held that the economic loss rule did not bar fraud and misrepresentation claims that were independent of the breach of contract. For discussion, see §1.15.

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§6.41 1. Lost Profits as Additional or Consequential Damages for Nonfiduciary Claims

Civil Code §3343(a)(3) provides for additional damages as follows:

> Where the defrauded party has been induced by reason of the fraud to sell or otherwise part with the property in question, [the defrauded party may recover] an amount which will compensate him for profits or other gains which might reasonably have been earned by use of the property had he retained it.

Subdivision (a)(3) was added by amendment in 1971. It retained and amended the preexisting out-of-pocket rule. The 1971 amendment permitted lost profits as an element of damages in appropriate cases to correct "certain logical inconsistencies [that] existed between the judicial application of [former §3343] and that of other enactments dealing with measure of damages for fraud." *Croeni v Goldstein* (1994) 21 CA4th 754, 759, 26 CR2d 412. However, the 1971 amendment did not provide for a double recovery by defrauded parties. 21 CA4th at 759.

Thus, lost profits are recoverable under CC §3343(a)(3) only if, under the terms of the transaction, the defrauded seller is entitled to profits from the property after it is transferred or those lost profits are not reflected in the value of the product already awarded. *Channell v Anthony* (1976) 58 CA3d 290, 314, 129 CR 704. See *Croeni,* 21 CA4th at 759 ("[i]n other words, the amount of profit earned by the business is one of the factors taken into account in establishing its value, and reflected in the sale price").

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§6.42 2. Lost Profits for Claims Against Fiduciaries

Some courts have recognized an exception to the general rule that CC §3343 governs fraudulent property transactions in cases in which a fiduciary relationship existed between the fraudulent and defrauded parties. In such cases, the general measure of tort damages under CC §3333, *i.e.,* the benefit of the bargain rule, provides for the measure of damages. *Salahutdin v Valley of Cal., Inc*. (1994) 24 CA4th 555, 566, 29 CR2d 463. In cases in which the fraudulent party is a fiduciary, the plaintiff should be able to recover lost profits as long as the CC §3333 requirements for recovery are met. But see *Hensley v McSweeney* (2001) 90 CA4th 1081, 1086, 109 CR2d 489 ("appropriate measure of damages on the fiduciary tort actions is the out of pocket measure, not the benefit of the bargain measure").

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§6.43 B. Conversion Damages and Statute of Limitations

The measure of damages for conversion is governed by CC §3336, which provides:

> The detriment caused by the wrongful conversion of personal property is presumed to be:
> First—The value of the property at the time of the conversion, with interest from that time, or an amount sufficient to indemnify the party injured for the loss which is the natural, reasonable, and proximate result of the wrongful act complained of and which a proper degree of prudence on his part would not have averted; and
> Second—A fair compensation for the time and money properly expended in pursuit of the property.

Attorney fees are not recoverable even though expensed in pursuit of the property. *Gladstone v Hillel* (1988) 203 CA3d 977, 991, 250 CR 372. The interest recoverable under CC §3336 is at the legal rate. *Beverly Fin. Co. v American Cas. Co*. (1969) 273 CA2d 259, 265, 78 CR 334. Prejudgment interest is recoverable from the date that claimant had a right to possession. *Nelkin & Co. v South Beverly Hills Wilshire Jewelry & Loan* (2005) 129 CA4th 692, 703, 28 CR3d 815.

The opinion of the owner of the converted property regarding its value is admissible. *Schroeder v Auto Driveaway Co.* (1974) 11 C3d 908, 921, 114 CR 622. However, the plaintiff is not free to offer his or her opinion of value without first establishing that such opinion has a proper factual basis. The rationale for this proposition was explained in *Contra Costa Water Dist. v Bar-C Prop.* (1992) 5 CA4th 652, 661, 7 CR2d 91. See also *Griffith v County of Los Angeles* (1968) 267 CA2d 837, 847, 73 CR 773 ("[o]pinions of value and other expert opinions, even though uncontradicted, are worth no more than the reasons and factual data upon which they are based").

NOTE: Under California law, conversion of intangible property lies only in cases in which the unauthorized taking of intangible interests is merged with, or reflected in, something tangible. *Thrifty-Tel, Inc. v Bezenek* (1996) 46 CA4th 1559, 1565, 54 CR2d 468; 5 Witkin, Summary of California Law, Torts §702 (10th ed 2005). While intangibles "represented by documents, such as bonds, notes, bills of exchange, stock certificates and warehouse receipts" may be converted by misappropriation of their physical manifestation, there can be no conversion in the abstract of intangible property or "trade secrets." In *Fremont Indem. Co. v Fremont Gen. Corp.* (2007) 148 CA4th 97, 124, 55 CR3d 621, the Second District Court of Appeal rejected the reasoning of *Thrifty-Tel* and held that misappropriation of intangible net operating losses supports a cause of action for conversion.

The statute of limitations for conversion is 3 years. CCP §338(c).

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§6.44 C. Restitution Based on Quasi-Contract/Unjust Enrichment

Restitution or quasi-contractual recovery is based on the principle of unjust enrichment. A party is unjustly enriched when he or she receives a benefit that may not be justly retained. A contract "implied in law" or "quasi-contract" is a duty created without regard to the parties' intention. It is designed to restore the aggrieved party to his or her former position by "return of the *thing* or its *equivalent* in money." 1 Witkin, Summary of California Law, *Contracts* §1013 (10th ed 2005) (emphasis in original) (citing Restatement of Restitution §1). Although a tort normally permits an action for damages, when "the defendant *acquires benefits* by his or her wrongful act, the plaintiff may 'waive the tort,' *i.e.,* elect to sue in quasi-contract for restitution instead of for damages." 1 Witkin, *Contracts* §1040 (emphasis in original).

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§6.45 1. General Measure of Restitution for Quasi-Contract/Unjust Enrichment

There is scarce California case law concerning the measure of restitution for quasi-contract/unjust enrichment when the claim is based on the wrongful acquisition of the plaintiff's property. However, Restatement of Restitution §151 (1937) ("Value of Property Acquired by Consciously Tortious Conduct") provides guidance regarding the amount of the plaintiff's recovery for such a claim. See Restatement of Restitution §128 ("Conversion and Other Tortious Dealings with Chattels"); Comment (a) to §151. Restatement of Restitution §151 states that

> [when] a person is entitled to a money judgment against another because by fraud, duress or other consciously tortious conduct the other has acquired, retained or disposed of his property, the measure of recovery for the benefit received by the other is the value of the property at the time of its improper acquisition, retention or disposition, or a higher value if this is required to avoid injustice where the property has fluctuated in value or additions have been made to it.

Restatement of Restitution §151, Comment (b) states:

> The value of property is its exchange value measured in money, or the amount for which it could be exchanged if there were an open market with a wide opportunity for buyers.... [W]here there is no market the value must be determined by the opinion of those having such information as gives them a basis for judgment.

Comment (f) to §151 explains:

> A person who tortiously has acquired, retained or disposed of another's property with knowledge that such conduct is wrongful is entitled to no profits therefrom. Therefore, he is subject to liability at the election of the rightful owner for the value of anything received in exchange therefor (see [Restatement of Restitution] §202). He is also liable for profits made by its use (see [Restatement of Restitution] §157). On the other hand, if a loss results whether or not the result of the transaction by which he acquired it, he suffers the loss; a change of circumstances is not a defense (see [Restatement of Restitution] §142(3)). Thus, if the property received deteriorates in value or is lost or destroyed, he remains liable for the value which it had at the time of his wrongful conduct.

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§6.46 2. Restitution for Lost Profits Attributable to Property

Restatement of Restitution §157 (1937) limits lost profits recovery to the property's "direct product." Direct product does not include profits resulting from transactions entered into by the defendant after the property is acquired. Comment (b) to §157 provides:

> The phrase "direct product" means that which is derived from the ownership or possession of the property without the intervention of an independent transaction by the possessor. Thus, a person who has a duty to make restitution of the title to land is under a duty to restore amounts received by him as rent upon a lease existing before he acquired the title. Likewise a person who has received corporate shares or bonds would have a duty to account for the dividends received from the shares or interest upon the bonds. This product is to be distinguished from the profits made by the holder of the subject matter through its use or through renting the property to a third person. Thus, a person who, being subject to a duty to account for money, lends it to a third person and receives interest thereon, does not receive the interest as the direct product of the money as this phrase is used herein.

Thus, under the Restatement of Restitution, passive type income generated by the property during the period it was wrongfully held by the defendant would be included as direct product and would therefore be recoverable, as opposed to income that was generated in part by the efforts and/or capital of the defendant.

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3. Constructive Trust Remedy

§6.47 a. Nature of Constructive Trust Remedy

"Civil Code §§2223 and 2224 codify the equitable principle that one who wrongfully acquires property of another holds the property as an involuntary constructive trustee." *Haskel Eng'r & Supply Co. v Hartford Acc. & Indem. Co*. (1978) 78 CA3d 371, 375, 144 CR 189. "[A] constructive trust is itself only a remedy." 78 CA3d at 378. To impose a constructive trust there must exist a res, *i.e.,* property; the plaintiff must have rights to the res; and the defendant must have gained the res by fraud, accident, mistake, undue influence, violation of the trust, or other wrongful act. *Kraus v Willow Park Pub. Golf Course* (1977) 73 CA3d 354, 373, 140 CR 744. "A constructive trust is a *remedy* used by a court of equity to compel a person who has property to which he is not justly entitled to transfer it to the person entitled thereto. The trust is passive, the only duty being to convey the property." 13 Witkin, Summary of California Law, *Trusts* §319 (10th ed 2005) (emphasis in original), citing, among others, *Haskel Eng'r & Supply Co. v Hartford Acc. & Indem. Co., supra,* and Restatement of Restitution §160 (1937).

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§6.48 b. Constructive Trust and Quasi-Contract Claims Based on Unjust Enrichment

Comment (a) to Restatement of Restitution §160 (1937) ("Constructive Trust") discusses the nature of a constructive trust and its relationship to a quasi-contract claim:

> A constructive trust differs from an express trust in much the same way as a quasi-contractual obligation differs from a contractual obligation. On the other hand, a quasi-contractual obligation and a constructive trust closely resemble each other, the chief difference being that the plaintiff in bringing an action to enforce a quasi-contractual obligation seeks to obtain a judgment imposing a merely personal liability upon the defendant to pay a sum of money, whereas the plaintiff in bringing a suit to enforce a constructive trust seeks to recover specific property. For these reasons Constructive Trusts are dealt with together with Quasi Contracts in the Restatement of this Subject.

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§6.49 c. Property Subject to Constructive Trust

The plaintiff must establish its right to the particular assets over which it seeks to impose a constructive trust. See *Pacific Lumber Co. v Superior Court* (1990) 226 CA3d 371, 377, 276 CR 425 (former shareholders were not entitled to constructive trust over property owned by corporation because they had no direct interest in property as shareholders). See also *Graham v Wood* (1935) 8 CA2d 451, 458, 48 P2d 124 ("the right of pursuing a trust fund fails when the means of ascertainment fails").

Comment (h) to Restatement of Restitution §160 (1937) discusses the concept of reaching the product of the property held in constructive trust:

> Where property is held by one person upon a constructive trust for another, and the constructive trustee by the wrongful disposition of the property acquires other property, he holds the property so acquired upon a constructive trust, in accordance with the rules stated in [Restatement of Restitution] §§202-215 (Chapter 13). On the other hand, where a person receives property from another under such circumstances that a merely personal liability is imposed upon him, the transferor having no beneficial interest in the property cannot reach the product of the property except to the extent that any creditor can reach it….
>
> So also, a constructive trust no longer continues when the person chargeable as constructive trustee of property no longer holds the property or other property which is its product. As to reaching the product, see [Restatement of Restitution] §§202-215 (Chapter 13).

Restatement of Restitution §215 concerns the requirement for tracing property for a constructive trust. Section 215(1) provides:

> (1) Except as stated in Subsection (2), where a person wrongfully disposes of the property of another but the property cannot be traced into any product, the other has merely a personal claim against the wrongdoer and cannot enforce a constructive trust or lien upon any part of the wrongdoer's property.

Comment (a) to Restatement of Restitution §215(1) elaborates on the requirement that the product of the property disposed of must be identified by the plaintiff:

> Where a person wrongfully disposes of the property of another, the other is not entitled to priority over the general creditors of the wrongdoer merely because of the character of the wrong done to him. This is true whether or not the wrongdoer is in a fiduciary relation to the other. Thus, if a trustee sells trust property and dissipates the proceeds, the beneficiary of the trust is not entitled to priority over other claimants of the trustee. The claimant must prove not only that the wrongdoer once had property legally or equitably belonging to him, but that he still holds the property or property which is in whole or in part its product. As has been stated, the mere fact that the property or its proceeds has been mingled with the wrongdoer's own property in one indistinguishable mass does not prevent the claimant from following his property and obtaining in part at least priority over the wrongdoer's general creditors. But if it is shown that the property or its proceeds have been dissipated so that no product remains, his claim is only that of a general creditor of the wrongdoer. Thus, if the wrongdoer has used the money of the claimant in speculation and has lost it all, the claimant cannot enforce a constructive trust of or an equitable lien upon other property of the wrongdoer, and has only a personal claim against the wrongdoer, and is not entitled to priority over other creditors of the wrongdoer.

It is the plaintiff's burden to trace the proceeds of the property disposed of. Restatement of Restitution, Comment (b) to §215(1) provides:

> A person whose property is wrongfully taken by another is not entitled to priority over other creditors unless he proves that the wrongdoer not only once had the property or its proceeds, but still has the property or its proceeds or property in which the claimant's property or its proceeds have been mingled indistinguishably.

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Source: Civil Litigation/California Attorney's Guide to Damages/6 Intellectual Property Infringement and Misappropriation/§6.50 VI. CHECKLIST: SUGGESTED DISCOVERY

§6.50 VI. CHECKLIST: SUGGESTED DISCOVERY

The following is a list of suggested subject matters to be covered by written discovery or by oral deposition on the matter of damages and restitution:

- Monthly sales information for the infringing and infringed product, as well as for related product lines, including periods prior to the infringement. This information is contained in sales journals, sales tax returns, or other records that are maintained to summarize sales.
- Information showing the sales history by customer or distributor for the product in question.
- Product pricing information, including published list price documents and policies for allowing discounts to the list price.
- All records reflecting the cost of goods sold and variances for the infringed and infringing product.
- All records reflecting a breakdown of fixed versus variable expenses for both cost of goods sold and operating expenses for the subject products.
- All correspondence with customers, including internal reports, that refers to contracts with customers.
- Income statements (showing gross profits and operating profits) and balance sheets for the company or division producing the product in question.
- Business plans and forecasts, including those discussing investment rate of return, for the business and the product line in question at the time of infringement.
- Sales literature that describes the product in question.
- License agreements for any technology of a similar nature.
- Identification of, and information concerning, other intellectual property and intangible assets associated with commercializing the product or service in question.
- Information that shows any effect of selling the product in question in promoting sales of other products.
- All records showing advertising expenses in promoting the infringing product.
- Mailing lists for all direct advertising.
- The identity of each publication in which advertising was placed.
- Information about financial ability to produce goods to satisfy claimed lost sales, manufacturing capability, and marketing ability and/or customer access.

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VII. REQUIRED FACTUAL BASIS FOR OPINIONS OF EXPERTS

A. Federal Rules of Evidence

§6.51 1. Permitted Basis for Expert's Opinion

Federal Rule of Evidence 703 provides:

> The facts or data in the particular case upon which an expert bases an opinion or inference may be those perceived by or made known to the expert at or before the hearing. If of a type reasonably relied upon by experts in the particular field in forming opinions or inferences upon the subject, the facts or data need not be admissible in evidence.

Under Fed R Evid 703, an expert's opinion should be excluded when it is based on assumptions that are speculative and not supported by the record. *Eastern Auto Distrib., Inc. v Peugeot Motors* (4th Cir 1986) 795 F2d 329, 337. An expert must have experience in placing a value on a patent and knowledge regarding reasonable royalties for industry-related patents. *State Contracting & Eng'g Corp. v Condotte Am., Inc.* (Fed Cir 2003) 346 F3d 1057.

An expert's opinion regarding damages must be causally related to the alleged harm. *Nat Harrison Assocs., Inc. v Gulf States Util. Co*. (5th Cir 1974) 491 F2d 578, 588 n3. Review of a trial court's decision to exclude expert testimony is for an abuse of discretion. *General Elec. Co. v Joiner* (1997) 522 US 136, 141, 118 S Ct 512, 139 L Ed 2d 508.

NOTE: The United States Supreme Court's decision in *Kumho Tire Co. v Carmichael* (1999) 526 US 137, 143 L Ed 2d 238, 119 S Ct 1167, held that the Supreme Court's test for the reliability of scientific expert testimony under *Daubert v Merrell Dow Pharms., Inc*. (1993) 509 US 579, 125 L Ed 2d 469, 113 S Ct 2786, applied also to nonscientific testimony. See *Playtex Prods., Inc. v Proctor & Gamble Co*. (SD NY, May 28, 2003) 2003 WL 21242769, 2003-2 Trade Cases 74, 153. Although the *Daubert/Kumho* test specifically applies to Fed R Evid 702, which includes the reliability of the expert's methodology, the inquiry concerning the methodology of an economic expert will usually overlap with the inquiry under Fed R Evid 703 regarding whether the expert relied on adequate data. See *In re Paoli R.R.Yard PCB Litig.* (3d Cir 1994) 35 F3d 717, 748. Although *Daubert* and *Kumho* reflect a change in the way trial courts must look at expert testimony, they do not necessarily impose a more restrictive test for determining when expert testimony is admissible. See *Idaho Rural Council v Bosma* (D Idaho 2001) 143 F Supp 2d 1169, 1184. The test is not whether the challenged expert is correct, but whether the testimony of the challenged expert is reliable. *Inline Connection Corp. v Earthlink, Inc.* (D Del 2007) 470 F Supp 2d 424, 430.

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§6.52 2. Procedure for Establishing Foundation of Expert Testimony

The court must make a preliminary determination of the admissibility of expert testimony under Fed R Evid 104. Exclusion of an expert witness's testimony on substantive evidentiary grounds may be accomplished by the filing of a motion in limine that is timely according to the court's scheduling order. *Busse v Bayerische Motoren Werke*, *A.G.* (ED La 1997) 1997 WL 106716, 1997 US Dist Lexis ¶2791.

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§6.53 3. Application of Reliable Data Requirement

Reiffin v Microsoft Corp. (ND Cal 2003) 270 F Supp 2d 1132, 1144, is illustrative of the requirement that an economic expert's testimony be based on reliable data and assumptions.

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B. California Evidence Code

§6.54 1. Permitted Basis for Expert's Opinion

Evidence Code §801(b) provides that expert opinion testimony that is not based on the expert's percipient knowledge must be based on matters that are of a type that reasonably may be relied on by experts in forming an opinion on the subject to which the testimony relates. "It is improper to use conjectural and speculative matters to support an expert's opinion on any subject because they render the opinion unreliable and irrelevant." Jefferson's California Evidence Benchbook §30.42 (4th ed CJA-CEB 2009). "[T]he courts have the obligation to contain expert testimony within the area of the professed expertise, and to require adequate foundation for the opinion." *Korsak v Atlas Hotels, Inc*. (1992) 2 CA4th 1516, 1523, 3 CR2d 833. An expert's opinion based on casual sampling of unknown sources lacks the appropriate factual foundation. 2 CA4th at 1526. See also *Wanland v Los Gatos Lodge, Inc*. (1991) 230 CA3d 1507, 1518, 281 CR 890 ("[w]hen an expert bases his or her conclusions on assumptions not supported by the record, on matters not reasonably relied on by other experts, or on factors that are remote, speculative, or conjectural, then his or her opinion lacks evidentiary value"); *Griffith v County of Los Angeles* (1968) 267 CA2d 837, 847, 73 CR 773 ("[o]pinions of value and other expert opinions, *even though uncontradicted,* are worth no more than the reasons and factual data upon which they are based").

The court, on objection, must exclude testimony in the form of an opinion that is based in whole or in significant part on matter that is not a proper basis for such an opinion. Evid C §803.

For detailed information about expert witnesses and testimony, see California Expert Witness Guide (2d ed Cal CEB 1991).

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§6.55 2. Need to Establish Foundation

Evidence Code §802 provides in pertinent part: "The court in its discretion may require that a witness before testifying in the form of an opinion be first examined concerning the matter upon which his opinion is based." The Law Revision Commission Comments for the 1965 enactment of Evid C §802 make clear that when an expert witness is offering opinion testimony not based on the witness's personal observation of facts, the foundation for such testimony is required to be first established under §802:

> Although Evid C §802 (like its predecessor, CCP §1872) provides that a witness may state the basis for his opinion on direct examination, it is clear that, in some cases, a witness is required to do so in order to show that his or her opinion is applicable to the action before the court. Under existing law, when a witness testifies in the form of an opinion not based on personal observation, the assumed facts on which the opinion is based must be stated in order to show that the witness has some basis for forming an intelligent opinion and to permit the trier of fact to determine the applicability of the opinion in light of the existence or nonexistence of such facts.

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Source: Civil Litigation/California Attorney's Guide to Damages/6 Intellectual Property Infringement and Misappropriation/§6.56 3. Procedure for Establishing Foundation

§6.56 3. Procedure for Establishing Foundation

The foundational showing required for the testimony of a plaintiff's damages expert under Evid C §802 is governed by Evid C §405. This section establishes the procedure for admitting or excluding proffered evidence based on the existence or nonexistence of preliminary facts other than those four items enumerated in Evid C §403, and other than the proffered evidence governed by Evid C §404. Evidence Code §405(a) provides in pertinent part:

> (a) When the existence of a preliminary fact is disputed, the court shall indicate which party has the burden of producing evidence and the burden of proof on the issue as implied by the rule or law under which the question arises. The court shall determine the existence or non-existence of the preliminary fact and shall admit or exclude the proffered evidence as required by the rule or law under which the question arises.

Evidence Code §400 defines "preliminary fact" to refer to foundational matters that the plaintiff must prove in order for the proffered evidence to be admitted over any objections. Under Evid C §401, the term "proffered evidence" means that which the proponent of the evidence wishes admitted.

The court must determine the existence or nonexistence of the preliminary facts by deciding first whether the proponent of the proffered evidence or the objecting party has the burden of proof with respect to the preliminary facts. Then the court will make a determination to admit or exclude the proffered evidence depending on whether the party having the burden of proof has or has not sustained its burden of convincing the judge of the existence or nonexistence of the preliminary facts. Evid C §405. See Jefferson's California Evidence Benchbook §26.1 (4th ed CJA-CEB 2009).

NOTE: Under the provisions of Evid C §405, the judge is the sole determiner of the existence or nonexistence of the preliminary facts and may admit or exclude the proffered evidence accordingly. Under Evid C §405, the jury is given no authority or power to decide the existence or nonexistence of preliminary facts supporting the admissibility of proffered evidence.

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§6.57 4. Application of Reliable Data Requirement

The reasonable reliance standard set forth in Evid C §801 does not appear to differ with respect to matters relied on by damages experts in the intellectual property setting. See, *e.g., NewWest Mortgage Co. v Home Loan Mortgage Co.* (June 27, 2002) 2002 WL 1397020 (unpublished opinion) ("[a] trial court's exclusion of expert testimony concerning lost anticipated profits for the reason that the expert did not rely on evidence of reasonable reliability will not be disturbed on appeal unless a manifest abuse of discretion is shown"), citing *Westrec Marina Mgmt., Inc. v Jardine Ins. Brokers* (2000) 85 CA4th 1042, 1051, 102 CR2d 673.

Although not dealing directly with the issue of intellectual property infringement or misappropriation damages, *City of San Diego v Sobke* (1998) 65 CA4th 379, 76 CR2d 9, an eminent domain proceeding, is illustrative of the requirement that an economic expert's testimony be based on reliable data and methods. In *Sobke,* the owners of a currency exchange business taken by the City of San Diego claimed compensation for loss of goodwill associated with their business.

The property owners offered expert witness testimony at trial on the value of the lost goodwill. The trial court excluded the expert's testimony under Evid C §803, based on a lack of foundation under Evid C §801(b) necessary for the expert to establish the existence and loss of goodwill. In affirming the trial court's exclusion of the expert's testimony, the court of appeal highlighted the deficiencies in the expert's testimony (65 CA4th at 397):

> [The expert] did not measure the value of Office No. 4's alleged intangible asset of goodwill in the business's pre-taking or post-taking condition. Hence, [the expert] never compared the value of goodwill before condemnation with its value after condemnation. Indeed, at deposition [the expert] admitted he "never actually sat down and calculated" the business's goodwill. Further, although this case involved alleged cost increases for rent and wages as well as increased revenues at Office No. 4's larger post-taking location, [the expert] did not compare the business's income or losses in its pre-taking and post-taking conditions. Instead, [the expert] focused only on increased isolated costs after condemnation while disregarding any post-taking revenue increases related to occupancy of a larger space, the new pension plan, use of additional employees in providing expanded services, and sharing of employees with other… locations….

[The expert] approached valuation of Office No. 4's goodwill as a laboratory exercise rather than as an empirical measure of what actually existed.… By attempting to predict Office No. 4's profitability without calculating and verifying its actual revenues, expenses and profits, [the expert] accomplished nothing toward the goal of determining the existence and true measure of any goodwill.

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§6.57A VIII. INSURANCE AS SOURCE FOR COLLECTION OF DAMAGES

Practitioners often overlook insurance as a source for collection of damages in intellectual property litigation. In federal court actions, a party must provide the party's insurance policy for inspection and copying as part of the initial disclosures under Fed R Civ P 26. Depending on the policy language, there could be potential coverage for infringement allegedly committed in the course of the defendant's advertising (and, just as important, a duty of defense may be owed to the defendant). For example, copyright infringement may be covered (*Zurich Ins. Co. (U.S. Branch) v Killer Music, Inc.* (9th Cir 1993) 998 F2d 674, 678), as well as trademark infringement (*Lebas Fashion Imports of USA, Inc. v ITT Hartford Ins. Group* (1996) 50 CA4th 548, 565, 59 CR2d 36) and trade dress infringement (*Peerless Lighting Corp. v American Motorists Ins. Co.* (2000) 82 CA4th 995, 1007, 98 CR2d 753). Some courts have ruled patent infringement is not covered, nor is inducement to infringe trademark, copyright, or patent covered because inducement has intent as an element of the cause of action. Insurance policies have exclusions for intentional acts, and coverage for intentional acts is statutorily prohibited. Ins C §533. However, many patent infringement actions involve unasserted claims for trade libel or product disparagement that may be covered by insurance. See *Atlantic Mut. Ins. Co. v J. Lamb, Inc.* (2002) 100 CA4th 1017, 123 CR2d 256.

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7

Tax Aspects

Robert W. Wood

I. IMPORTANCE OF TAX RULES IN TERMINATION OF LITIGATION
- A. Role of Taxation in Litigation §7.1
- B. Real Effects on Position of Parties §7.2

II. DISTINCTION BETWEEN SETTLEMENTS AND JUDGMENTS §7.3
- A. Reference to Underlying Claim: Origin of Claim §7.4
  - 1. Origin of Claim §7.5
  - 2. Sale or Exchange for Capital Treatment §7.6
- B. Lost Profits §7.7
- C. Harm to Capital Assets §7.8
- D. Involuntary Conversions §7.9
- E. Gain on Sale of Residence §7.10
- F. Reference to Basis of Capital Assets §7.11
- G. Goodwill §7.12
- H. Personal Physical Injuries §7.13
- I. Back Pay §7.14

III. CLASSIFYING OTHER RECOVERIES §7.15
- A. Income Subject to IRC §61 §7.16
- B. Continued Reference to Underlying Claims §7.17

IV. RECOVERIES FOR BUSINESS INJURIES
- A. Lost Profits §7.18
- B. Damage to Goodwill and Other Capital Recoveries §7.19
- C. Timing of Income §7.20
- D. Distinction Between Business Injuries and Personal Injury Damages **[Deleted]** §7.21

V. CHARACTER OF PAYMENTS: REFERENCE TO UNDERLYING TRANSACTION §7.22
- A. Types of Lost Profit Recoveries §7.23
  - 1. Noncapital Recoveries §7.24
  - 2. Commission Income §7.25
  - 3. Income Versus Nontaxable Bequest §7.26
  - 4. Miscellaneous Lost Profit Recoveries §7.27
- B. Fraud, Misrepresentation, and Breach of Fiduciary Duty Claims
  - 1. Fraud Claims §7.28
  - 2. Breach of Fiduciary Duty Claims §7.29
  - 3. Securities Fraud in Reorganization §7.30
  - 4. Operation of Tax Benefit Rule §7.31
  - 5. Compensation for Damages Causing Additional Federal Income Tax §7.32
  - 6. Recovery for Breach of Covenant Not to Compete §7.33
  - 7. Patent Infringement Damages §7.34
  - 8. Discharge of Debt §7.35

VI. TAXATION OF VARIOUS BUSINESS RECOVERIES
- A. Recoveries Involving Stock §7.36
  - 1. Patent Infringement Actions §7.37
  - 2. Recoveries Under Liquidated Damages Provisions §7.38
- B. Miscellaneous Business Injuries
  - 1. Presumption of Lost Profits Recovery §7.39
  - 2. Recoveries Under Contract Rights §7.40
  - 3. Proving Capital Asset Status and Basis §7.41

4. Allocating Among Claims §7.42
5. IRA Contributions §7.43
6. Involuntary Conversions §7.44
7. Settlement Versus Judgment §7.45
8. Cases Settling on Appeal §7.46
9. Semantics and Other Issues Involving "Interest" §7.47
10. Antitrust Recoveries §7.48
C. Tax Treatment of Recovered Attorney Fees §7.49
1. The Supreme Court's Decision in *Commissioner v Banks* §7.49A
2. Deduction for Attorney Fees in Unlawful Discrimination Cases §7.49B
3. Pre-*Banks* Cases: The Split in the Circuit Courts
a. First Circuit Authority—Applying Massachusetts Law **[Deleted]** §7.49C
b. Second Circuit Authority—Applying Vermont Law **[Deleted]** §7.49D
c. Third Circuit Authority—Applying Pennsylvania Law **[Deleted]** §7.49E
d. Fourth Circuit Authority—Applying North Carolina Law **[Deleted]** §7.49F
e. Fifth Circuit Authority—Applying Alabama and Texas Law
(i) Applying Alabama Law **[Deleted]** §7.49G
(ii) Applying Texas Law **[Deleted]** §7.49H
f. Sixth Circuit Authority
(i) Applying Michigan Law **[Deleted]** §7.49I
(ii) *Banks*: Reversed by the United States Supreme Court **[Deleted]** §7.49J
g. Seventh Circuit Authority—Applying Wisconsin Law **[Deleted]** §7.49K
h. Seventh Circuit Authority—Applying Iowa Law **[Deleted]** §7.49L
i. Ninth Circuit Authority—Applying Arizona, California, Alaska, and Oregon Law
(i) Applying Arizona Law **[Deleted]** §7.49M
(ii) Applying California Law **[Deleted]** §7.49N
(iii) Applying Alaska Law **[Deleted]** §7.49O
(iv) Applying Oregon Law **[Deleted]** §7.49P
j. Tenth Circuit Authority—Applying Missouri Law **[Deleted]** §7.49Q
k. Eleventh Circuit Authority—Applying Alabama Law **[Deleted]** §7.49R
l. Federal Circuit Precedent **[Deleted]** §7.49S
D. Net Versus Gross Recoveries Illustrated **[Deleted]** §7.50
E. Position of Internal Revenue Service and Various Circuit Courts of Appeal **[Deleted]** §7.51
1. *Srivastava v Commissioner* §7.52
2. *Benci-Woodward v Commissioner* §7.53
3. *Estate of Clarks v United States* §7.54
4. *Davis v Commissioner* §7.55
5. *Coady v Commissioner* §7.56
6. *Banaitis v Commissioner* §7.57
7. *Hukkanen-Campbell v Commissioner* §7.58
8. *Alexander v Commissioner* §7.59
9. *Syphrett v Commissioner* §7.60
10. *Baylin v Commissioner* §7.61
11. *Banks v Commissioner* §7.62
12. Alternative Minimum Tax Considerations §7.62A
13. Determining Person Entitled to Attorney Fees §7.63
14. Court Awards of Attorney Fees §7.64
15. IRS Field Service Advice May Contraindicate Requirement of Direct Interest in Case §7.65

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I. IMPORTANCE OF TAX RULES IN TERMINATION OF LITIGATION

§7.1 A. Role of Taxation in Litigation

Litigation plays a major role in our society, both in business and nonbusiness communities. At some point in the litigation process it is frequently—if not always—necessary to examine the tax consequences of the transaction. There are several reasons why the tax consequences of litigation should be examined.

The tax rules operating in this context may significantly impact the economic consequences of a particular result to either payor or payee. These rules generally apply regardless of whether the payment is made after final judgment or in settlement of the litigation. The planning aspects of any such transaction should not be overlooked. There may be opportunities to influence or structure the tax impact of the litigation's termination—to maximize the tax benefits to the payor, the payee, or both.

The importance of the tax rules in this context is often overlooked by the uninitiated. Unlike the well-planned business transaction, the plaintiff's goal in litigation may simply be to recover money damages. The defendant's goal may simply be to avoid liability. Consequently, tax planning is frequently overlooked in view of seemingly more pressing aspects of the case.

When tax issues are finally considered in this context, the opportunity for meaningful planning may already have passed. It is always best to begin planning for the desired tax treatment of the matter from the inception of the suit—even before the complaint is filed. Unfortunately, in the real world this is often not done.

This chapter reviews the major rules applicable to the federal income tax treatment of settlements and judgments. It also discusses the planning opportunities that may be availed of at various stages of the process. As used in this chapter, the term "settlement" refers to the generic process of resolving a dispute by means other than a formal adjudication. The concept of a settlement, therefore, excludes the conclusion of an action reached by the final judgment of a court or the binding conclusion of an arbitration proceeding or other administrative hearing. Mechanically, the settlement may be accomplished by a settlement agreement and release, or by a document bearing some other name.

As used in this chapter, a "judgment" refers to a formal resolution of a dispute in the nature of a court order, such as an order issued by a court to pay money and/or to take or refrain from action. Even after a judgment, a case may be settled, *e.g.,* when the case is on appeal and settles in advance of the appellate court's ruling.

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§7.2 B. Real Effects on Position of Parties

It should be obvious that if a particular judgment or settlement is fully taxable to the plaintiff at ordinary income rates, the real economic result of the litigation is far less successful than if the same dollar amount of money damages is paid to the plaintiff and is taxed at capital gain rates. That, in turn, is significantly less successful in an economic sense than if the same recovery is entirely tax-free.

From the payor or defendant's side, the degree of bitterness associated with the plaintiff's recovery may vary considerably depending on whether the judgment is paid out entirely on a tax deductible basis, or if the same judgment is only partially deductible or wholly nondeductible. It is conceivable that the defendant may also feel less ire at paying an amount to a plaintiff when the defendant knows that the amount the plaintiff receives will be taxable as opposed to tax-free.

Thus, the tax treatment of a payment made in the context of litigation may have a real bearing on the positions of the parties. Consideration of the tax impact may influence settlement negotiations and/or may even assist the parties in planning a recovery pursuant to a judgment to achieve favorable tax treatment.

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§7.3 II. DISTINCTION BETWEEN SETTLEMENTS AND JUDGMENTS

The first overriding principle governing the tax treatment of settlements and judgments is that it makes no difference whether the litigation is concluded through a court adjudication or through an agreement of the parties. *Estate of J.T. Longino* (1959) 32 TC 904 (involving a settlement); *Levens v Commissioner* (1951) 10 CCH TCM 1083 (involving an arbitration award). The Tax Court in *Longino* further noted that the fact that the settlement was in the form of the assignment of a claim was immaterial. *J.T. Longino,* 32 TC at 906. Thus, there should be no tax incentive for the parties to proceed to a final court adjudication of a dispute when an agreement can be reached without the intervention of the court.

Not only will it make no difference to the tax result whether the suit is settled or proceeds to judgment, but the planning opportunities that may hinge on the wording of the relevant document that concludes the litigation are not dissimilar whether the matter is concluded by settlement or judgment. However, there are generally considerably greater planning techniques available when the litigation will be concluded through settlement.

PLANNING TIP: It is sometimes suggested that a taxpayer may bolster his or her case regarding the excludability of a recovery from the plaintiff's income or the deductibility of a payment to the defendant by taking the matter to judgment and by insuring that the court order(s) contain appropriate guidance with respect to the tax treatment of the recovery or payment. However, the statement of a court with respect to the matter may be no more probative as to the actual tax treatment of the item than the recitation of its treatment in a settlement agreement between the plaintiff and defendant. Moreover, many courts are reluctant to prescribe the tax treatment of an item by virtue of the court's ostensibly nontax role. Many courts will not rule specifically on the tax characterization of the award. Nevertheless, taxpayers sometimes request a judge in a jury trial to specifically address the tax issue via jury instructions. The responses to such jury instructions may constitute some evidence of the tax treatment intended, but certainly would not bind the IRS. Taxpayers may derive some comfort from such a procedure, but ultimately it does not entirely resolve the tax inquiry.

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§7.4 A. Reference to Underlying Claim: Origin of Claim

The most important overriding rule applicable in this field is that one determines the tax result of a particular settlement award or judgment by reference to the underlying claim that the lawsuit seeks to redress. *U.S. v Gilmore* (1963) 372 US 39, 9 L Ed 2d 570, 83 S Ct 623, on remand, *Gilmore v U.S.* (ND Cal 1965) 245 F Supp 383; *U.S. v Patrick* (1963) 372 US 53, 9 L Ed 2d 580, 83 S Ct 618. See also *Hort v Commissioner* (1941) 313 US 28, 85 L Ed 1168, 61 S Ct 757. There are two controlling considerations:

- The origin of the claim; and
- When the taxpayer is seeking capital gain, whether a sale or exchange has occurred.

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§7.5 1. Origin of Claim

The Supreme Court has repeatedly held that the origin of the claim controls the tax treatment of any recovery, whether received pursuant to a settlement or a judgment. *U.S. v Gilmore* (1963) 372 US 39, 9 L Ed 2d 570, 83 S Ct 623, on remand, *Gilmore v U.S.* (ND Cal 1965) 245 F Supp 383; *U.S. v Patrick* (1963) 372 US 53, 9 L Ed 2d 580, 83 S Ct 618. See also *Hort v Commissioner* (1941) 313 US 28, 85 L Ed 1168, 61 S Ct 757. Thus, any funds generated by a lawsuit should be treated for tax purposes as if the harm and economic detriment had not occurred and the plaintiff had continued on undisturbed.

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§7.6 2. Sale or Exchange for Capital Treatment

The Internal Revenue Service, the Tax Court and the Tenth Circuit have ruled that there must also be an underlying sale or exchange in order to qualify for capital gains treatment. In Rev Rul 74-251, 1974-1 Cum Bull 234, the Internal Revenue Service ruled that acceptance of payments in settlement of claims in a lawsuit does not constitute a sale or exchange. The ruling states: "Unless it can be clearly established that there has been a sale or exchange of property, money received in settlement of litigation is ordinary income. The mere settlement of a law suit does not in itself constitute a sale or exchange."

The Tax Court in *Paul E. Kempter,* TC Memo 1963-68 indicated that the burden of proof on the taxpayer in the settlement of a lawsuit over the ownership of an oil and gas lease was to show that the settlement constituted a sale or exchange under IRC §1222 of an interest in the lease or a capital replacement. The court found that the settlement agreement reflected the extinguishment of an unrecognized claim against property and the settlement of a claim against income, neither of which was sufficient to support treating the recovery as a capital gain.

Similarly, the compromise settlement of amounts claimed for services rendered under a government construction contract was held by the Tenth Circuit in *Sanders v Commissioner* (10th Cir 1955) 225 F2d 629 not to constitute a sale or exchange because the money would have been taxed as ordinary income for services rendered if it had been collected when it was originally due. The court noted that the character of the income is not changed regardless of the intervening time between performance of the services and recovery through a lawsuit or compromise settlement.

In *Turzillo v Commissioner* (6th Cir 1965) 346 F2d 884, however, the Sixth Circuit reversed the Tax Court's determination to find that the settlement and release of a suit relating to the contractual rights of a former employee to purchase stock in the employer corporation was a surrender of property rights in exchange for money, affording capital gains treatment because there was a sale or exchange.

PRACTICE TIP: In summary, the origin of the claim, whether it be a suit for lost profits or for harm to capital assets (see discussion below) must be established. However, the taxpayer must also demonstrate that the judgment or settlement constituted a sale or exchange before capital gains treatment is permitted. In many cases, it will be clear that a sale or exchange occurred. Thus, a lawsuit brought to recover additional sales price with respect to the sale of a capital asset would clearly result in any proceeds being taxable as a capital gain.

It is a subject of continuing debate whether there must be a triggering event similar to a "sale or exchange" for capital gain treatment to be available. Although the issue is often neglected by taxpayers, who quite rightly seek to determine the origin of their claim and want to claim capital treatment if the origin of that claim is capital, the IRS has long taken the position that there must be a sale or disposition. The settlement of a lawsuit or other dispute and the transfer of legal rights (typically accomplished by a legal settlement agreement and release) may and, the author believes, should be enough. But there are circumstances in which the IRS has argued that this is not enough.

In *L&C Springs Assocs. v Commissioner* (7th Cir 1999) 188 F3d 866, the Tax Court had held that a limited partnership recognized capital gain in 1990 on the termination of its interest by abandonment in two apartment complexes. The value of the apartment complex was less than the amount the partnership owed on a nonrecourse promissory note. The big question in this case was not ordinary income versus capital gain, but timing.

The partnership contended that the abandonment occurred in 1991. The IRS argued that the partnership had abandoned the property no later than October 1990, triggering a capital gain at that time. The Tax Court largely agreed, finding that the partnership terminated its interest by November 1990, so at least the IRS was able to accelerate the gain into 1990 from 1991. The Tax Court's memorandum opinion appears in *Leonard Ray Blanton,* TC Memo 1997-496.

In the Seventh Circuit, the court elaborated on the question of an abandonment, stating that an affirmative act on the part of the taxpayer is entitled to great weight because it provides an objective measure of the taxpayer's intent. When the abandonment will result in the recognition of income, on the other hand, the court found that the unilateral activity of the taxpayer is entitled to less weight simply because the taxpayer might well be motivated by a desire to postpone the

recognition of income.

Finding no error in the Tax Court's decision that the partnership abandoned the property, the court found that it was likely that the partnership had effectively abandoned the property long before the end of 1990. There was simply no continuing substantive ownership interest in the properties, effectively meaning that the abandonment was treated as a disposition.

NOTE: What is most interesting about the *L&C Springs* case is not what it does say, but what it does not say. The case deals with an abandonment, but also with IRC §1001, the precise section under which one claims a capital gain or loss. In several other cases the IRS has been successful in arguing that a sale or exchange must occur in order for the settlement of a case to result in capital gain. Taxpayers may find a little ammunition to the contrary in *L&C Springs Assocs. v Commissioner*.

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§7.7 B. Lost Profits

If an amount is received either by way of settlement or judgment to compensate the plaintiff for lost profits the plaintiff would have realized had the defendant not interfered, the recovery is taxable as ordinary income. *Levy Collins,* TC Memo 1959-174; *Estate of J.T. Longino* (1959) 32 TC 904.

The type of harm causing the lost profits may depend upon the nature of the plaintiff's business. Thus, a recovery may be treated as one for lost profits and hence constitute taxable income even though the harm may involve injury to property. When a claim against an insecticide producer based on crop damage caused by the insecticide was settled, the plaintiff was held to receive ordinary income because the crop damage resulted in a loss of profits. *Estate of J.T. Longino, supra*. See also IRS Letter Ruling 8239043. Even when insurance proceeds are received under a policy insuring against loss of profits, the insurance proceeds will be taxable as ordinary income. Rev Rul 55-264, 1955-1 Cum Bull 11.

An important exception to the ordinary income tax treatment of lost profits applies in the case of physical injury recoveries. Even though a physical injury may have as one of its effects a loss of profits (or loss of personal services income) by the injured party, a recovery for the injury is fully nontaxable. Rev Rul 85-97, 1985-2 Cum Bull 50. This is so even though the plaintiff would have been subject to tax in the event he had not been injured and had earned his wages in due course.

Although it is easy enough to understand why a recovery for lost profits is generally taxable as ordinary income, it is frequently difficult to determine whether a recovery relates to lost profits or to a capital asset. *Levy Collins,* TC Memo 1959-174 (court allocated percentage of recovery to damage to property (capital gain) and remainder to anticipated loss of profits). The burden of proof will generally be on the taxpayer to show that a recovery achieved in settlement or litigation relates to a capital item rather than an ordinary income item. *Paul E. Kempter,* TC Memo 1963-68. The Internal Revenue Service is inclined to state this rule somewhat harshly, requiring that there be a sale or exchange. Rev Rul 74-251, 1974-1 Cum Bull 234. Indeed, this ruling states that "[u]nless it can be clearly established that there has been a sale or exchange of property, money received in settlement of litigation is ordinary income. The mere settlement of a law suit does not in itself constitute a sale or exchange." See also Rev Rul 75-527, 1975-2 Cum Bull 30.

When an ordinary breach of contract action is brought and there is no capital asset with respect to which recovery is sought, a settlement or judgment may be treated as ordinary income. *Martin Bros. Box Co. v Commissioner* (6th Cir 1944) 142 F2d 457. The payor in this case had a contract of purchase with the taxpayer, but this was not enough to be treated as a capital (or IRC §1231) asset.

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§7.8 C. Harm to Capital Assets

If a recovery compensates solely for damages to capital assets, the recovery will be treated as capital. Thus, it would produce a capital gain or would reduce the taxpayer's capital loss, depending on the taxpayer's basis in the asset. It may be difficult in some circumstances to determine whether the taxpayer received a recovery with respect to a capital asset or instead received a recovery representing loss of income. *Levy Collins,* TC Memo 1959-174; *Levens v Commissioner* (1951) 10 CCH TCM 1083.

EXAMPLE: In *Arcadia Refining Co. v Commissioner* (5th Cir 1941) 118 F2d 1010, the taxpayer received a payment in settlement of a suit for recovery of assets that were illegally taken from it. The court found that the settlement payment was income to the extent the amount recovered in the suit exceeded the value of the stolen assets. According to the court, the difference represented a recovery of profits from the illegal use of the stolen assets.

Similarly, an amount received by a taxpayer for early termination of a heating service supplier's contract to cover the cost of converting from a central heating to an individual heating system was ruled by the IRS not to be from the sale of a capital asset, and therefore to be includable in the taxpayer's gross income as ordinary income. Rev Rul 75-527, 1975-2 Cum Bull 30. See also Rev Rul 74-251, 1974-1 Cum Bull 234.

On the other hand, a contractor's payment of a sum of money to a buyer in exchange for the release of the buyer's claims against the contractor based on the contractor's failure to fulfill a construction contract for a plant was held to constitute a return of capital. Rev Rul 81-277, 1981-2 Cum Bull 14. The cost basis of the plant was adjusted downward to reflect the return of capital.

CAUTION: If there is no clear capital asset involved, the IRS may take the position that a recovery is ordinary income. It has ruled that an amount received by a regulated investment company in settlement of litigation involving the value of the right of the company to select its investment advisor was ordinary income rather than capital gain. Rev Rul 74-251, 1974-1 Cum Bull 234. See also *Phoenix Coal Co. v Commissioner* (2d Cir 1956) 231 F2d 420; *William Basle,* TC Memo 1957-169, aff'd (3d Cir 1958) 256 F2d 581; *Keller St. Dev. Co. v Commissioner* (9th Cir 1982) 688 F2d 675. But see *Farmers & Merchants Bank v Commissioner* (6th Cir 1932) 59 F2d 912 (holding that recovery for injury to plaintiff's reputation in banking business represented recovery for harm to intangible asset rather than for lost profits). In language one would not expect a court to echo today, the court in *Farmers & Merchants Bank* stated: "One may be recompensed for an injury, but it is a rare case in which one should have a profit out of it." 59 F2d at 914. The IRS appeared to base its conclusion on the fact that there was no demonstrable sale or exchange of a capital asset.

The distinction between recoveries on capital assets and recoveries of an ordinary nature arises both in business and nonbusiness contexts. Oddly enough, in a nonbusiness context, the plaintiff will generally have an easier time establishing that a recovery is of a capital nature because the "lost profits" concept is simply out of place in a nonbusiness context.

In fact, if the harm occurs in a business context, it may be particularly difficult to determine whether amounts were received with respect to lost profits or injury to capital assets (or assets used in a trade or business, so-called (IRC) §1231 assets). In the seminal case of *Sager Glove Corp. v Commissioner* (7th Cir 1962) 311 F2d 210, the taxpayer failed to overcome the presumptive correctness of the Commissioner's determination that the entire amount received in a compromise settlement of damages awarded in antitrust proceedings represented reimbursement for lost profits rather than a nontaxable return of capital. The settlement payments were therefore held to be taxable as ordinary income. *Paul v U.S.* (SD Ill 1972) 72-2 USTC ¶9720; *Aluminum & Metal Serv. v Commissioner* (7th Cir 1966) 358 F2d 138. In a nonbusiness context, this dichotomy does not arise.

Sometimes, the classification of the recovery is straightforward. For example, if an amount is received with respect to a clearly capital asset such as a stock investment, it may be relatively easy to conclude that the recovery pursuant to a judgment or settlement is capital.

EXAMPLE: An amount received by minority stockholders of a corporation in settlement of litigation concerning the

majority stockholder's failure to grant options to purchase property was held to represent consideration for the stock surrendered in addition to stock in another corporation received in a merger. The amount was therefore taxable as a long-term capital gain. *Victor E. Gidwitz Family Trust* (1974) 61 TC 664, acq 1974-2 Cum Bull 2.

NOTE: Special tax rules apply when property, whether business or nonbusiness, is destroyed due to casualty, including theft losses, or is taken by a state or municipality in a condemnation proceeding (or is sold under threat of a condemnation proceeding).

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§7.9 D. Involuntary Conversions

When property destroyed by casualty is replaced with property that is similar or related in service or use to that which is destroyed or condemned, and the latter is either received directly or acquired with money received as a result of the destruction or condemnation, the provisions of IRC §1033 (relating to involuntary conversions) apply.

In general, the application of §1033 results in no recognized gain when the converted property is exchanged for property that is "similar or related in service or use." However, when money or dissimilar property is received in exchange for the converted property, gain is realized to the extent that the money, or the value of the dissimilar property received, exceeds the basis of the converted property.

Internal Revenue Code §1231 applies to an involuntary conversion described in §1033 if:

- Section 1033 is not elected, or if elected, to the extent replacement is not made;
- The property that was involuntarily converted was a capital asset or business property;
- The disposition is of a type specified within §1231 and not excluded from its operation; and
- The converted property was held for more than the applicable holding period at the time of disposition.

Most, but not all, involuntary conversions are considered dispositions under §1231. The following involuntary conversions do not come within §1231: (1) conversion of property held less than 6 months (if acquired after June 22, 1984, and before January 1, 1988); (2) any conversion described in IRC §165(e)(3) (*i.e.*, casualties or thefts involving personal property); and (3) any conversion of property held for sale. Whether the resultant gain is taxed as capital gain depends on whether the conversion amounts to the sale or exchange of a capital asset. Whether the gain resulting from a non-§1231 conversion will be taxed as capital gain if a §1033 deferral is not elected will depend on whether the conversion amounts to a sale or exchange of a capital asset.

In *Phillip Lee Allen,* TC Memo 1998-406, the Tax Court held that a settlement payment a couple received from their insurance company qualified for nonrecognition treatment under §1033. The payment was intended to compensate for actual damages incurred in the involuntary conversion of their property. The couple used the funds to restore their property, so §1033 applied.

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§7.10 E. Gain on Sale of Residence

As described in §7.9, the proceeds of an involuntary conversion may be received tax-free under IRC §1033, assuming appropriate reinvestment. In addition, IRC §121 generally provides an exclusion from income on a sale of a principal residence. The section provides an exclusion for $250,000 of gain by a single taxpayer or, assuming certain requirements are met, $500,000 for a married couple. IRC §121(b)(2). The $500,000 exclusion can be used if a husband and wife file a joint tax return for the year of the sale of the property, and if:

- Either spouse meets the ownership requirements of §121(a) with respect to the property;
- Both spouses meet the use requirements (principal residence) with respect to the property, which must be for 2 years before the sale; and
- Neither spouse is ineligible for the benefits of the exclusion by reason of having used the exclusion too often (an exclusion can be used once every 2 years). See IRC §121(b)(3).

This provision is highly attractive in that it can be used, as noted above, every 2 years.

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§7.11 F. Reference to Basis of Capital Assets

When it appears that a settlement or judgment relates to a capital asset rather than a loss of profits, it will be necessary to refer to the basis of the asset to determine what portion of the recovery, if any, ought to be taxed as a capital gain or loss. If no basis is demonstrable, the entire amount is treated as a capital gain. *William Basle,* TC Memo 1957-169, aff'd (3d Cir 1958) 256 F2d 581. Thus, if a taxpayer shows no unrecovered basis in business property, the amount attributable to the destruction of that property will all be taxable income. *Telefilm, Inc.* (1954) 21 TC 688, nonacq 1954-2 Cum Bull 6, rev'd on other grounds (9th Cir 1955) 55-1 USTC ¶9453, 5 AFTR2d ¶1804. See also *Ralph Freeman* (1959) 33 TC 323; *William Basle, supra*. The same rule applies regardless of the type of capital asset as to which the taxpayer cannot establish basis (including goodwill, a topic discussed in more detail below), so that the entire recovery would be treated as taxable income. *Chalmers Cullins* (1955) 24 TC 322.

To the extent that the taxpayer can establish a basis in a capital asset, the basis will be taken into account in determining the extent to which any recovery constitutes a taxable gain. If an asset is destroyed, for example, and the amount of the basis in the asset exceeds the amount of the recovery, no gain will result. *State Fish Corp.* (1967) 48 TC 465, acq 1968-2 Cum Bull 3, modified (1967) 49 TC 13.

Thus, when a taxpayer received a settlement in a breach of a contract action concerning the withdrawal of a bottling franchise, and this amount was less than the loss claimed on the investment in physical assets for advertising, it was held that the amount received did not represent an allowance for loss of future profits. Instead, it was a recovery of capital and was excludable from gross income. *Berbiglia v Commissioner* (1951) 10 CCH TCM 413. See also *Arcadia Refining Co. v Commissioner* (5th Cir 1941) 118 F2d 1010 (settlement payment to compensate for assets illegally taken was income to the extent the amount recovered exceeded value of assets stolen; balance was held to represent recovery of profits from illegal use of assets); IRS Letter Ruling 8512010 (settlement received for diminution in value of personal residence, which amount was less than taxpayers' basis, reduced their basis in property). A number of cases have held that no part of an award constituted income until the taxpayer's basis was recovered. *Commissioner v Speyer* (2d Cir 1935) 77 F2d 824; *Commissioner v Ullman* (2d Cir 1935) 77 F2d 827; *Helvering v Drier* (4th Cir 1935) 79 F2d 501.

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§7.12 G. Goodwill

Taxpayers often seek to claim that a recovery in a business context compensates them for harm to goodwill and therefore ought to be treated as capital gain rather than ordinary income. To the extent that the goodwill can be demonstrated to have a basis, the amount may not even be taxed as a capital gain but may constitute a nontaxable return of capital.

In *Durkee v Commissioner* (6th Cir 1947) 162 F2d 184, on remand (1949) 8 CCH TCM 701, aff'd (6th Cir 1950) 181 F2d 189, the sum of $25,000 received by the taxpayer in settlement of a suit charging that the defendants had damaged his business by a conspiracy was held to be primarily compensation for the loss of goodwill and not for the loss of profits.

NOTE: The distinction between the tax consequences of a recovery of lost profits and a recovery of a capital item can be quite significant. The tax consequences of the latter recovery are even better if a basis, particularly a high basis, can be demonstrated. Unfortunately, it may be quite difficult to show a basis, particularly in goodwill. In *Durkee* on remand, the court concluded that the taxpayer had failed to show a basis other than zero for the goodwill.

The manner in which a complaint and the subsequent course of a lawsuit may influence the determination of the tax consequences of the settlement or judgment is illustrated by *W. Walley, Inc. v Commissioner* (1948) 7 CCH TCM 137. The taxpayer in a contract action had prayed for damages for lost profits and injury to goodwill. After a compromise of the dispute, the taxpayer gave a release of a general character. The court ruled that the entire compromised amount was due to lost profits and therefore was all subject to ordinary income tax. See also *Estate of J.G. Taracido* (1979) 72 TC 1014.

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§7.13 H. Personal Physical Injuries

Recoveries for personal physical injuries are nontaxable by statute. IRC §104. Presumably the theory of the provision is that physical well-being is in itself not taxable, and therefore that a payment of money damages to compensate for loss of that attribute also should not be taxable.

Although it may be quite clear that a suit seeking recovery for a simple physical injury should result in a nontaxable damage award or settlement, a suit may, and often does, claim various elements. The plaintiff may claim, *e.g.,* injury to his or her person, loss of wages for time spent in the hospital, reimbursement for medical bills, and compensation for the psychological harm suffered as a result of the incident. The scope of the personal physical injury damage exclusion of §104 extends to physical injuries, physical sickness, and to reimbursement for medical expenses. IRC §104.

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§7.14 I. Back Pay

A recovery for back pay is treated in the same manner as salary or wage payments. Thus, it is taxable as ordinary income. *William B. Hodge* (1975) 64 TC 616. See also *Sophia Coats,* TC Memo 1977-407. Moreover, a recovery for back pay is also treated as wages for purposes of Social Security tax, federal withholding tax, and FICA. *William B. Hodge, supra;* Rev Rul 96-35, 1996-2 Cum Bull 6 (payments made to employees from Title VII suit are not excludable from gross income under IRC §104(a)(2); are "wages" for purposes of Federal Insurance Contributions Act, Federal Unemployment Tax Act, and federal income tax withholding; and are "compensation" for purposes of Railroad Retirement Act).

Particularly when a suit seeks recovery for several elements, only one of which is back pay or other forms of compensation, it is not surprising that the plaintiff may try to characterize the recovery as relating solely or largely to the nonwage elements of the suit.

EXAMPLE: In *Joseph Frank* (1954) 22 TC 945, aff'd (6th Cir 1955) 226 F2d 600, the taxpayer unsuccessfully argued that a settlement related partially to damages for an assault. The court held that the entire amount related to the settlement of an employment contract, however, and allocated no portion of the settlement to the taxpayer's claims of physical injury. The *Frank* case also raised the issue of constructive receipt presented by the taxpayer's attempt to avoid current income by requesting that payment be made in a later year.

Many other cases have litigated the line between personal injury recoveries and recoveries under employment contracts. *Frank Gunderson,* TC Memo 1979-99, (sum received by university professor as cash settlement in return for release of all claims against university was held includable in income since his rights against university were founded in contract rather than tort). See also *Lee Dalbo,* TC Memo 1969-220; *Vernon Anderson,* TC Memo 1979-309 (both involving alleged defamation). When a claim for wage loss is made in the context of a personal injury suit, however, the Internal Revenue Service has treated such amounts, even the amount attributable to wage loss, as excludable under IRC §104. IRS Publication 525. Even when it may be arguable that a portion of amounts received in this context is attributable to tort claims, it will be up to the taxpayer to demonstrate what portion of such payments is so allocable. *William H. Evans,* TC Memo 1980-142 (failure to prorate termination dispute settlement for damage to professional reputation required inclusion of entire payment in income). See also *Lauren W. McKim,* TC Memo 1980-93. Prior to the Small Business Job Protection Act of 1996, many employment-related claims could still be the subject of exclusions of income under IRC §104 even in the absence of physical injuries. Now, physical injury or physical sickness is required.

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§7.15 III. CLASSIFYING OTHER RECOVERIES

As the statutory rules governing settlements and judgments cover only a few circumstances, the bulk of the rules governing the tax treatment of these items have been developed through case law and administrative practice. The Internal Revenue Code contains only a few sections explicitly affecting the includability or excludability of such payments on the part of payees (IRC §§104, 106, 186) and also only a few sections governing the deductibility of such payments by payors (IRC §§162, 212).

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§7.16 A. Income Subject to IRC §61

Internal Revenue Code §61 provides that gross income includes "all income from whatever source derived." This expansive concept is borne out in the area of litigation recoveries. Internal Revenue Code §61(a) sets forth many types of income that are expressly includable in income. The regulations state that, in addition to the items enumerated in §61(a), there are many other kinds of gross income. The regulations use punitive damages as an example, such as treble damages under the antitrust laws and exemplary damages for fraud, both of which constitute gross income. See Reg §1.61-14(a).

Although the regulations are no more specific than this, damages are generally lumped into this miscellaneous category of gross income. Numerous cases concerning settlements and judgments have been decided under IRC §61. Within the framework of §61, the distinction between business injuries for lost profits and injuries to capital assets or assets used in a trade or business must be made. Occasionally an issue arises whether a settlement otherwise producing taxable income may be excluded by the operation of another Code section.

EXAMPLE: In Rev Rul 84-176, 1984-2 Cum Bull 34, the IRS ruled that a compromise of a disputed amount owed under a contract did not result in excludable discharge of indebtedness income. The taxpayer was a wholesale distributor who received a partial shipment of goods. When the seller refused to deliver the remainder, the taxpayer withheld payment on the goods already delivered. The seller sued and the taxpayer counterclaimed for lost profits.

The settlement described in Rev Rul 84-176 called for the taxpayer to pay one-half of the amount owing, and for the seller to forgive the balance in exchange for the withdrawal of the taxpayer's counterclaim. The taxpayer claimed a deferral of recognition on the debt forgiveness under IRC §108 by reducing the basis of its assets. The ruling concludes that if a cancellation of indebtedness is simply a form of payment of some other type of income, it is ordinary income under IRC §61.

Another example of the interaction of the "all income" rule of IRC §61 and the exclusions provided by other Code sections in the context of a settlement or judgment is IRS Letter Ruling 8536064. In this ruling, in response to a class action suit, a corporation closed one of its facilities and ceased paying insurance premiums for hospital and medical benefits under a program covering its pensioners and surviving spouses. The company gave all members of the class an option to receive either a lump sum payment or supplemental pension payments under another of the company's pension plans. This offer was made in exchange for a release of all claims against the company.

Pursuant to an agreement with the class members who did not elect the settlement offer, the company transferred assets to a voluntary employees beneficiary association ("VEBA") trust, the earnings and corpus of which were used exclusively to provide medical and health benefits to participants. The IRS ruled that the amount transferred to the VEBA and the earnings on it were not includable in the gross income of the participants. Because the litigants did not constructively receive the amounts transferred by the employer to the trust, since the settlement offer was in exchange for a release of litigation rights, the Internal Revenue Service ruled that contributions to the accident and health plan trust were excludable from the participants' gross income under IRC §106. But see the different conclusion in Rev Rul 85-44, 1985-1 Cum Bull 22, in which there was no separate trust with respect to which contributions were made.

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§7.17 B. Continued Reference to Underlying Claims

The general issue of includability may be settled by the broad principles of IRC §61. However, resolving the issue of whether a payment is to be includable in income does not answer the question of how the payment should be characterized. In determining whether an item should be treated as capital or ordinary income, the underlying nature of the claim should control. *U.S. v Gilmore* (1963) 372 US 39, 9 L Ed 2d 570, 83 S Ct 623, on remand, *Gilmore v U.S.* (ND Cal 1965) 245 F Supp 383; *U.S. v Patrick* (1963) 372 US 53, 9 L Ed 2d 580, 83 S Ct 618. See also *Hort v Commissioner* (1941) 313 US 28, 85 L Ed 1168, 61 S Ct 757. This inquiry is not always a simple one.

EXAMPLE: In *Keller St. Dev. Co. v Commissioner* (9th Cir 1982) 688 F2d 675, a payment to the taxpayer by the buyer of the taxpayer's brewery, made pursuant to a court decision in a shareholder's derivative action, was determined to constitute ordinary income. The court found that the payment was to compensate the taxpayer for the buyer's use of the brewery during the ten years of the litigation. In the court's view, the event giving rise to the tax dispute was the sale of the brewery. The payment was a part of this capital asset sale and was analogous to either interest or to rent for the use of the brewery, both of which are taxable as ordinary income.

The issue will frequently be whether all of the facts, including pleadings, evidence, and testimony, indicate that a payment was intended to compensate for loss of profits or harm to capital. *Kucera v Commissioner* (1951) 10 CCH TCM 303.

EXAMPLE: An amount received in settlement of a suit by a taxpayer seeking damages from the purchaser of a patent for failure to produce the patented item was held taxable. The settlement was treated as in lieu of profits that would have resulted from the manufacture of the product, and not to constitute a payment for loss of goodwill. *Kucera v Commissioner, supra.*

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IV. RECOVERIES FOR BUSINESS INJURIES

§7.18 A. Lost Profits

The most important distinction in the authorities governing the tax treatment of business recoveries is the distinction between a recovery for lost profits and a recovery for damage to goodwill. A recovery for lost profits is always taxable as ordinary income because it represents income that would have been earned and taxable as ordinary income had it not been for the defendant's actions. In contrast, a recovery for damage to goodwill is capital in nature and is therefore taxed as a capital gain. Unfortunately, the parties are often not as specific as they might be as to the reason a payment is being made.

EXAMPLE 1: If an amount is received in settlement for the "destruction of a business," the settlement amount could conceivably be treated either as ordinary income for loss of profits or as capital for loss of goodwill. *Farmers & Merchants Bank v Commissioner* (6th Cir 1932) 59 F2d 912.

Except to the extent the taxpayer can prove demonstrable loss of goodwill, the IRS is inclined to treat such a recovery as purely a recovery of lost profits.

EXAMPLE 2: In *Phoenix Coal Co. v Commissioner* (2d Cir 1956) 231 F2d 420, an amount was received in settlement of a suit against the taxpayer's former officers and directors for conspiracy to destroy its coal distributorship business. The evidence showed that the taxpayer's goodwill primarily arose from the personal qualities of the company's principal stockholder, a person who had died before the activities of which the taxpayer complained. As a result, the entire amount received in settlement of the suit was held to be allocable to lost profits and taxable as ordinary income. See also *William Basle,* TC Memo 1957-169, aff'd (3d Cir 1958) 256 F2d 581.

The analysis of recoveries may be extremely complicated. For example in *OKC Corp. & Subsidiary* (1984) 82 TC 638, the taxpayer was a wholly-owned subsidiary of a cement manufacturing company. The taxpayer brought a suit against the seller of a refinery over an output contract. In settlement of the suit, the defendant canceled the taxpayer's debt to it. The court treated the cancellation of indebtedness as income on the theory that the payment represented the taxpayer's lost earnings. Another case in which amounts were held to represent lost earnings was *Estate of J.G. Taracido* (1979) 72 TC 1014.

PRACTICE TIP: The need to analyze a recovery, and to appropriately document it, should therefore be apparent. Even in an antitrust action, the plaintiff may claim that some portion of the recovery is for harm to goodwill or reputation, or conceivably even for personal injuries. However, in such an extreme circumstance it may be difficult to prove the nonordinary income element of the recovery. Careful planning and documentation in advance of the settlement or judgment is a must.

EXAMPLE: In *William Oleck,* TC Memo 1961-306, the court rejected the taxpayer's claim that part of the damages he recovered in an antitrust action were for damages to his health, reputation, or goodwill. The taxpayer contended that he had brought an antitrust action in order to avoid the statute of limitations that would have run on an action based on the destruction of capital and/or goodwill, and for the damage to the taxpayer's character, reputation, and health.

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§7.19 B. Damage to Goodwill and Other Capital Recoveries

The classic example of a payment held taxable as capital is a payment for damage to goodwill. *Durkee v Commissioner* (6th Cir 1947) 162 F2d 184, on remand (1949) 8 CCH TCM 701, aff'd (6th Cir 1950) 181 F2d 189. When there is an ascertainable value to the capital assets damaged or destroyed and a suit is brought to recover for their value as well as for resulting lost profits, it may be a simple matter to determine what part of a recovery constitutes damages for lost profits and what part of the recovery constitutes damages for injury to capital assets. *Arcadia Refining Co. v Commissioner* (5th Cir 1941) 118 F2d 1010 (payment in settlement of suit for recovery of assets illegally taken was income to extent that amount recovered exceeded value of stolen assets, the difference representing recovery of profits from illegal use of assets). See also *State Fish Corp.* (1967) 48 TC 465, acq 1968-2 Cum Bull 3, modified (1967) 49 TC 13.

If the recovery is pursuant to a judgment, the judgment itself may allocate the award. More commonly, the judgment will be silent on the point and some percentage allocation will have to be arrived at based on the total amount sought, the various claims made, and the proof introduced on those claims, among other factors. If the recovery is pursuant to a settlement, the settlement document will often (and generally should) include an allocation, although the allocation itself is not enough to secure the tax treatment that the settlement allocation suggests.

Indeed, the taxpayer will be expected to carry the burden of showing what portion of a recovery constitutes a capital item. The burden of proof is well illustrated by *Raytheon Prod. Corp. v Commissioner* (1st Cir 1944) 144 F2d 110. In *Raytheon,* the taxpayer received $410,000 from R.C.A. in settlement of an antitrust suit charging injury to its business. The settlement agreement did not allocate between payment for patent and license rights on the one hand and an amount for settlement of the suit on the other. Later, however, Raytheon's officers testified that $60,000 was the maximum worth of the patents, supporting the $60,000 allocated to the payment for patent and license rights on Raytheon's return. The other $350,000 was held to be taxable income because Raytheon did not demonstrate the receipt of capital replacement, nor had it shown any cost or other basis for the goodwill in the business that was allegedly destroyed. The court noted that it found nothing in the suit to show that it was for lost profits, but, with no proof of the basis of goodwill, the court had to find the entire recovery taxable.

The amount of the taxpayer's basis in an asset may result in a recovery that does not increase taxable income, but rather merely reduces taxable loss. In *Boehm v Commissioner* (2d Cir 1945) 146 F2d 553, aff'd on other grounds (1945) 326 US 287, 90 L Ed 78, 66 S Ct 120, for example, the taxpayer's receipt of $12,500 in settlement of a stockholder's derivative suit against corporate officers and directors for mismanagement was held to reduce her capital loss rather than to constitute income. The taxpayer's stock in the corporation had become worthless in a previous year, and the taxpayer had never received any deduction from gross income by reason of that investment loss. In another case, two taxpayers owned residential property in a city. The opening of another facility in the city rendered the property incompatible for residential use. Accordingly, the taxpayers (and other similarly situated persons) sued the city. The taxpayers accepted a settlement based on the diminution in value of the property. The settlement payment received by the taxpayers was less than the amount of their basis in the property, and so was held not to constitute income. Instead, the settlement payment reduced their basis in the property. IRS Letter Ruling 8512010. See also Rev Rul 70-510, 1970-2 Cum Bull 159 (1979).

The recovery of capital issue has often arisen in the context of construction defect litigation. For example, in IRS Letter Ruling 9041072, the IRS ruled that money received by a homeowners' association in settlement of a suit for construction defects was not income to the homeowners' association, but was rather a return of capital. The homeowners' association consisted of all the owners of the units in a condominium complex. The construction defects were in the common areas of the condominium complex. The association indicated that the money received under the settlement agreement would be held for the benefit of the condominium unit holders. For other Letter Rulings involving the determination that settlement funds received by a homeowners association are not taxable income to the association, but rather when distributed to the owners reduce their basis in their property, see IRS Letter Rulings 9131023, 9335019, and 9343025.

Another theory under which a recovery might be excluded as capital has been advanced under the rubric of IRC §1033. A group of companies agreed to construct and operate a water treatment facility in order to settle potential claims by a public water utility. The group of companies was responsible for cleaning chemical contamination from ground water at a Superfund site. To avoid litigation and negative publicity, and to minimize the risk of contaminating the utility's water supply, the companies agreed to finance, build, and operate a water treatment facility for use by the public utility. The ownership of the facility may eventually be transferred to the utility. IRS Letter Ruling 9814030 considered whether there would be any income to the utility on the companies' construction and operation of the water treatment facility. The Letter Ruling concluded that the utility did not experience any income recognition on that event. However, the IRS did not rule whether the transfer of the property to the utility would trigger income (the IRS normally does not issue rulings on ownership issues). Interestingly, the Ruling also concludes that the utility can deduct reimbursable costs in the year incurred unless the costs are reimbursed or are expected to be reimbursed. If the utility has nondeductible reimbursed costs, the reimbursements are not included in the utility's income. The companies, on the other hand, may deduct reimbursements paid to the utility (and the companies may depreciate their unrecovered construction costs).

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§7.20 C. Timing of Income

Questions of timing sometimes arise with both cash method and accrual method taxpayers. An examination of authorities in the cash or accrual accounting area (under IRC §446) will normally settle the issue of at what point the income arises. Traditionally, income to a cash basis taxpayer arises when all events have occurred that determine the right to receive it.

Nevertheless, the problems are sometimes thorny. An interesting problem, for example, is presented by IRS Letter Ruling 8504004, an IRS Technical Advice Memorandum. The corporate taxpayer discussed in the Memorandum was a participant in a joint venture that turned sour. The taxpayer sued the other joint venturer and settled under a settlement agreement that entitled the taxpayer to discounts on equipment, to a cash payment, and to a contingent interest in any proceeds resulting from an antitrust suit brought by the defendant against a third party. The cash payment, representing advance reimbursement for costs that the taxpayer would have to incur in the future as a result of the defendant's breach, was ruled to constitute taxable income. More importantly, the Memorandum ruled that the execution of the settlement agreement was a taxable event and that the receipt of discount rights generated immediate income to the accrual basis taxpayer.

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Source: Civil Litigation/California Attorney's Guide to Damages/7 Tax Aspects/§7.21 D. Distinction Between Business Injuries and Personal Injury Damages [Deleted]

§7.21 D. Distinction Between Business Injuries and Personal Injury Damages [Deleted]

The discussion formerly in this section has been removed from the text.

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§7.22 V. CHARACTER OF PAYMENTS: REFERENCE TO UNDERLYING TRANSACTION

The characterization of an amount paid as a result of a court judgment or settlement may be linked to a transaction that was capital in nature, thereby converting what would have been an ordinary deduction into a capital loss. It is necessary to analyze the nature of the claim no matter at what point the settlement or judgment is determined.

In *Arrowsmith v Commissioner* (1952) 344 US 6, 97 L Ed 6, 73 S Ct 71, two taxpayers liquidated their jointly owned corporation, reporting their profit on the transaction as capital gain. As transferees of the corporation's assets, they were subsequently required to pay a judgment rendered against the corporation. They deducted the payments as business expenses, but the Supreme Court ultimately held that the payments represented part of the original liquidation transaction. They were therefore held to be capital losses.

Subsequent cases have considered if it makes a difference whether the claim that is ultimately required to be paid is asserted before or after a liquidation of the paying (defendant) corporation. The answer is that it does not matter whether the claim is made before or after the liquidation. The Tax Court in *Jacob Abdalla* (1978) 69 TC 697, aff'd (5th Cir 1981) 647 F2d 487, noted that the prior liquidation transactions in *Arrowsmith* determined the character of the loss realized in the subsequent taxable year, rather than requiring a readjustment of the original amount realized.

In *Kimbell v U.S.* (5th Cir 1974) 490 F2d 203, the court noted that there was nothing in *Arrowsmith* to indicate that the claim had to be asserted before liquidation. The basic character of the transaction that gives rise to the settlement payment is the same whenever the legal claim is asserted. The origin of the claim, and not the taxpayer's subjective reasons for making the payment, controls its tax treatment.

In *Arrowsmith* and the cases following it, the issue was the nature of a payment made by a defendant (or potential defendant). The Internal Revenue Service extended the *Arrowsmith* principle to the income side in Rev Rul 79-278, 1979-2 Cum Bull 302. In that ruling, an accrual method taxpayer incurred short-term capital loss on the sale of stock and in a later year received a settlement payment for a suit alleging that the loss resulted from the issuer's violation of federal securities laws. The IRS ruled that the payment will be characterized as a short-term capital gain in the year of the settlement. In effect, the capital nature of the recovery is determined by reference to the initial transaction, but the timing of the income is determined according to its actual receipt (or under the accrual method, when all events have occurred to fix the right to the recovery).

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§7.23 A. Types of Lost Profit Recoveries

The types of recoveries that have been considered to be for lost profits, thus producing ordinary income, are extremely varied. Indeed, the IRS is inclined to treat any recovery as a recovery of lost profits unless it can be demonstrated that the harm is to capital assets. In IRS Letter Ruling 8504004, the Internal Revenue Service considered a cash settlement between joint venturers as relating purely to lost profits and not to a capital asset. One participant in a joint venture settled with another joint venturer over the second joint venturer's repudiation of a negotiated but unexecuted contract with the taxpayer. The IRS National Office viewed the cash receipt by the taxpayer as an advance reimbursement of funds the taxpayer would have to spend in the future to acquire the items that would have been obtained under the contract. Because it was not a return of capital previously expended, the Internal Revenue Service said that it constituted income to the taxpayer. The IRS also considered whether the receipt of the cash could be considered under a nontaxable contractual modification, concluding that it could not because the agreement differed materially in kind and in extent from the original contract. The Internal Revenue Service even considered whether the execution of the agreement could be considered a nontaxable exchange under IRC §1031, concluding (not surprisingly) that there was no exchange, and that in any case an exchange of a chose in action was specifically excluded from IRC §1031 treatment.

IRS Letter Ruling 8504004 also raises interesting issues concerning the accruability of discounts. Under the agreement reached between the taxpayer and the other venturer, the taxpayer was entitled to discounts. Predictably, the Letter Ruling concluded that the taxpayer is required to accrue the value of the discounts in the year the agreement was executed, assuming the value of the discounts is ascertainable at that time.

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§7.24 1. Noncapital Recoveries

Another illustration of the breadth of the lost profits/taxable income rule is Rev Rul 84-176, 1984-2 Cum Bull 34. In this Ruling, the taxpayer settled a lawsuit by forgiving a part of the contract price in exchange for the withdrawal of a counterclaim for lost profits. The taxpayer argued that the settlement of the lawsuit by the forgiveness of part of the contract price resulted in a forgiveness of indebtedness. This characterization was critical in that the taxpayer also argued that it could exclude the income realized on the discharge under IRC §108 by electing to reduce the basis of depreciable property under IRC §1017. The IRS disagreed.

The dispute between the taxpayer and its customer arose out of a shipment between the taxpayer, a wholesale distributor, and its supplier. After a partial shipment, the supplier refused to deliver the remaining goods. The taxpayer withheld payment for the goods already received, and the seller sued. The taxpayer counterclaimed for damages for lost profits resulting from the breach of contract. On settlement, the seller/supplier forgave the balance in exchange for the withdrawal of the taxpayer's countersuit. The taxpayer deferred recognition of the forgiven amount under §108 by reducing the basis of its assets. The IRS viewed §108 as inapposite, concluding that there was no true forgiveness of debt. The IRS viewed the transaction as, in substance, the payment of the debt in full, with the seller reimbursing the taxpayer for the lost profits. The IRS therefore held the reimbursement fully taxable.

It does not follow, however, that every recovery is taxable as ordinary income. When the suit is grounded in damage to capital assets, the recovery may be entirely capital. In IRS Letter Ruling 8802032, the trustee of a bankrupt agricultural cooperative and a class of demand noteholders filed a class action against the cooperative's former managers, directors, officers, lawyers, and accountants alleging wrongful payment of fees, fraud and violation of fiduciary duties, and various other charges. The basis of the complaint was that because of fraud and mismanagement, the cooperative improperly invested money in a facility worth less than it paid. The financial statements had been improperly prepared, resulting in investments that then became irretrievable. The end result of the investment in the facility was bankruptcy. The purpose of the complaint was to recover money for damages suffered from the investment. The trial court divided the settlement funds into three parts: the portion to be received by the class; the portion to be received by the cooperative; and the balance to pay expenses. The IRS ruled that the settlement proceeds were a return of capital and not income to the cooperative, except to the extent that the proceeds of the suit exceeded the cooperative's adjusted basis in the facility.

The tax treatment of damages (or settlement payments) for the tort of "fraud" has always been a gray area. Although many fraud statutes are cast in terms of tort statutes, the Internal Revenue Service has long been reluctant to classify any fraud recovery as personal injury damages. This became even more clear after the August 20, 1996, changes to IRC §104, which now requires physical injury or physical sickness for excludability. No exclusion from income is available under IRC §104 without physical injury or physical illness. Mere emotional injury, absent some violent reaction on the part of an eggshell-thin-skulled plaintiff, would not be enough.

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§7.25 2. Commission Income

Probably the most classic type of recovery to be classified as lost profits involves commission income or wages. When a plaintiff receives a settlement for lost commissions, it will be taxable as ordinary income. In *Robert C. Elliott,* TC Memo 1987-333, Robert Elliot was a commission manufacturer's representative who sold the defendant's tools. In addition to selling tools in the United States, he also sold in Canada. He established a company to conduct certain distribution activities. Eventually, he was terminated by the tool manufacturer. He then filed a complaint seeking declaratory relief and damages for breach of contract. After procedural problems, the matter was finally settled for $150,000, $40,000 of which was paid to Elliot individually, $10,000 paid to his company, with another $20,000 annually to be payable to Elliot and his wife from 1976 through 1980. Elliot and his wife argued that the final $20,000 payment represented a return on their investment in Elliot's company and their unrecouped investment in establishing a dealership, and was therefore not taxable. The IRS, on the other hand, argued that the entire proceeds represented lost profits or lost commission income and were therefore taxable. The Tax Court agreed with the IRS, noting that the IRS's determination was presumptively correct, and that the burden of proof was on the Elliots. The Tax Court found that the Elliots did not establish that any of the settlement payments constituted a return of their investments in either the corporation or their sole proprietorship. The court noted that the Elliots' complaint sought damages only for lost commissions resulting from the breach of contract. The settlement agreement suggested no other basis for recovery, and the court was compelled to find the entire amount taxable as ordinary income.

Generally speaking, since the Small Business Job Protection Act of 1996, there have been fewer attempts to try to pigeonhole suits for tortious interference with business relationships into the mold of IRC §104. Internal Revenue Code §104(a)(2) now requires physical injury or physical illness. The required link between a business tort and this physical injury or physical illness is still not clear.

There are still cases of interest being decided that arise from pre-1996 Act law. In *Richard D. Anderson,* TC Memo 2000-344, the Tax Court held that damage awards received for the tortious interference with business relationships are not excludable. (Interestingly, though, this same decision rules that an award allocable to slander was excludable; see *Ronald N. Gross,* TC Memo 2000-342.) Richard Anderson was the director of a company that developed certain race car components. A dispute arose and a lawsuit was filed between Anderson's company and another, with Anderson's company alleging tortious interference with business relationships, breach of fiduciary duty, and defamation. Eventually, the jury returned verdicts awarding Anderson an amount for tortious interference with business relationships and for slander. His company was awarded amounts for tortious interference with his business relationships, slander, and breach of fiduciary duty. The parties stipulated to an award for Anderson for $210,000 individually, and $300,000 for his company. The slander and breach of fiduciary duty awards were not disturbed.

However, the defendants filed Chapter 11 bankruptcy petitions and the parties entered into a settlement agreement thereafter. The settlement agreement allocated to the company a lump-sum payment of $331,250, and a promissory note to Anderson and the company for $325,000 plus interest. During 1993 and 1994, the Andersons received payments totaling $74,857 and $47,464, but failed to include these payments in income. They disclosed the income, specifying that it was excludable under IRC §104(a)(2). A deficiency notice followed and the matter wound up in Tax Court.

Tax Court Judge Gerber noted that the IRS conceded that the claims sounded in tort and satisfied the first prong of the two-part test announced in *Commissioner v Schleier* (1995) 515 US 323, 132 L Ed 2d 294, 115 S Ct 2159. However, the remaining prong of *Schleier* was whether the damages were received "on account of" personal injuries or sickness. The court found that most of the amounts received were for tortious interference with business relationships, and only a nominal amount was for slander. The IRS alleged that the damages received were for interference with the business relationship, and not on account of personal injuries. Ultimately, Judge Gerber agreed with the IRS that the damages were for economic injury and not for physical injury, but that one dollar for slander was excludable under §104(a)(2).

PRACTICE TIP: If one needs any indication that an express allocation in the settlement agreement is the preferable alternative, *Richard D. Anderson, supra,* certainly provides it. After all, the court applies its own allocation, which,

needless to say, is extremely unfavorable. The important principle in this case, as with the case discussed earlier, *Ronald N. Gross,* TC Memo 2000-342, is that the Tax Court still recognizes that (for pre-1996 Act recoveries anyway), slander and other traditional torts can give rise to an exclusion. Once an express allocation is bargained for between the parties (and hopefully based on some assessment of damages), a general release, coupled with an absence of information about the actual damages, leaves the taxpayer in an awkward position. Here, the victory was only Pyrrhic.

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§7.26 3. Income Versus Nontaxable Bequest

Occasionally, the distinction between taxable income and a nontaxable bequest is also raised. In one well-known case involving J. Paul Getty's estate, an amount received by one of Getty's sons in settlement of a suit was held to be excludable from income. *Jean R. Getty* (1988) 91 TC 160, rev'd (9th Cir 1990) 913 F2d 1486. The IRS's theory was that it compensated him for his claim for income interest in the estate, rather than for a claimed bequest, which would have been nontaxable. Here are the facts: In 1934, J. Paul Getty and his mother established a trust. J. Paul had five sons, one of whom (Jean Ronald) was expected to also inherit money from his mother's family. Accordingly, Jean Ronald received a $3000 income interest, with the other brothers receiving a larger share. Jean Ronald never received the expected inheritance because of the rise of the Nazis in Germany. Periodically thereafter, J. Paul Getty promised to cure the inequality in the trust.

J. Paul Getty died in 1976, leaving an estate worth $760 million. Jean Ronald received less than $2 million, and eventually sued the trust and its beneficiaries seeking reformation so that he would share equally in income. He also sued the residuary beneficiary of the estate (the J. Paul Getty Museum) to impose a constructive trust on its assets. The claim against the museum was settled for $10 million. The IRS treated the $10 million as compensation, while Jean Ronald treated it as a nontaxable settlement in lieu of a bequest. The Tax Court agreed with the IRS that the amount compensated Jean Ronald for lost income, because the "origin, goal, and measure of his claim were income."

The Ninth Circuit reversed, however, holding that the settlement money qualified for exclusion. The Ninth Circuit viewed Jean Ronald's claim broadly, finding that the complaint could be viewed as a claim for assets from J. Paul Getty's estate in an amount equal to the amount received by the other children. The Ninth Circuit indicated that the proceeds of the settlement did not need to be clearly classifiable as either property or income from property, and thus rejected a rigid approach based on such classifications. In fact, the Ninth Circuit stated that it was not necessary for Jean Ronald to establish that J. Paul would have fulfilled his promise with a bequest of property. The fact that J. Paul Getty probably would have made a property bequest to satisfy the claims was sufficient to allow Jean Ronald to exclude the $10 million from his gross income under IRC §102(a).

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§7.27 4. Miscellaneous Lost Profit Recoveries

The following list itemizes a miscellany of recoveries that have been held to be taxable as lost profits:

- Injury to crops resulting from improper insecticide. *Estate of J.T. Longino* (1959) 32 TC 904.
- Loss of future rental income because of reduced crops. Rev Rul 73-161, 1973-1 Cum Bull 366 (1973).
- Lost profits due to late equipment delivery. *Fowler Hosiery Co., Inc.* (1961) 36 TC 201, aff'd (7th Cir 1962) 301 F2d 394.
- Loss of dividend income. *Commissioner v John Murdoch* (3d Cir 1963) 318 F2d 414.

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B. Fraud, Misrepresentation, and Breach of Fiduciary Duty Claims

§7.28 1. Fraud Claims

Several cases have considered the taxability of damages and settlements of suits based on fraud. Most directly on point is *Griffiths v Helvering* (1939) 308 US 355, 84 L Ed 319, 60 S Ct 277, in which the court held that a settlement of the taxpayer's claim against one who had defrauded him in a sale of stock was taxable income. The court noted that in the years prior to the settlement, the taxpayer had taken a deduction for losses attributable to the fraud. Similarly, in *Nichol v U.S.* (Ct Cl 1943) 48 F Supp 662, the court held that an amount recovered pursuant to a suit for fraudulently inducing a sale of stock was taxable income. The taxpayer had sold the stock at a gain but, because of the fraud, sold it at less than its actual value. The court treated the amount recovered as additional gain on the sale.

In *Dobson v Commissioner* (1943) 320 US 489, 88 L Ed 248, 64 S Ct 239, the Court held that the taxpayer realized no income on recovering damages in settlement of a fraud action against a seller of securities. Although the taxpayer had sold the securities at a loss in an earlier year, the loss had resulted in no tax benefit owing to the absence of any taxable income in that year. The Supreme Court stated that (320 US at 507):

> [T]he Tax Court was free to decide for itself what significance it would attach to the previous reduction in taxable income as contracted with reduction of tax. The statute gives no inkling as to the correctness or incorrectness of the Tax Court's view, and we can find no compelling reason to substitute our judgment.

NOTE: *Dobson* arguably stands for the proposition that the tax benefit rule has continued vitality outside of IRC §111. Internal Revenue Code §22(b)(12) of the 1939 Internal Revenue Code was substantially similar to §111 of the current 1986 Code. Nevertheless, the addition of IRC §111(d) with its specific rule on carryovers, would make it very difficult for a court to hold that a claimed carryover is not a tax benefit.

In many ostensibly business disputes, a recovering plaintiff may attempt to characterize a portion of the settlement as excludable tort damages. When there is an individual plaintiff, emotional distress claims (intentional or negligent) will often be alleged and, under pre-August 20, 1996 law, could serve as the basis for the exclusion of at least a portion of the recovery. Under the Small Business Job Protection Act of 1996, there must be physical injury or physical sickness for an amount to be excludable under IRC §104. However, some of the pre-August 20, 1996 cases are still interesting, and are certainly relevant in resolving disputes under pre-August 20, 1996 law.

For example, one case involved an allocation of 95 percent to excludable mental anguish and 5 percent to lost profits. *Edward E. Robinson* (1994) 102 TC 116, aff'd (5th Cir 1994) 70 F3d 34. The IRS argued the exact opposite percentages, that only 5 percent (not 95 percent!) was excludable. The Tax Court reached its own decision, concluding that 33.1 percent of the settlement proceeds were allocable to personal injury damages. The Fifth Circuit affirmed.

The manner in which fraudulent misrepresentation may give rise to excludable personal injury damages is well illustrated by several cases. See *James R. Fitts,* TC Memo 1994-52, aff'd per curiam (8th Cir 1995) 53 F3d 335. Fitts sold his stock in a plumbing supply company to a larger company, Plumbmaster, entering into an employment relationship and covenant not to compete as part of the sale. After a dispute, Fitts was terminated and sued, alleging fraudulent misrepresentation, interference with prospective employment, and breach of the obligation to good faith. A settlement was reached, and no allocation of the payment was made. The payor reported the entire payment as nonemployee compensation and issued a Form 1099. Fitts, however, reported the amount as nontaxable on his own return, attaching the 1099 and reporting it as erroneous. The IRS determined that the amount received in the settlement was taxable. The Tax Court reached its own determination, concluding that one-fourth of the amount was excludable as damages for personal injury. The Eighth Circuit affirmed.

In *Pat G. Guidry,* TC Memo 1994-127, the facts arose out of six commercial loans from a credit union to Guidry. In an action by the credit union to enforce the debts, Guidry claimed affirmative defenses that the credit union had fraudulently induced him to execute the notes. He also filed a counterclaim charging that he had been damaged by misrepresentations and various statutory banking violations. In settlement of the actions, the credit union released Guidry from all liabilities and paid him $1,850,000. The settlement agreement did not allocate the claims, and Guidry

did not report any of the settlement proceeds as income. The Tax Court determined that the IRS was correct that the settlement payment was not excludable as personal injury damages. The court found no evidence that Guidry suffered a tort-like personal injury, and noted that the settlement agreement was silent about the credit union's intent in making the payments. Nonetheless, the court did not sustain the IRS's additions to tax for negligence, stating that the underpayment was due to a mistake of the law concerning settlement payments.

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§7.29 2. Breach of Fiduciary Duty Claims

Several cases have also considered the tax treatment of settlements of suits for breach of fiduciary duty. In *Arcadia Refining Co. v Commissioner* (5th Cir 1941) 118 F2d 1010, the court held that a portion of a settlement received by a corporation in an action against one of its officers was income to the corporation. The amount included in the corporation's income was only that portion of the award which exceeded the value of corporate assets wrongfully appropriated by the officer. In *Boehm v Commissioner* (2d Cir 1945) 146 F2d 553, aff'd on other grounds (1945) 326 US 287, 90 L Ed 78, 66 S Ct 120, on the other hand, the court held an amount received in settlement of a stockholder's action to be nontaxable. The court found that the taxpayer's stock had become worthless and that the amount received in settlement was paid to the taxpayer in compensation for the destruction of the stock's value. The court noted that the taxpayer received no deduction from gross income in any taxable year by reason of the loss of her investment in the stock, and that therefore the sum recovered was a capital item that reduced the stockholder's loss rather than constituting income to her. Similarly, in *Pennroad Corp.* (1954) 21 TC 1087, aff'd (3d Cir 1955) 228 F2d 329, a taxpayer's recovery of damages based on a breach of fiduciary duty was held nontaxable since the amount of the recovery was far less than the losses suffered by the taxpayer. The settlement was treated as a recovery of capital resulting in no taxable income. See also *Ollie B. Rose* (1947) 8 TC 854, acq 1947-2 Cum Bull 4 (amount recovered against taxpayer's guardian and administrator held to represent charges wrongfully made against taxpayer's property and therefore a nontaxable return of capital).

In another case, *Central R.R. Co. v Commissioner* (3d Cir 1935) 79 F2d 697, the taxpayer received property in settlement of a suit brought by it against an unfaithful officer who violated his fiduciary duty and deprived the plaintiff of revenues. A resulting trust was imposed on the fruits of the fraud in favor of the railway company, but the court considered the railroad's gain to be derived neither wholly nor in part from the taxpayer's capital or labor, and therefore not income at all under *Eisner v Macomber* (1920) 252 US 189, 64 L Ed 521, 40 S Ct 189.

CAUTION: In analyzing a claim based on fraud or breach of fiduciary duty, it is also necessary to inquire whether the damages are compensatory in nature on the one hand or punitive or exemplary in nature on the other. The regulations contain a statement which suggests that punitive or exemplary damages for fraud would be gross income in every case. Reg §1.61-14(a) ("punitive damages such as treble damages under the antitrust laws and exemplary damages for fraud are gross income"). See also *Commissioner v Glenshaw Glass Co*. (1955) 348 US 426, 99 L Ed 483, 75 S Ct 473; related proceeding (1956) 25 TC 1178. Of course, after the 1996 amendments to IRC §104 and the Supreme Court's decision in *O'Gilvie v U.S.* (1996) 519 US 79, 136 L Ed 2d 454, 117 S Ct 452, punitive damages are always gross income.

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§7.30 3. Securities Fraud in Reorganization

The Ninth Circuit's decision in *Tribune Publ'g Co. v U.S.* (9th Cir 1988) 836 F2d 1176 is a continuing reminder of the pervasiveness of the "origin of the claims" test. The disputed items—which actually arose long after a reorganization was completed—were settlement proceeds received in respect of securities fraud litigation. The case represents an interesting combination of the reorganization "boot" characterization rules and those governing litigation recoveries. The taxpayer argued that boot (taxable income) treatment was appropriate (ostensibly because the taxpayer wanted dividend treatment in order to take advantage of the dividends-received deduction). The government argued that the settlement proceeds were not triggered by the reorganization (but rather by the settlement of the lawsuit), and accordingly, that boot treatment was inappropriate.

The litigation arose out a merger between Boise Cascade and West Tacoma Newsprint Co. (the "Tribune"). In settling securities fraud litigation eight years after the merger, Tribune received $451,000 in cash from Boise Cascade, plus Boise Cascade's promise of discounts on newsprint to be purchased by Tribune. Tribune received the newsprint discounts over the next several years. Tribune reported a portion of the cash settlement as a dividend, with the bulk of the cash being treated as a nontaxable return of basis. Tribune also reduced its basis in the subsequent years by the amount of the newsprint discounts. The government disagreed and assessed a deficiency.

The IRS and Tribune agreed that the underlying claim in the securities fraud litigation was that the market value of the Boise Cascade stock Tribune received was inflated because of Boise Cascade's failure to disclose material facts. The IRS and the taxpayer also agreed that the purpose of the fraud action was to recoup for Tribune the difference between the actual value of the stock it received and the price Tribune effectively paid for it. Tribune and the IRS disagreed over the event that ultimately resulted in the payments. Tribune insisted that one had to view the transaction as if it had received not only Boise Cascade stock in exchange for the Tribune stock, but also the $451,000 in cash and the newsprint discounts as part of the same exchange. Because the underlying transaction was a reorganization under IRC §368(a)(1)(A), it followed that the cash and discounts were boot. The IRS, in contrast, argued that the subsequent amounts received in settlement of the lawsuit could not be boot because they were not received pursuant to the plan of reorganization. They were manifestly received pursuant to the settlement agreement rather than the merger agreement.

The court in *Tribune Publ'g Co.* felt that the IRS's inquiry stopped short of the traditional settlement/litigation recovery analysis. The question is: in place of what were the damages awarded? The court cited *Raytheon Prod. Corp. v Commissioner* (1st Cir 1944) 144 F2d 110. In *Tribune,* the settlement proceeds and discounts were clearly received by Tribune in place of additional consideration that Tribune would have received in the reorganization had the fraud not taken place. In effect, the later-received cash and the newsprint discounts are treated as if they had been received as part of the original transaction. So treated, they become "other consideration" necessarily taxable as boot. For additional discussion, see Wood, *Settlement Proceeds in Securities Fraud Litigation Is Held to Be Boot*, vol 1, No. 1, *Corporate Taxation* 44 (1988).

NOTE: Several other interesting issues were raised in *Tribune,* including an interest imputation issue. The IRS wanted to impute interest to Tribune on the settlement proceeds under IRC §483. The court agreed, stating that it was clear that interest should be imputed with respect to the discounted newsprint from the date of settlement to the date of purchase by Tribune. The court declined to impute interest all the way back to the date of the reorganization.

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§7.31 4. Operation of Tax Benefit Rule

Occasionally, a taxpayer attempts to exclude from income a recovery because of the operation of the tax benefit rule, codified in IRC §111. Under IRC §111(a), a taxpayer's gross income does not include income attributable to the recovery of any amount deducted in any prior taxable year to the extent the amount did not reduce the amount of the tax imposed. The basic idea is that the taxpayer should not have to include in his or her income an amount the taxpayer recovers unless he or she previously received a "tax benefit" (*i.e.,* in the form of a deduction) on account of that item.

Although IRC §111 would appear by its terms to apply only to a relatively small class of items, the regulations state that the IRC §111 exclusion applies to bad debts, prior taxes, delinquency amounts, and "all other losses, expenditures, and accruals made the basis of deductions from gross income for prior taxable years." Reg §1.111-1(a). In fact, the Regulations state specifically that "a loss sustained upon the sale of stock and later recovered, in full or in part, through an action against the party from whom such stock had been purchased" is subject to IRC §111. Reg §1.111-1(a).

In determining whether a tax benefit has been realized as a result of a deduction, the term "tax benefit" is interpreted liberally. For example, an increase in a carryover that has not expired is treated as a reduction in tax. IRC §111(c). Consequently, even though a taxpayer has realized no real tax benefit from excess capital losses, he or she will be deemed to have received a reduction in tax for purposes of the tax benefit rule under §111. The harsh results flowing from the treatment of carryovers is demonstrated by the following example: A taxpayer sustained a short-term capital loss of $650 on a note. In a subsequent taxable year, he collected the full $8000 face amount of the note. The taxpayer argued that the $7000 received (the additional $1000 constituted a return of capital) should be prorated between ordinary income and return of capital, because no tax benefit was derived from the $650 short-term capital loss. The taxpayer's argument was premised on the fact that he had capital losses of over $17,000 in that year, of which only $1000 was allowable as a deduction. The court held, however, that all $7000 in payments made on the note were taxable as ordinary income because a minute portion of every claimed capital loss was properly allocable to the $1000 deduction. *A. J. Mandt,* TC Memo 1955-226. In other words, the fact that the taxpayer had extensive capital losses that made the $650 short-term loss unusable had no bearing on the subsequent recovery on the note.

Apart from IRC §111, the nonstatutory tax benefit doctrine probably still has vitality. *Dobson v Commissioner* (1943) 320 US 489, 88 L Ed 248, 64 S Ct 239 (considering IRC §22(b)(12) of the 1939 Internal Revenue Code, the predecessor to the 1954 and 1986 Codes). Nevertheless, the addition of IRC §111(d) to §111 made in 1980, with its specific rule on carryovers, would preclude an argument that a claimed carryover is not a tax benefit.

The courts have been relatively strict in allowing exclusions from income based on the tax benefit doctrine. However, in *Allstate Ins. Co. v U.S.* (9th Cir 1991) 936 F2d 1271, the Ninth Circuit reversed *Allstate Ins. Co. v U.S.* (1990) 20 Cl Ct 308, and held that the tax benefit rule entitled an insurance company to exclude its subrogation recoveries from its "losses incurred" deduction computation. The taxpayer insurance company was entitled to a losses-incurred deduction reducing its premium income. The losses-incurred deduction consisted of two items, losses paid and unpaid losses. Like other insurers, the taxpayer commonly sought subrogation with respect to insurance claims. When it recovered on subrogation claims, the tax benefit rule operated to exclude those subrogation recoveries in which a sufficient relationship existed between the initial losses incurred and the subsequent recoveries.

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§7.32 5. Compensation for Damages Causing Additional Federal Income Tax

If someone incurs damages as a result of a defendant's action that results in harm to his or her tax position (*i.e.,* because of the defendant's actions, he or she incurs additional federal income tax), how should the resulting damages or settlement payment recovered be treated? Consider the following illustration of this problem. IRS Letter Ruling 8748072, revoked by IRS Letter Ruling 9226033. (For virtually the same set of facts, see GCM 39697 (Jan. 27, 1988), withdrawn by GCM 39857 (Aug. 15, 1991).)

Mistakenco Corporation purchased securities under an agreement in which the seller of the securities represented that the securities were backed by mortgages on property located in a qualifying possession, so that income from the certificates would qualify for the IRC §936 tax credit. Mistakenco claimed the credit on its federal and possession tax returns for four years before finally learning that the securities were backed by nonqualifying mortgages, and that its tax credits were therefore not allowable. Consequently, Mistakenco owed additional taxes for the years in which it claimed the credit, and was unable to claim the tax benefit in subsequent years.

Mistakenco sued the seller for misrepresentation, seeking to recover its additional federal and local income taxes, its lost tax benefits, interest, and costs incurred in seeking recovery. The parties settled the matter, with the seller agreeing to place Mistakenco in the same economic position it would have occupied if the certificates had been as represented. Accordingly, the seller paid Mistakenco an amount equal to the additional taxes Mistakenco was required to pay, and replaced the old mortgages with ones eligible for the IRC §936 credit. Mistakenco later requested a ruling from the IRS on whether its recovery would be taxable income. Obviously, if the amount recovered were taxable income to Mistakenco, a larger recovery would be required to put Mistakenco in the same economic position it would have been in had the securities been as represented.

The IRS determined that the recovery of federal income tax payments was not subject to tax. GCM 39697. The IRS cited authority for the proposition that if payments are made by the one causing the loss that only restore a taxpayer to the position he or she was in before the loss was incurred, no economic gain results and the payments are not includable in income. Rev Rul 57-47, 1957-1 Cum Bull 23 (1957). However, as discussed below, the IRS later revoked this ruling.

In IRS Letter Ruling 9226033, the IRS explained that it revoked the earlier ruling because it determined that the amounts received by the taxpayer as reimbursement of federal income tax paid were not the same as the indemnity payments addressed in *Clark v Commissioner* (1939) 40 BTA 333, nonacq 1939-2 Cum Bull 45, acq 1957-2 Cum Bull 4, and Rev Rul 57-47, 1957-1 Cum Bull 23 (1957). These were the two authorities on which the IRS had based its original ruling in IRS Letter Ruling 8748072.

According to Letter Ruling 9226033, the IRS revoked the earlier ruling because the transaction at issue there was to provide the taxpayer with tax advantages to offset income from other activities. Unlike the *Clark* case and Rev Rul 57-47, the taxpayer paid only minimum tax. According to the IRS, therefore, the tax reimbursement constituted income. Likewise, in IRS Letter Ruling 9226032, a companion ruling to IRS Letter Ruling 9226033, the IRS revoked a portion of IRS Letter Ruling 8923052, which had involved a safe harbor leasing transaction that was to provide additional tax benefits. For further discussion, see *Reimbursement of Unrealized Tax Benefits Revisited: IRS Reveals Rationale for Revocation of Rulings*, vol 33, No. 15, Tax Mgmt Memo (Part 1), p 233 (July 27, 1992).

PRACTICE TIP: It would appear from these authorities that the IRS is particularly concerned with a situation in which the plaintiff has invested in a scheme to reduce or eliminate tax liabilities, and, when the expected tax benefits do not materialize, brings suit and recovers these tax benefits. That presumably accounts for the IRS distinguishing this kind of situation from the case of a paid return preparer who makes a mistake costing the plaintiff/taxpayer additional taxes. IRS Letter Rulings 9226032 and 9226033, discussed above, implicitly recognize that the exclusion from income for the latter kind of tax reimbursement still seems appropriate.

When a tax return preparer undertakes to pay an additional assessment or penalty imposed on his client, there may be income to the client. However, the result may depend on the manner in which the problem is corrected. Both the

Tax Court and the Internal Revenue Service have agreed that where a tax return preparer makes a mistake, and the taxpayer pays additional taxes and interest because of the mistake, and then is reimbursed for these amounts by the tax return preparer, there is no income to the taxpayer/client. For a Tax Court case on point, see *Clark v Commissioner, supra*. For a Revenue Ruling on this point, see Rev Rul 57-47, 1957-1 Cum Bull 23.

However, when the preparer pays the assessment in the first instance, the result—at least according to the IRS—is different. In that case, the client/taxpayer would have income. IRS Letter Ruling 7749029.

PRACTICE TIP: Obviously this distinction makes it advisable to first have the taxpayer pay the liability, and then seek reimbursement from the tax return preparer. See also IRS Letter Ruling 8604065, involving reimbursement sought from an accountant, which held no income to the taxpayer.

The non-tax question of whether a plaintiff's tax benefits from a particular transaction should be offset against a damage recovery is the subject of a surprising number of cases. The question may be whether the plaintiff should be entitled to additional damages from the defendant because the defendant's conduct caused the plaintiff additional taxes. Or, the question may be whether any tax advantages enjoyed by the plaintiff despite the defendant's conduct, such as a loss deduction, should be properly an offset against the damages due the plaintiff. Since these questions are not tax questions, they are not addressed here. However, for an excellent survey of the cases, see Dunn, Recovery of Damages for Lost Profits (5th ed 1998).

In IRS Letter Ruling 9211015, the IRS considered the tax treatment of a CPA's reimbursement to a client of taxes, penalties, and interest caused by the CPA's negligence. The ruling treated the reimbursed amounts as a return of capital rather than income, noting that the reimbursement restored the taxpayer to the position it was in before the loss was incurred and resulted in no economic gain.

For further discussion of the tax treatment of recoveries for taxes, see *Concord Instruments Corp.,* TC Memo 1994-248, arising out of a Tax Court decision rendered in 1982. The case considers the tax treatment of $125,000 paid by an insurance carrier to Concord Instruments in settlement of its malpractice claim. For an article analyzing this case and its import, see Raby, *Tax Controversy Legal Malpractice Award Excluded from Income*, Tax Notes 591 (Oct. 31, 1994).

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§7.33 6. Recovery for Breach of Covenant Not to Compete

A recovery for a breach of a covenant not to compete has been held to be capital in nature, rather than taxable as ordinary income. *State Fish Corp.* (1967) 48 TC 465, acq 1968-2 Cum Bull 3, modified (1967) 49 TC 13. The fact that the acts complained of (the competition in violation of the covenant) may give rise to lost profits was not considered to alter the nature of the payment. The payment of the amount was viewed as a capital payment, notwithstanding the fact that a loss of profits could be viewed as evidence of the damages sustained through the defendant's actions.

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§7.34 7. Patent Infringement Damages

Damages for patent infringement are normally considered compensation for lost profits, and are therefore taxable as ordinary income. *W.W. Sly Mfg. Co.* (1931) 24 BTA 65. In some cases, some portion of an infringement award may be treated as allocable to damage to capital, such as goodwill. This is particularly clear, for example, when a taxpayer purchased patents and patent infringement claims, and later recovered on them; in this case, the recovery has been held to constitute a return of capital. *Hyatt Roller Bearing Co. v U.S.* (Ct Cl 1930) 43 F2d 1008. Typically, however, an award for patent infringement will be taxable in its entirety as ordinary income, even when a portion of the award is over and above the plaintiff's damages and represents an addition based on the willfulness of the defendant's actions. *Mathey v Commissioner* (1st Cir 1949) 177 F2d 259, aff'g (1948) 10 TC 1099.

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§7.35 8. Discharge of Debt

In *Preslar v Commissioner* (10th Cir 1999) 167 F3d 1323, the taxpayer argued that the Tax Court did not err in holding that there was a legitimate dispute regarding a couple's liability to a bank when the FDIC refused to honor a contract they made with the bank. The dispute arose out of Preslar buying a ranch in 1983 and planning to develop it. The $1 million purchase price was to be financed by the bank, with the bank paid out of lot sales. After each sale, the bank credited the debt with an amount equal to 95 percent of the contract price. By August 1985, the bank had received $200,540 in payments from purchasers of the lots, but was insolvent with the FDIC in place as receiver. The FDIC refused to accept these lot sale contracts, and directed the Preslars to pay the FDIC directly. The Preslars made no further payments, nor did they sell any further lots. Instead, they sued the FDIC for breach of contract. The parties settled in 1988 for $350,000, bringing the total amount paid on the loan to $550,540.

The IRS determined a deficiency, asserting $449,640 in discharge of indebtedness income. The Tax Court rejected the IRS determination, saying that the unusual arrangement with the bank cast doubt on the liability. The Tax Court found that the liability was not definite until a settlement with the FDIC was reached.

The IRS appealed to the Tenth Circuit, which rejected the Tax Court's finding that the Preslars' liability to the bank was in dispute. The Tenth Circuit concluded that the amount settled with the FDIC was not the amount of the debt. The Tenth Circuit also held that the Preslars were not entitled to treat the FDIC settlement as a reduction in purchase price under IRC §108(e)(5). This provision, said the court, applies only to direct agreements between a seller and a purchaser. A dissenting opinion in the Tenth Circuit argued that the "clearly erroneous" standard supported the Tax Court's finding that a dispute had arisen when the FDIC refused to honor the payment arrangement.

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VI. TAXATION OF VARIOUS BUSINESS RECOVERIES

§7.36 A. Recoveries Involving Stock

Recoveries in litigation involving stock typically raise questions about the appropriateness of capital versus ordinary characterization.

In one case, an amount received in settlement of litigation was held not to be entirely in exchange for the taxpayer's stock. The taxpayer did not specifically challenge the portion that the IRS had asserted was allocable to salary and commissions. Accordingly, the IRS determination was upheld. *Estate of Blain* (1949) 8 CCH TCM 540.

In another case, an IRS allocation was upheld when the allocation was between compensation and the purchase price of stock. The plaintiff and defendant had made this allocation in settlement documents, and there was no evidence to indicate that the agreements were not reflective of the parties' intentions. *Arthur Graf,* TC Memo 1969-61.

In *Victor E. Gidwitz Family Trust* (1974) 61 TC 664, acq 1974-2 Cum Bull 2, minority shareholders in a corporation received an amount in settlement of a suit concerning the majority shareholder's failure to grant options to purchase property. The amount was held to represent consideration for their stock (which was surrendered in addition to stock in another corporation they received in a merger). It was therefore held taxable as long-term capital gain. The same kind of rule applies in the context of shareholder derivative suits.

In *Deney v Commissioner* (5th Cir 1991) 945 F2d 401, a woman entered into a purchase agreement with another individual to buy 75 shares of a particular corporation's stock for $120,000. The contract specified that $5000 was to be paid in cash, and the balance was to be payable via two promissory notes issued by the corporation. The first called for $110,000, payable at $2500 per month. The second was a $5000 note. The sale was consummated, with the seller being redeemed out of the corporation so that the buyer was then the corporation's sole owner. The corporation made monthly payments totaling $30,000. The corporation then issued a form W-2 to the buyer showing payments that included the $30,000 paid to the seller on the buyer's behalf. In accordance with the Form W-2, the buyer reported this $30,000 as income.

The buyer later became dissatisfied with the stock and sued the seller in state court. The court ordered rescission of the stock sale but did not award additional damages, nor did it order reimbursement of the payments already made on the contract. The buyer subsequently filed an amended tax return claiming a $30,000 reduction in her income. The buyer's argument was basically that because the seller was not required to repay the $30,000 the buyer had already paid, the buyer had sustained a loss. The IRS issued the buyer her refund, but later determined it had granted the refund in error. When the matter wound up in Tax Court, the court agreed with the IRS, and the Fifth Circuit Court of Appeals affirmed. The Fifth Circuit stated that the seller's performance or nonperformance under the contract was irrelevant to whether the corporation's payments to the seller were income to the buyer.

In *Frederick Weisman Co.* (1991) 97 TC 563, the Tax Court held that expenses of a forced stock redemption were not deductible and instead must be capitalized. A corporation operated a Toyota dealership (FWC) through its wholly owned subsidiary (MAT). Commencing in 1970, MAT entered into a series of agreements with Toyota Motor Sales authorizing MAT to distribute new Toyotas in a certain geographical area. By 1982, Toyota demanded that FWC redeem the shares of all its shareholders except for one individual, Frederick Weisman. The aggregate purchase price for the stock redemption was $12 million. In addition to the purchase price, FWC incurred a total of $189,335 in legal expenses related to the redemption. FWC deducted these legal costs ratably over the term of the five-year agreement with Toyota that was entered into in 1982.

The IRS disallowed the deductions on the theory that amounts paid in connection with a stock redemption are not deductible nor amortizable. Internal Revenue Code §311(a) does speak to the issue, suggesting that all such costs are nondeductible. However, the taxpayer cited one case, *Five Star Mfg. Co. v Commissioner* (5th Cir 1966) 355 F2d 724, suggesting that if stock redemption costs are incurred in the face of an outside threat to the survival of the corporation, they may be deducted as ordinary and necessary business expenses. Unfortunately for the taxpayer, the Tax Court declined to follow the reasoning or holding of the *Five Star Manufacturing* case, and held rather that the legal expenses

of the stock redemption required by Toyota were not deductible. The rule regarding shareholder derivative suits is relatively straightforward. The recovery may be a return of capital (nontaxable) or may be taxable as a capital gain.

In *Joann C. Arnes v U.S.* (9th Cir 1992) 981 F2d 456, the issue was whether a taxpayer must recognize the gain that she realized when, under a divorce settlement, a corporation redeemed her half of the stock in the corporation. The court ruled that IRC §1041 prevented the taxable gain.

In *Arlington Metal Indus., Inc.* (1971) 57 TC 302, the receipt by a corporation of its own stock from minority shareholders (who were also former officers and employees) in exchange for a mutual release of its claims against them, was held to constitute ordinary income to the corporation. The claims related to mismanagement and alleged theft. Internal Revenue Code §311(a) makes redemptions nontaxable to corporations, except when appreciated property is distributed. Nonetheless, *Arlington Metal* held a corporation taxable on the receipt of its own stock.

In *Pennroad Corp. v Commissioner* (3d Cir 1955) 228 F2d 329, the taxpayer received a settlement award resulting from a shareholder's derivative suit. Another corporation, which controlled the taxpayer corporation, was charged with causing the plaintiff corporation to make investments at an excessive price, benefiting the controlling parent corporation. Because the amount of the proceeds received in settlement of the action did not exceed the amount of the verifiable losses, the taxpayer did not even recover its full basis; the entire amount was therefore treated as nontaxable. For another case in which the taxpayer could demonstrate that it had not recovered its basis, and the entire settlement was therefore held nontaxable, see *Marcal Pulp & Paper, Inc. v Commissioner* (3d Cir 1959) 268 F2d 739.

In *Boehm v Commissioner* (2d Cir 1945) 146 F2d 553, aff'd on other grounds (1945) 326 US 287, 90 L Ed 78, 66 S Ct 120, a taxpayer received an amount in settlement of a derivative suit against the corporation's officers and directors for mismanagement. Because the shareholder's stock had by then become worthless, the amount received was held a capital item, which, in effect, reduced her loss on her worthless stock. Notably, the taxpayer had not claimed a worthless stock deduction, so the recovery was not held to be income.

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§7.37 1. Patent Infringement Actions

Although patents generally constitute either capital assets or IRC §1231 assets, amounts received under a settlement or judgment of a patent infringement action are typically held to represent income. *Triplex Safety Glass Co. v Latchum* (3d Cir 1942) 131 F2d 1023. Some actions may involve claims other than merely patent infringement, however, and it may be possible to allocate an amount of the receipt under the settlement or judgment to injury to capital items such as goodwill. *Big Four Indus., Inc.* (1963) 40 TC 1055, acq 1964-1 Cum Bull 4. Unfortunately, if it cannot be demonstrated that any extra recovery is due to a capital asset, the entire amount received may constitute ordinary income.

In *Mathey v Commissioner* (1st Cir 1949) 177 F2d 259, aff'g (1948) 10 TC 1099, the court in a patent infringement action awarded a 50-percent increase in the damages due to the fact that the infringement was deliberate. The taxpayer was unsuccessful in convincing the court that this amount should be treated as a capital recovery because it could not demonstrate that the payment was intended to compensate for damages to capital.

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§7.38 2. Recoveries Under Liquidated Damages Provisions

Liquidated damage clauses are extremely common in a variety of types of contracts. If damages with respect to a breach of contract are difficult to assess, and if the parties wish to provide for their payment as a means of both helping to prevent breaches as well as providing for an orderly result if there is a breach, a liquidated damages clause may make a great deal of sense.

A number of decisions have considered the tax treatment of liquidated damage payments in the context of a sale of stock. If liquidated damages are received under a contract calling for a purchase of stock, and the purchasing party (defendant) defaults, any resulting liquidated damage payments to the selling party (plaintiff) will be treated as ordinary income. The theory of such treatment is that even though related to a capital asset, the plaintiff retains the stock as well as the liquidated damage payments. They are therefore held to be ordinary income. For decisions on this point, see *Albert G. Rooks* (1953) 12 CCH TCM 96; *Smith v Commissioner* (9th Cir 1969) 418 F2d 573; *James R. Parks* (1967) 26 TC Memo 1967-16; *Binns v U.S.* (6th Cir 1967) 385 F2d 159. A number of cases have reached the same result in the context of contracts to sell real property that include liquidated damages clauses. For cases on this topic, see *Paul F. Myers v Commissioner* (6th Cir 1961) 287 F2d 400; *Milton E. Ailes,* TC Memo 1983-388; *Gerald Melone* (1966) 45 TC 501; *Morris A. Mechanic* (1960) 19 TC Memo 1960-126; *Ralph A. Boatman* (1959) 32 TC 1188.

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B. Miscellaneous Business Injuries

§7.39 1. Presumption of Lost Profits Recovery

The receipt of damages or settlement payments in a business context will often be held attributable to lost profits.

In *Phoenix Coal Co. v Commissioner* (2d Cir 1956) 231 F2d 420, a settlement payment received by the taxpayer in a suit against its former officers and directors for conspiracy to destroy its business was held to be allocable solely to lost profits. Although the taxpayer claimed that a portion of the payments related to goodwill, the evidence showed that this "goodwill" was really the personal activities of the principal stockholder of the company, and not an asset of the company. Accordingly, the entire recovery was held to constitute ordinary income.

In any circumstance in which the taxpayer cannot show that an allocation to loss of goodwill is appropriate, the recovery will typically constitute lost profits. *William Basle,* TC Memo 1957-169, aff'd (3d Cir 1958) 256 F2d 581. Damages to crops have commonly been viewed as exclusively involving a loss of profits. *Estate of J.T. Longino* (1959) 32 TC 904. But see IRS Letter Ruling 8239043 (involving settlement for damages to cherry trees, in which distinction between lost profits and capital recovery is raised).

In many cases, a taxpayer will attempt to allocate a recovery between lost profits and harm to capital. A typical allocation is demonstrated by *Levens v Commissioner* (1951) 10 CCH TCM 1083, in which an arbitration award was allocated between lost profits and capital gain. The court found that the award was intended both to compensate the taxpayer for lost profits and also to compensate her for impairment to the value of her interest in a partnership business. For another case allocating business recoveries, see *Levy Collins,* TC Memo 1959-174 (amounts received allocated 25 percent to damages to oyster beds and 75 percent to anticipated loss of profits from their operation). Of course, for any allocation to goodwill to be appropriate, the lawsuit must be of a type that supports such an allocation. Taxpayers have occasionally used creative arguments in an attempt to avoid this rule.

In *William Oleck,* TC Memo 1961-306, a taxpayer claimed that part of the damages recovered in an antitrust action was for damages to his personal health, reputation, or goodwill. The taxpayer argued that the reason he brought an antitrust action was to avoid the statute of limitations, which would have barred an action based on the other claims. Nevertheless, the taxpayer's arguments were defeated.

To the extent that the taxpayer can demonstrate a capital recovery, of course, the recovery will be nontaxable up to the taxpayer's basis of the goodwill. *State Fish Corp.* (1967) 48 TC 465, acq 1968-2 Cum Bull 3, modified (1967) 49 TC 13 (court costs and legal fees incurred in recovering amount are reduced by reimbursement for such costs in determining net amount to be capitalized). The nexus between a lawsuit and an injury to a capital asset, which must be established in order to achieve capital gain treatment for the plaintiff, can be very clear when property rights such as trademarks are involved. In *Inco Electroenergy Corp.,* TC Memo 1987-437, amounts received by the plaintiff corporation in settlement of a trademark dispute and for injury to business goodwill were held to be capital gain items because the trademark and the associated goodwill were capital assets.

In contrast, when it cannot be shown that the injury relates to a capital asset, a recovery is likely to be treated as ordinary income. In Rev Rul 74-251, 1974-1 Cum Bull 234, a regulated investment company received a settlement amount arising out of litigation involving the company's right to select its investment advisor. The settlement amount was held to be ordinary income rather than capital gain because the Internal Revenue Service could find no sale or exchange of a capital asset.

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§7.40 2. Recoveries Under Contract Rights

Even contract rights are frequently not held to be capital assets. This conclusion seems appropriate when the contract itself would give rise to ordinary income if it had been completed as originally planned. Thus, if a heating service supplier receives a payment for early termination of a contract under which it would have received ordinary income for providing services, the cancellation payment for the contract is clearly taxable income. Rev Rul 75-527, 1975-2 Cum Bull 30.

In contrast, when a contractor makes a settlement payment to an owner of property in exchange for a release of the owner's claims against the contractor for failure to fulfill its contract to construct a plant, the payment may be viewed as a return of capital rather than as gross income to the owner. When the plant has been purchased and the construction is to follow thereafter, the buyer's basis in the plant is simply reduced in order to reflect the offsetting payment from the contractor. Rev Rul 81-277, 1981-2 Cum Bull 14.

Even when it is clear that a capital asset is involved and that the suit relates exclusively to the capital asset, a recovery may constitute ordinary income, depending on the nature of the item for which the settlement payment is intended to compensate. In *Keller St. Dev. Co. v Commissioner* (9th Cir 1982) 688 F2d 675, the taxpayer received a payment pursuant to a judgment made by the buyer of the taxpayer's brewery. The payment was to compensate the taxpayer for the buyer's use of the brewery for the ten years the litigation progressed. Although the purchase of the brewery was clearly a capital transaction, the payment was designed to compensate the taxpayer for the use of the brewery during this period. Under the origin of the claims test, such a payment was analogous to interest or rent, either one of which constitutes taxable income.

The mere fact that a contract exists with respect to a capital asset also does not mean that a resulting recovery with respect to the contract will be capital in nature. In *Martin Bros. Box Co. v Commissioner* (6th Cir 1944) 142 F2d 457, sums received in settlement of litigation with a corporation with which the taxpayer had a contract of purchase and assignment were held to be income rather than compensation for damage to capital. Although the case involved a breach of contract, the settlement was held to be for loss of profits rather than for injury to capital or goodwill. A similar result is likely to be reached whenever the status of the payment is unclear. In *Theodore F. Vanderlaan,* TC Memo 1962-130, the taxpayer received an amount pursuant to a settlement with another company, the amounts being designated as "funds received for development." The amount was held taxable as ordinary income.

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§7.41 3. Proving Capital Asset Status and Basis

The cases are legion in which the taxpayer is unable to demonstrate a return of capital or return of investment, or for that matter, any injury to a capital asset. See *Robert C. Elliott,* TC Memo 1987-333 (settlement between engineer and his former employer held damages for lost profits and/or lost commission income). See *Highland Farms Corp.* (BTA 1940) 42 BTA 1314, acq in part 1941-1 Cum Bull 5 (damages received by plaintiff corporation against bank mortgagee for injuries resulting from actions of bank's president against corporation were held restoration of lost capital rather than income). In *Biocraft Labs., Inc.,* TC Memo 1980-268, payments received by a manufacturer from a customer in consideration for the customer's release from a product requirements contract were held to compensate the plaintiff manufacturer for anticipated lost profits. Therefore, the payments were held to be ordinary income. The taxpayer had argued that the payments were in consideration for an option purchase, and therefore could be held in abeyance until the option was either exercised or lapsed.

It cannot be overemphasized that in a business context in which a taxpayer is unable to establish the cost or basis of any capital asset (such as goodwill) that was allegedly lost or damaged by the defendant's actions, the entire recovery is likely to be taxable as ordinary income. See *Chalmers Cullins* (1955) 24 TC 322. See also *Telefilm, Inc.* (1954) 21 TC 688, nonacq 1954-2 Cum Bull 6, rev'd on other grounds (9th Cir 1955) 55-1 USTC ¶9453, 5 AFTR2d ¶1804; *Ralph Freeman* (1959) 33 TC 323.

The manner in which a taxpayer may be successful in demonstrating harm to capital assets, and therefore prove that at least some amount should be taxable as capital gain rather than ordinary income is well illustrated by *Berbiglia v Commissioner* (1951) 10 CCH TCM 413. In that case, the taxpayer sued for a breach of contract occurring on the withdrawal of a bottling franchise. The amount received in settlement of the suit was less than the loss claimed on the investment in physical assets or advertising. Accordingly, the taxpayer was successful in showing that the amount received did not represent any payment for loss of future profits, but was strictly a recovery of capital (and not even a complete one at that). The recovery was therefore excludable from gross income.

A case illustrating an allocation between capital gain and ordinary income is *Morse Trust v Commissioner* (1947) 6 CCH TCM 855. The taxpayer in that case was a trust that had received a settlement from a predecessor trustee who had illegally acquired certain assets (land trust certificates), which had thereupon decreased in value. The Tax Court held that the amount recovered by the taxpayer from the illegal purchase of the land trust certificates was income only to the extent that the amount received in the settlement exceeded the amount of capital lost. The amount of capital lost was determined to be the decrease in value of each certificate. Of this amount, a certain portion constituted ordinary income under the tax benefit doctrine, because the taxpayer had previously deducted as ordinary losses from income some of the amounts which it had then recovered in its settlement.

With some capital assets, it may be very difficult to show that a recovery should not be treated as ordinary income. For example, although a patent is clearly a capital asset (or IRC §1231 asset) with respect to many businesses, damages may relate solely to a right or expectancy of exploiting the patent, an act that would produce ordinary income. In *Kucera v Commissioner* (1951) 10 CCH TCM 303, the taxpayer received an amount in settlement of a suit in which he sought damages from the purchaser of the patent for failure to produce the patented item. The settlement was held to be in lieu of the profits he would have received from the manufacturer, rather than a payment for loss of goodwill.

The importance of basis and being able to prove it is well illustrated by *Harvey Doud,* TC Memo 1982-158. In that case, a taxpayer received an amount in settlement from a bank. The suit related to the disappearance of the plaintiff's stamp collection, which the bank had held as collateral for a loan. The taxpayer showed that the settlement amount equaled his basis in the stamps. Therefore his recovery was held nontaxable. Similarly, in *Charlie Sturgill Motor Co.,* TC Memo 1973-281, amounts received by the taxpayer based on an error by the state in condemnation proceedings were held includable in income only to the extent that the award exceeded the adjusted basis of the property. Conversely, when the taxpayer is unable to prove that the entire recovery represents a recovery of capital, any overage will be taxable income. See *Morse v Commissioner* (Ct Cl 1967) 371 F2d 474; later proceeding (Ct Cl 1969) 186 Ct Cl 964.

Several Private Letter Rulings have ruled that amounts recovered by a condominium or homeowners association for construction defects do not constitute income to the association or to its member-homeowners. Rather, such amounts represent a return of capital. See IRS Letter Rulings 9343025, 9335019, 9131023, 9041072.

In *Ila I. Gail v U.S.* (10th Cir 1995) 58 F3d 580, the Tenth Circuit Court of Appeals ruled that a judgment a woman received to compensate her after natural gas had been removed from her property without her knowledge had to be allocated. The court determined that the recovery had to be allocated between royalties (which were ordinary income) and diminution in value to the property (which was characterized as capital gains). Gail had failed to declare any portion of the recovery as income, and the IRS disagreed. Gail paid the deficiency assessed by the IRS, and then sued for a refund in federal district court. The district court ruled that the IRS had been correct, and that the entire recovery was ordinary income. The appellate court, however, found that only part of the recovery was taxable as ordinary income. While the court found that a portion of the recovery represented royalties (ordinary income), it found that the balance was compensation for diminution to the value of her property that was taxable as a capital gain.

In another case, *Brenda J. Wachner,* TC Memo 1995-88, amended 95 TNT 48-18, the Tax Court held that settlement proceeds constituted ordinary income. The taxpayer argued that the dispute between her and her former employer resulted in a capital gain to her because she exchanged equity interests in her employer for cash. The case involved equity participation in a transaction that she alleged she was supposed to have received. Ultimately, the Tax Court found that the taxpayer had failed to meet her burden of proof on the capital asset and exchange points. Consequently, the Tax Court held that the entire recovery represented ordinary income.

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§7.42 4. Allocating Among Claims

It is frequently to the taxpayer's advantage to attempt to allocate a recovery between several claims, at least when several claims are alleged. In *Thomson v Commissioner* (9th Cir 1969) 406 F2d 1006, an allocation was made between injury to the business (nontaxable, provided that the amount received is not in excess of the taxpayer's basis in the property), loss of profits (taxable as ordinary income), and punitive damages (taxable as ordinary income).

In contrast, no allocation may sometimes result in the entire claim being held taxable income. In *W. Walley, Inc. v Commissioner* (1948) 7 CCH TCM 137, the taxpayer in a contract action prayed for damages for lost profits and injury to goodwill, but the settlement document did not allocate the settlement payment. The entire amount was held to be lost profits and was therefore held to be taxable. See *William H. Evans,* TC Memo 1980-142.

The mere allegation that a defendant's conduct injured the plaintiff's goodwill will not be sufficient, particularly when the release is of a general character and does not attempt to allocate the payment received. For example, in *Durkee v Commissioner* (6th Cir 1947) 162 F2d 184, on remand (1949) 8 CCH TCM 701, aff'd (6th Cir 1950) 181 F2d 189, the Sixth Circuit treated the settlement proceeds as compensation for harm to capital asset, but remanded the case to the Tax Court to determine the taxpayer's basis in his goodwill. On remand in *Durkee,* the taxpayer was unable to show a basis other than zero for goodwill, and the recovery was therefore held taxable.

Occasionally, despite the taxpayer's efforts to prove that a recovery related to a specific capital asset, the language of other documents may preclude such treatment. In *Maryland Shipbuilding & Dry Dock Co. v U.S.* (Ct Cl 1969) 409 F2d 1363, an insurance policy covered only loss of earnings, precluding the plaintiff from successfully arguing that a recovery could constitute a return of capital.

An excellent example of a case in which no allocation was made in the settlement document is *Eleanor L. Stocks* (1992) 98 TC 1. A professor who was not rehired by a college after she filed a charge of racial discrimination eventually received a cash settlement. Although she never filed a lawsuit, she actually had two distinct claims against the college, one for racial discrimination, and one for contract claims. The genesis of the contract claim was that the college was to have notified her by a certain date whether it would rehire her, and it missed that date. The professor eventually received a $24,000 settlement, which she treated as tax-free. The IRS disagreed, and asserted that the entire recovery was taxable. In Tax Court, the judge attempted to determine what portion of the settlement was allocable to each claim. The court put great reliance on the fact that the college had perceived that it did have exposure on the contract claim. From the college's perspective, it was paying the entire amount to settle the contract claim. Eventually, the Tax Court concluded that $20,000 should be allocated to the contract claim (and hence would be taxable), and that only $4000 should be allocated to the claim for racial discrimination.

Particularly since the Small Business Job Protection Act of 1996, the employment tax consequences of dispute resolution have become as significant as the income tax consequences. With the 1996 amendments to IRC §104, many people are more concerned today about employment tax consequences, even though there were good reasons to be concerned about these consequences prior to the 1996 law change.

Evidence surrounding settlement payments, *e.g.,* revealed in discovery, can be crucial in their tax treatment. In *Cleveland Indians Baseball Co. v U.S.* (ND Ohio 1998) 98-1 USTC ¶50,197, 81 AFTR2d 645, aff'd (6th Cir 2000) 215 F3d 1325, the U.S. District Court for the Northern District of Ohio granted most of the government's motion to compel compliance with requests for admission. The action was brought by the Cleveland Indians baseball club for a refund of FICA (Federal Insurance Contributions Act) and FUTA (Federal Unemployment Tax Act) taxes paid on settlement payments the club made to players. The original dispute arose out of claims by the Major League Baseball Players' Association against the professional clubs (including the Cleveland Indians). The players' allegations were that the clubs had violated the collective bargaining rights of the free agent players. A panel of arbitrators agreed with these allegations, and the clubs and the Association settled the matter in 1990 for approximately $280 million. The 26 baseball clubs were to pay the amount in equal portions. The settlement agreement did not specify what amount was to be paid to the players, that amount being determined in a separate proceeding.

Before making any payments, however, the baseball clubs requested a Letter Ruling from the IRS regarding the tax treatment of the payments to the individual players. In 1995, the IRS ruled that the non-interest portion of the payments

would be treated as wages subject to FICA and FUTA taxes. The interest portion, however, would not be treated as wages. The Ruling also concluded that the settlement payments were taxable in the year paid (1994), rather than in the years to which the payments related (1986 and 1987).

In October 1996, the Cleveland Indians baseball club filed a refund action, seeking a refund of the FICA and FUTA taxes it paid on the settlement payments. The court set a December 1997 deadline for non-expert discovery. Later, however, the government notified the court that the club had not responded to requests for admissions, interrogatories, and requests for documents. The club asserted objections to the document requests, but the court ordered the club to comply. The government then filed a motion to compel. The district court granted the government's motion in part. The court concluded that the club's claims of attorney-client privilege or work product doctrine protection were meritless, as the club had placed in issue the character of the settled claims. Thereafter the court ordered the club to provide (1) copies of all documents discussing the nature of the claims and damages asserted by the players and the Association, (2) the club's reasons for settling, and (3) the settlement itself.

NOTE: More significantly, this case also shows that evidence of the tax discussions surrounding a settlement payment may be important. That seems an obvious proposition. What is not so obvious is that the attorney-client privilege and work product doctrine protection covering such evidence may be waived. A refund action such as this would put in question matters relating to the character of the settlement payments. The fact that the court in this refund action found the attorney-client privilege and work product protections not to be applicable should cause lawyers (and clients) in settlement discussions to be cautious of what they are saying and to whom.

In *Preslar v Commissioner* (10th Cir 1999) 167 F3d 1323, the court held that a $450,000 debt forgiven in a settlement agreement was discharge of indebtedness income. Preslar purchased 2500 acres of land for $1 million. Preslar subdivided the land and repaid Moncor, the mortgagor, by assigning it the subdivision sales contracts. Moncor later declared bankruptcy, and the FDIC was appointed receiver. The FDIC refused to accept further assigned sales contracts as repayment.

In settlement, the FDIC agreed to accept $350,000 in full satisfaction of Preslar's indebtedness. Through assignment, Preslar had already repaid approximately $200,000. Therefore, in total, Presoak paid off $550,000 of the $1 million loan. Preslar did not include the remaining $450,000 as income. The IRS argued that Preslar should have included the $450,000 as discharge of indebtedness income.

While the Tax Court held that the remaining $450,000 was not discharge of indebtedness income because of the contested liability doctrine, Preslar argued that no absolute obligation to repay the loan existed because repayment depended on sale of the subdivided lots. The Tenth Circuit found that the contested liability doctrine only applies when the debt is unliquidated. Preslar clearly received a $1 million loan.

The Tenth Circuit also addressed whether the debt reductions were purchase price adjustments under IRC §108(e)(5). Although argued in Tax Court, the Tax Court did not address this issue. Generally, IRC §108(e)(5) states that when a seller reduces a buyer's debt to the seller, and the buyer is not bankrupt, the reduction is a purchase price adjustment rather than discharge of indebtedness income. The court held that IRC §108(e)(5) did not apply because Moncor was a mortgagor, not the seller. Common law purchase price adjustment principles, on which IRC §108(e)(5) is based, also did not apply for the same reason. Therefore, the $450,000 discharged debt was held to constitute income.

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§7.43 5. IRA Contributions

In IRS Letter Ruling 9234016 the IRS ruled that settlement payments made to depositors by a savings and loan as reimbursement to them for funds embezzled by an officer of the S&L could be restored to the depositors' individual retirement accounts (IRAs) without any tax. Thus, these restitution payments were not taxable to the recipients, but became part of the assets of the IRAs.

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§7.44 6. Involuntary Conversions

Under the rules of *William J. Every v U.S.* (9th Cir 1995) 95-1 USTC ¶50,229, 75 AFTR2d 1639, interest income included as part of a settlement or judgment is typically taxable without reference to the type of the award. Interest is simply taxable income, and that element can therefore not be excluded. Rev Rul 80-364, 1980-2 Cum Bull 294 (interest element on back pay award held taxable). For example, the interest portion of a judgment assessed in addition to damages—designed to compensate the plaintiff for delay in receiving payment of the damages—will be taxable as ordinary income when the taxpayer has already recovered his capital investment. *Ellis D. Wheeler* (1972) 58 TC 459.

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§7.45 7. Settlement Versus Judgment

The tax treatment of interest in a business context is of greatest concern when litigation is resolved by judgment. A specific court order that, among other damages, a plaintiff is receiving "$_____ in interest" will make the taxable character of this element clear to everyone. There is certainly more flexibility in the treatment of the ostensible interest elements of a settlement than of a judgment.

The interest question has arisen frequently in the context of condemnation awards. The government has occasionally sought to tax the recipient of an award in a condemnation action on the interest element of the award as it accrues over the years, rather than at the conclusion of the action. However, the courts have treated the interest as accruing only when the final award or decree has been entered. See *Casalina Corp. v Commissioner* (4th Cir 1975) 511 F2d 1162. See also *Flushingside Realty & Constr. Co.,* TC Memo Lexis 267, aff'd in part, rev'd in part (2d Cir 1945) 149 F2d 572.

In contrast, a taxpayer in a condemnation action received a payment that represented 10 percent principal of the condemnation award, plus interest on the full award for a period of more than one year. In this case, the court held that only the interest that accrued in the taxable year was taxable in that year, rather than the entire amount of interest received. See *Williams Land Co. v U.S.* (Ct Cl 1940) 31 F Supp 154. This case seems peculiar to accrual method taxpayers.

However, in *John B. Leonard v Commissioner* (9th Cir 1996) 96-2 USTC ¶50,404, 78 AFTR2d 5793, the Ninth Circuit affirmed a Tax Court holding that prejudgment interest paid as part of an inverse condemnation award is taxable as ordinary income.

Occasionally, a taxpayer may acquire in settlement of its own claim a claim (or "chose in action") against someone else. In *Koerner v Commissioner* (1951) 10 CCH TCM 867, the taxpayer acquired a claim from a controlled corporation in satisfaction of the corporation's indebtedness to the taxpayer. The claim was subsequently reduced to a judgment that included accrued interest. This interest element of the claim represented taxable income to the taxpayer when received. The principal on the claim, however, was tax-free to the taxpayer because it represented a return of capital, *i.e.,* the repayment of the loan. Note that under the origin of the claims test, this result is appropriate, because it is the origin of the taxpayer's claim that would control, not the origin of the claim that was ultimately assigned to the taxpayer by the debtor.

In *James V. Crews,* TC Memo 1994-64, aff'd in part, rev'd in part (9th Cir 1996) 94 F3d 523, the Tax Court held that prejudgment interest on an inverse condemnation award was taxable as ordinary income. In *Vernon F. Burns,* TC Memo 1994-284, the Tax Court held that an age discrimination recovery was excludable (a holding subsequently overruled by the Supreme Court in *Commissioner v Schleier* (1995) 515 US 323, 132 L Ed 2d 294, 115 S Ct 2159), but determined that prejudgment interest awarded on the age discrimination recovery was not excludable under IRC §104. For this proposition, the Tax Court cited *Rosemary S. Kovacs* (1993) 100 TC 124, aff'd (6th Cir 1994) 25 F3d 1048. For a complete discussion of cases dealing with pre-judgment interest, see Koplin, *Taxability of Pre-Judgment Interest*, *ABA Section of Taxation Newsletter*, vol 14, No. 1 (1994), p 7.

In the context of business disputes, it should hardly be surprising that an amount awarded as interest should constitute taxable income. Indeed, there is significant case law authority for the notion that the use of the term "interest" in virtually any context will make the amount taxable. Even when it is not designated as interest, if it appears to be interest, some thought should be given to reporting it as such. The tax treatment of interest payments has received increasing focus. Probably the most famous case dealing with prejudgment interest is *Rosemary S. Kovacs* (1993) 100 TC 124, aff'd (6th Cir 1994) 25 F3d 1048. *Kovacs* was a wrongful death case in which, despite a lump-sum payment for wrongful death damages, the court determined that the interest portion of the award (which was awardable under Michigan state law) simply did not constitute damages on account of personal injuries. Thus, IRC §104 could apply to exclude the balance of the recovery from income, but not to exclude the interest. Other cases have made similar findings. See *Andrew Aames* (1990) 94 TC 189 (involving a stated interest element that was held taxable on a personal injury award). See also *Robert Pagliarulo,* TC Memo 1994-506 (in which interest was held taxable on a workers' compensation award); *James V. Crews, supra* (involving the question of whether attorney fees allocable to prejudgment

interest were deductible by the payor).

Apart from *Kovacs*, the most widely cited case is probably *Brabson v U.S.* (10th Cir 1996) 73 F3d 1040. The *Brabson* case involved what was indisputably a tort claim. Mary Brabson and her children were awarded $2.9 million in a 1988 judgment arising out of the explosion of the Brabson household due to a gas leak. The $2.9 million award included $370,723 of mandatory prejudgment interest. There was no question but that the balance of the award was excludable under IRC §104. The IRS, however, argued that the $370,723 was taxable interest. When the matter reached the Tenth Circuit, the Tenth Circuit Court of Appeals went through what can only be described as a tortured analysis of the law and the legislative history of IRC §104, as interpreted by the Supreme Court in *Commissioner v Schleier* (1995) 515 US 323, 132 L Ed 2d 294, 115 S Ct 2159. Ultimately, the Tenth Circuit in *Brabson* found that despite the indisputably tort nature of the case, the mandatory prejudgment interest that the Brabson family received was—unfortunately, it seemed to the court—taxable income.

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§7.46 8. Cases Settling on Appeal

The tax treatment of interest in a business context was raised in *Rozpad v Commissioner* (1st Cir 1998) 154 F3d 1. The First Circuit affirmed the Tax Court, holding that the taxpayers received taxable prejudgment interest as part of what was indisputably a personal injury settlement. Moreover, the court reached this holding even though the settlement agreements did not allocate any portion of the settlement amount to prejudgment interest. The underlying dispute also arose out of what was indisputably a tort action. Mrs. Rozpad sued a surgeon in 1989 for medical malpractice, receiving a $2 million jury award. Her husband received a related award in the case for $65,000. The trial court reduced this award, and judgment was entered in the amount of $965,250, which included $250,250 in state-mandated (Rhode Island) prejudgment interest.

However, as is so often the case in appellate cases, during the appeal period, the case settled for $800,000. The settlement agreement (not having had the benefit of experienced tax advice) did not deal with tax consequences at all. Still, the parties to the litigation filed a stipulation with the court stating that there would be no interest payable on the settlement amount. After the deduction of attorney fees and costs, Mr. and Mrs. Rozpad received $438,900, none of which they reported on their 1992 tax return.

In a companion case (cite also as *Rozpad v Commissioner, supra*), Floriano DiBiasio also received a medical malpractice verdict in Rhode Island. The final judgment was for $1.3 million, including $572,800 in prejudgment interest. Mr. DiBiasio reached a settlement and filed a stipulation (no interest) that was similar to the stipulation entered into in the Rozpad case. Mr. DiBiasio netted $552,500, and did not report any portion of it on his 1989 tax return.

In both the *Rozpad* and *DiBiasio* cases, the IRS determined deficiencies, arguing that a portion of each of these indisputable tort settlements constituted taxable prejudgment interest. The Tax Court did not require much convincing to agree with the IRS, despite the stipulation that the parties had all agreed that no interest would be payable. When the matter reached the First Circuit Court of Appeals, the circuit court rejected the argument that the stipulations effectively annulled the trial court judgment.

According to the First Circuit, while it expressly said that it would not engage in line-drawing concerning what constitutes interest in circumstances in which that is not clear, in these two pending cases it was eminently clear (said the court) that the interest could be separated out with accuracy and ease. The court stated that when there had been a jury verdict and an ensuing judgment that contains separate itemizations of damages and interest, a subsequent settlement that does not purport to make a different allocation is quite logically viewed as including a pro rata share of the interest. The court stated that in such cases it had a duty to look beyond the settlement language used by the parties to the agreement.

Faced with this rather harsh conclusion, the First Circuit had an easy time holding for the IRS, relying on such decisions as *Brabson v U.S.* (10th Cir 1996) 73 F3d 1040, as well as *Rosemary S. Kovacs* (1993) 100 TC 124, aff'd (6th Cir 1994) 25 F3d 1048. The First Circuit did acknowledge that the taxpayers were arguing that some of the authorities involved postjudgment as opposed to prejudgment interest, but the First Circuit was not convinced that there was a significant difference for tax purposes between these two types of interest.

NOTE: One of the thornier questions concerning the tax treatment of damage awards and settlement payments is what level of security applies to a settlement allocation entered into on appeal. There will by definition be a verdict that may delineate quite clearly what the trial court believes is appropriate treatment for the various elements awarded. It may also not be clear on the subject. The verdict may specify explicitly that an amount is awarded for prejudgment interest.

Can this be undone in a settlement agreement? The *Rozpad* decision suggests that merely stipulating that there will be "no interest" payable will be insufficient to carry the day, at least in the First Circuit. Indeed, it would seem to invite the IRS either to invoke the full amount of the interest awarded, or at least to try to apply a pro rata amount of the interest awarded in relationship to the other portions of the recovery.

On the other hand, if the parties stipulated to a much smaller figure for interest payable, perhaps this would be respected. Many elements of a case, after all, can be compromised on appeal. The court seems to suggest in

Rozpad that it would not get involved in delineating amounts of prejudgment interest when the circumstance was not clear. Presumably, the court found the stipulation of "no interest" incredible, particularly given the more than one-half million dollars of prejudgment interest that had been entered in one of the cases involved in *Rozpad* (the *DiBiasio* case). If a more modest figure of interest (say prejudgment interest only from a certain date forward) were agreed on, then it might be much more difficult for a court (or the IRS for that matter) to second guess the stipulation.

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§7.47 9. Semantics and Other Issues Involving "Interest"

The case of *Michael J. Woods,* TC Memo 1998-435, which also raises the question about interest in cases settling on appeal, underscores the need to be clear about the taxability of interest. The Woods case arose out of an injury to Jacqueline Woods's shoulder during birth in 1985. Her parents sued the doctor and hospital on their own behalf as well as on the baby's behalf. After a jury trial, the jury awarded damages to the baby and her parents, and the court clerk added prejudgment interest. Prejudgment interest was apparently 42.5 percent of the total amount awarded.

During the pendency of the doctor's appeal, the parties settled the case. The settlement agreement did not allocate any portion of the settlement proceeds to anything other than damages. In other words, interest was not mentioned. In 1992, the doctor's insurer issued two checks, one to the baby and her lawyer for $1.86 million and one check to the baby's parents and the lawyer for $184,000. The attorney for the Woodses retained his portion of the payment for legal fees and paid the balance to the plaintiffs.

Neither the baby nor her parents reported any portion of the settlement proceeds on their tax returns. The IRS determined deficiencies, asserting that the plaintiffs received the taxable interest income from the settlement proceeds. The Tax Court held that the IRS correctly applied the percentage resulting from the state court's judgment to apportion the total settlement proceeds between damages and prejudgment interest. The court cited and relied on *Rozpad v Commissioner* (1st Cir 1998) 154 F3d 1. The *Rozpad* case, which the court took to be controlling authority in the First Circuit, was particularly relevant because the *Woods* case in the Tax Court would be appealable to the First Circuit. The Tax Court noted that the First Circuit in *Rozpad* had rejected the contention that prejudgment interest is part of damages under Rhode Island law.

CAUTION: In *Michael J. Woods,* the plaintiffs and their counsel probably figured that as this was a real physical injury case, there was no question about the applicability of IRC §104(a)(2). Because the case settled during the pendency of an appeal, all parties may have thought that any verdict rendered by the trial court was really unimportant. What was important, it must have seemed, was that a settlement was ultimately reached and the defendant was paying to get rid of this personal injury lawsuit. Unfortunately, the parties apparently did not even consider the applicability of the underlying verdict, which resulted in a whopping 42.5 percent of the assertedly nontaxable award being treated as taxable interest. One can imagine the consternation faced by a plaintiff who has received an amount only to find out some years later (in 1998), that the amount was partially taxable. Finding out that 42.5 percent of the total settlement amounted to taxable interest could be a crushing blow (not to mention one that could conceivably lead to malpractice claims). It is not clear whether there would have been a way to prevent the result that obtained in this case. On the surface, one would hope that specifically mentioning (and negating) the applicability of any prejudgment interest in the settlement agreement might result in a different conclusion. After all, if an amount was awarded at trial and appealed, and if there is also a cross-appeal on the actual damages, one would hope that the settlement figure could be regarded as purely that, a settlement of a disputed amount for personal injuries. Specifically negating the payment of any prejudgment interest might help to avoid the unfortunate result that obtained in this case. At least this theory may help to reduce prejudgment interest exposure.

In another decision, *Joseph M. Perry,* TC Memo 1998-433, the IRS determination was also upheld in a case that similarly involved a state court (Rhode Island) settlement. Mr. Perry's case involved a vehicular accident, and he received a jury verdict to which the court clerk added prejudgment interest. The case settled on appeal, but the settlement agreement did not state whether any portion of the settlement proceeds constituted interest. Mr. Perry did not report any portion of the proceeds as taxable, and the IRS determined that a percentage of the proceeds was taxable interest. As in *Michael J. Woods,* the Tax Court in *Joseph M. Perry* found that the IRS had correctly applied the percentage resulting from the state court's judgment to apportion the total settlement proceeds between nontaxable damages and taxable prejudgment interest. Again, the court cited *Rozpad v Commissioner, supra.*

In yet another prejudgment interest case, *Manuel J. Serpa, Jr.,* TC Memo 1998-453, the Tax Court held that a

portion of a settlement payment that a Rhode Island couple received from a tort action constituted prejudgment interest and was not excludable under IRC §104. A judgment included statutory prejudgment interest as required by Rhode Island law. Then there was a settlement with a general release. The release did not state whether any of the amount was interest, and the parties did not allocate any of the amount to interest. Nonetheless, the Tax Court concluded that 28.61 percent of the $150,000 settlement was prejudgment interest, therefore not excludable under IRC §104. The court rejected the notion that the settlement eviscerated any prejudgment interest award. Notably, however, the Tax Court stated that "absent a contrary allocation" one can assume that the interest and damages were comprised of the same proportions of the settlement as the judgment. This statement suggests that an allocation could have been made in the settlement agreement that might have eliminated the prejudgment interest problem.

The U.S. District Court in *Estate of Arthur L. Clarks v U.S.* (ED Mich 1998) 98-2 USTC ¶50,868, 82 AFTR2d 7068, rev'd (6th Cir 2000) 202 F3d 854, faced the same question as in *Manuel J. Serpa, Jr., supra.* Interest was received on a personal injury judgment, and the court held it to be taxable income, not excludable under IRC §104. Interestingly, the case arose because it was rather clear that a portion of the award was interest under a jury verdict. The jury verdict was for damages plus interest, so the interest portion was readily calculable. More important than the interest element was the attorney fee portion of the case. The IRS also claimed that Mr. Clarks was taxable on the attorney fees paid to his contingent fee lawyer in the personal injury case. The court distinguished *Cotnam v Commissioner* (5th Cir 1959) 263 F2d 119, because the court found that Michigan law did not have a similar attorney fee provision as that applicable in Alabama, which governed the Cotnam decision. In fact, the court found that even though Mr. Clarks had never come in contact with the money that was paid to his attorney in the contingent fee case, it was not necessary for him to touch the money to have income. The court cited *Baylin v U.S.* (Fed Cir 1995) 43 F3d 1451 with approval.

NOTE: Whenever the label "interest" is attached to a payment in the context of a settlement or judgment, it is likely to be viewed as ordinary income by the Internal Revenue Service. Indeed, it seems difficult to argue that a payment is truly anything else when it has been labeled by a court or by the parties as "interest." Whether the payment is prejudgment or postjudgment interest, and regardless of the type of action in which it arises, even physical injury actions in which the underlying payment (apart from interest) would be excludable under IRC §104, the "interest" element has been held to be taxable.

More interesting questions arise, of course, when it is arguable that interest could be awarded, but when the parties expressly provide that no interest is being paid or received. It is arguable in such cases that the generally negative consequences of an interest payment should not attach. Some of the cases considering these issues have focused on the absolute right to prejudgment or postjudgment interest under applicable state law. Sometimes, though, the pendency of appeals can make issues such as this arguable.

Although IRS administrative guidance may be of less interest than case law, it can still be helpful. IRS Letter Ruling 199922056 rules that a business taxpayer must include postjudgment interest on a punitive damages award in the year in which the underlying court judgment became final and was no longer appealable. Apart from the includability of the interest, the real key to this Letter Ruling was timing. The business was an accrual basis taxpayer that had fought for insurance coverage for a natural disaster. The insurance company did not pay disputed interest on the damage award until the year after the judgment became final and nonappealable. The question in the Ruling, therefore, was whether the interest should be taxable in the year when it was received (when the insurance company eventually capitulated and paid the amount over), or in the year in which the court judgment for the underlying damages became final and nonappealable. Predictably, the IRS agent contended that the interest should be includable in the earlier year. The business, on the other hand, argued that the underlying judgment may have become final, but that its right to receive the interest was not fixed until the following year. The amount of the interest, the business also argued, could not reasonably be determined until it was actually paid.

Unfortunately, the Letter Ruling comes out on the side of the agent, noting that state law made the payment of the postjudgment interest mandatory. According to the Ruling, the business had a right to the interest, which became fixed on the date the judgment became final. The IRS also found the interest amount to be readily determinable (because state law provided the interest rate). This is a particularly frustrating result in a case in which one is trying to induce payment from a defendant. In this kind of reluctant payor situation, it would seem arguable that even under the accrual accounting method, the recipient's rights to the interest would not have been fixed. Imagine the situation, for example, where the fight over the payment of interest goes on for several years. Being required to take the interest into income

in the earliest year (the year of the judgment) would therefore seem that much more punitive.

In IRS Letter Ruling 199952080, the IRS ruled that damages that a couple received for lost wages and unpaid medical bills, pain and suffering, and loss of consortium in a personal injury accident against the husband's employer are properly excludable under IRC §104. The IRS even considered postjudgment interest received on the damage award, concluding (predictably) that the interest was taxable income. It is interesting to contemplate exactly why this Ruling was requested. Given the facts in the Ruling, an exclusion from income would seem obvious. The Ruling arose out of the husband sustaining a life-threatening injury in a logging accident while at work. The couple ultimately sued the employer for damages and loss of consortium. A jury awarded the couple damages for lost wages and unpaid medical bills, pain and suffering, and loss of consortium. The judgments were paid, except for a portion of the damages that exceeded the state's statutory limit for noneconomic personal injury damages in a tort action. The IRS sensibly concluded that because the damages were compensation for personal injuries sustained in the accident, they are excludable. The postjudgment interest has been held by case law (and by the IRS) not to be received "on account of" any physical injury or physical sickness, and is therefore taxable.

PRACTICE TIP: Very frequently, particularly in a settlement context, lawyers and tax advisors forget to ask about the interest element. When a verdict is paid, as was the case in IRS Letter Ruling 199952080, it seems difficult to argue that the interest element should be excludable as well. On the other hand, in the context of a negotiated settlement in which a settlement figure is reached that compromises many claims, it may be possible to avoid the negative result typically visited on tort plaintiffs who receive taxable interest. Some of this planning may also hinge on the degree to which state law imposes the interest obligation in an absolute fashion. Frequently, though, there is some room to negotiate, because the interest element would not apply to a settlement but only to a verdict that becomes final. Of course, one can expect that the IRS would not necessarily agree with this position. If the case had been on appeal and the interest element compromised along with everything else, the question would be what is the definition of "interest," something that also is not clear in the context of a negotiated settlement. There have been a number of articles dealing with the scope of IRC §104. See *Portion of Settlement in Personal Injury Case Allocated to Taxable Prejudgment Interest: Rozpad v Commissioner*, vol 52, No. 3, Tax Lawyer (Spring 1999). This article considers the question of whether prejudgment interest in a case that was indisputably a physical injury case ought to be regarded as part of the IRC §104 recovery, or should be simply treated as "interest" and therefore taxable.

As noted above, the courts have not been terribly forgiving of taxpayers who receive an indisputably excludable award under IRC §104, only to also receive interest (which the IRS and the courts are likely to want to tax). A district court case highlights the notion that semantics ("delay damages" versus "interest") is not the most important consideration. In *Francisco v U.S.* (ED Pa 1999) 54 F Supp 2d 427, a U.S. district court held that a married couple injured in a car accident had to pay tax on the portion of their award that was attributable to "delay damages." They were awarded $1.8 million in damages plus $1.6 million in "delay damages." The taxpayers did not report any portion of this money on their tax return. The IRS determined that 46 percent of the settlement proceeds were allocable to these delay damages, based on the ratio of the delay damages to the total of damages in the original award, and thus taxable.

The district court held that "delay damages" are not received "on account of personal injuries" and are therefore taxable income. The court noted that such delay damages are effectively a procedural tool to affect the behavior of a defendant, and in part are compensation for the time value of money (much like the dreaded word "interest"). The Franciscos' settlement agreement did not designate any portion of the award attributable to delay damages. The judge requested that both parties submit briefs on how the delay damages should be apportioned.

NOTE: Whether or not a state law on "delay damages" as opposed to "prejudgment interest" (or even "postjudgment interest") should be viewed differently may be an arguable point. It may depend on the legislative history for the delay damage provision. It may also depend on how similar the delay damage provision looks to normal prejudgment and postjudgment interest provisions in other state laws.

However, what is clear is that an unallocated amount may not be the wisest choice. At the very least, if the numbers work, perhaps one can negate (in the settlement agreement to be signed by both the plaintiff and defendant) any allocation to such amount. If the numbers are not otherwise skewed, *i.e.,* there are sufficient actual damages being

awarded so that it cannot be said that an additional amount simply must be interest, then perhaps this negation technique might work. In any event, it seems better than leaving the matter unaddressed.

Few tax practitioners would argue that calling something "interest" in any context will probably make it taxable. That is why there is often inherent conflict between plaintiffs' attorneys and tax attorneys on the items requested in a settlement or judgment. Very frequently, "interest" is required to be paid, or at least sought. Whether it ends up in the final settlement agreement or verdict denominated as "interest" remains a separate question.

In the context of a suit for lost profits, a recovery for which would be taxable as ordinary income, denominating an element of the recovery as "interest" should result in no tax detriment, since the interest would also be taxable as ordinary income. In the context of a true personal (and physical) injury suit, however, interest would be taxable while the recovery for physical injuries would not. *Rosemary S. Kovacs* (1993) 100 TC 124, aff'd (6th Cir 1994) 25 F3d 1048.

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§7.48 10. Antitrust Recoveries

Many interesting allocation questions arise in the context of antitrust proceedings. The same issues regarding a taxpayer's ability to demonstrate loss of capital arise in that context. For example, in *Raytheon Prod. Corp. v Commissioner* (1st Cir 1944) 144 F2d 110, the taxpayer received a settlement in a damage suit under the antitrust laws. The suit claimed injuries to the taxpayer's radio tube business involving certain actions with respect to patent cross-licenses. $60,000 of the payment was allocated to the patent and license rights, and the balance of $350,000 was held to be taxable income. As is so often the case, the case turned on the taxpayer's inability to demonstrate the receipt of capital replacement and/or any cost or other basis of the goodwill and business, which the taxpayer alleged had been destroyed.

When the taxpayer is unable to show that a portion of the settlement or damages received represents a nontaxable return of capital, the payments will almost always be viewed entirely as lost profits. For cases in the antitrust area, see the following: *Sager Glove Corp. v Commissioner* (7th Cir 1962) 311 F2d 210; *Peter K. Pappas,* TC Memo 1962-203; *Estate of Carter v Commissioner* (8th Cir 1962) 298 F2d 192; *Aluminum & Metal Serv. v Commissioner* (7th Cir 1966) 358 F2d 138; *David Bresler* (1975) 65 TC 182, acq 1976-2 Cum Bull 1; *Paul v U.S.* (SD Ill 1972) 72-2 USTC ¶9720.

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§7.49 C. Tax Treatment of Recovered Attorney Fees

The tax treatment of contingent attorney fees has been one of the most hotly contested issues in federal tax law.

In 2005, the U.S. Supreme Court held that the taxpayer's gross income does include the portion of the recovery paid to his or her lawyer under a contingency fee agreement. The Court said: "[A]s a general rule, when a litigant's recovery constitutes income, the litigant's income includes the portion of the recovery paid to the attorney as a contingent fee." *Commissioner v Banks* (2005) 543 US 426, 160 L Ed 2d 859, 866, 125 S Ct 826.

The Supreme Court thus aligned itself with the majority of the circuit courts of appeal in ruling that contingent attorney fees are taxable to both the attorney and the plaintiff. See *Alexander v Commissioner* (1st Cir 1995) 72 F3d 938; *Raymond v U.S.* (2d Cir 2004) 355 F3d 107; *Walter F. O'Brien* (1962) 38 TC 707, aff'd (3d Cir 1963) 319 F2d 532; *Young v Commissioner* (4th Cir 2001) 240 F3d 369; *Kenseth v Commissioner* (7th Cir 2001) 259 F3d 881; *Bagley v Commissioner* (8th Cir 1997) 121 F3d 393, en banc rehearing denied 1997 US App Lexis 27256; *Benci-Woodward v Commissioner* (9th Cir 2000) 219 F3d 941, cert denied (2001) 531 US 1112; *Coady v Commissioner* (9th Cir 2000) 213 F3d 1187, cert denied (2001) 532 US 972; *Sinyard v Commissioner* (9th Cir 2001) 268 F3d 756, cert denied (2002) 536 US 904; *Hukkanen-Campbell v Commissioner* (10th Cir 2001) 274 F3d 1312, cert denied (2002) 535 US 1056; *Baylin v U.S.* (Fed Cir 1995) 43 F3d 1451.

The reasoning of the minority view, that contingent attorney fees are not taxable to the plaintiff, but only to the attorney, has been rejected by the Supreme Court. For minority view cases, see *Srivastava v Commissioner* (5th Cir 2000) 220 F3d 353, overruled in part in *Commissioner v Banks* (2005) 543 US 426, 160 L Ed 2d 859, 125 S Ct 826, 830; *Cotnam v Commissioner* (5th Cir 1959) 263 F2d 119; *Banks v Commissioner* (6th Cir 2003) 345 F3d 373, rev'd in *Commissioner v Banks* (2005) 543 US 426, 160 L Ed 2d 859, 125 S Ct 826; *Estate of Clarks v U.S.* (6th Cir 2000) 202 F3d 854, overruled in part in *Commissioner v Banks* (2005) 543 US 426, 160 L Ed 2d 859, 125 S Ct 826; *Banaitis v Commissioner* (9th Cir 2003) 340 F3d 1074, rev'd in *Commissioner v Banks* (2005) 543 US 426, 160 L Ed 2d 859, 125 S Ct 826; *Davis v Commissioner* (11th Cir 2000) 210 F3d 1346.

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Source: Civil Litigation/California Attorney's Guide to Damages/7 Tax Aspects/§7.49A 1. The Supreme Court's Decision in Commissioner v Banks

§7.49A 1. The Supreme Court's Decision in *Commissioner v Banks*

In *Commissioner v Banks* (2005) 543 US 426, 160 L Ed 2d 859, 125 S Ct 826, the Supreme Court reiterated the principle that gains should be taxed "to those who earn them." 160 L Ed 2d at 869, quoting *Lucas v Earl* (1930) 281 US 111, 114, 74 L Ed 731, 50 S Ct 241. To help ensure that those who earn are taxed, the anticipatory assignment doctrine provides that "[a] taxpayer cannot exclude an economic gain from gross income by assigning the gain in advance to another party." 160 L Ed 2d at 869, citing *Lucas v Earl* (1930) 281 US 111, 114, 74 L Ed 731, 50 S Ct 241; *Commissioner v Sunnen* (1948) 333 US 591, 604, 92 L Ed 898, 68 S Ct 715; and *Helvering v Horst* (1940) 311 US 112, 85 L Ed 75, 61 S Ct 144. The doctrine makes no distinction between assignments based on any tax avoidance purpose the taxpayer may have had. 160 L Ed 2d at 869.

The Court concluded that a contingent fee agreement between a client and his or her attorney "should be viewed as an anticipatory assignment to the attorney of a portion of the client's income from any litigation recovery" and refused to treat a contingent fee agreement as creating, for tax purposes, something like a joint venture or partnership between the client and attorney. 160 L Ed 2d at 869.

In an anticipatory assignment case, the question is whether the assignor retains dominion over the income-generating *asset*, even though at the time of receipt, the assignor often does not have dominion over the income. There was no dispute between the parties, that, as the Court said:

> In the case of a litigation recovery the income-generating asset is the cause of action that derives from the plaintiff's legal injury. The plaintiff retains dominion over this asset throughout the litigation.

160 L Ed 2d at 869. The Court refused to accept counterarguments that (1) a legal claim is speculative at the moment of assignment and may be worth nothing at all, and (2) in addition to the plaintiff's legal injury, the attorney also contributes income-generating assets of effort and expertise that are necessary for the plaintiff to prevail.

First, the anticipatory assignment doctrine is not limited to cases in which the precise dollar value of the assigned income is known in advance; the essence is that the taxpayer retained control over the income-producing asset. Second, the attorney-client relationship is not like a partnership or joint venture, but is rather the "quintessential principal-agent relationship." 160 L Ed 2d at 870. Although the client needs the attorney's expertise and skill to obtain a result that the client alone could not achieve, that is the case with most principal-agent relationships and "does not alter the fact that the client retains ultimate dominion and control over the underlying claim." 160 L Ed 2d at 870. Because the attorney is duty bound to act only in the interests of the principal, "it is appropriate to treat the full amount of the recovery as income to the principal." 160 L Ed 2d at 870.

NOTE: As the Supreme Court noted in *Commissioner v Banks, supra,* the taxpayers in both *Banks* and *Banaitis* in the tax years in question could have deducted the attorney fees as miscellaneous itemized deductions under IRC §§67-68, but to do so would have been useless to them because of the Alternative Minimum Tax. For discussion of the AMT, see, *e.g.,* §7.62A. The Court also noted that had the American Jobs Creation Act of 2004 been in force at the time of the transactions in *Banks* and *Banaitis,* those cases probably would not have arisen. On the American Jobs Creation Act of 2004, see §7.49B.

The anticipatory assignment doctrine applies whether or not the attorney-client contract or state law confers any special rights or protections on the attorney, so long as they do not alter the fundamental agency nature of the relationship. Although state laws vary with respect to the strength of the attorney's security interest in a contingent fee, "No state laws of which we are aware…even those that purport to give attorneys an 'ownership' interest in their fees… convert the attorney from an agent to a partner." 160 L Ed 2d at 870.

The Court did not address the issue of whether, when a case is brought under a statute that authorizes fee awards to prevailing plaintiff's attorneys, the analysis would be different because to treat the fee award as income to the plaintiff in such cases might lead to the "perverse result that the plaintiff loses money by winning the suit" and "would undermine the effectiveness of fee-shifting statutes in deputizing plaintiffs and their lawyers to act as private attorneys general." 160 L Ed 2d at 872.

NOTE: The Supreme Court decision in *Banks* was announced as a "general rule," implying that there may be exceptions. It is unclear at this point what impact the decision may have on other cases based on different fact patterns, although the IRS probably will treat all contingent attorney fees as income. Also, the IRS will likely treat the *Banks* decision as retroactive, even though the court did not discuss retroactivity in its opinion.

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Source: Civil Litigation/California Attorney's Guide to Damages/7 Tax Aspects/§7.49B 2. Deduction for Attorney Fees in Unlawful Discrimination Cases

§7.49B 2. Deduction for Attorney Fees in Unlawful Discrimination Cases

Section 703 of the American Jobs Creation Act of 2004 (Pub L 108-357, 118 Stat 1418) amends IRC §62 to end the Internal Revenue Service's "double taxation" of attorney fee awards in suits claiming unlawful discrimination. Under amended IRC §62, deductions from an individual's gross income that are permissible in determining adjusted gross income include (IRC §62(a)(20), (e)):

> Any deduction allowable under this chapter for attorney fees and court costs paid by, or on behalf of, the taxpayer in connection with any action involving a claim of unlawful discrimination (as defined in subsection (e)) or a claim of a violation of subchapter III of chapter 37 of title 31, United States Code [31 USC §§3721 et seq.] or a claim made under section 1862(b)(3)(A) of the Social Security Act (42 U.S.C 1395y(b)(3)(A)). The preceding sentence shall not apply to any deduction in excess of the amount includible in the taxpayer's gross income for the taxable year on account of a judgment or settlement (whether by suit or agreement and whether as lump sum or periodic payments) resulting from such claim.

A claim of unlawful discrimination under IRC §62(e) can be brought for violation of any one of a laundry list of statutes:

- Civil Rights Act of 1991 §302 (2 USC §1202);
- Congressional Accountability Act of 1995 §201, §202, §203, §204, §205, §206, or §207 (2 USC §1312, §1313, §1314, §1315, §1316, or §1317);
- National Labor Relations Act (29 USC §§151-187);
- Fair Labor Standards Act of 1938 (29 USC §§201-219);
- Age Discrimination in Employment Act of 1967 §4 or §15 (29 USC §623 or §633a);
- Rehabilitation Act of 1973 §501 or §504 (29 USC §791 or §794);
- Employee Retirement Income Security Act of 1974 §510 (29 USC §1140);
- Title IX of the Education Amendments of 1972 (20 USC §§1681-1688);
- Employee Polygraph Protection Act of 1988 (29 USC §§2001-2009);
- Worker Adjustment and Retraining Notification Act (29 USC §§2101-2109);
- Family and Medical Leave Act of 1993 §105 (29 USC §2615);
- Chapter 43 of Title 38, United States Code (38 USC §§4301-4333) (relating to employment and reemployment rights of members of the uniformed services);
- Section 1981, 1983 and 1985 cases (42 USC §1981, §1983, or §1985);
- Civil Rights Act of 1964 §703, §704, or §717 (42 USC §2000e-2, §2000e-3, or §2000e-16);
- Fair Housing Act §804, §805, §806, §808, or §818 (42 USC §3604, §3605, §3606, §3608, or §3617);
- Americans with Disabilities Act of 1990 §102, §202, §302, or §503 (42 USC §12112, §12132, §12182, or §12203);
- Any provision of federal law (known as Whistleblower Protection Provisions) that prohibits the discharge of an employee, discrimination against an employee, or any other form of retaliation or reprisal against an employee for asserting rights or taking other actions permitted under federal law; or
- Any provision of federal, state or local law, or common law claims permitted under federal, state, or local law, that provides for the enforcement of civil rights, or regulates any aspect of the employment relationship, including claims for wages, compensation, or benefits, or prohibiting the discharge of an employee, discrimination against an employee, or any other form of retaliation or reprisal against an employee for asserting rights or taking other actions permitted by law.

PRACTICE TIP: There is a need to carefully analyze the cause of action. In many cases, the deduction only applies to specific sections of laws. For example, only ERISA claims brought under §510 of ERISA are entitled to this deduction for attorney fees. Plaintiffs with claims under any other ERISA section cannot use it. Further, the new deduction does not apply to many types of discrimination not included on the list.

The deduction was enacted October 22, 2004, and applies to fees and costs paid after that date "with respect to any judgment or settlement occurring after such date." Pub L 108-357, 118 Stat 1418. Thus, the deduction applies only to attorney fees or court costs in discrimination cases in which the judgment or settlement occurred after October 22, 2004.

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3. Pre-*Banks* Cases: The Split in the Circuit Courts [Deleted]

§7.49C a. First Circuit Authority—Applying Massachusetts Law [Deleted]

The subject matter formerly discussed in §7.49C is now discussed in §7.49.

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§7.49D b. Second Circuit Authority—Applying Vermont Law [Deleted]

The subject matter formerly discussed in §7.49D is now discussed in §7.49.

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§7.49E c. Third Circuit Authority—Applying Pennsylvania Law [Deleted]

The subject matter formerly discussed in §7.49E is now discussed in §7.49.

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§7.49F d. Fourth Circuit Authority—Applying North Carolina Law [Deleted]

The subject matter formerly discussed in §7.49F is now discussed in §7.49.

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e. Fifth Circuit Authority—Applying Alabama and Texas Law [Deleted]

§7.49G (i) Applying Alabama Law [Deleted]

The subject matter formerly discussed in §7.49G is now discussed in §7.49.

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§7.49H (ii) Applying Texas Law [Deleted]

The subject matter formerly discussed in §7.49H is now discussed in §7.49.

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f. Sixth Circuit Authority [Deleted]

§7.49l (i) Applying Michigan Law [Deleted]

The subject matter formerly discussed in §7.49l is now discussed in §7.49.

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Source: Civil Litigation/California Attorney's Guide to Damages/7 Tax Aspects/§7.49J (ii) Banks: Reversed by the United States Supreme Court [Deleted]

§7.49J (ii) *Banks*: Reversed by the United States Supreme Court [Deleted]

The subject matter formerly discussed in §7.49J is now discussed in §7.49.

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§7.49K g. Seventh Circuit Authority—Applying Wisconsin Law [Deleted]

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§7.49L h. Eighth Circuit Authority—Applying Iowa Law [Deleted]

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i. Ninth Circuit Authority—Applying Arizona, California, Alaska, and Oregon Law [Deleted]

§7.49M (i) Applying Arizona Law [Deleted]

The subject matter formerly discussed in §7.49M is now discussed in §7.49.

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§7.49N (ii) Applying California Law [Deleted]

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§7.49O (iii) Applying Alaska Law [Deleted]

The subject matter formerly discussed in §7.49O is now discussed in §7.49.

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§7.49P (iv) Applying Oregon Law [Deleted]

The subject matter formerly discussed in §7.49P is now discussed in §7.49.

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§7.49Q j. Tenth Circuit Authority—Applying Missouri Law [Deleted]

The subject matter formerly discussed in §7.49Q is now discussed in §7.49.

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§7.49R k. Eleventh Circuit Authority—Applying Alabama Law [Deleted]

The subject matter formerly discussed in §7.49R is now discussed in §7.49.

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§7.49S I. Federal Circuit Precedent [Deleted]

The subject matter formerly discussed in §7.49S is now discussed in §7.49.

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Source: Civil Litigation/California Attorney's Guide to Damages/7 Tax Aspects/§7.50 D. Net Versus Gross Recoveries Illustrated [Deleted]

§7.50 D. Net Versus Gross Recoveries Illustrated [Deleted]

The subject matter formerly discussed in §§7.50 is now discussed in §7.49.

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Source: Civil Litigation/California Attorney's Guide to Damages/7 Tax Aspects/§7.51 E. Position of Internal Revenue Service and Various Circuit Courts of Appeal [Deleted]

§7.51 E. Position of Internal Revenue Service and Various Circuit Courts of Appeal [Deleted]

The subject matter formerly discussed in §§7.51-7.62 is now discussed in §§7.49-7.49B.

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§7.52 1. *Srivastava v Commissioner*

On *Srivastava v Commissioner* (5th Cir 2000) 220 F3d 353, overruled in part in *Commissioner v Banks* (2005) 543 US 426, 160 L Ed 2d 859, 125 S Ct 826, see §7.49.

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§7.53 2. *Benci-Woodward v Commissioner*

On *Benci-Woodward v Commissioner* (9th Cir 2000) 219 F3d 941, cert denied (2001) 531 US 1112, see §7.49.

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§7.54 3. *Estate of Clarks v United States*

On *Estate of Clarks v U.S.* (6th Cir 2000) 202 F3d 854, overruled in part in *Commissioner v Banks* (2005) 543 US 426, 160 L Ed 2d 859, 125 S Ct 826, see §7.49.

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§7.55 4. *Davis v Commissioner*

On *Davis v Commissioner* (11th Cir 2000) 210 F3d 1346, see §7.49.

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§7.56 5. *Coady v Commissioner*

On *Coady v Commissioner* (9th Cir 2000) 213 F3d 1187, cert denied (2001) 532 US 972, see §7.49.

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§7.57 6. *Banaitis v Commissioner*

On *Banaitis v Commissioner* (9th Cir 2003) 340 F3d 1074, rev'd in *Commissioner v Banks* (2005) 543 US 426, 160 L Ed 2d 859, 125 S Ct 826, see §7.49.

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§7.58 7. *Hukkanen-Campbell v Commissioner*

On *Hukkanen-Campbell v Commissioner* (10th Cir 2001) 274 F3d 1312, cert denied (2002) 535 US 1056, see §7.49.

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§7.59 8. *Alexander v Commissioner*

On *Alexander v Commissioner* (1st Cir 1995) 72 F3d 938, see §7.49.

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§7.60 9. *Syphrett v Commissioner*

The discussion formerly in this section has been removed from the text.

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§7.61 10. *Baylin v Commissioner*

On *Baylin v U.S.* (Fed Cir 1995) 43 F3d 1451, see §7.49.

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§7.62 11. *Banks v Commissioner*

On *Banks v Commissioner* (6th Cir 2003) 345 F3d 373, rev'd in *Commissioner v Banks* (2005) 543 US 426, 160 L Ed 2d 859, 125 S Ct 826, see §§7.49-7.49A.

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Source: Civil Litigation/California Attorney's Guide to Damages/7 Tax Aspects/§7.62A 12. Alternative Minimum Tax Considerations

§7.62A 12. Alternative Minimum Tax Considerations

In cases not covered by the new above-the-line deduction for attorney fees (see §7.49B) it is possible for taxpayers to owe more in taxes than they recovered in their lawsuits. See *Spina v Forest Preserve Dist.* (ND Ill 2002) 207 F Supp 2d 764.

This result can occur because attorney fees and costs are usually not fully deductible (on costs and fees in unlawful discrimination actions, see §7.49B) and sometimes are not deductible at all. Fees and costs to individual taxpayers are generally categorized as miscellaneous itemized deductions under IRC §67(b), but as a general rule, a taxpayer may deduct only that portion of miscellaneous itemized deductions that exceeds 2 percent of adjusted gross income (IRC §67(a)), and these deductions are phased out for higher income taxpayers. IRC §68(a).

If the alternative minimum tax (AMT) (IRC §§55-59) comes into the picture, however, the situation becomes worse for the taxpayer. The AMT sets a tax liability floor (liability will be at least this amount) for noncorporate individual taxpayers. This floor is equal to 26 percent of the taxpayer's "alternative minimum taxable income" (minus specified exemptions) up to $175,000, plus 28 percent of alternative minimum taxable income over $175,000. No miscellaneous itemized deductions are allowed to AMT income. IRC §56(b)(1)(A)(i). If the plaintiff's income from a judgment or settlement triggers the AMT provisions, the plaintiff will have to pay tax on the entire recovery, including fees and costs, with no offsetting deduction. This can be disastrous if a plaintiff recovers a large amount of attorney fees along with a small amount of damages.

EXAMPLE: A plaintiff who receives a $100 million judgment including attorney fees in a defamation case must recognize the entire gross amount ($100 million) as income. The plaintiff is entitled to a miscellaneous itemized deduction for the amount of the recovered attorney fees (assume these are $80 million). But this deduction is disallowed entirely for AMT purposes, and is also subject to a 2 percent of adjusted gross income (AGI) floor for regular tax purposes. As a result, the plaintiff owes a little less than $28 million in federal income tax on the recovery, over $19 million of which stems from the AMT. The plaintiff will actually end up losing almost $8 million, however, because although the plaintiff must recognize $100 million in gross income, the plaintiff actually receives only $20 million in cash (the $100 million dollar recovery minus $80 million in attorney fees). From a cash-flow standpoint, the plaintiff has an approximately $28 million tax bill and only $20 million with which to pay it. This problem has existed without solution for years. See 2002 National Taxpayer Advocate Annual Report to Congress at p. 166. See also 2003 National Taxpayer Advocate Annual Report to Congress at p. 347.

In at least one case, *Frank Biehl* (2002) 118 TC 467, aff'd (9th Cir 2003) 351 F3d 982, the taxpayer attempted to use an accountable plan to mitigate the effects of the AMT.

Plaintiff Biehl was a company employee and shareholder and his wife was also a shareholder. They and other shareholders signed an agreement imposing certain restrictions on the transfer of company stock and providing that in any suit for breach of the agreement, the prevailing party would be entitled to recover all costs of the suit, including attorney fees.

Later, having entered into a contingent fee agreement with their attorneys, the Biehls filed an action against the company claiming wrongful termination and seeking to dissolve the company. The jury returned a verdict for plaintiff on the bifurcated wrongful termination claim. The parties negotiated a global settlement, which included an agreement that separate payments would be made to plaintiff and to its attorneys. When the company issued plaintiff a Form 1099 for the entire settlement amount, a state court granted plaintiff's motion that issuance of two payments violated the settlement agreement.

Plaintiff and his wife reported as income the amount plaintiff received, but not the amount paid to the lawyers. The IRS determined a deficiency, primarily due to alternative minimum tax liability resulting from disallowance of the itemized deductions under IRC §56(b)(1)(A)(i).

The Tax Court held that amounts paid by a former employer to a former employee in a wrongful termination settlement fail to satisfy the business connection requirement of IRC §62(a)(2)(A) and thus are not eligible to be treated

as amounts disbursed from an accountable plan. The court concluded that the fees were not paid under an employee reimbursement or expense allowance arrangement.

The Tax Court noted that the attorney fees satisfied the threshold requirement of deductibility under IRC §162(a) as a trade or business expense. See *Snow v Commissioner* (1974) 416 US 500, 40 L Ed 2d 336, 94 S Ct 1876 ("in connection with" requirement of IRC §162(a) is narrower than §174(a)(1) "in connection" language). But under IRC §162(a), the "connection" requirement is met only when the expenditure was integrated or integral to the business, which plaintiff's attorney fees were not. The expense must be incurred during a current employer-employee relationship, not a former relationship.

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§7.63 13. Determining Person Entitled to Attorney Fees

In resolving the question about the tax treatment of fees paid to contingent fee lawyers (and the potential alternative minimum tax impact), counsel should analyze the impact of state law on who actually is entitled to the attorney fees. In a court-award setting (admittedly, not the most typical fact pattern because most cases are settled), someone should determine whether it is the client or the attorney who is entitled to the portion of the award considered attorney fees. If it is the attorney who is entitled to that portion of the award, then the argument against income attribution (at least on that portion) to the client has a better chance of success.

CAUTION: Counsel must also weigh the possible effect of *Commissioner v Banks* (2005) 543 US 426, 160 L Ed 2d 859, 125 S Ct 826, on any argument. For the amendment making deductible attorney fees and costs in unlawful discrimination cases, see §7.49B.

In *Flannery v Prentice* (2001) 26 C4th 572, 110 CR2d 809, the California Supreme Court held that attorney fees awarded to a prevailing party under the state Fair Employment and Housing Act belong to the attorney (not the client) in the absence of an enforceable agreement to the contrary. The client argued that she was entitled to recover attorney fees under the statute, even though she did not intend to turn the fees over to her counsel. The court reasoned that the term "prevailing party" is ambiguous and that both legislative history and public policy require interpreting the statutory language to refer to the attorney rather than the client in this context. The case was remanded to determine whether there was an enforceable fee agreement.

CAUTION: In the post-*Banks* world, at least one court has not been persuaded by *Flannery*. In *Nancy J. Vincent*, TC Memo 2005-95, the Tax Court noted that *Vincent*'s reliance on *Flannery* was misplaced. Indeed, the court said it was not bound by state law classifications as to the ownership of income.

The *Vincent* court was presented with statutory attorney fees and noted that this was an issue that the Court in *Banks* did not reach. Although the court relied on pre-*Banks* law (see *Sinyard v Commissioner* (9th Cir 2001) 268 F3d 756, cert denied (2002) 536 US 904), it noted that the outcome would be the same as under *Banks*.

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§7.64 14. Court Awards of Attorney Fees

Closely related to the topic of taxable income when an attorney fee award is actually made in court to attorneys is the nontax question of whether the attorney or client is actually entitled to the money. This varies among the jurisdictions and may depend not only on the fee agreement between attorney and client, but also on whether state or federal law applies.

An unpublished nontax federal district court case (*Sommerville v Transworld Airlines, Inc.* (ED Mo, Sept. 28, 1999, No. 4:96CV02379)) raises the issue of whether a small actual damage award may limit the award for attorney fees. The plaintiff in *Sommerville* received a small award, only $39,081 in back pay (although he claimed $175,000). In response to the plaintiff's request for $192,548 in attorney fees, the defendant claimed that the amount of the back pay recovery should limit the amount of attorney fees. The district court found that the lack of success on the substantive claim did not necessarily limit the fee award. Cases such as *Sommerville* suggest that the attorney fee problem (and reporting on same) could actually result in the taxpayer paying significantly more in taxes than he or she ultimately receives. In *Sommerville,* if the plaintiff was awarded only $39,000 in back pay, and there was a fee award (with costs) of over $160,000, he would have a huge tax liability if taxed on the entire attorney fee amount, and if he was also forced to claim a miscellaneous itemized deduction for the $160,000 in fees and costs. Of course, today the plaintiff would presumably be entitled to the above-the-line deduction. See §7.49B.

Although in *Flannery v Prentice* (2001) 26 C4th 572, 110 CR2d 809, the California Supreme Court held that attorney fees awarded to a prevailing party under the state Fair Employment and Housing Act belonged to the attorney (not the client) in the absence of an enforceable agreement to the contrary, issues still remain about the tax treatment of such awards. At least one post-*Banks* court has not been persuaded by *Flannery*. See §7.63. For example, §703 of the American Jobs Creation Act of 2004 (Pub L 108-357, 118 Stat 1418), which amends IRC §62 to end the Internal Revenue Service's "double taxation" of attorney fee awards in suits claiming unlawful discrimination, is not retroactive. See §7.49B.

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§7.65 15. IRS Field Service Advice May Contraindicate Requirement of Direct Interest in Case

Although the United States Supreme Court has resolved that attorney fees usually do constitute gross income to a plaintiff in a contingent fee case (see §§7.49-7.49B), another issue is whether the attorneys have a direct interest in the case. One IRS Field Service Advice, IRS Field Service Advice 199907003 (Feb. 19, 1999), suggests that a law firm does not have a direct interest in an estate under the facts given. Although this may be somewhat far afield from the normal contingent fee litigation case, this Field Service Advice might be viewed as relevant on the issue.

In IRS Field Service Advice 199907003, a law firm and the heirs of an estate created a community of interest in the form of a partnership. The law firm contributed the value of the firm's past and future legal services and future cost advances. The heirs in the litigation contributed all beneficial interest in the claims of those heirs. When the litigation was ultimately resolved and some of the costs were reimbursed, the firm was entitled to a percentage of the heirs' estate interest.

The lawyers in the firm did not include the value of their estate interests in income either when the partnership was formed or when the litigation was resolved. The estate treated the partnership as an heir, and the law firm assigned a percentage of its partnership interest to individual attorneys within the firm. The individual attorneys likewise treated themselves as beneficiaries of the estate. Thus, they only included in their income distributable net income that flowed through to their individual returns. They did not include the considerable accumulated income on which the estate had paid taxes, nor did they include their share of stock and limited partnership interests that were distributed in excess of distributable net income.

Not surprisingly, the IRS concluded that the law firm did not need to include any interest in the partnership in income until the litigation was completed, which was the triggering tax event. However, the IRS ruled that neither the firm nor any individual attorneys were actually beneficiaries. All distributions related back to the firm's underlying claim for compensation for services. Thus, it was all income to the law firm.

CAUTION: Counsel must also weigh the possible effect of *Commissioner v Banks* (2005) 543 US 426, 160 L Ed 2d 859, 125 S Ct 826, on any argument. For the amendment making deductible attorney fees and costs in unlawful discrimination cases, see §7.49A.

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Table of Statutes, Regulations, and Rules

CALIFORNIA

Constitution

Art I, §1: §3.99
Art I, §16: §§4.48, 5.22
Art VI, §1: §4.48
Art VI, §10: §2.3
Art XV, §1: §4.88
Art XV, §1(1): §4.88

Statutes

BUSINESS AND PROFESSIONS CODE

Chap 2: §6.33
1017(g): §2.34
9884.9: §1.56
10237-10238.8: §2.51
10237.8: §2.51
10471: §2.59
11018.12: §2.15
14200-14272: §6.33
14250(a): §6.33
16700-16770: §3.84
16750: §3.84
17200: §3.90A
17208: §6.28

CIVIL CODE

47: §1.58
51-52: §4.93
52(a): §4.93
654-655: §6.40
789.3: §§4.37, 4.45
789.3(c): §4.45
789.3(d): §§4.45, 4.93
798-799.10: §4.95
798.85: §§1.30, 4.93, 4.95
821: §4.99
822-823: §4.1
823: §4.99
826: §4.60
895-945.5: §5.10
980: §6.40
987: §5.33
1013.5: §§4.75, 5.33
1019: §4.75
1021: §1.30
1033.5(c)(5): §2.12
1102-1102.17: §2.36
1102.6: §5.54
1102.6(c): §5.54
1102.13: §5.54
1133(d): §2.48
1368(d): §2.48
1431-1431.5: §5.40
1431.2(b)(2): §5.40
1440: §2.8

1466: §4.51
1504: §4.88
1571-1573: §2.48
1572: §2.47
1573: §§2.34, 2.49
1624(a)(4): §2.30
1667: §4.56
1668: §1.46
1671: §§1.42, 1.44, 2.21-2.22, 4.81
1671(a): §1.42
1671(b): §§1.42, 2.24, 4.106
1671(c): §1.42
1671(c)-(d): §1.42
1671(d): §§1.44, 4.106
1675: §2.23
1675-1681: §§1.42, 2.18, 2.22
1675(a): §2.23
1675(b)-(d): §2.23
1675(c): §§2.18, 2.23
1675(d): §§2.18, 2.23
1675(e): §2.23
1675(f)-(g): §2.23
1676: §2.24
1677: §§2.22-2.24
1678: §2.23
1679: §2.22
1680: §2.22
1695-1695.17: §2.53
1695.1(a): §2.53
1695.7: §2.53
1695.10: §2.53
1695.13: §2.53
1695.13(b): §2.53
1695.14(a): §2.53
1695.14(d): §2.53
1708.8: §5.54
1709: §§2.10, 2.35-2.36, 2.49
1709-1710: §2.48
1710: §2.47
1717: §§1.3, 1.21-1.30, 2.12, 2.48, 4.44, 4.49, 4.93-4.96, 4.99, 4.102, 4.104, 4.109-4.110
1717(a): §§1.22, 1.29, 2.12, 4.93-4.94, 4.102
1717(a)-(b)(1): §1.26
1717(b)(1): §§1.26, 2.12, 4.44, 4.94, 4.102
1717(b)(2): §§1.26-1.27, 2.12, 4.44, 4.95-4.96, 4.102
1717(c): §§2.12, 4.96
1750-1784: §1.1
1927: §4.14
1928-1929: §4.62
1929: §4.35
1930: §§4.58-4.59
1940-1954.1: §4.35
1940.1(b): §4.93
1941: §4.35
1941.1: §4.35
1941.2: §4.35
1942: §§4.35-4.36
1942.4: §§4.34-4.35, 4.39, 4.44, 4.93, 4.95
1942.4(b): §§4.44, 4.93
1942.4(c): §4.35
1942.4(e): §4.35
1942.4(f): §4.35
1942.5: §4.36
1942.5(f): §4.36
1942.5(g): §§4.36, 4.93
1942.5(h): §4.36

1947.3: §4.52
1947.7: §4.48
1947.8: §4.48
1947.11: §4.48
1947.11(a): §4.48
1947.11(b): §4.48
1950.5: §§4.52-4.53, 4.55
1950.5(b): §4.52
1950.5(j): §4.53
1950.5(*l*): §4.53
1950.5(n): §4.53
1950.6: §4.52
1950.7: §§4.52-4.53
1950.7(f): §4.53
1951-1951.8: §4.27
1951.2: §§4.78-4.82, 4.106, 5.54
1951.2(a): §4.79
1951.2(a)(1): §4.79
1951.2(a)(2): §4.79
1951.2(a)(2)-(3): §4.79
1951.2(a)(3): §4.79
1951.2(a)(4): §4.79
1951.2(b): §§4.79, 4.88
1951.2(c): §4.79
1951.2(d): §4.79
1951.4: §§4.79-4.82
1951.4(a): §4.80
1951.4(a)-(b): §4.80
1951.4(b): §4.80
1951.4(c): §4.80
1951.4(c)(2): §4.81
1951.5: §4.81
Comment: §4.106
1951.8: §4.81
1952: §4.27
1952(a): §4.81
1952(b): §4.81
1952.2: §4.81
1954.50-1954.535: §4.87
2223: §6.47
2224: §6.47
2772-2784.5: §1.3
2782-2784: §1.3
2924-2924h: §2.60
2929: §5.54
2983.4: §4.95
2985: §§2.15, 2.22, 2.60
2985(a): §2.15
2985(b): §2.15
3275: §§1.17, 1.44, 2.25
3283: §§1.19, 4.31, 5.42
3287: §§1.3, 2.46, 4.13, 4.18, 4.26, 4.54, 4.66, 4.73
3287-3288: §5.37
3287(a): §§1.20, 2.11, 4.6, 4.88, 5.37
3287(b): §§1.20, 2.11, 4.6, 4.33
3288: §2.46
3289: §1.20
3289(b): §4.88
3291: §1.58
3294: §§1.15, 1.34-1.35, 2.13, 2.47, 2.51, 3.96, 3.105, 4.5, 4.13, 4.19-4.20, 4.36, 4.43, 4.49, 4.76, 5.38
3294(a): §§1.34, 2.13, 2.34, 2.47, 4.76, 5.38
3294(a)-(b): §3.96
3294(b): §3.96
3294(c): §3.96
3294(c)(1): §5.38

3295: §§1.37, 3.96
3295(c): §1.37
3300: §§1.17-1.18, 1.39, 1.50, 2.5, 2.10, 3.92, 4.2, 4.9, 4.15-4.17, 4.28, 4.56, 4.68-4.71
3300-3321: §2.49
3301: §§1.17, 1.39-1.40, 4.3, 4.112
3302: §1.52
3304: §4.15
3306: §§2.9-2.11, 4.10
3307: §§2.11, 2.17, 2.20, 2.25-2.27, 2.29
3333: §§1.15, 1.18, 2.10, 2.36, 2.49, 3.96, 4.20, 4.49, 5.27, 5.29, 6.42
3334: §§2.49, 4.58, 4.71, 4.83, 4.85, 5.27, 5.30, 5.35, 5.54
3334(a): §§5.27, 5.30
3334(b)(1): §§5.30, 5.35, 5.54
3334(b)(2): §5.30
3335: §5.54
3336: §§4.46, 6.43
3339: §§3.13A, 3.93
3343: §§2.35-2.37, 2.40-2.41, 2.44-2.47, 2.49-2.50, 2.57, 6.40, 6.42
3343 (former): §6.41
3343(a): §§2.10, 2.36, 6.40
3343(a)(1): §§2.40, 2.43, 2.51
3343(a)(2): §2.40
3343(a)(3): §§2.44, 2.52, 6.41
3343(a)(4): §§2.44, 2.52
3343(a)(4)(i): §2.44
3343(a)(4)(ii): §2.44
3343(a)(4)(iii): §2.44
3343(b)(1): §2.44
3346: §5.32
3358: §1.17
3358-3359: §1.50
3359: §1.17
3360: §§1.17, 4.58, 4.113, 5.27
3369: §2.25
3426-3426.11: §6.34
3426.3: §§6.34, 6.37
3426.3(a): §§6.36, 6.38
3426.3(b): §§6.37-6.38
3426.3(c): §6.38
3426.4: §6.39
3426.6: §6.34
3479: §§5.2, 5.4-5.6, 5.19
3480: §§5.7, 5.9
3481: §5.9
3482: §§5.4, 5.52
3482.1: §5.39
3482.5: §5.39
3482.6: §5.39
3490: §§5.41, 5.46
3491-3496: §5.20
3493: §§5.8, 5.12, 5.28
3494: §5.8
3496: §5.36
3501: §5.26
3501-3503: §5.21
3502: §5.25
3503: §5.25
3533: §5.26

CODE OF CIVIL PROCEDURE

85: §2.3
85-86.1: §5.23
85-89: §5.23
86: §§2.3, 5.23
86(a): §2.3

87: §2.3
88: §§2.3, 5.23
90-100: §5.23
116.220: §§2.3, 4.92, 5.23
128.5: §§4.97, 6.39
128.7: §§1.25, 4.96-4.97
318: §§4.27, 4.77, 4.85, 4.105
326: §§4.85, 4.105
335.1: §4.38
337: §§4.38, 4.82, 5.44A
337(1): §§2.33, 3.88, 4.8, 4.21, 4.34, 4.55, 4.57, 4.64
337.2: §4.82
337.15: §5.44A
337.15(a): §5.44A
338: §§3.88A, 4.38, 4.59, 4.61, 4.77
338(2): §5.44A
338(b): §5.42
338(c): §§4.47, 6.43
338(d): §6.40
339: §§4.38, 4.82
339(1): §§3.88, 4.8, 4.21, 4.34, 4.55, 4.57, 4.64
339.5: §4.82
340: §4.21
340(3): §5.42
340(a): §3.85
392(a)(1): §§2.4, 5.24
395(a): §§2.4, 5.24
405.33: §2.7
425.10: §2.7
425.11: §1.13
425.11(d)(1): §1.13
431.70: §2.54
473: §4.104
487.020: §1.55
527.6(i): §4.93
532: §5.53
533: §5.53
580: §1.13
580b: §§2.32, 2.57
581(c): §4.95
581(i): §4.95
585(a): §1.27
592: §5.22
685.010(a): §4.88
685.040: §1.27
731: §5.26
731a: §5.51
732: §§4.60, 5.54
735: §5.54
736(a): §5.54
736(b)-(c): §5.54
736(e): §5.54
785 (former): §2.25
873.760: §2.25
877.6: §1.58
998: §§1.27, 1.29, 1.33, 4.93
998(c)(1): §1.33
998(g)(2): §1.33
1021: §§1.21, 2.12, 2.48, 4.4, 4.13, 4.26, 4.93, 4.95, 4.109, 5.36
1021-1038: §4.111
1021.4: §1.30
1021.5: §§1.30, 3.96, 4.93, 4.109, 5.36
1021.6: §1.30
1021.9: §5.36
1031: §3.90

1032: §§2.48, 4.44, 4.102
1032-1034.5: §4.90
1032(a)(4): §4.89
1032(b): §4.89
1033: §4.96
1033(a): §4.92
1033(b): §§4.92, 4.111
1033(b)(2): §4.92
1033.5: §§1.27, 1.29, 2.48, 4.109
1033.5(a): §4.111
1033.5(a)(1)-(2): §4.90
1033.5(a)(3): §4.90
1033.5(a)(4)(B)-(D): §4.90
1033.5(a)(7): §4.90
1033.5(a)(8): §4.90
1033.5(a)(9): §4.90
1033.5(a)(10): §§4.91, 6.39
1033.5(a)(10)(A): §§1.27, 4.102, 4.109
1033.5(a)(10)(B): §4.103
1033.5(a)(11): §4.90
1033.5(a)(12): §4.90
1033.5(b)(1): §4.90
1033.5(c)(5): §§1.29, 4.91, 4.102-4.104, 4.109, 6.39
1034: §4.92
1034(b): §§4.90, 4.100
1034.5: §§4.90-4.91
1141.21: §1.30
1141.21(a)(1)(C): §4.111
1159-1160: §4.19
1159-1161: §5.54
1159-1179a: §4.22
1161: §4.105
1161.5: §4.79
1166a: §4.22
1172: §§4.22, 4.27
1173: §4.87
1174: §§4.22, 4.25, 4.86
1174(b): §§4.25, 4.86-4.87, 5.54
1174(c): §4.88
1174.2: §§4.89, 4.94
1174.21: §§4.35, 4.93
1280-1294.2: §3.106
1281: §1.33
1281.2: §1.16
1283.1(b): §1.5
1285: §3.106
1286.6: §1.28
1293.2: §§1.28, 1.30
1295: §1.33
1717(b): §4.95
1872: §6.55

COMMERCIAL CODE
2719: §1.46
2719(b)(3): §1.46
2721: §§2.35-2.36

EDUCATION CODE
48900.1: §3.93
92050: §1.43

EVIDENCE CODE
400: §6.56
401: §6.56
403: §6.56

404: §6.56
405: §6.56
405(a): §6.56
701: §2.38
800: §§2.28, 2.38
801: §§2.38, 6.57
801(b): §§6.54, 6.57
802: §§2.38, 6.55-6.56
803: §§6.54, 6.57
813: §§2.28, 2.38
813(a): §2.38
813(a)(1): §2.38
813(a)(2): §2.38
813(c): §2.38
813(c)(2): §2.28
814: §2.38
816: §2.39
819: §2.39
822: §2.38
823: §2.39
1520-1523: §1.13
1521: §1.13

FISH AND GAME CODE
5650: §5.54

GOVERNMENT CODE
3300-3313: §3.97
3500-3511: §3.82
3505: §3.82
3512-3524: §3.82
3540-3549.3: §3.82
3560-3599: §3.82
7285: §§3.13A, 3.93
12900-12996: §§3.92, 3.97, 3.103, 3.105
12926(d): §3.92
12926(m): §3.92
12926(p): §§3.48, 3.105
12940: §§3.31, 3.105
12940-12996: §3.92
12940(a): §3.92
12940(h): §3.92
12941: §3.92
12945(a): §3.92
12965: §4.97
12965(b): §3.105
12970: §3.105
12970(a)(1): §3.105
12970(a)(3): §3.105
12970(c)-(d): §3.105
12970(d): §3.105
16645-16649: §§3.2, 3.84A
16645.2: §3.84A
16645.7: §3.84A
16645.8: §3.84A
16645.8(d): §3.84A
19683: §3.97
25845: §5.20
26733.5: §4.91
26820: §4.91
38733.5(b): §5.36
38771: §5.3
38773.1-38773.7: §5.20
39561: §5.7
53069.85: §1.43

68093: §4.90
68097: §4.90
69953: §4.90

HEALTH AND SAFETY CODE
5410-5416: §5.54
11570-11587: §4.39
11571: §5.8
17980(b): §5.20
17980.6: §5.7
24000: §3.93
25249.5-25249.13: §5.54
25300-25395.15: §5.54

INSURANCE CODE
533: §6.57A
790.03(h): §1.58

LABOR CODE
96: §3.90
96-98.5: §3.90
98: §§3.45, 3.90
98-98.8: §3.89
98.6: §3.93
102: §3.90
132a: §3.93
201: §§3.85-3.86, 3.88A
201.3: §§3.87, 3.88A
201.5: §3.88A
202: §§3.85, 3.88A
203: §§3.85-3.86, 3.88A, 3.90-3.90A
203(a): §3.85
204: §3.87
204b: §3.87
205: §3.87
205.5: §3.88A
206(b): §3.87
209: §3.87
210(a): §3.87
210(b): §3.87
211: §3.87
225.5: §3.90A
226(e): §3.90A
226.7: §3.88A
227.3: §3.88
229: §3.86
230: §3.93
230.3: §3.93
230.7: §3.93
230.8: §3.93
232: §3.93
432.2: §3.93
450: §3.100
512(a): §3.88A
922-923: §3.82
970: §3.101
972: §3.101
1050: §§3.98, 3.102
1054: §3.102
1101-1102: §§3.93, 3.99, 3.103
1102.1 (former): §3.103
1102.5: §3.93
1103: §3.103
1105: §3.103
1115: §3.82

1116: §3.82
1118: §3.82
1122: §3.82
1126: §3.82
1140-1166.3: §3.83
1171: §3.100
1171-1204: §3.100
1171.5: §§3.13A, 3.93
1182: §3.100
1193.6: §3.100
1194: §3.100
1194.5: §3.100
1197.5: §3.100
1197.5(b): §3.100
1197.5(g): §3.100
1350-1350.5 (former): §3.100
2698: §3.90A
2698-2699.5: §3.90A
2699(a): §3.90A
2699(f): §3.90A
2699(i): §3.90A
2699.3(a)(1): §3.90A
2699.3(a)(2)(B): §3.90A
2699.3(c)(3): §3.90A
2699.5: §3.90A
2751: §3.104
2751-2752: §3.104
2752: §3.104
2802: §3.91
2922: §3.92
2929: §§3.92-3.93
6310: §3.97
6310-6312: §3.93
6311: §3.92

MILITARY AND VETERANS CODE
394: §3.93

PENAL CODE
370: §5.7
422.56: §3.105
11201: §5.8
11225(b): §5.20
11226: §5.8

PUBLIC CONTRACT CODE
10226: §1.43
10826: §1.43

PUBLIC RESOURCES CODE
4170: §5.7
4171: §5.7

WATER CODE
13350(b)(1): §5.54

ACTS BY POPULAR NAME
Agricultural Labor Relations Act (ALRA): §3.83
Automotive Repair Act: §1.56
California Consumer Legal Remedies Act: §1.1
California Occupational Safety and Health Act (OSHA): §3.97
Carpenter-Presley-Tanner Hazardous Substance Account Act (HSAA): §5.54
Cartwright Act: §3.84
Costa-Hawkins Rental Housing Act: §4.87
Educational Employment Relations Act (EERA): §3.82

Fair Employment and Housing Act (FEHA): §§3.31, 3.48, 3.92, 3.96-3.97, 3.103, 3.105, 7.63-7.64
Higher Education Employer-Employee Relations Act (HEERA): §3.82
Home Equity Sales Contract Act (Home Equity Act): §2.53
Labor Code Private Attorneys General Act of 2004: §3.90A
Meyers-Milias-Brown Act (MMBA): §3.82
Mobilehome Residency Law: §§1.30, 4.95
Narcotics Nuisance Abatement Act: §4.39
Occupational Safety and Health Act of 1970 (OSHA): §3.97
Proposition 51: §5.40
Proposition 65: §5.54
Public Safety Officers Procedural Bill of Rights Act: §3.97
Real Property Securities Dealers Act: §2.51
Rees-Levering Automobile Sales Finance Act: §4.95
Song-Beverly Act: §1.30
State Employer-Employee Relations Act (SEERA): §3.82
Trademark Law: §6.33
Uniform Trade Secrets Act: §6.34
Unruh Act: §4.93

SESSION LAWS
Stats 2003, ch 906, §1: §3.90A
Stats 1990, ch 804, §2: §§4.102, 4.104

Regulations and Rules

CALIFORNIA CODE OF REGULATIONS

Title 8
11090: §3.88A

CALIFORNIA RULES OF COURT

3.1700: §4.104
3.1700(a)(1): §4.91
3.1700(b)(1): §4.91
3.1702: §§1.29, 2.12, 2.48, 4.91, 4.109
3.1702(a): §§4.102-4.103
3.1702(b): §4.104
3.1702(b)(1): §4.104
3.1702(b)(2): §§4.100, 4.104
3.1702(c): §4.100
3.1702(c)(2): §4.100
3.1702(d): §§4.100, 4.104
3.1702(e): §§4.91, 4.102-4.104
3.1800(b): §1.27
3.2000: §4.91
8.104: §§1.29, 4.104
8.104(a): §4.104
8.104(a)(1): §4.104
8.104(d): §4.104
8.108: §§1.29, 4.104
8.108(b): §4.104
8.108(c): §4.104
8.108(d): §4.104
8.278(c): §§4.100, 4.104
8.822(a): §4.104
8.822(b): §4.104
8.823(b): §4.104
8.823(c): §4.104
8.823(d): §4.104
8.891(c): §4.100
870.2 (former): §1.29

Jury Instructions

CALIFORNIA JURY INSTRUCTIONS, CIVIL (CACI) APPROVED

2400-2433: §3.96
2500-2561: §3.96

CALIFORNIA JURY INSTRUCTIONS, CIVIL (BAJI)
14.10-14.13: §3.96

Miscellaneous

CALIFORNIA LABOR COMMISSIONER INTERPRETATIVE BULLETINS
86-3: §3.88

INDUSTRIAL WELFARE COMMISSION WAGE ORDERS
1-2002—17-2001: §3.88A

UNITED STATES

Constitution

Amend I: §§3.80, 3.82
Amend IV: §§3.81, 3.94

Statutes

UNITED STATES CODE

Title 2
1202: §7.49B
1312: §7.49B
1313: §7.49B
1314: §7.49B
1315: §7.49B
1316: §7.49B
1317: §7.49B

Title 5
552a: §3.81
552a(d): §3.81
552a(g)(1): §3.81
552a(g)(1)(C): §3.81
5596(b): §3.79
7101-7135: §3.77
7121(a)-(b): §3.78
7121(c)(1)-(5): §3.78
7121(d): §3.78
7121(e)(1): §3.78
7701-7703: §3.78
7701(g)(1): §3.79

Title 8
1101-1537: §§3.13A, 3.54
1324a: §3.6

Title 11
1113: §3.5

Title 15
1-7: §3.36
12-27: §3.36
15: §3.36
17: §3.36
1116(d): §6.31A
1117: §6.30
1117(a): §§6.28-6.29
1117(c): §6.31A
1117(d): §6.31A
1125(d): §§6.28, 6.30

1125(d)(1): §6.31A
1601-1667e: §1.1

Title 17
101-914: §6.26A
412: §§6.15, 6.25
504: §§6.15, 6.21
504(b): §§6.15-6.16, 6.21
504(c)(1): §§6.15, 6.25
504(c)(2): §6.25
505: §6.26
1201: §6.27
1201-1205: §6.27
1202: §6.27
1203(c)(2): §6.27
1203(c)(3): §6.27
1203(c)(3)(A): §6.27
1203(c)(3)(B): §6.27
1203(c)(4): §6.27
1203(c)(5)(A): §6.27

Title 20
1681: §7.49B
1688: §7.49B

Title 26
1031: §2.31
3121: §3.49

Title 28
1367: §3.21
1658: §§3.63-3.64
1961(a): §6.14
2412: §5.36

Title 29
8(d): §3.15
10(e): §3.4
105: §3.36
151: §7.49B
151-169: §3.93
152(3): §3.83
153: §3.24
157: §3.1
158-160: §3.24
158(a)-(b): §3.3
158(a)(1): §3.3
158(a)(2): §3.16
158(a)(3): §§3.1, 3.3, 3.6, 3.17
158(a)(5): §§3.15, 3.18
158(b)(1)-(4): §3.21
158(b)(2): §3.6
158(b)(3): §3.20
158(d): §3.15
158(e): §3.37
158(e)-(f): §3.37
160(b): §§3.4, 3.14
160(c): §§3.4, 3.19, 3.48
160(e): §3.4
160(f): §3.4
164: §3.24
185: §§3.2, 3.20, 3.22-3.23, 3.92
185(a)-(b): §3.22
185(h): §3.21
186-187: §3.24

187: §§3.21, 7.49B
187(b): §3.21
201: §7.49B
201-219: §§3.39, 3.46
203: §3.39
203(d): §3.44
203(s): §§3.39, 3.44
206(d): §§3.43-3.44
213: §§3.40, 3.43
216: §3.41
216(b): §3.44
219: §7.49B
255(a): §§3.41, 3.45
259: §3.42
401-531: §3.24
411: §3.24
411(a)(4): §3.24
412: §3.24
621-634: §3.46
623: §7.49B
626(b): §3.46
633a: §7.49B
701-796l: §3.63
706: §3.31
791: §7.49B
793: §3.30
794: §§3.30-3.31, 7.49B
794(d): §3.30
1001-1461: §§3.65, 3.92
1002(21)(A): §3.69
1021-1031: §3.68
1024(b)(1): §3.72
1024(b)(3): §3.72
1051-1053: §3.68
1054: §3.68
1055: §3.68
1081-1086: §3.68
1101-1114: §3.68
1104: §3.69
1105: §3.69
1106: §3.69
1107: §3.68
1109(a): §3.69
1132(a): §§3.69, 3.73
1132(a)(1)(B): §3.69
1132(a)(3): §3.70
1132(c): §3.69
1132(d)(1): §3.69
1132(d)(2): §3.69
1132(g): §3.69
1132(i): §3.69
1140: §7.49B
1144(a): §3.66
1301-1310: §3.68
2001-2009: §7.49B
2101-2109: §7.49B
2615: §7.49B

Title 31
3721: §7.49B

Title 33
1251-1387: §5.54
1365: §5.54
1365(d): §5.36

1415(g)(4): §5.36

Title 35
261: §6.1
271(b): §6.1
284: §§6.1, 6.7, 6.13-6.14
286: §6.1
289: §§6.1-6.2

Title 38
Chap 43: §7.49B
4301-4333: §§3.47, 7.49B
4312(e)(1): §3.47
4316(c): §3.47
4322-4323: §3.47

Title 40
3141-3148: §3.76
3142: §3.76
3144(a)(2): §3.76
3147: §3.76

Title 41
35-45: §3.75
36: §3.75
36-37: §3.75

Title 42
1395y(b)(3)(A): §7.49B
1981: §§3.49, 3.63-3.64, 3.97, 7.49B
1981a: §§3.30-3.31, 3.63-3.64
1981a(a)(1): §3.61
1981a(b): §3.63
1981a(b)(1): §3.61
1981a(b)(3): §3.63
1983: §§3.64, 3.94, 3.97-3.98, 3.106, 7.49B
1985: §7.49B
1988: §3.15
1988(c): §3.63
2000e-2: §7.49B
2000e-2(a)-(c): §3.48
2000e-3: §7.49B
2000e-3(a): §3.48
2000e-5(g): §§3.48, 3.52-3.53
2000e-5(k): §§3.62-3.63
2000e-16: §7.49B
2000e—2000e-17: §§3.43, 3.48-3.49
3604: §7.49B
3605: §7.49B
3606: §7.49B
3608: §7.49B
3617: §7.49B
4911(d): §5.36
6901-6992k: §5.54
6972(a): §5.54
6972(e): §5.36
7607(f): §5.36
9601: §5.54
9601-9675: §§5.36-5.37, 5.44A, 5.54
9607: §5.54
9607(a): §5.37
9613(f): §5.37
9613(f)(1): §5.54
9658: §5.44A
12101: §3.31

12101-12213: §§3.31, 3.63
12111: §3.31
12111-12112: §3.31
12112: §7.49B
12112(b)(5)(A): §3.31
12114: §3.31
12117: §3.31
12131-12134: §3.31
12132: §7.49B
12182: §7.49B
12201: §3.31
12201-12204: §3.30
12202: §3.31
12203: §§3.31, 7.49B
12205: §3.31
12210: §3.31
12210-12213: §3.30
12211: §3.31

Title 45
151-163: §3.32
152: §3.32
153: §3.33
153(p): §3.33
159: §3.33
181-188: §3.32
184: §3.33

INTERNAL REVENUE CODE
22(b)(12): §§7.28, 7.31
55-59: §7.62A
56(b)(1)(A)(i): §7.62A
61: §§7.16-7.17
61(a): §7.16
62: §§7.49B, 7.64
62(a)(2)(A): §7.62A
62(a)(20): §7.49B
62(e): §7.49B
67-68: §7.49A
67(a): §7.62A
67(b): §7.62A
68(a): §7.62A
102(a): §7.26
104: §§7.13-7.15, 7.24-7.25, 7.28-7.29, 7.42, 7.45, 7.47
104(a)(2): §§7.14, 7.25, 7.47
106: §§7.15-7.16
108: §§7.16, 7.24
108(e)(5): §§7.35, 7.42
111: §§7.28, 7.31
111(a): §7.31
111(c): §7.31
111(d): §§7.28, 7.31
121: §7.10
121(a): §7.10
121(b)(2): §7.10
121(b)(3): §7.10
162: §7.15
162(a): §7.62A
165(e)(3): §7.9
174(a)(1): §7.62A
186: §7.15
212: §7.15
311(a): §7.36
368(a)(1)(A): §7.30
446: §7.20

483: §7.30
936: §7.32
1001: §7.6
1017: §7.24
1031: §7.23
1033: §§7.9-7.10, 7.19
1041: §7.36
1222: §7.6
1231: §§7.7-7.9, 7.37, 7.41
4975: §3.69

ACTS BY POPULAR NAME

Age Discrimination in Employment Act of 1967 (ADEA): §§3.46, 3.52
§4: §7.49B
§7(b): §3.46
§15: §7.49B
American Jobs Creation Act of 2004: §7.49A
§703: §§7.49B, 7.64
Americans with Disabilities Act of 1990 (ADA): §§3.30-3.31, 3.44, 3.62-3.63
§102: §7.49B
§202: §7.49B
§302: §7.49B
§503: §7.49B
Anticybersquatting Consumer Protection Act (ACPA): §§6.28, 6.30
Berne Convention: §6.25
Civil Rights Act of 1991: §§3.30-3.31, 3.61, 3.63-3.64
§302: §7.49B
Civil Rights Act of 1964: §3.15
Title VII: §§3.43, 3.46, 3.48-3.50, 3.52, 3.55-3.64, 3.100, 3.105, 7.14
§703: §7.49B
§703(a)-(c): §3.48
§704: §7.49B
§704(a): §3.48
§706(g): §3.48
§706(k): §3.62
§717: §7.49B
Civil Rights Act of 1871: §3.64
Civil Rights Act of 1866: §3.64
Civil Rights Attorney's Fees Awards Act of 1976: §3.15
Clayton Act: §§3.36-3.38
§6: §3.36
Clean Air Act: §5.36
Clean Water Act: §5.54
Comprehensive Environmental Response, Compensation, and Liability Act of 1980 (CERCLA): §§5.36-5.37, 5.44A, 5.54
Congressional Accountability Act of 1995
§201: §7.49B
§202: §7.49B
§203: §7.49B
§204: §7.49B
§205: §7.49B
§206: §7.49B
§207: §7.49B
Copyright Act of 1909: §6.26A
Copyright Revision Act of 1976: §6.26A
Davis-Bacon Act: §3.76
Digital Millennium Copyright Act (DMCA): §6.27
Education Amendments of 1972
Title IX: §7.49B
Employee Polygraph Protection Act of 1988: §7.49B
Employee Retirement Income Security Act of 1974 (ERISA): §§3.65-3.72, 3.74, 3.88, 3.92, 7.49B
§409: §3.73
§510: §7.49B
§514(a): §3.66
Equal Access to Justice Act: §5.36
Equal Pay Act of 1963 (EPA): §3.44

Federal Insurance Contributions Act (FICA): §§7.14, 7.42
Federal Unemployment Tax Act (FUTA): §7.42
Fair Housing Act
§804: §7.49B
§805: §7.49B
§806: §7.49B
§808: §7.49B
§818: §7.49B
Fair Labor Standards Act of 1938 (FLSA): §§3.39-3.46, 7.49B
§16(b): §3.44
Fair Labor Standards Amendments of 1985: §3.44
False Statements Act: §1.55
Family and Medical Leave Act of 1993 §105: §7.49B
Federal Insurance Contributions Act: §7.14
Federal Privacy Act: §3.81
Federal Service Labor Management Relations Act (FSLMRA): §§3.77-3.79
Federal Unemployment Tax Act: §7.14
Federal Water Pollution Control Act: §5.36
Immigration Reform and Control Act of 1986 (IRCA): §§3.6, 3.13A, 3.48, 3.54
Labor-Management Reporting and Disclosure Act of 1959 (LMRDA): §§3.24, 3.27, 3.29
Title I: §3.28
Title IV: §3.28
§101: §3.24
§101(a)(4): §3.24
§102: §3.24
§412: §3.26
Labor Management Relations Act of 1947 (LMRA): §§3.1, 3.4, 3.6, 3.12, 3.15-3.18, 3.20-3.24, 3.33, 3.46, 3.48, 3.52, 3.55, 3.82, 3.107
§7: §3.1
§8(a)-(b): §3.3
§8(a)(5): §3.18
§8(b)(1)-(4): §3.21
§8(b)(2): §3.6
§8(b)(4): §3.21
§10(b): §3.4
§10(c): §§3.4, 3.19
§10(f): §3.4
§301: §§3.2, 3.22-3.23, 3.92
§301(a): §3.22
§301(b): §3.22
§303: §3.21
Labor Relations Act: §3.5
Landrum-Griffin Labor Reform Act: §3.24
Lanham Act: §§6.28-6.33
§35(a): §6.28
§43(a): §6.28
Marine Protection, Research, and Sanctuaries Act of 1972: §5.36
Military Selective Service Act of 1967 (former): §3.47
National Labor Relations Act of 1935 (NLRA): §§3.3, 3.5, 3.15, 3.31, 3.37, 3.77, 3.83, 3.86, 3.93, 7.49B
§8(a)(1): §3.3
§8(e): §3.37
Noise Control Act of 1972: §5.36
Norris-La Guardia Act
§5: §3.36
Public Contracts Act: §3.75
Railroad Retirement Act: §7.14
Railway Labor Act: §§3.32-3.34
Rehabilitation Act of 1973: §§3.30-3.31, 3.44, 3.63
§501: §7.49B
§503: §3.30
§504: §§3.30-3.31, 7.49B
Resource Conservation and Recovery Act of 1976 (RCRA): §§5.36, 5.54
Social Security Act
§1862(b)(3)(A): §7.49B
Sherman Antitrust Act: §§3.36-3.38

Small Business Job Protection Act of 1996: §§7.14, 7.25, 7.28, 7.42
Truth in Lending Act: §1.1
Uniformed Services Employment and Reemployment Rights Act of 1994 (USERRA): §3.47
Visual Artists Rights Act of 1990: §5.33
Walsh-Healey Act: §§3.75-3.76
Whistleblower Protection Provisions: §7.49B
Worker Adjustment and Retraining Notification Act: §7.49B

SESSION LAWS
Pub L 108-357, 118 Stat 1418: §§7.49B, 7.64
Pub L 102-166, 105 Stat 1072: §§3.30-3.31
Pub L 102-166, 105 Stat 1071: §§3.61, 3.63
Pub L 101-650 §§601-610, 104 Stat 5128: §5.33
Pub L 101-433, 104 Stat 978 (1990): §3.46
Pub L 99-150, 99 Stat 787: §3.44

CONGRESSIONAL REPORTS
S Rep No. 105: §3.22
HR Rep No. 94-1476: §6.25

CONGRESSIONAL RECORD
110 Cong Rec 6549 (1964): §3.48
110 Cong Rec 6527 (1964): §3.48

Regulations and Rules

CODE OF FEDERAL REGULATIONS
Title 45
Pt 84: §3.30

TREASURY REGULATIONS
1.61-14(a): §§7.16, 7.29
1.111-1(a): §7.31
31.3121(a)-1(i): §3.49

FEDERAL RULES OF CIVIL PROCEDURE
26: §6.57A
65(d): §3.14
68: §3.62

FEDERAL RULES OF EVIDENCE
104: §6.52
702: §6.51
703: §6.51

Rulings

REVENUE RULINGS
96-35: §7.14
85-97: §7.7
85-44: §7.16
84-176: §§7.16, 7.24
81-277: §§7.8, 7.40
80-364: §7.44
79-278: §7.22
75-527: §§7.7-7.8, 7.40
74-251: §§7.6-7.8, 7.39
73-161: §7.27
70-510: §7.19
57-47: §7.32
55-264: §7.7

INTERNAL REVENUE SERVICE LETTER RULINGS
199952080: §7.47
199922056: §7.47

9814030: §7.19
9343025: §§7.19, 7.41
9335019: §§7.19, 7.41
9234016: §7.43
9226033: §7.32
9226032: §7.32
9211015: §7.32
9131023: §§7.19, 7.41
9041072: §§7.19, 7.41
8923052: §7.32
8802032: §7.24
8748072: §7.32
8604065: §7.32
8536064: §7.16
8512010: §§7.11, 7.19
8504004: §§7.20, 7.23
8239043: §§7.7, 7.39
7749029: §7.32

INTERNAL REVENUE SERVICE DOCUMENTS - GCM
39857 (Aug. 15, 1991): §7.32
39697 (Jan. 27, 1988): §7.32

INTERNAL REVENUE FIELD SERVICE ADVICE
199907003: §7.65

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Table of Cases

250 LLC v Photopoint Corp. (2005) 131 CA4th 703, 32 CR3d 296: §4.53

A

A&M Produce Co. v FMC Corp. (1982) 135 CA3d 473, 186 CR 114: §§1.19-1.20, 1.45
A-Z Int'l v Phillips (9th Cir 2003) 323 F3d 1141: §3.15
A. J. Mandt, TC Memo 1955-226: §7.31
ABF Capital Corp. v Grove Props. Co. (2005) 126 CA4th 204, 23 CR3d 803: §1.23
ABF Freight Sys., Inc. v NLRB (1994) 510 US 317, 127 L Ed 2d 152, 114 S Ct 835: §3.6
AT&T Corp. v Microsoft Corp. (SDNY 2003) 290 F Supp 2d 409: §6.1
Aames, Andrew (1990) 94 TC 189: §7.45
Aas v Superior Court (2000) 24 C4th 627, 101 CR2d 718: §5.10
Abdalla, Jacob (1978) 69 TC 697, aff'd (5th Cir 1981) 647 F2d 487: §7.22
Abeshouse v Ultragraphics, Inc. (2d Cir 1985) 754 F2d 467: §6.19
Abrams v Motter (1970) 3 CA3d 828, 83 CR 855: §§2.27-2.28, 2.31
Acadia, Cal., Ltd. v Herbert (1960) 54 C2d 328, 5 CR 686: §§4.40, 5.34
Adams v Murakami (1991) 54 C3d 105, 284 CR 318: §§1.37, 6.38
Adler v Elphick (1986) 184 CA3d 642, 229 CR 254: §4.87
Adler v Los Angeles Unified Sch. Dist. (1979) 98 CA3d 280, 159 CR 528: §3.94
Adray v Adry-Mart, Inc. (9th Cir 1995) 76 F3d 984: §6.29
Advanced-Tech Sec. Servs., Inc. v Superior Court (2008) 163 CA4th 700, 77 CR3d 757: §3.100
Aero Prods. Int'l, Inc. v Intex Recreation Corp. (Fed Cir 2006) 466 F3d 1000: §6.29
Aetna Health Inc. v Davila (2004) 542 US 200, 159 L Ed 2d 312, 124 S Ct 2488: §3.66
Agarwal v Johnson (1979) 25 C3d 932, 160 CR 141, disapproved on other grounds in White v Ultramar, Inc. (1999) 21 C4th 563, 88 CR2d 19: §3.98
Agosta v Astor (2004) 120 CA4th 596, 15 CR3d 565: §1.55
Agricultural Ins. Co. v Superior Court (1999) 70 CA4th 385, 82 CR2d 594: §1.36
Aguilar v Avis Rent a Car Sys., Inc. (1999) 21 C4th 121, 87 CR2d 132: §3.105
Ailes, Milton E., TC Memo 1983-388: §7.38
Aircraft & Engine Maintenance Employees Local 290 v I. E. Schilling Co. (5th Cir 1965) 340 F2d 286: §3.21
Aitken, Hazen, Hoffman, Miller, P.C. v Empire Constr. Co. (D Neb 1982) 542 F Supp 252: §6.23
Ajaxo Inc. v E*Trade Group, Inc. (2005) 135 CA4th 21, 37 CR3d 221: §6.38
Akazawa v Link New Technol. Int'l, Inc. (Fed Cir 2008) 520 F3d 1354: §6.1
Akins v Sacramento Mun. Util. Dist. (1992) 18 CA4th 208, 8 CR2d 785: §5.10
Al-Husry v Nilsen Farms Mini-Market, Inc. (1994) 25 CA4th 641, 31 CR2d 28: §§2.11, 2.46
Alamo, Tony & Susan, Found. v Secretary of Labor (1985) 471 US 290, 85 L Ed 2d 278, 105 S Ct 1953: §3.44
Albemarle Paper Co. v Moody (1975) 422 US 405, 45 L Ed 2d 280, 95 S Ct 2362: §3.57
Albert G. Rooks (1953) 12 CCH TCM 96: §7.38
Albin v QWEST Communications Corp. (D Or 2002) 194 F Supp 2d 1138: §3.66
Alcoa S.S. Co. v Conerford (SD NY 1949) 17 CCH Lab Cas ¶65,480: §3.23
Alcorn v Anbro Eng'g (1970) 2 C3d 493, 86 CR 88: §3.98
Alexander v Commissioner (1st Cir 1995) 72 F3d 938: §§7.49, 7.59
Alexander v McKnight (1992) 7 CA4th 973, 9 CR2d 453: §§5.28, 5.34, 5.54
Alexander Milburn Co. (1947) 78 NLRB 747: §3.14
Alfred M. Lewis, Inc. v Teamsters Local 542 (1958) 163 CA2d 771, 330 P2d 53: §3.84
Allen v Amalgamated Transit Union (8th Cir 1977) 554 F2d 876: §3.64
Allen v Enomoto (1964) 228 CA2d 798, 39 CR 815: §§2.29, 2.31
Allen v Jones (1980) 104 CA3d 207, 163 CR 445: §3.92
Allen v United Transp. Union (8th Cir 1992) 964 F2d 818: §3.33
Allen Bradley Co. v IBEW Local 3 (1945) 325 US 797, 89 L Ed 1939, 65 S Ct 1533: §3.36
Allen, Phillip Lee, TC Memo 1998-406: §7.9
Alliance Mortgage Co. v Rothwell (1995) 10 C4th 1226, 44 CR2d 352: §§2.10, 2.36, 2.40, 2.49
Allis-Chalmers Corp. v Lueck (1985) 471 US 202, 85 L Ed 2d 206, 105 S Ct 1904: §§3.2, 3.92
Allstate Ins. Co. v Loo (1996) 46 CA4th 1794, 54 CR2d 541: §§1.29, 4.93, 4.109
Allstate Ins. Co. v U.S. (1990) 20 Cl Ct 308: §7.31
Allstate Ins. Co. v U.S. (9th Cir 1991) 936 F2d 1271: §7.31
AlphaMed Pharms. Corp. v Arriva Pharms., Inc. (SD Fla 2006) 432 F Supp 2d 1319: §6.34
Aluminum & Metal Serv. v Commissioner (7th Cir 1966) 358 F2d 138: §§7.8, 7.48

Alyeska Pipeline Serv. Co. v Wilderness Soc'y (1975) 421 US 240, 44 L Ed 2d 141, 95 S Ct 1612: §3.15
Amador Valley Investors v City of Livermore (1974) 43 CA3d 483, 117 CR 749: §5.37
Amaral v Cintas Corp. (2008) 163 CA4th 1157, 78 CR3d 572: §§3.88, 3.90A
Amato v Mercury Cas. Co. (1997) 53 CA4th 825, 61 CR2d 909: §1.58
American Airlines, Inc. (1967) 48 Lab Arb 705: §3.107
American Honda Motor Co. v Two Wheel Corp. (2d Cir 1990) 918 F2d 1060: §§6.29, 6.32
American Mfg. Co. (1967) 167 NLRB 520: §3.9
American Motorcycle Ass'n v Superior Court (1978) 20 C3d 578, 146 CR 182: §1.20
American Trust Co. v Truck Ins. Exch. (1957) 147 CA2d 395, 305 P2d 73: §4.74
Amerson v Christman (1968) 261 CA2d 811, 68 CR 378: §1.50
Amusing Sandwich, Inc. v City of Palm Springs (1985) 165 CA3d 1116, 211 CR 911: §5.3
Anderson v Souza (1952) 38 C2d 825, 243 P2d 497: §5.53
Anderson, Richard D., TC Memo 2000-344: §7.25
Anderson, S.C., Inc. v Bank of America (1994) 24 CA4th 529, 30 CR2d 286: §1.19
Anderson, Vernon, TC Memo 1979-309: §7.14
Andrew Aames (1990) 94 TC 189: §7.45
Andrew Corp. v Gabriel Electronics, Inc. (D Me 1992) 785 F Supp 1041: §6.6
Andrews v Louisville & N.R.R. (1972) 406 US 320, 32 L Ed 2d 95, 92 S Ct 1562: §3.33
Andrews v Mobile Aire Estates (2005) 125 CA4th 578, 22 CR3d 832: §5.54
Angeles Chem. Co. v Spencer & Jones (1996) 44 CA4th 112, 51 CR2d 594: §§5.43, 5.44A
Angell v Rowlands (1978) 85 CA3d 536, 149 CR 574: §2.31
Anmaco, Inc. v Bohlken (1993) 13 CA4th 891, 16 CR2d 675: §1.23
Appalachian Ins. Co. v McDonnell Douglas Corp. (1989) 214 CA3d 1, 262 CR 716: §1.46
Applied Equip. Corp. v Litton Saudi Arabia Ltd. (1994) 7 C4th 503, 28 CR2d 475: §1.36
Applied Med. Resources Corp. v United States Surgical Corp. (Fed Cir 2006) 435 F3d 1356: §6.12
Aquinaga v United Food & Commercial Workers Int'l Union (D Kansas 1989) 720 F Supp 862, aff'd in part and rev'd in part (10th Cir 1993) 993 F2d 1463: §3.9
Arachnid, Inc. v Merit Indus., Inc. (Fed Cir 1991) 939 F2d 1574: §6.1
Arcade Water Dist. v U.S. (9th Cir 1991) 940 F2d 1265: §5.16
Arcadia Refining Co. v Commissioner (5th Cir 1941) 118 F2d 1010: §§7.8, 7.11, 7.19, 7.29
Arciero Ranches v Meza (1993) 17 CA4th 114, 21 CR2d 127: §5.22
Argaman v Ratan (1999) 73 CA4th 1173, 86 CR2d 917: §4.96
Arlington Metal Indus., Inc. (1971) 57 TC 302: §7.36
Armenta v Osmose, Inc. (2005) 135 CA4th 314, 37 CR3d 460: §3.100
Armitage v Decker (1990) 218 CA3d 887, 267 CR 399: §5.28
Armstrong v Wilson (9th Cir 1997) 124 F3d 1019: §3.44
Arnes, Joann C. v U.S. (9th Cir 1992) 981 F2d 456: §7.36
Arnold, William E., Co. v Carpenters Dist. Council (1974) 417 US 12, 40 L Ed 2d 620, 94 S Ct 2069: §3.22
Aro Mfg. Co. v Convertible Top Replacement Co. (1964) 377 US 476, 12 L Ed 2d 457, 84 S Ct 1526: §6.5
Arrowsmith v Commissioner (1952) 344 US 6, 97 L Ed 6, 73 S Ct 71: §7.22
Artesia Med. Dev. Co. v Regency Assocs. (1989) 214 CA3d 957, 266 CR 657: §§1.24, 4.96
Arthur Graf, TC Memo 1969-61: §7.36
Arthur L. Clarks, Estate of v U.S. (ED Mich 1998) 98-2 USTC ¶50,868, 82 AFTR2d 7068, rev'd (6th Cir 2000) 202 F3d 854: §7.47
Asbestos Workers Local 66 v Leona Lee Corp. (WD Tex 1973) 84 LRRM 2165, aff'd (5th Cir 1974) 489 F2d 1032: §3.108
Asell v Rodrigues (1973) 32 CA3d 817, 108 CR 566: §4.16
Ashburn v Miller (1958) 161 CA2d 71, 326 P2d 229: §2.38
Askari v R & R Land Co. (1986) 179 CA3d 1101, 225 CR 285: §§2.29, 2.33
Associated Gen. Contractors (1957) 119 NLRB 663: §3.12
Associates Discount Corp. v Tobb Co. (1966) 241 CA2d 541, 50 CR 738: §4.65
Atkinson v Sinclair Ref. Co. (1962) 370 US 238, 8 L Ed 2d 462, 82 S Ct 1318: §3.109
Atlantic Mut. Ins. Co. v J. Lamb, Inc. (2002) 100 CA4th 1017, 123 CR2d 256: §6.57A
Atlas-Pacific Eng'r Co. v Geo. W. Ashlock Co. (9th Cir 1964) 339 F2d 288: §6.2
Audi AG v D'Amato (6th Cir 2006) 469 F3d 534: §6.28
Austin v Board of Retirement (1989) 209 CA3d 1528, 258 CR 106: §1.20
Austin v City of Bisbee (9th Cir 1988) 855 F2d 1429: §3.44
Austin v Duggan (1958) 162 CA2d 580, 328 P2d 224: §2.51
Avery v Fredericksen & Westbrook (1944) 67 CA2d 334, 154 P2d 41: §1.50
Aweeka v Bonds (1971) 20 CA3d 278, 97 CR 650: §4.36
Axis Petroleum Co. v Taylor (1941) 42 CA2d 389, 108 P2d 978: §2.5

B

BIC Leisure Prods., Inc. v Windsurfing Int'l Corp. (Fed Cir 1993) 1 F3d 1214: §§6.6, 6.9
Badih v Myers (1995) 36 CA4th 1289, 43 CR2d 229: §1.55
Baffa v Johnson (1950) 35 C2d 36, 216 P2d 13: §§2.20, 2.33
Bagdasarian v Gragnon (1948) 31 C2d 744, 192 P2d 935: §§2.35-2.37, 2.50, 2.54, 2.58

Bagley v Commissioner (8th Cir 1997) 121 F3d 393, en banc rehearing denied 1997 US App Lexis 27256: §7.49
Bailey v Outdoor Media Group (2007) 155 CA4th 778, 66 CR3d 322: §§5.27, 5.35
Baird v Barton (1958) 163 CA2d 502, 329 P2d 492: §§2.8, 2.17
Baker v Burbank-Glendale-Pasadena Airport Auth. (1985) 39 C3d 862, 218 CR 293: §§5.2, 5.13, 5.15-5.16, 5.28-5.29, 5.42, 5.44-5.45
Baker v Pratt (1986) 176 CA3d 370, 222 CR 253: §1.39
Baker v Superior Court (1983) 150 CA3d 140, 197 CR 480: §1.15
Bakersfield Laundry Ass'n v Rubin (1955) 131 CA2d Supp 862, 280 P2d 921: §4.14
Bakkebo v Municipal Court (1981) 124 CA3d 229, 177 CR 239: §§4.97, 4.109
Baldwin Builders v Coast Plastering Corp. (2005) 125 CA4th 1339, 24 CR3d 9: §1.23
Baldwin Cooke Co. v Keith Clark, Inc. (ND Ill 1976) 420 F Supp 404: §6.19
Balmoral Hotel Tenants Ass'n v Lee (1990) 226 CA3d 686, 276 CR 640: §4.49
Banaitis v Commissioner (9th Cir 2003) 340 F3d 1074, rev'd in Commissioner v Banks (2005) 543 US 426, 160 L Ed 2d 859, 125 S Ct 826: §§7.49, 7.57
Banff Ltd. v Express, Inc. (SD NY 1996) 921 F Supp 1065: §6.23
Banjo Buddies, Inc. v Renosky (3d Cir 2005) 399 F3d 168: §6.29
Bank of America Nat'l Trust & Sav. Ass'n v Moore (1937) 18 CA2d 522, 64 P2d 460: §4.109
Bankamerica Pension Plan v McMath (9th Cir 2000) 206 F3d 821: §3.66
Banks, Commissioner v (2005) 543 US 426, 160 L Ed 2d 859, 125 S Ct 826: §§7.49-7.49A, 7.63, 7.65
Banks v Commissioner (6th Cir 2003) 345 F3d 373, rev'd in Commissioner v Banks (2005) 543 US 426, 160 L Ed 2d 859, 125 S Ct 826: §§7.49, 7.62
Banville v Schmidt (1974) 37 CA3d 92, 112 CR 126: §2.51
Baran v Goldberg (1948) 86 CA2d 506, 194 P2d 765: §2.7
Barber v State Personnel Bd. (1976) 18 C3d 395, 134 CR 206: §3.94
Barbera v Sokol (1980) 101 CA3d 725, 161 CR 843: §2.21
Bard, C.R. v Medtronic, Inc. (D Del June 15, 1999) No. CA 96-589-SLR, 1999 WL 458305, 1999 US Dist Lexis 9875, aff'd and vacated in part (Fed Cir, June 29, 2000) 2000 US App Lexis ¶15,316: §6.11
Barela v United Nuclear Corp. (10th Cir 1972) 462 F2d 149: §3.48
Barndt v County of Los Angeles (1989) 211 CA3d 397, 259 CR 372: §1.39
Barnes v Dobbins (1958) 159 CA2d 737, 324 P2d 696: §2.39
Barney v Aetna Cas. & Sur. Co. (1986) 185 CA3d 966, 230 CR 215: §1.57
Barnick v Longs Drug Stores (1988) 203 CA3d 377, 250 CR 10: §3.92
Baron v Fire Ins. Co. (2007) 154 CA4th 1184, 65 CR3d 502: §1.31
Bartleson v U.S. (9th Cir 1996) 96 F3d 1270: §§5.15, 5.29, 5.34, 5.45
Bartlett v U.S. (ED Wash 1993) 835 F Supp 1246: §3.54
Barton v White Oak Realty, Inc. (1969) 271 CA2d 579, 76 CR 587: §2.30
Basle, William, TC Memo 1957-169, aff'd (3d Cir 1958) 256 F2d 581: §§7.8, 7.11, 7.18, 7.39
Bauer v Sampson (9th Cir 2001) 261 F3d 775: §3.80
Baugh v Garl (2006) 137 CA4th 737, 40 CR3d 539: §5.22
Baychester Shopping Ctr., Inc. v San Francisco Residential Rent Stabilization & Arbitration Bd. (2008) 165 CA4th 1000, 81 CR3d 341: §4.48
Baylin v U.S. (Fed Cir 1995) 43 F3d 1451: §§7.47, 7.49, 7.61
Bayuk v Edson (1965) 236 CA2d 309, 46 CR 49: §1.50
Bear Creek Planning Comm. v Title Ins. & Trust Co. (1985) 164 CA3d 1227, 211 CR 172, disapproved on other grounds in Bay Dev., Ltd. v Superior Court (1990) 50 C3d 1012, 269 CR 720: §§1.20, 1.30
Beason v Griff (1954) 127 CA2d 382, 274 P2d 47: §2.20
Beaty v BET Holdings, Inc. (9th Cir 2000) 222 F3d 607: §3.62
Beck Dev. Co. v Southern Pac. Transp. Co. (1996) 44 CA4th 1160, 52 CR2d 518: §§5.3, 5.7, 5.9-5.10, 5.13-5.16, 5.28, 5.42, 5.48
Becker v S.P.V. Constr. Co. (1980) 27 C3d 489, 165 CR 825: §1.13
Beckett v City of Paris Dry Goods Co. (1939) 14 C2d 633, 96 P2d 122: §4.17
Beebe v Richards (1953) 115 CA2d 589, 252 P2d 688: §4.46
Beeman v Burling (1990) 216 CA3d 1586, 265 CR 719: §4.49
Behniwal v Mix (2007) 147 CA4th 621, 54 CR3d 427: §2.12
Behrendt v Abraham (1966) 64 C2d 182, 49 CR 292: §2.33
Bello v ABA Energy Corp. (2004) 121 CA4th 301, 16 CR3d 818: §5.17
Benard v Walkup (1969) 272 CA2d 595, 77 CR 544: §1.17
Benci-Woodward v Commissioner (9th Cir 2000) 219 F3d 941, cert denied (2001) 531 US 1112: §§7.49, 7.53
Bender v Teamsters Local 63 (9th Cir, Dec. 23, 1991) 1991 US App Lexis 30601: §3.27
Bennett v Total Minetone Corp. (5th Cir 1998) 138 F3d 1053: §3.56
Benson v City of Los Angeles (1963) 60 C2d 355, 33 CR 257: §§1.20, 4.6
Berbiglia v Commissioner (1951) 10 CCH TCM 413: §§7.11, 7.41
Berg v Watson (SD NY 1976) 417 F Supp 806: §3.27
Berge v International Harvester Co. (1983) 142 CA3d 152, 190 CR 815: §§1.19, 1.41
Bergstrom v Sears, Roebuck & Co. (D Minn 1980) 496 F Supp 476: §6.2
Berkley v Dowds (2007) 152 CA4th 518, 61 CR3d 304: §§1.34, 3.97, 6.38

Bertram v Orlando (1951) 102 CA2d 506, 227 P2d 894: §§5.30-5.31
Bessho v General Petroleum Corp. (1921) 186 C 133, 199 P 22: §4.20
Better Foods Mkts., Inc. v American Dist. Tel. Co. (1953) 40 C2d 179, 253 P2d 10: §1.42
Betts v Allstate Ins. Co. (1984) 154 CA3d 688, 201 CR 528: §1.58
Beverage v Canton Placer Mining Co. (1955) 43 C2d 769, 278 P2d 694: §2.8
Beverly Fin. Co. v American Cas. Co. (1969) 273 CA2d 259, 78 CR 334: §6.43
Beverly Hills Nat'l Bank v Glynn (1968) 267 CA2d 859, 73 CR 808: §4.100
Bhullar v Tayyab (1996) 46 CA4th 582, 54 CR2d 17: §1.30
Biakanja v Irving (1958) 49 C2d 647, 320 P2d 16: §5.28
Bice v Stevens (1955) 136 CA2d 368, 289 P2d 95: §2.39
Biehl, Frank (2002) 118 TC 467, aff'd (9th Cir 2003) 351 F3d 982: §7.62A
Big Four Indus., Inc. (1963) 40 TC 1055, acq 1964-1 Cum Bull 4: §7.37
Big O Tire Dealers, Inc. v Goodyear Tire & Rubber Co. (D Colo 1976) 408 F Supp 1219, aff'd with modification (10th Cir 1977) 561 F2d 1365: §6.30
Billetter v Posell (1949) 94 CA2d 858, 211 P2d 621: §§1.53, 3.52, 3.95
Bing v Roadway Express, Inc. (5th Cir 1973) 485 F2d 441: §3.53
Binns v U.S. (6th Cir 1967) 385 F2d 159: §7.38
Bio-Rad Labs., Inc. v Nicolet Instrument Corp. (Fed Cir 1984) 739 F2d 604: §6.6
Biocraft Labs., Inc., TC Memo 1980-268: §7.41
Birch v Ciria (1962) 205 CA2d 1, 22 CR 798: §2.55
Bird v American Sur. Co. (1917) 175 C 625, 166 P 1009: §1.49
Birke v Oakwood Worldwide (2009) 169 CA4th 1540, 87 CR3d 602: §§5.7, 5.12
Birman v Loeb (1998) 64 CA4th 502, 75 CR2d 294: §2.32
Black v Knight (1917) 176 C 722, 169 P 382: §4.14
Blain, Estate of (1949) 8 CCH TCM 540: §7.36
Blanchard v Bergeron (1989) 489 US 87, 103 L Ed 2d 67, 109 S Ct 939: §3.62
Blanton, Leonard Ray, TC Memo 1997-496: §7.6
Blegen v Superior Court (1981) 125 CA3d 959, 178 CR 470: §1.35
Blevins v Mullally (1913) 22 CA 519, 135 P 307: §5.17
Blickman Turkus v MF Downtown Sunnyvale (2008) 162 CA4th 858, 76 CR3d 325: §1.24
Blue Booth v Santa Barbara Biplane Tours (2008) 158 CA4th 1173, 70 CR3d 660: §1.46
Blum v Stenson (1984) 465 US 886, 79 L Ed 2d 891, 104 S Ct 1541: §3.62
Board of Educ. v Round Valley Teachers Ass'n (1996) 13 C4th 269, 52 CR2d 115: §3.106
Boarts v Imperial Irrig. Dist. (1947) 80 CA2d 574, 182 P2d 246: §5.6
Boatman, Ralph A. (1959) 32 TC 1188: §7.38
Bodine Produce, Inc. v UFW (9th Cir 1974) 494 F2d 541: §3.36
Boehm v Commissioner (2d Cir 1945) 146 F2d 553, aff'd on other grounds (1945) 326 US 287, 90 L Ed 78, 66 S Ct 120: §§7.19, 7.29, 7.36
Boeing Co. v UAW (3d Cir 1967) 370 F2d 969: §3.109
Boicourt v Amex Assur. Co. (2000) 78 CA4th 1390, 93 CR2d 763: §1.58
Boilerwakers Local 445 v Terry (5th Cir 1968) 398 F2d 491: §3.25
Bonde v Bishop (1952) 112 CA2d 1, 245 P2d 617: §5.25
Boney, Stephen W., Inc. v Boney Servs., Inc. (9th Cir 1997) 127 F3d 821: §6.32
Bonnie Lass Knitting Mills, Inc. (1960) 126 NLRB 1396: §3.17
Borg-Warner Corp. v York-Shipley, Inc. (7th Cir 1961) 293 F2d 88: §6.30
Boston v Penny Lane Ctrs., Inc. (2009) 170 CA4th 936, 88 CR3d 707: §1.55
Bouchard v Orange (1960) 177 CA2d 521, 2 CR 388: §§2.26, 2.28
Bourdieu v Seaboard Oil Corp. (1941) 48 CA2d 429, 119 P2d 973: §5.54
Bovard v American Horse Enters. (1988) 201 CA3d 832, 247 CR 340: §1.23
Bowe v Colgate-Palmolive Co. (SD Ind 1967) 272 F Supp 332: §3.51
Bowen v U.S. Postal Serv. (1983) 459 US 212, 103 S Ct 588, 74 L Ed 2d 402: §3.19
Bowles v Reade (9th Cir 1999) 198 F3d 752: §3.73
Bowman v Ruchti Bros. (1970) 4 CA3d 897, 84 CR 563: §3.107
Boyd v Oscar Fisher Co. (1989) 210 CA3d 368, 258 CR 473: §4.111
Boz Scaggs Music v KND Corp. (D Conn 1980) 491 F Supp 908: §6.25
Brabson v U.S. (10th Cir 1996) 73 F3d 1040: §§7.45-7.46
Bradley, Allen, Co. v IBEW Local 3 (1945) 325 US 797, 89 L Ed 1939, 65 S Ct 1533: §3.36
Bradshaw v Zoological Soc'y (9th Cir 1978) 569 F2d 1066: §3.64
Brady v Carman (1960) 179 CA2d 63, 3 CR 612: §2.38
Bran, Inc. v Dynamics Corp. (Fed Cir 1992) 975 F2d 815: §6.2
Branch v Homefed Bank (1992) 6 CA4th 793, 8 CR2d 182: §§2.45, 2.47
Brandt v Superior Court (1985) 37 C3d 813, 210 CR 211: §§1.31, 1.57
Branti v Finkel (1980) 445 US 507, 63 L Ed 2d 574, 100 S Ct 1287: §3.80
Braun v Agri-Systems (ED Cal, May 16, 2006, No. CV-F-02-6482) 2006 US Dist Lexis 29947: §5.10
Brawley v Risdon Iron Works (1869) 38 C 676: §4.22

Breininger v Sheetmetal Workers Int'l (1989) 493 US 67, 107 L Ed 2d 388, 110 S Ct 424: §3.2
Brenda J. Wachner, TC Memo 1995-88, amended 95 TNT 48-18: §7.41
Brennan v Chestnut (D Minn 1991) 777 F Supp 1469: §3.21
Bresler, David (1975) 65 TC 182, acq 1976-2 Cum Bull 1: §7.48
Brewer v Premier Golf Props., LP (2008) 168 CA4th 1243, 86 CR3d 225: §§1.55, 3.88A
Brick & Clay Workers v Deena Artware, Inc. (6th Cir 1952) 198 F2d 637: §3.21
Bricklayers & Masons Local No. 2 (1967) 166 NLRB 117: §3.19
Bridgeport Music, Inc. v Lorenzo (MD Tenn 2003) 255 F Supp 2d 795: §6.15
Brinker Restaurant Corp. v Superior Court (review granted Oct. 22, 2008, S166350; superseded opinion at 165 CA4th 25, 80 CR3d 781): §3.88A
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Burkhouse v Phillips (1971) 18 CA3d 661, 96 CR 197: §2.36
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Burlesque Artists Ass'n v Hirst Enters., Inc. (3d Cir 1959) 267 F2d 414: §3.23
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Burnaby v Standard Fire Ins. Co. (1995) 40 CA4th 787, 47 CR2d 326: §1.31
Burns, Vernon F., TC Memo 1994-284: §7.45
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Bussey v Affleck (1990) 225 CA3d 1162, 275 CR 646: §4.110
Butcher v City of McAlester (10th Cir 1992) 956 F2d 973: §3.80
Butler-Rupp v Lourdeaux (2007) 154 CA4th 918, 65 CR3d 242: §§1.29, 4.100
Butler-Rupp v Lourdeaux (2005) 134 CA4th 1220, 36 CR3d 685: §§4.2, 4.10, 4.28
Buxbom v Smith (1944) 23 C2d 535, 145 P2d 305: §§1.19, 1.51

C

C & K Eng'g Contractors v Amber Steel Co. (1978) 23 C3d 1, 151 CR 323: §2.2
C. Norman Peterson Co. v Container Corp. of Am. (1985) 172 CA3d 628, 218 CR 592: §§1.11, 1.20
C.R. Bard v Medtronic, Inc. (D Del June 15, 1999) No. CA 96-589-SLR, 1999 WL 458305, 1999 US Dist Lexis 9875, aff'd and vacated in part (Fed Cir, June 29, 2000) 2000 US App Lexis ¶15,316: §6.11
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CRST Van Expedited, Inc. v Werner Enters., Inc. (9th Cir 2007) 479 F3d 1099: §6.39
CSEA v Personnel Comm'n (1973) 30 CA3d 241, 106 CR 283: §3.95
Cacique, Inc. v Robert Reiser & Co. (9th Cir 1999) 169 F3d 619: §6.37
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Caldwell v Walker (1963) 211 CA2d 758, 27 CR 675: §5.32
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California Ins. Co. v Krusiewicz (2005) 131 CA4th 273, 31 CR3d 619: §1.58
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Campbell v Cal-Gard Sur. Services, Inc. (1998) 62 CA4th 563, 73 CR2d 64: §1.31
Campbell v Superior Court (1996) 44 CA4th 1308, 52 CR2d 385: §1.58
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Canova v NLRB (9th Cir 1983) 708 F2d 1498: §3.9
Caplan v Schroeder (1961) 56 C2d 515, 15 CR 145: §§2.19-2.20, 2.30
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Carole Ring & Assocs. v Nicastro (2001) 87 CA4th 253, 104 CR2d 519: §1.28
Carpenters Local 978 v Markwell (8th Cir 1962) 305 F2d 38: §3.21
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Carwash of America-PO v Windswept Ventures No. 1 (2002) 97 CA4th 540, 118 CR2d 536: §1.33
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Case v Sisich (1929) 97 CA 106, 275 P 492: §5.19
Cassim v Allstate Ins. Co. (2004) 33 C4th 780, 16 CR3d 374: §1.31
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Central Mut. Ins. Co. v Schmidt (1957) 152 CA2d 671, 313 P2d 132: §2.37
Central R.R. Co. v Commissioner (3d Cir 1935) 79 F2d 697: §7.29
Central Valley Gen. Hosp. v Smith (2008) 162 CA4th 501, 75 CR3d 771: §1.7
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Certilus v Peeples (MD Fla 1984) 101 Lab Cas (CCH) ¶34,587: §3.44
Chalmers Cullins (1955) 24 TC 322: §§7.11, 7.41
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Chambers v Nasco, Inc. (1991) 501 US 32, 115 L Ed 2d 27, 111 S Ct 2123: §3.15
Chambers v Security Commercial & Sav. Bank (1920) 46 CA 32, 188 P 818: §4.88
Chan v Tsang (1991) 1 CA4th 1578, 3 CR2d 14: §2.30
Chang, Philip & Sons Assocs. v La Casa Novato (1986) 177 CA3d 159, 222 CR 800: §§2.36, 2.42
Channell v Anthony (1976) 58 CA3d 290, 129 CR 704: §§2.40, 2.47, 2.52, 6.41
Chaplin v Consolidated Edison Co. (SD NY 1984) 587 F Supp 519: §3.30
Chapman v Pacific Tel. & Tel. Co. (ND Cal 1978) 456 F Supp 77: §3.56
Charles J. Rounds Co. v Teamsters No. 42 (1971) 4 C3d 888, 95 CR 53: §3.109
Charlie Sturgill Motor Co., TC Memo 1973-281: §7.41
Chelini v Nieri (1948) 32 C2d 480, 196 P2d 915: §1.38
Chelios v Kaye (1990) 219 CA3d 75, 268 CR 38: §1.27
Chernoff v Pandick Press, Inc. (SD NY 1977) 440 F Supp 822: §3.47
Chesapeake Indus. v Togova Enters. (1983) 149 CA3d 901, 197 CR 348: §1.20
Cheung v Daley (1995) 35 CA4th 1673, 42 CR2d 164: §1.34
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Chipman v Emeric (1855) 5 C 239: §4.60

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Christensen v Dewor Devs. (1983) 33 C3d 778, 191 CR 8: §1.16
Christensen v Slawter (1959) 173 CA2d 325, 343 P2d 341: §2.10
Christiansen v Roddy (1986) 186 CA3d 780, 231 CR 72: §§2.46, 2.49
Christopher v Jones (1964) 231 CA2d 408, 41 CR 828: §5.51
Christopher v Mobil Oil Corp. (5th Cir 1992) 950 F2d 1209: §3.92
Church v Jamison (2006) 143 CA4th 1568, 50 CR3d 166: §3.88
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Circuit City, Inc. v Adams (2001) 532 US 105, 149 L Ed 2d 234, 121 S Ct 1302: §3.46
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City & County of San Francisco v Padilla (1972) 23 CA3d 388, 100 CR 223: §5.3
City & County of San Francisco v Sainez (2000) 77 CA4th 1302, 92 CR2d 418: §4.37
City & County of San Francisco v United Ass'n of Journeymen (1986) 42 C3d 810, 230 CR 856: §3.82
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City Solutions Inc v Clear Channel Communications, Inc. (9th Cir 2004) 365 F3d 835: §6.40
City of Atascadero v Merrill Lynch, Pierce, Fenner & Smith, Inc. (1998) 68 CA4th 445, 80 CR2d 329: §2.34
City of Bakersfield v Miller (1966) 64 C2d 93, 48 CR 889: §5.3
City of Burlington v Dague (1992) 505 US 557, 120 L Ed 2d 449, 112 S Ct 2638: §3.62
City of Costa Mesa v Soffer (1992) 11 CA4th 378, 13 CR2d 735: §5.3
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City of Los Angeles v Retlaw Enters., Inc. (1976) 16 C3d 473, 128 CR 436: §2.39
City of Malibu v California Coastal Comm'n (2005) 128 CA4th 897, 27 CR3d 501: §5.10
City of Monte Sereno v Padgett (2007) 149 CA4th 1530, 58 CR3d 218: §5.36
City of Moorpark v Superior Court (1998) 18 C4th 1143, 77 CR2d 445: §3.93
City of Palo Alto v Service Employ-ees Int'l Union (1999) 77 CA4th 327, 91 CR2d 500: §3.106
City of San Diego v Sobke (1998) 65 CA4th 379, 76 CR2d 9: §6.57
City of San Diego v U.S. Gypsum Co. (1994) 30 CA4th 575, 35 CR2d 876: §5.5
City of San Jose v Operating Eng'rs Local Union No. 3 (review granted June 18, 2008, S162647; superseded opinion at 160 CA4th 951, 73 CR3d 159): §3.82
City of Santa Barbara v Superior Court (2007) 41 C4th 747, 62 CR3d 527: §1.46
City of Santa Paula v Narula (2003) 114 CA4th 485, 8 CR3d 75: §§4.93, 4.109
Claiborne v Illinois Cent. R.R. (5th Cir 1978) 583 F2d 143: §3.64
Clar v Cacciola (1987) 193 CA3d 1032, 238 CR 726: §1.24
Clark v American Marine Corp. (ED La 1970) 320 F Supp 709: §3.62
Clark v Commissioner (1939) 40 BTA 333, nonacq 1939-2 Cum Bull 45, acq 1957-2 Cum Bull 4: §7.32
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Cloak, Skirt & Dressmakers Union v Senco, Inc. (D Mass 1968) 289 F Supp 513: §3.108
Coady v Commissioner (9th Cir 2000) 213 F3d 1187, cert denied (2001) 532 US 972: §§7.49, 7.56
Coast Plaza Doctors Hosp. v Blue Cross of Cal. (2009) 173 CA4th 1179, 93 CR3d 479: §3.66
Coats v Atchison, T. & S. F. Ry. (1905) 1 CA 441, 82 P 640: §§5.27, 5.34
Coats, Sophia, TC Memo 1977-407: §7.14
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Cole v Fair Oaks Fire Protection Dist. (1987) 43 C3d 148, 233 CR 308: §3.97
Cole v Hall (ED NY 1964) 35 FRD 4: §3.26
Collins, Levy, TC Memo 1959-174: §§7.7-7.8, 7.39
Collyer Insulated Wire (1971) 192 NLRB 837: §3.22
Colvig v RKO Gen., Inc. (1965) 232 CA2d 56, 42 CR 473: §§1.18, 1.39
Commerce Tankers Corp. v National Maritime Union (2d Cir 1977) 553 F2d 793: §3.37
Commercial Life Ins. v Superior Court (1988) 47 C3d 473, 253 CR 682: §3.66

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Communication Workers of Am. v NLRB (7th Cir 1986) 784 F2d 847: §3.3
Complete Auto Transit, Inc. v Reis (1981) 451 US 401, 68 L Ed 2d 248, 101 S Ct 1836: §3.22
Computer Prepared Accounts, Inc. v Katz (1991) 235 CA3d 428, 286 CR 556: §6.39
Comunale v Traders & Gen. Ins. Co. (1958) 50 C2d 654, 328 P2d 198: §1.57
Concord Instruments Corp., TC Memo 1994-248: §7.32
Cone Bros. Contracting Co. (1966) 158 NLRB 186: §3.7
Conger v White (1945) 69 CA2d 28, 158 P2d 415: §2.46
Connell v Brownstein-Louis Co. (1927) 86 CA 610, 261 P 331: §4.72
Connell Constr. Co. v Plumbers & Steamfitters Local 100 (1975) 421 US 616, 44 L Ed 2d 418, 95 S Ct 1830: §3.37
Connick v Myers (1983) 461 US 138, 75 L Ed 2d 708, 103 S Ct 1684: §3.80
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Consolidated Rail Corp. v Railway Labor Executives Ass'n (1989) 491 US 299, 109 S Ct 2477, 105 L Ed 2d 250: §3.33
Consolidated World Invs. v Lido Preferred Ltd. (1992) 9 CA4th 373, 11 CR2d 524: §2.16
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Continental Can Co. (1962) 39 Lab Arb 821: §3.107
Contra Costa Water Dist. v Bar-C Prop. (1992) 5 CA4th 652, 7 CR2d 91: §6.43
Cook v City of Buena Park (2005) 126 CA4th 1, 23 CR3d 700: §5.7
Cook v King Manor & Convalescent Hosp. (1974) 40 CA3d 782, 115 CR 471: §2.21
Cook v Nordstrand (1948) 83 CA2d 188, 188 P2d 282: §2.7
Cooke v Orange Belt Dist. Council of Painters 48 (9th Cir 1976) 529 F2d 815: §3.27
Cooper v Superior Court (1984) 153 CA3d 1008, 200 CR 746: §5.33
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Cordova v Bache & Co. (SD NY 1970) 321 F Supp 600: §3.38
Cornell v Sennes (1971) 18 CA3d 126, 95 CR 728: §§4.75, 5.33
Cory v Villa Props. (1986) 180 CA3d 592, 225 CR 628: §§2.10, 2.36-2.38, 2.43-2.44
Costar Group, Inc. v Loopnet, Inc. (D Md 2001) 164 F Supp 2d 688: §6.25
Cotnam v Commissioner (5th Cir 1959) 263 F2d 119: §§7.47, 7.49
Cottrell v Gulf, M. & O.R.R. (SD Ala 1971) 321 F Supp 1401: §3.33
Coughlin v Blair (1953) 41 C2d 587, 262 P2d 305: §2.10
County Sanitation Dist. No. 2 v Los Angeles County Employees Ass'n, Local 660 (1985) 38 C3d 564, 214 CR 424: §3.82
County of Contra Costa v Cowell Portland Cement Co. (1932) 126 CA 267, 14 P2d 606: §5.2
County of Los Angeles v Faus (1957) 48 C2d 672, 312 P2d 680: §2.39
County of Los Angeles v Hoe (1955) 138 CA2d 74, 291 P2d 98, disapproved on other grounds in Merced Irrig. Dist. v Woolstenhulme (1971) 4 C3d 478, 93 CR 833: §2.39
County of Mariposa v Yosemite W. Assocs. (1988) 202 CA3d 791, 248 CR 778: §2.42
County of Sacramento v AFSCME Local 146 (review granted Oct. 16, 2008; superseded opinion at 165 CA4th 401, 80 CR3d 911): §3.82
County of San Diego v Carlstrom (1961) 196 CA2d 485, 16 CR 667: §5.10
County of Solano v Vallejo Redev. Agency (1999) 75 CA4th 1262, 90 CR2d 41: §2.8
Cowell v Snyder (1911) 15 CA 634, 115 P 961: §4.83
Coyne v Westinghouse Elec. Corp. (SD Cal 1962) 204 F Supp 403: §3.47
Crabtree v Baptist Hosp. (11th Cir 1985) 749 F2d 1501: §3.44
Crag Lumber Co. v Crofoot (1956) 144 CA2d 755, 301 P2d 952: §2.9
Crawford v Nastos (1960) 182 CA2d 659, 6 CR 425: §2.41
Cream Records, Inc. v Joseph Schlitz Brewing Co. (9th Cir 1989) 864 F2d 668: §6.21
Cream Records, Inc. v Joseph Schlitz Brewing Co. (9th Cir 1985) 754 F2d 826: §6.22
Crews, James V., TC Memo 1994-64, aff'd in part, rev'd in part (9th Cir 1996) 94 F3d 523: §7.45
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Crosset Lumber Co. (1938) 8 NLRB 440: §3.6
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Cruz v Aryromloo (2007) 155 CA4th 1270, 66 CR3d 725: §1.22
Cuadra v Millan (1998) 17 C4th 855, 72 CR2d 687, disapproved on other grounds in Samuels v Mix (1999) 22 C4th 1, 91 CR2d 273: §§3.45, 3.89
Cullins, Chalmers (1955) 24 TC 322: §§7.11, 7.41
Cummings Med. Corp. v Occupational Med. Corp. (1992) 10 CA4th 1291, 13 CR2d 585: §§1.37, 6.38
Curcio Webb, LLC, v National Benefit Programs Agency, Inc. (SD Ohio 2005) 367 F Supp 2d 1191: §6.29
Curran v Heslop (1953) 115 CA2d 476, 252 P2d 378: §2.43
Curry v Moody (1995) 40 CA4th 1547, 48 CR2d 627: §1.24
Czosek v O'Mara (1970) 397 US 25, 25 L Ed 2d 21, 90 S Ct 770: §3.34

D

DFEH v San Francisco Mun. Ry. (1982) No. 82-23, FEHC Precedential Decisions: §3.52
DSU Med. Corp. v JMS Co. (Fed Cir 2006) 471 F3d 1293: §6.1
Dalbo, Lee, TC Memo 1969-220: §7.14
Dallas Typographical Union No. 173 v A. H. Belo Corp. (5th Cir 1967) 372 F2d 577: §3.107
Dalrymple v United Servs. Auto. Ass'n (1995) 40 CA4th 497, 46 CR2d 845: §1.58
Daluiso v Boone (1969) 71 C2d 484, 78 CR 707: §§4.20, 4.24
Daly v Smith (1963) 220 CA2d 592, 33 CR 920: §5.32
Damian v Tamondong (1998) 65 CA4th 1115, 77 CR2d 262: §4.95
Danner v Jarrett (1983) 144 CA3d 164, 192 CR 535: §5.54
Darlington Mfg. Co. v NLRB (4th Cir 1968) 397 F2d 760: §3.5
Data Gen. Corp. v Grumman Sys. Support Corp. (1st Cir 1994) 36 F3d 1147: §6.24
Dauberman v Grant (1926) 198 C 586, 246 P 319: §1.14
Daubert v Merrell Dow Pharms., Inc. (1993) 509 US 579, 125 L Ed 2d 469, 113 S Ct 2786: §6.51
Daulton v Williams (1947) 81 CA2d 70, 183 P2d 325: §4.30
Daum Dev. Corp. v Yuba Plaza, Inc. (1970) 11 CA3d 65, 89 CR 458: §1.7
Davaris v Cubaleski (1993) 12 CA4th 1583, 16 CR2d 330: §3.98
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Estate of _____ (*see* name of decedent)
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F

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Frederick Weisman Co. (1991) 97 TC 563: §7.36
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Freeman, Ralph (1959) 33 TC 323: §§7.11, 7.41
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G

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Gargoyles, Inc. v U.S. (1997) 37 Fed Cl 95: §6.4
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Garibaldi Vincent v Trend W. Tech. Corp. (9th Cir 1987) 828 F 2d 563: §3.92
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Gil v Masano (2004) 121 CA4th 739, 17 CR3d 420: §1.23
Gilbert v Master Washer & Stamping Co. (2001) 87 CA4th 212, 104 CR2d 461: §1.25
Gill Petrolium, Inc. v Hayer (2006) 137 CA4th 826, 40 CR3d 648: §4.87
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Greenup v Rodman (1986) 42 C3d 822, 231 CR 220: §1.13
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Guidry, Pat G., TC Memo 1994-127: §7.28
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H

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Haney v Aramark Unif Servs., Inc. (2004) 121 CA4th 623, 17 CR3d 336: §3.93
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Hannon Eng'g v Reim (1981) 126 CA3d 415, 179 CR 78: §3.98
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Harman v City & County of San Francisco (2007) 158 CA4th 407, 69 CR3d 750: §3.64
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Harris v Atlantic Richfield Co. (1993) 14 CA4th 70, 17 CR2d 649: §1.55
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Harvey Doud, TC Memo 1982-158: §7.41
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Hasler v Howard (2004) 120 CA4th 1023, 16 CR3d 217: §1.30
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Helvering v Horst (1940) 311 US 112, 85 L Ed 75, 61 S Ct 144: §7.49A
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Hilltop Inv. Assocs. v Leon (1994) 28 CA4th 462, 33 CR2d 552: §1.26
Hinchliffe v City of San Diego (1985) 165 CA3d 722, 211 CR 560: §3.94
Hines v Brode (1914) 168 C 507, 143 P 729: §2.36
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Hitz v First Interstate Bank (1995) 38 CA4th 274, 44 CR2d 890: §1.44
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Horning v Shilberg (2005) 130 CA4th 197, 29 CR3d 717: §2.30

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I

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J

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Jacob Abdalla (1978) 69 TC 697, aff'd (5th Cir 1981) 647 F2d 487: §7.22
Jacobs v Levin (1943) 58 CA2d Supp 913, 137 P2d 500: §2.35
Jacobson v Simmons Real Estate (1994) 23 CA4th 1285, 28 CR2d 699, disapproved on other grounds in 11 C4th at 292: §2.12
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Jersey v John Muir Med. Ctr. (2002) 97 CA4th 814, 118 CR2d 807: §1.55
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Johnson v Siegel (2000) 84 CA4th 1087, 101 CR2d 412: §1.30
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Jones v Dodson (4th Cir 1984) 727 F2d 1329: §3.80
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Jones v Gregory (2006) 137 CA4th 798, 40 CR3d 581: §3.90
Jones v Kvistad (1971) 19 CA3d 836, 97 CR 100: §1.50
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Judson v Los Angeles Suburban Gas Co. (1910) 157 C 168, 106 P 581: §5.34
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K

KFC W., Inc. v Meghrig (1994) 23 CA4th 1167, 28 CR2d 676: §5.54
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Kamar Int'l, Inc. v Russ Berrie & Co. (9th Cir 1984) 752 F2d 1326: §6.20
Kangarlou v Progressive Title Co. (2005) 128 CA4th 1174, 27 CR3d 754: §1.22
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Karoutas v HomeFed Bank (1991) 232 CA3d 767, 283 CR 809: §5.54
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Kempter, Paul E., TC Memo 1963-68: §§7.6-7.7
Kempton v City of Los Angeles (2008) 165 CA4th 1344, 81 CR3d 852: §§5.7-5.8
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Klamath-Orleans Lumber, Inc. v Miller (1978) 87 CA3d 458, 151 CR 118: §6.35
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Koehrer v Superior Court (1986) 181 CA3d 1155, 226 CR 820: §3.92
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Kraus v Willow Park Pub. Golf Course (1977) 73 CA3d 354, 140 CR 744: §6.47
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L

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Lauren W. McKim, TC Memo 1980-93: §7.14
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Leaf v City of San Mateo (1980) 104 CA3d 398, 163 CR 711: §5.44A
Lebas Fashion Imports of USA, Inc. v ITT Hartford Ins. Group (1996) 50 CA4th 548, 59 CR2d 36: §6.57A
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Lee Dalbo, TC Memo 1969-220: §7.14
Lee Way Motor Freight, Inc., U.S. v (WD Okla 1977) 15 FEP Cases 1385, aff'd in part (10th Cir 1979) 625 F2d 918: §3.53
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Levens v Commissioner (1951) 10 CCH TCM 1083: §§7.3, 7.8, 7.39
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Levy v Wolff (1956) 46 C2d 367, 294 P2d 945: §2.9
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Levy-Zentner Co. v Southern Pac. Transp. Co. (1977) 74 CA3d 762, 142 CR 1: §1.20
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Lewis, Alfred M., Inc. v Teamsters Local 542 (1958) 163 CA2d 771, 330 P2d 53: §3.84
Licht v Gallatin (1927) 84 CA 240, 257 P 914: §4.70
Lifton v Harshman (1947) 80 CA2d 422, 182 P2d 222, disapproved on other grounds in 50 C2d at 506: §2.8
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Lineberger v Delaney Petroleum Corp. (1935) 8 CA2d 153, 47 P2d 326: §4.58
Linforth v San Francisco Gas & Elec. Co. (1909) 156 C 58, 103 P 320: §5.33
Link v Antioch Unified Sch. Dist. (1983) 142 CA3d 765, 191 CR 264: §3.82
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Lippman v Sears Roebuck & Co. (1955) 44 C2d 136, 280 P2d 775: §4.67
Little v Cox's Supermarkets (7th Cir 1995) 71 F3d 637: §3.71
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Livitsanos v Superior Court (1992) 2 C4th 744, 7 CR2d 808: §3.98
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Local 82, Furniture & Piano Moving v Crowley (1984) 467 US 526, 81 L Ed 2d 457, 104 S Ct 2557: §3.28
Lockheed Aircraft Corp. v Superior Court (1946) 28 C2d 481, 171 P2d 21: §3.103
Locklin v City of Lafayette (1994) 7 C4th 327, 27 CR2d 613: §5.6
Lockyer, People ex rel v Fremont Gen. Corp. (2001) 89 CA4th 1260, 108 CR2d 127: §1.33
Loder v City of Glendale (1997) 14 C4th 846, 59 CR2d 696: §3.99
Loduca v Polyzos (2007) 153 CA4th 334, 62 CR3d 780: §1.23
Loeb v Kivo (2d Cir 1948) 169 F2d 346: §3.47
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Loehr v Ventura Community College Dist. (1983) 147 CA3d 1071, 195 CR 576: §3.97
Lomax v Armstrong Cork Co. (5th Cir 1970) 433 F2d 1277: §3.21
London v Hill (1934) 136 CA 560, 29 P2d 281: §4.17
Longino, J.T., Estate of (1959) 32 TC 904: §§7.3, 7.7, 7.27, 7.39
Lorillard v Pons (1978) 434 US 575, 55 L Ed 2d 40, 98 S Ct 866: §3.46
Los Angeles v City Bank (1893) 100 C 18, 34 P 510: §1.20
Los Angeles County Civil Serv. Comm'n v Superior Court (1978) 23 C3d 55, 151 CR 547: §3.82
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Lowe v Yolo County Consol. Water Co. (1910) 157 C 503, 108 P 297: §5.32
Lu v Grewal (2005) 130 CA4th 841, 30 CR3d 623: §4.80
Lubey v City & County of San Francisco (1979) 98 CA3d 340, 159 CR 440: §3.94
Lubner v City of Los Angeles (1996) 45 CA4th 525, 53 CR2d 24: §5.33
Lucas v Earl (1930) 281 US 111, 74 L Ed 731, 50 S Ct 241: §7.49A
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Lussier v San Lorenzo Valley Water Dist. (1988) 206 CA3d 92, 253 CR 470: §§5.2, 5.6, 5.18
Lyles v State (2007) 153 CA4th 281, 62 CR3d 696: §5.43

M

M.C. & D. Capital Corp. v Gilmaker (1988) 204 CA3d 671, 251 CR 178: §§1.29, 4.104
MAI Basic Four, Inc. v Basis, Inc. (10 Cir 1992) 962 F2d 978: §6.15
MBNA Am. Bank, N.A. v Gorman (2006) 147 CA4th Supp 1, 54 CR3d 724: §1.23
MCA, Inc. v Wilson (2d Cir 1981) 677 F2d 180: §6.22
MST Farms v C.G. 1464 (1988) 204 CA3d 304, 251 CR 72: §1.29
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Mackey v Lanier Collections Agency & Serv. (1988) 486 US 825, 100 L Ed 2d 836, 108 S Ct 2182: §3.66
Mackie v Rieser (9th Cir 2002) 296 F3d 909: §§6.16, 6.21
Mackinder v OSCA Dev. Co. (1984) 151 CA3d 728, 198 CR 864: §1.23
Macy's Cal., Inc. v Superior Court (1995) 41 CA4th 744, 48 CR2d 496: §§5.10, 5.34
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Magnuson-Hoyt v County of Contra Costa (1991) 228 CA3d 139, 278 CR 770: §5.44A
Mahon v Berg (1968) 267 CA2d 588, 73 CR 356: §§2.47, 4.5
Major v Western Home Ins. Co. (2009) 169 CA4th 1197, 87 CR3d 556: §1.58
Major-Blakeney Corp. v Jenkins (1953) 121 CA2d 325, 263 P2d 655: §2.28
Mandt, A. J., TC Memo 1955-226: §7.31
Mangini v Aerojet-General Corp. (1996) 12 C4th 1087, 51 CR2d 272 (Mangini II): §§5.2, 5.14, 5.28, 5.45, 5.47
Mangini v Aerojet-General Corp. (1991) 230 CA3d 1125, 281 CR 827 (Mangini I): §§5.5, 5.12, 5.14, 5.16-5.17, 5.27-5.28, 5.41, 5.44-5.45, 5.48
Manhattan Indus., Inc. v Sweater Bee by Banff, Ltd. (2d Cir 1989) 885 F2d 1: §6.29
Manuel J. Serpa, Jr., TC Memo 1998-453: §7.47
Manufacturers Technol., Inc. v Cams, Inc. (D Conn 1989) 728 F Supp 75: §6.23
Manville Sales Corp. v Paramount Sys., Inc. (Fed Cir 1990) 917 F2d 544: §6.1
Marcal Pulp & Paper, Inc. v Commissioner (3d Cir 1959) 268 F2d 739: §7.36
Marconi Wireless Tel. Co. v North Pac. S. S. Co. (1918) 36 CA 653, 173 P 103: §1.41
Marcus & Millichap Real Estate Inv. Brokerage Co. v Woodman Inv. Group (2005) 129 CA4th 508, 28 CR3d 584: §1.30
Marek v Chesny (1985) 473 US 1, 87 L Ed 2d 1, 105 S Ct 3012: §3.62
Marina Glencoe, L.P. v Neue Sentimental Film AG (2008) 168 CA4th 874, 85 CR3d 800: §4.95
Marine Terminals Corp. v Paceco, Inc. (1983) 145 CA3d 991, 193 CR 687: §1.20
Mariotti v Berns (1952) 114 CA2d 666, 251 P2d 72: §4.30
Markman v Westview Instruments, Inc. (Fed Cir 1995) 52 F3d 967: §6.13
Markowitz v Ikemoto (1958) 159 CA2d 242, 323 P2d 513: §4.69
Marquez v Screen Actors Guild (1998) 525 US 33, 142 L Ed 2d 242, 119 S Ct 292: §3.2
Marriage of McNeill (1984) 160 CA3d 548, 206 CR 641, disapproved on other grounds in 41 C3d at 451: §2.45
Marriage of Micalizio (1988) 199 CA3d 662, 245 CR 673: §2.38

Marriage of Stoll (1998) 63 CA4th 837, 74 CR2d 506: §§2.28, 2.38
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Martin v Cassidy (1957) 149 CA2d 106, 307 P2d 981: §4.78
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Martinez v Yancy (1919) 40 CA 503, 180 P 945: §4.2
Maryland Shipbuilding & Dry Dock Co. v U.S. (Ct Cl 1969) 409 F2d 1363: §7.42
Mason, People v (1981) 124 CA3d 348, 177 CR 284: §§5.7, 5.41, 5.53
Masonic Temple Ass'n v Stockholders Auxiliary Corp. (1933) 130 CA 234, 19 P2d 865: §4.72
Massachusetts v Morash (1989) 490 US 107, 104 L Ed 2d 98, 109 S Ct 1668: §3.88
Massachusetts Mut. Life Ins. Co. v Russell (1985) 473 US 134, 87 L Ed 2d 96, 105 S Ct 3085: §3.73
Massei v Lettunich (1967) 248 CA2d 68, 56 CR 232: §2.57
Mastro Plastics Corp. (1962) 136 NLRB 1342: §3.12
Mathews v MacArthur (1953) 119 CA2d 196, 258 P2d 1068: §2.28
Mathey v Commissioner (1st Cir 1949) 177 F2d 259, aff'g (1948) 10 TC 1099: §§7.34, 7.37
Maxwell v Fire Ins. Exch. (1998) 60 CA4th 1446, 70 CR2d 866: §1.58
Maxwell v J. Baker, Inc. (Fed Cir 1996) 86 F3d 1098: §6.11
Maye v Yappen (1863) 23 C 306: §5.32
Mayer v Multistate Legal Studies, Inc. (1997) 52 CA4th 1428, 61 CR2d 336: §3.95
Mayhew, Clifton D., Inc. v Wirtz (4th Cir 1969) 413 F2d 658: §3.42
Mays v Motorola, Inc. (ND Ill 1979) 22 FEP Cases 803: §3.53
McCarn v Pacific Bell Directory (1992) 3 CA4th 173, 4 CR2d 109: §1.46
McCarroll v Los Angeles County Dist. Council of Carpenters (1957) 49 C2d 45, 315 P2d 322: §3.82
McCarthy v Tally (1956) 46 C2d 577, 297 P2d 981: §4.106
McCauley v Dennis (1963) 220 CA2d 627, 34 CR 90: §2.55
McCoy v Olin Mathieson Chem. Corp. (SD Ill 1973) 360 F Supp 1336: §3.47
McCoy v Progressive W. Ins. Co. (2009) 171 CA4th 785, 90 CR3d 74: §1.58
McCoy v Superior Court (2007) 157 CA4th 225, 68 CR3d 483: §3.85
McCue v Bruce Enters., Inc. (1964) 228 CA2d 21, 39 CR 125: §§2.37-2.38, 6.40
McCulloch v Liguori (1948) 88 CA2d 366, 199 P2d 25: §§4.2-4.3, 4.9
McCulloch v M & C Beauty Colleges, Inc. (1987) 194 CA3d 1338, 240 CR 189: §4.96
McDonald v City of W. Branch (1984) 466 US 284, 80 L Ed 2d 302, 104 S Ct 1799: §3.106
McGregor v Paul Revere Life Ins. Co. (9th Cir 2004) 369 F3d 1099: §1.31
McHugh v Santa Monica Rent Control Bd. (1989) 49 C3d 348, 261 CR 318: §4.48
McIvor v Mercer-Fraser Co. (1946) 76 CA2d 247, 172 P2d 758: §§5.6, 5.38
McKean v Alliance Land Co. (1927) 200 C 396, 253 P 134: §5.19
McKim, Lauren W., TC Memo 1980-93: §7.14
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McLarand, Vasquez & Partners, Inc. v Downey Sav. & Loan Ass'n (1991) 231 CA3d 1450, 282 CR 828: §1.26
McLaughlin v Richland Shoe Co. (1988) 486 US 128, 100 L Ed 2d 115, 108 S Ct 1677: §§3.46, 6.13
McNairy v C.K. Realty (2007) 150 CA4th 1500, 59 CR3d 429: §4.34
McNally v Ward (1961) 192 CA2d 871, 14 CR 260: §4.37
McNeill v Bredberg (1961) 192 CA2d 458, 13 CR 580: §§2.37, 2.42
McNeill, Marriage of (1984) 160 CA3d 548, 206 CR 641, disapproved on other grounds in 41 C3d at 451: §2.45
McRoberts Software, Inc. v Media 100, Inc. (7th Cir 2003) 329 F3d 557: §6.16
Mead, W.L., Inc. v Teamsters Local 25 (D Mass 1955) 129 F Supp 313: §3.23
Mechanic, Morris A. (1960) 19 TC Memo 1960-126: §7.38
Medeiros v Medeiros (1960) 177 CA2d 69, 1 CR 696: §2.2
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Melone, Gerald (1966) 45 TC 501: §7.38
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Meninga v Raley's, Inc. (1989) 216 CA3d 79, 264 CR 319: §§3.97, 3.105
Menzies v Geophysical Serv., Inc. (1953) 116 CA2d 419, 254 P2d 51: §§4.75-4.76
Merced Irrig. Dist. v Woolstenhulme (1971) 4 C3d 478, 93 CR 833: §2.39
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Merrell v All Seasons Resorts, Inc. (CD Cal 1989) 720 F Supp 815: §3.97
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Merritt v Reserve Ins. Co. (1973) 34 CA3d 858, 110 CR 511: §1.57
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Michael J. Woods, TC Memo 1998-435: §7.47
Mike Davidov Co. v Issod (2000) 78 CA4th 597, 92 CR2d 897: §1.37
Miklosy v Regents of Univ. of Cal. (2008) 44 C4th 876, 80 CR3d 690: §3.96
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Miller v National Am. Life Ins. Co. (1976) 54 CA3d 331, 126 CR 731: §1.58
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Miller v Provost (1994) 26 CA4th 1703, 33 CR2d 288: §1.29
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Milman v Shukhat (1994) 22 CA4th 538, 27 CR2d 526: §2.12
Milton E. Ailes, TC Memo 1983-388: §7.38
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Mix v Tumanjan Dev. Corp. (2002) 102 CA4th 1318, 126 CR2d 267: §1.25
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Mock v Michigan Millers Mut. Ins. Co. (1992) 4 CA4th 306, 5 CR2d 594: §1.58
Mollala Holdings, Inc. v Akers (2002) 100 CA4th Supp 6, 123 CR2d 342: §1.27
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Moore v First Bank of San Luis Obispo (2000) 22 C4th 782, 94 CR2d 603: §1.28
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Morlife, Inc. v Perry (1997) 56 CA4th 1514, 66 CR2d 731: §6.36
Morris v American Nat'l Can Corp. (8th Cir 1991) 952 F2d 200: §3.52
Morris v Redwood Empire Bancorp (2005) 128 CA4th 1305, 27 CR3d 797: §1.44
Morris, Philip, USA v Williams (2007) 549 US 346, 166 L Ed 2d 940, 127 S Ct 1057: §§1.34, 3.96, 4.19, 4.65, 5.38, 6.38
Morris A. Mechanic (1960) 19 TC Memo 1960-126: §7.38
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Morse v Commissioner (Ct Cl 1967) 371 F2d 474; later proceeding (Ct Cl 1969) 186 Ct Cl 964: §7.41
Morse Trust v Commissioner (1947) 6 CCH TCM 855: §7.41
Moshonov v Walsh (2000) 22 C4th 771, 94 CR2d 597: §1.28
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Mountain Copper Co. v U.S. (9th Cir 1906) 142 F 625: §5.26
Muko, Larry V., Inc. v Southwestern Pa. Bldg. & Constr. Trades Council (3d Cir 1979) 609 F2d 1368: §3.37
Murdoch, John, Commissioner v (3d Cir 1963) 318 F2d 414: §7.27
Murphy v Kenneth Cole Prods., Inc. (2007) 40 C4th 1094, 56 CR3d 880: §3.88A
Murphy v Nielsen (1955) 132 CA2d 396, 282 P2d 126: §5.32
Musaelian v Adams (2009) 45 C4th 512, 87 CR3d 475: §§1.25, 4.96
Mustafa v Clark County Sch. Dist. (9th Cir 1998) 157 F3d 1169: §3.30
Myers, Paul F. v Commissioner (6th Cir 1961) 287 F2d 400: §7.38

N.R. v San Ramon Valley Unified Sch. Dist. (ND Cal, July 6, 2006, No. C-05-0441 SI) 2006 US Dist Lexis 47287: §1.26
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NMSBPCSLDHB v County of Fresno (2007) 152 CA4th 954, 61 CR3d 425: §2.2
Nancy J. Vincent, TC Memo 2005-95: §7.63
Nash v Superior Court (1978) 86 CA3d 690, 150 CR 394, overruled on other grounds in 29 C3d at 528: §2.17
Nasser v Superior Court (1984) 156 CA3d 52, 202 CR 552: §4.94
Nat Harrison Assocs., Inc. v Gulf States Util. Co. (5th Cir 1974) 491 F2d 578: §6.51
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Nathanson v NLRB (1952) 344 US 25, 97 L Ed 23, 73 S Ct 80: §3.13
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nCube Corp. v SeaChange Int'l, Inc. (Fed Cir 2006) 436 F3d 1317: §6.13
Neal v Farmers Ins. Exch. (1978) 21 C3d 910, 148 CR 389: §6.38
Nece v Bennett (1963) 212 CA2d 494, 28 CR 117: §§2.38-2.39
Nelkin & Co. v South Beverly Hills Wilshire Jewelry & Loan (2005) 129 CA4th 692, 28 CR3d 815: §6.43
Nevada Land & Inv. Corp. v Sistrunk (1934) 220 C 174, 30 P2d 389: §2.58
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New Horizons for the Retarded (1987) 283 NLRB 1173: §3.13
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NewWest Mortgage Co. v Home Loan Mortgage Co. (June 27, 2002) 2002 WL 1397020: §6.57
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Newhall Land & Farming Co. v Superior Court (1993) 19 CA4th 334, 23 CR2d 377: §§2.45, 5.12, 5.14, 5.16, 5.18, 5.27-5.28, 5.48
Newhart v Pierce (1967) 254 CA2d 783, 62 CR 553: §2.28
Newman v Smith (1888) 77 C 22, 18 P 791: §2.45
Ng v Warren (1947) 79 CA2d 54, 179 P2d 41: §4.30
Nguyen v Scott (1988) 206 CA3d 725, 253 CR 800: §2.44
Nichol v U.S. (Ct Cl 1943) 48 F Supp 662: §7.28
Nielsen v Farrington (1990) 223 CA3d 1582, 273 CR 312: §2.31
Ninety Five Ten v Crain (1991) 231 CA3d 36, 282 CR 141: §§1.7, 1.20
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Norman v Unemployment Ins. Appeals Bd. (1983) 34 C3d 1, 192 CR 134: §5.12
North Assocs. v Bell (1986) 184 CA3d 860, 229 CR 305: §4.94
North Oakland Med. Clinic v Rogers (1998) 65 CA4th 824, 76 CR2d 743: §1.20
Northbrook Excess & Surplus Ins. Co. v Coastal Rescue Sys. (1986) 182 CA3d 763, 227 CR 639: §1.31
Northwestern Title Sec. Co. v Flack (1970) 6 CA3d 134, 85 CR 693: §1.57
Nourafchan v Miner (1985) 169 CA3d 746, 215 CR 450: §4.51
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O

O. L. Shafter Estate Co. v Alvord (1906) 2 CA 602, 84 P 279: §4.75
O2 Micro Int'l Ltd. v Monolithic Power Sys., Inc. (ND Cal 2005) 399 F Supp 2d 1064: §6.34
OKC Corp. & Subsidiary (1984) 82 TC 638: §7.18
Oakland Cal. Towel Co. v Sivils (1942) 52 CA2d 517, 126 P2d 651: §1.19
O'Brien, Walter F. (1962) 38 TC 707, aff'd (3d Cir 1963) 319 F2d 532: §7.49
O'Connor v Televideo Sys. (1990) 218 CA3d 709, 267 CR 237: §1.44
O'Donnell v Georgia Osteopathic Hosp. (11th Cir 1984) 748 F2d 1543: §3.46
Ofsevit v Trustees of Cal. State Univs. & Colleges (1978) 21 C3d 763, 148 CR 1: §3.94
O'Gilvie v U.S. (1996) 519 US 79, 136 L Ed 2d 454, 117 S Ct 452: §7.29
Old Republic Ins. Co. v FSR Brokerage, Inc. (2000) 80 CA4th 666, 95 CR2d 583: §1.58
Oldenburg v Brody (1956) 139 CA2d 543, 293 P2d 844: §2.39
Oleck, William, TC Memo 1961-306: §§7.18, 7.39
Oliver v AT&T Wireless Servs. (1999) 76 CA4th 521, 90 CR2d 491: §5.5
Oliver v Benton (1949) 92 CA2d 853, 208 P2d 375: §§2.39, 2.45
Oliver v Campbell (1954) 43 C2d 298, 273 P2d 15: §1.53
Oliver, People v (1948) 86 CA2d 885, 195 P2d 926: §5.10
Ollie B. Rose (1947) 8 TC 854, acq 1947-2 Cum Bull 4: §7.29
Olson v Cory (1983) 35 C3d 390, 197 CR 843: §1.20
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O'Malley v Wilshire Co. (1963) 59 C2d 482, 30 CR 452: §3.82
Operating Eng'rs, U.S. v (ND Cal 1973) 6 Empl Prac Dec (CCH) P8946: §3.62
Orozco v Casimiro (2004) 121 CA4th Supp 7, 17 CR3d 175: §4.106
Orthokinetics, Inc. v Safety Travel Chairs, Inc. (Fed Cir 1986) 806 F2d 1565: §6.1
Ortiz v Bank of Am. Nat'l Trust & Sav. Ass'n (9th Cir 1987) 852 F2d 383: §3.52
Ortiz v U.S. (1st Cir 1979) 595 F2d 65: §3.21
Otay River Constructors v San Diego Expressway (2008) 158 CA4th 796, 70 CR3d 434: §1.23
Overgaard v Johnson (1977) 68 CA3d 821, 137 CR 412: §§2.35, 2.49
Overnite Transp. Co. (1966) 157 NLRB 1185, enforced (4th Cir 1967) 372 F2d 765: §3.14

P

P. J. Freiermuth Co. v Faustino (1932) 120 CA 136, 7 P2d 370: §4.46
PG&E v Zuckerman (1987) 189 CA3d 1113, 234 CR 630: §§2.38-2.39
PLCM Group, Inc. v Drexler (2000) 22 C4th 1084, 95 CR2d 198: §§1.25, 2.12, 4.96
PPG Indus., Inc. v Transamerica Ins. Co. (1999) 20 C4th 310, 84 CR2d 455: §1.58
Pacific Custom Pools, Inc. v Turner Constr. Co. (2000) 79 CA4th 1254, 94 CR2d 756: §§1.26, 4.93
Pacific Lumber Co. v Superior Court (1990) 226 CA3d 371, 276 CR 425: §6.49
Pacific Preferred Props., Inc. v Moss (1999) 71 CA4th 1456, 84 CR2d 500: §§1.23, 2.12, 2.48
Pacific Tel. & Tel. Co. v NLRB (9th Cir 1983) 711 F2d 134: §3.3
Pagliarulo, Robert, TC Memo 1994-506: §7.45
Painters Dist. Council No. 38 v Edgewood Contracting Co. (5th Cir 1969) 416 F2d 1081: §3.21
Pallco Enters., Inc. v Beam (2005) 132 CA4th 1482, 34 CR3d 490: §5.12
Palm v Schilling (1988) 199 CA3d 63, 244 CR 600: §2.32
Palm v Smither (1942) 52 CA2d 500, 126 P2d 428: §2.51
Palmer v Shawback (1993) 17 CA4th 296, 21 CR2d 575: §1.30
Palmer v Ted Stevens Honda, Inc. (1987) 193 CA3d 530, 238 CR 363: §§1.31, 2.47
Panduit Corp. v Stahlin Bros. Fibre Works Inc. (6th Cir 1978) 575 F2d 1152: §6.4
Paoli R.R.Yard PCB Litig., In re (3d Cir 1994) 35 F3d 717: §6.51
Paolini v Sulprizio (1927) 201 C 683, 258 P 380: §2.55
Pappas, Peter K., TC Memo 1962-203: §7.48
Paredez v Pillsbury Co. (CD Cal 1966) 259 F Supp 493: §3.47
Parham v Southwestern Bell Tel. Co. (8th Cir 1970) 433 F2d 421: §3.62
Park Magnolia v Fields (1987) 191 CA3d Supp 1, 236 CR 900: §4.97

Parker v Twentieth Century-Fox Film Corp. (1970) 3 C3d 176, 89 CR 737: §§1.53, 3.95
Parks v IRS (10th Cir 1980) 618 F2d 677: §3.81
Parks, James R. (1967) 26 TC Memo 1967-16: §7.38
Parlour Enters., Inc. v Kirin Group, Inc. (2007) 152 CA4th 281, 61 CR3d 243: §1.19
Parlour Enters., Inc. v Kirin Group, Inc. (2007) 149 CA4th 529, 57 CR3d 187: §1.19
Parrott v Barney (D Cal 1868) 18 F Cas 1249 (No. 10,773a): §4.60
Parsons v Luhr (1928) 205 C 193, 270 P 443: §5.25
Pasadena Live, LLC v City of Pasadena (2004) 114 CA4th 1089, 8 CR3d 233: §1.15
Pasadena Unified Sch. Dist. v Pasadena Fed'n of Teachers (1977) 72 CA3d 100, 140 CR 41: §3.82
Pasillas v ALRB (1984) 156 CA3d 312, 202 CR 739: §3.83
Passantino v Johnson & Johnson Consumer Prods., Inc. (9th Cir 2000) 212 F3d 493: §3.61
Pat G. Guidry, TC Memo 1994-127: §7.28
Pat Rose Assocs. v Coombe (1990) 225 CA3d 9, 275 CR 1, disapproved on other grounds in Adams v Murakami (1991) 54 C3d 105, 284 CR 318: §§2.47, 2.50
Paterno v State (1999) 74 CA4th 68, 87 CR2d 754: §5.4
Patrick, U.S. v (1963) 372 US 53, 9 L Ed 2d 580, 83 S Ct 618: §§7.4-7.5, 7.17
Patterson v American Tobacco Co. (4th Cir 1976) 535 F2d 257: §3.54
Patterson v McLean Credit Union (1989) 491 US 164, 105 L Ed 2d 132, 109 S Ct 2363: §§3.63-3.64
Paud v Alco Plating Corp. (1971) 21 CA3d 362, 98 CR 706: §3.108
Paul v Schoellkopf (2005) 128 CA4th 147, 26 CR3d 766: §1.22
Paul v U.S. (SD Ill 1972) 72-2 USTC ¶9720: §§7.8, 7.48
Paul E. Kempter, TC Memo 1963-68: §§7.6-7.7
Paul F. Myers v Commissioner (6th Cir 1961) 287 F2d 400: §7.38
Paularena v Superior Court (1965) 231 CA2d 906, 42 CR 366: §§2.2, 5.22
Pavlovich v Neidhardt (1954) 128 CA2d 559, 275 P2d 836: §§2.46, 2.54
Payne v Pathe Studios, Inc. (1935) 6 CA2d 136, 44 P2d 598: §1.53
Payton v City of Santa Clara (1982) 132 CA3d 152, 183 CR 17: §3.98
Pearl v Figoni (1942) 49 CA2d 662, 122 P2d 385: §4.46
Pecarovich v Becker (1952) 113 CA2d 309, 248 P2d 123: §1.47
Peckham v Gem State Mut. (10th Cir 1992) 964 F2d 1043: §3.66
Peerless Lighting Corp. v American Motorists Ins. Co. (2000) 82 CA4th 995, 98 CR2d 753: §6.57A
Pell v E.I. DuPont de Nemours & Co. (3d Cir 2008) 539 F3d 292: §3.70
Pennroad Corp. v Commissioner (3d Cir 1955) 228 F2d 329: §7.36
Pennroad Corp. (1954) 21 TC 1087, aff'd (3d Cir 1955) 228 F2d 329: §7.29
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Pennsylvania State Police v Suders (2004) 542 US 129, 159 L Ed 2d 204, 124 S Ct 2342: §3.48
People v Jones (1988) 205 CA3d Supp 1, 252 CR 216: §5.7
People v Mason (1981) 124 CA3d 348, 177 CR 284: §§5.7, 5.41, 5.53
People v Oliver (1948) 86 CA2d 885, 195 P2d 926: §5.10
People ex rel _____ (*see* name of relation)
Pepitone v Russo (1976) 64 CA3d 685, 134 CR 709: §§2.10, 2.46, 2.49
Perdue v Crocker Nat'l Bank (1985) 38 C3d 913, 216 CR 345: §1.44
Perez v Rodriguez Bou (1978) 575 F2d 21: §3.15
Perkins v Blauth (1912) 163 C 782, 127 P 50: §§5.31, 5.37
Perma Vinyl Corp. (1967) 164 NLRB 968: §3.14
Permanente Med. Group (1968) 52 Lab Arb 217: §3.107
Perry v Magneson (1929) 207 C 617, 279 P 650: §1.20
Perry v Robertson (1988) 201 CA3d 333, 247 CR 74: §1.23
Peter K. Pappas, TC Memo 1962-203: §7.48
Perry, Joseph M., TC Memo 1998-433: §7.47
Peters v Missouri Pac. R.R. (5th Cir 1973) 483 F2d 490: §3.53
Petersen v Hartell (1985) 40 C3d 102, 219 CR 170: §§2.15, 2.25, 2.60
Peterson v Air Line Pilots Ass'n, Int'l (4th Cir 1985) 759 F2d 1161: §3.35
Peterson v Larquier (1927) 84 CA 174, 257 P 873: §§4.2, 4.6
Peterson, C. Norman, Co. v Container Corp. of Am. (1985) 172 CA3d 628, 218 CR 592: §§1.11, 1.20
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Pettway v American Cast Iron Pipe Co. (5th Cir 1974) 494 F2d 211: §§3.49, 3.56
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Phelps Dodge Corp. v NLRB (1941) 313 US 177, 85 L Ed 1271, 61 S Ct 845: §§3.6, 3.10
Philip Chang & Sons Assocs. v La Casa Novato (1986) 177 CA3d 159, 222 CR 800: §§2.36, 2.42
Philip Morris USA v Williams (2007) 549 US 346, 166 L Ed 2d 940, 127 S Ct 1057: §§1.34, 3.96, 4.19, 4.65, 5.38, 6.38
Phillip Lee Allen, TC Memo 1998-406: §7.9
Phillippe v Shapell Indus., Inc. (1987) 43 C3d 1247, 241 CR 22: §2.30
Phillips v City of Pasadena (1945) 27 C2d 104, 162 P2d 625: §§5.15, 5.44
Phillips v Civil Serv. Comm'n (1987) 192 CA3d 996, 237 CR 751: §3.94

Phillips v Gemini Moving Specialists (1998) 63 CA4th 563, 74 CR2d 29: §1.55
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Pistorious v Prudential Ins. Co. (1981) 123 CA3d 541, 176 CR 660: §1.58
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Plumbing & Pipefitters Local 231 (1956) 115 NLRB 594: §3.16
Plumbing, Heating & Piping Employers Council v Quillin (1976) 64 CA3d 215, 134 CR 332: §4.109
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Poseidon Dev., Inc. v Woodland Land Estates (2007) 152 CA4th 1106, 62 CR3d 59: §1.44
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Post v Palpar, Inc. (1960) 184 CA2d 676, 7 CR 823: §§2.9, 2.60
Postal Instant Press, Inc. v Sealy (1996) 43 CA4th 1704, 51 CR2d 365: §1.19
Posz v Burchell (1962) 209 CA2d 324, 25 CR 896: §5.32
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Precision Window Mfg. v NLRB (8th Cir 1992) 963 F2d 1105: §3.6
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Prilliman v United Air Lines, Inc. (1997) 53 CA4th 935, 62 CR2d 142: §3.98
Priver v Young (1923) 62 CA 405, 216 P 966: §4.35
Profit Concepts Mgmt., Inc. v Griffith (2008) 162 CA4th 950, 76 CR3d 396: §1.23
Public Employees Retirement Sys. v Betts (1989) 492 US 158, 106 L Ed 2d 134, 109 S Ct 2854: §3.46
Public Employees' Retirement Sys. v Winston (1989) 209 CA3d 205, 258 CR 612: §§4.54, 4.94, 4.111
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Q

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Quesinberry v Life Ins. Co. of N. Am. (4th Cir 1993) 987 F2d 1017: §3.71
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R

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Rabago-Alvarez v Dart Indus. (1976) 55 CA3d 91, 127 CR 222: §§1.53, 3.95
Rabinowitch v California W. Gas Co. (1967) 257 CA2d 150, 65 CR 1: §§4.66, 4.109, 4.111
Railway Employees v Universal Carloading & Distrib. Co. (1969) 1 CA3d 145, 81 CR 516: §3.107
Ralph A. Boatman (1959) 32 TC 1188: §7.38
Ralph Freeman (1959) 33 TC 323: §§7.11, 7.41
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Rangel v Interinsurance Exchange (1992) 4 C4th 1, 14 CR2d 783: §1.58
Rankin v DeBare (1928) 205 C 639, 271 P 1050: §5.19
Raxton Corp. v Anania Assocs. (1st Cir 1982) 668 F2d 622: §6.29
Raymond v U.S. (2d Cir 2004) 355 F3d 107: §7.49
Raytheon Prod. Corp. v Commissioner (1st Cir 1944) 144 F2d 110: §§7.19, 7.30, 7.48
Razzano v Kent (1947) 78 CA2d 254, 177 P2d 612: §5.29
Read Corp. v Portec, Inc. (Fed Cir 1992) 970 F2d 816: §6.13

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Rebel v Peckham (1949) 94 CA2d 834, 211 P2d 883: §4.108
Redevelopment Agency v First Christian Church (1983) 140 CA3d 690, 189 CR 749: §§2.38-2.39
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Regal Knitwear Co. v NLRB (1945) 324 US 9, 89 L Ed 661, 65 S Ct 478: §3.14
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Renteria v County of Orange (1978) 82 CA3d 833, 147 CR 447: §3.97
Renton News Record (1962) 136 NLRB 1294: §3.5
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Rhodes v San Mateo Inv. Co. (1955) 130 CA2d 116, 278 P2d 447: §5.28
Rich v Schwab (1998) 63 CA4th 803, 75 CR2d 170: §1.37
Richard D. Anderson, TC Memo 2000-344: §7.25
Richard W. Kaase Co. (1967) 162 NLRB 1320: §3.7
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Ridgeley v Topa Thrift & Loan Ass'n (1998) 17 C4th 970, 73 CR2d 378: §2.22
Rifkin v Achermann (1996) 43 CA4th 391, 50 CR2d 661: §§2.11, 2.46
Ring, Carole & Assocs. v Nicastro (2001) 87 CA4th 253, 104 CR2d 519: §1.28
Ripley v Pappadopoulos (1994) 23 CA4th 1616, 28 CR2d 878: §§1.33, 4.110
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Rite-Hite Corp. v Kelley Co. (Fed Cir 1987) 819 F2d 1120: §6.13
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Roam v Koop (1974) 41 CA3d 1035, 116 CR 539: §1.15
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Robert C. Elliott, TC Memo 1987-333: §§7.25, 7.41
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Roberts v Lomanto (2003) 112 CA4th 1553, 5 CR3d 866: §2.34
Roberts v Permanente Corp. (1961) 188 CA2d 526, 10 CR 519: §5.17
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Roemer v Pappas (1988) 203 CA3d 201, 249 CR 743: §2.15

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Ronald N. Gross, TC Memo 2000-342: §7.25
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Rosemary S. Kovacs (1993) 100 TC 124, aff'd (6th Cir 1994) 25 F3d 1048: §§7.45-7.47
Rosen v Public Serv. Elec. & Gas Co. (3d Cir 1973) 477 F2d 90: §3.51
Rosen v Robert P. Warmington Co. (1988) 201 CA3d 939, 247 CR 635: §1.26
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Rosenkranz v Pellin (1950) 99 CA2d 650, 222 P2d 249: §4.99
Ross v Frank W. Dunne Co. (1953) 119 CA2d 690, 260 P2d 104: §1.40
Ross v Long Beach (1944) 24 C2d 258, 148 P2d 649: §4.65
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Rounds, Charles J., Co. v Teamsters No. 42 (1971) 4 C3d 888, 95 CR 53: §3.109
Royal Globe Ins. Co. v Superior Court (1979) 23 C3d 880, 153 CR 842: §1.58
Royer v Carter (1951) 37 C2d 544, 233 P2d 539: §§2.26, 2.28-2.30
Rozpad v Commissioner (1st Cir 1998) 154 F3d 1: §§7.46-7.47
Ruiz v Department of Corrections (2000) 77 CA4th 891, 92 CR2d 139: §3.97
Rulon-Miller v IBM Corp. (1984) 162 CA3d 241, 208 CR 524: §§1.54, 3.92
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S

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Saari v Jongordon Corp. (1992) 5 CA4th 797, 7 CR2d 82: §1.38
Saben, Earlix & Assocs. v Fillet (2005) 134 CA4th 1024, 36 CR3d 610: §1.29
Saberi v Bakhtiari (1985) 169 CA3d 509, 215 CR 359: §4.86
Saf-Gard Prod., Inc. v Service Parts, Inc. (D Ariz 1980) 491 F Supp 996: §6.6
Safeco Ins. Co. v Burr (2007) 551 US 47, 167 L Ed 2d 1045, 127 S Ct 2201: §6.32
Safeco Ins. Co. v J & D Painting (1993) 17 CA4th 1199, 21 CR2d 903: §5.27
Safeco Ins. Co. v Superior Court (1999) 71 CA4th 782, 84 CR2d 43: §1.58
Saferian v Baer (1930) 105 CA 238, 287 P 142: §4.14
Sager Glove Corp. v Commissioner (7th Cir 1962) 311 F2d 210: §§7.8, 7.48
Saint Agnes Med. Ctr. v PacifiCare (2003) 31 C4th 1187, 8 CR3d 517: §1.16
Salahutdin v Valley of Cal., Inc. (1994) 24 CA4th 555, 29 CR2d 463: §§2.49, 6.42
Sallee v Daneri (1942) 49 CA2d 324, 121 P2d 781: §4.60
Sam Teague Ltd. v Hawaii Civil Rights Comm'n (1999) 89 Haw 269, 971 P2d 1104: §3.50
Samson v Transamerica Ins. Co. (1981) 30 C3d 220, 178 CR 343: §1.58
Samuels v Singer (1934) 1 CA2d 545, 36 P2d 1098: §4.88
San Diego Bldg. Trades Council v Garmon (1959) 359 US 236, 3 L Ed 2d 775, 79 S Ct 773: §3.21
San Diego Gas & Elec. Co. v Superior Court (1996) 13 C4th 893, 55 CR2d 724: §§5.10, 5.18, 5.39
San Diego Teachers Ass'n v Superior Court (1979) 24 C3d 1, 154 CR 893: §3.82
San Diego Unified Sch. Dist. v County of San Diego (2009) 170 CA4th 288, 87 CR3d 796: §5.44A
San Francisco & Suburban Home Bldg. Soc'y v Leonard (1911) 17 CA 254, 119 P 405: §4.24
San Joaquin County Employees Ass'n v County of San Joaquin (1974) 39 CA3d 83, 113 CR 912: §3.82
Sanabria v Embrey (2001) 92 CA4th 422, 111 CR2d 837: §1.29
Sanchez v Bay Shores Med. Group (1999) 75 CA4th 946, 89 CR2d 634: §4.90
Sanchez-Corea v Bank of America (1985) 38 C3d 892, 215 CR 679: §1.19
Sanders v Commissioner (10th Cir 1955) 225 F2d 629: §7.6
Sanders v Park Beverly Corp. (1952) 109 CA2d 698, 241 P2d 597: §2.38
Sanders Constr. Co. v San Joaquin First Fed. Sav. & Loan Ass'n (1982) 136 CA3d 387, 186 CR 218: §5.54
Sands v Abelli (SD NY 1968) 290 F Supp 677: §3.25
Sanfran Co. v Rees Blow Pipe Mfg. Co. (1959) 168 CA2d 191, 335 P2d 995: §2.42
Sangster v Paetkau (1998) 68 CA4th 151, 80 CR2d 66: §2.54

Sanson v General Motors Corp. (11th Cir 1992) 966 F2d 618: §3.66
Santa Barbara Pistachio Ranch v Chowchilla Water Dist. (2001) 88 CA4th 439, 105 CR2d 856: §5.32
Santa Clara County Envt'l Health Ass'n v County of Santa Clara (1985) 173 CA3d 74, 218 CR 678: §1.20
Santa Fe Partnership v ARCO Prods. Co. (1996) 46 CA4th 967, 54 CR2d 214: §§5.28-5.29
Santisas v Goodin (1998) 17 C4th 599, 71 CR2d 830: §§1.27, 1.30, 2.48, 4.44, 4.95, 4.102
Saridakis v United Airlines (9th Cir 1999) 166 F3d 1272: §3.33
Sarkes Tarzian, Inc. v Audio Devices, Inc. (SD Cal 1958) 166 F Supp 250: §6.35
Saunders v Taylor (1996) 42 CA4th 1538, 50 CR2d 395: §2.36
Scaggs, Boz, Music v KND Corp. (D Conn 1980) 491 F Supp 908: §6.25
Schaeffer v San Diego Yellow Cabs, Inc. (9th Cir 1972) 462 F2d 1002: §3.48
Schaffter v Creative Capital Leasing Group, LLC (2008) 166 CA4th 745, 83 CR3d 19: §2.30
Schieldahl, G.T., Co. v Machinists Local 1680 (1st Cir 1968) 393 F2d 502: §3.109
Schleier, Commissioner v (1995) 515 US 323, 132 L Ed 2d 294, 115 S Ct 2159: §§7.25, 7.45
Schnierow v Boutagy (1917) 33 CA 336, 164 P 1132: §4.3
Scholey v Steele (1943) 59 CA2d 402, 138 P2d 733: §4.30
Schroeder v Auto Driveaway Co. (1974) 11 C3d 908, 114 CR 622: §§3.96, 6.43
Schwarz v Secretary of Health & Human Servs. (9th Cir 1995) 73 F3d 895: §3.62
Schweizer v Waiters & Bartenders Local 500 (1953) 121 CA2d 45, 262 P2d 568: §3.84
Scott v Mullins (1962) 211 CA2d 51, 27 CR 269: §4.78
Scott v TraveLodge Corp. (1968) 265 CA2d 881, 71 CR 547: §§4.28, 4.34, 4.109
Scott Co. v Blount, Inc. (1999) 20 C4th 1103, 86 CR2d 614: §1.29
Scripto-Tokai Corp. v Gillette Co. (CD Cal 1992) 788 F Supp 439: §6.6
Scurich v Ryan (1910) 14 CA 750, 113 P 123: §§4.18, 4.107
Seagate Technol., LLC, In re (Fed Cir 2007) 497 F3d 1360: §6.13
Seaman's Direct Buying Serv., Inc. v Standard Oil Co. (1984) 36 C3d 752, 206 CR 354: §1.36
Seamprufe, Inc. (1953) 106 NLRB 1143: §3.12
Seattle Times Co. v Seattle Mailer's Union (9th Cir 1982) 664 F2d 1366: §3.15
Seeger v Odell (1941) 18 C2d 409, 115 P2d 977: §2.51
Segura v McBride (1992) 5 CA4th 1028, 7 CR2d 436: §2.53
Seid Pak Sing v Barker (1925) 197 C 321, 240 P 765: §4.30
Selb Mfg. Co. v Machinists, Dist. 9 (8th Cir 1962) 305 F2d 177: §3.108
Selma Pressure Treating Co. v Osmose Wood Preserving Co. (1990) 221 CA3d 1601, 271 CR 596, disapproved on other grounds in Johnson v American Standard, Inc. (2008) 43 C4th 56, 74 CR3d 108: §5.20
Semore v Poole (1990) 217 CA3d 1087, 266 CR 280: §3.92
Sequeira v Rincon-Vitova Insectaries, Inc. (1995) 32 CA4th 632, 38 CR2d 264: §3.88
Sereboff v Mid Atl. Med. Servs. (2006) 547 US 356, 164 L Ed 2d 612, 126 S Ct 1869: §3.70
Serian Bros., Inc. v Agri-Sun Nursery (1994) 25 CA4th 306, 30 CR2d 382: §§1.19, 5.32
Serpa, Manuel J., Jr., TC Memo 1998-453: §7.47
Service Employees Int'l Union v Hollywood Park, Inc. (1983) 149 CA3d 745, 197 CR 316: §3.82
Seven-Up Bottling Co. v Grocery Drivers Union Local 848 (1953) 40 C2d 368, 254 P2d 544: §3.82
Shafter, O. L., Estate Co. v Alvord (1906) 2 CA 602, 84 P 279: §4.75
Shapiro v Sutherland (1998) 64 CA4th 1534, 76 CR2d 101: §1.32
Share v Casiano Bel-Air Homeowners Ass'n (1989) 215 CA3d 515, 263 CR 753: §1.27
Sheet Metal Workers Int'l Ass'n Local 355 v NLRB (1983) 716 F2d 1249: §3.19
Sheldon v Metro-Goldwyn-Mayer Pictures Corp. (1940) 309 US 390, 84 L Ed 825, 60 S Ct 681: §6.24
Shell v Schmidt (1958) 164 CA2d 350, 330 P2d 817: §1.50
Shelley v Hansen (1966) 244 CA2d 210, 53 CR 20: §1.51
Shepard v NLRB (1983) 459 US 344, 74 L ED 2d 523, 103 S Ct 665: §3.16
Sher v Leiderman (1986) 181 CA3d 867, 226 CR 698: §5.11
Shoemaker v Myers (1990) 52 C3d 1, 276 CR 303: §3.97
Shoemaker v Myers (1992) 2 CA4th 1407, 4 CR2d 203: §3.97
Shoeworkers Local 127 v Brooks Shoe Mfg. Co. (3d Cir 1962) 298 F2d 277: §3.23
Shook v Pearson (1950) 99 CA2d 348, 221 P2d 757: §4.3
Shultz v Wheaton Glass Co. (3d Cir 1970) 421 F2d 259: §3.43
Sid & Marty Kroft Television Prods., Inc. v McDonald's Corp. (9th Cir 1977) 562 F2d 1157: §6.17
Sidney Wanzer & Sons v Teamsters Local 753 (ND Ill 1966) 249 F Supp 664: §3.23
Siegel v Anderson Homes, Inc. (2004) 118 CA4th 994, 13 CR3d 462: §§5.27, 5.42
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Silberg v California Life Ins. Co. (1974) 11 C3d 452, 113 CR 711: §§1.35, 1.38
Siligo v Castellucci (1994) 21 CA4th 873, 26 CR2d 439: §1.23
Sill Prop., Inc. v CMAG, Inc. (1963) 219 CA2d 42, 33 CR 155: §§4.58, 4.113
Silver Creek, LLC v BlackRock Realty Advisors, Inc. (2009) 173 CA4th 1533, 93 CR3d 864: §1.26
Silverstein v Sisters of Charity (Colo Ct App 1976) 559 P2d 716: §3.30
Simen v Sam Aftergut Co. (1915) 26 CA 361, 146 P 1058: §4.68
Simmons v Avisco Textile Workers Local 713 (4th Cir 1965) 350 F2d 1012: §3.25

Simon v San Paolo U.S. Holding Co. (2005) 35 C4th 1159, 29 CR3d 379: §§1.34, 1.37, 2.47, 6.38
Simone v McKee (1956) 142 CA2d 307, 298 P2d 667: §2.49
Simpson v Reynolds Metals Co. (7th Cir 1980) 629 F2d 1226: §3.30
Simpson v Smith (1989) 214 CA3d Supp 7, 263 CR 110: §1.29
Sing, Seid Pak v Barker (1925) 197 C 321, 240 P 765: §4.30
Singer v Eastern Columbia, Inc. (1945) 72 CA2d 402, 164 P2d 531: §4.30
Sinyard v Commissioner (9th Cir 2001) 268 F3d 756, cert denied (2002) 536 US 904: §§7.49, 7.63
Sipe v Local 191, United Bhd. of Carpenters & Joiners (MD Pa 1975) 393 F Supp 865: §3.27
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Skelly v State Personnel Bd. (1975) 15 C3d 194, 124 CR 14: §3.94
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Small Prop. Owners v City & County of San Francisco (2006) 141 CA4th 1388, 47 CR3d 121: §4.54
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Snow v Commissioner (1974) 416 US 500, 40 L Ed 2d 336, 94 S Ct 1876: §7.62A
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Sommerville v Transworld Airlines, Inc. (ED Mo, Sept. 28, 1999, No. 4:96CV02379): §7.64
Sophia Coats, TC Memo 1977-407: §7.14
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Standard Havens Prods., Inc. v Gencor Indus., Inc. (Fed Cir 1991) 953 F2d 1360: §§6.4, 6.6
Standard Livestock Co. v Pentz (1928) 204 C 618, 269 P 645: §§4.15, 4.17
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Stantisas v Goodin (1998) 17 C4th 599, 71 CR2d 830: §2.12
Staples v Hoefke (1987) 189 CA3d 1397, 235 CR 165: §§5.17, 5.27
Starrh & Starrh Cotton Growers v AERA Energy LLC (2007) 153 CA4th 583, 63 CR3d 165: §§5.16, 5.27
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Stevens Linen Assocs., Inc. v Mastercraft Corp. (2d Cir 1981) 656 F2d 11: §6.19
Stewart v United States Bancorp (9th Cir 2002) 297 F3d 953: §3.92
Stillwell Hotel Co. v Anderson (1935) 4 C2d 463, 50 P2d 441: §4.15
Stocks, Eleanor L. (1992) 98 TC 1: §7.42
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Stoiber v Honeychuck (1980) 101 CA3d 903, 162 CR 194: §§4.38, 4.41-4.43
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Stone v Williams (2d Cir 1992) 970 F2d 1043: §6.15
Storage Servs. v Oosterbaan (1989) 214 CA3d 498, 262 CR 689: §2.47
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Stratton v Tejani (1982) 137 CA3d 758, 187 CR 231: §1.20
Strauss v A.L. Randall Co. (1983) 144 CA3d 514, 194 CR 520: §3.97
Strebel v Brenlar Invs., Inc. (2006) 135 CA4th 740, 37 CR3d 699: §2.49
Structural Steel & Ornamental Iron Ass'n, Inc. v Shopmens Local 545 (D NJ 1959) 172 F Supp 354: §3.23
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Suastez v Plastic Dress-Up Co. (1982) 31 C3d 774, 183 CR 846: §3.88
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Sutter v Madrin (1969) 269 CA2d 161, 74 CR 627: §2.31
Swaffield v Universal Ecsco Corp. (1969) 271 CA2d 147, 76 CR 680: §3.92
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T

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TWM Mfg. Co., Inc. v Dura Corp. (Fed Cir 1986) 789 F2d 895: §§6.9, 6.11
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Tameny v Atlantic Richfield Co. (1980) 27 C3d 167, 164 CR 839: §§1.54-1.55, 3.92, 3.96
Tanner v Tanner (1997) 57 CA4th 419, 67 CR2d 204: §1.30
Taracido, J.G., Estate of (1979) 72 TC 1014: §§7.12, 7.18
Taracorp Indus. (1984) 273 NLRB 221: §3.3
Tarrant v Butler (1960) 180 CA2d 235, 4 CR 230: §2.42
Taylor v Goodyear Tire & Rubber Co. (ND Ala 1973) 6 FEP 672: §3.62
Taylor v Meirick (7th Cir 1983) 712 F2d 1112: §§6.15-6.16, 6.20
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Theodore F. Vanderlaan, TC Memo 1962-130: §7.40
Thomas v Krug (1956) 139 CA2d Supp 941, 294 P2d 785: §2.50
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Thompson v Prudential Ins. Co. of Am. (D NJ 1992) 795 F Supp 1337, aff'd (3d Cir 1993) 993 F2d 226: §3.67
Thompson v Sawyer (DC Cir 1982) 678 F2d 257: §3.54
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Thrifty-Tel, Inc. v Bezenek (1996) 46 CA4th 1559, 54 CR2d 468: §6.43
Tidwell v American Oil Co. (D Utah 1971) 332 F Supp 424: §3.51
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Timney v Lin (2003) 106 CA4th 1121, 131 CR2d 387: §2.23
Tint v Sanborn (1989) 211 CA3d 1225, 259 CR 902: §§5.4, 5.40
Tomaselli v Transamerica Ins. Co. (1994) 25 CA4th 1269, 31 CR2d 433: §2.13
Tomko Woll Group Architects, Inc. v Superior Court (1996) 46 CA4th 1326, 54 CR2d 300: §5.44A
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Tooke v Allen (1948) 85 CA2d 230, 192 P2d 804: §§4.20, 4.112
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Totten v Hill (2007) 154 CA4th 40, 64 CR3d 357: §3.66
Track Mortgage Group, Inc. v Crusader Ins. Co. (2002) 98 CA4th 857, 120 CR2d 228: §1.31
Trading Port, Inc. (1975) 219 NLRB 298, 89 LRRM 1565: §3.15
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Transgo v Ajac Transmission Parts Corp. (9th Cir 1985) 768 F2d 1001: §6.24
Triad Data Servs. v Jackson (1984) 153 CA3d Supp 1, 200 CR 418, disapproved on other grounds in Smith v Rae-Venter Law Group (2002) 29 C4th 345, 127 CR2d 516: §3.87
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Trope v Katz (1995) 11 C4th 274, 45 CR2d 241: §§1.21, 1.25, 2.12, 2.48, 4.96, 5.36
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Tunkl v Regents of Univ. of Cal. (1963) 60 C2d 92, 32 CR 33: §1.46
Turner v Anheuser-Busch, Inc. (1994) 7 C4th 1238, 32 CR2d 223: §1.55
Turzillo v Commissioner (6th Cir 1965) 346 F2d 884: §7.6

U

U.S. v _____ (*see* name of defendant)
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UMW v Gibbs (1966) 383 US 715, 16 L Ed 2d 218, 86 S Ct 1130: §3.21
UMW v Osborne Mining Co. (8th Cir 1960) 279 F2d 716: §3.21
UMW v Patton (4th Cir 1954) 211 F2d 742: §3.21
UMW v Pennington (1965) 381 US 657, 14 L Ed 2d 626, 85 S Ct 1585: §§3.37-3.38
Ulane v Eastern Airlines, Inc. (7th Cir 1984) 742 F2d 1081: §3.48
Ullman, Commissioner v (2d Cir 1935) 77 F2d 827: §7.11
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Unger v Campau (1956) 142 CA2d 722, 298 P2d 891: §§2.36-2.37
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Union Oil Co. v Mutual Oil Co. (1937) 19 CA2d 409, 65 P2d 896: §5.32
Union Oil Co. v Reconstruction Oil Co. (1937) 20 CA2d 170, 66 P2d 1215: §5.32
Union Starch & Refining Co. v NLRB (7th Cir 1951) 186 F2d 1008: §3.19
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United States Fid. & Guar. Co. v Scott Cos. (ND Cal, Sept. 18, 2007, No. C-03-5376 SBA (EMC)) 2007 US Dist Lexis 71100: §4.110
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United States Pipe & Foundry Co. v NLRB (5th Cir 1968) 398 F2d 544: §3.14

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United Textile Workers Local 120 v Newberry Mills, Inc. (WD SC 1965) 238 F Supp 366: §3.23
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Universal Producing Co. (1971) 57 Lab Arb 1072: §3.107
Universities Research Ass'n v Coutu (1981) 450 US 754, 67 L Ed 2d 662, 101 S Ct 1451: §3.76
Upholsterers v Star Upholstery & Mfg. Co. (WD Pa 1960) 39 CCH Lab Cas ¶66,414: §3.23
Upton v Toth (1940) 36 CA2d 679, 98 P2d 515: §4.99
Ursic v Bethlehem Mines (3d Cir 1983) 719 F2d 670: §3.71
Utility Consumers' Action Network, Inc. v AT&T Broadband (2006) 135 CA4th 1023, 37 CR3d 827: §§1.42, 1.44, 2.21

V

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Vacco Indus., Inc. v Van Den Berg (1992) 5 CA4th 34, 6 CR2d 602: §§6.38-6.39
Valle de Oro Bank v Gamboa (1994) 26 CA4th 1686, 32 CR2d 329: §1.41
Vanderlaan, Theodore F., TC Memo 1962-130: §7.40
Vanelli v Reynolds Sch. Dist. (9th Cir 1982) 667 F2d 773: §3.94
Varity Corp. v Howe (1996) 516 US 489, 134 L Ed 2d 130, 116 S Ct 1065: §3.73
Varjabedian v City of Madera (1977) 20 C3d 285, 142 CR 429: §5.52
Vasey v California Dance Co. (1977) 70 CA3d 742, 139 CR 72: §4.87
Vaughn v Dame Constr. Co. (1990) 223 CA3d 144, 272 CR 261: §§5.27-5.28
Vella v Hudgins (1984) 151 CA3d 515, 198 CR 725: §4.97
Venable v Harmon (1965) 233 CA2d 297, 43 CR 490: §2.15
Venegas v Mitchell (1990) 495 US 82, 109 L Ed 2d 74, 110 S Ct 1679: §3.62
Venuto v Owens-Corning Fiberglas Corp. (1971) 22 CA3d 116, 99 CR 350: §§5.7, 5.12
Vermont Microsystems, Inc. v Autodesk, Inc. (2d Cir 1998) 138 F3d 449: §§6.36-6.37
Vernon Anderson, TC Memo 1979-309: §7.14
Vernon F. Burns, TC Memo 1994-284: §7.45
Victor E. Gidwitz Family Trust (1974) 61 TC 664, acq 1974-2 Cum Bull 2: §§7.8, 7.36
Vincent, Nancy J., TC Memo 2005-95: §7.63
Viner v Sweet (2003) 30 C4th 1232, 135 CR2d 629: §6.40
Vo v Las Virgenes Mun. Water Dist. (2000) 79 CA4th 440, 94 CR2d 143: §§3.62, 4.109
Vogelsang v Wolpert (1964) 227 CA2d 102, 38 CR 440: §2.51
Vowinckel v N. Clark & Sons (1932) 216 C 156, 13 P2d 733: §§5.51, 5.53
Vrgora v Los Angeles Unified Sch. Dist. (1984) 152 CA3d 1178, 200 CR 130: §1.43
Vucinich v Gordon (1942) 51 CA2d 434, 124 P2d 868: §4.106
Vuillemainroy v American Rock & Asphalt, Inc. (1999) 70 CA4th 1280, 83 CR2d 269: §3.98
Vuitton, Louis, S.A. v Spencer Handbags Corp. (2d Cir 1985) 765 F2d 966: §6.29
Vulcan Eng'g Co. v Fata Aluminium, Inc. (Fed Cir 2002) 278 F3d 1366: §6.13

W

W. Walley, Inc. v Commissioner (1948) 7 CCH TCM 137: §§7.12, 7.42
W.L. Mead, Inc. v Teamsters Local 25 (D Mass 1955) 129 F Supp 313: §3.23
W.W. Sly Mfg. Co. (1931) 24 BTA 65: §7.34
WYDA Assocs. v Merner (1996) 42 CA4th 1702, 50 CR2d 323: §2.16
Wachner, Brenda J., TC Memo 1995-88, amended 95 TNT 48-18: §7.41
Wade v Campbell (1962) 200 CA2d 54, 19 CR 173: §5.7
Wagner Constr. Co. v Pacific Mechanical Corp. (2007) 41 C4th 19, 58 CR3d 434: §1.16
Wagoner v Bennett (Okla 1991) 814 P2d 476: §4.19
Wakefield v Bohlin (2006) 145 CA4th 963, 52 CR3d 400: §2.48
Wal-Noon Corp. v Hill (1975) 45 CA3d 605, 119 CR 646: §4.30
Walker v Chanslor (1908) 153 C 118, 94 P 606: §4.24
Walker v Northern San Diego County Hosp. Dist. (1982) 135 CA3d 896, 185 CR 617: §3.92
Walker v Signal Cos. (1978) 84 CA3d 982, 149 CR 119: §§2.31, 2.47
Wallace v Hardee's Inc. (MD Ala 1995) 874 F Supp 374: §3.47
Walley, W., Inc. v Commissioner (1948) 7 CCH TCM 137: §§7.12, 7.42
Walpole v Prefab Mfg. Co. (1951) 103 CA2d 472, 230 P2d 36: §§1.39-1.40
Walsh v Hooker & Fay (1963) 212 CA2d 450, 28 CR 16: §2.49
Walt v Superior Court (1992) 8 CA4th 1667, 11 CR2d 278: §4.79
Walt Disney Co. v Powell (DC Cir 1990) 897 F2d 565: §6.25
Walter F. O'Brien (1962) 38 TC 707, aff'd (3d Cir 1963) 319 F2d 532: §7.49
Walters v Marler (1978) 83 CA3d 1, 147 CR 655, disapproved on other grounds in 35 C3d at 507: §§2.12, 2.40, 2.49
Wanland v Los Gatos Lodge, Inc. (1991) 230 CA3d 1507, 281 CR 890: §6.54
Wanzer, Sidney & Sons v Teamsters Local 753 (ND Ill 1966) 249 F Supp 664: §3.23
Ward v Taggart (1959) 51 C2d 736, 336 P2d 534: §2.47

Wards Cove Packing Co. v Atonio (1989) 490 US 642, 104 L Ed 2d 733, 109 S Ct 2115: §3.63
Warner Bros. Pictures, Inc. v Bumgarner (1961) 197 CA2d 331, 17 CR 171: §1.53
Warren v Merrill (2006) 143 CA4th 96, 49 CR3d 122: §2.34
Wasson v Sonoma County Jr. College (9th Cir 2000) 203 F3d 659: §3.80
Water Technols. Corp. v Calco, Ltd. (Fed Cir 1988) 850 F2d 660: §6.1
Waters v Churchill (1994) 511 US 661, 128 L Ed 2d 686, 114 S Ct 1878: §3.80
Waters v United Servs. Auto. Ass'n (1996) 41 CA4th 1063, 48 CR2d 910: §1.58
Watson v Department of Transp. (1998) 68 CA4th 885, 80 CR2d 594: §1.32
Watson Land Co. v Shell Oil Co. (2005) 130 CA4th 69, 29 CR3d 343: §5.30
Wattleton v Ladish Co. (ED Wis 1981) 520 F Supp 1329, aff'd on other grounds (7th Cir 1982) 686 F2d 586: §3.54
Wayte v Rollins Int'l (1985) 169 CA3d 1, 215 CR 59: §1.54
Webb v Jones (1927) 88 CA 20, 263 P 538: §4.88
Webber v Inland Empire Invs., Inc. (1999) 74 CA4th 884, 88 CR2d 594: §1.23
Weber v Board of Retirement (1998) 62 CA4th 1440, 73 CR2d 769: §1.20
Weber, Lipshie & Co. v Christian (1997) 52 CA4th 645, 60 CR2d 677: §1.42
Weingarten v Superior Court (2002) 102 CA4th 268, 125 CR2d 371: §1.37
Weisman, Frederick, Co. (1991) 97 TC 563: §7.36
Wells v B. F. Porter Estate (1928) 205 C 776, 272 P 1039: §4.15
Wells v Marina City Props. (1981) 29 C3d 781, 176 CR 104: §4.95
Weneda Corp. v Dispalatro (1964) 225 CA2d 187, 37 CR 267: §§2.8-2.9, 2.17
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X

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Y

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Z

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59 Ops Cal Atty Gen 321 (1976): §4.53

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Index

A B C D E F G H I J K L M N O P Q R S T U V W X Y Z

The symbol "" after a section number indicates thata form appears in the section.

Abandonment
Defined, 4.78
Termination of lease for tenant's abandonment. See **Termination of Lease**

Abatement of Nuisance. See **Nuisance**

ADA. See **Americans with Disabilities Act (ADA)**

Administrative Remedies
Wrongful termination, requirement of exhausting administrative procedures before bringing discrimination lawsuit under FEHA, 3.97

Admissibility of Evidence. See **Evidence**

Age Discrimination
Age Discrimination in Employment Act (ADEA), 3.46, 7.49B
Federal Service Labor Management Relations Act (FSLMRA), grievance procedure for age discrimination claims, 3.78

Agents
Statute of frauds requiring written contract for agent's commission, 2.30

Agricultural Products. See **Crops**

Air and Light
Encroachment by structure into airspace of adjacent land, nuisance remedies applicable to, 5.19
Private nuisance, blockage of air, light, or view not constituting, 5.11

Aliens
Immigration Reform and Control Act (IRCA)
Benefits claimed by undocumented aliens, review of cases involving, 3.54
Unfair labor practices, undocumented workers not entitled to back pay for unearned wages resulting from, 3.13A
Standing to assert prevailing wage claim, no preemption by federal immigration law, 3.93
Title VII, protection for undocumented alien workers under, 3.48

Alternative Minimum Tax (AMT)
Miscellaneous itemized deductions not allowed to AMT income, 7.62A

Amendments and Modifications
Injunction, defendant's application for modification or dissolution of, 5.53

Americans with Disabilities Act (ADA)
Generally, 3.31
Attorney fees in unlawful discrimination claims under ADA, deduction for, 7.49B
Prisoners, inapplicability of ADA to, 3.44

Anticipatory Breach of Contract. See **Breach of Contract (Generally)**

Antideficiency Statute
Breach of real property purchase and sale agreement, effect of antideficiency statute on, 2.32

Antitrust

See also **Sherman and Clayton Antitrust Acts**
Taxation of recoveries in antitrust litigation, 7.48

Appeals
Arbitrator's decision, standard for overturning, 3.106
Attorney fees, award on appeal, 1.29, 4.100, 4.109
Injunction, grounds for reversal on appeal, 5.53
Interest
Rent due, effect of plaintiff's failure to request trial court for interest on, 4.88
Settlement of case on appeal, taxation of interest, 7.46-7.47
Taxation income, appellate courts' positions on. See **Taxes**

Appraisals. See **Fraud Claims in Real Property Transactions**

Arbitration
See also **Mediation**
Age Discrimination in Employment Act (ADEA), arbitration of discrimination claims under, 3.46
Attorney fees
CC §1717 contract claim, prevailing party's right to attorney fees for postarbitration judicial proceedings, 1.28
Dismissal filed after arbitration award, effect on liability for previously awarded attorney fees, 1.26
Collective bargaining agreement, damage awards in arbitration under
Generally, 3.106
Computation of damages by arbitrator, 3.107
Disadvantages of, 1.5
Enforcement of arbitration award, 3.106
Federal Service Labor Management Relations Act (FSLMRA), grievances procedure with binding arbitration, 3.78
Labor Management Relations Act (LMRA)
NLRB declining jurisdiction in favor of arbitration, 3.22
Strike and refusal of union to arbitrate, employer's recovery of lost profits caused by, 3.23
Strikes. See **Strikes**

Art Works and Collectibles
Destruction or alteration of art, recovery of damages by artist for injury to reputation, 5.33

Assignment
Anticipatory assignment doctrine, effect on contingent fee agreement, 7.49A
Covenant against assignment of lease, landlord's termination of lease for tenant's breach of, 4.70

Attorney-Client Privilege
Patent infringement action, no adverse inference from assertion of attorney-client privilege, 6.13

Attorneys
Exclusive remedy rule of workers' compensation, inapplicability to exercising right to counsel under Public Safety Officer's Procedural Bill Of Rights Act, 3.97
Trespass or private nuisance, attorney's evaluation of case as equitable, legal, or hybrid action, 5.22

Attorneys' Fees
Age Discrimination in Employment Act (ADEA), recovery of fees under, 3.46, 7.49B
American rule, 1.21
Americans with Disabilities Act (ADA), award of fees under, 3.31
Appeal, award of fees in, 1.29, 4.100, 4.109
Arbitration. See **Arbitration**
Bad faith. See **Bad Faith**
Bargain with union, award of fees in action for employer's refusal to, 3.15
Breach of contract. See **Breach of Contract (Generally)**
Breach of real property purchase and sale agreement, buyer's recovery of fees, 2.12
Complaint lacking prayer for attorney fees, effect of, 4.87, 4.109
Copyright infringement action, recovery of fees in, 6.26
Corporate in-house counsel, recovery of fees by, 1.25, 2.12
Default judgment, restrictions on fee award as part of, 1.13
Definition of prevailing party, 1.23, 3.62
Dismissal of action, effect on fee recovery. See **Dismissal of Actions**
Employment contract, no recovery of fees as element of damages for breach of covenant of good faith and dealing, 3.96
ERISA, recovery of fees under, 3.71, 7.49B
Federal Service Labor Management Relations Act (FSLMRA), recovery of fees under, 3.79

Fraud in real property transaction, recovery of fees, 2.48
Implied covenant of good faith and fair dealing, award of fees for breach of, 1.31, 2.15
Indemnity. See **Indemnity**
Interpretation of statutes or contracts affecting fees. See **Construction and Interpretation**
Labor-Management Reporting and Disclosure Act (LMRDA), recovery of fees in action under, 3.26
Landlord and tenant. See **Landlord and Tenant**
Leases. See **Leases**
Limited civil cases. See **Limited Civil Cases**
Memorandum of costs, sufficiency to request fee award, 1.29
Nuisance. See **Nuisance**
Ownership of fee award
Generally, 7.64
Fair Employment and Housing Act (FEHA), attorney's ownership of fees awarded under, 7.63-7.64
Patent infringement actions, 6.13
Prevailing party, determination of, 2.48
Private Attorney General theory. See **Private Attorney General Theory**
Pro per attorney's recovery of attorney fees for opposing party's bad faith tactics, 4.96
Pro se litigant, prohibition against recovery of fees by, 2.12, 4.96
Quiet enjoyment, restrictions on recovery of fees in action against landlord for breach of covenant of, 4.18
Railway Labor Act, recovery of fees under, 3.33, 3.35
Rent control. See **Rent Control**
Sanctions, award of fees as. See **Penalties**
Sexual harassment, indemnification of falsely accused defendant for attorney fees, 3.81
Statutes awarding fees, 4.44, 4.93
Taxation of fee award. See **Taxes**
Title VII cases, recovery of fees in, 3.62
Trademark infringement action, recovery of fees in, 6.32
Trade secrets misappropriation claim, prevailing party's recovery of fees in, 6.39
Unlawful detainer action, recovery of fees in. See **Unlawful Detainer**
Warranty of habitability. See **Habitability, Breach of Warranty of**

At-Will Employment
Common law exceptions to, 3.92

Automobiles. See **Motor Vehicles**

Back Pay
Age Discrimination in Employment Act (ADEA), back pay provisions of, 3.46
Civil Rights Acts of 1866 and 1871, recovery of back pay in actions under, 3.64
Davis-Beacon Act, restrictions on private right of action for back pay under, 3.76
Deductions
Disability benefits, deduction from back pay, 3.95
Strike benefits, restrictions on deduction from back pay awards, 3.8
Unemployment compensation, no deduction from back pay award of, 3.9, 3.59, 3.95
Defined, 3.49, 3.51
Discrimination by employer for union activity, award of back pay. See **Labor Management Relations Act of 1947 (LMRA)**
Equal Pay Act, prejudgment interest on back pay award, 3.44
Equal pay, award of back pay for violating California statute mandating, 3.100
Federal Service Labor Management Relations Act (FSLMRA), recovery of back pay under, 3.79
Filing date of unpaid wage claim, calculation of back pay award from, 3.89
FLSA. See **Fair Labor Standards Act of 1938 (FLSA)**
Railway Labor Act, recovery of back pay under, 3.33-3.34
Reinstatement of employee. See **Reinstatement of Employee**
Strikes. See **Strikes**
Taxability of back pay award as ordinary income, 7.14
Termination of employee without due process, award of back pay based on, 3.94
Title VII, back pay awards under. See **Title VII**

Back Rent. See **Rent**

Bad Faith
AntiCybersquatting Consumer Protection Act, bad faith use of trademark in domain name as violation of, 6.28
Attorney fees
Implied covenant of good faith and fair dealing, fee award in action for bad faith breach of, 1.31

Pro per attorney's recovery of attorney fees for opposing party's bad faith tactics, limitations on, 4.96
Breach of contract. See **Breach of Contract (Generally)**
Security deposit, statutory damages for landlord or landlord's successor's bad faith retention of, 4.53

Bankruptcy and Insolvency
Attorney fees incurred in obtaining dismissal of party's bankruptcy proceeding
Generally, 1.27
Landlord's recovery of attorney fees after successfully moving to dismiss tenant's bankruptcy filing, 4.54
Rent control ordinance, nondischargeability of damage award for fraudulent collection of rents in excess allowed by, 4.48, 4.114

Basis
Capital gain or loss, basis of capital assets determining if portion of recovery taxable as, 7.11
Proof of basis, 7.41-7.42

Benefit of the Bargain Damages
Fraud in real property transaction, benefit-of-the bargain versus out-of-pocket rules, 2.35-2.36, 2.49

Benefits
Age Discrimination in Employment Act (ADEA), applicability to employee benefit plans, 3.46
Disability benefits. See **Disabled Persons**
Fair Labor Standards Act (FLSA), gender discrimination in benefits prohibited under, 3.43
Immigration Reform and Control Act (IRCA), review of cases involving benefits claimed by undocumented aliens, 3.54
Pension plans. See **Retirement and Pension Plans**
Strikes. See **Strikes**
Uniformed Services Employment and Reemployment Rights Act of 1994, employer's liability for benefits for refusal to reinstate employee, 3.47
Vacation benefits, terminated employee's entitlement to, 3.88

Borrowing Money. See **Breach of Contract (Generally)**

Breach of Contract (Generally)
Generally, 1.1
Analysis of contract damages problems
Negotiation (see Negotiation and drafting of contract, below)
Performance continues (see Performance, breach of contract with continued, below)
Potential or actual breach before litigation (see Potential or actual breach, handling before litigation, below)
Anticipatory breach of contract
Real property purchase and sale agreement, party's repudiation of contract as anticipatory breach, 2.5
Recovery of damages before other party's performance due, 1.7
Attorney fees
Generally, 1.21
Antipathy of court toward party, litigation strategy, or attorney, as improper basis for lowering fees, 2.12
Arbitration, award of CC §1717 fees in, 1.28
Bad faith breach of contract, recovery of fees in action for, 1.31
Examples of recovery under CC §1717, 1.23
Fiduciary duty, recovery of fees for breach of, 1.31
In-house counsel and attorney litigants, recovery of fees under CC §1717 by, 1.25, 2.12
Negotiating contract to provide for fees in event of breach, 1.3
Noncontractual claims, inapplicability of CC §1717 to, 1.27
Prevailing party, determination under CC §1717, 1.26
Procedure for recovery under CC §1717, 1.29
Reciprocal recovery of fees, parties' rights under CC §1717, 1.22-1.29, 2.12
Sanctions, unavailability to attorney litigants recovering fees as, 1.25
Secured lender's recovery of fees and costs in breach of contract action against borrower for breach of environmental covenant, 5.54
Statute limiting recovery of fees to prevailing plaintiff or prevailing defendant, effect of, 1.22
Statutes other than CC §1717, recovery of fees under, 1.30
Strangers to contract, recovery of fees under CC §1717 by, 1.24
"Tort of another" or "third party tort" doctrine, recovery of fees under, 1.32, 2.12
Trial court's lack of discretion to deny fee award to prevailing defendant, 1.26
Bad faith
Attorney fees, recovery in bad faith breach of contract action, 1.31
Existence of contract, unavailability of punitive damages for bad faith denial of, 1.36
Borrowing (see Loans, below)
Burden of proof

Party claiming damages, burden of proof on, 1.13

Breach of Contract (Generally)
Punitive damages, plaintiff's burden of producing evidence of defendant's financial condition, 1.37
Certainty of damages as requirement for recovery in breach of contract action, 4.112
Costs
Expert witness fees, recovery as costs by prevailing party, 1.33
Mitigation of damages, recovery of costs involved with, 1.41
Secured lender's recovery of fees and costs in breach of contract action against borrower for breach of environmental covenant, 5.54
Covenant of good faith and fair dealing, damages for breach limited to breach of contract damages, 3.92
Election of remedies, 1.53
Emotional distress damages, recovery of, 1.38, 3.92
Employment contracts. See **Employment Contracts**
Exemplary damages (see Punitive and nominal damages, below)
Fiduciary duty. See **Fiduciaries**
Franchise contract, unavailability of tort remedies for breach of, 1.55
Future damages, determination of, 1.7
Goodwill, recovery of damages for loss of, 1.39
Insurance contract, breach of. See **Insurance**
Interest (see Loans, below)
Leases. See **Leases**
Limits on amount of damages
Generally, 1.4
Liquidated damages (see Liquidated damages, below)
Mitigation of damages (see Mitigation of damages, below)
Public policy, contract with liability exemption for party's own fraud, willful injury to property, or violation of laws void, 1.46
Uncertain and speculative damages, rule against recovery of, 1.17, 1.40
Warranties, courts denying enforcement of unconscionable disclaimers of, 1.45
Liquidated damages
Generally, 1.42
Disadvantages of liquidated damages clause, 1.4
Processing charges or late fees, liquidated damages provisions disguised as, 1.44
Public contracts, liquidated damages clauses in, 1.43
Validity of liquidated damages clauses, 1.42
Loans
Interest on loan, restrictions on recoverability of, 1.20
Mitigation of damages, party not required to obtain insurance for collateral as condition to recovery on defaulted loan, 1.41
Secured lender's recovery of attorney fees and costs in breach of contract action against borrower for breach of environmental covenant, 5.54
Special damages, interest paid by plaintiff on loan for carrying out performance as, 1.49

Breach of Contract (Generally)
Measure of damages
Destruction of best evidence, effect on measure of damages, 3.23
Foreseeability requirement, 1.18
General and special damages, rule of *Hadley vs Baxendale,* 1.18
Money, measure of damages for failure to pay, 1.52
Negotiate agreement, measure of damages for breach of contract to, 1.59
Performance (see Performance (generally), below)
Speculative damages prohibited, 1.17, 1.40
Statutory provisions controlling, 1.17
Value of services in attempting to perform contract, measure of damages for, 1.40
Mental distress or physical suffering as result of breach of noninsurance contract, recovery of damages for, 1.38
Mitigation of damages
Generally, 1.41, 3.23
Punitive damages, defendant showing evidence of financial condition in mitigation, 1.37
Negotiation and drafting of contract
Generally, 1.2
Amount of recovery, drafting contract to improve, 1.3
Limiting amount of recovery, 1.4
Measure of damages for breach of contract to negotiate agreement, 1.59
Notice of claim as method for limiting amount of damages, 1.4
Venue and arbitration clauses, 1.5
Nominal damages (see Punitive and nominal damages, below)

Notice
Limiting amount of damages, notice of claim as method for, 1.4
Notice of breach and demand for performance, 1.7, 1.12
Performance (generally)
Defect in performance, measure of damages for, 1.50
Delay in performance, damages resulting from, 1.49
Partial performance, measure of damages for, 1.48
Prevention or obstruction of performance, measure of damages for, 1.51
Total failure to perform, measure of damages for, 1.47
Performance continued
Aggravation of damages, avoidance of, 1.10
Documentation of damages and conduct of parties, importance of, 1.11
Future breach result, avoidance of, 1.9
Notice of breach and demand for performance, 1.7
Security interests, protection of, 1.8
Performance not continued
Analysis and proof of client's recoverable damages, 1.13
Counterclaims and suits against third parties, counsel exploring possibility of, 1.13
Notice of claim and demand for performance, 1.12
Security rights, protection of, 1.12

Breach of Contract (Generally)
Potential or actual breach, handling before litigation
Generally, 1.6
Alternative or supplemental causes of action to breach of contract action, 1.15
Alternative or supplemental remedies to damages, 1.14
Examples of potential defendants, 1.15
Litigation checklist, 1.16
Tort and contract causes of action, avoiding election between, 1.15
Punitive and nominal damages
Generally, 1.34
Actual damages as prerequisite for award of punitive damages, 1.34
Bad faith denial of contract's existence, unavailability of punitive damages for, 1.36
Financial condition of defendant, plaintiff's burden of producing evidence of, 1.37
Independent tort, recovery of punitive damages in action involving, 1.35
Insurance contract, recovery of punitive damages in action involving breach of, 1.35
Publicity, recovery of nominal damages for loss of, 1.40
Reasonable relationship between punitive and actual damages, requirement of, 1.34
Rescission. See **Rescission**
Security interests
Environmental covenant, breach of contract action by secured lender against borrower for breach of, 5.54
Protection of security interests, 1.8, 1.12
Special damages
Interest paid by plaintiff on loan for carrying out performance as, 1.49
Measure of damages, 1.18
Specific items, recoverability of
Attorney fees (see Attorney fees, above)
Costs (see Costs, above)
Expert witness fees, prevailing party's recovery of, 1.33
Loans (see Loans, above)
Lost profits or benefits, 1.19, 1.51
Punitive damages (see Punitive and nominal damages, above)
Unauthorized services performed, plaintiff's recovery of damages for, 1.56

Breach of Covenant. See **Covenants**

Breach of Fiduciary Duty. See **Fiduciaries**

Breach of Lease Covenant. See **Lease Covenants**

Breach of Real Property Purchase and Sale Agreement
Generally, 2.1
Anticipatory breach, party's repudiation of contract as, 2.5
Buyer's breach
Generally, 2.16

Antideficiency statute, effect on seller, 2.32
Conditional performance by buyer, 2.16
Defenses for buyer, 2.32-2.33
Distinguishing between purchase agreement and installment land contract, 2.15
Late performance by buyer, effect of, 2.17
Liquidated damages clause, liberal interpretation in favor of buyer, 2.33
Offset of seller's loss against appreciated value of property, 2.29, 2.33
Seller's remedies (see Seller's remedies for buyer's breach, below)
Statute of limitations for action based on, 2.33
Buyer's damages
Attorney fees, recovery of, 2.12
Failure to convey title, damages for breach other than, 2.10
General damages under CC §3306, 2.9
Prejudgment interest, recovery of, 2.11
Punitive damages, 2.13
Defenses
Buyer's defenses, 2.32-2.33
Seller's defenses, 2.14
Deposit, seller's disposition of
Generally, 2.18
Actual damages, seller limited to in absence of liquidated damages clause, 2.20
Agreements executed before July 1, 1978, liquidated damages clause in, 2.21
Agreements executed on or after July 1, 1978, liquidated damages clause in, 2.22-2.24
Amount of liquidated damages, determining reasonableness of, 2.23
Burden of proof regarding reasonableness of liquidated damages clause, 2.18, 2.23
Failure of condition, buyer's entitlement to return of deposit on, 2.19
Liberal construction of liquidated damages provision in favor of buyer, 2.33
No liquidated damages clause, 2.19-2.20
Nonresidential real property, statutes governing liquidated damages clauses for, 2.24
Requirements for liquidated damages provision, 2.22-2.23
Residential real property purchase agreement, statutory protections for buyer under, 2.23
Validity of liquidated damages provisions, 2.22
Essentials of damages action
Definition of breach, 2.5
Inadequacy of remedies, 2.6
Jurisdiction, 2.3
Legal or equitable nature of action, 2.2
Selection of remedies, 2.7
Venue, 2.4
Expenses, seller's recovery of (see Special damages, seller's recovery of, below)
Fraud. See **Fraud Claims in Real Property Transactions**
Liquidated damages (see Deposit, seller's disposition of, above)
Partial breach, performance excused by material breach, 2.5
Performance by nonbreaching party, breach of contract excusing, 2.5
Reselling to new party after buyer's breach, seller's vulnerability in, 2.7
Seller's breach
Actions constituting breach, 2.9
Buyer's damages (see Buyer's damages, above)
Defenses for seller, 2.14
Initial steps by buyer after seller's breach, 2.8
Title (see Title, below)
Seller's damages
Antideficiency statute, effect on seller's recovery of damages, 2.32
Discounting price cash equivalent, 2.27
General damages, 2.25
Mitigation of damages, seller's duty concerning, 2.17, 2.25, 2.31
Proof of damages, 2.28
Rising or declining market, effect on seller's recovery of damages, 2.26
Special damages (see Special damages, seller's recovery of, below)
Seller's remedies for buyer's breach
Deposit (see Deposit, seller's disposition of, above)
Initial steps for seller after buyer's breach, 2.17
Seller's damages (see Sellers' damages, above)
Special damages, seller's recovery of
Broker's commission, seller recovering expenses from buyer, 2.30

Miscellaneous expenses recoverable by seller, 2.31
Resale expenses, seller's recovery of, 2.29
Specific performance
Alternative to damages, action for specific performance as, 2.6
Buyer's action for, 2.17
Mutually exclusive remedies, specific performance and damages as, 2.7
Required allegations in action for, 2.7
Seller's action for, 2.17
Title
Recovery of damages for breach other than failure to convey title, 2.10
Time specified in contract, breach consisting of failure to convey title within, 2.9
Valuation
Cash basis, valuation of property for assessing seller's damages, 2.27
Offset of seller's loss against appreciated value of property, 2.29, 2.33

Breach of Warranty. See **Warranties**

Brokers. See **Real Estate Brokers**

Burden of Proof
See also **Evidence; Proof**
Attorney fees, appellant's burden to furnish appellate court with adequate record when challenging award of, 4.109
Back pay, employer's burden of proof to show employee failed to mitigate damages by searching for interim employment, 3.11
Breach of contract. See **Breach of Contract (Generally)**
Breach of real property and purchase sale agreement, burden of proof regarding reasonableness of liquidated damages clause, 2.18, 2.23
Copyright infringement. See **Copyright Infringement**
Costs and expenses, tenant's burden to show deductibility of, 6.29
Fair Labor Standards Act (FLSA), burden of proof in action for liquidated damages against employer, 3.44
Fraud in real property transaction, burden of proof in, 2.34
Lost profits, plaintiff's burden of producing best evidence in establishing claim for, 1.19
Mitigation of damages, employer's burden of proving employee's failure concerning, 3.47
Nuisance. See **Nuisance**
Patent infringement, patent owner's burden of proof. See **Patent Infringement**
Prospective landlord's breach of agreement to execute lease, tenant's burden of proof to show ability to perform under lease, 4.7
Punitive damages, 2.34, 2.47, 6.38
Sale or exchange, taxpayer's burden of proof to show settlement of lawsuit involving oil and gas lease constitutes, 7.6
Security deposit, landlord's burden of proving reasonableness of amounts claimed under, 4.53
Statute of limitations barring cause of action, plaintiff's burden of pleading reasons for late discovery, 5.43
Taxpayer's burden to prove recovery relates to capital item rather than ordinary income item, 7.7, 7.19
Trademark infringement, plaintiff's burden to prove defendant's revenue, 6.29
Wrongful discharge in violation of public policy, employee's burden of proof, 1.55

Capital Gains and Losses
Allocation of recovery between lost profits and harm to capital, 7.39
Basis of capital assets determining if portion of recovery taxable as capital gain or loss, 7.11
Breach of covenant not to compete, recovery characterized as capital in nature, 7.33
Burden on taxpayer to prove recovery relates to capital item rather than ordinary income item, 7.7, 7.19
Contract rights not characterized as capital assets, 7.40
Distinction between recovery based on capital assets or ordinary nature, 7.8
Divorce settlement, effect of corporation redeeming half of taxpayer's stock, 7.36
Goodwill, capital gains treatment of damages recovered for injury to, 7.12, 7.18-7.19
Harm to capital assets, recovery based on, 7.8
Involuntary conversions, no gain recognized on, 7.9
Lost profits or capital asset, determining if recovery of damages for, 7.7
Proof of injury to capital assets, 7.41
Sale of residence, exclusion of gain on, 7.10
Sale or exchange as subject of lawsuit, capital gains treatment of award, 7.6
Underlying nature of claim determining if damages treated as capital or ordinary income, 7.17

Cartwright Act
Restraint of trade prohibited under, 3.84

CERCLA. See **Comprehensive Environmental Response, Compensation, and Liability Act (CERCLA)**

Charts, Checklists, Questionnaires, and Tables
Breach of contract, litigation checklist, 1.16
Intellectual property, checklist for suggested discovery in action for misappropriation of, 6.50

Childbirth. See **Pregnancy and Childbirth**

Children
Walsh-Healey Act, standards for child labor under, 3.75

Churches and Religious Organizations
Fair Employment and Housing Act (FEHA), inapplicability to religious corporation not organized for private profit, 3.92
Fair Labor Standards Act (FLSA), applicability to religiously connected businesses, 3.44

Civil Rights Act of 1964. See **Title VII**

Civil Rights Act of 1991
See also **Title VII**
Generally, 3.63
Attorney fees in unlawful discrimination cases, deduction for, 7.49B
Compensatory and punitive damages, recovery of, 3.31, 3.61
Expert fees, recovery of, 3.62
Statute of limitations for §1981 action, 3.63-3.64

Civil Rights Acts of 1866 and 1871
Race and alienage discrimination actions under, 3.64

Collectibles. See **Art Works and Collectibles**

Collective Bargaining. See **Labor Unions**

Colleges. See **Universities and Colleges**

Commercial Tenancies
Back rent, restrictions on landlord's recovery of, 4.86
Holdover by commercial tenant, liability to new tenant, 4.84
Security deposit, commercial tenant's right to recover punitive damages for landlord's bad faith retention of, 4.53

Commissions. See **Salaries and Compensation**

Common Law
At-will employment, common law exceptions to, 3.92
Habitability, common law implied warranty of. See **Habitability, Breach of Warranty of**
Intellectual property, common law remedies for misappropriation of. See **Intellectual Property**
Seller's duty to disclose facts materially affecting value or desirability of property, 5.54
Visual Artists Rights Act, preemption of common law right of recovery for injury to artist's reputation caused by destruction or alteration of art, 5.33

Compensation. See **Salaries and Compensation**

Competition. See **Covenants**

Complaints
See also **Cross-Complaints**
Attorney fees, effect of complaint lacking prayer for, 4.87, 4.109
Legal or equitable nature of action, prayer of complaint not conclusive in determining, 2.2
Special damages, specific pleading requirements for, 4.3
Unlawful detainer complaint. See **Unlawful Detainer**
Waste committed by tenant, landlord's request for treble damages, 4.60, 5.54

Comprehensive Environmental Response, Compensation, and Liability Act (CERCLA)
Generally, 5.54
Contribution actions under
Generally, 5.54
Prejudgment interest, recovery as cost in contribution actions under CERCLA, 5.37

Nuisance
Discovery of contamination, nuisance actions triggered by, 5.44A
Prejudgment interest, recovery as cost in contribution actions under CERCLA, 5.37

Concealment
Broker's concealment of termite report, recovery of punitive damages and damages for emotional distress, 2.47

Condemnation
Interest element of condemnation award, taxability of, 7.45

Condominium Association. See **Homeowners' Association**

Consent
Public nuisance, consent not defense to, 5.41, 5.48

Conspiracy
Sherman and Clayton Antitrust Acts, examples of illegal conspiracies under, 3.37

Constitutional Law
Due process
Public employees' due process (*Skelly*) rights before termination, 3.94
Punitive damages. See **Punitive Damages**
Treble damages for violation of rent control ordinance, no due process violation by awarding, 4.49
First Amendment
Peaceful picketing for lawful purpose, First Amendment protection for, 3.82
Political activities by employee, protection for, 3.80
Fourth Amendment, federal drug testing programs not violation of, 3.81
Privacy, constitutional right to privacy limiting or prohibiting certain employment practices by private employers, 3.99
Utility services, constitutionality of penalty against landlord for disconnecting, 4.45

Construction
Capital, recovery for construction defects representing return of, 7.41
Davis-Beacon Act, standards for wages and benefits of government contractors' employees, 3.76

Construction and Interpretation
See also **Definitions**
Anticipatory assignment doctrine, 7.49A
Attorney fees
Entire sales contract, applicability of fee provision to, 2.12
Reciprocity of fees under CC §1717, 1.24
Avoidable consequences doctrine, assessing FEHA damages under, 3.105
Continuing nuisance, construction of nuisance as, 5.16, 5.44
Fencing in rule, 5.17
Fencing out rule, 5.17
Home Equity Sales Contract Act, liberal construction of, 2.53
Lease provision for recovery of attorney fees, construction of provision in favor of prevailing party, 4.93
Liquidated damages provision, liberal interpretation in favor of buyer, 2.33
Public policy, contract with for liability exemption for party's own fraud, willful injury to property, or violation of laws void, 1.46
San Francisco rent control ordinance, 4.49
State labor laws, liberal interpretation of, 3.82
Tax benefit, liberal interpretation of, 7.31

Construction Defects
Homeowners' inability to recover in tort for negligent construction not resulting in actual damage, 5.10
Statute of repose for latent construction defects, 5.44A

Constructive Fraud
Elements of constructive fraud, 2.34
Real property purchase agreement, buyer's fraud as grounds for constructive fraud action, 2.51

Constructive Trust
Imposition of constructive trust, requirements for, 6.47
Intellectual property, constructive trust as remedy for misappropriation of. See **Intellectual Property**

Continuing Nuisance. See **Nuisance**

Continuing Trespass. See **Trespass**

Contracts
Breach of contract. See **Breach of Contract (Generally)**
Defined, 1.20
Employment contracts. See **Employment Contracts**
Installment land sale contract. See **Installment Land Sale Contract**
Intellectual property, quasi-contract recovery for misappropriation of. See **Intellectual Property**
Leases. See **Leases**
Quantum meruit. See **Quantum Meruit**
Real property purchase and sale agreement. See **Real Property Purchase and Sale Agreement**
Rescission. See **Rescission**
Unlawful detainer action, procedure for claiming contractual attorney fees, 4.102
Wrongful termination, recovery of contract damages, 3.95

Contribution. See **Comprehensive Environmental Response, Compensation, and Liability Act (CERCLA)**

Control Substances. See **Drugs**

Conversion
Intellectual property, measure of damages for conversion of, 6.43
Trade fixtures, tenant's action for conversion for landlord's wrongful withholding of, 4.46

Copyright Infringement
See also **Intellectual Property**
Actual damages
Generally, 6.16
Digital Millennium Copyright Act (DMCA), recovery of damages under, 6.27
Illegality no defense to damages, 6.27A
Loss in value of copyrighted material, 6.17
Lost profits (see Lost profits, below)
Market value of copyrighted material, testimony by copyright owner and expert witness establishing, 6.17
Measure of damages determined by value of use of copyrighted material, 6.18
Statutory damages as alternative to, 6.25
Attorney fees and costs, recovery of, 6.26
Burden of proof
Apportionment of profits between infringing and noninfringing elements, defendant's burden of proof to show, 6.24
Gross revenue of infringer, plaintiff's burden of proof to show, 6.21
Lost revenue as result of infringement, plaintiff's burden to establish, 6.19
Willful infringement, plaintiff's burden of proving, 6.25
Deductions (see Expenses and costs, below)
Defendant's profits, plaintiff's recovery of
Generally, 6.21
Apportionment of profits between infringing and noninfringing elements, 6.24
Burden of proof on plaintiff to show infringer's gross revenue, 6.21
Deductibility of defendant's expenses and costs from gross revenue attributable to infringement, restrictions on, 6.23
Digital Millennium Copyright Act (DMCA), recovery of infringer's profits under, 6.27
Gross revenues attributable to infringement, recovery of, 6.22
Indirect profits, recovery of, 6.22
Statutory damages as alternative to recovery of profits, 6.25
Digital Millennium Copyright Act (DMCA), recovery of damages under, 6.27
Expenses and costs
Generally, 6.26
Gross revenue attributable to infringement, restrictions on deducting defendant's expenses and costs from, 6.23
Lost profits, deduction of plaintiff's costs to determine amount of, 6.20
Lost profits
Burden on plaintiff to establish lost revenue as result of infringement, 6.19
Deduction of plaintiff's costs to determine amount of, 6.20
Defendant's profits (see Defendant's profits, plaintiff's recovery of, above)
Multiple infringements, recovery of statutory damages for, 6.25
Prejudgment interest, recovery of, 6.26A
Statute of limitations for copyright infringement action, 6.15
Statutory basis for damages, 6.15
Valuation (see Actual damages, above)
Willful versus nonwillful infringement, difference in statutory damages for, 6.15, 6.25

Corporations
Attorney fees, recovery by in-house counsel under CC §1717, 1.25, 2.12
Stock, taxation of recoveries in litigation involving, 7.36
Wrongful termination of employee, corporation's liability for punitive damages, 3.96

Costs
See also **Expenses and Expenditures; Fees**
Breach of contract action, recovery of costs in. See **Breach of Contract (Generally)**
Copyright infringement action. See **Copyright Infringement**
Eviction, recovering costs of, 4.91
Labor Management Relations Act (LMRA), lack of provision for recovery of costs in action under, 3.23
Negotiating contract to provide for costs of litigation in event of breach, 1.3
Nuisance action, recovery of costs in, 5.36
Prevailing party, recovery of costs by, 4.111
Rent control ordinance, tenant's recovery of costs in action against landlord for violating, 4.48
Tenant's burden to show deductibility of costs, 6.29
Unlawful detainer. See **Unlawful Detainer**
Warranty of habitability, statute governing award of costs in action for, 4.44

Covenants
Breach of covenant
Attorney fees award for breach of implied covenant of good faith and fair dealing, 1.31, 2.13
Lease covenant, breach of. See **Lease Covenants**
Quiet enjoyment, landlord's breach of covenant of. See **Quiet Enjoyment, Breach of Covenant of**
Repair, breach of covenant to. See **Repairs**
Secured lender's breach of contract action against borrower for breach of environmental covenant, 5.54
Competition, covenant against
Breach of covenant not to compete, taxation of damages, 7.33
Tenant's recovery of damages against landlord for breach of, 4.29
Implied covenant of good faith and fair dealing. See **Good Faith**
Improvements. See **Improvements**
Rent, tenant's covenant to pay. See **Rent**

Coworkers
Wrongful termination of employee in retaliation for testifying concerning coworker's sexual harassment claim, 1.55

Credit and Creditors
See also **Debts**
Property wrongfully taken by another, restrictions on owner's priority over other creditors, 6.49

Criminal Law
Antiunion activities as misdemeanor, 3.82
Attorney fees, statute permitting recovery in damages action based on defendant's felonious conduct, 1.30
ERISA, criminal sanctions for willful violations of, 3.69
Misrepresentation, criminal penalties for employer soliciting employees by, 3.101
Public nuisance, criminal indictment or information as remedy for, 5.20
Tenant's use of property for illegal purposes. See **Leases**
Union involved in illegal conduct, recovering of damages from, 3.21
Use-it-or-lose-it vacation policy as forfeiture, 3.88
Whistleblower disclosing information to governmental agency, misdemeanor to terminate or retaliate for, 3.93

Crops
Agricultural Labor Relations Act (ALRA), collective bargaining rights for agricultural workers under, 3.83
Lost profits
Damages to crops characterized as, 7.39
Taxability of recovery for lost profits due to damaged crops, 7.7
Trespass. See **Trespass**

Cross-Complaints
See also **Complaints**
Voluntary dismissal of entire action, effect of defendant filing cross-complaint on plaintiff's ability to enter, 4.95

Customer Lists
Trade secret misappropriation of, 6.35

Dangerous Condition or Activity
Nuisance resulting in dangerous condition or activity, comparative negligence as defense to action for, 5.40

Davis-Beacon Act
Standards for wages and benefits of government contractors' employees, 3.76

Debts
See also **Credit and Creditors**
Purchase price adjustments, debt reductions characterized as, 7.42
Tax treatment of discharge of indebtedness income, 7.35

Deductions
Attorney fees in unlawful discrimination cases, deduction for, 7.49B
Back pay. See **Back Pay**
Copyright infringement. See **Copyright Infringement**
Trademark infringement, deductibility of costs and expenses from defendant's profits, 6.29

Deeds of Trust. See **Mortgages and Deeds of Trust**

Defamation
Workers' compensation, defamation claims not preempted by, 3.98

Default and Default Judgments
Attorney fees, restrictions on award as part of default judgment, 1.13

Default of Obligations
Installment land sale contract, redemption of property by buyer after default, 2.60
Real property purchase and sale agreement, requirements for seller placing buyer in default, 2.17

Defective Construction. See **Construction Defects**

Defenses
Breach of lease covenant by landlord, defenses in action based on, 4.34
Fair Labor Standards Act (FLSA), defenses available to employer in action under, 3.42
Fraud by buyer in real property transaction as defense for seller, 2.51
Laches. See **Laches**
Nuisance. See **Nuisance**
Real property purchase and sale agreement, defenses to breach of. See **Breach of Real Property Purchase and Sale Agreement**
Setoff claimed by seller against unpaid and past-due payments owed by defrauded buyer, 2.54
Statute of limitations. See **Statutes of Limitations**
Title VII action, employer's good faith not defense to request for back pay award, 3.57
Trespass. See **Trespass**
Unlawful detainer action, raising defense of implied warranty of habitability in, 4.38

Definitions
See also **Construction and Interpretation**
Abandonment, 4.78
Attorney fees, 4.91
Back pay, 3.49, 3.51
Back rent, 4.86
Breach of contract, 2.5
Caravan sales, 6.2
Competition, landlord's breach of covenant against, 4.14
Constructive eviction, 4.14
Contingent risk, 3.62
Contract, 1.20
Cost rule, 1.50
Damages adequate to compensate (for patent infringement), 6.1
Deprivation of utility service, 4.45
Direct product, 6.46
Encroachment, 5.19
Exemplary damages, 4.5

Fair-value use of premises, 4.2
Fraud, 2.47
Front pay, 3.54
Future damages, 4.87
General damages (breach of contract), 1.18
Gross income, 7.16
Gross revenues attributable to copyright infringement, 6.22
Improvements, 2.42
Indirect costs, 6.23
Installment land contract, 2.15
Installment land sale contract, 2.60
Intangibles, 6.43
Judgment, 7.1
Jurisdictional strikes, 3.82
Land sale contract, 2.15
Malice, 3.96, 6.38
Marketing contracts, 2.15
Net earnings, 3.9
Nominal damages, 1.34
Noneconomic damages, 5.40
Nuisance, 5.2
Out-of-pocket expenses, 2.36
Owner of real property, 2.38
Personalty, 4.75
Preliminary fact, 6.56
Prevailing parties, 3.62
Price erosion damages, 6.9
Proffered evidence, 6.56
Property, 6.40
Public nuisance, 5.7
Purchase agreement for residential property, 2.23
Real property sale contract, 2.60
Security deposit, 4.52
Settlement, 7.1
Special damages, 4.12
Strict foreclosure, 2.60
Tort damages, 3.96
Trespass, 5.17-5.18
Unfair labor practice, 3.21
Value rule, 1.50
Willful (patent infringement), 6.13
Willful (trade secret misappropriation), 6.38

Delay
Performance of contract, damages resulting from delay in, 1.49
Waiver of right to terminate lease, tenant's delay in acting after landlord's interference with beneficial enjoyment resulting in, 4.16

Deposits
Breach of real property purchase and sale agreement, seller's disposition of deposit. See **Breach of Real Property Purchase and Sale Agreement**
Escrow. See **Escrow**
Security deposits. See **Security Deposits**

Destruction of Property
Measure of damages for, 5.33

Digital Millennium Copyright Act (DMCA)
Copyright infringement, recovery of damages for, 6.27

Diminution in Value. See **Valuation**

Disabled Persons
ADA. See **Americans with Disabilities Act (ADA)**
Back pay, deduction of disability benefits from, 3.95
Federal Service Labor Management Relations Act (FSLMRA), grievance procedure for disability discrimination claims, 3.78

Rehabilitation Act of 1973, discrimination against disabled persons prohibited by employers receiving federal funds, 3.30

Disclaimers
Warranties, courts denying enforcement of unconscionable disclaimers of, 1.45

Disclosure
ERISA, disclosure requirements under, 3.68
Federal Privacy Act, protection against disclosure of personal information by federal agency, 3.81
Seller's duty to disclose facts materially affecting value or desirability of property, 5.54
Whistleblowers. See **Whistleblowers**

Discovery
Intellectual property, checklist for suggested discovery in action for misappropriation of, 6.50
Nuisance action, recovering discovery costs in, 5.36
Punitive damages claim, trial court allowing discovery of defendant's financial condition, 1.37
Sanctions, restrictions on recovery of expenses and attorney fees by pro se litigant, 4.96

Discretion of Court
Attorney fees, award of. See **Attorneys' Fees**
Costs, court's discretion to award, 4.92
Equitable or legal nature of action, court's role in deciding, 2.2
Jury trial for equitable issues, court's discretion in allowing, 2.2
Patent infringement, court's discretion to award prejudgment interest, 6.14
Waste committed by tenant, court's discretion to award landlord treble damages, 4.60

Discrimination
Age discrimination. See **Age Discrimination**
Attorney fees in unlawful discrimination cases, deduction for, 7.49B
Civil Rights Act of 1991. See **Civil Rights Act of 1991**
Disabled persons, discrimination against. See **Disabled Persons**
Federal Service Labor Management Relations Act (FSLMRA), grievances procedure with binding arbitration, 3.78
FEHA. See **Fair Employment and Housing Act (FEHA)**
LMRA, employee's protection against employer's discriminatory actions under. See **Labor Management Relations Act of 1947 (LMRA)**
Racial discrimination. See **Racial Discrimination**
Sex discrimination. See **Sex Discrimination**
Title VII. See **Title VII**

Dismissal of Actions
Attorney fees
Bankruptcy proceeding, recovery of fees in obtaining dismissal of. See **Bankruptcy and Insolvency**
Contract cause of action, no recovery of fees after dismissal of, 2.12
Filing dismissal after arbitration award, effect on liability for previously awarded fees, 1.26
Prevailing party for attorney fees, effect of dismissal in determining, 4.95
Voluntary dismissal, effect on award based on contractual fee agreement, 1.30, 4.102
Cross-complaint filed by defendant, effect on plaintiff's ability to dismiss entire action, 4.95

Dismissal of Employee. See **Termination of Employment**

Dissolution of Marriage
Corporation redeeming half of taxpayer's stock as part of divorce settlement, effect on capital gains taxation, 7.36

Drugs
Narcotics Nuisance Abatement Act, landlord's liability and forced sale of property under, 4.39

Drug Testing
Americans with Disabilities Act (ADA), employer's drug testing program not violation of, 3.31
Fourth Amendment, federal drug testing programs not violation of, 3.81
Privacy rights of employee, termination of employee for refusal to submit to unannounced drug test as violation of, 3.99

Due Process. See **Constitutional Law**

Earnings. See **Salaries and Compensation**

Easements
Air, light, or view, lack of easement for, 5.11
Nuisance action involving easement over private land for public works, consent as defense in, 5.48

Educational Employment Relations Act (EERA)
Collective bargaining rights for elementary, secondary, and community college employees under, 3.82

Electromagnetic Fields
Property owners prohibited from suing public utility for diminution in value damages caused by, 5.39

Eminent Domain
Expert's testimony on lost goodwill in eminent domain proceeding, 6.57

Emotional Distress
Breach of contract, restrictions on recovery of damages for emotional distress, 1.38, 3.92
Civil Rights Acts of 1866 and 1871, recovery of emotional distress damages under, 3.64
Conversion of tenant's personal property, recovery of emotional distress damages against landlord for, 4.46
Destruction or alteration of art, no recovery of emotional distress damages by artist for, 5.33
Eviction, recovery of damages for, 4.20
Fair Employment and Housing Commission's authority to award damages for emotional injuries, 3.105
Fraud in real property transaction, recovery of emotional distress damages, 2.45, 2.47
Intentional infliction of emotional distress
Elements of prima facie case for, 1.38
Statute of limitations for recovery of damages for intentional infliction of emotional distress, 4.38
Warranty of habitability, claim for intentional infliction of emotional distress in action for breach of, 4.38
Labor Management Relations Act (LMRA), no recovery of mental distress damages under, 3.23
Nuisance or trespass, recovery of damages for mental suffering caused by, 5.34
Predisciplinary due process requirements, award of emotional distress damages against employer for failure to follow, 3.94
Real property purchase and sale agreement, recovery of emotional distress damages for breach of, 2.13
Title VII action, lack of recovery for mental distress damages in, 3.55
Trebling of award for mental anguish in action for violation of rent control ordinance, 4.49
Workers' compensation exclusive remedy rule, emotional distress claim precluded by, 3.97-3.98
Wrongful termination, recovery of emotional distress damages for, 3.96-3.98

Employee Retirement Income Security Act (ERISA)
Generally, 3.65
Attorney fees, recovery of, 3.71, 7.49B
Civil and criminal penalties for violation of, 3.69
Fiduciaries
Breach of duty, fiduciary's personal liability for, 3.74
Definition and duties of, 3.69
Measure of damages for loss to pension fund, 3.73
Preemption of state law under, 3.66
Punitive damages, restrictions on award of, 3.72
Remedies available under ERISA, 3.70
Reporting and disclosure requirements, 3.68
Scope of ERISA coverage, 3.67
Vacation wages not covered by, 3.88
Wrongful termination claim involving employee benefit plan, preemption by ERISA, 3.92

Employers and Employees
See also **Labor Law**
Back pay. See **Back Pay**
Civil Rights Act. See **Civil Rights Act of 1991**
Constitutional protections for employees. See **Constitutional Law**
Discrimination. See **Discrimination**
FEHA. See **Fair Employment and Housing Act (FEHA)**
FLSA. See **Fair Labor Standards Act of 1938 (FLSA)**
Fraud. See **Fraud and Misrepresentation**
Misrepresentations about employees. See **Fraud and Misrepresentation**
Political activities by employees. See **Political Activities by Employees**
Public employees. See **Public Entities and Employees**
Reinstatement of employee. See **Reinstatement of Employee**
Retaliation. See **Retaliation Against Employee**
Salaries. See **Salaries and Compensation**

Termination of employment. See **Termination of Employment**
Title VII. See **Title VII**
Unions. See **Labor Unions**
Wages. See **Wages and Hours**
Workers' compensation. See **Workers' Compensation**
Wrongful termination, employee's recovery of damages for, 1.53

Employment Contracts
Breach of contract
Generally, 1.53
Attorney fees, no recovery as element of damages for breach of covenant of good faith and fair dealing, 3.96
Foley vs Interactive Data Corp., rule of, 1.54
Post-*Foley* cases, effect on tort remedies for wrongfully discharged employees, 1.55
Tort remedies in wrongful termination cases, restrictions on, 1.54
Commission contracts by out-of-state employers, statutory requirements for, 3.104
Existence of implied contract as question for jury, 3.92
NLRB terminating contract between employer and union based on employer's domination of union, 3.16

Encroachment
Nuisance or trespass, encroachment treated as, 5.19
Punitive damages for, 5.38

Environmental Law
Attorney fees award in environmental litigation, 5.36
CERCLA. See **Comprehensive Environmental Response, Compensation, and Liability Act (CERCLA)**
Hazardous materials. See **Hazardous Materials and Toxic Waste**
Secured lender's breach of contract action against borrower for breach of environmental covenant, 5.54

Equal Access to Justice Act
Environmental litigation, award of attorney fees in, 5.36

Equal Pay
Statutory basis for, 3.100

Equal Pay Act (Federal)
Back pay award, prejudgment interest on, 3.44

ERISA. See **Employee Retirement Income Security Act (ERISA)**

Escrow
Interest
Fraud in real property transaction, recovery of prejudgment interest on buyer's escrow deposit, 2.46
Prejudgment interest on buyer's escrow deposit, seller's breach of sales agreement resulting in recovery of, 2.11
Request to place escrow funds in interest-bearing account, 2.6
Replacement of purchase and sale agreement by note and deed of trust at escrow, 2.15

Eviction
Breach of lease by tenant as grounds for, 5.54
Constructive eviction defined, 4.14
Costs of eviction, recovery of, 4.91
Forcible detainer. See **Forcible Entry or Detainer**
Physical injury suffered as proximate result of eviction, recovery of damages for, 4.20
Quiet enjoyment. See **Quiet Enjoyment, Breach of Covenant of**
Rent control ordinance, eviction in violation of. See **Rent Control**
Retaliatory eviction of tenant for complaining of premise's tenantability, 4.36

Evidence
See also **Burden of Proof; Proof**
Breach of contract action, effect of destruction of best evidence on measure of damages, 3.23
Converted property, admissibility of owner's opinion regarding value of, 6.43
Copyright infringement, plaintiff's projection plus sales based on supporting documentary or other evidence, 6.19
Expert testimony. See **Experts and Expert Witnesses**
Fraud in real property transactions. See **Fraud Claims in Real Property Transactions**
Proffered evidence defined, 6.56

Exchange of Property. See **Sale or Exchange of Property**

Execution of Documents. See **Leases**

Exemplary Damages. See **Punitive Damages**

Expenses and Expenditures
See also **Costs; Fees**
Admissibility of cost of repairs to prove actual value of property, 2.37
Back pay awarded to employees on strike, reimbursement of medical expenses improperly excluded from coverage under employer's group plan, 3.7
Breach of contract action, limits on party incurring expenses to mitigate damages, 1.41
Copyright infringement. See **Copyright Infringement**
Environmental cleanup, recovering costs of, 5.54
Fraud in real property transaction, recovery of expenditures made in reliance on fraud, 2.43
No-strike clause, employer's recovery of overhead expenses for union's violation of, 3.23
Nuisance, owner's liability for costs of abating, 5.20
Patent infringement, inappropriateness of adding fixed or overhead costs to hypothetically increased sales, 6.6
Pro se litigant, restrictions on recovery of discovery expenses by, 4.96
Real property purchase and sale agreement, seller's recovery of expenses after buyer's breach of. See **Breach of Real Property Purchase and Sale Agreement**
Runaway shops, NLRB requiring employers to offer employees moving expenses or transportation costs between old and new locations, 3.17
Trademark infringement, deductibility of costs and expenses from defendant's profits, 6.29
Work-related expenses or losses, indemnification of employee for, 3.91

Experts and Expert Witnesses
California evidence code, requirements for expert opinion testimony under
Permitted basis for expert's opinion, 6.54
Procedure for establishing foundation of expert's testimony, 6.56
Reliable data and methods, economic expert's testimony based on, 6.57
Requirement for establishing foundation for expert opinion, 6.55
Factual basis for expert's opinions, requirements for
California evidence code (see California evidence code, requirements for expert opinion testimony under, above)
Federal Rules of Evidence (see Federal Rules of Evidence, requirements for factual basis for expert's opinions, below)
Federal Rules of Evidence, requirements for factual basis for expert's opinions
Foundation of expert testimony, procedure for establishing, 6.52
Permitted basis for expert's opinions, 6.51
Reliable data and assumptions, economic expert's testimony based on, 6.53
Fees
Generally, 4.110
Breach of contract action, recovery of expert witness fees in, 1.33
Civil Rights Act of 1991, recovery of expert fees under, 3.62
Unlawful detainer action, restrictions on recovery of witness fees in, 4.90
Fraud in real property transaction, owner or expert witness's testimony used to establish market value, 2.38
Intellectual property
Copyright infringement action, testimony by expert witness establishing market value of copyrighted material, 6.17
Federal Rules of Evidence (see Federal Rules of Evidence, requirements for factual basis for expert's opinions, above)
Patent infringement, expert testimony supporting price erosion damages as result of, 6.9
Rental value, expert testimony establishing, 4.11

Extension and Shortening of Time
Attorney fee motion, stipulation to extend time for, 4.104
Back pay, unconditional offer of reinstatement shortening eligibility period for, 3.10

Fair Employment and Housing Act (FEHA)
Generally, 3.105
Attorney fee award to prevailing party, attorney's ownership of, 7.63-7.64
Private and public employers, applicability of FEHA to, 3.92
Wrongful termination, requirement of exhausting administrative procedures before bringing discrimination lawsuit under FEHA, 3.97

Fair Labor Standards Act of 1938 (FLSA)
Generally, 3.39

Age Discrimination in Employment Act (ADEA) incorporating remedies of FLSA, 3.46
Back pay
Generally, 3.41
Statute of limitations for back pay suit under FLSA, 3.45
Burden of proof in action for liquidated damages against employer, 3.44
Defenses available to employer in action under, 3.42
Examples of application of Act, 3.44
Exemption of types of employees from, 3.40, 3.44
Gender discrimination in pay prohibited under, 3.43
Remedies under, 3.41

Federal Labor Law. See **Labor Law**

Federal Preemption
Americans with Disabilities Act (ADA) not preempted under NLRA, 3.31
ERISA, preemption of state law under, 3.66
Immigration Reform and Control Act (IRCA), state law concerning immigrant's status in regards to labor, civil rights, and employment law claims not preempted by, 3.13A
LMRA. See **Labor Management Relations Act of 1947 (LMRA)**
Visual Artists Rights Act, preemption of common law right of recovery for injury to artist's reputation caused by destruction or alteration of art, 5.33

Federal Service Labor Management Relations Act (FSLMRA)
Generally, 3.77
Grievances
Back pay and attorney fees, recovery of, 3.79
Procedure for grievance with binding arbitration, 3.78

Fees
See also **Costs; Expenses and Expenditures**
Attorney fees. See **Attorneys' Fees**
Expert witness fees. See **Experts and Expert Witnesses**
Liquidated damages provisions disguised as late fees, 1.44
Penalties. See **Penalties**

FEHA. See **Fair Employment and Housing Act (FEHA)**

Fiduciaries
Breach of fiduciary duty
Attorney fee award in action for, 1.31
Emotional distress damages, recovery for breach of fiduciary obligation, 1.38
Tax treatments of settlement of action for, 7.29
ERISA, fiduciary duty under. See **Employee Retirement Income Security Act (ERISA)**
Fraud committed by fiduciary in real property transaction, recovery of damages for, 2.49
Intellectual property misappropriation, recovery of lost profits in claims against fiduciaries, 6.42

First Amendment. See **Constitutional Law**

Fixtures
See also **Trade Fixtures**
Punitive damages, landlord's recovery for tenant's wrongful removal of fixtures, 4.76
Removal of fixtures, tenant's liability for
Generally, 4.75
Measure of damages for removal or destruction of fixtures, 5.33
Statute of limitations for wrongful removal of fixtures, 4.77

Forcible Entry or Detainer
Generally, 4.22
Measure of damages
Attorney fees, restrictions on recovering, 4.26
General damages, 4.23
Interest on damages prohibited, 4.26
Nominal damages, tenant's recovery of, 4.26
Punitive damages, requirements for, 4.25
Special damages, 4.24

Statutory damages on showing of malice, 5.54
Statute of limitations for filing action, 4.27
Writ of possession, tenant obtaining, 4.22

Foreclosure
Fraud in real property transaction, effect of foreclosure on recovery of damages from seller, 2.57
Installment land sale contract, foreclosure by seller, 2.60

Foreseeability
Breach of contract action, foreseeability test measure of damages for, 1.18

Forfeiture
Use-it-or-lose-it vacation policy as forfeiture, 3.88

Franchises
Breach of franchise contract, unavailability of tort remedies for, 1.55

Fraud and Misrepresentation
Constructive fraud. See **Constructive Fraud**
Defined, 2.47
Employees
Former employee, statute prohibiting misrepresentation concerning, 3.102
Solicitation of employees by misrepresentation, statute prohibiting, 3.101
Wrongful termination of employee, restrictions on recovering damages for fraud or deceit, 1.55
Intellectual property, recovery of damages for fraud and deceit in misappropriation of. See **Intellectual Property**
Public policy, contract with liability exemption for party's own fraud, willful injury to property, or violation of laws void, 1.46
Punitive damages award against party fraudulently inducing another party to enter into contract, 1.35
Rent control ordinance, nondischargeability in bankruptcy of damage award for fraudulent collection of rents in excess allowed by, 4.48
Taxation of recovery of damages for fraud, 7.24, 7.28
Wrongful termination, restrictions on tort recovery based on fraud, 3.98

Fraud Claims in Real Property Transactions
Generally, 2.34
Actual value as market value
Cost of repairs, admissibility to prove actual value of property, 2.37
Methods of establishing value for real property, 2.39
Opinion testimony of owner or expert witness, establishing market value through, 2.38
Prices paid for other properties, admissibility of, 2.39
Proving market value, 2.37
Admissibility of evidence (see Actual value as market value, above)
Appraisals (see Actual value as market value, above)
Burden of proof in fraud action, 2.34
Buyer as victim, measure of damages for
Generally, 2.35
Actual value (see Actual value as market value, above)
Additional damages arising from transaction, plaintiff's recovery of, 2.40-2.48
Attorney fees, recovery of, 2.48
Benefit-of-the bargain versus out-of-pocket rules, 2.35-2.36, 2.49
Consequential or additional damages, out-of-pocket losses not required for recovery of, 2.40
Emotional distress damages, 2.45, 2.47
Equitable remedies versus damages, 2.50
Expenses made in reliance on fraud, recovery of, 2.43
Fiduciary, recovery of damages for fraud committed by, 2.49
Interest, restrictions on recovery of, 2.46
Litigation considerations (see Litigation considerations, below)
Lost profits, buyer's recovery of, 2.44
Negligent and intentional misrepresentation by fiduciary, distinction between, 2.49
Personal injury damages, recoverability in fraud actions, 2.45
Punitive damages, pleading requirements for, 2.47
Repairs and improvements, buyer's recovery of expenditures made on, 2.42
Time and money spent in reliance on fraud, recoverability of, 2.41
Constructive fraud. See **Constructive Fraud**
Elements of fraud, 2.34
Installment land sale contracts, special rules applicable to, 2.60

Litigation considerations
Continued performance by buyer under contract after discovery of fraud, effect of, 2.58
Foreclosure on property, effect on recovering damages from seller, 2.57
Mitigation of damages by defrauded party, 2.54, 2.55
Real Estate Recovery Fund, recovering unsatisfied monetary judgments against real estate licensees from, 2.59
Rents, buyer's right to collect after discovering fraud, 2.56
Sale by buyer for equal or higher price before discovery of fraud, effect on recovery from seller, 2.57
Setoff against unpaid and past-due payments owed by defrauded buyer, 2.54
Market value (see Actual value as market value, above)
Measure of damages
Buyer as victim (see Buyer as victim, measure of damages for, above)
Seller as victim (see Seller as victim, measure of damages for, below)
Out-of-pocket losses (see Buyer as victim, measure of damages for, above)
Punitive damages
Pleading requirements for, 2.47
Seller's recovery of, 2.51, 2.53
Seller as victim, measure of damages for
Generally, 2.51
Litigation considerations (see Litigation considerations, above)
Lost profits, seller's recovery of, 2.44, 2.52
Punitive damages, seller's recovery of, 2.51, 2.53
Statutory protection for sellers of residential real property, 2.53

Frivolous Actions
Attorney fee as sanction for, 4.97

Front Pay
Title VII action, recovery of front pay in, 3.54

Future Damages
Age Discrimination in Employment Act (ADEA), recovery of future damages under, 3.46
Breach of contract, determination of future damages, 1.7
Labor Management Labor Relations Act (LMRA), employer's recovery of future damages against union for breach of contract, 3.23
Permanent nuisance, recovery for future damages, 5.29
Unlawful detainer action, court prohibited from awarding future damages in, 4.87
Wrongful termination, recovery of damages for lost future earnings, 3.96

Future Profits. See **Profits**

Gains. See **Capital Gains and Losses**

Gas. See **Oil and Gas**

Good Faith
Attorney fees award for breach of implied covenant of good faith and fair dealing, 1.31, 2.13, 3.96
Breach of contract damages, damages for breach of covenant of good faith and fair dealing limited to, 3.92
Fair Labor Standards Act (FLSA), employer's good faith defense under, 3.42
Insurance contract, implied covenant of good faith and fair dealing in. See **Insurance**
Nuisance or trespass, effect of defendant's good faith effort to control on award of damages for, 5.38
Public employers, applicability of covenant of good faith and fair dealing to, 3.94
Termination of employee in violation of implied covenant of good faith and fair dealing, 3.92
Title VII action, employer's good faith not defense to request for back pay award, 3.57
Tort remedies, unavailability for breach of implied covenant of good faith and fair dealing in wrongful termination cases, 1.54

Goodwill
Breach of contract action, restrictions on recovery of damages for loss of goodwill, 1.39
Expert's testimony on lost goodwill in eminent domain proceeding, 6.57
Taxability of recovery of damages for injury to goodwill. See **Taxes**

Grievances
FSLMRA. See **Federal Service Labor Management Relations Act (FSLMRA)**
Unions. See **Labor Unions**
Wrongful termination, no requirement of employee pursuing matter through internal grievance procedures, 3.97

Groundwater Contamination. See **Hazardous Materials and Toxic Waste**

Guaranties
Negotiating contract to provide for guarantor of performance, 1.3

Habitability, Breach of Warranty of
Generally, 4.38
Abatement of condition, landlord's duty concerning, 4.39
Attorneys' fees and costs
Statute governing, 4.44
Unlawful detainer arising from breach of habitability induced failure to pay, availability of fees for defense to, 4.35
Availability of damages, 4.38
General damages
Attorney fees and costs (see Attorneys' fees and costs, above)
Determining amount of damages caused by breach of warrant, difference in value or percentage reduction, 4.40
Discomfort and annoyance, restrictions on recovery of damages for, 4.41
Reasonable rent payable by tenant during period of breach, determining amount of, 4.40
Punitive damages, tenant's recovery of, 4.43
Special damages, recovery of, 4.38-4.39, 4.42
Statutory damages, 4.39

Handicapped Persons. See **Disabled Persons**

Harassment
See also **Sexual Harassment**
Union's harassing tactics during labor negotiations, permissibility of, 3.20

Hazardous Materials and Toxic Waste
California environmental law, recovery of damages under, 5.54
CERCLA. See **Comprehensive Environmental Response, Compensation, and Liability Act (CERCLA)**
Cleanup, recovering costs of, 5.54
Clean Water Act, claims under, 5.54
Nuisance
Continuing nuisance or trespass, requirements for finding groundwater contamination as, 5.16
Private nuisance, soil contamination as, 5.9
Private property rights of plaintiff, groundwater and soil contamination as injury to, 5.13
Statute of limitations for pollution cases, 5.45

Health and Safety
Walsh-Healey Act, standards for wages, hours of work, child labor, health and safety of employees under, 3.75

Hearings
Public employee's right to pre-termination hearing, 3.94
Wages, hearing on claim for, 3.89-3.90

Holdover Tenant
Measure of damages for wrongful holding over, 5.54
New tenant, holdover tenant's liability to, 4.84
Statute of limitations for recovering damages from holdover tenant, 4.85
Trespasser, landlord's election to treat tenant as, 4.83
Unlawful detainer action, statutory damages for malicious holding over, 4.87

Home Equity Sales Contract Act, 2.53

Homeowners' Association
Capital, recovery for construction defects representing return of, 7.41

Homosexuality. See **Sexual Orientation**

Immigration Reform and Control Act (IRCA). See **Aliens**

Improvements

See also **Repairs**
Continuing nuisance, improvement as, 5.44A
Covenants
Landlord's recovery of damages for breach of covenant to improve, 4.68
Tenant's recovery for landlord's breach of covenant to pay for improvements, 4.32
Defined, 2.42
Fraud in real property transaction, buyer's recovery of expenditures made on improvements, 2.42
Rescission of contract, depreciation of repairs for time buyer in possession of property, 2.50

Indemnity
Attorney fees
CC §1717, inapplicability to indemnity provisions providing for attorney fees, 1.27
Sexual harassment action, indemnification of falsely accused defendant for attorney fees, 3.81
Statutory basis for recovery of fees by party prevailing on claim for implied indemnity, 1.30
Negotiating contract to provide for indemnity in event of breach, 1.3
Prejudgment interest award in indemnity action, 1.20
Work-related expenses or losses, indemnification of employee for, 3.91

Individual Retirement Accounts (IRAs)
Reimbursement of embezzled funds by Savings and Loan, nontaxability of, 7.43

Inferences. See **Presumptions and Inferences**

Infringement of Intellectual Property. See **Intellectual Property**

Injunctions
Appeal, grounds for reversal on, 5.53
Copyright infringement action, injunctive relief in, 6.15
Fair Labor Standards Act (FLSA), injunctive relief under, 3.41
Minimum wage and overtime provisions, injunctive relief for violation of, 3.100
Modification or dissolution of injunction, defendant's application for, 5.53
Nuisance. See **Nuisance**
Strike, injunction against. See **Strikes**
Title VII, injunctive relief under, 3.48
Trademark infringement, inadequacy of injunctive relief, 6.28
Trespass, injunction against, 5.13, 5.30
Venue for injunctive relief action, 5.24

Injury to Real Property. See **Real Property**

In Limine Motions
Combined legal and equitable claims, motion in limine to set order and procedure for hearing, 2.2
Expert testimony, motion in limine to exclude, 6.52

In Propria Persona
Attorney fees and sanctions, party representing self not entitled to, 2.12, 4.96, 5.36

Insolvency. See **Bankruptcy and Insolvency**

Installment Land Sale Contract
Generally, 2.60
Distinguishing real property purchase agreement and installment land contract, 2.15
Liquidated damages provision, 2.22
Redemption rights, 2.25, 2.60

Insurance
Attorney fees, recovery in action for bad faith breach of implied covenant of good faith and fair dealing, 1.31
Breach of covenant to insure, tenant's liability for, 4.74
Breach of insurance contract
Examples of courts enforcing implied covenant of good faith and fair dealing, 1.58
Implied covenant of good faith and fair dealing, recovery of damages for breach of, 1.57
Mitigation of damages in breach of contract action, party not required to obtain insurance for collateral as condition to recovery on defaulted loan, 1.41
Punitive damages, recovery in action involving breach of insurance contract, 1.35
Intellectual property litigation, insurance as source for collection of damages in, 6.57A

Lost profits, taxability of insurance proceeds for, 7.7
Negotiating contract to provide for insurance in event of breach, 1.3

Intellectual Property
Common law, remedies for misappropriation under
Conversion, measure of damages for, 6.43
Fraud (see Fraud and deceit, recovery of damages for, below)
Restitution (see Restitution based on quasi-contract or unjust enrichment, below)
Constructive trust remedy
Generally, 6.47
Property subject to constructive trust, 6.49
Unjust enrichment, constructive trust and quasi-contract claims based on, 6.48
Expert witness, required factual basis for opinions of. See **Experts and Expert Witnesses**
Fraud and deceit, recovery of damages for
Generally, 6.40
Lost profits as additional or consequential damages for nonfiduciary claims, 6.41
Lost profits, recovery in claims against fiduciaries, 6.42
Measure of damages, out-of-pocket loss rule as, 6.40
Statute of limitations for fraud or deceit claim, 6.40
Infringement
Copyrights. See **Copyright Infringement**
Patents. See **Patent Infringement**
Trademarks. See **Trademark Infringement**
Insurance as source for collection of damages in intellectual property litigation, 6.57A
Restitution based on quasi-contract or unjust enrichment
Generally, 6.44
Checklist for suggestive discovery on matters of damages and restitution, 6.50
Constructive trust (see Constructive trust remedy, above)
Lost profits attributable to property, restitution for, 6.46
Measure of recovery, 6.45
Trade secrets. See **Trade Secrets, Misappropriation of**
Unjust enrichment (see Restitution based on quasi-contract or unjust enrichment, above)

Intent
Land sale contract and real property purchase and sale agreement, parties' intent as factor in distinguishing between, 2.15

Intentional Infliction of Emotional Distress. See **Emotional Distress**

Interest on Money
Appeals. See **Appeals**
Back pay award, interest on, 3.13
Breach of contract. See **Breach of Contract (Generally)**
Conversion of personal property, recovery of interest, 6.43
Escrow. See **Escrow**
Fraud in real property transaction, restrictions on recovery of interest, 2.46
Landlord and tenant. See **Landlord and Tenant**
Negotiating contract to provide for interest in event of breach, 1.3
Penalty interest on note, seller's recovery after buyer's breach of real estate purchase sale agreement, 2.31
Prejudgment interest
Breach of contract action, recovery of prejudgment interest in, 1.20
Breach of real property purchase and sale agreement, buyer's recovery of prejudgment interests, 2.11
Copyright infringement action, recovery of prejudgment interest in, 6.26A
Equal Pay Act, prejudgment interest on back pay award, 3.44
Fraud in real property transaction, recovery of prejudgment interest on buyer's escrow deposit, 2.46
Nuisance or trespass actions, restrictions on recovery of prejudgment interest in, 5.37
Patent infringement, court's discretion to award prejudgment interest, 6.14
Settlement provision concerning prejudgment interest, effect of, 7.46
Taxability of prejudgment interest award, 7.45-7.47
Title VII action, prejudgment interest on back pay awards under, 3.56
Trademark infringement, plaintiff's recovery of prejudgment interest for, 6.32
Unlawful detainer action, criteria for awarding prejudgment interest on rent due, 4.88
Prospective landlord's breach of agreement to execute lease, restrictions on lessee's recovery of interest on damages, 4.6
Quiet enjoyment, restrictions on recovery of interest on damages in action against landlord for breach of covenant of, 4.18
Security deposit, recovery of interest in action based on landlord's bad faith retention of, 4.54
Settlement or judgment, taxability of interest income included as part of, 7.44-7.47

Unliquidated damages, no recovery of interest on, 1.20

Interpretation of Cases and Statutes. See **Construction and Interpretation**

Intrusion
Requirements for recovery of damages for intrusion, 5.54

Investigations
Nuisance action, recovering costs of investigation in, 5.36
Private Attorneys General Act of 2004 violations, investigation of, 3.90A

Involuntary Conversion of Property
Gain not recognized on involuntary conversion of property, 7.9

IRAs. See **Individual Retirement Accounts (IRAs)**

Joinder of Actions
Legal and equitable actions, 2.2

Joint and Several Liability
Back pay, joint liability of employers and unions if found in violation of LMRA, 3.19
Unfair labor practices, joint liability of offending employer and successor employer for, 3.14

Judgments
Default judgment, restrictions on award of attorney fees as part of, 1.13
Defined, 7.1
Enforcement of judgment, inapplicability of CC §1717 to attorney fees incurred in, 1.27
Real Estate Recovery Fund, recovering unsatisfied monetary judgments against real estate licensees from, 2.59
Tax consequences of judgment. See **Taxes**

Judicial Discretion. See **Discretion of Court**

Jurisdiction
Generally, 2.3
Concurrent jurisdiction of state and federal courts over labor issues, 3.82
Dismissal of breach of contract action for lack of jurisdiction, no prevailing party for awarding attorney fees, 1.26
Limited civil cases. See **Limited Civil Cases**
LMRA. See **Labor Management Relations Act of 1947 (LMRA)**
Strikes, jurisdiction over. See **Strikes**
Trespass or private nuisance action, subject matter jurisdiction governed by amount in controversy, 5.23
Unlawful detainer actions not within jurisdiction of small claims court, 4.92

Jury Instructions
Tax treatment of award, request for instructions on, 7.3

Jury Trial
Equitable relief, limitations on right to jury trial in action seeking, 2.2

Labor Law
See also **Employers and Employees; Labor Unions**
ADA. See **Americans with Disabilities Act (ADA)**
Age discrimination. See **Age Discrimination**
California statutes
Agricultural Labor Relations Act, collective bargaining rights for agricultural workers under, 3.83
Cartwright Act, restraint of trade prohibited under, 3.84
Commission contracts by out-of-state employers, 3.104
FEHA. See **Fair Employment and Housing Act (FEHA)**
Indemnification of employee for work-related expenses or losses, 3.91
Interstate commerce, applicability of state law in absence of, 3.82
Miscellaneous state statutes, 3.101
Misrepresentation, statutes prohibiting. See **Fraud and Misrepresentation**
Private Attorneys General Act of 2004, 3.90A
Wages, timely payment of. See **Wages and Hours**

Wrongful termination. See **Wrongful Termination**
Davis-Beacon Act, standards for wages and benefits of government contractors' employees, 3.76
Discrimination. See **Discrimination**
Employees, federal protections for
Federal Privacy Act, protection against disclosure of personal information by federal agency, 3.81
Federal Service Labor Management Relations Act. See **Federal Service Labor Management Relations Act (FSLMRA)**
Political activity by employee, First Amendment protection for, 3.80
Enforceability of employee's rights under Labor Code, 3.86
Equal Pay Act, prejudgment interest on back pay award, 3.44
ERISA. See **Employee Retirement Income Security Act (ERISA)**
FLSA. See **Fair Labor Standards Act of 1938 (FLSA)**
Immigration Reform and Control Act (IRCA), undocumented workers not entitled to back pay for unearned wages resulting from unfair labor practices under, 3.13A
LMRA. See **Labor Management Relations Act of 1947 (LMRA)**
NLRB. See **National Labor Relations Board (NLRB)**
Railway Labor Act. See **Railway Labor Act**
Rehabilitation Act of 1973, discrimination against disabled persons prohibited by employers receiving federal funds, 3.30
Sherman and Clayton Antitrust Acts. See **Sherman and Clayton Antitrust Acts**
Strikes. See **Strikes**
Title VII. See **Title VII**
Uniformed Services Employment and Reemployment Rights Act of 1994, veterans' reemployment rights governed by, 3.47
Wages, timely payment of. See **Wages and Hours**
Walsh-Healey Act, standards for wages, hours of work, child labor, health and safety of employees under, 3.75

Labor Management Relations Act of 1947 (LMRA)
Generally, 3.1
Arbitration. See **Arbitration**
Awards to employees
Back pay (see Back pay awarded to employee for employer's discrimination based on union activity, below)
Domination of union by employer in violation of LMRA, 3.16
Partial shutdown to chill unionism, 3.5
Refusal of employer to bargain with labor union, remedies for, 3.15
Runaway shops, NLRB requiring employers to offer employees moving expenses or transportation costs between old and new locations, 3.17
Unilateral changes by employers in wages, hours, and working conditions without bargaining with union, remedies for, 3.18
Awards to employers
Breach of collective bargaining agreement by union, action for, 3.22-3.23
Measure and proof of damages, 3.23
Refusal of union to bargain with employer, 3.20
Unfair labor practices by union, employer's recovery of damages for, 3.21
Back pay awarded to employee for employer's discrimination based on union activity
Generally, 3.6
Bona fide purchaser of business, reinstatement and back pay orders imposed on, 3.14
Burden of proof on employer to show employee seeking back pay failed to mitigate damages by searching for interim employment, 3.11
Calculation of back pay on quarterly basis by NLRB, 3.13
Exclusions from back pay, 3.8
Joint and several liability of employers and unions for back pay if both found in violation of LMRA, 3.19
NLRB rules on back pay for employees discriminatorily discharged, 3.12
Reduction in back pay by net earnings received from other employment, 3.9
Specific items included in back pay, 3.7
Standard of conduct on employee to mitigate back pay, 3.12
Time period for which employees can recover back pay, 3.10
Costs, lack of provision in LMRA for recovery of, 3.23
Federal preemption
State law tort action for unjust termination preempted by LMRA, 3.2
Wrongful termination claims by employees subject to collective bargaining agreements, preemption by LMRA, 3.92
Full and partial closing distinguished, 3.5
Harassing tactics by union during negotiations, permissibility of, 3.20
Jurisdiction
Arbitration, NLRB declining jurisdiction in favor of, 3.22
Breach of no-strike agreement by union, state's concurrent jurisdiction to enjoin strike, 3.22
Fair representation, federal court's jurisdiction over disputes involving union's duty of, 3.2
Labor-Management Reporting and Disclosure Act. See **Labor-Management Reporting and Disclosure Act of 1959 (LMRDA)**
Mental distress, no recovery of damages under LMRA for, 3.23

Mitigation of damages
Back pay (see Back pay awarded to employee for employer's discrimination based on union activity, above)
Breach of contract action, requirement of mitigating damages, 3.23
Procedures for dealing with unfair labor practice after charges filed, 3.4
Punitive damages
Breach of contract action under §301 of LMRA, federal court's lack of jurisdiction to award punitive damages in, 3.23
Unlawful but peaceful conduct by union in violation of LMRA, no recovery of punitive damages for, 3.21
Title VII, similarity of LMRA to, 3.48
Unfair labor practices by employers and labor organizations prohibited under, 3.3
Union activity, discrimination by employer for
Back pay (see Back pay awarded to employee for employer's discrimination based on union activity, above)
Restoration of position as remedy for employer's discrimination, 3.6
Successor employer of offending employer, NLRB's authority to award remedies for unfair labor practices against, 3.14
Union officials, protection from discriminatory or selected disciplinary action based on union status, 3.3

Labor-Management Reporting and Disclosure Act of 1959 (LMRDA)
Generally, 3.24
Attorney fees, recovery of, 3.26
Bill of rights for union members under, 3.24
Cause of action against employer, lack of, 3.29
Compensatory damages, union member's recovery of, 3.25
New elections, Secretary of Labor's exclusive authority to supervise, 3.28
Punitive damages, recovery of, 3.26-3.27

Labor Unions
See also **Labor Law**
Collective bargaining
Generally, 3.82
Agricultural Labor Relations Act (ALRA), collective bargaining rights for agricultural workers under, 3.83
Arbitration under collective bargaining agreement. See **Arbitration**
Labor Management Relations Act (LMRA), action for breach of collective bargaining agreement by union under, 3.22-3.23
No-strike clause. See **Strikes**
Timely payment of wages to terminated employee, effect of collective bargaining agreement on, 3.86
Wrongful termination claims by employees subject to collective bargaining agreements, preemption by Labor Management Relations Act (LMRA), 3.92
Federal Service Labor Management Relations Act. See **Federal Service Labor Management Relations Act (FSLMRA)**
Grievances
Breach of contract by employer, union filing grievance over, 3.108
No-strike commitment, employer filing grievance over violation of express or implied, 3.109
Illegal conduct by union, recovery of damages for, 3.21
Labor-Management Reporting and Disclosure Act. See **Labor-Management Reporting and Disclosure Act of 1959 (LMRDA)**
LMRA. See **Labor Management Relations Act of 1947 (LMRA)**
Railway Labor Act. See **Railway Labor Act**
Sherman and Clayton Antitrust Acts. See **Sherman and Clayton Antitrust Acts**
State funds for antiunion activities, prohibited use of, 3.84A
Strikes. See **Strikes**

Laches
Nuisance or trespass action, laches as defense in, 5.46
Uniformed Services Employment and Reemployment Rights Act of 1994, effect of laches on veteran's suit for reemployment under, 3.47

Landlord and Tenant
See also **Leases; Rent**
Generally, 4.1
Attorney fees
Generally, 4.109
Bankruptcy filing by tenant, landlord's recovery of fees after successfully moving to dismiss, 4.54
Breach of landlord's duty to deliver possession, restrictions on tenant's ability to recover fees, 4.13
Forcible entry or detainer, restrictions on tenant's recovery of fees for, 4.26
Rent control ordinance, tenant's recovery of fees in action against landlord for violating, 4.48
Retaliatory eviction, tenant's recovery of fees in action for, 4.36
Security deposit, nonrecoverability of fees in action based on landlord's bad faith retention of, 4.54
Utility services, tenant's recovery of fees in action against landlord for disconnecting, 4.45
Certainty of damages, requirement of, 4.112

Commercial tenancies. See **Commercial Tenancies**
Costs, prevailing party recovering, 4.111
Eviction. See **Eviction**
Expert witness fees, recovery of, 4.110
Future profits
Beneficial enjoyment of property, tenant's recovery for landlord's interruption of, 4.16
Repair, tenant's recovery of future profits for landlord's breach of covenant to, 4.30
Habitability. See **Habitability, Breach of Warranty of**
Holdover tenant. See **Holdover Tenant**
Improvements. See **Improvements**
Interest on damages
Breach of lease covenants by landlord, restrictions on tenant's recovery of interest on damages, 4.33
Deliver possession, prohibition against tenant collecting interest on damages based on landlord's duty to, 4.13
Forcible entry or detainer, prohibition against tenant's recovery of interest on damages for, 4.26
Rent, landlord's recovery of interest based on tenant's breach of covenant to pay, 4.66
Lease covenants. See **Lease Covenants**
Mitigation of damages
Breach of lease by tenant, landlord's duty to mitigate damages, 5.54
Duty of landlord and tenant concerning, 4.108
Termination of lease, effect of landlord's failure to mitigate damages by reletting premises, 4.79
Nominal damages
Generally, 4.113
Breach of covenant to remain in business, landlord recovering nominal damages as result of, 4.67
Forcible entry or detainer, tenant's recovery of nominal damages for, 4.26
Use of property for other than intended purpose by tenant, landlord's recovery of nominal damages for breach of lease, 4.58
Notice to quit or terminate tenancy, statutory warnings in, 4.92
Personal property of tenant, landlord's wrongful withholding of
Remedies for tenant, 4.46
Statute of limitations for actions based on detaining or injury to personal property, 4.47
Possession, landlord's breach of duty to deliver. See **Possession**
Profits, tenant's recovery of
Beneficial enjoyment of premises, tenant's recovery for lost profits based on landlord's interruption of, 4.16
Covenant against competition, tenant's action for lost profits against landlord for violating, 4.29
Deliver possession, tenant's recovery of special damages for lost profits as result of landlord's failure to, 4.12
Execution of lease, tenant's recovery of anticipated profits based on landlord's breach of agreement for, 4.3
Future profits (see Future profits, above)
Holdover tenant's liability to new tenant for lost profits, 4.84
Proof of damages by landlord or tenant, 4.107
Punitive damages
Breach of lease covenants by landlord, restrictions on tenant's recovery of punitive damages, 4.33
Deliver possession, prohibition against tenant recovering punitive damages based on landlord's duty to, 4.13
Fixtures, landlord's recovery of punitive damages for tenant's wrongful removal of, 4.76
Forcible entry or detainer, requirements for tenant's recovery of punitive damages, 4.25
Holdover tenant, new tenant recovering punitive damages from, 4.84
Prospective landlord's breach of agreement to execute lease, tenant prohibited from recovering punitive damages for, 4.5
Retaliatory eviction, tenant's recovery of punitive damages for, 4.36
Security deposit, statutory damages for landlord or landlord's successor's bad faith retention of, 4.53
Warranty of habitability by landlord, tenant's recovery of punitive damages for breach of, 4.43
Quiet enjoyment. See **Quiet Enjoyment, Breach of Covenant of**
Rent control. See **Rent Control**
Repairs. See **Repairs**
Security deposits. See **Security Deposits**
Special damages
Breach of lease covenants, tenant's recovery of special damages, 4.28, 4.30
Forcible entry or detainer, tenant's recovery of special damages for, 4.24
Landlord's breach of duty to deliver possession, tenant's recovery of special damages for, 4.12
Prospective landlord's breach of agreement to execute lease, tenant's recovery of special damages for, 4.3
Quiet enjoyment, tenant's recovery of special damages for landlord's breach of covenant of, 4.17, 4.20
Warranty of habitability, tenant's recovery of special damages in action for breach of, 4.38-4.39, 4.42
Statute of limitations
Breach of implied warranty of habitability, statute of limitations for recovery of damages for, 4.38
Fixtures, action for wrongful removal of, 4.77
Forcible entry or detainer action, statute of limitations for filing, 4.27
Holdover tenant, statute of limitations for recovering damages from, 4.85
Personal property, statute of limitations for actions based on detaining or injury to, 4.47

Quiet enjoyment, statute of limitations against landlord for breach of covenant of, 4.21
Security deposit, statute of limitations in action based on landlord's failure to return, 4.55
Unlawful detainer action, statute of limitations for filing, 4.105
Use of property for illegal purposes, statute of limitations for bringing action against tenant for, 4.57
Use of property for other than intended purpose by tenant, landlord's action for, 4.59
Waste, statute of limitations for tenant committing, 4.61
Writ of possession, landlord's recovery of damages against tenant for dispossession, 4.22
Unlawful detainer. See **Unlawful Detainer**
Waste committed by tenant. See **Waste**
Withholding of tenant's personal property by landlord. See **Personal Property**

Landrum-Griffen Labor Reform Act. See **Labor-Management Reporting and Disclosure Act of 1959 (LMRDA)**

Land Sale Contract. See **Installment Land Sale Contract**

Land Use Regulations. See **Zoning and Land Use**

Lanham Act. See **Trademark Infringement**

Late Fees
Liquidated damages provisions disguised as late fees, 1.44

Layoffs
Title VII, effect of seniority system on layoffs, 3.60

Lease Covenants
Landlord's breach of lease covenants
Build, tenant's measure damages for landlord's breach of covenant to, 4.31
Competition, landlord's breach of covenant against, 4.29
Defenses available to landlord, 4.34
General and special damages, tenant recovering, 4.28
Habitability. See **Habitability, Breach of Warranty of**
Improvements, tenant's recovery for landlord's breach of covenant to pay for, 4.32
Interest on damages, restrictions on tenant's recovery of, 4.33
Remedies for breach of contact, applicability to breach of lease, 4.38
Rent reduction, effect of, 4.34
Repair, measure of damages for landlord's breach of covenant to, 4.30
Statute of limitations for bringing action for breach of covenant, 4.34
Measure of damages for breach of lease covenant by tenant
Improve, landlord's measure of damages for tenant's breach of covenant to, 4.68
Repair, landlord's measure of damages for tenant's breach of covenant to, 4.69
Statute of limitations for breach of lease covenant, 4.34, 4.57, 4.64, 4.72
Surrender
Covenant to surrender in as good condition as received, 4.72
Measure of damages for breach of covenant to surrender premises, 4.71
Tenant's breach of lease covenants
Generally, 4.63
Assignment or subletting, tenant's breach of covenant against, 4.70
Holding over. See **Holdover Tenant**
Improve, damages for tenant's breach of covenant to, 4.68
Insure, tenant's liability for breach of covenant to, 4.74
Measure of damages (see Measure of damages for breach of lease covenant by tenant, above)
Nuisance, breach of lease action against tenant based on, 5.54
Remain in business, damages for tenant's breach of covenant to, 4.67
Rent. See **Rent**
Repair, breach of covenant to, 4.69
Statute of limitations for, 4.64, 4.72
Taxes, covenant to pay, 4.73
Termination of lease for tenant's breach. See **Termination of Lease**
Unlawful detainer. See **Unlawful Detainer**

Leases
See also **Landlord and Tenant; Rent**
Attorney fees
Construction of leave provision for, 4.93

Prospective landlord's breach of agreement to execute lease, express contractual provision required for tenant's recovery of fees, 4.4
Restrictions on tenant's recovery of, 4.33
Breach by landlord
Forcible entry or detainer. See **Forcible Entry or Detainer**
Habitability, warranty of. See **Habitability, Breach of Warranty of**
Lease covenants, breach of. See **Lease Covenants**
Personal property of tenant. See **Landlord and Tenant**
Possession, landlord's breach of duty to deliver. See **Possession**
Quiet enjoyment, landlord's breach of covenant of. See **Quiet Enjoyment, Breach of Covenant of**
Rent control ordinances, landlord's violation of. See **Rent Control**
Repair, breach of statutory duty to. See **Repairs**
Security deposits. See **Security Deposits**
Utility services, tenant's recovery of damages from landlord for disconnecting, 4.45
Breach by tenant
Fixtures. See **Fixtures**
Illegal purposes, tenant's use of property for. See **Landlord and Tenant**
Intended use of property (see Use of property for other than intended purpose, below)
Lease covenants, breach of. See **Lease Covenants**
Repairs, tenant's statutory duty to make, 4.62
Termination of lease. See **Termination of Lease**
Waste. See **Waste**
Breach of agreement to execute lease
Prospective landlord's breach (see Prospective landlord's breach of agreement to execute lease, below)
Prospective tenant's breach of agreement to execute lease, landlord's recovery of damages for, 4.9
Breach of lease covenant. See **Lease Covenants**
Criminal law, tenant's use of property in violation of (see Illegal purposes, tenant's use of property for, below)
Illegal purposes, tenant's use of property for
Generally, 4.56
Statute of limitations for bringing action against tenant, 4.57
Liquidated damages
Measure of damages for tenant's breach or abandonment, enforceability of liquidated damages provision in lease, 4.81
Residential and nonresidential leases, different standards for liquidated damages provision in, 4.106
Measure of damages (generally)
Breach of lease covenants (see Breach of agreement to execute lease, above)
Tenant's breach or abandonment, enforceability of liquidated damages provision in lease, 4.81
Measure of damages for prospective landlord's breach of agreement to execute lease
Attorney fees, express contractual provision required for recovery of, 4.4
General damages, tenant's recovery of, 4.2
Interest on damages, restrictions on lessee's recovery of, 4.6
Special damages, tenant's recovery of, 4.3
Prospective landlord's breach of agreement to execute lease
Burden of proof on tenant to show ability to perform under lease, 4.7
Measure of damages (see Measure of damages for prospective landlord's breach of agreement to execute lease, above)
Statute of limitations for breach of agreement to execute lease, 4.8
Punitive damages or interest, restrictions on tenant's recovery of, 4.33
Remedies
Abandonment of lease, statutory remedies for recovering damages on, 4.81
Breach of lease covenant, applicability of remedies for breach of contact to, 4.38
Rent control. See **Rent Control**
Statutes of limitations
Breach of agreement to execute lease, statute of limitations for, 4.8
Breach of lease covenant, statute of limitations for bringing action based on, 4.34, 4.57, 4.64, 4.72
Termination of lease by breach or abandonment, statute of limitations for filing action, 4.82
Termination of lease. See **Termination of Lease**
Use of property for other than intended purpose
Illegal purposes (see Illegal purposes, tenant's use of property for, above)
Liability of tenant for damages resulting from unintended use, 4.58
Statute of limitations for bringing action based on, 4.59

Libel. See **Defamation**

Light. See **Air and Light**

Limitations of Actions. See **Statutes of Limitations**

Limited Civil Cases
Attorney fees
Jurisdictional limit, court not limited to in awarding fees, 4.97
Time limit for filing motion for, 4.104
Costs, recovery of, 4.111
Jurisdiction
Amount in controversy deciding, 2.3, 5.23
Attorney fees, court not limited to jurisdictional limit in awarding, 4.97

Liquidated Damages
Breach of contract. See **Breach of Contract (Generally)**
Breach of real property sales contract. See **Breach of Real Property Purchase and Sale Agreement**
Lease provision for. See **Leases**
Taxation of recoveries under liquidated damages provisions, 7.38
Walsh-Healey Act, recovery of liquidated damages under, 3.75

Lis Pendens
Breach of real property purchase and sale agreement, buyer recording lis pendens, 2.17
Resale of property, lis pendens preventing, 2.31

Loans. See **Breach of Contract (Generally)**

Local Government
Meyers-Milias-Brown Act (MMBA), local government employer-employee relations governed by, 3.82
Rent control ordinances. See **Rent Control**

Losses. See **Capital Gains and Losses**

Lost Profits. See **Profits**

Malice
Defined, 3.96, 6.38
Forcible entry or unlawful detainer, statutory damages on showing of malice, 5.54
Private nuisance, action to abate malicious blocking of air, light, or view, 5.11
Punitive damages. See **Punitive Damages**

Marketing Contract. See **Real Property Purchase and Sale Agreement**

Market Value. See **Valuation**

Measure of Damages
Back rent, determining amount of, 4.86
Breach of contract. See **Breach of Contract (Generally)**
Breach of real property purchase and sale agreement, measure of damages for, 2.9
Breach or abandonment of lease by tenant, landlord's measure of damages. See **Termination of Lease**
Conversion, measure of damages for, 4.46
Copyright infringement, 6.18
Deliver possession, breach of landlord's duty to. See **Possession**
Destruction of property, measure of damages for, 5.33
ERISA, measure of damages for loss to pension fund, 3.73
Fixtures, measure of damages for removal or destruction of, 5.33
Forcible entry or detainer. See **Forcible Entry or Detainer**
Fraud in real property transactions. See **Fraud Claims in Real Property Transactions**
Intellectual property, measure of damages for misappropriation of. See **Intellectual Property**
Leases
Breach of lease. See **Leases**
Lease covenant, breach of. See **Lease Covenants**
Termination of lease. See **Termination of Lease**
Nuisance. See **Nuisance**
Patent infringement, measure of damages for lost profits, 6.5
Personal property. See **Personal Property**
Quiet enjoyment, measure of damages for landlord's breach of covenant. See **Quiet Enjoyment, Breach of Covenant of**
Real property, measure of damages for injury or destruction of, 4.75, 5.32

Surrender premises, measure of damages for tenant's breach of covenant to, 4.71
Trespass. See **Trespass**
Union's unfair labor practices, employer's measure of damages, 3.23
Unlawful detainer action, measure of damages in, 4.87
Use of property for other than intended purpose by tenant, measure of landlord's damages for, 4.58
Wrongful holding over by tenant, 5.54
Wrongful occupancy, measure of damages for, 5.54
Wrongful occupation of real property, 5.27, 5.35

Mediation
See also **Arbitration**
Real estate disputes, mediation of, 2.26

Medical Expenses
Back pay awarded to employees on strike, reimbursement of medical expenses improperly excluded from coverage under employer's group plan, 3.7

Mental Anguish or Distress. See **Emotional Distress**

Meyers-Milias-Brown Act (MMBA)
Local government employer-employee relations governed by, 3.82

Military. See **Veterans**

Minimum Wage
See also **Overtime Compensation**
Establishment of, 3.100
Fair Labor Standards Act (FLSA), minimum wage requirements of, 3.44

Misappropriation of Intellectual Property. See **Intellectual Property**

Misappropriation of Trade Secrets. See **Trade Secrets, Misappropriation of**

Misrepresentation. See **Fraud and Misrepresentation**

Mitigation of Damages
Back pay. See **Labor Management Relations Act of 1947 (LMRA)**
Breach of contract. See **Breach of Contract (Generally)**
Fraud in real property transaction, duty of defrauded party to mitigate damages, 2.54-2.55
Landlord and tenant. See **Landlord and Tenant**
Punitive damages, defendant showing evidence of financial condition in mitigation, 1.37
Real property purchase and sale agreement, seller's duty to mitigate damages after buyer's breach of, 2.17, 2.25, 2.31
Uniformed Services Employment and Reemployment Rights Act of 1994, employee's duty to mitigate damages by seeking other employment after employer's refusal to reinstate, 3.47
Wrongfully terminated employee's duty to mitigate damages, 3.95

Modifications. See **Amendments and Modifications**

Mortgages and Deeds of Trust
Contract, deed of trust not included within definition of, 1.20
Replacement of purchase and sale agreement by note and deed of trust at escrow, 2.15

Motor Vehicles
Automotive Repair Act, recovery of damages for unauthorized repairs, 1.56

Narcotics Nuisance Abatement Act
Landlord's liability and forced sale of property under, 4.39

National Labor Relations Act (NLRA)
Americans with Disabilities Act (ADA) not preempted under, 3.31
Attorney fees in unlawful discrimination cases under NLRA, deduction for, 7.49B
Secondary boycotts, NLRA exempting construction industry unions from prohibitions against, 3.37

National Labor Relations Board (NLRB)

Back pay for employees discriminatorily discharged. See **Labor Management Relations Act of 1947 (LMRA)**
Unfair labor practices, filing charge with NLRB, 3.4

Negligence
Comparative negligence as defense in nuisance or trespass cases, 5.40
Fiduciary's negligent and intentional misrepresentation, distinction between, 2.49
Homeowners' inability to recover in tort for negligent construction not resulting in actual damage, 5.10
Release of liability for future gross negligence in sports or recreational programs, unenforceability of, 1.46

Nominal Damages
Breach of contract. See **Breach of Contract (Generally)**
Defined, 1.34
Landlord and tenant. See **Landlord and Tenant**
Nuisance or trespass, recovery of nominal damages for, 5.27

No-Strike Clause. See **Strikes**

Notice and Notification
Breach of contract. See **Breach of Contract (Generally)**
Default judgment, notice requirements for, 1.13
Disciplinary action, notice to public employee of proposed, 3.94
Lease provision requiring tenant to notify landlord of needed repairs, 4.30
Private Attorneys General Act of 2004, notice requirements under, 3.90A
Rescission, effect of buyer continuing to make payments after giving notice of, 2.58
3-day notice. See **3-Day Notice**
Timely payment of wages after giving notice of intent to quit, 3.85
Unlawful detainer action, noticed motion for attorney fees, 4.102

Notice to Quit or Terminate Tenancy
Statutory warnings in, 4.92

Nuisance
See also **Trespass**
Abatement of nuisance
Attorney fees and costs, owner's liability in action for abatement, 5.20
Private nuisance, action to abate malicious blocking of air, light, or view, 5.11
Standing to bring action to abate public nuisance, 5.8
Air and light, nuisance affecting. See **Air and Light**
Attorney fees
Abatement, owner's liability for fees in action for, 5.20
Restrictions on recovery of fees in nuisance actions, 5.36
Breach of lease, nuisance created by tenant as, 5.54
Burden of proof
Factual elements of nuisance, plaintiff's burden of proof to show, 5.3
Injury, plaintiff required to plead and prove injury in private nuisance action, 5.12
Private nuisance action, plaintiff's burden of showing potential for future injury based on objective standard, 5.10
Categories of nuisance under CC §3479
Generally, 5.4
Balancing of equities, CC §3479 requiring, 5.6
Objective standard for determining substantial and unreasonable interference with enjoyment of property rights, 5.5
CERCLA. See **Comprehensive Environmental Response, Compensation, and Liability Act (CERCLA)**
Continuing nuisance (see Permanent nuisances and temporary or continuing nuisances, distinction between, below)
Damages and remedies for private nuisance
Generally, 5.21
Annoyance, discomfort, and mental suffering, recovery of damages for, 5.34
Attorney fees, recovery of damages for, 5.36
Equitable, legal, or hybrid action, attorney's evaluation of case as, 5.22
Fixtures or personal property, damage, destruction, removal of, 5.33
Injunctive relief (see Injunctive relief, below)
Lost profits, 5.35
Prejudgment interest, restrictions on recovery of, 5.37
Punitive damages (see Punitive damages, below)
Self-help in abating nuisance, right to, 5.25
Statutory limits on recovery of damages, 5.39
Subject matter jurisdiction governed by amount in controversy, 5.23

Tort measure of damages (see Tort measure of damages for private nuisance, below)
Venue, effect of classification of action as transitory or local on, 5.24
Defenses
Coming to the nuisance doctrine, repudiation of, 5.47
Comparative negligence, 5.40
Consent as defense to private nuisance claim, 5.41, 5.48
Due care, lack of defense to nuisance action, 5.50
Injunction, defenses against granting (see Injunctive relief, below)
Laches, 5.46
Separation of powers as defense in nuisance action, 5.52
Statute of limitations (see Statute of limitations, below)
Statute of repose, 5.44A
Defined, 5.2
Distinction between trespass and nuisance, 5.18
Encroachment treated as trespass or nuisance, 5.19
Hazardous materials. See **Hazardous Materials and Toxic Waste**
Injunctive relief
Generally, 5.13, 5.26
Balancing equities in determining existence of nuisance and granting injunction, 5.49
Comparative fault as defense to, 5.40
Nuisance per se, injunction without proof of injury, 5.3
Public nuisance, injunction as private party's only remedy against, 5.8
Scope of injunction, limits on, 5.53
Zoning laws, plaintiff's inability to obtain injunction against business operated in accordance with applicable, 5.51
Natural conditions on property, owner's responsibility to exercise reasonable care to control, 5.6
Nuisance per se, statute or ordinance declaring object, substance, or activity as, 5.3
Permanent nuisance and temporary or continuing nuisance, distinction between
Election by plaintiff to treat nuisance as permanent or continuing, 5.15
Factors in determining if nuisance permanent or continuing, 5.14
Improvement as continuing nuisance, 5.44A
Injunctive relief, availability of, 5.13
Preference of court for finding continuing nuisance, 5.16, 5.44
Remedies for continuing or permanent nuisance, 5.28-5.29
Remedies, importance of classification of nuisance for selection of, 5.13
Statute of limitations (see Statute of limitations, below)
Private nuisance
Blockage of air, light, or view not actionable nuisance, 5.11
Both public and private nuisance, activity constituting, 5.12
Damages and remedies (see Damages and remedies for private nuisance, above)
Defenses (see Defenses, above)
Defined, 5.9
Injury, plaintiff required plead and prove injury in private nuisance action, 5.12
Proof of substantial invasion of plaintiff's interest in use enjoyment of land as requirement for nuisance action, 5.18
Threat of future injury insufficient to maintain action for private nuisance, 5.10
Proof
Nuisance per se, injunction without proof of injury, 5.3
Private nuisance action, proof of substantial invasion of plaintiff's interest in use enjoyment of land as requirement for, 5.18
Public nuisance
Both private and public nuisance, activity constituting, 5.12
Costs of abating nuisance, owner's liability for, 5.20
Defenses (see Defenses, above)
Defined, 5.7
Injunction as private party's only remedy against public nuisance, 5.8
Remedies and damages for public nuisance, 5.20
Standing to bring action to abate public nuisance, 5.7, 5.8
Punitive damages
Generally, 5.38
Good faith effort by defendant to control nuisance, effect of, 5.38
Theories of nuisance and intentional infliction of mental distress, recovery of punitive damages for, 4.38
Statute of limitations
Continuing nuisance, statute of limitations for, 5.44-5.44A
Permanent nuisance, commencement of statute of limitations for, 5.13, 5.43
Personal injury damages, statute of limitations for recovery of, 4.38
Pollution cases, special rules for, 5.45
Private nuisance, statute of limitations as defense to, 5.41-5.42

Public nuisance, statute of limitations not defense to, 5.41
Temporary nuisance (see Permanent nuisances and temporary or continuing nuisances, distinction between, above)
Tort measure of damages for private nuisance
Generally, 5.27
Continuing nuisance, 5.13, 5.28
Nominal damages, recovery of, 5.27
Permanent nuisance, 5.29
Torts and other related actions, 5.54
Utilities. See **Utilities**
Valuation. See **Valuation**
Warranty of habitability, nuisance claim in action for breach of, 4.38

Objections
Expert testimony, objection to, 6.54

Occupancy. See **Wrongful Occupancy**

Offsets. See **Setoffs**

Oil and Gas
Sale or exchange, taxpayer's burden of proof to show settlement of lawsuit involving oil and gas lease constitutes, 7.6
Trespass resulting in severance and appropriation of coal, oil, or gas, recovery of damages for, 5.32

Out-of-Pocket Losses
Definition of "out-of-pocket expenses," 2.36
Fraud claims in real property transactions. See **Fraud Claims in Real Property Transactions**

Overtime Compensation
See also **Minimum Wage**
Generally, 3.100
Fair Labor Standards Act (FLSA), overtime requirements of, 3.44

Pain and Suffering. See **Personal Injuries**

Patent Infringement
See also **Intellectual Property**
Attorney-client privilege or work product doctrine, no adverse inference from assertion of, 6.13
Burden of proof (see Lost profits for sales of products covered by owner's patents, below)
Expert witness, required factual basis for opinions of. See **Experts and Expert Witnesses**
Lost profits for sales of products covered by owner's patents
Generally, 6.2
Calculation of patent owner's lost profits, 6.6
Caravan sales defined, 6.2
Double recovery by patent owner prohibited, 6.2
"Entire Market Value Rule," recovery of damages under, 6.8
Fixed or overhead costs, inappropriateness to add to hypothetically increased sales, 6.6
Measure of damages for lost profits, 6.5
Panduit causation test for determining if patent owner entitled to lost profit damages, burden of proof under, 6.4
Price erosion damages, 6.9
Probability asserted sales would have occurred but for infringement, burden on patent owner to show, 6.3
Royalty rate (see Reasonable royalty rate as alternative measure of recovery, below)
Unpatented projects, recovery of lost profits for, 6.7
Measure of recovery (see Reasonable royalty rate as alternative measure of recovery, below)
Prejudgment interest, court's discretion to award, 6.14
Reasonable royalty rate as alternative measure of recovery
Generally, 6.10
Factors serving as basis for reasonable royalty rate, 6.11
Georgia-Pacific factors in determining reasonable royalty rate, 6.12
Statute of limitations for recovering damages for, 6.1
Statutory basis for damages, 6.1, 6.13
Taxation of damages for patent infringement, 7.34, 7.37, 7.41
Willful infringement damages, statutory basis for recovery of, 6.13

Penalties
Antiunion activities, civil penalties for use of state funds for, 3.84A
Attorney fees
Attorney litigants recovering fees as sanctions, unavailability of, 1.25
Frivolous action, attorney fee award as sanction for, 4.97
Criminal penalties. See **Criminal Law**
Discovery sanctions, 4.96
Fees
Attorney fees (see Attorney fees, above)
Liquidated damages provisions disguised as late fees constituting illegal penalties, 1.44
Interference with employee's political activities, penalties against employer for, 3.103
Meal and rest periods, penalties for nonpayment of, 3.88A
Private Attorneys General Act of 2004, assessment of civil penalties under, 3.90A
Unfair labor practice, sanctions available to NLRB to punish, 3.4
Utility services, penalty against landlord for disconnecting, 4.45
Wages for terminated employees, penalty for employer's failure to pay, 3.85, 3.87

Pension Plans. See **Retirement and Pension Plans**

Permanent Nuisance. See **Nuisance**

Permanent Trespass. See **Trespass**

Personal Injuries
Breach of contract, restrictions on recovery of damages for physical suffering, 1.38
Comparative negligence as defense in nuisance action seeking personal injury damages, 5.40
Eviction, recovering damages for physical injury suffered as proximate result of, 4.20
Fraud in real property transaction, recovery of personal injury damages, 2.45
Nontaxability of recovery for physical personal injuries, 7.7, 7.13
Nuisance, statute of limitations for recovery of personal injury damages, 4.38
Title VII, recovery of back pay despite duplication of previous back pay award in personal injury action against employer, 3.53

Personal Property
See also **Real Property**
Covenant to repair and replace landlord's personal property, measure of damages for tenant's breach of, 4.69
Destruction or removal of personal property, recovery of damages for, 5.33
Fixtures. See **Fixtures**
Intellectual property. See **Intellectual Property**
Landlord's wrongful withholding of tenant's personal property. See **Landlord and Tenant**
Measure of damages
Conversion of personal property, measure of damages for, 6.43
Destruction of personal property, 5.33

Pleadings
Breach of contract action, burden of pleading and proving damages, 1.13
Complaints. See **Complaints**
Cross-complaints. See **Cross-Complaints**

Political Activities by Employees
First Amendment protection for employee's political activities, 3.80
Interference with employee's political activities, employer's prohibited from, 3.103

Possession
Deliver possession, measure of damages for landlord's breach of duty to
Attorney fees, interest, and punitive damages, restrictions on tenant's recovery of, 4.13
General damages, 4.10
Rental value, proof of, 4.11
Special damages, tenant's recovery of, 4.12
Quiet enjoyment, landlord's breach of covenant by refusing possession of premises to tenant, 4.14

Possession, Writ of
Tenant in forcible detainer or entry obtaining writ, 4.22

Preemption. See **Federal Preemption**

Pregnancy and Childbirth
Sex discrimination, pregnancy discrimination as, 1.55

Prejudgment Interest. See **Interest on Money**

Presumptions and Inferences
Conversion of personal property, presumption affecting, 6.43
Lost profits, presumption that recovery attributable to, 7.39
Patent infringement action, no adverse inference from assertion of attorney-client privilege or work product doctrine, 6.13

Pretrial Conference
Combined legal and equitable claims, motion in limine to set order and procedure for hearing, 2.2

Prisons and Prisoners
Americans with Disabilities Act (ADA), inapplicability to state prisoners, 3.44

Privacy
Federal Privacy Act, protection against disclosure of personal information by federal agency, 3.81
Private employers, constitutional right to privacy limiting or prohibiting certain employment practices by, 3.99

Private Attorney General Theory
Contract cases resulting in significant benefit to general public, award of fees in, 1.30
Nuisance or trespass action, recovery of attorney fees in, 5.36
Wrongful termination of employee, recovery of fees in action for, 3.96

Private Attorneys General Act of 2004, 3.90A

Private Nuisance. See **Nuisance**

Profits
Breach of contract action, recovery of lost profits by plaintiff, 1.19, 1.51
Capital asset or lost profits, determining if recovery of damages for, 7.7
Copyright infringement, recovery of lost profits. See **Copyright Infringement**
Crops. See **Crops**
Fraud in real estate transaction, recovery of lost profits, 2.44, 2.52
Future profits
Difficulty in proving future lost profits, 4.112
Landlord and tenant. See **Landlord and Tenant**
Intellectual property, recovery of lost profits for misappropriation claims. See **Intellectual Property**
Patent infringement, recovery of lost profits due to. See **Patent Infringement**
Strike and refusal of union to arbitrate, employer's recovery of lost profits caused by, 3.23
Taxability of award for lost profits. See **Taxes**
Trademark infringement, plaintiff's recovery of defendant's profits, 6.29
Trade secret misappropriation, plaintiff's recovery of lost profits, 6.35
Trespass or nuisance, lost profits as measure of damages for, 5.35

Promissory Estoppel
Broker's recovery of commission without written contract, inapplicability of promissory estoppel, 2.30

Promissory Fraud
Real property purchase agreement, buyer's fraud as grounds for promissory fraud action, 2.51

Proof
See also **Burden of Proof; Evidence**
Basis of asset, effect of taxpayer's inability to prove, 7.41-7.42
Breach of contract action, proof of damages at trial, 1.13
Breach of real property purchase and sale agreement, proof of damages, 2.28
Capital asset, proof of injury to, 7.41
Fraud in real property transaction, proving market value, 2.37
Future lost profits, difficulty in proving, 4.112
Landlord or tenant, proof of damages by, 4.107
Measure of damages for landlord's breach of duty to deliver possession, proof of rental value, 4.11
Nuisance. See **Nuisance**
Trespass action, proof of deposit of particulate matter on plaintiff's property or actual physical damage to property as requirement for, 5.18

Union's unfair labor practices, employer's proof of damages, 3.23

Proposition 51
Noneconomic damages, Proposition 51 limiting recovery for, 5.40

Public Contracts Act. See **Walsh-Healey Act**

Public Employment Relations Board (PERB)
Jurisdiction of Board to determine if strike covered by Educational Employment Relations Act, examining exclusivity of initial, 3.82

Public Entities and Employees
California statutes governing employer-employee relations, 3.82
Covenant of good faith and fair dealing, applicability to public employers, 3.94
Due process rights of public employees before termination, 3.94
Fair Employment and Housing Act (FEHA), applicability to public employers, 3.92
Fair Labor Standards Act (FLSA), exemption for public employees from, 3.44
First Amendment protection for employee's political activities, 3.80
Liquidated damages clauses in public contracts, 1.43
Local government. See **Local Government**
Nuisance operated by public entity, plaintiff's election to treat as permanent or continuing, 5.15
Skelly rights of tenured public employees, 3.94

Publicity
Loss of publicity, recovery of damages based on, 1.40

Public Nuisance. See **Nuisance**

Public Policy
Contract with liability exemption for party's own fraud, willful injury to property, or violation of laws void, 1.46
Release of liability for future gross negligence in sports or recreational programs, unenforceability of, 1.46
Sex discrimination in employment as violation of public policy, 1.55
Wrongful termination in violation of public policy
Generally, 3.92
Burden of proof, employee's responsibility to carry, 1.55
Recovery against individual supervisors, limitations on, 3.96

Public Safety Officer's Procedural Bill Of Rights Act
Exclusive remedy rule of workers' compensation, inapplicability to exercising right to counsel under Act, 3.97

Public Utilities. See **Utilities**

Punitive Damages
Breach of contract. See **Breach of Contract (Generally)**
Burden of proof for, 2.34, 2.47, 6.38
Civil Rights Act of 1991, recovery of punitive damages under, 3.31, 3.61
Compensatory damages as prerequisite for awarding, 1.34, 3.97
Due process
Judicial review of punitive damages, 1.34
Nonparties, violation of due process for jury to consider injuries to, 6.38
Predisciplinary due process requirements, award of punitive damages against employer for failure to follow, 3.94
Encroachment, punitive damages for, 5.38
ERISA, restriction on award of punitive damages under, 3.72
Fraud in real property transactions. See **Fraud Claims in Real Property Transactions**
Home Equity Sales Contract Act, recovery of punitive damages under, 2.53
Labor Management Relations Act. See **Labor Management Relations Act of 1947 (LMRA)**
Labor-Management Reporting and Disclosure Act (LMRDA), recovery of punitive damages in action under, 3.26-3.27
Landlord and tenant. See **Landlord and Tenant**
Nonparties, unavailability of punitive damages to punish defendant for injuries to, 3.96, 4.19, 5.38, 6.38
Nuisance. See **Nuisance**
Quiet enjoyment, restrictions on recovery of punitive damages for breach of covenant of, 4.19-4.20
Real property purchase and sale agreement, requirements for buyer's recovery of punitive damages for breach of, 2.13
Rehabilitation Act of 1973, lack of recovery of punitive damages under, 3.30
Rest and meal periods, limitations on availability of punitive damages for, 3.88A
Taxation of punitive damages. See **Taxes**

Title VII cases, award of punitive damages in, 3.61, 3.64
Trademark infringement, no recovery of punitive damages under Lanham Act, 6.31
Trade secret misappropriation, recovery of punitive damages for willful and malicious misappropriation, 6.38
Trespass, 5.38
Unrelated bad acts by defendants, unavailability of damages for, 5.38
Wrongful termination, recovery of punitive damages for, 3.96

Quantum Meruit
Breach of contract, plaintiff's election to rescind and sue for recovery on quantum meruit, 1.53
Broker's recovery of commission without written contract, inapplicability of quantum meruit, 2.30

Questionnaires. See **Charts, Checklists, Questionnaires, and Tables**

Questions of Law and Fact
Breach of contract action, foreseeability of damages as question of fact, 1.18
Existence of implied contract of employment as question for jury, 3.92

Quiet Enjoyment, Breach of Covenant of
Actions constituting breach of covenant, 4.14
Actual or constructive eviction as breach of covenant, 4.14-4.15
Measure of damages for landlord's breach of covenant
Actual or constructive eviction, recovery of damages for, 4.15
Attorney fees and interest, restrictions on recovery of, 4.18
Beneficial enjoyment by tenant, recovery of damages for interruption of, 4.16
General damages, 4.15-4.16
Punitive damages, restrictions on recovery of, 4.19-4.20
Special damages resulting from eviction, tenant's recovery of, 4.17, 4.20
Statute of limitations for action against landlord for, 4.21
Tort, breach of covenant as, 4.20

Racial Discrimination
Civil Rights Acts of 1866 and 1871, racial discrimination actions under, 3.64
Federal Service Labor Management Relations Act (FSLMRA), grievance procedure for racial discrimination claims, 3.78
Railway Labor Act, employer's liability for racial discrimination under, 3.34

Railway Labor Act
Generally, 3.32
Attorney fees, recovery of, 3.33, 3.35
Back pay, recovery of, 3.33-3.34
Classification of disputes concerning Railway Labor Act as major or minor, 3.33

Real Estate Brokers
Concealment of termite report by broker, recovery of punitive damages and damages for emotional distress, 2.47
Misrepresentations by broker causing buyer to mistakenly sue for specific performance, broker's liability for buyer's attorney fees, 2.48
Principle, no commission for broker acting as, 2.30
Real Estate Recovery Fund, recovering unsatisfied monetary judgments against real estate licensees from, 2.59
Statute of frauds requiring written contract for broker, 2.30

Real Estate Recovery Fund
Recovery of unsatisfied monetary judgments against real estate licensees from, 2.59

Real Property
See also **Personal Property**
Breach of real property purchase and sale agreement. See **Breach of Real Property Purchase and Sale Agreement**
Brokers. See **Real Estate Brokers**
Fixtures. See **Fixtures**
Foreclosure. See **Foreclosure**
Injury to property
Generally, 5.1
Measure of damages for injury or destruction of, 4.75, 5.32
Nuisance. See **Nuisance**
Trespass. See **Trespass**

Owner defined, 2.38
Residential real property. See **Residential Real Property**
Sale of. See **Sale of Real Property**
Venue, 5.24

Real Property Purchase and Sale Agreement
Breach of. See **Breach of Real Property Purchase and Sale Agreement**
Conditional performance by buyer, 2.16
Fraud claims. See **Fraud Claims in Real Property Transactions**
Rescission. See **Rescission**

Records and Reports
Attorney fees, applicant's burden to furnish appellate court with adequate record when challenging award of, 4.109
Breach of contract, importance of documenting conduct of parties and damages, 1.11
ERISA, reporting requirements under, 3.68
Federal Privacy Act, protection against disclosure of personal information by federal agency, 3.81
Labor-Management Reporting and Disclosure Act. See **Labor-Management Reporting and Disclosure Act of 1959 (LMRDA)**

Redemption
Installment land sale contract, redemption rights, 2.25, 2.60

References
Triple damages for false references, employee's recovery of, 3.98

Rehabilitation Act of 1973
Discrimination against disabled persons prohibited by employers receiving federal funds, 3.30

Reimbursement
ERISA's preemption of fiduciary's state law action to enforce reimbursement of third party benefit, 3.66
Nontaxability of reimbursement of embezzled funds, 7.43

Reinstatement of Employee
Back pay
Arbitrator ordering reinstatement of employee with back pay, 3.107
Bona fide purchaser of business, reinstatement and back pay orders imposed on, 3.14
Unconditional offer of reinstatement shortening eligibility period for, 3.10
Uniformed Services Employment and Reemployment Rights Act of 1994, employer's liability for back pay for refusal to reinstatement employee, 3.47
Unilateral action by employees in violation of LMRA, NLRB order for reinstatement of employees with back pay, 3.18
Discrimination by employer for union activity, reinstatement of employee, 3.6
Pre-termination hearing, reinstatement of probationary employee based on denial of, 3.94
Title VII, reinstatement of employee as remedy under, 3.48
Uniformed Services Employment and Reemployment Rights Act of 1994, veterans' reinstatement rights governed by, 3.47

Releases
Public policy, release of liability for future gross negligence in sports or recreational activities unenforceable as against, 1.46

Religious Organizations. See **Churches and Religious Organizations**

Remedies
Constructive trust remedy. See **Intellectual Property**
Injunctions. See **Injunctions**
Leases. See **Leases**
Nuisance. See **Nuisance**
Real property purchase and sale agreement, breach of. See **Breach of Real Property Purchase and Sale Agreement**
Trespass. See **Trespass**
Waste, remedies for, 5.54

Remote, Speculative, or Uncertain Damages
Breach of contract, recovery of uncertain or speculative damages prohibited, 1.17, 1.40
Prospective landlord's breach of agreement to execute lease, tenant's inability to recover for remote, speculative, or uncertain damages, 4.3

Removal of Fixtures. See **Fixtures**

Rent
See also **Landlord and Tenant; Leases**
Appeal, effect of plaintiff's failure to request trial court for interest on rent due, 4.88
Back rent
Defined, 4.86
3-day notice to pay rent or quit as prerequisite for recovering back rent, 4.87
Breach of lease covenant by landlord, reduction of rent as settlement of damages, 4.34
Breach of real property purchase and sale agreement, buyer's recovery of overstated amount of rent, 2.9
Breach of warranty of habitability, determining amount of reasonable rent payable by tenant during period of, 4.40
Cash as exclusive form of rent payment, limits on landlord's ability to demand, 4.52
Expert testimony establishing rental value, 4.11
Fraud in real property transaction, buyer's right to collect rents after discovering, 2.56
Rescission, payment of rent to seller for time to buyer in possession of property, 2.50
Tenant's covenant to pay
Generally, 4.65
Interest, landlord's recovery of, 4.66
Termination of lease, landlord's right to unpaid rent earned up to time of, 4.79
Unlawful detainer. See **Unlawful Detainer**

Rent Control
Attorney fees
Eviction cases, rent control ordinances providing for award of fees to prevailing party in, 4.50
Tenant's recovery in action against landlord for violating rent control ordinance, 4.48
Bankruptcy, nondischargeability of damage award for fraudulent collection of rents in excess allowed by rent control ordinance, 4.48, 4.114
Evictions (see Landlord's violation of local rent control ordinances, below)
Landlord's violation of local rent control ordinances
Attorney fees, rent control ordinances providing for award to prevailing party in eviction cases, 4.50
New owner's liability for rent overcharges collected by previous owner, 4.51
Overcharges, strategies for and defenses to tenant's recovery of damages for, 4.48
Unlawful evictions, tenant's recovery of damages for, 4.49
Treble damages
Local rent control boards' award of treble damages, invalidity of, 4.48
Unlawful eviction, mandatory award of treble damages for unlawful eviction under San Francisco rent control ordinance, 4.49
Unlawful detainer action, inapplicability of rent control ordinance to recovering damages in, 4.87
Withholding portion of monthly rent as restitution for past overcharge, rent control board prohibited from issuing order allowing, 4.48

Repairs
See also **Improvements**
Admissibility of cost of repairs to prove actual value of property, 2.37
Automotive Repair Act, recovery of damages for unauthorized repairs, 1.56
Breach of covenant to repair
Landlord's breach, measure of damages for, 4.30
Tenant's liability for, 4.69
Breach of landlord's statutory duty to repair
Civil Code §§1941-1942, landlord's duty to repair under, 4.35
Housing Codes, landlord's duty to repair under, 4.37
Retaliator eviction of tenant for complaining of premise's tenantability, 4.36
Breach of tenant's statutory duty to repair, 4.62
Defect in performance of contract, cost of repairs as measure of damages, 1.50
Discomfort and annoyance caused by landlord's failure to make repairs, recovery of damages for, 4.41
Fraud in real property transaction, buyer's recovery of expenditures made on repairs, 2.42

Reports. See **Records and Reports**

Reputation
Breach of contract, recovery of damages for injury to reputation prohibited, 1.39
Destruction or alteration of art, recovery of damages by artist for injury to reputation, 5.33
Wrongful termination action, recovery of damages for injury to reputation, 3.96

Resale of Property
Breach of real property purchase and sale agreement, seller's recovery of resale expenses, 2.29
Lis pendens preventing, 2.31
Mitigation of damages, resale of property as, 2.55

Rescission
Breach of real property purchase and sale agreement by buyer, seller's action for rescission after, 2.17
Fraud in real property transaction, rescission as remedy for, 2.50-2.51
Home Equity Sales Contract Act, statutory right of rescission in, 2.53
Improvements, rescinding buyer recovering for costs of, 2.42
Interest, rescinding buyer recovering, 2.46
Notice of rescission, effect of buyer continuing to make payments after giving, 2.58
Rent for time to buyer in possession of property, payment to seller of, 2.50
Seller's failure to disclose facts materially affecting value or desirability of property as grounds for rescission, 5.54

Residential Real Property
Home Equity Sales Contract Act, exclusion for property acquired for use as personal residence, 2.53
Sale of residence, exclusion of gain on, 7.10

Restaurants
Credit against minimum wage for value of meals furnished, employer prohibited from receiving, 3.100

Restitution
Intellectual property, restitution for misappropriation of. See **Intellectual Property**
Withholding portion of monthly rent as restitution for past overcharge, rent control board prohibited from issuing order allowing, 4.48

Retaliation Against Employee
Americans with Disabilities Act (ADA), retaliation against employees prohibited under, 3.31
Whistleblower disclosing information to governmental agency, retaliation prohibited, 3.93
Wrongful termination of employee as retaliation
Generally, 3.97
Coworker's sexual harassment claim, termination of employee for testifying concerning, 1.55

Retirement and Pension Plans
Back pay awarded to employees on strike, inclusion of employer's contributions to pension fund, 3.7
Early retirement program favoring older employees as not violating Age Discrimination in Employment Act (ADEA), 3.46
ERISA. See **Employee Retirement Income Security Act (ERISA)**

Right to Counsel
Exclusive remedy rule of workers' compensation, inapplicability to exercising right to counsel under Public Safety Officer's Procedural Bill Of Rights Act, 3.97

Royalties
Patent infringement, reasonable royalty rate as alternative measure of recovery for. See **Patent Infringement**
Trade secret misappropriation, recovery of reasonable royalty for, 6.37

Rules of Court
Attorney fees, applicability of Rules of Court to claim for statutory, 1.29

Safety. See **Health and Safety**

Salaries and Compensation
See also **Wages and Hours**
Agent or broker's commission, statute of frauds requiring written contract for, 2.30
Back pay. See **Back Pay**
Commission contracts by out-of-state employers, statutory requirements for, 3.104
FLSA. See **Fair Labor Standards Act of 1938 (FLSA)**
Net earnings defined, 3.9
Standing to assert prevailing wage claim, no preemption by federal immigration law, 3.93
Taxes. See **Taxes**
Unemployment compensation. See **Unemployment Compensation**
Wrongful termination of employee, recovery of compensation in action for, 1.53

Sale of Real Property
Breach of sale agreement. See **Breach of Real Property Purchase and Sale Agreement**
Gain on sale of residence, exclusion of gain on, 7.10

Sale or Exchange of Property
Capital gains treatment of award, sale or exchange of property as subject of lawsuit, 7.6

Sanctions. See **Penalties**

Schools
See also **Universities and Colleges**
Educational Employment Relations Act (EERA), collective bargaining rights for elementary, secondary, and community college employees under, 3.82

Securities
Taxation of award in securities fraud action, 7.30

Security Deposits
Generally, 4.52
Attorney fees, nonrecoverability of, 4.54
Bad faith retention of deposit by landlord or landlord's successor, statutory damages for, 4.53
Cash as exclusive form of security deposit, limits on landlord's ability to demand, 4.52
Statute of limitations in action based on landlord's failure to return security deposit, 4.55

Security Interests. See **Breach of Contract (Generally)**

Self-Representation. See **In Propria Persona**

Seniority
Title VII, effect of seniority system on layoffs, 3.60

Service Contracts. See **Employment Contracts**

Setoffs
Breach of real property purchase and sale agreement, buyer's right to offset appreciation against seller's consequential damages, 2.29, 2.33
Fraud by seller in real property transaction, seller claiming setoff against unpaid and past-due payments owed by buyer, 2.54

Settlement
Defined, 7.1
Insurer's liability for failure to accept settlement offer within policy limits, 1.57
Prejudgment interest, effect of settlement agreement provision concerning, 7.46
Tax consequences of settlement. See **Taxes**

Sex Discrimination
Fair Labor Standards Act (FLSA), gender discrimination in pay prohibited under, 3.43
Federal Service Labor Management Relations Act (FSLMRA), grievance procedure for sex discrimination claims, 3.78
Pregnancy discrimination as form of, 1.55

Sexual Harassment
See also **Harassment**
Attorney fees, indemnification of falsely accused defendant for, 3.81
Fair Employment and Housing Act (FEHA), employer's strict liability for hostile environment sexual harassment by supervisor under, 3.105
Title VII, sexual harassment prohibited under, 3.48
Wrongful termination of employee in retaliation for testifying concerning coworker's sexual harassment claim, 1.55

Sexual Orientation
Fair Employment and Housing Act (FEHA), discrimination based on sexual orientation based prohibited under, 3.92, 3.105

Shares of Stock
Taxation of recoveries in litigation involving, 7.36

Sherman and Clayton Antitrust Acts
See also **Antitrust**
Generally, 3.36
Examples of illegal conspiracies, 3.37
Exemption of employers from, 3.38

Shortening of Time. See **Extension and Shortening of Time**

Skelly Rights
Public employees, rights of, 3.94

Slander. See **Defamation**

Small Claims Court
Jurisdictional amount, 2.3, 5.23
Security deposit, tenant seeking statutory damages in small claims court for landlord's bad faith retention of, 4.53
Unlawful detainer actions not within jurisdiction of, 4.92

Soil Contamination. See **Hazardous Materials and Toxic Waste**

Song-Beverly Act
Attorney fees, recovery of, 1.30

Special Damages
Breach of contract, recovery of special damages in action for. See **Breach of Contract (Generally)**
Interest paid by plaintiff on loan for carrying out performance as, 1.49
Landlord and tenant. See **Landlord and Tenant**
Real property purchase and sale agreement, seller's recovery of special damages for buyer's breach of. See **Breach of Real Property Purchase and Sale Agreement**

Specific Performance
Breach of real property and purchase sale agreement. See **Breach of Real Property Purchase and Sale Agreement**
Broker's misrepresentations causing buyer to mistakenly sue for specific performance, liability of broker for buyer's attorney fees, 2.48

Speculative Damages. See **Remote, Speculative, or Uncertain Damages**

Sports and Recreational Activities
Release of liability for future gross negligence, unenforceability of, 1.46

Standing
Labor Management Relations Act (LMRA), standing to bring damages action against union for unfair labor practice under, 3.21
Public nuisance, standing to bring abatement action, 5.8
Wage claim, no preemption by federal immigration law of standing to assert, 3.93

Statute of Frauds
Agent or broker, written contract required for, 2.30

Statute of Repose
Landlord and tenant. See **Landlord and Tenant**
Nuisance or trespass action, 5.44A

Statutes of Limitations
See also **Time**
Breach of real estate purchase and sale agreement, 2.33
Conversion of property, statute of limitations for, 6.43
Copyright infringement action, statute of limitations for, 6.15
Fair Labor Standards Act (FLSA), statute of limitations for back pay suit under, 3.45
Fraud or deceit claim, statute of limitations for, 6.40
Landlord and tenant. See **Landlord and Tenant**
Late discovery rule, effect on statute of limitations, 5.43
Leases. See **Leases**
Nuisance. See **Nuisance**
Patent infringement, statute of limitations for action based on, 6.1
§1981 action, statute of limitations for, 3.63-3.64
Tolling of statute of limitations, effect of plaintiff's lack of knowledge of wrongdoing on, 5.43
Trademark infringement action, statute of limitations for, 6.28
Trade secret, statute of limitations for misappropriation of, 6.34
Trespass. See **Trespass**
Unfair labor practice charges, statute of limitations for filing, 3.14
Vacation benefits, applicable limitations period for limiting employer's liability to pay for, 3.88

Wage claim, statute of limitations for, 3.88A

Stipulations
Attorney fee motion, stipulation to extend time for, 4.104
Breach of implied warranty of habitability, effect of stipulation to give up possession in unlawful detainer on action for, 4.38
Legal rate of interest stipulated in contract, effect of breach of contract on, 1.20

Stock. See **Shares of Stock**

Strike, Motion to
Unlawful detainer action, motion to strike cost bill, 4.91

Strikes
Arbitration
Illegal strikes, arbitration as means of securing damages for, 3.109
Lost profits caused by strike and union's refusal to arbitrate, employer's recovery of, 3.23
Back pay awarded to employees on strike
Inclusion of employer's contributions to pension fund, 3.7
Restrictions on deduction of strike benefits from back pay awards, 3.8
Time period for back pay, commencement of, 3.10
Decertifying public employee union for instigating strike, local government prohibited from unilaterally, 3.82
Educational Employment Relations Act (EERA), superior court's lack of jurisdiction over school district's tort action for damages based on teacher's strike led by noncertified unions, 3.82
Illegal strike, recovery of damages for, 3.82
Injunctions against
Breach of no-strike agreement by union, state's concurrent jurisdiction to enjoin strike, 3.22
Jurisdictional strikes prohibited, 3.82
No-strike clause, injunction against violation of, 3.109
Jurisdiction
Educational Employment Relations Act (EERA), superior court's lack of jurisdiction over school district's tort action for damages based on teacher's strike led by noncertified unions, 3.82
Public Employment Relations Board (PERB), examining exclusive initial jurisdiction to determine if strike covered by Educational Employment Relations Act, 3.82
No-strike clause
Breach of no-strike agreement by union, state's concurrent jurisdiction to enjoin strike, 3.22
Grievance filed by employer over violation of, 3.109
Overhead expenses, employer's recovery for union's violation of no-strike clause, 3.23
Unlawful interference with employer's business, NLRB determining if strikes and bargaining tactics as, 3.21

Subdivision Map
Expenditures in obtaining recorded subdivision map, recovery of, 2.43

Subleases
Covenant against subletting, landlord's termination of lease for tenant's breach of, 4.70

Successor Employers
NLRB's authority to award remedies for unfair labor practices against successor of offending employer, 3.14

Successors in Interest
Unlawful detainer action, attorney fees award against successors in interest, 4.99

Surrender
Abandonment distinguished, 4.78
Lease covenants. See **Lease Covenants**

Tables. See **Charts, Checklists, Questionnaires, and Tables**

Tax-Deferred Exchange
Default, recovery of lost tax benefit in event of, 2.31

Taxes
Alternative minimum tax (AMT) income, miscellaneous itemized deductions not allowed to, 7.62A
Attorney fees, tax treatment of award for
Generally, 7.49

American Jobs Creation Act, effect of, 7.49B
Anticipatory assignment doctrine, effect of, 7.49A
Commissioner vs Banks, tax treatment of contingent attorney fees under, 7.49-7.49A
Deduction for fees in unlawful discrimination cases, 7.49B
IRS Field Service Advice, law firm's lack of direct interest in estate, 7.65
Person eligible to receive fees, determination of, 7.63-7.64
Back pay, taxability as ordinary income, 7.14
Business injuries, recoveries for
Allocation of recovery between several claims, advantage of, 7.42
Antitrust litigation, effect of taxpayer's inability to show portion of damages as representing nontaxable return of capital, 7.48
Contract rights, recoveries under, 7.40
Covenant not to compete, taxation of damages in action for breach of, 7.33
Delay damages, taxability of, 7.47
Goodwill (see Goodwill, taxability of recovery of damages for injury to, below)
Interest income included as part of settlement or judgment, taxability of, 7.44-7.47
Liquidated damages provisions, recoveries under, 7.38
Lost profits (see Lost profits, recovery of damages for, below)
Patent infringement damages, allocating portion of recovery to injury to goodwill, 7.34, 7.37, 7.41
Stock, recoveries in litigation involving, 7.36
Timing of income, effect of, 7.20
Capital gains. See **Capital Gains and Losses**
Classifying other recoveries
Generally, 7.15
IRC §61, definition of gross income under, 7.16
Underlying nature of claim determining if damages treated as capital or ordinary income, 7.17
Covenant to pay taxes, tenant's liability for breach of, 4.73
Distinction between settlements and judgments
Generally, 7.3
Definition of settlements and judgment, 7.1
Lost profits, taxability of compensation as ordinary income, 7.7
Goodwill, taxability of recovery of damages for injury to
Generally, 7.12
Basis for goodwill, effect of taxpayer's inability to prove, 7.42
Capital, payment for damage to goodwill taxable as, 7.19
Distinction between recovery for lost profits and recovery for injury to goodwill, 7.18
IRA, nontaxability of reimbursement for embezzled funds, 7.43
Jury instructions on tax treatment of award, request for, 7.3
Litigation, termination of (see Termination of litigation, tax consequences of, below)
Lost profits, recovery of damages for
Generally, 7.7, 7.18, 7.23
Commission income or wages, taxability of damages as ordinary income, 7.25
Distinction between recovery for lost profits and recovery for injury to goodwill, 7.18
Income versus nontaxable bequest, 7.26
Interest, taxability of, 7.47
Miscellaneous lost president of profit recoveries, 7.27
Noncapital recoveries, effect on taxation, 7.24
Presumption that recovery attributable to lost profits, 7.39
Personal physical injury damages, nontaxability of, 7.7, 7.13
Position of IRS and various Circuit Court of Appeals on taxability of attorney fees (see Attorney fees, tax treatment of award for, above)
Prejudgment interest award, taxability of, 7.45-7.47
Punitive damages
Generally, 7.29
Attorney fees attributable to punitive damages, taxation of (see Attorney fees, tax treatment of award for, above)
Termination of litigation, tax consequences of
Generally, 7.1
Distinguishing between ordinary and capital treatment of recovery, 7.2
Underlying claim, tax consequences of award determined by
Generally, 7.4, 7.22
Additional federal income tax, taxation of compensation for damages resulting in, 7.32
Breach of fiduciary duty, tax treatment of settlements in actions for, 7.29
Discharge of indebtedness income, tax treatment of, 7.35
Fraud claims, taxability of damages recovered in, 7.24, 7.28
Lost profits (see Lost profits, recovery of damages for, above)
Origin of claim, 7.5

Patent infringement damages, taxability as ordinary income, 7.34, 7.37
Punitive damages, taxation as gross income, 7.29
Sale or exchange as requirement for capital gains treatment, 7.6
Securities fraud in reorganization, 7.30
Tax benefit rule, operation of, 7.31

Temporary Nuisance. See **Nuisance**

Temporary Trespass. See **Trespass**

Tenants. See **Landlord and Tenant**

Termination of Employment
See also **Wrongful Termination**
Employment contract, termination of employee in violation of. See **Employment Contracts**
Reinstatement of employee. See **Reinstatement of Employee**
Wages. See **Wages and Hours**

Termination of Lease
Breach or abandonment by tenant
Definition of abandonment, 4.78
Equitable relief, landlord's right to, 4.81
Measure of damages (see Measure of damages for tenant's breach of abandonment, below)
Statute of limitations for bringing action, 4.82
Statutory remedies for recovering damages on abandonment, nonexclusivity of, 4.81
Covenant against assignment of lease, landlord's termination of lease for tenant's breach of, 4.70
Measure of damages for tenant's breach of abandonment
Continuation of lease by landlord, effect of, 4.80
Liquidated damages provision in lease, enforceability of, 4.81
Termination of lease, landlord's recovery of damages on, 4.79
Quiet enjoyment, invalid termination notice interrupting tenant's beneficial enjoyment of premises as breach of covenant of, 4.14
Waiver of right to terminate lease, tenant's delay in acting after landlord's interference with beneficial enjoyment resulting in, 4.16

Third Parties
Breach of contract, counsel exploring possibility of third party actions, 1.13
Punitive damages for harm caused to third parties, limitations on, 5.38

Third Party Tort Doctrine
Attorney fees, recovery of, 1.32

3-Day Notice
Back rent, 3-day notice to pay rent or quit as prerequisite for recovering, 4.87
Unlawful detainer action, service of 3-day notice as prerequisite for filing, 4.105

Timber. See **Trees and Timber**

Time
See also **Statutes of Limitations**
Back pay, time period for which employees can recover, 3.10
Breach of real property purchase and sale agreement, failure to convey title within time specified in contract, 2.9
Contract breach liquidated damages clause, necessity of anticipating amount of damages at contract formation time, 1.42
Extension of time. See **Extension and Shortening of Time**
Private Attorneys General Act of 2004, timely notice under, 3.90A
Prospective landlord's breach of agreement to execute lease, tenant's recovery of special damages for loss of time, 4.3
Title VII, time limits for accumulation of back pay under, 3.48-3.49
Unlawful detainer action, time limit for claiming attorney fees, 4.104
Wages, timely payment of. See **Wages and Hours**

Title. See **Breach of Real Property Purchase and Sale Agreement**

Title VII
See also **Civil Rights Act of, 1991**
Generally, 3.48
Attorney fees, recovery of, 3.62
Back pay awards

Generally, 3.49
Bona fide offer of employment, plaintiff's refusal terminating back pay period, 3.52
Definition of back pay, 3.49, 3.51
Duplication of previous back pay award in personal injury action against employer, recovery of back pay award despite, 3.53
Equivalent employment, effect on employer's liability for back pay of refusing to offer employee, 3.58
Formula for calculating amount of back pay, 3.50
Good faith of employer not defense to request for back pay award, 3.57
Prejudgment interest on back pay awards, 3.56
Time limits for accumulation of back pay, 3.48-3.49
Unemployment benefits, no deduction from back pay in Title VII cases, 3.59
Employment discrimination prohibited by, 3.48
Examples of actionable employment discrimination under Title VII, 3.48
Front pay, employee's recovery of, 3.54
Injunctive relief under, 3.48
Labor Management Relations Act (LMRA), similarity of Title VII to, 3.48
Mental distress damages, lack of recovery for, 3.55
Punitive damages in Title VII cases, 3.61, 3.64
Seniority system, effect on layoffs, 3.60
Sex discrimination in benefits as violation of, 3.43

Tort of Another Theory
Attorney fees, award of, 1.32, 2.12

Torts
Breach of contract action, recovery of punitive damages for independent tort, 1.35
Quiet enjoyment, breach of covenant as tort, 4.20
Wrongful termination, employee's recovery of tort damages, 3.96

Toxic Waste. See **Hazardous Materials and Toxic Waste**

Trade Fixtures
See also **Fixtures**
Personal property, trade fixtures as, 4.75
Tenant's recovery for landlord's wrongful withholding of, 4.46

Trademark Infringement
See also **Intellectual Property**
AntiCybersquatting Consumer Protection Act, bad faith use of trademark in domain name as violation of, 6.28
California Trademark Law, recovery of damages for trademark infringement under, 6.33
Expert witness, required factual basis for opinions of. See **Experts and Expert Witnesses**
Injunctive relief, inadequacy of, 6.28
Lanham Act
Attorney fees, recovery of, 6.32
Burden of proof on plaintiff to show defendant's revenues, 6.29
Plaintiff's damages, recovery of, 6.30-6.32
Prejudgment interest, plaintiff's recovery of, 6.32
Profits made by defendant, plaintiff's recovery of, 6.29
Punitive damages, no recovery of, 6.31
Statutory basis for recovery of damages, Lanham Act as, 6.28
Statutory damages for counterfeit marks and for violation of 15 USC §1125(d)(1), 6.31A
Treble damages, 6.31
Statute of limitations for, 6.28

Trade Secrets, Misappropriation of
See also **Intellectual Property**
Generally, 6.34
Actual damages resulting from misappropriation, plaintiff's recovery of, 6.35
Attorney fees, prevailing party's recovery of, 6.39
Expert witness, required factual basis for opinions of. See **Experts and Expert Witnesses**
Punitive damages, recovery for willful and malicious misappropriation, 6.38
Reasonable royalty, plaintiff's recovery of, 6.37
Statute of limitations for trade secret claim, 6.34
Unjust enrichment, plaintiff's recovery based on, 6.36

Treble Damages

False references for employee, recovery of triple damages, 3.98
Nuisance, owner's liability for treble costs of abating, 5.20
Rent control. See **Rent Control**
Sherman and Clayton Antitrust Acts, recovery of treble damages under, 3.36
Trademark infringement, plaintiff's recovery of treble damages for, 6.31
Waste, action for treble damages against tenant, 4.60, 5.54

Trees and Timber
Trespass resulting in injury or removal of trees or timber, recovery of damages for, 5.32

Trespass
See also **Nuisance**
Actual damage to property as requirements for trespass action, 5.17
Continuing trespass (see Permanent trespass and temporary or continuing trespass, distinction between, below)
Crops
Attorney fees, recovery of, 5.36
Injury or removal of crops, recovery of damages for, 5.32
Damages and remedies
Generally, 5.21
Annoyance, discomfort, and mental suffering, recovery of damages for, 5.34
Attorney fees, restrictions on recovery of, 5.36
Classification of trespass for selection of remedies, importance of, 5.13
Crops and timber, measure of damages for injury or removal of, 5.32
Equitable, legal, or hybrid action, attorney's evaluation of case as, 5.22
Fixtures or personal property, damage, destruction, removal of, 5.33
Good faith effort by defendant to control trespass, effect of, 5.38
Lost profits, 5.35
Prejudgment interest, restrictions on recovery of, 5.37
Punitive damages, 5.38
Statutory limits on recovery of damages, 5.39
Subject matter jurisdiction governed by amount in controversy, 5.23
Tort measure of damages (see Tort measure of damages, below)
Value, recovery of damages for diminution in, 5.13, 5.28
Venue, effect of classification of action as transitory or local on, 5.24
Defenses
Comparative negligence, 5.40
Due care, lack of defense to trespass action, 5.50
Laches as defense in, 5.46
Separation of powers as defense in trespass action, 5.52
Statute of limitations (see Statute of limitations, below)
Statute of repose, 5.44A
Defined, 5.17-5.18
Distinction between nuisance and trespass, 5.18
Encroachment treated as nuisance or trespass, 5.19
Holdover tenant, landlord's election to treat as trespasser, 4.83
Permanent trespass and temporary or continuing trespass, distinction between
Factors in determining if trespass permanent or continuing, 5.14
Injunctive relief, 5.13, 5.30
Measure of damages (see Tort measure of damages, below)
Remedies (see Damages and remedies, above)
Statute of limitations for action against permanent trespass, 5.13
Proof of deposit of particulate matter on plaintiff's property or actual physical damage to property as requirement for trespass action, 5.18
Statute of limitations
Commencement of statute of limitations for trespass action, 5.42
Continuing trespass, statute of limitations for, 5.44-5.44A
Permanent trespass, statute of limitations for action against, 5.13
Pollution cases, special rules for, 5.45
Temporary trespass (see Permanent trespass and temporary or continuing trespass, distinction between, above)
Tort measure of damages
Generally, 5.27
Continuing trespass, recovery of damages for, 5.30
Nominal damages, recovery of, 5.27
Permanent trespass, recovery of past and prospective damages for, 5.31
Torts and other related actions, 5.54

Trusts. See **Constructive Trust**

Uncertain Damages. See **Remote, Speculative, or Uncertain Damages**

Unemployment Compensation
Back pay award, no deduction of unemployment benefits from, 3.9, 3.59, 3.95

Unfair Labor Practices. See **Labor Management Relations Act of 1947 (LMRA)**

Unintended Use of Property by Tenant. See **Leases**

Unions. See **Labor Unions**

Universities and Colleges
See also **Schools**
Higher Education Employer-Employee Relations Act (HEERA), collective bargaining rights for employees of University of California and California State University and Colleges, 3.82

Unjust Enrichment
Breach of real property purchase and sale agreement, buyer reducing seller's damages by showing unjust enrichment, 2.33
Intellectual property, recovery for misappropriation of. See **Intellectual Property**
Trademark infringement, disgorgement of defendant's profits under unjust enrichment theory, 6.29
Trade secret misappropriation, plaintiff's recovery of damages based on unjust enrichment, 6.36

Unlawful Detainer
Attorney fees
Amount of fees, determination of, 4.97
Basis for recovery of fees, 4.93
Contractual fees, procedure for claiming, 4.102
Cost item, attorney fees defined as, 4.91
Dismissal of action, no prevailing party in event of, 4.95
Greater relief, prevailing party as party recovering, 4.94
Limits on recovery by prevailing party, 4.96
Party or attorney, award of fees to, 4.97
Prevailing party, awarding fees to, 4.94-4.95
Procedures for claiming fees, 4.101-4.104
Services performed before complaint filed, recovering fees for, 4.98
Statutory fees, procedure for claiming, 4.103
Successors in interest, award of fees against, 4.99
Time limits for claiming fees, 4.104
Back rent, landlord's recovery of, 4.86
Breach of implied warranty of habitability, effect of stipulation to give up possession in unlawful detainer on action for, 4.38
Breach of lease by tenant as grounds for, 5.54
Complaint
Attorney fees, requesting in complaint, 4.93
Court awarding damages despite absence of prayer for damages in complaint, 4.87
Costs
Allowable costs and expenses, 4.90
Attorney fees (see Attorney fees, above)
Limits on costs, 4.92
Prevailing party, awarding costs to, 4.89
Procedure for claiming costs, 4.91
Interest on damages caused by unlawful detainer prohibited, 4.88
Limit on amount recovered by landlord to damages resulting from unlawful detainer, 4.87
Malicious holding over, statutory damages for, 4.87
Prejudgment interest on rent due, criteria for awarding, 4.88
Rent control ordinance, tenant contesting amount of overcharge in unlawful detainer preceding, 4.48
Statute of limitations for filing unlawful detainer action, 4.105
Statutory damages on showing of malice, 5.54

Use of Property
Destruction of building or structures on real property, no recovery for loss of use, 5.33
Fair-value use of premises defined, 4.2

Nuisance resulting in loss of use of property, 5.13
Other than intended purposes, use of property for. See **Leases**
Trespass resulting in loss of use of property, 5.13, 5.30

Utilities
Landlord disconnecting utility services, tenant's recovery of damages for, 4.45
Nuisance
Electromagnetic fields, property owners prohibited from seeking diminution in property value damages against public utility for, 5.39
Permanent nuisance, operation of public utility as, 5.15

Vacating Premises
Waiver of right to vacate premises, tenant's delay in acting after landlord's interference with beneficial enjoyment resulting in, 4.16

Vacation Benefits
Terminated employee's entitlement to, 3.88

Valuation
Breach of real property purchase and sale agreement. See **Breach of Real Property Purchase and Sale Agreement**
Converted property, admissibility of owner's opinion regarding value of, 6.43
Copyright infringement, valuation of damages. See **Copyright Infringement**
Diminution in value
Defect in performance of contract, measure of damages for diminution in market value, 1.50
Nuisance (see Nuisance, below)
Fraud claims. See **Fraud Claims in Real Property Transactions**
Market value
Copyrighted material, and testimony by copyright owner and expert witness establishing market value of, 6.17
Defect in performance of contract, measure of damages for diminution in market value, 1.50
Fraud claims in real property transactions. See **Fraud Claims in Real Property Transactions**
Seller testifying about property's market value, 2.28
Nuisance
Continuing nuisance, plaintiff's recovery of damages for diminution in value, 5.13, 5.28
Electromagnetic fields, property owners prohibited from seeking diminution in property value damages against public utility for, 5.39
Permanent nuisance, plaintiff's recovery of damages for diminution in value, 5.29
Seller's common law duty to disclose facts materially affecting value or desirability of property, 5.54
Trespass, recovery of damages for diminution in value, 5.13, 5.28
Witness's testimony used to establish market value (see Market value, above)

Venue
Breach of contract, forum affecting recovery for, 1.5
Breach of real property purchase and sale agreement, venue for, 2.4
Trespass or private nuisance action, effect of classification of action as transitory or local on venue, 5.24

Veterans
Uniformed Services Employment and Reemployment Rights Act of 1994, veterans' reemployment rights governed by, 3.47

Wages and Hours
See also **Salaries and Compensation**
Back pay. See **Back Pay**
Cartwright Act, restraint of trade prohibited under, 3.84
Davis-Beacon Act, standards for wages and benefits of government contractors' employees, 3.76
Equal pay, statutory basis for, 3.100
FLSA. See **Fair Labor Standards Act of 1938 (FLSA)**
Hearing on employee's claim for wages, 3.89-3.90
Industrial Welfare Commission, wage orders enacted by, 3.100
Meal and rest periods, 3.88A
Meyers-Milias-Brown Act (MMBA), requirement of local government employers to meet and confer with employee representatives on wages, hours and other conditions of employment, 3.82
Minimum wage. See **Minimum Wage**
Overtime. See **Overtime Compensation**
Penalty for employer's failure to timely pay wages, 3.85, 3.87

Standing to assert prevailing wage claim, no preemption by federal immigration law, 3.93
Statute of limitations for wage claim, 3.88A
Timely payment of wages
Generally, 3.85
Berman hearing on claim for unpaid wages, 3.89
Collective bargaining agreement, effect on employee, 3.86
Enforcement of claims for unpaid wages, 3.90
Penalties for employer's failure to pay wages for terminated employees, 3.85, 3.87
Periods for which wages are to be paid in relation to work performed, 3.87
Temporary employees, requirement of established wage periods for, 3.87
Vacation benefits, terminated employee's entitlement to, 3.88
Unilateral changes by employers in wages, hours, and working conditions without bargaining with union, remedies for, 3.18
Walsh-Healey Act, standards for wages, hours of work, child labor, health and safety of employees under, 3.75

Waiver
Antideficiency statute, restrictions on waiver of, 2.32
Attorney fees provided for by CC §1717, parties' inability to waive, 2.12
Fraud in real property transaction, continued performance by buyer under contract after discovery of fraud not waiver, 2.58
Home Equity Sales Contract Act, waiver of provisions prohibited, 2.53
Landlord's efforts to mitigate damages after termination of lease not waiver of damages, 4.79
Termination of lease, tenant's delay in acting after landlord's interference with beneficial enjoyment resulting in waiver of rights regarding, 4.16

Walsh-Healey Act
Standards for wages, hours of work, child labor, health and safety of employees under, 3.75

Warranties
Breach of contract, courts denying enforcement of unconscionable disclaimers of warranties, 1.45
Breach of warranty
Habitability. See **Habitability, Breach of Warranty of**
Lost profits, plaintiff's recovery of, 1.19

Waste
Generally, 4.60
Remedies for, 5.54
Repairs, effect of tenant's failure to make, 4.62
Statute of limitations for bringing action based on, 4.61
Treble damages, tenant's liability for, 4.60, 5.54

Water, Contamination of. See **Hazardous Materials and Toxic Waste**

Whistleblowers
Exclusive remedy rule of workers' compensation, inapplicability to whistleblower's retaliation claim, 3.97
Termination or retaliation against whistleblower for disclosing information to governmental agency as misdemeanor, 3.93

Witnesses
Converted property, admissibility of owner's opinion regarding value of, 6.43
Copyright infringement action, testimony by copyright owner establishing market value of copyrighted material, 6.17
Expert witnesses. See **Experts and Expert Witnesses**
Market value. See **Valuation**
Unlawful detainer action, recovery of witness fees in, 4.90

Words and Phrases. See **Construction and Interpretation; Definitions**

Workers' Compensation
Back pay award, deduction of worker's compensation award from, 3.9
Emotional distress claim precluded by exclusive remedy rule, 3.97-3.98

Work Product
Patent infringement action, no adverse inference from assertion of work product doctrine, 6.13

Writing
Agent or broker, written contract required for, 2.30

Writs. See **Possession, Writ of**

Wrongful Death
Comparative negligence as defense in nuisance action seeking personal injury damages, 5.40

Wrongful Occupancy
Measure of damages for, 5.54

Wrongful Termination
See also **Termination of Employment**
Generally, 3.92
Administrative remedies, exhaustion of, 3.97
Attorney fees, recovery of, 3.96
Back pay for discriminatorily discharged employees, NLRB rules on, 3.12
Breach of employment contract. See **Employment Contracts**
Compensation, employee's recovery of, 1.53
Contract damages, recovery of, 3.95
Emotional distress damages, recovery of, 3.96-3.98
ERISA's preemption of wrongful termination claims affecting employee benefit plans, 3.66
Fraud and deceit, restrictions on employee recovering damages for, 1.55
Labor Management Relations Act (LMRA), state law tort action for unjust termination preempted by, 3.2
Mitigation of damages, employee's duty concerning, 3.95
Privacy rights of employee, termination of employee for refusal to submit to unannounced drug test as violation of, 3.99
Public employee's rights, 3.94
Public policy, wrongful termination in violation of. See **Public Policy**
Punitive damages, recovery of, 3.96
Reinstatement of employee. See **Reinstatement of Employee**
Retaliation against employee. See **Retaliation Against Employee**
Statutory prohibitions against wrongful termination, 3.92-3.93
Tort damages, employee's recovery of, 3.96

Zoning and Land Use
Nuisance, plaintiff's inability to obtain injunction against business operated in accordance with applicable zoning laws, 5.51

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