ASSOCIATION OF BUSINESS TRIAL LAWYERS

abtl REPORT

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The Corporate Director's Deposition: An Insider's View

A director's deposition can make or break a case. As with the successful defense of most depositions, preparation is critical. Here are some practical tips from corporate counsel's perspective on preparing to defend a director's deposition.

A. *Find and Study Relevant Documents*

Jasmina A. Theodore

Read every document that mentions the director deponent and each document pertinent to key issues. Focus not only on statements by the director, but memos and other documents that evidence issues brought to the director's attention. If the director received a memorandum criticizing a bank's inadequate reserves, for example, you should know about it before the deposition. You must prepare the director to answer questions regarding such "hot" documents and to explain how he responded when he first saw them.

Find and study:

Corporate minutes and minute notes, including minutes and notes of board and committee meetings. If the corporation has subsidiaries, affiliates, or a parent, and the director also sits on their boards, you should review the minutes of the companies likely to be implicated in the litigation.

Notes of the corporate secretary and directors. Corporate minutes are often written in an abbreviated fashion, merely noting the date and time of a meeting, who was present, who made presentations, and board resolutions. Ask the corporate secretary for informal notes, which are usually more discursive than official minutes. Also ask directors for their notes of the

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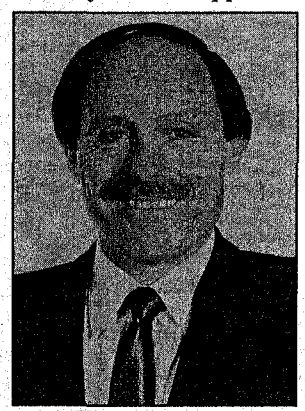
INSIDE

Shooting Holes in the *Shell* Game With Expert Testimony

Insurance company attorneys are quick to trumpet the potency of the pollution exclusion in comprehensive general liability (CGL) policies. Understandably so, since at first reading, the standard pollution exclusion may seem a broad and formidable bastion against pollution coverage. This apparent strength has been buttressed by recent appellate decisions concerning the pollution exclusion's scope — that is, whether the policy terminology "sudden and accidental" is to be given a temporal meaning. *Shell Oil Company v. Winterthur Swiss Insurance Co.*, 12 Cal.App.4th 715 (1993); *ACL Technologies, Inc. v. Northbrook Property And Casualty Insurance Co.*, 17 Cal.App. 4th 1773 (1993); *Truck Insurance Exchange v. Pozzuoli, et al.*, 17 Cal.App. 4th 856 (1993).



Terry W. Bird

In California, *Shell Oil Company v. Winterthur Swiss Insurance Co., supra*, is the first and most prominent of these pro-insurer pronouncements dealing with the "sudden and accidental" language in the pollution exclusion. In *Shell*, the Court attempted to harmonize competing positions on the issue and held that the word "sudden" in the phrase "sudden and accidental" conveys "the sense of an unexpected event that is abrupt or immediate in nature." *Shell, supra*, at page 841. The court explained that:

> "we cannot reasonably call 'sudden' a process that occurs slowly and incrementally over a relatively long time, no matter how unexpected or unintended the process. A 'discharge, dispersal, release or escape' of pollutants that happens gradually and continuously for years is not 'sudden' in the ordinary and popular sense of the word [citations omitted]." *Shell, supra*, at p. 841.

The *Shell* decision has led many to believe that coverage under CGL policies with pollution exclusions will be limited hereafter to situations which involve explosions, collisions or similar events.

Notwithstanding this apparent carrier triumph, there is good news for insureds. The pollution exclusion is increasingly being proven to be a paper tiger. Even when armed with a temporal meaning for "sudden," the pollution exclusion is being beaten at trial in cases which do not involve explosions, collisions or similar events (*Purex Industries, Inc. v. Harbor Insurance Company*, No. 446835, California Superior Court, Los Angeles County [daily discharges of cleaning solvents at a distribution

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center]; *Aydin Corp. v. American Employers' Insurance Co., et al.*, No. 857826, California Superior Court, San Francisco County [leaking underground storage tanks]). These recent successes are evidence that juries are moved more by facts sympathetic to insureds than by the arcane and cumbersome provisions of the standard pollution exclusion.

The Achilles' heel of the pollution exclusion at trial is its inherent ambiguity. How long is "abrupt"? Is it one second or can it last for two minutes or two hours? Where is the jury to draw lines as to what is "sudden" and what is not? Clearly, the *Shell* court's decision found the answers to these questions elusive. The court flipped and flopped as it struggled to provide a clear sense of its holding. It said for instance,

> "We also agree...that 'sudden' refers to the pollution's commencement and does not require that the polluting event terminate quickly or have only a brief duration. [Citations omitted.] If a sudden and accidental discharge continues for a long time, at some point it ceases to be sudden or accidental. [Citations omitted]. Still, a sudden and accidental discharge of a dangerous pollutant could continue unabated for some period because of a negligent failure to discover it, technical problems or a lack of resources that delay curtailment, or some other circumstance. Liability from such an event could well be covered." *Shell, supra*, pp. 841 to 842.

This formulation of "abrupt" or "immediate" provides fertile ground for insureds confronted with jury instructions based on *Shell*. Since most polluting events which might otherwise be thought of as "gradual" will fit into the *Shell* language, insureds will have considerable flexibility in formulating their arguments and structuring their jury presentations.

As a consequence of this ambiguity, most juries will pay little attention to the pseudo-esoteric questions relating to the meaning of "sudden" or "gradual." Instead pollution exclusion cases will be resolved on the basis of the jury's resolution of more traditional questions of fairness and equity. This is very important to insureds since, absent the arbitrariness of the pollution exclusion, resolution of jury-decided pollution coverage cases is more dependent on issues relating to expectations and intentions. These issues include whether the insured or a predecessor put the pollution in the ground, what the insured knew about groundwater pollution at the time, the credibility of employee witnesses, the care with which the insured operated its business, the manner in which the insured responded to clean-up demands, the existence of other responsible parties, etc.

Of course, the ambiguities of *Shell* and the pollution exclusion will not win pollution coverage cases by themselves. An insured still must have facts which allow it to postulate a credible argument and raise a factual issue that the discharge or release was "sudden." In most instances, however, an understanding of hydrogeology and chemistry in concert with creative lawyering can overcome this hurdle. Indeed, there are a myriad of contaminants and soil conditions from which to structure a winning position.

Pollution coverage cases are close and complicated. They require thorough preparation. Generally, the insured's success against the pollution exclusion will depend on a number of factors, including:

(1) a realistic view of how juries conceptualize coverage cases;

(2) the absence of shocking, wanton behavior by the insured (*e.g.* the knowing dumping of pollutants that led to scores of dead ducks in *Shell, supra.*);

(3) a practical, accurate, and sympathetic theme by which the insured's case is presented to the jury;

(4) a cohesive strategy on how the contamination at issue was "sudden" and a discharge into a watercourse or a body of water;

(5) a thorough analysis of the pattern and timing of the contamination at issue;

(6) careful jury selection;

(7) creative jury instructions which apply concepts such as the concurrent cause doctrine; (*see*: Mark T. Drooks, *Environmental Liability, Concurrent Causation And Insurance Coverage: Some Practical Experience*, 8 Mealey's Litigation Reports: *Insurance* No. 5 (Dec. 1, 1993));

(8) specialized jury verdict forms; and

(9) correct allocation to the carrier of the burden of proof on the pollution exclusion.

In addition to each of these, one of the key factors in successfully overcoming the pollution exclusion involves creative and effective expert witness testimony. The hydrogeologist who is essential to establishing property damage to third party property (i.e., contamination of groundwater), is also essential to establishing the insured's case that a discharge, release or escape of contaminants into the ground, a watercourse or body of water was "sudden," as defined by *Shell*. The discussion below centers on the hydrologic circumstances and expert testimony employed successfully in the first post-*Shell* jury trial dealing with contamination of groundwater. In the *Purex Industries*' trial, the strategy used to deal with the ambiguities of *Shell* and the pollution exclusion successfully convinced the jury that the discharge, release or escape of chlorinated solvents was "sudden."

Analyzing Hydrologic Circumstances in the Context of the Pollution Exclusion's Language

> In its common form the pollution exclusion excludes coverage for "...property damage and bodily injury arising out of the discharge, dispersal, release or escape of smoke, vapor, soot, fumes, acids, alkalis, toxic chemicals, liquids or gases, waste materials or other irritants, contaminants or pollutants into or upon land, the atmosphere or any watercourse or body of water, unless that discharge, dispersal, release or escape is sudden and accidental."

The operative terms are "discharge, dispersal, release or escape...into or upon land, the atmosphere or *any watercourse or body of water*...." This language involves much more than a simple disposal of a contaminant onto or into the ground. It clearly includes "dispersals, releases or escapes...into or upon...any watercourse or body of water."

Any successful strategy for dealing with the pollution exclusion necessarily involves a careful study of hydrology and the specific hydrologic circumstances by which the contaminants at issue entered the ground and groundwater at the subject site. It is crucial to keep in mind that such circumstances differ from site to site and from contaminant to contaminant.

Third party damage in most pollution exclusion cases, like *Purex*, involves "groundwater." Groundwater is "subsurface water that occurs beneath the water table in soils and geologic formations that are fully saturated" (R. Allan Freeze & John A Cherry, *Groundwater*, 1979, p. 2). Almost all groundwater is part of the hydrologic cycle by which water enters or recharges the surface geology as the result of rain and then moves through subsurface environments until it is discharged to rivers, streams or oceans where evaporation continues the cycle.

While water exists in various states below ground surface, "groundwater" is defined to exist below the groundwater table. The watertable or groundwater table serves to differentiate between subsurface soil and rock which is or is not saturated with water. The region beneath the watertable is referred to by some as the zone of saturation or the groundwater system (Fletcher G. Driscoll, *Groundwater and Wells* (2d ed. 1987), pp. 60-61).

The groundwater system can be visualized as huge reservoirs or systems of reservoirs which exist in rocks. The groundwater in these zones exists in the spaces and interstices between the rocks. The thickness of the groundwater zone is governed by the local geology, availability of pores or openings in the rock formation, and various other factors dealing with recharge and discharge of water into and out of the groundwater zone (*Id.*, p. 61).

The groundwater system is comprised of aquifers and confining beds. An aquifer is a water-bearing formation which is area extensive and may be overlain or underlain by a "confining bed," such as an impermeable clay layer. (Keith Todd, *Groundwater Hydrology* (2d ed. 1980), pp. 25-26). Typically the confining bed is comprised of finer grains and lower permeability which make it difficult to remove water from the confining bed. The aquifer is by definition sufficiently large to yield water in a quantity which is economically useful (Fletcher G. Driscoll, *Groundwater and Wells* (2d ed. 1987), p. 61).

Since most groundwater at issue in coverage cases exists in aquifers, the subject discharges, releases or escapes will have been into a "body of water." Such contamination also will have occurred into or upon a "watercourse." Indeed, groundwater is constantly moving through the groundwater system's aquifers and confining beds. Aquifers and confining beds serve both a storage and a conduit or pipeline function in the hydrologic cycle (*Id.* at p. 66).

Water moves through the groundwater system as the result of the pull of gravity and pressure differentials. The speed of such movement is normally measurable as a function of the hydraulic conductivity and hydraulic gradients of the aquifer. The rate of movement can vary from feet per year to feet per day (*Id.*) Direction of these underwater watercourses is commonly measured by hydrogeologists.

Since contaminated groundwater is the centerpoint of most pollution exclusion cases, it is crucial to explain to the jury how quickly the discharge, release or escape at issue reached the underground watercourse and body of water. Depending upon the characteristics of the contaminant at issue, the geological characteristics of the subject soil and the depth of the water table, the initial contact between the contaminant and the groundwater will have taken minutes, days or months.

If the insured's case involves chlorinated solvents, as it did in *Purex* and *Aydin*, there is an excellent chance under any definition of "sudden and accidental" that coverage exists. Chlorinated solvents (chemicals comprised of carbon, oxygen and chlorine which are used generally as industrial cleaners) are referred to as non-aqueous-phase-liquids ("NAPLs"). NAPLs are liquids which move in the subsurface independent of the movement of water. Most chlorinated solvents are dense non-aqueous-phase-liquids or "DNAPLs". Since DNAPLs are heavy liquids which are denser than water, it can take only minutes for them to move from the surface to shallow water tables. If releases of chlorinated solvents which are DNAPLs take place from underground storage tanks buried in soil with a high water table, the discharge, dispersal or release to a body of water or watercourse will have taken place even more rapidly.

It is also important to note that many dense non-aqueous-phase-liquids, such as chlorinated solvents, are not easily dissolved in water. They tend to exist in undissolved globules or continuous lengths of the contaminant. Consequently, they exist in aquifers for decades or longer. While suspended between the pores and interstices of the aquifer, the DNAPL chlorinated solvent globules will release or chip off into groundwater in small amounts of the contaminant on a regular basis. Such releases into the aquifer are abrupt and take place on a moment to moment basis over long periods of time.

Using the Expert Witness

A successful presentation which establishes that the operative discharge or release was "sudden" is impossible without properly prepared and delivered expert testimony. At best, groundwater science or hydrology is dry, unfamiliar stuff. Every jury will quickly lose its attention unless the insured's expert simply and clearly explains how contaminants were "suddenly" introduced into a watercourse or body of water. The expert becomes the key to the process by which the jury applies obscure scientific concepts to oblique legal standards.

Every battle of experts before a jury resolves itself as a matter of credibility. Jurors will rarely become knowledgeable in the science of hydrogeology. They will resolve the insured's case according to which expert is more credible. Accordingly, the manner of presentation is as important as the substance. The expert's qualifications, conclusions and bases for conclusions should be concisely and efficiently presented. If the expert's conclusions are numerous or involved, they should be broken down, numbered and written out by hand during the examination in front of the jury.

The expert's ability to simplify technical terms is of primary importance in establishing the trust and credibility that is crucial to victory. The expert must be able to use simple, clear graphics and apt analogies to tell the insured's story. For example, in cases involving chlorinated solvents, the expert must clearly and simply explain how DNAPLs work. To do so, for example, the expert in *Purex* analogized DNAPLs to peppermint sticks plunged into the earth which dissolved slowly but regularly over time as groundwater in an aquifer passed by the DNAPL lodged in the aquifer's pores and interstices.

To testify effectively the expert must have the ability to teach without being condescending or fawning. One effective way of striking this crucial balance in *Purex* was by having the expert use hand-drawn pictures rather than expensive, prepared graphics.

The teeth of crucial cross-examination should be pulled without over-emphasis. The expert should be willing to acknowledge weaknesses which do not undermine ultimate conclusions. Since most juries are persuaded as much by how testimony sounds as by what it is, thorough preparation is crucial to maintain credible demeanor. The expert must have a polite but forceful way of showing the jury how the examiner's questions misconstrue technical information or data.

In the *Purex* case, the hydrogeologist demonstrated how the industrial solvents handled by Purex were found in the aquifers beneath Purex's site operations (*i.e.*, a solvent distribution cen-

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Earthquake MCLE Relief

The 6.6 Earthquake prompted state bar officials to grant an extension of time for completion of MCLE credits. Attorneys will now have until the end of February (not the end of January) to complete initial continuing education requirements if their last names begin with the letters H-M. If you are in this category, you now have until February 28, 1994, to complete 24 hours of approved continuing legal education activities, including five in the areas of legal ethics and/or law practice management, with at least three of those five hours in legal ethics.

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meetings, including notes written on reports or documents provided at the meetings.

Materials sent to directors in advance of meetings. Review the materials sent in advance of meetings, and determine when they were sent and when the director received them.

Materials used at meetings. Review all materials used at board meetings, including reports, exhibits, slides, videotapes, and models.

Documents mentioning or referring to outside consultants (e.g., investment bankers, accountants, and management consultants). Review advice given, data or reports prepared, and the terms of retention.

B. *Know the Director*

Learn as much as possible about the director. Contact other lawyers who know the director's personality, style, and opinions. Transcripts of prior depositions can be helpful.

The company's most recent proxy statement and the questionnaire that the director filled out for the statement is another good source of information. The proxy statement discloses, among other things, how long the director has served on the board, how many meetings the director attended, and whether the director owns stock, sits on any other boards, or has chaired any committees.

The proxy statement also discloses whether the director has had any material transactions with the corporation. You would not want to wait until the deposition started to find out that the director had engaged in a significant transaction with the corporation. You should know about such issues in advance and prepare the director for accusatory questions.

The corporation's communications and investor relations departments may also have useful information. These departments likely have copies of the company's press releases and publications mentioning the company or its directors.

You should also become familiar with material developments in any other company with a board on which the director sits. If the communications department does not have information about material developments in other companies, you should be able to get it from NEXIS® and other news sources.

Opposing counsel is likely to ask questions about other companies on which the director sits. Questions about related companies are probably irrelevant. It may be proper to instruct the director not to answer or to condition responses on the presence of counsel representing the other corporation. In any case, you should be aware of developments involving related companies so that you can anticipate questions and be prepared to object if appropriate.

C. *Prepare the Director*

Briefing

Brief the director on the case, the corporation's position, pending motions, other witnesses, questions the director can expect, and the opposing lawyer's style.

Discuss what the director knows about the transaction at issue. Did the board study the transaction? Was it unusual? How far in advance of meetings was information provided?

What did the directors think about management's presentations? Did outside advisors make any presentations? If not, why not? If so, were the presentations credible?

Were alternatives discussed?

Did any directors have reservations about the transaction? If the vote was not unanimous, does the director know why? Did counsel give any advice?

Did the director ask questions during board meetings? Does the director believe that all directors had ample opportunity to ask questions and to discuss the transaction?

Inability to recall details

Remember that the director may remember a challenged transaction as a process, not a series of discrete meetings. Thus, the director may not be able to recall specific dates of meetings or when a particular statement was made. Confronted with what appears as unwillingness to recall details, an opposing attorney may attempt to harass the director. Tell the director to expect it and not be troubled. The following exchange is typical after several "I don't recall" responses:[1]

> Q: Has anyone ever told you that the appropriate way to proceed . . . is not to remember anything?
> A No.
> ***
> Q: Were you taking any sort of drugs at that time, or have you since then, that would impair your memory?
> A: No.

Failure to use "due care"

An opposing attorney may also try to show that the director did not carefully make a decision on a unique, unusually large, or complex transaction. Tell the director to anticipate such questions and to answer them completely and truthfully, as in the following example:

> Q: In the past two years, have you made any decisions the consequences of which were at least $80 million [like the transaction at issue here]?
> A: Many.
> Q: What were they?
> A: Many. I mean, I expose [company X] to that kind of risk and investment probably twice a month, and if you talk about things you avoid, I would say dozens of similar magnitude decisions.
> ***
> Q: Is it unusual for you in your career as an important official that you would have just about no recall about important events that happened two years ago?
> ***
> From your history of your career, it looks to me like you spent a lot of time in important positions in important companies. You are president and CEO of [company X]. You were a director of [company Y]. Is it surprising to you that you have so very little recollection about such important events that went on a year and a half ago?
> A: Not at all. I mean, I process enormous amounts of information every day, and once you have made a decision, there is no reason to clutter up your mind with all the details of why you made that decision and who said what. If I tried to retain all of that information, I would have no room for anything else and no room for the next thing coming down the pike.
> ***
> A: I can tell you about a similar situation we had at [company X] two years ago. We really thought about it, we debated it, we discussed it, and we arrived at the decision, and it was done, and it was over, and then it was on to the next thing. And you don't worry about that two years later and start thinking, well, you know, boy, I remember what [John Doe] said. That is very unrealistic.

Failure to read or verify signed documents

The opposing lawyer may try to make a director feel defensive about not having read every page of a long document that he or she signed, or about signing it without independently verifying it. An outside director not responsible for preparing a document might respond to this type of attack as follows:

[1]The exchanges below are excerpts from actual deposition transcripts. The names and gender of witnesses and references to companies have been deleted, as have any objections and lawyer colloquy.

Q: What did you do, if anything, to ensure that the statements contained [in the prospectus] were true?

A: I relied on the representations of management and counsel and everyone else who would have been involved with it, as I do at [company X].

Q: Who made the representations you relied on?

A: I don't remember specifically. But, I know in general how I deal with documents such as this. And I know how I deal with them at my own company, and I deal with them the same way in every other company.

Q: How is that?

A And that is to hear from my lawyers and hear from my financial people and hear from my comptroller and the senior financial people, and if outside people have been involved I hear from them...assuring me that everything is accurate and as it should be.

Q: Is it your practice to read documents like this?

A: No. If I read documents like this, I would never have time for anything else. I will glance at them. If there is a particularly sensitive subject or disclosure issue, I will read that section very carefully to make sure I am in agreement with it. But read the whole document? Come on. It's a day's work to read one of these or more.

Q: Is that true also if it is a document that you know is going to be publicly disseminated after you sign it?

A: I sign documents that are publicly disclosed all the time. There is no one who could read all of these documents and

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California Rejects Fraud-on-the-Market Doctrine

The California Supreme Court recently issued its long-awaited decision in *Mirkin v. Wasserman*, 5 Cal.4th 1082 (1993), rejecting a bid by securities fraud plaintiffs to incorporate the so-called "fraud on the market" doctrine into the California common law of fraud and deceit. Instead, the court reaffirmed the principle that California fraud plaintiffs must plead and prove actual reliance on defendants' alleged misrepresentations or omissions. The ruling has national significance, and has been termed "a major defeat for the plaintiffs' bar," which brought the action as a test case in hopes that California would become the first state to accept the doctrine for use in conjunction with common law claims carrying the threat of punitive damages.

Barbara Moses

The fraud-on-the-market doctrine, approved by the U.S. Supreme Court in *Basic, Inc. v. Levinson*, 485 U.S. 224 (1988), was developed for use in cases brought under Section 10(b) of the Securities Act of 1934, 15 U.S.C. § 78j(b), and SEC Rule 10b-5, 17 C.F.R. § 240.10b-5, which generally prohibits fraud "in connection with" the purchase or sale of securities. Securities purchasers or sellers suing under Rule 10b-5, like those suing under the common law of fraud, had long been required to establish, among other things, that they "relied" on the defendants' alleged misrepresentations or omissions. *Basic*, 485 U.S. at 243. This requirement, in turn, made it difficult to certify a plaintiffs' class in a federal Rule 10b-5 suit, because each class member would be required to produce individualized evidence of his or her reliance, such that it would be difficult for a court to find, as required under Fed. R. Civ. P. 23(b)(3), that "questions of law or fact common to the members of the class predominate over any questions affecting only individual members." *Id.* at 223.

The fraud-on-the-market doctrine solved this problem, at least for Rule 10b-5 plaintiffs claiming that they were defrauded by annual or quarterly reports, press releases, or other information widely distributed to the public. The four-justice majority in *Basic* saw actual reliance as one way — not necessarily the only way — to establish "the requisite causal connection between a defendant's misrepresentation and a plaintiff's injury." 485 U.S. at 243. It reasoned that, where securities are traded on "well-developed markets" that quickly absorb all available information, a plaintiff who has relied on the "integrity of the market price" when trading has been damaged by any materially misleading misrepresentations that distorted that price, whether or not she knew of the misrepresentations or personally believed them to be true. *Id.* at 246-47.

Moreover, according to the *Basic* majority, "the reliance of individual plaintiffs on the integrity of the market price may be presumed." *Id.* at 247. Thus, under *Basic*, a Rule 10b-5 plaintiff need only plead that defendants' alleged misrepresentations were material and public, and that she traded on a well-developed, efficient market. Unless *defendants* can meet the difficult

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burden of showing that the alleged misrepresentations did not distort the price of the stock, or that plaintiff would have traded even if she had known the truth, the court will presume that she relied on the integrity of the market and was thereby damaged by the alleged fraud. 485 U.S. at 248-49.

Thanks to *Basic* and the fraud-on-the-market doctrine, the federal courts now routinely certify "open-market" Rule 10b-5 suits as class actions under Rule 23(b)(3), whether or not the named plaintiffs (much less the members of the putative class) can plead or prove that each of them read (or heard) and believed the alleged misrepresentations disseminated into the market.

The plaintiffs in *Mirkin*, however — investors in Maxicare Health Plans, Inc. who alleged that they were defrauded by a series of misleading prospectuses and other public communications — chose to bring their putative class action in state court, under Cal. Civ. Code § 1709-10 (which codify the state common law of fraud and deceit) rather than in federal court under Rule 10b-5. They did so because California common law is more advantageous to plaintiffs than Rule 10b-5 (or than California's "blue sky" securities statutes) in several respects. For example, the California statute of limitations for fraud is more generous to plaintiffs than the limitations rule applicable to Rule 10b-5 suits. *Compare* Cal. Civ. Proc. Code § 338(d) (fraud claims may be filed up to three years after the violation is discovered) *with Lampf, Pleva, Lipkind, Prupis & Petigrow v. Gilbert*, 111 S. Ct. 2773, 2782 (1991) (Rule 10b-5 claims must be filed "within *one year after discovery* of the facts constituting the violation and within three years after such violation") (emphasis added). In addition — and perhaps most significantly — California law permits recovery of punitive and emotional distress damages, which are unavailable under Rule 10b-5. *Compare* Cal. Civ. Code § 3294 *with Ryan v. Foster & Marshall, Inc.*, 556 F.2d 460, 464 (9th Cir. 1977).

The *Mirkin* plaintiffs admitted, in the trial court, that they could not plead or prove actual or "eyeball" reliance on defendants' alleged misrepresentations, but asked the court to permit their claims to proceed nonetheless under the fraud-on-the-market doctrine, which, they argued, should be adopted by the courts of California for use under state law. 5 Cal.4th at 1088. The superior court rejected this request and sustained defendants' demurrers with prejudice, holding that actual reliance was, and should remain, an essential element of a fraud claim under state law. *Id.* The Court of Appeals agreed and affirmed. *Id.* The California Supreme Court then granted plaintiffs' petition for review, raising the possibility that California would become the first state to accept the fraud-on-the-market doctrine for use in conjunction with common-law claims. At this point, the case sparked nationwide interest and attracted *amicus* briefs from a number of industry and investor groups.

Two years after it agreed to review the case, and more than a year after the last brief was filed, the California Supreme Court heard oral argument in *Mirkin v. Wasserman*. Three months later it voted, five to two, to affirm the Court of Appeals. The majority opinion, written by Justice Edward Panelli, explained that the California courts had "always" required a fraud plaintiff to plead and prove actual reliance on any alleged misrepresentations. *Mirkin*, 5 Cal.4th at 1088-89. Indeed, the majority explained, the same rule applied, in California, where defendants allegedly omitted material information rather than issuing affirmatively false statements. *Id.* at 1093. Justice Panelli also noted that no other state appellate court had thus far accepted the fraud-on-the-market doctrine for use under the common law. *Id.* at 1090. *See also Gaffin v. Teledyne, Inc.*, 611 A.2d 467, 474-75 (Del. 1992); *Kahler v. E.F. Hutton & Co.*, 558 So. 2d 144, 145 (Fla. Dist. Ct. App. 1990); *Katz v. NVF Co.*, 473 N.Y.S.2d 786, 789 (1st Dep't 1984).

The *Mirkin* majority then declined plaintiffs' invitation to depart from California's historical rule on policy grounds. "Investors, including plaintiffs in this case, already have remedies under state and federal law that do not require the pleading or proof of actual reliance," Justice Panelli wrote (referring not only to Rule 10b-5 but also to certain provisions of California's blue sky law, Cal. Corp. Code §§ 25400, 25500). 5 Cal.4th at 1101-03. Further, Justice Panelli reasoned, the additional advantages sought by plaintiffs — such as the right to recover punitive damages — appeared to "conflict with several specific legislative policy choices," as neither Congress nor the California legislature had permitted punitive damages claims under statutes dealing specifically with securities fraud. *Id.* at 1105.

Finally, Justice Panelli commented on "the effect that the prospect of punitive damages might have on the settlement value of marginal claims." *Id.* at 1107. Noting that defendants facing a Rule 10b-5 class action are often forced, even without the threat of punitive damages, to abandon meritorious defenses and settle dubious claims, he stated, "To create a cause of action that would offer prospective plaintiffs *both* the advantages of a presumption of reliance and the prospect of recovering punitive damages would only exacerbate the problem." *Id.* (emphasis added).

Justice Joyce Kennard, joined by Justice Stanley Mosk, wrote a concurring and dissenting opinion, agreeing that the fraud-on-the-market doctrine should not be applied to claims for negligent misrepresentation, but arguing that it was appropriate for use in affirmative fraud cases under California law. 5 Cal.4th at 1108-24.

As soon as the decision in *Mirkin* was announced, it was hailed by defense lawyers as a victory for the securities markets, and denounced by plaintiffs' lawyers as a blow to the interests of small investors. Richard Levy of Gibson Dunn & Crutcher, who represented the underwriter-defendants in *Mirkin*, told the press that it would have been "potentially catastrophic to California businesses" if the case had gone forward. William Lerach of Milberg Weiss Bershad Specthrie & Lerach, who represented the plaintiffs, criticized the California Supreme Court for issuing what he called "another in a series of decisions that favor corporations and businesses instead of individuals."

Both sides believe that the California decision (coupled with several earlier cases from other states rejecting the fraud-on-the-market doctrine) will make it difficult for plaintiffs to convince any state court, henceforth, to adopt the doctrine for use in conjunction with common-law claims. This in turn, of course, means that it will be difficult for investors to obtain punitive damages under state fraud law in individual securities cases and nearly impossible for them to do so on a classwide basis.

The *Mirkin* case has also been noticed by the Securities and Exchange Commission. In a recent speech to the National Association of Manufacturers 1993 Government Relations Committee, Commissioner Richard Y. Roberts remarked that it made a "lot more sense" to limit the perceived abuses of securities fraud class actions by way of cases like *Mirkin* than by way of the "well-intentioned but misguided legislative vehicles currently being bounced around." Roberts was presumably referring to recent efforts to amend the federal securities laws to limit the liability of "deep-pocket" defendants by, among other things, abolishing joint and several liability under certain circumstances.

Mirkin is not, of course, the end of the road for the plaintiffs

securities bar on the issue at hand. Where an appeal to the courts has failed, it is always possible that an appeal to the state legislature could succeed. Thus, many observers expect to see significant efforts to overrule *Mirkin* legislatively or to expand investors' rights under the California blue sky statutes.

Other state legislatures may also receive such appeals, even in states where the courts have not yet spoken on the issue. Given that most publicly-traded securities are distributed nationwide, it would provide the plaintiffs' bar with a significant toehold if even one state proved willing to certify class actions under statutes or common-law theories providing for punitive damages.

—Barbara Moses

Cases of Note

Insurance

In *Montrose Chemical Corp. v. Superior Court*, 6 Cal.4th 287 (1993), the California Supreme Court resolved a split among the California Courts of Appeal with respect to whether a CGL insurer may deny coverage for a lawsuit on the basis of evidence beyond the pleadings. The Court held that coverage determinations may be based on such extrinsic evidence. At the same time, it held that the insurer must provide a defense under a CGL policy unless it can prove that the subject litigation does not involve a potentially covered claim.

Denise M. Parga

The California Supreme Court accepted review of a decision that could dramatically alter the scope of potential coverage under workers compensation policies. *La Jolla Beach and Tennis Club v. Industrial Indem.*, 93 Daily Journal D.A.R. 12857 (Oct. 7, 1993). It appears to suggest that a workers compensation insurer could be required to provide a defense to an employer in almost any civil lawsuit filed by a former employee. The Court of Appeal held that a workers compensation insurer was required to defend an employer in a civil lawsuit alleging wrongful termination and intentional infliction of emotional distress. The court held that there was a duty to defend, notwithstanding the fact that the policy provided coverage only for damages arising from accidental conduct and bodily disease. The *La Jolla* court followed another controversial decision also finding a duty to defend, *Wong v. State Compensation Ins. Fund*, 12 Cal.App.4th 686 (1993). The California Supreme Court refused to depublish *Wong* despite an outpouring of criticism from the insurance industry.

Fear of Cancer

In a sweeping decision, the California Supreme Court ruled that plaintiffs exposed to toxic chemicals may recover for fear of cancer even if they show no symptoms of the disease. At the same time, the Court sharply limited the availability of damages, holding that recovery would be permitted only under two circumstances: (1) if the chance of developing the disease is more than 50%; or (2) if the defendants' conduct in causing exposure to toxic chemicals amounts to oppression, fraud or malice as defined in Civil Code Section 3294. *Potter v. Firestone Tire & Rubber Co.*, 93 Daily Journal D.A.R. 16566 (Dec. 29, 1993). The decision has potentially far-reaching implications for those in manufacturing, healthcare and other industries, who filed dozens of *amicus* briefs.

Wrongful Termination

The California Supreme Court held that a fired worker cannot recover tort damages for fraud unless he can show a fraud "that is separate from the termination of the employment contract." *Hunter v. Up-Right, Inc.*, 94 Daily Journal D.A.R. 53 (Jan. 4, 1994). This decision further limited the availability of tort remedies in the wrongful termination context, already sharply circumscribed by *Foley v. Interactive Data Corp.*, 47 Cal.3d 654 (1988), and its progeny.

Insurance

An insurance company was held to provide coverage to an insured despite the insured's failure to pay the premium in *Golden Eagle Insurance Co. v. Foremost Insurance Co.*, 93 Daily Journal D.A.R. 15652 (Dec. 8, 1993), modified 94 Daily Journal D.A.R. 359 (Jan. 7, 1994). The insurance company sent a notice of renewal to its insured, indicating the amount due for continued coverage but failing to indicate the date for payment. The insured told his agent that he was going to shop around for another rate. Ultimately, the insurance company sent a notice of cancellation for nonpayment of the premium and the agent billed the insured for the earned premium for the time the policy was in force. The insured never paid any portion of the premium. In the period intervening between the notice of renewal and the cancellation, the insured was sued. The Second Appellate District held that the insured had accepted the insurance company's renewal offer and that the insurance company was stopped from denying the renewal was in effect.

Vivian R. Bloomberg

Attorneys' Fees

In *Russell v. Trans Pacific Group*, 93 Daily Journal D.A.R. 14227 (Nov. 8, 1993), the Third Appellate District held that the trial court correctly denied a defendant's claim for contractual attorneys' fees because the defendant failed to file a motion for attorneys' fees concurrently with his memorandum of costs claiming such fees. According to the court, the cost procedure requirements are mandatory and the trial court does not have discretion to disregard noncompliance.

Torts

In *The Newhall Land and Farming Co. v. Superior Court*, 93 Daily Journal D.A.R. 12791 (Oct. 6, 1993), the Fifth Appellate District held that a subsequent landowner could state a cause of action for nuisance and continuing trespass against a prior landowner who discharged hazardous substances on the land, holding that liability for these torts is not limited to invasions of a third party's interest in the use and enjoyment of its land.

Securities Class Actions

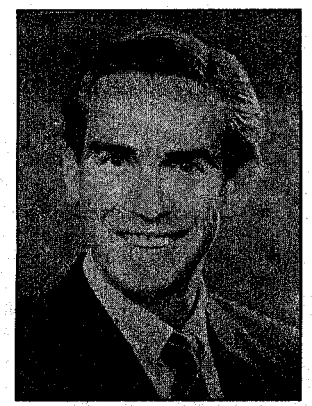
Defense attorneys were triumphant in a recent decision affirming the dismissal of a securities fraud class action despite allegations that defendants violated disclosure requirements of the New York Stock Exchange. *In re Verifone Securities Litigation*, 93 Daily Journal D.A.R. 14496, 11 F.3d 865 (9th Cir. Nov. 18, 1993). The court held that plaintiffs failed to adequately allege a claim for securities fraud where they alleged a failure to disclose negative forecasts in the absence of allegations that defendants withheld financial data or other existing facts.

—Vivian R. Bloomberg and Denise Parga

Getting Paid Under Section 2860: Practice Tips for Arbitration

Your client has been sued and its insurance company has accepted the defense of the action under a reservation of rights. Your client insists that you defend the action because of your superior knowledge of the client's business. However, your client and its insurer never agree on the hourly rate which the insurer will pay for your services. You initiate arbitration under Civil Code Section 2860. What are the pitfalls to this course of action and how can you avoid them?

In 1987, the Legislature enacted Civil Code Section 2860 as a refinement of the decision in *San Diego Federal Credit Union v. Cumis Insurance Society Inc.*, 162 Cal. App. 3d 358 (1984). The *Cumis* court held that, where the insurer reserved the right to assert noncoverage at a later date, the insurer must pay the reasonable cost for hiring independent counsel by the insured. Section 2860 attempts to describe the insurer's obligations for payment of independent or, as it is commonly called, *Cumis* counsel. Under Civil Code Section 2860(c), the insurer's obligation is "limited to the rates which are actually paid by the insurer to attorneys retained by it in the ordinary course of business in the defense of similar actions in the community where the claim arose or is being defended."



Ralph O. Williams

Rates

Thus, hypothetically, if a particular insurer can demonstrate that it actually pays $50 per hour for defense of a construction defect claim in the Los Angeles area, it is under no obligation to pay more than that rate to *Cumis* counsel even if other insurers pay twice that amount for similar work in the same geographic area.

In most instances, Section 2860's subjective rate standard will not result in any significant difference in rates because most insurers, as a practical matter, pay the same rates to insurance defense counsel. Some insurers have begun a practice of retaining only a limited number of defense counsel for a given geographic region in exchange for a volume discount. The rates these insurers pay can be significantly less than the hourly rate paid by insurers who depend upon a larger defense pool. Thus, the rates which the insurer will pay for *Cumis* counsel depends solely on the rates it customarily pays defense counsel, which may not necessarily be in conformity with the rates paid by other insurers for similar services in the community.

What if the insurer has never paid for the kind of defense that *Cumis* counsel is providing? Section 2860 does not address this issue but, in practice, both insurer and insured will be guided by the rates that are generally paid by other insurers in the community for the kind of service provided.

Disputes

Section 2860 provides that disputes concerning payment of *Cumis* counsel's fees can be resolved by any method provided in the insurance policy. Any dispute not resolved by these methods must be resolved by final and binding arbitration by a single neutral arbitrator selected by the parties. Thus, under the hypothetical scenario which opens this article, you and your client may demand arbitration to establish the hourly rate which the insurer must pay for attorneys and paralegal assistants defending your client. Once you have initiated the process, you can expect two kinds of responses from the insurer.

The insurer might be provoked into filing a defensive declaratory relief action to determine whether the claim is covered by the insurance policy. Because declaratory relief actions are given priority under Code of Civil Procedure Section 1060, there is the risk of a speedy adjudication that the disputed claim is not covered and the insurer accordingly has no duty to defend the insured. If the insurer determines not to adjudicate coverage, it might request that the following additional issues be subject to arbitration: (1) whether the number of hours of attorney and paralegal assistant time were reasonably and necessarily charged for the defense of the claims; and (2) whether the costs incurred by the attorney were reasonably and necessarily incurred. Thus, an insured who initiates arbitration to establish the rate which the insurer must pay for *Cumis* counsel or to compel its insurer to pay a greater portion of the attorney's fees incurred by *Cumis* counsel faces the risk that the arbitrator will find that *Cumis* counsel's defense was excessive. Then the insurer would not be responsible for paying that portion of the fees deemed not "reasonably and necessarily" incurred for the defense of the claim.

Risk Reduction

Many of these risks can be avoided or minimized in the pre-arbitration phase. First, an insured who retains Cumis counsel under Civil Code Section 2860 should enter into a negotiated fee arrangement with the insurer which sets forth not only the hourly rate for all the professionals providing representation but also the kinds of costs the insurer has agreed to pay. For example, while you might customarily charge your client for secretarial overtime, local meals or word processing costs, the insurer might not agree to pay these costs. A negotiated fee arrangement identifies and focuses the issues for later dispute. Once the range of fees and kinds of expenses which the insurer is willing to pay has been established, it is easier to evaluate your client's likelihood of recovery of additional amounts in arbitration.

In addition, knowing the range of fees and the kinds of expenses that the insurer will pay might well affect your strategy in staffing the case so that you can minimize the fees and expenses which may be disputed at a later date. For example, if the insurer will only pay $100 for associates and $150 for partners, it might not make sense to staff the case with three partners who customarily bill at $250 per hour. Similarly, non-reimbursed expenses could be kept to a minimum.

Once the fees and expenses have been negotiated, you should strictly comply with Section 2860's requirement that *Cumis* counsel timely inform and consult with the insurer on all matters relating to the defense. Advising the insurer of the costs entailed for certain strategies prior to embarking on such action and obtaining the insurer's tacit approval will later undermine the

insurer's defense in arbitration that certain strategies were not reasonably necessary for the defense of the action.

Evaluation Considerations

You now have a negotiated fee arrangement and you have involved the insurer in strategic defense decisions but your client is considering arbitration, perhaps because it has experienced a financial reversal and cannot pay its portion of your fees. The first step in evaluating the desirability of arbitration is to assess the likelihood and chances of a successful defensive declaratory relief action to determine coverage.

If you are convinced that the risk of a defensive declaratory relief action is worth taking, you must then determine whether the rate which the insurer is paying is less than the rate it actually pays for the services you are providing. Unfortunately, the insured is at a disadvantage because generally it has no knowledge of the rates the insurer customarily pays for similar services. The Association of Southern California Defense Counsel prepares an annual survey of hourly rates charged in the Southern California geographic area for various kinds of representation.

Arbitration Preparation

You have decided to arbitrate. You now need to prepare your case. Every Section 2860 arbitration requires at least three categories of evidence, regardless of whether you are representing the insured or the insurer. You need to introduce a client witness who will authenticate the attorneys' monthly statements, the insurance policy and the negotiated fee agreement (if applicable) and who will provide the background facts concerning the claim. You will also need an expert witness, an attorney in the community, who will testify regarding the rates in the community and whether the defense provided was reasonable and necessary. Finally, it is suggested that you also introduce testimony from the defense counsel or an auditor concerning the preparation and accuracy of the monthly statements and the defense counsel's communications with the insurer during the course of the defense.

The duration of the arbitration will vary and obviously depend on the complexity of the defense that is at issue. However, the insured cannot recover the attorneys' fees and costs incurred in arbitration unless the insurer acted in bad faith.

Arbitration Hearing

The insurer has the burden of proving that the rates and costs which it has agreed to pay are customary for the kind of defense which you are providing. The insurer likely will introduce evidence of the rates which it has paid for similar kinds of cases. Because there is no mechanism for discovery in Section 2860, you may want to subpoena the insurer's records to determine whether the insurer has, in fact, paid higher rates for the kind of defense that you are providing. If the insurer has paid other defense counsel the same rates that it proposes to pay *Cumis* counsel, you would then want to examine the insurer concerning those other cases, to determine whether they were, in fact, similar to the case under arbitration. You may want to introduce evidence that the defense provided by *Cumis* counsel was so complicated or special, or required particular expertise, so as to justify the imposition of an hourly rate higher than the usual hourly rate.

The next, and most crucial, issue to be arbitrated is the determination of how many hours of attorney and paralegal time were reasonably and necessarily charged for the defense of the claim. The insurer has no defense obligation for legal matters which are not potential claims under the insurance policy. For example, under most comprehensive general liability policies, an insured who initiates a lawsuit might not be entitled to *Cumis* counsel for the prosecution of the action. However, if it is named as a cross-defendant it might be entitled to a defense by its insurer. If the same counsel is prosecuting the complaint and defending against the cross-complaint, the insurer is only obligated to pay fees relating to the defense of the cross-complaint. Therefore, it is essential that the description of the professional's activities be complete and the time spent for each activity be separately allocated and recorded. Accurate timekeeping will avoid an attack by the insurer that the services provided were not related to the covered claim.

Additionally, the insured's agenda and interests may not necessarily coincide with those of the insurer. A given claim may have business implications for the insured that are of no concern to the insurer. For example, the insured might be faced with a series of similar claims. In that situation, your client may be concerned that an adverse adjudication in one action involving relatively insignificant damages might have a negative impact on other actions where more is at stake.

Denise Parga

Where an action may have serious future implications, the insured would probably want to mount a more vigorous defense than is ordinarily required for a case involving inconsequential damages. However, if the insurer is not providing coverage for the later actions, it has less incentive to provide a more thorough defense to the earlier action and greater reason to contest the number of hours spent on the defense.

As with all cases, careful preparation thorough analysis and a grasp of the local knowledge, custom, and practice leads to the best results.

—Ralph O. Williams and Denise Parga

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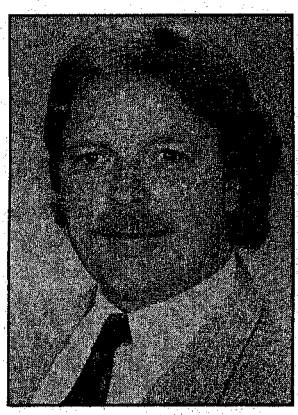
After-Acquired Evidence Doctrine: Something Old or Something New?

The after-acquired evidence doctrine has generated a storm of activity in the area of employment discrimination law since the Tenth Circuit decision in *Summers v. State Farm Mutual Ins. Co.*, 864 F.2d 700 (10th Cir. 1988). The doctrine allows an employer to assert evidence of an employee's misconduct discovered after the alleged unlawful employment decision as a defense against the employee's charge of discriminatory treatment. In *Summers*, the employee's claim was completely barred even though the court assumed that he was fired, at least in part, for unlawful reasons.



James F. Elliott

Although the swirl of apparently conflicting federal circuit court opinions following the *Summers* decision might suggest otherwise, the principle underlying the after-acquired evidence doctrine is not new. It is based on long-standing principles of contract law, and it has been applied in the context of general commercial disputes. Despite current confusion, the doctrine should not be controversial, nor should its applicability be confined to labor law.

With an understanding of the doctrine's foundation, it can be a useful tool in the context of many commercial disputes. In fact, this article concludes that the real question for commercial lawyers is not whether the after-acquired evidence doctrine applies, but the extent to which it applies to either bar a plaintiff's claim or limit available remedies.

Roots of the Doctrine

The after-acquired evidence doctrine is based on common law principles of contract law. Under contract law, the intent or motive of the breaching party is not relevant. After-acquired evidence that justifies termination of a contract as a matter of law bars any recovery for breach of contract regardless of the defendant's ignorance of the justification at the time of the breach or the defendant's actual motive. Restatement (Second) of Contracts § 237 cmt. c, illus. 8 (1981). This principle was long ago extended to the law of agency, with the result that, where a principal has cause to discharge an agent, the fact that the principal is unaware of the cause at the time of the discharge is immaterial. *See* Restatement (Second) of Agency § 409 cmt. e, illus. 5 (1958).

Courts have applied the after-acquired evidence doctrine as a defense in employment disputes for more than a century, and by 1892 it was considered well-settled law. *See Crescent Horseshoe & Iron Co. v. Eynon*, 95 Va. 151, 27 S.E. 935, 936 (1897) (stating that where sufficient cause for discharge exists it justifies discharge although not employer's inducing motive); *Odoneal v. Henry*, 70 Miss. 172, 12 So. 154, 155 (1892). By 1932, the rule had earned a place in the Restatement of Contracts. *See* Restatement of Contracts 278 cmt. c, illus. 1 (1932) (stating that discharge of employee for inadequate reason not wrongful where employer unaware of employee's material breach of duty to give efficient service).

As a creature of contract and agency law, the doctrine of after-acquired evidence has been very much at home in wrongful termination cases. 35 Am. Jur. *Master and Servant* § 37 (1941). The extension of the doctrine to the employment discrimination area, however, has resulted in a clash of policy concerns and confusion.

After-Acquired Evidence as a Defense to Employment Discrimination

The recent debate surrounding the applicability and effect of the after-acquired evidence doctrine has developed in the wake of the Tenth Circuit's decision in *Summers v. State Farm Mutual Ins. Co.*, 864 F.2d 700 (10th Cir. 1988). The United States Supreme Court agreed to address the effect of the after-acquired evidence doctrine in the employment discrimination context when it granted certiorari in *Milligan-Jensen v. Michigan Technological University*, 975 F.2d 302 (6th Cir. 1992), *cert. granted*, 113 S. Ct. 2991, *cert. dismissed*, 114 S. Ct. 22 (1993). The Court did not have an opportunity to reach these issues because the case settled while review was pending. *Supreme Court Drops From Docket Case Involving After-Acquired Evidence*, Daily Lab. Rep., (BNA) Aug. 12, 1993, at A1.

A thorough survey of cases applying this defense in employment discrimination actions is beyond the scope of this article. *See generally* Francis J. Connell, III, *Emerging Defenses to Employment Discrimination Claims: After-Acquired Evidence and Stray Remarks*, in EMPLOYMENT DISCRIMINATION LITIGATION 1993 (PLI Litig. & Admin. Practice Course Handbook Series No. H-464, 1993). Nevertheless, it is safe to say without too much oversimplification that the law in this area has developed into a three-way split among the United States Courts of Appeals.

The *Summers* rule represents one side of the debate. Summers was fired from his position handling claims for an insurance company. The employer asserted that Summers had been discharged because of his poor attitude and problems dealing with the public and co-workers. *Id.* at 703. Summers brought an action for discrimination based on age and religion. *Id.* at 702. At trial, the employer asserted a defense based on evidence *discovered nearly four years after the termination* that Summers had falsified insurance company records. *Id.* at 703. The employer conceded that Summers' misconduct was not the cause of the termination, *Id.* at 702, but argued that, in view of the employee's falsifications, Summers should not be given any relief for the employer's unlawful conduct. *Id.* at 704. The Court agreed and granted summary judgment. For purposes of its summary judgment ruling, the court *assumed* the employer's discriminatory intent. *Summers*, 864 F.2d at 708.

A different approach was taken by the court in *Wallace v. Dunn Construction Co.*, 968 F.2d 1174 (11th Cir. 1992). That court expressly rejected the *Summers* rule that after-acquired evidence bars recovery as a matter of law. *Id.* at 1180-81. The *Wallace* court, however, accepted that evidence of employee misconduct could limit the amount of a plaintiff's award for backpay. Under *Wallace*, to reduce the amount of backpay awarded, an employer must prove that evidence of the employee's misconduct would have come to light even in the absence of the employer's unlawful acts and the ensuing litigation. The employee's entitlement to backpay is terminated as of the date when the wrongful conduct would have been discovered. *Id.* at 1182.

Other courts have adopted a middle ground. *E.g., Kristufek v. Hussman Foodservice Co.*, 985 F.2d 364 (7th Cir. 1993). There, the Seventh Circuit held that an employer's backpay liability may be curtailed as of the date the employer actually discovered the employee misconduct. *Id.* at 371.

The Policy Basis for Varied Approaches

The centerpoint of the split among the circuits is their approach to the issue of intent. The *Summers* court considered the employer's intent to be irrelevant and barred recovery, in keeping with established contract and agency principles that the intent or motive of the breaching party is not relevant. *See Patton v. Mid-Continent Sys.*, 841 F.2d 742, 750 (7th Cir. 1988); 3 E. Allan Farnsworth, *Farnsworth on Contracts* §§ 12.1, 12.3 (1990).

On the other hand, the *Wallace* court recognized the importance of the intent element in anti-discrimination law and held that the doctrine cannot preclude Title VII liability.

The Seventh Circuit expressed concern regarding the employer's wrongful intent, but found "nothing to be gained by further penalizing [the employer] after [the employee misconduct] came to light." Kristufek, 985 F.2d at 370-71.

Applying the Defense in Other Areas of Business Law

The above discussion points to two conclusions. First, in areas of the law where the defendant's intent or motive is not at issue, such as contract or agency claims, the after-acquired evidence doctrine should apply without debate to bar the cause of action. Second, where intent or motive is relevant, the effect of after-acquired evidence will vary according to the public policies associated with the particular cause of action at issue. In any event, the doctrine will function as either an affirmative defense to bar the plaintiff's claim in toto or as a limit on recoverable damages.

With these principles in mind, the lesson learned from the *Summers-Wallace-Kristufek* debate should be useful in applying the after-acquired evidence doctrine to other areas of business law. Where, as in a breach of contract case or agency dispute, motive for the disputed conduct is not at issue, then the defense based on after-acquired evidence may effectively bar the plaintiff's claim. When motive or intent is at issue, as under principles of tort law or statutorily created causes of action with an intent element, the court will likely look to competing policies to determine the extent of the doctrine's applicability. In either context, the question is not whether the defense should apply, but rather the extent to which it will apply.

The doctrine fits smoothly into the context of commercial disputes. One such example is *Marnon v. Vaughan Motor Co.*, 189 Or. 339, 219 P.2d 163 (1950), which involved a dispute over a licensing agreement. The defendant arbitrarily reduced the plaintiff's commission from 8 percent of sales price to 4 percent. *Id.* at 164. When the plaintiff sued to enforce the agreement, the defendant terminated the contract. *Id.* at 165. The plaintiff argued that the defendant had terminated the contract without cause and he was entitled to his share of the profits for the ensuing 22 years—or his normal life expectancy. *Id.* At trial, the defendant justified the termination with after-acquired evidence that the plaintiff had obtained secret profits in violation of their agreement. *Id.*

The Oregon Supreme Court found that the defendant had legal cause to cancel the contract because of plaintiff's breach in obtaining secret profits. *Id.* at 167. The court recognized that, under the general rule, a plaintiff forfeited all rights to recover for services rendered as a result of his breach of contract. *Id.* at 168. The court went on to state that, because the defendant had authority and right to terminate the contract for cause, it did not necessarily follow that the plaintiff was divested of all rights under the contract. *Id.* Instead, the court looked to the terms of the contract at issue and determined that the plaintiff was entitled to some payment for the value of his idea even if he had abandoned the contract. *Id.*

In contrast, where the defendant's intent or motive is at issue, the effect of after-acquired evidence on a plaintiff's remedy should depend on the balance the court strikes between competing concerns. Tort claims such as fraud may be susceptible to an after-acquired evidence defense. In an action for false promise fraud, a defendant may be able to assert after-acquired evidence that the plaintiff was unable to perform under the agreement or had otherwise breached. Because of the policy to deter fraudulent conduct, the plaintiff's bar will argue that the defense should limit the plaintiff's remedy, rather than preclude the plaintiff's claim. *Cf. Tenzer v. Superscope, Inc.*, 39 Cal. 3d 18, 30 (1985) (rejecting statute of frauds defense against claim for fraudulent promise because law precludes use of rule to aid perpetration of fraud).

The defense bar will argue, however, that the state's interest in deterring commercial fraud is not at the same heightened level as the interest in deterring employment discrimination, and that after-acquired evidence should bar a fraud claim altogether. Support for this position may be found in a recently-decided California Supreme Court case. In *Hunter v. Up-Right, Inc.*, 94 D.A.R. 53, Jan. 5, 1994 (Cal. Dec. 30, 1993), the California Supreme Court held that a terminated employee may not sue his employer for fraud when the employee's termination was induced by a misrepresentation by the employer. In so holding, the Court in *Hunter* characterized the fraud claim at issue as "fundamentally contractual" and expressly minimized the State's interest in preventing fraud, opining that "[a] claim of fraud or deceit is essentially a private dispute seeking a monetary remedy, not an action to vindicate a broader public interest." *Id.* at 53.

Thus, it may be implied from the reasoning of the *Hunter* majority that the public policy concerns limiting the application of the after-acquired evidence doctrine in employment discrimination cases will only be duplicated in circumstances in which the alleged fraud is linked to a public policy specifically embodied in a statute or constitutional provision. *See also Hunter* at 56 (justifying its holding that no fraud claim would lie by noting that the employer could have terminated the employee on other grounds without using the fraudulent misrepresentation). It can therefore be expected that the defense bar will argue that there is no basis for limiting the effect of the after-acquired evidence doctrine as an affirmative defense in common law commercial fraud claims.

Other business torts, such as interference with existing or prospective economic relations, have intent as an element of the cause of action. 5 B. Witkin, *Summary of California Law: Torts* § 653 (9th ed. 1988). These torts are a hybrid cause of action in the sense that the plaintiff must also prove that the defendant's act caused the breach of contract or disrupted an existing or prospective business relationship. *Id.* at §§ 648, 652. As such, defendants will likely argue that the relationships involved are "fundamentally contractual" relying on the *Hunter* decision for support. *But see Speegle v. Board of Fire Underwriters of the Pacific*, 29 Cal. 34, 39 (1946) (tortious interference claim will lie even where contract is terminable at-will because the fact that a contract is at the will of the parties does not make it at the will of others). The defense bar will contend that, unless the plaintiff can establish that the defendant acted with a motive which contravenes a public policy rooted in statute or constitutional provision, a California court should allow the doctrine to function as a complete bar to a plaintiff's claim.

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The Corporate Director's Deposition

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attest to the accuracy of every word unless you rely on experts and people who spend their lives doing that kind of work.

...I think I am responsible to make sure that the people who are directly involved with it [still referring to the prospectus] have done their job and tell me they have done their job, that we have an audit report opinion, and stuff like that.

An outside director may also respond as follows:

Q: What did you understand were the specific reasons for this transaction? Did you verify the reasons stated in the prospectus?

A: It was good economic and tax sense, what I would call the bottom line business reasons.

Finance and taxes are not my long suit, so one relied on those who have that expertise. And, as a board member, each person brings different expertise to the board. That's why the diversity and richness of a board is helpful to a company.

So, when I would listen attentively to these kinds of discussions, I would be mindful of both those inside and outside the company, who would know more than I and make my judgments accordingly. So, that's why I am familiar with the issue, but not the specifics.

D. *Conclusion*

Directors adeptly handle hostile questions — from the media, from government officials, and from lawyers. They pick up cues quickly. If a director knows the case, defense strategy, and how the director fits into that strategy, the deposition can go smoothly. In other words, to maximize your success, be prepared, and prepare the director.

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—Jasmina A. Theodore

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Shooting Holes in the Shell *Game*

Continued from page 3

ter). The expert explained to the jury that, based on his review of Purex employee testimony, it was his conclusion that chlorinated solvents, such as trichlorethylene (TCE), perchlorethylene (PCE), and trichloroethane (1,1,1 TCA) had been discharged into the ground surface as DNAPLs. The hydrogeologist concluded that the watertable under Purex's site was 20-25 feet below ground surface. Based on his experience with chlorinated solvent DNAPLs, his understanding of the hydrogeologic circumstances at the site, the volumes of chlorinated solvents found in the groundwater, and the characteristics of DNAPLs generally, the hydrogeologist opined that the chlorinated solvents handled by Purex had made contact with a watercourse/body of water (*i.e.*, the groundwater) within minutes or hours after the initial discharge onto the land surface.

The hydrogeologist also concluded that the discharged chlorinated solvents had entered the groundwater as early as 1950 (*i.e.*, well before Purex owned the site) and were still located in the pores and interstices beneath the site at the time that Purex first purchased and insured site operations in 1969. As noted, the expert likened the DNAPLs to peppermint sticks which were dissolved on a moment to moment basis by groundwater which flowed past the DNAPL globules over a 40-year period.

The Purex jury reported in post-trial interviews that it had little difficulty concluding that the expert's opinion supported the special verdict finding it made that the discharge or release was "sudden." And rightly so! The Shell opinion focused on the commencement of the polluting event. The *Purex* jury had two separate bases for concluding that this contact between pollutant and groundwater was "abrupt," as defined by *Shell*.

Conclusion

The First District Court of Appeal's *Shell* decision may have settled a long standing debate over whether "sudden" is to be given a temporal meaning. But that is all it did. It has not resolved the debate over the ability of the pollution exclusion to prevent coverage in pollution cases. Since *Shell*, the dispute over the meaning of "sudden" continues in a different, more important context — the jury's consideration of facts. Recent experiences in *Purex* and *Aydin* show that the Court of Appeal's definition of "sudden" by any other name is still a shell game, which can be beaten with the right facts, creative lawyering and properly presented expert testimony.

—Terry W. Bird

After-Acquired Evidence Doctrine

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The foregoing discussion suggests that the key to asserting the after-acquired evidence doctrine is an awareness of the policies underlying the law giving rise to the plaintiff's cause of action. In commercial contexts, where a vital public interest is specifically embodied in a statutory scheme or constitutional provision, the assertion of after-acquired evidence to justify the defendant's conduct should, at the very least, limit the remedy sought. The eventual resolution of the *Summers-Wallace-Kristufek* debate regarding application of the defense in employment discrimination actions should determine the extent to which the doctrine will apply when such a public interest exists. In commercial disputes involving pure common law contract, tort or agency claims, the doctrine should bar the plaintiff's claim altogether.

—James F. Elliott