

Letter from  
the President

Last Friday evening at 7:00 p.m., I made the mistake of answering my phone as I was leaving my office only to be subjected to a barrage of threats, ultimatums, and profane comments from an opposing counsel upset about his inability to close a complex multi-party settlement before a pretrial conference scheduled for Monday. Having just moder-



Jeffrey I. Weinberger

ated an ABTL program on lawyer incivility three nights before, I found this a particularly timely reminder of the abuse to which we are all at least occasionally subjected in litigation practice. The widespread perception of bench and bar is that incivility and a lack of professionalism in litigation are on the rise.

A number of courts have looked at this issue in the last few years, most notably the Seventh Circuit Court of Appeals which, after an extensive study, found substantial factual support to back up this perception and promulgated a code of standards to address it. All potential admittees

must now state that they are willing to abide by the code, the substance of which has been incorporated in curricula in all law schools within the Seventh Circuit.

In California, both of our sister ABTL chapters have adopted standards intended to curb incivility and unprofessional or abusive conduct. In the Fall of 1994, the ABTL of Northern California adopted its "Guide to Professional Practice" which addresses a wide range of subjects, including tone of discourse among

(Continued on page 7)

INSIDE	
Major Changes Imminent to the Federal Local Rules for the Central District of Calif.	by Michael K. Grace ..... p. 2
Drafting Settlement Agreements: Five Pitfalls	by Robert J. Stumpf, Jr. .... p. 3
The Impact of the Securities Reform Act	by Michael A. Sherman ..... p. 5
An Appealing Settlement Program	by Robin Meadow ..... p. 7
The Ten Most Frequent Errors in Litigating Business Damages	by James Plummer Gerald McGown ..... p. 9
Cases of Note	by Denise M. Parga ..... p. 11

When Will You  
Get to Trial?

While there is no clear winner in the debate over which region of California suffers from the greatest level of automobile traffic congestion, the most recent available statistics regarding the flow of civil cases in federal district courts show that Southern California venues provide the quickest path to trial. According to data from the Statistics Division of Administrative Office of the United States Courts for the year ended September 30, 1995, the median time from the filing of a civil case to the start of trial in both the Central and Southern Districts of California was 18 months.

During the same period, the median time to trial in the Northern District was 25 months and in the Eastern District, 26 months.

The statistics also reveal that time to trial in all districts has increased significantly in the last five years. In the Central District for the year ended September 30, 1990, it took an average of 12 months for a civil case to reach trial; that number had increased to 18 months by the end of September 30, 1995. In the Northern District, the time to trial increased from 15 months in 1990 to 25 months in 1995. The Eastern District increased from 18 months in 1990 to 26 in 1995. Interestingly, the Southern District average increased only two months — from 16 months in 1990 to 18 months in 1995.

The time period from filing to trial in the Northern and Eastern Districts is among the worst in the nation. The Eastern District, with 26 months, places 82nd among 94 districts in the country, the Northern District's 25 months places it 77th out of 94 districts. For the Central and Southern Districts, their 18-month period ranks 40th of 94 districts in the country and fourth within the 9th Circuit.

Contrary to popular thinking, the number of civil filings in both the Northern and Central Districts has actually decreased since 1992. There were 433 civil filings per judge in the Northern District in 1992, compared to 373 per judge in the period ending September 30, 1995. In the Central District, there were 413 civil filings per judge in 1992, down to 382 per judge for the period ending September 30, 1995.

The number of civil cases pending over three years has also decreased. The Central District has experienced a near 15 percent drop from 19.5 in 1990 to 5.2 percent in 1995 and the Southern District has seen a decrease of almost 10 percent from



Graig R. Woodburn

(Continued on page 4)

## Major Changes Imminent to the Federal Local Rules for the Central District of California

**I**n the next few weeks, the U.S. District Court for the Central District of California is expected to announce new amendments to the Local Rules of Civil Practice. These amendments represent the most dramatic changes to the Local Rules since 1985 and will implement, in modified form, the mandatory initial disclosure requirements and other discovery rules set forth in the 1993 amendments to the Federal Rules of Civil Procedure. This article briefly summarizes the amendment history and highlights the anticipated new rules that will have the most dramatic impact on federal civil practice in the Central District.



Michael K. Grace

The Supreme Court's 1993 amendments to the Federal Rules impose mandatory initial disclosure obligations and a discovery standstill until the disclosures are made. The purpose of these and other changes to the Federal Rules was to "accelerate the exchange of basic information about the case and to eliminate the paper work involved in requesting such information" with a view toward reducing the expense and delay of civil litigation in federal courts. Advisory Committee Comments, 1993

Amendment, Comment to Rule 26(a).

The changes were adopted by the Supreme Court over the vigorous dissent of Justice Scalia, joined by Justices Souter and Thomas, who disagreed with the majority's expectation that the changes would reduce the costs and time necessary to conduct discovery. (*See* 146 F.R.D. 401, 507 (1993).) By general order, the Central District temporarily "opted out" of the changes to the Federal Rules from December 1, 1993 until October 1, 1994 and then permanently deferred the most controversial changes to Federal Rules 16(b), 26(a)(1), 26(a)(4), 26(d) and 26(f).

On November 3, 1995, the Rules Committee of the Central District published proposed changes to the Local Rules for public comment and received extensive comments. The Rules Committee currently is finalizing the proposed changes based upon those comments for the approval by majority vote of all of the judges of the Central District.

### Proposed Changes to Local Rule 6

The most significant changes will be to Local Rule 6, which concerns the early meeting of counsel. Each party will have an obligation to all other parties, at the early meeting of counsel and throughout the case, to disclose certain witnesses and to produce certain documents "as they become known." Local Rule 6.2.1 and 6.2.2.

The party must identify all witnesses (with addresses and telephone numbers) known to be aware of facts supporting the material allegations of the party's pleadings or "rebutting the material allegations" of the opposing party's pleadings. In addition, each party must provide at the early meeting a written list of all documents and tangible things supporting the material allegations of the party's pleadings or "rebutting the material allegations" of the opposing party's pleadings. All such documents and things then reasonably available also must be produced at the early meeting. All continuing disclosures regarding knowledgeable witnesses and supporting documents must be disclosed as they become known but not later than 30 days prior

to the discovery cutoff or be subject to possible exclusion at trial. Finally, at the early meeting, the party in the position of plaintiff must provide damages computations and unprivileged supporting documentation at the early meeting, and all parties must produce all insurance agreements "under which any person carrying on an insurance business may be liable to satisfy part or all of a judgment which may be entered in the action" or to indemnify or reimburse payments to satisfy a judgment. Proposed Local Rule 6.2.3 and Local Rule 6.2.4.

Federal Rules 26(a)(1)(A) and (B) have similar requirements concerning the identification of witnesses and production of documents, but with one big difference: the Federal Rules require identification of all witnesses and production of all unprivileged documents "relevant to disputed facts alleged with particularity in the pleadings." This relevance standard imposes an obligation to disclose information that is prejudicial to the client and triggers a conflict between the attorney's obligation to the client to perform a thorough investigation and analysis of the case and the attorney's obligation as an officer of the court to disclose the results of that investigation — including the adverse results — to counsel for the opposing party. The mandatory obligation to disclose "smoking guns" as part of an initial disclosure based on the investigation of counsel for the producing party engendered the greatest controversy when the amendments were considered by the U.S. Supreme Court.

The second most controversial change is the obligation to identify expert witnesses and produce their reports, beginning at the early meeting of counsel and continuing up to trial. Local Rule 6.2.1. Although the reports and the identity of consultants who are not expected to testify at trial need not be disclosed, the distinction between "consultant" and "expert witness," and especially when one moves from consultant to expert witness, are not defined. Disputes likely will arise as to when an individual became an "expert witness" under the rules, thereby triggering the mandatory disclosure requirements, and whether the disclosure of such person was timely and adequate under all the facts and circumstances of the case. The sanction for failure to comply with the disclosure requirements is possible exclusion at trial.

The changes also make enforcement easier and tighten the sanctions as compared to the former Local Rules. For example, initial disclosures at the early meeting and all subsequent disclosures must be in writing, signed by counsel, and served on all parties. Local Rule 6.3. In addition, an attorney of record must certify that the initial or subsequent disclosure is "complete and correct" "to the best of the signer's knowledge, information and belief formed after a reasonable inquiry...." Local Rule 6.3.1. Moreover, each party is prohibited by a "discovery standstill" rule from engaging in formal discovery "from any source" until it has made its initial disclosures. Local Rule 6.7.1. Additional sanctions include exclusion of evidence at trial and monetary sanctions. Local Rule 6.3.2.

### Proposed Changes to Local Rule 9

The most significant change under Local Rule 9 is the timing of expert witness designations. The party in the position of plaintiff must designate experts and provide reports required under Federal Rule 26(a)(2)(B) not later than eight weeks before the discovery cutoff date. The party in the position of defendant has a similar disclosure obligation not later than five weeks before the discovery cutoff date. The sanction for non-compliance is possible exclusion of expert witness testimony at trial. Finally, the discovery cutoff, including resolution of all discovery motions, will be set automatically in most cases on the date four weeks prior to the date of the Pretrial Conference ordered by the court.

(Continued on page 12)

## Drafting Settlement Agreements: Five Pitfalls

**W**hen drafting settlement agreements, the careless attorney can snatch defeat from victory by making mistakes in the paperwork. This article discusses five pitfalls to avoid. Some come from new court decisions; others, from first-hand experience. In any event, if you want to take yourself out of the "unwary" category, you may want to ask the following five questions:

**Question No. 1:** *How Can I Get The Court To Retain Jurisdiction, Post-Dismissal, To Enforce The Settlement?*

Sometimes you will want the court to retain jurisdiction to supervise a settlement, particularly if the settlement involves more than merely exchanging releases for money, or if there are continuing obligations or some special doubt that one of the parties will perform. But most settlements also provide that the pending litigation is to be dismissed as part of the deal. So, what happens if something goes wrong after the case is already dismissed? Do you have to file a whole new action, or can you go back lickety-split to the first court to enforce?

It all depends on how you drafted the agreement. In federal court, it's now clear that you'll be back to square one unless your settlement agreement is coupled with a court order that does one of two things: (1) expressly retains jurisdiction to enforce the agreement, or (2) specifically incorporates the terms of the settlement agreement itself. *William Keeton Enterprises, Inc. v. A All American Strip-O-Rama, Inc.*, 74 F.3d 178 (9th Cir. 1996). This case is a good example of what can go wrong. There, the principal issue was whether the district court had jurisdiction to enforce the parties' settlement agreement in such a way as to enjoin the defendants from using certain trade names (in the strip-tease telegram business, no less).

Unfortunately for the plaintiff, the stipulated injunction was limited to enjoining the parties from disparaging each other in the marketplace and did not reserve jurisdiction in the court to enjoin the defendants from using any particular trade names, including "Strip-O-Rama." The district court entered the injunction nonetheless, but the Ninth Circuit set it aside — both because the written stipulation fell short and because the parties' oral recitation of their agreement on the record was, in the Ninth Circuit's words, "enigmatic."

The bottom line is this: if you want a federal court to retain jurisdiction to enforce your settlement agreement, you should include a provision in the agreement that makes the settlement contingent upon a dismissal order from the court that either expressly retains jurisdiction to enforce the agreement or incorporates the terms of the settlement into the court's order. *See also In re Hunter*, 66 F.3d 1002 (9th Cir. 1995) (bankruptcy court did not have "ancillary jurisdiction" to relieve a party from his acknowledgement of satisfaction) and the Supreme Court's decision in *Kokkonen v. Guardian Life Ins. Co.*, 114 S.Ct. 1673, 128 L.Ed.2d 391 (1994) (district court did not have "inherent power" to enforce a settlement where the parties' stipulation did not reserve jurisdiction allowing the court to do so).

One more caveat. The decision in *William Keeton Enterprises* underscores the point that if your settlement includes an injunction, your agreement (and hence any court order that incorporates that agreement) must meet the requirement of Rule 65(d) of the Federal Rules of Civil Procedure that every injunction order must be specific and describe in reasonable detail the act or acts to be restrained. The settlement agreement and court order

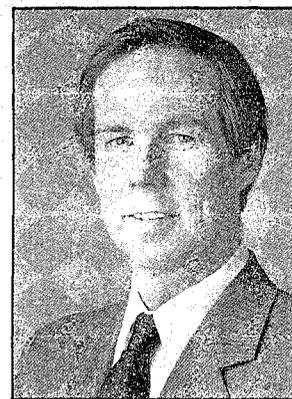
must be drafted accordingly.

**Question No. 2:** *How Can I Get The Mediator To Retain Jurisdiction, Post-Settlement, To Enforce The Settlement?*

Let's now talk about a related pitfall that could turn out to be a real opportunity. These days, many commercial litigation cases are resolved through the efforts of a third party mediator, who becomes intimately familiar with the case, the parties, and the attorneys — and the negotiating history underlying the settlement. As a result, who better to enforce the settlement agreement, or resolve disputes about its terms, than the mediator who helped bring it about? And how better to keep the parties honest than by having ready access to the mediator in case a dispute does arise?

All this makes sense but will be to no avail unless you include appropriate language in the settlement agreement to give the necessary authority to the mediator to act as, in effect, a post-settlement arbitrator. Here is an example of the kind of language that may do the trick:

Any dispute relating to or arising out of any aspect of the interpretation or performance of this Agreement shall be resolved by final and binding arbitration, in California, before [the mediator], who shall have the power to authorize such discovery, and the means to obtain it, as he or she may deem appropriate. If [the mediator] is unavailable, the arbitration shall be conducted before another [for example, JAMS arbitrator] agreed to by the parties, or if they cannot agree, before [another arbitrator selected by the mediator or if mediator is unable to make such a selection, by an arbitrator selected by JAMS]. The cost of the arbitration shall initially be split equally, with the prevailing party, as determined by the arbitrator, then to recover its costs and attorneys' fees incurred in the arbitration.



Robert J. Stumpf, Jr.

**Question No. 3:** *How Can I Minimize The Risk Of A Malicious Prosecution Case Against My Plaintiff Client Who Dismisses All Of The Defendants Pursuant To A Settlement But Cannot Extract A Release From One Of The Defendants?*

This pitfall is more arcane, but there are those who love it. Suppose, for example, that your client sues a corporation and several of its officers and directors. You negotiate a terrific settlement with the corporation and have no desire to continue the case against the individuals after the settlement. But one of the individuals refuses to sign the settlement agreement and makes vague noises about malicious prosecution. Is there anything you can put in the settlement agreement to minimize this risk?

Yes. Assuming that the defendant corporation indeed demands a dismissal of the entire litigation as a condition of the settlement, the agreement should simply say so, *i.e.*, it should include a recital to the effect that "The release of the Released Persons, in addition to the Settling Defendants, is a necessary condition of this settlement." If this can be accomplished, it should go a long way toward avoiding, as a matter of law, a "favorable termination" that is a necessary element of a claim for malicious prosecution. *See, e.g., Fuentes v. Berry*, 38 Cal.App.4th 1800, 1808-11 (1995) (summary judgment denied in malicious prosecution action because, among other things, the settlement agreement did not specifically recite that the dismissal of all defendants was a necessary condition to the settlement). *Compare Pender v. Radin*, 23 Cal. App.4th 807 (1994) (summary judgment granted in malicious prosecution action because, among other things, settlement

(Continued on page 4)

## Drafting Settlement Agreements

Continued from page 3

agreement provided that all parties were to bear their own costs and fees).

**Question No. 4:** *How Can I Make Sure That I Have An Enforceable Settlement Agreement Before All The Formal Paperwork Is Completed?*

This is another somewhat technical point, but one that could be all-important in a very practical sense. It is often the case that a settlement is negotiated in principle and, at the end of a long day of negotiations, is memorialized in a short document that will ultimately be replaced by a formal settlement document with all the appropriate bells and whistles. But in drafting the term sheet or preliminary "settlement agreement," you need to keep one thing in mind if you want to be able to move for summary enforcement of the agreement under C.C.P. § 664.6: you need to have the clients — not just the lawyers — sign the document. So said the California Supreme Court in its recent decision in *Levy v. Superior Court*, 10 Cal.4th 578 (1995). There, the attorneys negotiated, or thought they had negotiated, a settlement that culminated in a five-page letter from one attorney to the other outlining the terms. The other attorney accepted by sending back a return fax. The first attorney's client then balked at signing the formal agreement, and the other attorney moved for summary enforcement. Denied. In resolving a conflict among the Courts of Appeal, the California Supreme Court held that since a settlement involved a "substantial right" of the client, the word "parties" as used in section 664.6 should be narrowly construed to mean the litigants themselves, not just their attorneys. See also *Johnson v. Department of Corrections* (1995) 38 Cal.App.4th 1700, which applies the *Levy* "principals-have-to-sign" rule to oral stipulations of settlement that are recited into the record before the court.

Although the side that lost in *Levy* could theoretically still move to enforce the settlement through a motion for summary judgment or a separate suit in equity (whatever that is), both would probably be quite cumbersome and expensive. Far better to have avoided the problem in the first instance through good drafting.

**Question No. 5:** *How Can I Use The Settlement Agreement To Help My Client With The Taxing Authorities?*

It is occasionally the case, though less so these days in light of certain court decisions, that settlements in business litigation cases can also involve settlements of personal injury claims. If such is your case, you will want to keep in mind the general principle that section 104 of the Internal Revenue Code generally excludes from gross income the "amount of any damages received (whether by suit or agreement and whether as lump sums or as periodic payments) on account of personal injuries or sickness..." Section 104(a)(2) excludes from gross income damages received for non-physical (for example, mental or emotional) as well as physical injuries. See *United States v. Burke* (1992) 112 S.Ct. 1867, 1871 n. 6.

In determining whether a particular injury is *personal* in nature, the tax court typically focuses upon the origin and nature of the taxpayer's claim in litigation. *Threlkeld v. Commissioner* (1986) 87 T.C. 1294. And here is where settlement agreements come in. The most common method of making allocations between personal and nonpersonal injuries for purposes of section 104 is by explicit allocation — either in a judgment or in a settlement agreement. While the federal courts and the IRS are not bound by such allocations, an allocation in a written settlement agreement is typically respected by the IRS (although allocations made only for tax purposes will not be given effect). See K. Gideon, *Lawsuits and Settlements*, Vol. A6: Forms — Planning Aides, ¶ 2002.03 (CCH Tax Trans Lib.). And the tax court has held that,

"When the settlement agreement allocates clearly the settlement proceeds between tort-like personal injury damages and other damages, the allocation is generally binding for tax purposes..." *Robinson v. Commissioner* (1994) 102 T.C. No. 7.

In sum, if an express allocation is made in a settlement agreement, it will usually be the starting point — and often the ending point — of the IRS' analysis of the issue. But if there is no allocation, the situation becomes much murkier; and the intent of the parties must be determined "from all the facts and circumstances," including the details surrounding the litigation in the underlying proceeding, the allegations in the complaint, and the arguments made in the underlying proceeding. *Estate of Morgan v. Commissioner*, 332 F.2d 144, 150-51 (5th Cir. 1964). A well-drafted settlement agreement with an express allocation can help avoid such an unpredictable inquiry into all the surrounding "facts and circumstances."

In closing, please mark your calendars for March 2000. By then, the *ABTL Report* will probably be available online. And I will probably have discovered at least five more pitfalls.

—Robert J. Stumpf, Jr.

## When Will You Get to Trial?

Continued from page 1

	Time From Filing Civil Action to Trial 1990-1995 (in months)		Percentage of Civil Cases Over Three Years Old	
	1995	1990	1995	1990
Central District	18	12	5.2	19.5
Eastern District	26	18	6.6	4.9
Northern District	25	15	6.8	9.8
Southern District	18	16	2.7	12.2

12.2 of its cases being over three years old in 1990 to a low of 2.7 percent for 1995. The Northern District has seen a 3 percent decline from 9.8 percent to 6.8 percent. Only the Eastern District has seen an increase in the number of cases over three years old from 4.9 percent in 1990 to 6.6 percent in the period ending September 30, 1995.

While critics of the legal profession are quick to point to a "litigation crisis," in reality, it seems that the number of civil lawsuits is actually diminishing in District Courts throughout California. Based on this data, a Federal Court litigant can expect his or her case to proceed to trial, even in the worst case scenario, within about two years after filing a civil complaint.

—Graig R. Woodburn

## JOIN US



Association of Business Trial Lawyers  
P.O. Box 87C46, Los Angeles, California 90067  
(310) 839-3954

I would like to join  renew my membership in ABTL. Enclosed is a check for \$75.00 covering my first year's dues (or \$50.00 for members admitted to the State Bar within the past three years).

Name(s) \_\_\_\_\_

Firm \_\_\_\_\_

Address \_\_\_\_\_ Suite \_\_\_\_\_

City \_\_\_\_\_ Zip Code \_\_\_\_\_

Telephone \_\_\_\_\_ Dues Enclosed \$ \_\_\_\_\_

## The Impact of the Securities Reform Act

**O**n December 22, 1995, the Private Securities Litigation Reform Act of 1995, Public Law 104-67 (H.R. 1058) (Reform Act) became law. The business community applauded the passage of this sweeping package of legislation aimed at curbing frivolous and abusive securities lawsuits. Now that it is law, energies have turned to understanding the intricacies of this cobbled-together law — a process likened by some practitioners to attempting to understand the Talmud.

The Reform Act will affect all aspects of private litigation under the Federal Securities Laws, and will likely have a significant impact on many years of judicial precedent. Key provisions of the reform measure, which survived a veto by President Clinton, create a safe harbor from private fraud liability for certain forward-looking statements made by corporations and their executives, with some exceptions. The law also creates a system of proportionate liability so that only defendants who have knowingly committed a securities law violation are jointly and severally liable for it. It also raises pleading standards for fraud actions. Further, it provides for a stay on discovery during the pendency of a motion to dismiss in the absence of a showing of particularized need.

This article focuses on the impact of the Reform Act on two aspects of securities litigation — on pleading requirements for private securities fraud litigation and on the potential role to be played by institutional investors in securities fraud class actions.

### The Reform Act's Impact on Pleading Requirements

Pre-Reform Act pleading strategies and motions to dismiss often revolved around whether plaintiff had alleged the circumstances constituting the alleged fraud with the requisite level of specificity under Federal Rule of Civil Procedure 9(b). The Reform Act unquestionably raises the threshold of these pleading barriers.

The Ninth Circuit set forth its pleading requirements in a pre-Reform Act case, *In re: Glenfed, Inc. Securities Litigation*, 42 F.3d 1541 (9th Cir. 1994). The Ninth Circuit, en banc, held that plaintiffs' pleadings obligations under Rule 9(b) required plaintiffs to "aver with particularity the circumstances constituting the fraud", including the alleged time, place and content of the misrepresentation or omission." *Id.* at 1547. The Ninth Circuit further held that "the plaintiff must set forth what is false or misleading about a statement, and why it is false." *Id.* at 1548. In other words, a plaintiff must set forth an explanation of why the alleged statement or omission complained of was false or misleading. Further, the statement or omission must be shown to have been false or misleading when made. *Id.* at 1548.

**I**n spite of these stringent pleading requirements, the Ninth Circuit in *Glenfed* announced a relaxed standard for pleading the defendant's scienter, or mental state: Plaintiffs may "simply...say[] that scienter existed." *Id.* at 1547. The Ninth Circuit specifically rejected decisions from the Second Circuit requiring plaintiffs in securities fraud cases to plead facts giving rise to a "strong inference of fraudulent intent." *Id.* at 1545. (At the time, a plaintiff in the Second Circuit could plead scienter by alleging that either (1) the defendants' motive and opportunity

to commit fraud, or (2) facts constituting strong circumstantial evidence of conscious misbehavior or recklessness. *Acito v. IMCERA Group, Inc.*, 47 F.3d 47, 52 (2d Cir. 1995). The Ninth Circuit instead followed the express language of Rule 9(b) which states that "[m]alice, intent knowledge, and other conditions of mind of a person may be averred generally." The Ninth Circuit reasoned that a change to Rule 9(b)'s pleading requirements was a "job for Congress." *Glenfed*, 42 F.3d at 1546.

Congress evidently heard that remark by the Ninth Circuit. The Conference Report for the Reform Act states that "the courts of appeals have interpreted Rule 9(b)'s requirement in conflicting ways, creating distinctly different standards among the circuits." Conference Report at 41. In response, Section 21D(b)(2) of the Reform Act provides:

"REQUIRED STATE OF MIND - In any private action arising under this title in which the plaintiff may recover money damages only on proof that the defendant acted with a particular state of mind, the complaint shall, with respect to each act or omission alleged to violate this title, state with particularity facts giving rise to a strong inference that the defendant acted with the required state of mind."



Michael A. Sherman

Clearly, *Glenfed's* lenient scienter pleading standard is no longer applicable in cases decided under the Reform Act. Moreover, the pleading standards established by the Reform Act may even exceed those of the Second Circuit. The Conference Report states that "[b]ecause the Conference Committee intends to strengthen existing pleading requirements, it does not intend to codify the Second Circuit's case law interpreting this pleading standard." Because Section 21D(b)(2) is a new provision rather than a codification of prior case law, courts as well as practitioners will undoubtedly struggle during the upcoming years with its meaning.

### The Changing Role of Institutional Investors

Historically, institutional investors have played a minimal role in securities class action litigation, passively sitting on the sidelines, avoiding confrontational litigation with corporate issuers, and meekly submitting claims forms in settlements. Recently, however, there has been an increase in pension fund and institutional policing of securities class actions, possibly tied generally to the increasing climate of institutional activism being experienced in corporate boardrooms. (See "Let the Money do the Monitoring: How Institutional Investors can Reduce Agency Costs in Securities Class Actions," 104 Yale L.J. 2053 (June, 1995) (providing a comprehensive analysis of the diverse issues concerning institutional investor participation in securities fraud class actions.)

By way of example:

- In response to Intel Corp.'s disclosures of flaws surrounding its Pentium Chip in late 1994, a number of securities fraud and derivative lawsuits were filed against the chip maker. Following those filings, the California Public Employees Retirement System (known as CALPERS) and three other pension funds wrote an extensive analysis questioning the merits of those actions, and sent a copy of it to plaintiffs' counsel prosecuting the derivative lawsuit. Shortly after the letter was sent, the derivative and class action lawsuits were voluntarily dismissed.

(Continued on page 6)

- The Council of Institutional Investors, representing pension funds managing assets of approximately \$800 billion, has solicited proposals from law firms around the country seeking ways for their members to play a more active role in securities fraud lawsuits.

The drafters of the Reform Act attempted to make these actions more hospitable to the interests of institutional investors. The Reform Act clearly attempts to move control over prosecution of securities class action lawsuits from plaintiffs' lawyers and figurehead plaintiffs to institutional investors. The Committee Report provides that its "provisions are intended to increase the likelihood that the parties with significant holdings in the issuers...will participate in the litigation and exercise control over the selection and actions of [plaintiffs' counsel]." H.R. Conf. Rep. No. 369, 104th Cong., 1st Sess. 32 (1995). The Committee Report also states that "increasing the role of institutional investors in class actions will ultimately benefit shareholders and assist courts by improving the quality of representation in securities class actions." H.R. Conf. Rep. No. 369, 104th Cong., 1st Sess. 34 (1995).

The Reform Act attempts to accomplish these goals in several ways:

- It requires the appointment of a "lead plaintiff" and publication of an "early notice to class members" within 20 days of the filing of the complaint. 15 U.S.C. § 77 z-1(a)(3). The Committee Report observed that this provision was intended to blunt the "race to the courthouse" to be the first to file a securities class action complaint." *Id.*

- It creates a rebuttable presumption that the most adequate "lead plaintiff" is the plaintiff with the largest financial interest in the relief sought in the case. *Id.*

- It permits the "lead plaintiff" to select plaintiffs' class counsel. *Id.*

- It improves the disclosure of settlement terms in class actions, by requiring notices of settlement to disclose per-share recovery. 15 U.S.C. § 77 z-1(a)(4).

A recent decision of the United States District Court for the Northern District of California, *In re California Micro Devices Securities Litigation* C-94-2817-VRW, 1996 U.S. Dist. LEXIS 1361 (February, 1996) addresses many of these institutional investor issues, in a decision that has been reported by the news media as a "dress rehearsal" for the Reform Act. (See "A Class Action Is Seen As A Dress Rehearsal For New Securities Laws," *New York Times*, February 23, 1996, Section D, page 6, column 1.) In that case, District Court Judge Vaughn R. Walker denied plaintiffs' counsel's request for appointment as lead counsel, and denied preliminary approval of a settlement.

The proposed settlement — characterized by Judge Walker as an "early settlement" 1996 U.S. Dist. LEXIS 1361 [\*13] — had been negotiated by plaintiffs' counsel and lawyers for California Micro Devices after the court was advised that failure to settle would lead to the company's bankruptcy. Prior to the preliminary settlement approval hearing, Judge Walker had directed plaintiffs' counsel and the corporate defendant to show that the proposed settlement "enjoys the 'affirmative support, as opposed to the silent toleration,'" of a majority of class members. 1996 U.S. Dist. LEXIS 1361 [\*3].

During the process of soliciting investor reaction to the proposed settlement, sharp differences of opinion regarding the merits of the settlement emerged between investors who bought

and sold the issuer's stock during the class period, and investors who held the stock throughout the class period. The court concluded that the proponents of the proposed settlement had not shown that it enjoyed genuine, informed support among class members, and that by permitting such a deficient settlement to be submitted for consideration the small shareholders who were named as putative class representatives had failed to adequately monitor plaintiffs' counsel and thus did not "fairly and adequately" represent the class. 1996 U.S. Dist. LEXIS 1361 [\*4].

Judge Walker then went one step further, and certified the Colorado Public Employees Retirement Fund (COLPERA) as class representative. In appointing COLPERA to that position, the court observed:

"[T]here are many reasons to suspect that [institutional investors] will be willing and able to monitor attorney conduct in securities class actions much more rigorously than either figurehead plaintiffs or courts can do. Institutional investors have financial interests in the outcome of securities class actions which dwarf the interests of individual plaintiffs, and with this increased financial interest comes an increased incentive to monitor class counsel's conduct of the action." 1996 U.S.

Dist. LEXIS 1361 [\*57].

As reported in the news media, COLPERA retained its own counsel recruited through the Council of Institutional Investors, and — notwithstanding the dire predictions of imminent bankruptcy unless a settlement was quickly reached — settlement talks with the new lead plaintiff and its counsel resumed approximately a year after they first commenced. "A Class Action Is Seen As A Dress Rehearsal For New Securities Laws," *N.Y. Times*, February 23, 1996 at D6.

\*\*\*

While it is difficult to predict so soon after its enactment how effective the Reform Act will be in preventing the filing of frivolous lawsuits or permitting the prosecution of meritorious ones, the pleading changes and rumblings of institutional investors discussed above may presage certain changes in the practical aspects of securities class action litigation:

- Settling cases may become more difficult. Plaintiffs that have survived pleading motions will have already met a higher threshold, and the smaller number of remaining cases will likely be prosecuted more vigorously by plaintiffs' counsel.

- Courts may come to see that they have more options than simply accepting or rejecting a proposed settlement. In cases that appear to be in danger of settling "too cheaply" more courts may follow Judge Walker's lead in attempting to assess shareholder reaction to the settlement and in some cases may change both the identity of representative plaintiffs and their counsel. As Judge Walker observed, an institutional investor "will likely use securities class actions to preserve the integrity of the securities markets rather than maximize damages claims and attorney fees." *In re California Micro Devices Securities Litigation*, at 1996 U.S. Dist. LEXIS 1361 [\*58].

- Institutional investors may be less reluctant to passively sit on the sidelines, especially as they see barriers to participation crumbling and courts actively soliciting their input and recommendations.

—Michael A. Sherman

## Letter from the President

Continued from page 1

counsel, disposition of reasonable extension requests and other courtesies in scheduling, and the avoidance of abusive discovery and unnecessary sanctions motions. Those firms who sign on to the guidelines commit to offer training to young lawyers in order to create greater sensitivity to these types of issues. In addition, the guidelines provide a mechanism for informal resolution of inter-firm disputes through the appointment of a firm contact person or ombudsman.

The San Diego ABTL chapter recently announced its adoption of substantially similar guidelines, which also contain these unique alternative dispute resolution mechanisms.

In the Los Angeles area, as many of you know, the L.A. County Bar Association was an early pioneer of civility rules, enacting guidelines in 1989 which are required to be served with every summons and complaint issued by the United States District Court for the Central District of California, and which have now been incorporated as part of the Superior Court rules in Los Angeles County.

At last month's ABTL dinner program, a panel consisting of my ABTL co-Presidents in Northern California and San Diego, Steven Schatz and Michael Duckor, United States District Judge George H. King, Judge George P. Schiavelli of the L.A. Superior Court, and Anne H. Egerton, Senior Counsel at NBC, explored a variety of issues relating to this subject. A clear consensus emerged that the perception of increasing incivility was indeed well grounded in fact.

In response to a questionnaire which we distributed, our audience provided us with an astounding array of true incidents demonstrating the depths to which some attorneys can sink. These included an opposing counsel who insisted on smoking cigars during all depositions taken at his office, while he objected to the form of every single question: a thirty minute objection articulated by an attorney between 5:00 p.m. and 5:30 p.m., after a court had ordered the deposition to proceed for an extra half hour over his objection; a production of client records that had been saturated in raw sewage and were spread out on a table in a law library to dry; an attorney who called the court to continue his opponent's preliminary injunction motion without

(Continued on page 9)

### Contributors to this Issue

Michael K. Grace is special counsel to Latham & Watkins, where he practices in the field of intellectual property.

Robin Meadow is a member of Greines, Martin, Stein & Richland, a firm that practices exclusively appellate law. Mr. Meadow served on the steering committee that created the District-Wide Settlement Conference Program described in his article.

Denise M. Parga practices with Wolf, Rifkin & Shapiro.

James Plummer (MBA, Ph.D.) is President, and Gerald McGowin (MBA, CPA) is a Principal of QED Research, Inc., an economic and financial consulting firm in Palo Alto that provides litigation assistance to both plaintiff and defense counsel.

Michael A. Sherman is a partner with Alschuler, Grossman & Pines in Century City.

Jeffrey I. Weinberger is a partner with Munger, Tolles & Olson in Los Angeles.

Graig R. Woodburn is a member of ABTL's Federal Courts Committee and an associate with Callahan, Blaine & Williams in Irvine, California.

## An Appealing Settlement Program

Early last year, the Court of Appeal and the Superior Court identified a source of appellate delay that was fast reaching crisis proportions: a 2,000-case backlog of pending appeals in which preparation of the clerk's transcript had not even started. Since it was already taking the Superior Court nearly a year to complete a clerk's transcript, the backlog posed an ominous threat to the orderly administration of appeals.

Justices Fred Woods (Division Seven) and Richard Aldrich (Division Three) spearheaded a unique collaboration. They

assembled a committee that included the head of the Superior Court's Appeal Transcripts Division and a group of experienced appellate lawyers from the Los Angeles County Bar Association Appellate Courts Committee, and asked them to help devise a program that would attack the transcript backlog. The committee, chaired by Pamela E. Dunn of Robie & Matthai, confronted several problems that were bedeviling the system: (a) While some 30% of appeals are abandoned, the abandonment often takes place after the record has already been prepared; (b) many appeals are plainly headed for affirmance and should probably be discouraged; and (c) many appeals are presented on over-inclusive records and overbroad arguments that waste the parties' and the court's time and unnecessarily lengthen the appellate process.

The committee came up with a two-pronged approach: minimizing the clerk's involvement in preparing the record on appeal and providing for early settlement opportunities.

There was a ready mechanism for the first prong in Rule 5.1 of the California Rules of Court, an under-utilized procedure that allows the parties to prepare an appendix instead of ordering a formal clerk's transcript. However, the second prong required the creation of a completely new settlement conference program for which there was no direct precedent. Scarce judicial resources limit the availability of court-supervised settlement conferences; and while Division Seven routinely invites the parties to participate in a settlement program that uses appellate lawyers as settlement officers, the case must first be assigned to that division — meaning, usually, that the record has already been completed and filed. The steering committee's challenge was to come up with a program that could begin before the parties had made a substantial investment of time and money and would not require significant judicial resources. The result is the District-Wide Settlement Conference Program which began in January.

The program kicks in at the earliest possible moment, when the appellant files the notice of appeal. The Superior Court immediately sends the appellant a "Mandatory Docketing Statement." This document tells the appellant two things: First, it describes the delays involved in obtaining a clerk's transcript and invites the appellant to utilize Rule 5.1; and second, it describes the settlement conference program and invites the parties' participation. The appellant must return the docketing statement within 20 days, advising the court whether the parties

(Continued on page 8)



Robin Meadow

agree to participate in the settlement program and, optionally, electing Rule 5.1.

### **The Settlement Conference Program**

If the parties agree to participate, the Superior Court faxes a copy of the docketing statement to the Court of Appeal, which is responsible for the conference from that point forward. The Court of Appeal locates a settlement officer from a panel of about 75 appellate lawyers who have volunteered to serve one day per calendar quarter. The court also sends the parties a questionnaire designed to elicit basic information about the appeal, including information that might reveal a conflict for the settlement officer.

In addition to their experience as appellate lawyers, many members of the panel have handled voluntary settlement conferences in Division Seven's program. Most of them also received a full day of settlement conference/mediation training in a program sponsored by the Los Angeles County Bar Association. The panelists for that program included Justice Aldrich and Superior Court Judge Richard Harris, who both regularly teach settlement techniques to judges, and Richard Chernick, a former County Bar president who has long been a leader in the development of alternative dispute resolution techniques.

Settlement conferences are held at the Court of Appeal, which provides unused chambers with adjoining rooms for caucusing. Normally a justice and limited secretarial facilities are available if the parties need them to complete a settlement. Since cases in the program have not yet been assigned to a division, they come under the supervision of the Clerk of the Court of Appeal, Joseph Lane. If the settlement requires any judicial action, it will be assigned to a division at that time.

There are advantages and disadvantages to participating in a settlement process this early in an appeal. Some factors the parties should consider:

- Many cases have no business being in the appellate system at all. To an experienced appellate lawyer, they are obvious affirmances (or, rarely, obvious reversals). However, trial counsel may not have enough appellate experience to advise their clients wisely on the chances of prevailing. The program's settlement officers can provide a perspective on the case that the parties may not otherwise have available to them.

- Although the most informed assessment of an appeal comes after briefing, by that time the parties may have invested tens or even hundreds of thousands of dollars in the appeal. Regardless of the settlement officer's assessment of the case, at that late stage the parties may feel they have nothing to lose by proceeding further.

- It is difficult for the parties' appellate counsel, much less the settlement officer, to evaluate the merits of an appeal without having reviewed the record. However, it may be possible to identify central issues or themes that will govern the evolution of the appeal in such a way that the settlement officer can provide a meaningful prediction of how the case is likely to go.

- There is strong empirical evidence that early settlement conferences work, and work well. The Ninth Circuit's mediation program, which since 1992 has operated as a separate department within the court, has achieved substantial success. According to mediator Claudia Bernard, she and her colleagues have settled as many as 73% of the cases they have worked on. Of course, there are differences — among other things, the Ninth Circuit uses full-time mediators, who screen cases for the program — but this compelling statistic at least shows that holding settlement conferences early does not necessarily limit their success.

The program has broader goals than settlement. A perennial

problem in the appellate courts is appeals in which the issues are not sharply focused and the record is overly inclusive. If a settlement conference fails to produce a settlement, the settlement officers may nevertheless be able to help the parties narrow the issues and limit the size of their record. Achieving even that limited goal may enable the appeal to move through the system less expensively and possibly more quickly. The result helps not only the parties to the particular appeal, but also parties to other appeals that are waiting in line.

### **Record Preparation**

From the Superior Court's perspective, the simplest way to break up the transcript-preparation logjam is for parties to use Rule 5.1. Once a party elects that procedure, the clerk's transcript portion of the record becomes entirely the parties' responsibility and requires virtually no court resources. Indeed, if the appellant does not need a reporter's transcript, record preparation bypasses the Superior Court almost completely. One cautionary note, however: Preparing a good appendix takes a lot of careful work and may, in a complex case, end up costing more than a court-prepared clerk's transcript because of the need for lawyer and paralegal time. *See generally* Meadow and Geffen, "Taking Care of the Record on Appeal," *Los Angeles Lawyer* March 1993.

The settlement program strongly endorses the appendix procedure. The Mandatory Docketing Statement allows an appellant who has already designated a clerk's transcript to change that designation and to elect Rule 5.1 instead, even if the original ten days for designating the record has expired. (The current version of the docketing statement contemplates a complete redesignation of the record, including *both* the Rule 5.1 election and the designation of the reporter's transcript. If the record *has not yet been designated*, the appellant can simply file a regular designation of record, electing Rule 5.1 if he or she chooses.)

The new program does *not* relieve the appellant from complying with the usual appellate deadlines and paying required deposits, and record preparation is not stayed unless the parties stipulate. However, at least until the backlog gets reduced, participation in the program is still a no-lose proposition for both sides:

- Since it normally takes six to seven months before the clerk starts preparing the transcript, the program allows a settlement to occur before the deposits have been used. A settling appellant can therefore get the deposits back.

- For the same reason, participating in the program does not cost parties their place in line. If they fail to settle, their transcript will be prepared just as quickly (or slowly) as if they had not participated.

- At most, the program requires an investment of perhaps a couple of days' time. That is a small price to pay for the opportunity of avoiding the substantial time and expense of carrying the appeal to its conclusion. And every case that settles early helps the progress of those cases that cannot settle.

One thing is certain: If this program fails to have a significant impact, the Court of Appeal and the Superior Court will need to look for other innovative solutions, and some form of aggressive early intervention seems likely. In a recent interview, for example, Justice Aldrich suggested the possibility of mandatory early mediation for all appeals (a possibility the Legislature is already exploring for trial courts via Senate Bill 1429).

While the District-Wide Settlement Conference Program does not pretend to be a panacea, broad participation can make a real difference in the appellate system. All it takes is for open-minded lawyers and clients to give it a try.

informing the other side; a lawyer who refused an extension to file a brief during the two day period his opponent's wife was in the hospital to give birth to a child.

From the judges' point of view, one of the greatest manifestations of increasing civility was the ever increasing number of ubiquitous sanctions motions. Both judges reported that only rarely was a dispute filed in state or federal court unaccompanied by accusations of misbehavior or impropriety and requests for sanctions by both parties (which were almost always denied).

A number of different reasons have been cited for the increase in uncivil behavior. The practice of law is far more business-oriented and impersonal than in the past. Firms and courts are bigger, more cases go to trial, and the litigator in a city like Los Angeles is unlikely to have many repeat experiences before the same judge, or even with the same opposing counsel. Competition for clients is intense, perhaps putting greater pressure on litigators to "be tough." The increased size of many law firms has made mentoring of younger attorneys more and more difficult, and, consequently, it is less likely that the mores and traditions of the profession are being passed on. With fewer partnership slots and perhaps less distributable income in many firms, the pressure to win at all costs may be greater than ever.

Whatever the causes, our panel agreed, as have others who have studied this issue, that there is no quick fix to the problem. From a practical standpoint, both judges acknowledged that most of their colleagues generally dislike dealing with these kinds of disputes. At least initially, a common judicial reaction is the same that many parents have when two of their fighting children come to complain — "both of you go to your rooms." This kind of judicial response was frequently reported in response to the audience questionnaires which we reviewed prior to the program. Of course, a recurring pattern of unprofessional conduct by one party in a case will likely manifest itself in time to a court, with negative consequences for the perpetrator and perhaps his client as well. However, given the enormous workload of our courts, it is simply unrealistic for litigators to expect that the courts can be a panacea in dealing with this problem.

What about new rules? For example, could the adoption by the ABTL Southern California of guidelines similar to its sister chapters advance the ball, or just create more confusion? For the most part, the L.A. County Bar Association guidelines are substantially similar in content, but they have the advantage of having already gained acceptance in both the federal and state court systems. On the other hand, adoption of the ABTL guidelines would create the only statewide standards addressing civility issues. In addition, the Los Angeles County Bar rules contain no counterpart to the inter-firm ADR procedure described above. For these reasons, it may be worthwhile for our organization to take some action in the near future.

Effectuating real change will, however, be a far more complex task. The legal community needs to develop a true consensus that we ought to conduct ourselves differently. This requires long-term education and dialogue. It should be the responsibility of law firms in our community to establish and promote a culture of civility and professionalism, and train its new lawyers that this culture is not at odds with zealous vigorous advocacy but, to the contrary, will make them more effective and credible advocates. While lacking the cachet of yet another new set of highly publicized rules, I believe this process is the most likely to yield permanent and meaningful results.

## The Ten Most Frequent Errors in Litigating Business Damages

**E**RROR #1 Using the "chronological sequence" method to depose an expert.

Most business litigators use the following "chronological sequence" to depose an expert: 1) the resume, 2) the assignment, 3) documents provided, 4) conversations with counsel, client, and others, 5) analyses done, 6) opinions, 7) exhibits for trial, and 8) further work planned before trial. Throughout this process, the expert can refresh his memory of the case and his analysis and decide how to tailor his opinions at the end to match what counsel has revealed in his questions. Most importantly, the expert can figure out how to finesse the fact that he still has not received some important information, still has work to do, may change his opinions, and may have entirely different exhibits at trial. The big fight between counsel as to a) whether the witness was adequately prepared for the deposition, b) whether counsel can continue the deposition, and c) whether opposing counsel has to provide revised exhibits takes place at the end of the deposition when everyone is ready to leave the room. The lawyer appears to have had a "meaningful deposition." The witness was paid at the start. So how much leverage is left?



James Plummer

The following "pre-emptive fences approach" forces the expert to reveal himself and make choices earlier in the deposition: 1) What exhibits will you use at trial. 2) What assignment were you given? 3) Is there any part of that assignment that you have not completed? 4) Will doing that work change these exhibits? 5) What changes? 6) When can we continue your deposition? 7) What are the areas in which you will be offering opinions, 8) Only those areas? 9) No opinions about \_\_\_? 10) What is the basis for \_\_\_ opinion? 11) What documents, conversations, meetings and reference materials support that opinion? 12) What parts of your education, work experience, publications, etc. qualify you to offer that opinion?

This approach forces the expert (and opposing counsel) to make critical decisions early in the deposition. The deposing lawyer can have his checkbook out while he is asking the first few crucial questions. If he doesn't like the answers, he can declare that the witness was not ready for the deposition and reschedule it (and payment) for a later date when the witness promises to have all his work and exhibits completed.

**Error #2 Not hiring an economic damages witness early enough to assist in discovery.**

A typical disaster scenario. The damages expert gets hired two days before the deadline for expert disclosure. A pile of documents and depositions arrives at the expert's office a week later. When the expert calls the litigator to ask for key data that was not in the pile, the litigator says "It looks like we never asked for that in the document request or at the depositions. Oh, by the way, they want to take your deposition next week." The expert must do a damages analysis that makes assumptions about key facts and then alter those assumptions depending on trial testimony. This often results in poorer analysis and testimony and increases expert costs by a factor of 2 or 3.

The damages expert can avoid this problem by helping to word interrogatories, document requests and expert witness disclosure.

(Continued on page 10)

## Ten Most Frequent Errors

Continued from page 10

tures. In addition, many damage experts know the styles of opposing litigators and damage experts and can predict their damage approaches. Damage experts can also craft deposition scripts for percipient and expert witnesses.

### **Error #3 Not knowing how to deal correctly with issues of diminution in business value.**

If the plaintiff business has been "destroyed" or greatly diminished before trial, it is important to appraise what the fair market value would have been. Although it is possible to assume that the firm would have grown beyond that date, this tactic ordinarily backfires because the jury regards it as speculative and overreaching. (See Plummer, "Is the Value of a Firm the Upper Limit on Future Lost Profits in Business Litigation?" *Litigation Economics Digest*, fall 1995.)



Gerald McGowin

When the plaintiff firm has failed before trial, defense counsel sometimes try to avoid measuring lost profits separately by having an expert value the plaintiff firm immediately prior to the alleged wrong and asserting that this value includes any profits that would have been earned thereafter. This is incorrect because a) it denies the plaintiff lost profits between the alleged wrong and the trial, especially the period prior to the failure of the firm, and b) it requires the appraiser to "put on blinders" as to events between the alleged wrong and the trial, even though the law al-

lows such events to be considered by a jury. Apart from the technical errors, this approach makes the defense look mean spirited and overreaching.

### **Error #4 Not taking into account the fact that the plaintiff is an owner-operated corporation.**

Suppose an owner-operated corporation has been damaged so much that it fails before trial. The damages will consist of lost profits prior to trial, plus what the fair market value of the firm would have been on the trial date but for the wrongful acts. However, there is a problem here. The lost profits before trial include the compensation and profits of the owner. However, the estimate of the fair market value of the firm on the trial date is based on profit levels net of the compensation of the owner-operator.

An attorney drafting a complaint for such a corporation needs to consider whether to add the owner as a plaintiff. If he does, he may increase that individual's exposure to an award of attorney fees or a cross-complaint. On the other hand, if the owner is added as a plaintiff, he can claim lost personal income extending beyond the date of trial. This discounted value of future lost earnings can be estimated in a similar manner as personal injury claims (with offsetting alternative income).

The alternative tactic is not to list the individual as a plaintiff, but claim damages for the business beyond the trial date. Then the individual's compensation losses are part of the business' future lost profits. However, the discount rates for future lost profits may be considerably higher than those used for personal lost earnings. More importantly, it may seem less credible to claim lost profits beyond the trial date for a failed business.

If the owner is not a plaintiff, defense counsel may seek to reduce the company's claim for lost profits by the amount of owner compensation. If the owner is a plaintiff, defense counsel may also claim attorney fees or file a cross-complaint against the individual as well as the corporation (which may be judgment proof).

### **Error #5 Believing that all CPAs are qualified to offer lost profits or business appraisal testimony.**

Only about 6 out of every 1,000 CPAs is a member of either the

American Society of Appraisers or the Institute of Business Appraisers. Testimony on lost profits is not nearly as treacherous as testimony on business appraisal, and does not require as much technical knowledge, so perhaps 60 of every 1,000 CPAs would be qualified to do that. Those are still very lousy odds.

Some lawyers simply ask a local tax CPA: "Have you testified before?" When the CPA answers "Yes," they feel very comforted. They shouldn't be. Most of these local tax CPAs have testified only in divorce cases or in very small business disputes.

Some lawyers consider only whether the CPA would "qualify in court." Unlike federal courts, most California state courts use no formal qualification procedure for experts, unless the other side objects (which rarely succeeds). So, of course the CPA would "qualify." The real issue is how they will stand up on unfamiliar ground. Local tax CPAs are particularly at sea when they have to deal with exotic litigation situations, like Section 2000 business appraisals, high tech startups, valuation of intellectual property, or valuation of minority interests.

In lost profits cases, the most important issue is not how to calculate lost profits from lost revenues. The most important and difficult issue is "What would the level of revenue have been but for the alleged wrong?" That requires forecasting, a task that CPAs on the other hand are not only untrained to do, but trained to avoid. Economists, on the other hand, are specifically trained to do forecasting, but they can get too creative and aggressive.

### **Error #6 Not knowing when and how to deal with "unjust enrichment."**

A claim for unjust enrichment, can be made in causes of action for fraud, constructive fraud, duress, conversion, mistake, or theft of trade secrets. Many business complaints can be written to include these causes of action. Claiming unjust enrichment does not ordinarily bar claiming lost profits as well in these or other causes of action.

Because the case law on unjust enrichment (formally a subset of "restitution," rather than "damages") is much thinner than on lost profits, many litigators are unfamiliar with the concept and reluctant to use it. However, precisely because the concept is not well known to many litigators, it can throw the other side off balance. An even smaller percentage of damages experts has experience with unjust enrichment, even though it is often easier to measure than lost profits.

### **Error #7 Confusing Incremental Lost Profit Margin with Gross or Net Profit Margin.**

Where the wrongful act has caused a nonfatal loss of revenue, the plaintiff's expert frequently argues that lost profits should be measured by multiplying the amount of lost revenue by the historical *Gross Profit Margin* (gross profit as a % of revenue), while the defendant's expert argues that lost profits should be measured by multiplying the lost revenue by the historical *Net Profit Margin* (gross profit minus overhead, all as a % of revenue). This dispute can devolve into a fruitless search for accounting definitions. Actually, it is rare for either the Gross Profit Margin or the Net Profit Margin to be appropriate for measuring lost profits.

The legal standard is to measure the *change in net profits* (before taxes) that resulted from the alleged wrong. However, that is not done by use of the Net Profit Margin, which is simply the *average* ratio of the net profit to revenue for a given period. In spite of the word "margin," there is nothing "marginal" about a Net Profit Margin. What is needed to measure the *change* in net profits is the *Incremental Lost Profit Margin*, which measures how much net profits will change as a result of a *change* in revenue. This is the most important single concept in lost profits analysis. (See Plummer & McGowin, "Key Issues in Measuring Lost Profits," *Journal of Forensic Economics*, 1993.)

### **Error #8 Not having a separate "industry expert" to work with the damages expert.**

In many smaller business cases, the most economical approach

## Ten Most Frequent Errors

Continued from page 10

is for the damages expert to "get up to speed on the industry" and do double duty. For larger litigation, especially for exotic industries, this is too much of a gamble. A damage expert can help find a good industry expert by calling trade associations, trade journals, or consulting firms serving a given industry. Litigators worry that opposing counsel can then make the damages expert look as though he is a member of the litigation team instead of an independent expert. In our experience, however, this never happens.

The damages expert, who is usually more experienced in litigation, can help the industry expert get ready for issues like mitigation of damages and whether other factors could have decreased revenue and profits.

Some litigators want to erect "Chinese walls" between their experts and have all communications go through counsel. If many "consultants" are hired and only a few will actually testify, this may be a good idea before the list of witnesses is finalized. In most business litigation, however, it is a very bad idea to keep the expert witnesses isolated from one another. They can waste a lot of time and money in doing inconsistent analyses. More importantly, they cannot brainstorm with one another. Attempting to keep the experts isolated usually arises from the litigator's inexperience or a "control freak" mentality that does not serve the client's interests.

### **Error #9 Hiring the wrong real estate appraiser or allowing inconsistencies between the appraisal and damages testimonies.**

Many litigators do not know how to shop for real estate appraisal witnesses. Get an appraiser who is familiar with a particular real estate market. The appraiser should have ASA (American Society of Appraisers) or MAI (Member of Appraisal Institute) after their name. They should have a college education. (Many older MAIs do not.) Ask for lawyer references from similar cases. Look them up in *Trials Digest* or in *Jury Verdicts Weekly*. Conduct a mock question and answer session.

In most real estate or environmental litigation, there are long periods in the future involved — e.g., the time necessary to clean up a site. The damages expert will be using a discount rate to convert future cash flows to present value. The *discount rate* used by the damages expert is quite different from the *capitalization rate* used by the real estate appraiser. If the real estate appraiser has modern training, he will recognize that, for litigation, he must use market-derived cap rates for appraisal, and not expose himself by constructing a "build up cap rate" (which adds up elements of real return on investment, expected inflation and "risk premium"). If the appraiser does not have modern training, he will not be able to explain that the capitalization rate will ordinarily be lower than the discount rate by the annual rate of expected growth in net income for similar properties in that market.

### **Error #10 Not having damage experts familiar with business failure rates.**

Everyone has heard the statistic that 75% of new businesses fail within five years. Defense counsel often take this pot-shot on cross-examination of plaintiff's expert, but it can be dangerous. Failure rates for smaller businesses go down dramatically with the number of employees and years in business and with whether they ever turned a profit. For larger businesses, statistical studies show that the risk of failure increases as certain key financial ratios get weaker. For startup high tech firms, there are dramatic differences in risk as firms move through the stages of new venture development.

A defense attorney not familiar with these subtleties can see the potshot backfire. A sophisticated damages expert can explain to you (and later the judge or jury) how these nuances affect your case.

—James Plummer & Gerald McGowin

## Cases of Note

### Insurance

In *Buss v. Superior Court*, 96 Daily Journal D.A.R. 2372 (Feb. 29, 1996), the Second Appellate District held that, where an insurance carrier provides a defense to an entire action, it may recover defense costs from its insured if it can prove by a preponderance of the evidence that they are reasonably allocable solely to defense of noncovered claims. Similarly, in *Imcera Group, Inc. v. Liberty Mutual Insurance Company*, 96 Daily Journal D.A.R. 2495 (Mar. 1, 1996), the Second Appellate District held that an insured is liable for defense costs which the carrier can prove are attributable to uninsured damages.

In *Moore v. Continental Ins. Co.*, 44 Cal. App.4th 10 (1996), the First Appellate District ruled that Insurance Code Section 533 precludes coverage for defense of a claim of constructive termination due to sexual harassment, as well as related claims for defamation and false imprisonment that were "inseparably intertwined" with the harassment. The Court ruled that coverage was precluded both for the costs of defense and indemnity, rejecting the insured's arguments that defense costs should be paid because Section 533 only precludes coverage for indemnification. The Court ruled that this general principle did not apply with respect to a standard CGL policy, saying:



Denise M. Parga

"this statement of principle... mean[s] only that an insurer and an insured are free to contract for the provision of a defense to a claim which can not be indemnified.... The policy in this case is not a litigation policy under which a defense was purchased without regard to indemnification. As previously noted, Continental's obligation to defend is predicated upon liability for a loss covered by the policy." 44 Cal. App.4th at 21 [Citations omitted.]

### Sanctions

The Ninth Circuit held that Rule 11 sanctions could not be issued where after-acquired evidence revealed that a complaint had merit, even though the attorney failed to conduct any investigation prior to filing it. In *re: Keegan Management Co.*, 96 Daily Journal D.A.R. 2305 (Mar. 1, 1996). Sanctions must be imposed if a paper is frivolous—meaning it is both baseless and made without a reasonable and competent inquiry. Sanctions may not be imposed, however, if a complaint that is well-founded, even if the attorney failed to conduct a reasonable inquiry.

### Questions of Law Or Fact

In *Granite States Insurance Company v. Smart Modular Technologies, Inc.*, 96 Daily Journal D.A.R. 1673 (9th Cir. Feb. 14, 1996), the Ninth Circuit, in a diversity case, held that the question of whether the plaintiff was equitably estopped from asserting claims for breach of contract and negligence is equitable in nature and, therefore, is an issue to be resolved by the court and not the jury.

### Malicious Prosecution

In *Dalany v. American Pacific Holding Corporation*, 96 Daily Journal D.A.R. 1697 (Feb. 14, 1996), the Fourth Appellate District held that a stipulated judgment does not qualify as a "favorable termination" for purposes of establishing a malicious prosecution claim because a termination of an action by way of

(Continued on page 12)

### Transition Rules

The proposed changes to the Local Rules are silent on obligations in existing cases. The transition rule adopted by the Supreme Court for its amendments to the Federal Rules of Civil Procedure was to include "all proceedings in civil cases commenced [after the effective date of December 1, 1993,] and insofar as just and practicable, all proceedings in civil cases then pending." 146 F.R.D. 401, 404 ¶ 2 (1993). Unfortunately, that standard does not provide much guidance to district court judges or counsel attempting to assess the impact of the new rules on existing cases.

To reduce the current uncertainty, the proposed changes to Local Rule 6 should apply only to those pending cases in which no defendant has yet answered. Revised Local Rule 9 should apply only to those pending cases in which the Status Conference contemplated by Rule 6.9 has not yet been held. That transition rule will simplify discovery in existing cases and will avoid the necessity of holding new status conferences and setting new scheduling orders to enable the parties to comply with the new requirements.

The proposed amendments to the Local Rules of Practice will be finalized soon and are based on the 1993 changes to the Federal Rules of Civil Procedure. Except for revising the relevance standard to eliminate the duty to produce evidence adverse to one's client at the early meeting of counsel, the proposed Local Rules are faithful in essence to the mandatory initial disclosure model embodied in the revised Federal Rules.

It is too early to determine whether, over the long term, the changes will reduce the costs and delays of civil litigation or increase costs and delays by adding another layer of discovery disputes. Further experimentation with discovery and procedural rules are likely to take place as the judicial system continues to react to pressure to reduce the expense and delay associated with civil litigation in federal court.

—By Michael K. Grace

### Cases of Note

Continued from page 11

agreement of the parties creates an ambiguity with respect to the merits of the proceeding.

### Good Faith Determinations

In *John Hancock Mutual Life Insurance Co. v. Setser*, 96 Daily Journal D.A.R. 2219 (Feb. 28, 1996), the Court of Appeal, First Division, held that a good faith determination under Code of Civil Procedure § 877.6 does not bar a party who previously prevailed against an implied indemnity claim from recovering its attorneys' fee because that claim had been perfected prior to the good faith determination. According to the court, Section 877.6 only bars "further" claims for indemnity; therefore, where there is a prior adjudication of an indemnity claim, it could not be construed as a "further" claim for indemnification.

### Capacity to Sue

In *American Alternative Energy Partners II, 1985 v. Windridge, Inc.*, 96 Daily Journal D.A.R. 1339 (Feb. 5, 1996), the Fifth Appellate District held that a defectively formed limited partnership has capacity to sue as a general partnership.

—Denise M. Parga

## 23rd Annual Seminar Set for Maui in October

Nothing motivates a plaintiff or threatens a defendant like the potential of sizable punitive damages in business litigation. For its 23rd Annual Seminar, The Association of Business Trial Lawyers presents a premier line-up of judges, trial lawyers, mediators and jury consultants to give actual demonstrations on challenging aspects of voir dire, opening statements, witness examination, closing argument and mediation, set in the context of a "bet the company" high profile trade secrets case.

Using a unique "real life" format, two jury panels will be voir dired, selected, hear the evidence and deliberate, and will be observed, analyzed and videotaped as they follow the case and reach their verdicts.

The seminar will be conducted at the Four Seasons Resort on the Hawaiian Island of Maui, from October 25 to October 29, 1996. In addition to meeting numerous state and federal judges from California and receiving 12 hours of MCLE credit, participants will explore beautiful Maui and enjoy swimming, hiking, biking and other island activities at one of Hawaii's most complete yet intimate resorts.

To reserve your hotel and air reservations, act now and call Fran Rafter at Windsor Travel (310) 477-6783 or (800) 535-1123. Registration fee (includes continental breakfasts, Friday night reception, Saturday and Monday night receptions and dinner) \$795 if paid by June 30th or \$895 if paid after June 30th.

## abtl REPORT

P.O. Box 67C46  
Los Angeles, California 90067  
(310) 287-0397 • FAX: (310) 287-0398

OFFICERS

Jeffrey I. Weinberger  
President  
(213) 683-9127

Karen Kaplowitz  
Vice President  
(310) 277-1226

Kim M. Wardlaw  
Secretary  
(213) 669-6380

David M. Stern  
Treasurer  
(310) 451-8001

BOARD OF GOVERNORS

Seth Aronson • Patricia Benson • Michael Bertz  
Vivian R. Bloomberg • Hon. Paul Boland  
Jeffrey C. Briggs • Richard J. Burdge, Jr.  
Hon. Judith Chirlin • Anne H. Egerton  
Larry R. Feldman • T. Warren Jackson  
Robert A. Long • Nora Manella  
Steven A. Marenberg • John R. Pennington  
Hon. William J. Rea • Barbara A. Reeves  
Miles N. Ruthberg • Robert S. Span  
Hon. Dickran Tevrizian • Eric S. Waxman

EDITOR

Vivian R. Bloomberg

ASSOCIATE EDITORS

Michael A. Bertz • John W. Cotton • John A. Dito  
Joseph S. Dzida • Laurence D. Jackson • Joel Mark  
Denise M. Parga • Larry C. Russ • Alice A. Seebach  
Michael A. Sheriman • Richard L. Stone • Mary Lee Wegner

MANAGING EDITOR

Stan Bachrack, Ph.D.