ASSOCIATION OF BUSINESS TRIAL LAWYERS

abtl REPORT

Volume IX No. 1 *December 1986*

Proposition 51 and You

Beware, business litigators. Proposition 51 is here. No, it doesn't just affect personal injury lawyers. The new rule limiting the liability of the so-called "deep pocket" on noneconomic damages will also affect business litigation, including even simple breach of contract actions.

What is Proposition 51? It allocates "noneconomic" damages in direct proportion to each defendant's percentage of fault. In short, it limits joint and several liability.

We might start by looking at what the Act does and what it does not do. The Act's initial thrust is to amend the definition of Joint Liability (Civil Code 1431).

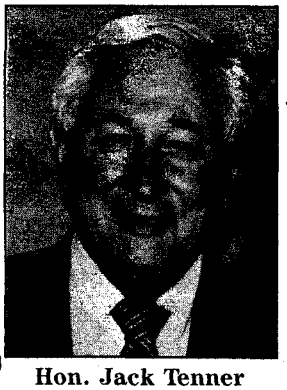
> "An obligation imposed upon several persons or a right created in favor of several persons is presumed to be joint, and not several, except as provided in section 1431.2 and except in the special cases mentioned in the title on interpretation of contracts." (1635, et seq.)

The findings and declaration of purpose (1431.1) provides:

> ". . . therefore, the People or the State of California declare that to remedy these inequities, defendants in *tort actions* shall be held financially liable in closer proportion to their degree of fault."

And 1431.2 provides:

> "(a) in any action for personal injury, property damage or wrongful death based upon *the principles of comparative fault,* the liability of each defendant for noneconomic damages shall be several only and shall not be joint."



Hon. Jack Tenner

It must be noted that the word tortfeasor does not appear in the Act. Reference is only to *"defendant".*

Are the provisions of this initiative therefore relevant to the practice of the business trial lawyer — *i.e.,* wrongful termination, breach of contract, emotional distress, defamation, et cetera?

Damages are defined as economic and noneconomic. The law as to economic damages has not been changed at all — it is what it has always been — a joint and several obligation. What is changed is the allocation of noneconomic.

The definition of economic damages for our purpose here is "objectively verifiable monetary losses including medical

Continued on Page 2

A Tax Primer for the Business Litigator

Too often litigators ignore the tax consequences of their actions. Tax law is thought of as something for the corporate lawyers down the hall.

But picture this: you just won a $1 million libel verdict. Your client is ecstatic — until the tax man comes calling. Only then do you find out that had you sued for damages to your client's personal instead of professional reputation the award would not have been challenged by the IRS.

Through proper tax planning, the business litigator can maximize his client's net recovery or tax deductible damage payments.

General Considerations

From a plaintiff's perspective, compensatory damage awards are taxed based on a substitution theory. The recovery is taxed to a plaintiff in the same manner as the item it is intended to replace. For example, an award for lost wages would be taxed as ordinary income while an award for damaged property might be taxed either at capital gains rates or be a tax-free recovery of cost. In contrast, personal injury damages in tort actions are generally tax-free.

Punitive damages awards in a business context are taxable. The IRS consistently treats punitive damages in personal injury actions as taxable, although courts, on occasion, will exclude them from taxation.

Interest earned on damage awards is always taxable, regardless of the taxability of the underlying damages.

From the defendant's point of view, compensatory damages are not deductible if they arise out of a personal (non-business) matter. Damages arising from business matters may be deductible as business expenses or expenses for the production of income, whether resulting from civil judgments or settlements.

Richard K. Cole, Jr.

Punitive damages are similarly deductible. However, fines, penalties, and the punitive portion of certain anti-trust damages are nondeductible.

Interest is normally deductible in all cases, subject to the consumer (non-business) and investment interest disallowance rules.

It should also be noted that, where a compensatory or punitive payment is considered a capital expenditure, deductions may be spread over several years or disallowed entirely (*e.g.,* expenditures concerned with the acquisition or main-

Continued on Page 4

Proposition 51 and You

Continued from Page 1

expenses, loss of earnings . . . loss of employment and loss of business or employment opportunities" (Civ. Code §1431.2(b) (2).

The Act allocates noneconomic damages as follows:

> "Each defendant shall be liable only for the amount of noneconomic damages allocated to that defendant in direct proportion to that defendant's percentage of fault and a separate judgment shall be rendered against the defendant for that amount."

The definitions of economic and noneconomic damages include, of course, other matters for which damages can be awarded, but they are omitted here as they are essentially tortious, personal injury items of damages, *i.e.*, pain, suffering, medical expenses, loss of earnings, et cetera.

In ititiating or defending a business matter, one would now look to parties who might share fault. The parties have to share the fault on the principle of comparative fault.

Special mention should be made of the Use Note to BAJI 16.00 (1986 Revision) which provides:

> "This instruction and others in the series discussed above re 'Form of Special Verdict' *is designed to enable the court to include the entire universe of actors in the jury's determination of percentage of fault.*"

Absent some appellate ruling that the fault of a party immune from suit or liability cannot be included in the "entire universe of actors," it is safe to assume that the parties whose fault you are considering will be submitted to the fact-finder.

What does this mean as a practical matter? If you are bringing the action:

(1) Do you bring in everyone who could be at fault?

(2) Can you assume that the defendant will bring others in — so as to shift the burden to the defendant, who would then have the burden of proof against this cross-defendant?

(3) What if neither party brings him into the litigation? Will the defendant be able to argue the fault of the empty chair? That seems more likely than not.

The business litigator required to answer a complaint should consider the value and the necessity of filing cross-complaints to bring in any additional parties. Although the Act speaks only of "defendant," a safe prediction would seem to be that when the dust has settled, the Act will be deemed to apply to defendants, cross-defendants and other parties who may be found to be at fault.

The attorney might consider:

(1) If I bring in a cross-defendant, he might contribute to a settlement (90%-95% of the filed cases will settle).

(2) Do I want to have the burden of proof as to that cross-defendant?

(3) If the party "at fault" but not sued by plaintiff is without assets or insurance, why bring him in? Better to point at the empty chair?

A few illustrations might be of some assistance in projecting some areas of commerical concern. Assume that a lawsuit has been filed alleging that the named defendant wrongfully terminated the plaintiff (a growing field of legal activity). One of the defenses that might be alleged is that the employment was terminated by reason of a report received from (a) a law enforcement agency; (b) a private detective agency employed by the defendant — an independent contractor; (c) also an independent contractor, but this time an in-house security service.

Prior to the enactment of the Act, a cross-complaint might have been filed against such parties (assuming no immunity on the law enforcement agency); but, if the defendant was at all responsible, regardless of the percentile of fault, that defendant would have been liable for the entire verdict without a breakdown of economic or noneconomic damages. The financial integrity of the cross-defendant — uninsured, under insured, or unavailable for service — would only have affected the ability of the defendant to get contribution from the cross-defendant. It would not have affected the defendant's joint and several obligation to the plaintiff.

The Act makes a significant departure from this rule. Now the defendant and cross-defendant and other responsible parties not sued are jointly and severally liable for only the economic damages. As to noneconomic damages, the defendant would only be liable for an amount equal to his percentage of fault as applied to those noneconomic damages.

The recent decision of *Cione v. URS Corporation*, 183 Cal.App.3d 194 227 Cal.Rptr. 887 (1986), suggests a use of the Act in what might have appeared to be a simple breach-of-contract lawsuit. Former clients filed suit against Cicone and his law corporation alleging legal malpractice in connection with negotiations for the sale of plaintiffs' business. The attorney filed a cross-complaint for comparative equitable indemnity, damages and punitive damages against the purchaser corporation, its president and its attorney. The trial court sustained general demurrers to all causes of action of the cross-complaint without leave to amend.

The facts underlying the malpractice action concerned an agreement for the sale of plaintiffs' business to cross-defendant URS Corporation. At a conference, Cicone stated that the sellers could not guarantee the accuracy of the balance sheet. The purchaser's attorney replied that the buyer understood, and they could proceed on the basis that the information of the balance sheet was correct only to the seller's best knowledge. In reliance on this promise, Cicone advised his clients to proceed with the transaction and the deal was concluded. Shortly thereafter, the buyer made a claim against the sellers based on a $200,000 understatement of deferred tax liabilities in the balance sheet of which the seller had been unaware. The parties settled the claim without litigation for $125,000, and the sellers filed the legal malpractice suit against Cicone.

Although the Court of Appeal extensively discussed the elements of the cross-complaint's alleged causes of action for fraud, duty, justifiable reliance, proximate causation, damages, negligent misrepresentation, those issues need not be discussed here. Relying on *American Motorcycle Association v. Superior Court*, 20 Cal. 3d 578, 146 Cal. Rptr. 182 (1978), *E. L. White, Inc. v. City of Huntington Beach*, 138 Cal.App.3d 366 (187 Cal. Rptr. 879 (1982), and *Restatement of Torts*, section 886(b), the court held that Cicone stated a cause of action for equitable indemnity, stating:

> "The concept of joint tortfeasors for the purpose of indemnity is explained in the Restatement as '. . . two or more persons who are liable to the same person for the same harm. *It is not necessary that they act in concert or in pursuance of a common design, nor is it necessary that they be joined as defendants. The rule stated applies to all torts, including not only negligence but also misrepresentation, defamation, injurious falsehood, nuisance or any other basis of tort liability.*' " (Rest. 2nd Torts, §886A, Com. b, emphasis added. *(Cicone, Supra,* 227 Cal. Rptr. at 899.)

The court concluded this issue by stataing that indemnity:

> ". . . only requires a significant difference in the kind or quality of the conduct of each tortfeasor." (*American Motorcycle, supra* 594-595, fn. 4).
>
> *"Here Cicone is alleged only to have been negligent, while the cross-defendants Canaday and his clients are alleged to have intentionally deceived Cicone and his*

client. Should this be proved at trial, then the entire liability may be shifted to Canaday and his client. On the other hand, if cross-defendants are only found to have been negligent in their representation to cross-complaint, then partial (comparative) indemnity under the American Motorcycle *principles will come into play." (Cicone, supra* 227 Cal. Rptr. at 899) (Emphasis added).

Extended examples are not required to foresee the use of cross-complaints and/or the principles of comparative indemnity and the application of the Act to business litigation.

Attorneys should examine their present litigation to determine whether some liability which has been assumed to lie wholly on one party may not be reduced using these principles. As indicated above, parties who have brought about this condition by reason of the pleadings would have to move the trial court for an allocation of damages, economic versus noneconomic, together with an allocation of fault as between defendants, cross-defendants and other parties. It is not the duty of the judge to instruct the jury on these issues *sua sponte.* See *Moore v. Preventative Medicine Medical Group,* 178 Cal.App.3d 728 (1986). In light of this decision, defendants who do not request segregation run a risk of having all liability deemed joint. See also *Codekas v. Dyna-Lift Company,* 48 Cal.App.3d 20 (1975).

The threshold question is the applicability of the Act to cases filed before June 3, 1986. Multiple superior court decisions in one form or another have discussed this issue and as of this writing, all writs to appellate courts have been rejected save one: Division Five of the First Appellate District has ruled in the case of *Russell v. Superior Court of Alameda County — Asbestos Claims Facility Defendants, et al., Real Parties in Interest,* Case No. A 035 818 — that *the initiative "is not retroactive."* This issue would appear to be far from resolved, as other divisions of the Court of Appeal are presently looking at this question and, of course, the ultimate resolution will have to be determined by the Supreme Court.

The current approach to the applicability of the Act by most — if not all — of the trial courts in the State is to try the matter to a jury verdict and employ a special verdict form in those instances where the Act *might* apply.

These special verdict forms are set forth in a special BAJI pamphlet entitled California Jury Instructions, Civil Proposition 51 Instruction, August 1986, commencing with BAJI 16.00, *et seq.*

These instructions provide for a finding by the jury on all of the issues presented by the Act, *i.e.,* the amount of economic damages, the amount of noneconomic damages, and the fault of each of the parties whose conduct is in question.

The trial court would then enter a judgment after making a finding that the Act does or does not apply. This approach would guarantee the avoidance of a second trial, as all of the figures would be available to recalculate the verdict, if necessary.

There are many questions raised by the Act which are not discussed here. Appellate review will eventually answer these issues. Meanwhile, pleadings and discovery should be re-examined to make certain you have not omitted parties at fault, unless your clients' interests would be thereby prejudiced. Trials should proceed on the basis that the Act is in effect now and applies to pending litigation.

Requested BAJI instructions should protect the record as to *all* findings to avoid a second trial — regardless of how the trial court rules.

Properly considered and carefully nurtured, Proposition 51 can provide a great deal of new business for everyone!

—Hon. Jack Tenner

Letter from the President

Nineteen eighty-six has brought us sweeping tax reform, a Summit, ABTL's first annual seminar in Hawaii and what appears to be a revolution in associates' salaries.

Last April, when all of us were preparing our 1985 tax returns, the New York firm of Cravath, Swaine & Moore made an announcement which sent shock waves throughout the New York legal community. Not stopping at the Hudson River, the shock waves continued west and, like frequent earthquakes, have been felt throughout the Los Angeles legal community.

Robert A. Shlachter

Looking for an edge over other New York law firms as well as out-of-state firms Cravath, Swaine & Moore announced that it would increase its beginning associates' salaries from $53,000 to $65,000 (for the class of 1986). Although couched in terms of a "housing allowance" to compensate for the high cost of living in New York, the announcement was appropriately interpreted as reflecting a dramatic leap in associate compensation, an increase of almost 25%.

A few months later, Los Angeles law firms began to respond. The *Los Angeles Daily Journal* headline of July 25, 1986 read:

Associates' Pay Reaches New High as Partners Groan — Salaries Spiral Begun by New York Firms Has Local Impact — Effect on Rates Seen.

Firms such as Gibson, Dunn & Crutcher and O'Melveny & Myers, who were paying new associates in the class of 1985 $40,000-$42,000, announced that they would be paying new associates (class of 1986) $52,000, an increase of approximately 25%. Many other firms stated that they would make similar upward adjustments, while a few firms candidly admitted that they did not know what to do and were considering the matter.

How things have changed in only a few years! In 1982, when the economy took a downturn, law practice articles predicted the early doom for mid-sized law firms and observed that general practice firms were rapidly losing corporate and litigation business to in-house counsel. Only two years ago, major firms such as Gibson, Dunn & Crutcher, who were then paying starting associates approximately $36,000, announced that they would be holding the line on salaries and, in light of slowing inflation, would make only modest increases in associates' compensation. At that time, the increases were in the range of four to six percent.

Continued on Page 8

Contributors to this Issue:

The Hon. Jack Tenner is a judge of the Los Angeles County Superior Court.

Richard K. Cole, Jr., a lawyer and C.P.A., is a partner in the accounting firm of Grant Thornton.

Robert A. Shlachter, President of ABTL, is a partner in the firm of Alschuler, Grossman & Pines.

Mark A. Neubauer, Editor of *ABTL Report,* is a partner in the firm of Stern & Miller.

Continued from Page 1

tenance of a capital asset, such as stock).

Specific Types of Actions: Personal Injuries

(1) Plaintiff (*i.e.,* avoiding taxes). Amounts received to compensate a person for damages on account of his personal injury or sickness are nontaxable by statute, I.R.C. 104(a) (2). The rationale for the exclusion is that the victim is being made whole rather than receiving an increase in wealth. This rule applies whether payment is received in a lump sum or through a series of periodic payments. Examples of personal injuries recoverable on a tax free basis include alienation of affections; age, race and sex discrimination; emotional distress; wrongful death; and personal reputation damages.

Recent Development

On December 8, 1986, the Tax Court in *Threlkeld v. Commissioner,* 87 T.C. No. 76 (1986) reversed its pro IRS position in *Roemer v. Commissioner,* 79 T.C. 392 (1982), rev'd 716 F.2d 693 (9th Cir. 1983) and joined the Ninth Circuit in holding that tortious damages to an individual's professional reputation are received on account of personal injury and are also recoverable on a tax-free basis. Until such time as the IRS acquiesces in *Threlkeld* however, complaints, settlements and other documentation should stress the damage to personal reputation whenever possible.

In the area of punitive damages, the IRS and the courts have begun to take increasingly polarized positions. After initially announcing that punitive damages arising out of nontaxable personal injury suits were nontaxable, the IRS later argued, with Tax Court concurrence, that punitive damages are taxable on the grounds that they are punishment to the defendant rather than a means of compensating the plaintiff for his loss.

Recently, three courts have directly rejected this position. In *Roemer vs. Commissioner* 716 F.2d 693 (9th Cir. 1983), rev'g 79 TC 392 (1982), the Court held that the taxability of *both* compensatory and punitive damages in a libel suit did not depend on the personal or professional nature of the defamation but on the personal or nonpersonal nature of the state action. Since suit in *Roemer* was brought under the California personal defamation statute rather than under the related tort of disparagement of trade libel, all damages received were held nontaxable, regardless of whether received due to harm to Roemer's professional or business reputation.

The Service immediately announced it would not follow *Roemer* because it felt that tax-free compensatory damages should depend on the nature of the libel (*i.e.,* personal or professional reputation) rather than on the characterization of the lawsuit under state law and reiterated its position regarding punitive damages, *i.e.,* they are taxable because they are based on the defendant's degree of fault and not on account of personal injury.

Because of its reliance solely on the action brought rather than the nature of the harm alleged, *Roemer* remains an extremely valuable precedent in libel damage suits, particularly in the Ninth Circuit.

In a similar and perhaps more widesweeping attack on the IRS position, the United States District Court for the Northern District of Alabama refused to accept the Service position on punitive damages in *Buford v. United States,* ___ F.2d ___ (N.D. Ala. 1986), a wrongful death case. The IRS previously had held that damages under Alabama's wrongful death statute were punitive in nature and were consequently taxable because they were not received on account of personal injury. However, the District Court ruled that, although the Alabama wrongful death proceeds were intended to punish wrongdoers, "this characterization does not alter the inescapable fact that a wrongful death action arises only upon a person's death . . . and damages received . . . are personal injury proceeds excludible from gross income."

Finally, in the recent *Threlkeld* decision, the Tax Court's conclusion that there is no valid distinction between damages to personal and profession or business reputation for purposes of tax exemption further weakens the Services's argument that related punitive damages should be taxable.

Planning Tip: As a result of the above litigation, a position may now be taken under the proper state statute, or even in spite of that statute, that punitive damages are not taxable. Look at the underlying purpose of a statute in arguing for the tax-free nature of the recovery, *e.g.,* a wrongful death statute is primarily to compensate for personal injury. If appropriate, consider bringing a suit under a personal defamation rather than the disparagement of trade statute.

(2) Defendant (*i.e.,* deductions). Generally, compensatory payments made in a nonbusiness, personal situation are nondeductible. However, if it can be shown that the defendant made the payment in the conduct of his trade or business or in an income producing activity, they are deductible. A defendant can also deduct any of plaintiff's legal fees the defendant pays to the extent attributable to taxable damages.

Similarly, you can deduct punitive damages. However, you cannot deduct fines and penalties paid to the government.

Interest paid to the plaintiff is normally deductible as long as it is not investment interest (limited to investment income) or, after 1986, consumer (non-business) interest, which is being phased out.

Business Damages

(1) Plaintiff. Under the substitution principle, the taxation of compensatory business damages generally depends on whether the award is for (1) lost profits or wages or (2) lost goodwill, business reputation or other assets.

If damages for lost profits are awarded, they are normally taxed as ordinary income unless the sale or exchange of a capital asset is involved. Should an award represent payments for a lost or damaged asset, then its cost may be recovered tax-free with the remainder subject to ordinary or capital gains tax depending on the nature of the asset.

As discussed above, while individual professional reputation damages have been previously held taxable by the Tax Court, that Court now agrees with the Ninth Circuit that such damages are not taxable when arising in a tortious claim.

One common plaintiff argument is that the defendant has done irreparable damage to the company's goodwill. Where this can be shown, the damages can be received tax-free to the extent there is a cost basis in the goodwill. Unfortunately, however, there is normally no such goodwill basis unless the business was acquired in a taxable transaction and a specific part of the purchase price was allocated to goodwill.

Planning Tip: If defensible, phrase the complaint in terms of damages to assets with substantial basis or include claims for personal, non-taxable damages to company executives.

One statutory benefit does exist with respect to taxable business damages in compensable injuries in the areas of (1) patent infringements, (2) breach of contract, (3) breach of fiduciary duty or (4) injuries under section 4 of the Clayton Act. In these cases, the taxable damage amounts may be reduced by the amount of unrecoverable losses sustained due to the injury, even if due to loss carryovers which would otherwise have expired.

Punitive damages in a business or investment context are generally treated as taxable.

(2) Defendant. A defendant making a damage payment, including interest and legal fees, in the active conduct of its

trade or business or in an income producing activity is normally entitled to deduct it. Punitive damages are similarly deductible with the exceptions as noted above.

Planning Tip: The intent of the defendant payor rather than the plaintiff's assertion of damages is controlling in the settlement area. For example, an employer defendant's intent that a settlement payment be wage compensation to the plaintiff could override the plaintiff's claim for personal injuries damages.

Antitrust Actions

(1) Plaintiff. Compensatory and punitive damages paid to private individuals and entities in antitrust actions are generally subject to taxation in a manner similar to the business damage rules set forth above.

(2) Defendant. Compensatory and punitive damages paid to private parties in settlement of or as a result of a judgment in an antitrust action are normally deductible as long as they qualify as ordinary and necessary business expenses or expenses for the production of income. However, if there is a conviction (or plea of guilty or nolo contendere) in a related antitrust case preceding or following payment, one-third of the total damages paid are deemed deductible compensatory and two-thirds nondeductible punitive damages. Legal fees in both successful and unsuccessful civil and criminal defenses are deductible if ordinary and necessary business expenses.

Planning Tip: Settlement amounts paid in a civil suit before the institution of a related antitrust criminal action could triple the deductibility of the damage payments.

Damage payments to the government appear to be deductible unless considered a fine or penalty.

Tax Planning During Litigation

Income Inclusion and Expense Deduction. In planning litigation to maximize tax benefits for clients, it is important to be familiar with the time when payments are includable in income or deductible as expenses.

For cash basis plaintiffs, damages are included in income in the year they are actually or constructively received (*i.e.*, at plaintiff's disposal) without substantial restrictions.

For accrual basis plaintiffs, damages are included in income in the tax year the amount awarded becomes "fixed and determinable" (although unpaid).

Planning Tip: An interesting planning opportunity arises in the case of property destroyed by casualty, theft or condemnation. In these cases, if the property is replaced within a two-year period by property which is similar or related in service or use, no tax arises.

For cash basis defendants, deductions for compensatory and (in certain cases) punitive damages are allowed in the year that they are actually paid.

For accrual basis defendants, deductibility arises when the defendant provides the payments or services required.

In all cases, an otherwise deductible payment must instead be capitalized if it relates to a capital asset, *e.g.*, the protection of property rights or the acquisition of goodwill.

Planning

In order to obtain the maximum tax benefit to a judgment or settlement, certain steps should be taken:

Appraisal: Obtain an independent appraisal of damages subject to valuation prior to the commencement of any action. For maximum value, the appraisal should be completed as soon as possible after the alleged damages arise.

Complaints and Answers: The nontaxable nature of the claim (*e.g.*, tort damages as opposed to contract damages) should be set forth in the complaint. Conversely, the deductibility features of the claim should be set forth by the defendant (*e.g.*, compensation for lost wages, professional reputation).

Release/Settlement: This is an ideal time to set forth an allocation of the total award among the various elements (*e.g.*, damages to personal, professional reputation, capital assets, goodwill, lost wages). As a practical matter, however, the IRS will give these allocations more weight when the parties' tax positions are adverse (*e.g.*, plaintiff — taxable lost wages; defendant — deductible wages payments) than mutually advantageous (*e.g.*, tax-free award for damages to personal reputation and deductible business expense).

Antitrust Settlement: The defendant should strive for a settlement prior to criminal proceedings being instituted to avoid the treble damage deduction limitation. In return, the plaintiff may negotiate for more sizable damages.

Court Testimony: Although admittedly somewhat self-serving, placing the damage basis or defense in the record may both influence the court's allocation of damages and provide a basis for appeal.

Special Verdict Request: Although not specifically binding

Continued on Page 6

abtl REPORT

P.O. Box 67C46
Los Angeles, California 90067

Continued from Page 5

on the IRS, a court's determination is certainly influential. Thus a request for a specific allocation or special verdict is certainly advisable.

State Taxation: All planning should be done with state tax in mind. Conformity to Federal rules is not always the case.

Post Judgment/Settlement Planning. Both the plaintiff and defendant may benefit by agreeing to payments over a number of years, *i.e.*, the plaintiff through taxation in smaller increments at lower brackets under the Tax Reform Act of 1986 and the defendant through decreased short-term cash disbursement. In addition, the defendant could purchase an annuity under which the plaintiff's damages could be paid periodically.

With certain exceptions for large corporate plaintiffs, tax on the damage award need not be paid until the original due date of the plaintiff's tax return as long as last year's tax is paid in during the year. If the taxable award is substantial, payment of last year's tax (no matter how small) through quarterly estimated payments will allow the plaintiff maximum use of the award money until such due date.

In certain cases, it is possible to satisfy a judgment through a spinoff or split off of a business division, or subsidiary to the plaintiff. If properly structured, the transaction may be effected tax-free to both plaintiff and defendant.

Tax Reform Act of 1986

The Tax Reform Act of 1986 has effected a number of changes which may affect damage strategy beginning in 1987. Among such changes:

Income averaging is no longer allowable. Consequently, a large, taxable damage award in a given year may subject a plaintiff to an intolerable tax. An alternative would be to agree to a payment structure over several years which would be taxable as received.

Consumer interest is not deductible. Therefore, to the extent a damage payment is not a legitimate business deduction to a defendant, interest expense on damage payments may be nondeductible consumer interest. Similarly, if the expense is classified as investment interest, deductions are limited to investment income.

Capital gains are eliminated after 1986. However, capital gain payments received in 1987 are subject to a maximum individual tax of 28 percent as opposed to the normal 38.5 percent maximum. Corporate capital gains are effectively eliminated after 1986.

State taxes are still deductible against Federal income. Consequently, the taxes paid on damages at the state level lessen the federal tax.

Passive losses may be deductible only to the extent of passive income.

Structured settlement companies may no longer exclude from gross income amounts received in cases other than those involving payments for physical injury, sickness or wrongful death arising from physical injury or sickness.

These rules are, of course, just a general guide. It is important for the litigator to be aware of the tax consequences of a lawsuit. But that general awareness is no substitute for in-depth knowledge. So the best advice is simple: Recognize the tax issues of litigation and plan for them with the help of a competent tax professional.

—Richard K. Cole, Jr.

Annual Update: Time to Trial in Southern California Courts

From three months to almost five years, the waiting time for trial continues to vary widely in the Los Angeles County system, according to the latest annual ABTL survey.

Overall, the Los Angeles County system has greatly improved in the past year, cutting almost a half-year off the waiting time for trial. For the entire system, it takes just 33 months from the filing of the at-issue memorandum to commencement of a jury trial, as opposed to last year's 41 month wait. Non-jury trials are even faster throughout the system. The wait is just 18 months from the filing of the at-issue memorandum, a reduction of over 10 months from last year's figure.

But log jams still remain not only in the Central District but also in branch courts such as Pasadena, Long Beach and Santa Monica.

Incoming Presiding Judge Jack E. Goertzen warns that delays could increase, especially if the civil courts are continually called upon to handle criminal trials. According to Judge Goertzen, last year the civil panel of the Central District handled 161 criminal trials. This year the total is already over 219 and said Goertzen, "that limits our responsiveness."

In the Central District, which processes more than half of the civil cases pending throughout Los Angeles County, the wait for jury trials increased from 45 to 50 months, but non-jury trials can be had in as little as 21.5 months from the filing of an at-issue as opposed to last year's waiting time of 38 months.

The biggest improvement in branch courts was shown by Pomona, which cut the wait for jury trials from 59 to just 21 months and reduced the non-jury wait time by over a half-year to just 30.5 months. Pasadena, long the most delayed branch court, continues that dubious honor with an astounding 61 months from the filing of an at-issue to trial with a jury.

Improvements were also scored by the South Central District in Compton, which cut the jury trial wait to 15 months from the filing of an at-issue, slightly less than one-third of last year's figure. Improvements were also scored by the Norwalk Court.

According to the most recent statistics available, there were 35,144 cases awaiting trial in Los Angeles County Superior Courts this year, of which 20,623 were pending in the Central District alone. The next largest case load was that of the South District in Long Beach, which had 2,372 cases awaiting trial.

Elsewhere in Southern California, Orange County marked the biggest increase, cutting trial delays to just 8½ months from the filing of an at-issue as opposed to last year's 19 month wait.

Other Southern California State courts' waiting time for trial remain the same as in last year's survey. Ventura County Superior Court remains the fastest with an astounding five months from filing an at-issue to commencement of trial. San Bernardino County is not far behind at a mere six month wait.

Federal Court delays also remain stable. The Central District marked a slight increase to 16 months between the time a case becomes at-issue to trial, an increase of just one month

Continued on Page 7

U.S. DISTRICT COURTS[1]

	Months From Issue To Trial (Median)
Central District	16
Northern District	15
Southern District	20
Eastern District	18

LOS ANGELES SUPERIOR COURT[2]

(Number of Months From Filing of At-Issue Memorandum to Commencement of Trial (Median))

	Jury	Nonjury
Central District	50	21.5
West District (Santa Monica)	34.5	22
East District (Pomona)	21	30.5
North Central District (Burbank-Glendale)	2.5	5
Northeast District (Pasadena)	61 *	31 *
North Valley (San Fernando)	27	13
Northwest District (Van Nuys)	20.5	17
South District (Long Beach)	50	42.5
South Central District (Compton)	15	14
Southeast District (Norwalk)	15	13
Southwest District (Torrance)	37.5	9 *
TOTAL	33	18

* No such cases disposed of in August, so July statistics are latest available.

OTHER SUPERIOR COURTS[3]

	Number of Months From Filing of At-Issue to Commencement of Trial
Orange County	8.5
San Diego County	16-18
San Bernardino County	6
Ventura County	5
Santa Barbara County	17
Riverside County	18

1 From Annual Report of the Office of the Circuit Executive of U.S. District Courts for the 12 months ending December 31, 1985.
2 From Los Angeles County Monthly Conspectus for August, 1986, issued by Los Angeles Superior Court.
3 This information was obtained from the County Clerk's offices of the respective courts. The data upon which the figures are based differ: some are based upon median time calculations and others on current estimates of the Clerk's offices.

over last year's tally. Slight increased delays were also experienced by the Northern, Southern and Eastern districts in the federal system in California. The Southern District suffered the largest increase to 20 months from last year's 16 months wait.

At the same time, the Central District of Los Angeles is the busiest United States District Court in the Ninth Circuit. Part of the reason can be traced to the attractiveness of diversity jurisdiction. In 1985, civil filings in the Central District increased 19.7%. An astounding 22.8% of the Central District's civil caseload was based on diversity jurisdiction as opposed to 7.6% in the Southern District of the United States District Court and only 9.1% in the Northern District.

According to Judge Goertzen, who will be next year's presiding judge for the Los Angeles County Superior Court, the pressures to give priority to criminal trials is severely handicapping prompt adjudication of civil disputes. "The pressure to take criminal trials really limits our responsiveness," Goertzen said.

"We are making every effort to free up four to five dependency courts to handle criminal trials. We need substantial help to stem the flow of criminal cases over here [to the civil courts]," he said.

"For example," added Goertzen," this past month we even had to stop civil trials for a period because of the criminal situation. The criminal trials are tying up a lot of our civil resources."

Goertzen said that he does not expect the logjam to improve at least through January, 1987.

"Earlier this year (in 1986), we were going great guns in Department 1, with as low as five to six cases trailing. Yet, in the first week in December, we had 58 cases trailing," Goertzen said.

For the present, Goertzen warned, civil litigators should not expect to be assigned out for trial in Department 1 of the Central District of the Superior Court unless they are within 60 days of a mandatory dismissal under C.C.P.§ 583.310.

"We are trying not to put too many people on the trailing calendar in Department 1," Goertzen said. "So we ask counsel not to be too disappointed or surprised if they are called for trial only to find their trial date is kicked over because they are not a priority case or within that 60 day limit."

Goertzen added that on occasion a non-jury case for less than five days may still be assigned out even though it is not within the 60 day guideline. He also warned that it is difficult to predict how many cases will be on the trailing calendar or up for trial.

"Generally there is a two to three months lag between trial settings and when the cases actually come up for trial," Goertzen said. "If we ascertain a problem, we will cut back on trial settings. But, the lag time makes it difficult to predict." It is also difficult to predict how many cases will settle. According to Goertzen, "a lot of cases do not settle until the day of trial."

"Now," Goertzen added, "we are not seeing a lot of movement across the street in the criminal courts building. Instead there is a lot of protracted litigation, including retrial of a number of death penalty cases. These may occupy two to four months and, when they do, they cause a substantial backlog throughout the system."

For the present, Goertzen said, he hopes to solve the problem "in-house." But he also warned that lawyers may have to assist in resolving the backlog if criminal overflow continues to congest the civil courts.

—Mark A. Neubauer

U.S. DISTRICT COURTS[1]

	Months From Issue To Trial (Median)
Central District	16
Northern District	15
Southern District	20
Eastern District	18

LOS ANGELES SUPERIOR COURT[2]

(Number of Months From Filing of At-Issue Memorandum to Commencement of Trial (Median))

	Jury	Nonjury
Central District	50	21.5
West District (Santa Monica)	34.5	22
East District (Pomona)	21	30.5
North Central District (Burbank-Glendale)	2.5	5
Northeast District (Pasadena)	61 *	31 *
North Valley (San Fernando)	27	13
Northwest District (Van Nuys)	20.5	17
South District (Long Beach)	50	42.5
South Central District (Compton)	15	14
Southeast District (Norwalk)	15	13
Southwest District (Torrance)	37.5	9 *
TOTAL	33	18

* No such cases disposed of in August, so July statistics are latest available.

OTHER SUPERIOR COURTS[3]

	Number of Months From Filing of At-Issue to Commencement of Trial
Orange County	8.5
San Diego County	16-18
San Bernardino County	6
Ventura County	5
Santa Barbara County	17
Riverside County	18

1 From Annual Report of the Office of the Circuit Executive of U.S. District Courts for the 12 months ending December 31, 1985.
2 From Los Angeles County Monthly Conspectus for August, 1986, issued by Los Angeles Superior Court.
3 This information was obtained from the County Clerk's offices of the respective courts. The data upon which the figures are based differ: some are based upon median time calculations and others on current estimates of the Clerk's offices.

over last year's tally. Slight increased delays were also experienced by the Northern, Southern and Eastern districts in the federal system in California. The Southern District suffered the largest increase to 20 months from last year's 16 months wait.

At the same time, the Central District of Los Angeles is the busiest United States District Court in the Ninth Circuit. Part of the reason can be traced to the attractiveness of diversity jurisdiction. In 1985, civil filings in the Central District increased 19.7%. An astounding 22.8% of the Central District's civil caseload was based on diversity jurisdiction as opposed to 7.6% in the Southern District of the United States District Court and only 9.1% in the Northern District.

According to Judge Goertzen, who will be next year's presiding judge for the Los Angeles County Superior Court, the pressures to give priority to criminal trials is severely handicapping prompt adjudication of civil disputes. "The pressure to take criminal trials really limits our responsiveness," Goertzen said.

"We are making every effort to free up four to five dependency courts to handle criminal trials. We need substantial help to stem the flow of criminal cases over here [to the civil courts]," he said.

"For example," added Goertzen," this past month we even had to stop civil trials for a period because of the criminal situation. The criminal trials are tying up a lot of our civil resources."

Goertzen said that he does not expect the logjam to improve at least through January, 1987.

"Earlier this year (in 1986), we were going great guns in Department 1, with as low as five to six cases trailing. Yet, in the first week in December, we had 58 cases trailing," Goertzen said.

For the present, Goertzen warned, civil litigators should not expect to be assigned out for trial in Department 1 of the Central District of the Superior Court unless they are within 60 days of a mandatory dismissal under C.C.P.§ 583.310.

"We are trying not to put too many people on the trailing calendar in Department 1," Goertzen said. "So we ask counsel not to be too disappointed or surprised if they are called for trial only to find their trial date is kicked over because they are not a priority case or within that 60 day limit."

Goertzen added that on occasion a non-jury case for less than five days may still be assigned out even though it is not within the 60 day guideline. He also warned that it is difficult to predict how many cases will be on the trailing calendar or up for trial.

"Generally there is a two to three months lag between trial settings and when the cases actually come up for trial," Goertzen said. "If we ascertain a problem, we will cut back on trial settings. But, the lag time makes it difficult to predict." It is also difficult to predict how many cases will settle. According to Goertzen, "a lot of cases do not settle until the day of trial."

"Now," Goertzen added, "we are not seeing a lot of movement across the street in the criminal courts building. Instead there is a lot of protracted litigation, including retrial of a number of death penalty cases. These may occupy two to four months and, when they do, they cause a substantial backlog throughout the system."

For the present, Goertzen said, he hopes to solve the problem "in-house." But he also warned that lawyers may have to assist in resolving the backlog if criminal overflow continues to congest the civil courts.

—Mark A. Neubauer

Letter from the President

Continued from Page 3

What has happened in the last two years to merit the quantum leap in salary? There is no clear explanation for the surge in salaries. Once Cravath made its move, competitive forces took over and the increases became widespread. Some attorneys speculate that the increases were necessary to prevent loss of corporate lawyers to investment banking firms. That rationale, however, does not explain increased compensation for business litigators, who are unlikely to move laterally to an investment banking firm.

What does the salary leap reveal about the practice of law today, as well as about attorneys' and society's values? Ironically, at the same time the Los Angeles firms were reacting to the New York announcements, the California taxpayers' revolt successfully placed Proposition 61 on the November ballot. That initiative, opposed by hundreds of organizations throughout the state, including the ABTL, would have, among other things, so limited judges' salaries that a Harvard law student would not accept a judge's job under any circumstances. Because judges cannot negotiate for salaries as do lawyers in private practice, the free enterprise system applicable to private practice will have an adverse impact on the judicial system as well as government.

Only ten years ago, the differential between incomes in private practice as opposed to government practice was not as disparate as today. A bright law student who wanted to work for the FTC or attorneys general offices may have started at $13,000-$15,000, while his or her private practice counterpart made between $16,000-$18,000. Today, the brand new private practice lawyer at a major Los Angeles firm may make 200% more than the government counterpart.

As a result, ten years ago, a law student who had a choice between government service and private practice would make some sacrifices in entering government service, but today the sacrifices are monumental. Likewise, with young associates (not to mention more senior associates) making as much or more than judges, only an extraordinarily dedicated and/or wealthy individual will in the future choose to be a judge.

No lawyer — and certainly not litigators — should welcome a climate where the quality of government lawyers and judicial officers may deteriorate.

Another casualty of the recent leap in salaries is sure to be pro bono work. In the 1970s, most law students interviewing with major firms cross-examined prospective employers about the firm's commitment to pro bono work and support of associates who wanted to undertake such representation. Questions often asked were: Will I be penalized for working 10 or 20 hours per week on pro bono matters? Do hours devoted to pro bono work count as much as billable hours? How many pro bono matters does the firm undertake? How much of the firm's budget is set aside for pro bono work? Does the firm undertake any high profile pro bono work? If my pro bono case goes to trial, may I work full time on the matter? And so on.

In recent months, such questions are as rare as a brontosaurus. The recruit in fall 1986 asks not about the firm's commitment to pro bono work but about the firm's commitment to match Cravath, Swaine & Moore's compensation.

Because of the workings of the free legal enterprise system and competition for top law school talent among expanding law firms and new law firms, it is inevitable that most if not all of the major firms in Los Angeles will be making at least some adjustments in reaction to the Cravath, Swaine & Moore announcement, if such firms have not already done so. It is also inevitable, in my view, that another casualty of this movement may be the remaining distinctions between the California lifestyle and New York lifestyle for law firms. In the coming years, attorneys at every level of the law firm (associates and partners) will most likely be asking themselves whether, economically, the firm can undertake pro bono work; whether hours requirements must be increased; whether the time to track to partnership must be increased; whether fewer people will be admitted to partnership; and, of course, whether rates must be raised.

The ability of a firm to raise rates (and keep clients) will directly impact upon the questions such as increased hours requirements among attorneys. In my crystal ball, I conjure up images of more associates assigned to more matters, billing more hours at higher rates and not necessarily producing a better product. Judges, both federal and state, have increasingly noted in recent years the intensity of litigation battles which mire everyone in expensive discovery and overbriefing of issues, the only real winners being the attorneys. If that has been the case in the last five years, it most likely will increase as a result of the salary push.

Although Cravath, Swaine & Moore claims that it will not raise rates as a result of the salary boosts, it is probable in Los Angeles that in a few years the $100 per hour rate will be reserved only for paralegals (and perhaps word processors). More expensive talent, such as young associates, will eagerly record their time drafting discovery requests, stipulations and the ever present demurrer.

One positive fallout from the salary move may be the increased use of arbitrations, rent-a-judges and referees. The business community will likely react to dramatic increases in rates by insisting that lawyers pursue opportunities for alternative dispute resolution and by asking why interrogatories, depositions and protracted pretrial proceedings must be utilized.

—Robert A. Shlachter