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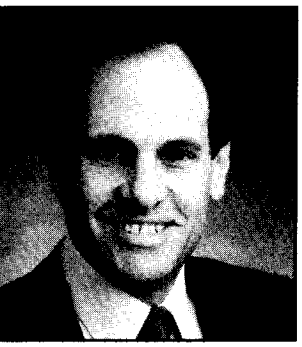
'Cutting-Edge' Evidence: Admissibility at Trial

CONSISTENCY and predictability are essential elements of justice and the fair administration of the law. Can we expect the consistent application of evidentiary rules in state courts when our judges have the broad charter of "sound judicial discretion" under California Evidence Code section 352? How consistent is the exercise of this discretion? The vagaries of the judge's discretion may not be known until the lawyer offers critical evidence at trial over objection of counsel.



Arthur J. Shartsis

Is a lawyer entitled to expect different judges to agree on evidence 90 percent of the time or only 50 percent? I recently had a unique opportunity to gain insight into my chances in court and develop some ideas on how to protect my clients from the potential coin flip of "sound judicial discretion."

In January, I served on a panel at the California Judges Association's comprehensive three-day program on evidence, co-sponsored (and videotaped) by The Rutter Group. Our panel – the three-hour finale – addressed "cutting edge" issues of modern demonstrative evidence. We used a courtroom format so that the two judges on our panel could rule on each of the evidentiary questions argued by two lawyers. Modern electronic technology enabled our audience of judges to rule simultaneously before our judicial panelists ruled orally.

The judicial audience rulings were both enlightening and disturbing. On some matters the audience, exercising its sound judicial discretion under section 352, split virtually down the middle. On easier issues, there were majorities but never unanimity.

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The Bily *Decision: Limiting Accountants' Liability*

ACCOUNTANTS doing business in California heaved a sigh of relief after the California Supreme Court's decision in *Bily v. Arthur Young & Co.*, 3 Cal. 4th 370 (1992). *Bily* significantly limited the scope of an accountant's potential liability for negligence. While prior appellate authority permitted any reasonably foreseeable user of accountant-prepared information (audit reports, for example) to assert a claim for negligence against the accountant, *Bily* held, instead, that an accountant "owes no general duty of care regarding the conduct of an audit to persons other than the client." *Id.* at 376. Thus, *Bily* established a privity requirement which confined negligence claims against an accountant to its client, that is, "the person who contracts for or engages" the accountant's services. *Id.* at 406.

Charlene S. Shimada

Bily, however, distinguished negligence from negligent misrepresentation. As to the latter, the Court did not insist upon strict privity and allowed claims by persons the accountant

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specifically intended to influence in connection with a specific transaction or type of transaction.

This limitation on negligent misrepresentation claims significantly reduces the potential liability of accountants. Businesses regularly retain accountants to conduct annual audits of financial statements and to render opinions on them, without specifying any particular purpose for these services. Yet, accountants are doubtlessly aware that their opinions are "customarily used in a wide variety of financial transactions by the [client] corporation and that they may be relied upon by lenders, investors, shareholders, creditors, purchasers and the like, in numerous possible kinds of transactions." *Id.* at 393-94. Therefore, if accountants could be liable for negligent misrepresentations to such third parties, all of whom arguably would be reasonably foreseeable users of an accountant's opinion, a virtually limitless liability exposure would result. Under *Bily*, however, the absence of a particular purpose for the accountant's opinion should preclude third party claims for negligent misrepresentation because it would be difficult, if not impossible, to show that the accountant intended to influence those third parties in a specific transaction.

The Court described a number of policies supporting its ruling. By limiting negligent misrepresentation claims to third parties the accountant intended to influence, a reasonable proportionality is maintained between an accountant's fault and its exposure to damages. In contrast, allowing all reasonably foreseeable users of accountant-furnished information to sue for negligent misrepresentation would threaten accountants with gargantuan liability. This is particularly inequitable because free riders who obtained information generated by an accountant cost-free would still be allowed to recover from the accountant for the slightest deviation from professional standards. Moreover, the free rider would lose almost all incentive for taking steps to protect his or her own interests. The law should encourage, not disfavor, self-reliance.

Bily did not alter the law for intentional fraud. A fraud claim may be asserted so long as it was reasonably foreseeable that the plaintiff would rely upon the fraudulent misrepresentation at issue. *Bily* explicitly reaffirmed this principle for claims against accountants.

Bily announced exceedingly broad principles of law. Accordingly, it will likely produce significant litigation to apply these principles in specific contexts. One case has already held that *Bily* should be applied retroactively. *Industrial Indemnity Co. v. Touche Ross & Co.*, 13 Cal. App. 4th 1086 (1993). Other issues that may arise can be organized around three general aspects of *Bily*: (1) Who is a "client" of an accountant? (2) Which nonclients may bring negligent misrepresentation claims? (3) What is the distinction between claims of nonclients for negligence as opposed to negligent misrepresentation?

Defining the Client

The client who may bring a negligence action against an accountant is "the person who contracts for or engages" the accountant's services. *Bily*, 3 Cal. 4th at 406. The Court, however, indicated in a footnote that this definition may be under-inclusive. The Court stated that "[i]n theory, there is an additional class of persons who may be the practical and legal equivalent of 'clients.'" *Id.* at 406 n.16. In particular, a contract with an accountant might "identify a particular third party or parties so as to make them express third party beneficiaries of the contract." *Id. Bily* declined to decide whether express third party beneficiaries would be permitted to bring negligence claims against an accountant.

The California Supreme Court also modified *Bily* to answer one question regarding the meaning of "client," but raised another. *Id.* at 407 n.17. The modification addressed whether "client" included a director of a corporation which had retained an accounting firm to audit its financial statements. The Court held that where the director is seeking damages for losses suffered in trading personal stock in the corporation, he does not qualify as the client of the accountants. In that situation, the director acts in his individual capacity and has no contractual or similar relationship to the accountants. Accordingly, the director could not bring a negligence claim against the accounting firm. Persumably, the same principle would apply to other positions within a corporation such as the chief executive officer.

This gives rise, however, to another question. How will the courts treat limited partners who wish to assert negligence claims against an accountant hired by their partnership? If the focus is on the fact that a partnership is an association of individuals, each limited partner might be deemed a party to any agreement of the partnership and therefore a client of an accountant retained by the partnership. On the other hand, if limited partners are viewed principally as investors, a claim based on losses suffered to a personal interest in a partnership would arise in the partner's individual capacity, not in the partner's capacity as a member of the partnership that contracted with an accountant.

Defining Third Parties

Nonclients may have negligent misrepresentation claims under *Bily*. The *Bily* modification discussed above explicitly provided that a corporate director investing personally does not possess a negligence claim against the corporation's accountant. The modification did not foreclose a cause of action for negligent misrepresentation.

We can expect litigation over which third parties may bring negligent misrepresentation claims. *Bily* describes such parties as "the intended beneficiaries of an audit report," the "specifically intended beneficiaries," and persons whom the accountant "has undertaken to inform and guide...with respect to an identified transaction or type of transaction." *Id.* at 407, 410 and 413. These ambiguous formulations may encourage third parties to bring negligent misrepresentation claims based on little more than their belief that an accountant had some reason to believe that the third party would rely on the accountant's opinions.

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This would misread *Bily*, which permits only a highly restricted group of third parties to bring negligent misrepresentation claims against accountants.

> [W]e do not suggest the question of intent to benefit a third party will inevitably involve a question of fact. If competent evidence does not permit a reasonable inference that the auditor supplied its report with knowledge of the existence of a specified transaction or a well-defined type of transaction which the report was intended to influence, the auditor is not placed on notice of the risks of the audit engagement. In such cases, summary adjudication will be appropriate because plaintiff will not, as a matter of law, fall within the class of intended beneficiaries.

Id. at 414-15.

Based on this language, it seems relatively clear that third parties will not have valid negligent misrepresentation claims unless an accountant has received notice that its client has sought information from the accountant for the use of a third party in a specifically identified transaction. This view is also supported by section 552 of the Restatement Second of Torts, which *Bily* followed in defining the third parties with negligent misrepresentation claims.

Careful attention to section 552 should also prevent unnecessary litigation over the meaning of *Bily*. That provision contains a good explanation, supplemented by useful hypotheticals, of the conditions for third party claims of negligent misrepresentation against an accountant. In particular, section 552 clarifies the requirement that the accountant must have furnished information for the benefit of a third party, or a class of persons to which the third party belongs. The accountant need not know the actual identity of the third party. It is enough that the accountant understands the information will be used by a certain class of persons and the third party falls within that class. For instance, if an accountant is advised that its audit opinion will be supplied to prospective acquirors of its client corporation, a third party who turns out to be the acquiror can bring a negligent misrepresentation claim, even if the accountant never learned its identity.

In addition, section 552 sheds light on the need for an accountant to know the specific transaction or type of transaction for which the third party will be using the accountant-furnished information. The need for clarification can be illustrated by the following hypothetical from section 552. Suppose an accountant has been told that its client will be supplying the accountant's audit opinion to a bank in order to obtain a $10,000 loan. If the client actually obtains a $500,000 loan, can it be said that the accountant knew the specific transaction or type of transaction for which the audit was to be furnished, such that the bank could bring a claim against the accountant for any negligent misrepresentations? If the terms "specific transaction or type of transaction" were construed broadly, it would be possible to con-

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Shell Oil: *Something for Everyone*

Now that the California Supreme Court has denied Shell's petition for review, *Shell Oil Co. v. Winterthur Swiss Ins. Co.*, 12 Cal.App.4th 715 (1993) stands as the first California appellate decision on several key and usually-more-than-six-million-dollar questions in environmental coverage litigation.

The sheer magnitude of the *Shell* case sets it apart from most disputes over insurance coverage for environmental damage. Shell was seeking coverage from over 800 policies issued by more than 50 insurance carriers for a $1.8 billion cleanup. Nonetheless, the nature of the contamination, the relief sought by the regulatory agencies, and the crucial points of dispute in *Shell* are the same as those faced by individuals and businesses of much humbler size when they make the horrifying discovery that some abandoned practice or waste container on property they own or lease has led to a pricey, long-term remediation order.

Margaret A. Corrigan

The contamination in *Shell* resulted from disposal practices in Shell's manufacture of agricultural chemicals at the Rocky Mountain Arsenal in Colorado from 1952 until 1978. Shell leased a portion of the Arsenal from the U.S. Army and used the Army's waste-disposal facilities. Shell's disposal practices included the use of both unlined and asphalt-lined evaporation basins for manufacturing wastes and the disposal of contaminated materials, solid wastes and sludges in shallow earthen trenches. Water was drawn from three nearby lakes to cool the manufacturing equipment, then returned to the lakes.

The Court of Appeal noted that, in the mid-1950s, complaints of crop damage and salt contamination had led to the construction of the asphalt-lined Basin F for Shell's effluent wastes. *Id.* at 733. After Basin F was built, the unlined basins were no longer used for effluent disposal. *Id.* at 734. In 1970, the Army told Shell that Army engineers had concluded that the chemical mix in Basin F had caused the liner to deteriorate, that use of Basin F was to end and that Shell would have to pay a substantial portion of the cost of new waste facilities and aquifer contamination claims. However, Basin F was used for Shell's waste until 1978, and by the Army until 1981 or 1982. *Id.*

In 1983, Shell was sued by the federal and state governments for the environmental damage and cleanup costs. Shell signed a consent decree to perform the cleanup within certain dollar limits and brought a declaratory relief action against its primary and excess comprehensive general liability carriers from 1940 to 1983 over coverage.

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After an 18-month trial, the jury returned a general verdict in favor of the insurance carriers on every policy for the 1952 through 1982 policy years. Shell's appeal focused on the jury instructions for the definitions and standards governing the coverage determinations.

The most notable holdings of the First District's 56-page opinion in *Shell* concern two much-litigated provisions of standard comprehensive liability policies issued before 1985: first, the phrase "neither expected nor intended from the standpoint of the insured," which qualifies which "occurrences" are covered by the basic insuring clause; and second, the notorious pollution exclusion, which (in one of its several permutations) excludes from coverage damages caused by a comprehensive laundry list of polluting events except those which are "sudden and accidental." Because trial courts across the country have reached wildly different results, this area has been a heyday for policyholders and insurance carriers looking for authority for their respective positions but a nightmare for those trying to assess the risks of environmental coverage litigation. The long-awaited *Shell* decision promised to provide some much needed clarity in California on these two crucial issues.

And, by most reports, it does. With respect to the "neither expected nor intended" language, the *Shell* court held that "expected" connotes the *subjective* expectations of the specific insured, not an objective assessment of what a reasonable insured would have expected. *Id.* at 746. (Interestingly, despite the controversy over that term, *Shell* found that the meaning of "expected" is not ambiguous.) *Shell* establishes that the relevant question is whether the particular insured knew or believed its conduct was substantially certain or likely to result in the kind of damage which resulted. *Id.* at 747-48. The court partially reversed the verdict in favor of Shell's insurers for the pre-1970 years because the jury instructions defined "expected" in terms of what Shell *should have known*, instead of what Shell actually knew or believed.

The subjective "expected" holding of *Shell* has been touted as a victory for policyholders who cringe at the prospect of environmentally conscious juries of the '90s judging their disposal practices of the '50s and '60s by a stricter objective standard. Still, insurance carriers can take full advantage of *Shell's* approval of the role of circumstantial evidence in deciding what was "expected." The court warned that "[c]laims of ignorance are unlikely to succeed when circumstantial evidence shows the insured expected damage or avoided confirming such a belief in hopes of denying awareness of the risk." *Id.* at 745.

Moreover, demonstrating that a subjective standard of "expected" can be met without admissions by guilt-ridden or disgruntled employees, *Shell* upheld the verdict against Shell with respect to its post-1969 policies on the basis of circumstantial evidence. It found that *Shell's* knowledge that its toxic wastes would deteriorate the containment systems, that such deterioration was taking place, and that leaks were inevitable foreclosed any reasonable probability that the jury would have found that, after 1969, *Shell* did not expect contaminants to escape. So, as a practical matter a "must have known" standard for what an insured "expected" may be just as hard on the policyholder as a "should have known" standard.

With respect to the pollution exclusion, the *Shell* holding looks like a victory for the insurers. The Court sided with half of the dozen or so state supreme courts which have decided the issue in concluding that the "sudden and accidental" exception contains a temporal element in addition to its connotation of unexpected. As one of Shell's brokers put it, and the Court quoted, seemingly with its endorsement: "[There's no] better description of 'sudden' than sudden, something that happens at a precise point in time." *Id.* at 755. The Court found no error in instructing the jury that the term "sudden" means "characterized by hastiness, abruptness, quickness and swiftness" (*id.* at 751-52), and concluded that, except for some spills, none of the polluting events at the Arsenal had been sudden: "Pollutants escaped...through long, continuous and gradual processes [which] leads us to conclude that it was not 'sudden.'" *Id.* at 783.

So *Shell* ostensibly ends the long debate in California. Sudden means sudden. But—not quite. In light of the Court's ruling that Shell "expected" the pollution after 1969, insureds will argue that the Court's discussion of the "sudden and accidental" language, which is only contained in later policies, is *dictum*. The split in authority around the country and this Court's lack of discussion of the drafting history of "sudden and accidental" may encourage insureds to revisit this issue. Moreover, the following remarks of the court leave the reader with the distinct impression that "sudden" events aren't confined to those which "happen[] at a precise point in time":

> We also agree with *Lumbermens [Mut. Cas. v. Belleville Ind.*, 555 N.E.2d 568 (Mass.1990)] that "sudden" refers to the pollution's commencement and does not require that the polluting event terminate quickly or have only a brief duration. (*Lumbermens*[]) If a sudden and accidental discharge continues for a long time, at some point it ceases to be sudden or accidental. [Citation.] 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.

That these parting words were not simply an afterthought is certainly indicated by the title of this section of the *Shell* opinion: "'Sudden' Events Start Abruptly."

So if "sudden" refers only to the *commencement* of a polluting event, and not its duration or termination, couldn't most polluting events which might otherwise be thought of as excluded "gradual" pollution fit this description? And isn't this policyholder argument especially plausible in the case of many commonly used solvents and other contaminants which seep quickly through soil into groundwater – and have very low action levels, so that little need accumulate before triggering an administrative cleanup order?

Arguments to that effect have already been made, successfully, by a policyholder in a recent coverage case – despite the policyholder's concession that most of the

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pollution at issue was caused by small releases from leaking tanks, dripping valves and other accidents over the years during routine operations of its solvent repackaging facility. In *Purex Industries Inc. v. Harbor Insurance Co.* (Super.Ct. L.A. County, 1993, No. 446-935), the jury was given *both* of the following instructions on the pollution exclusion: "'Sudden' does not include a process that occurs slowly and incrementally over a relatively long time, no matter how unexpected or unintended the process" *and* "Sudden refers to the pollution's commencement and does not require that the polluting event terminate quickly or have only a brief duration." By special verdict form, the jury found that the pollution exclusion did not exclude coverage for any of the six years at issue.

Certainly, the fact that *Shell* leaves open the possibility of coverage if a policyholder shows that the polluting event began quickly, even if it continued "for some period," guarantees that the *Shell* decision will not end the debate over where "sudden" ends and "gradual" begins.

In addition, *Shell* did not decide which party bears the burden of proof on either issue. The general rule is that the policyholder bears the burden of proving that its claim is within the policy's basic coverage while the burden to prove that any exclusion applies rests on the insurer. The *Shell* opinion does note, apparently with approval, that the jury was instructed that the insurers had to prove "all of the facts necessary to establish that an exclusion or any exclusionary language applies to limit or abrogate coverage...." But beyond that passing reference, *Shell* does not address who has the burden of showing that the insured "neither expected nor intended" the pollution – language in the basic insuring clause which *limits* coverage and thus has the effect of an exclusion – or the burden of proving that the polluting event was "sudden and accidental" – language in the exclusion which has the effect of giving back coverage otherwise excluded. Proving a policyholder's "expectations" as well as the sudden or gradual nature of the polluting events is arduous, complicated and expensive, especially when coverage is litigated decades after the relevant events took place. That, and the inconsistent positions of trial and appellate courts in California and elsewhere on this critical issue, assures that environmental coverage contestants will continue their skirmishes over the burdens of proof.

Shell does tilt the playing field in favor of policyholders on the "neither expected nor intended" language and in favor of the insurers on the pollution exclusion. Nonetheless, *Shell* leaves plenty of room for creative lawyering with technical experts, arguments about burdens of proof, and circumstantial evidence pieced together from aerial photos, octogenarian former employees and newspaper archives. In other words, rather than settling some key issues, *Shell* continues the current state of the law created by the many appellate decisions in every jurisdiction on these issues – something for everyone.

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The Seven 'Myths of Arbitration'

To say anything negative about alternative dispute resolution or ADR these days is risky business. To voice concerns about the oldest, best-established ADR technique – arbitration – is heresy in some quarters. But to blindly accept the myths of arbitration as truth is dangerous for litigators and their clients. My purpose is to provoke some thought and discussion about seven of these "conventional wisdoms" so we may all give better advice.

Myth No. 1: Cost – "Arbitration costs less than traditional litigation."

James P. Kleinberg

The source of this myth was the high cost of discovery and other pre-trial preparation, which reached its zenith in the 1970s. Twenty years ago judges pledged, often in open court, their avowed belief in "full and open discovery." The burden was on the respondent/objector to convince the court why discovery should *not* occur. Since arbitration did not contemplate or allow pre-hearing discovery except in extraordinary circumstances, the difference in cost was obvious. But more recently, there has been a well-known backlash to the excesses (real or perceived) in discovery. Limits on the number and style of interrogatories, the number and length of depositions, and a powerful reorientation by the federal courts are either in place or on the way. Code of Civil Procedure § 2030(c), and Local Rule 230-1(b), Guidelines for Discovery, Motion Practice, and Trial (1992) and General Order No. 34, Northern District of California; see, also, proposed amendments to the Federal Rules of Civil Procedure approved by the Supreme Court in April, 1993.

In the state court system, "fast track" programs mandate that cases move at a quicker and more managed pace than the old approach of letting the lawyers fend for themselves. Thus, the "war of attrition" in conventional litigation is not what it used to be.

Interestingly, while traditional litigation has shifted away from "wide-open" discovery, there seems to be a trend the other way in arbitration. Now, there seems to be a greater willingness to allow discovery in certain instances. Another development encouraged by the American Arbitration Association ("AAA") is the use of "preliminary hearings" – pre-trial conferences by another name. Not in all cases, to be sure. But in AAA arbitration of even moderately complex cases, you should expect that the deposition of witnesses who will not appear at the hear-

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The Seven 'Myths of Arbitration'

ing may well be ordered. See, e.g., Code of Civil Procedure § 1283. You should also expect that ground rules – such as listing of witnesses, exchanging documents, scheduling briefs – will all be discussed and decided at the "preliminary hearing." It's not just AAA. Even in securities arbitration, discovery and depositions are now being allowed. Thus, the gulf between over-discovery in normal litigation and no discovery in arbitration has narrowed.

There is another hidden cost to arbitration: limited discovery can result in a hearing where neither side knows what the other side will say. Without the opportunity to plan fully the examination of witnesses, the hearing can degenerate into unfocused "discovery" questioning or, worse, cross-examination without a beginning, middle or end. In these ways, the supposed "lower cost" advantage of arbitration may not be what it's cracked up to be.

Myth No. 2: Speed – "Arbitration is quicker."

Yes, and no. Arbitration is usually quicker than traditional litigation. But you must temper this notion with the realities of coordinating three arbitrators' schedules with that of at least two lawyers – not an easy task. After all, the arbitrators aren't like a courtroom – open for business every day of the week. In a complex case with multiple arbitrators, it is often hard to arrange solid blocks of time. You may have hearings for a week, then be forced to skip weeks or even months before resuming. Naturally, memories fade, and you wind up preparing a second or third time.

The arbitration policy in favor of allowing, rather than excluding, evidence is another factor that can protract arbitration. Arbitrators are loathe to rule evidence inadmissible because one of the few grounds to vacate an arbitration decision is "...[t]he refusal of the arbitrators to hear evidence material to the controversy..." Code of Civil Prodecure § 1286.2, 9 U.S.C. § 10(a)(3). Consequently, hours, days or weeks may be spent dealing with irrelevant or duplicative testimony and exhibits. Unless the arbitrators can obtain a stipulation by the parties *not* to introduce evidence, the case can drag on interminably.

Here is another heresy on the "speed" benefit: maybe speed isn't in your client's interest. Maybe justice delayed – is justice. In particular, maybe events outside the litigation need to play out before the two sides can resolve the dispute between them.

Myth No. 3: Expertise – "You can get someone who knows something to decide your case."

Early in the arbitration process, you will see a brief resumé of proposed arbitrators. This form and whatever intelligence you can gather from colleagues are your only sources about what to expect from the person deciding your case. What that person has ruled in a case like yours is not a matter of record; it's an unknown unless you learn of it by happenstance. After all, arbitration awards are private and arbitrators need not (and usually don't) give reasons for their decisions. This is a very thin basis on which to select one arbitrator over another, especially when compared to the officially and unofficially reported decisions of judges.

Another problem is the arbitrator who *thinks* he or she knows something and is constantly grading your performance or, worse, mucking it up by examining or cross-examining witnesses or going off on tangents. All in all, you won't necessarily receive more expert judging in the arbitration setting than in the courthouse.

Myth No. 4: Finality – "In litigation, it's not over 'til it's over, and that can take years – and even then you're not sure. But in arbitration, it's OVER!"

In fairness, this is more of a truth than a myth. Recent cases, such as *Moncharsh v. Heily & Blase*, 3 Cal. 4th 1 (1992), underscore how difficult it is to undo an arbitrator's award. Of course, if you win, this is fine. But, as an advocate, are you so sure of the strength of your case that you don't care about a right to appeal? If you are considering binding arbitration, this bears some discussion with your client.

Myth No. 5: Privacy – "No one knows what is going on in these hearings behind closed doors."

Again, yes and no. If one of the parties is a public company, the results may well be public if the impact is material. And there are also those cases where you *want* testimony out in the open, e.g., where there is some precedential value to the litigation. And privacy is another two-edged sword. As I alluded to before, there are no published decisions and therefore no way to know how this arbitrator or panel has ruled in other cases, what points or witnesses were persuasive, and which were not. Like speed, privacy is another benefit of arbitration you may not want.

Myth No. 6: Ease – "It's easier to start and manage an arbitration; all you need is a simple form clause."

With the popularity of ADR these days, you are likely to be faced with the eleventh-hour decision to insert an arbitration clause or, as a litigator, the consequences of someone having done so earlier. Here are some of the questions that lawyers frequently fail to ask or answer:

Coverage. Should the arbitration clause address certain issues or *any* problems that arise? If only specified problems are identified, you can pretty much bet there will be litigation over whether a particular problem is inside or outside the category. Beware of words or phrases as: "If any question of *fact* arises..." (because then arbitrators may be exceeding their authority if they delve into legal issues) or "either party *may* demand an arbitration..." (implying arbitration isn't necessarily mandatory). Is the clause general ("any dispute") or specific ("if the controversy concerns the quality and condition of the printed circuit boards, it shall be decided by X; all other controversies shall be submitted to arbitration under the rules of the AAA")?

Detail. When should the arbitration commence? Under whose auspices? How many arbitrators? What qualifications? Do you want a "reasoned opinion" or just the usual "bare-bones" award?

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ZELA G. CLAIBORNE

On CONSTRUCTION

INCREASINGLY, mediation is being utilized to resolve complex construction disputes. Many courts now require that the litigants try alternative dispute resolution (ADR), such as mediation, before the case is set for trial. In mediation, a neutral individual works with the parties to assess their respective positions and assist in negotiating a settlement. Mediation is not binding but, instead, may result in a mutually agreeable compromise.

When to Mediate

If a case can be mediated successfully before extensive discovery, the parties can realize great savings. Although the mediation may not settle the case, it may help narrow the issues and streamline discovery.

Even on the eve of trial, mediation may be worth a try because of its low cost and because it may lead to settlement and avoid a lengthy trial. Presiding judges, who may order the parties to non-binding, judicial arbitration before trial, often can be persuaded to let the parties try less expensive mediation instead.

Choosing a Mediator

For a complex construction case, it is useful to select a mediator who understands the construction process and who is familiar with related insurance issues and construction indemnity provisions. The parties may select an attorney mediator or a retired judge from the Judicial Arbitration and Mediation Service (JAMS) or another panel. The American Arbitration Association (AAA) handles mediations at a relatively low cost and maintains a panel of construction industry mediators.

Persuading Opposing Counsel to Mediate

Some contracts require the mediation of disputes. The AAA suggests the following provision:

> If a dispute arises out of or relates to this contract, or the breach thereof, and if said dispute cannot be settled through direct discussions, the parties agree to first endeavor to settle the dispute in an amicable manner by mediation....

In the absence of a written agreement, try contacting opposing counsel to suggest mediation. Clients will often agree because it can take place promptly and save money. Opposing counsel may promote the idea with their clients, especially if you encourage them to participate actively in selecting a mediator and establishing the ground rules such as the number of mediators, the method of compensating them, and the length and location of the meetings. The AAA will assist in persuading parties to submit to mediation pursuant to Rule 2 of the Construction Industry Mediation Rules.

Discovery Before Mediation

In a construction case, the parties may need detailed information about a claim in order to resolve it. Therefore, they may agree to exchange certain documents, including the plans and specifications. They may also agree to some key depositions, including the project manager, the architect, the structural engineer, or others. Most important, they may want to exchange expert reports or statements of claims to facilitate settlement negotiations. Since the expert's report may be preliminary and subject to revision, be sure that counsel agree that this material is protected by a confidentiality agreement.

Procedure During Mediation

Mediation is an informal and flexible proceeding. Rule 9 of the AAA Construction Industry Mediation Rules requires a pre-mediation brief. At the beginning of the mediation, the attorney may present an opening statement or engage in a more informal discussion of the facts and positions. Sometimes a party will present the testimony of an expert witness or one or two key percipient witnesses during the mediation. Thereafter, the mediator caucuses with each party separately in order to test the strengths and weaknesses of its position and explore settlement possibilities.

Zela G. Claiborne

In order to encourage the free exchange of information, the parties usually agree that the mediation is confidential. AAA Rule 12 on confidentiality is typical and provides that the mediator and the parties shall keep all information disclosed during the mediation confidential and shall not attempt to introduce it as evidence in a future arbitration or trial. If the parties enter into a proper written mediation agreement, statements made or materials prepared by parties also are protected by California Evidence Code section 1152.5(c).

Whatever procedure is used, each party should be represented not only by counsel but by a client representative with settlement authority. A mediation is likely to be successful only if decision makers from one party can hear the opposing party's case. Ideally, mediation should open minds and make resolution possible.

Why Mediate

Most mediations, even complex ones, can be completed in a day or two and require less preparation than arbitration or trial. Thus, mediation is a low risk procedure because the case may be resolved quickly and at far less cost than arbitration or trial. Because mediation is voluntary and encourages the parties to be involved in the process, a successful mediation may even allow the participants to reach a creative settlement solution and salvage their business relationship.

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'Cutting-Edge' Evidence

To a certain extent, it all seemed effectively summed up by one of our panelists, Justice Charles Froelich (Fourth Appellate District), when he commented prior to a ruling made by our other judicial panelist, Los Angeles Superior Court Judge Stanley Weisberg: "Whichever way His Honor rules, he would be sustained on appeal." How much comfort is this for the litigants, prosecutors or criminal defendants who run the 50 percent chance of having potentially important demonstrative evidence excluded from the courtroom?

A review of the judical votes on the evidentiary questions presented underscores the possible litigation risks and provides some clues to reduce those risks.

In our first case, a personal injury plaintiff presented admissible lay witness opinion regarding the speed of an automobile in an accident. The judges were asked to rule whether a bystander's properly authenticated home video of the defendant's automobile traveling immediately before the accident (and concluding just before impact) was admissible to impeach the lay witness. Sixty-nine percent of the judges allowed the evidence, 31 percent refused admission.

In our next case, the plaintiffs offered a computer reconstruction of an airplane that crashed at takeoff. The computer reconstruction, created two years after the crash, was basically a moving picture that included the voice overlay of the pilots and the control tower. The eyewitness, an experienced airfield technician, testified that the computer graphic accurately depicted exactly what he had witnessed from where he had stood at the time of the crash. On cross-examination, the eyewitness admitted that he was miles from the beginning of the plane's movement as the plane flew directly toward where he was standing. He also admitted that the computer depiction was much brighter and clearer than the nighttime crash scene. He conceded that he had not been able to see the detailed elements of the entire plane at all times. Finally, he admitted that he had contemporaneously heard some but not all of the audio portion included in the computerized reconstruction.

The judges voted as follows: 45 percent would admit the video portion without the audio; 55 percent would not. Forty-three percent would admit the film including the audio; 57 percent would not.

We then put this first round of judicial decisions to the test. We assumed that the first computer reconstruction had been admitted. Plaintiff then offered another computer reconstruction of the same crash. This time the computer looked at the plane from the "chase" position, following it from the rear throughout the course of the accident. Here, there had been no witness from the rear. The attorney opposing the second film argued that it "compounded the felony," since even the first film was not a fully reliable portrayal of what the front-view witness had seen. The proponent conclusively demonstrated that the "chase" point of view was a mathematically accurate rendition of the rear view of the plane, assuming that the front computer view was accurate. There was no question that the computer was capable of turning the plane around and looking at it from the rear. When asked to rule whether the second film could now be admitted to illustrate an expert's testimony, 46 percent of the judges allowed it, and 54 percent did not.

What do these votes tell us, aside from the fact that the chance of admitting this evidence was basically a coin toss? All of the judges who voted to admit the front view apparently voted to admit the rear view, since the rear view was scientifically as accurate as the front view. A few judges even voted for the rear view who had not voted to admit the reconstruction of what the witness actually saw, perhaps to be consistent with the assumed earlier decision. Since the vote didn't change much, however, most of the judges seemed unpersuaded by the assumed admission of the first film. This sequence could probably benefit from further testing.

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The Seven 'Myths of Arbitration'

Procedure. Should discovery be allowed? Incorporate the Rules of Evidence? Splitting of the arbitrator's fees and administrative costs? Choice of law? Where may the award be enforced?

Hopefully, these questions were addressed when the agreement to arbitrate was negotiated. The point is that the proper launching and management of arbitration is more complicated than it appears on the surface.

Myth No. 7: Compromise — "All arbitrators ever do is 'split the baby' and wind up with a compromise decision."

This is one of the more popular myths about arbitration. There are no box scores of arbitration awards to prove or disprove this conventional wisdom. (Even in the Biblical tale, King Solomon only threatened to divide the baby to test which was the real mother; in the end, one woman was awarded the baby intact.) All I can say is it has not been my experience, either as a lawyer or arbitrator. An informal survey I've conducted disproves this myth, too. It may be true that, due to the increased use of arbitration and the power to hear all kinds of cases (e.g., antitrust) and grant all kinds of relief (e.g., injunctions, punitive damages), arbitrators today feel "empowered" and less inclined to compromise. You should certainly plan for, and discuss with your client, the possibility that the award could be all or nothing.

While arbitration is a justifiably popular alternative to traditional litigation, it is not without its own complications. We need to educate ourselves and our clients to the fact that, while arbitration is touted widely as cheaper, faster, and better than a visit to the courts, "it ain't necessarily so."

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MICHAEL A. JACOBS

On PATENTS

PATENT litigation presents a variety of situations in which you may lack access to supporting facts that would be useful in initial pleading. Your patent-holder client, for example, may suspect infringement of its process patent, but be unable to obtain specific facts supporting that suspicion prior to filing a complaint because pre-litigation inspection of the defendant's process is not possible. Your alleged infringer client, on the other hand, will almost certainly want to plead invalidity based on best mode or prior use grounds but find that the other side is in sole possession of the relevant evidence. Can you plead these claims in the absence of specific factual support? If you can't, will you ever get the evidence you need in discovery to plead them subsequently? Several recent cases illustrate this conundrum.

Rule 8's Pleading Requirements

Fed. R. Civ. P. Rule 8 permits "bare bones" pleadings, and Fed. R. Civ. P. Form 16 provides a sample of a patent complaint that illustrates how simply infringement claims can be pleaded. 35 U.S.C. § 282, however, states that if invalidity is alleged, the grounds must be pleaded. How much detail do Rule 8 and section 282 require of the alleged infringer?

In the recent case of *Grid Systems Corp. v. Texas Instruments*, 771 F. Supp. 1033 (N.D.Cal. 1991) ("*Tandy/TI*"), the district court rejected a pleading that merely cited the statutory grounds for invalidity. Seeking a declaratory judgment, Tandy had pleaded that nine patents owned by TI were invalid for "failure to comply with the requirements of 35 U.S.C. §§ 101, 102, 103 and 112." The Court said:

> More importantly, conclusory pleading of the statutory language is insufficient to meet the fair notice requirement of Rule 8 in the present context. Given the complexity of the processes at issue, and the close interrelation between many of the patents controlled by TI, TI cannot assess the strength of Tandy's claims, begin to preserve relevant evidence or identify related claims or cross-claims without some indication from Tandy of the factual basis for its invalidity claims with regard to each patent.

The Court dismissed the invalidity claim with leave to amend, indicating that, if Tandy chose to amend, it "must link each challenged patent with particular defects, and allege some factual basis for each alleged defect."

The *Tandy/TI* decision raises difficult pleading questions. As the court's reference to the preservation of evidence implies, a defendant who cannot meet the decision's pleading requirements may be unable to obtain discovery relating to invalidity. But, as noted above, absent discovery, the factual basis for the allegation may be impossible to develop.

Oddly, *Tandy/TI* has never been cited in a reported decision, and as yet seems not to have had a broader impact on pleading practice. Perhaps impracticality has led it to be disregarded, or perhaps it is best read as limited to a multi-patent declaratory judgment action.

Rule 11's Reasonable Inquiry Requirement

Fed. R. Civ. P. Rule 11 requires a "reasonable inquiry" into both the facts and the law supporting a pleading and an objective basis for believing the plea to be well-founded. Two recent cases illustrate its application to patent pleading.

In *Cambridge Products Ltd. v. Penn Nutrients Inc.* 22 U.S.P.Q. 2d 1577 (Fed. Cir. 1992), Cambridge sued for infringement of a process claim. Two weeks before trial, it moved for voluntary dismissal with prejudice. Penn sought Rule 11 sanctions, arguing that Cambridge had not made a reasonable pre-filing investigation because "a simple phone call to Penn would have revealed that the method was not the same." The Federal Circuit said:

> Cambridge had tested a sample of the allegedly infringing product and had commissioned further chemical analyses and acquired documentary evidence that appeared to confirm that the product alleged to infringe fell within the chemical specifications of the patented method. Without the aid of discovery, any further information was not practicably obtainable.

Michael A. Jacobs

It held, therefore, that "Cambridge had met the Rule 11 standard for filing and maintaining its case."

By contrast, the plaintiff in *Refac International, Ltd. v. Hitachi, Ltd.* 19 U.S.P.Q. 2d 1855 (C.D. Cal. 1991), sued 118 alleged infringers without any investigation of the allegedly infringing products. The district court held that Refac had "assumed without justification that all of the accused products violated one or more of its patents, but made no reasonable (or any) investigation to confirm this." The Court thus held that Refac had violated Rule 11.

Commentary to Proposed F.R.C.P. Amendments

The commentary to the current proposed amendments to the Federal Rules of Civil Procedure states, among other things, that Rule 11 "has created problems for a party which...needs discovery...to determine if [its] belief about the facts can be supported with evidence." Because these situations in fact arise in patent litigation, the proposed revisions to Rule 11 may give some comfort to counsel in such circumstances. The revisions will amend the Rule 11 certification to include the possibility that "allegations and other factual contentions..., if specifically so identified, are likely to have evidentiary support after a reasonable opportunity for further investigation or discovery." Nonetheless, careful pre-filing investigation will remain important.

Mr. Jacobs is a partner in the firm of Morrison & Foerster.

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'Cutting-Edge' Evidence

On the extremely topical issue of film or computer recreations of crimes, our panel used a film that had been successfully kept out of a murder trial in the mid-1980s. As of the date of our presentation, there was no clear appellate court decision on the admission of such a film depiction, although there is certainly ample case law on the use of charts and diagrams.

Arguing that the film depiction of defendant's account of the crime was a careful reconstruction of the testimony of the defendant and experts, defendant moved to use the exhibit both during the trial and as part of closing argument. The defendant argued that it was nothing more than a moving diagram and should be admissible since diagrams generally are. Even if it couldn't be used as evidence, the defendant argued that it should be allowed during closing argument as merely a filmed account of what defendant's counsel would say in explanation of the events and the evidence. Moreover, defense counsel argued that, since one of the court's concerns under section 352 is prolonging trials, such concise video presentations would speed up the proceeding to the court's benefit. "A picture is worth a thousand words," and a thousand words takes a long time.

The judges voted as follows: 59 percent would allow the video as evidence; 41 percent would keep it out. Seventy-eight percent agreed that the defendant could use it in closing, and 21 percent did not. Given a murder trial, where an individual's life was at stake, these statistics provided little comfort.

One final example was used by the panel to bring the judges back to the commonplace. Three clearly argumentative charts were offered over objection from counsel. The third was a chart with a picture of a large brown bear under the caption "Operation Bear Hug." Listed down the front of the bear were the eight elements of "Operation Bear Hug," an alleged scheme of corporate espionage to undermine a merger transaction.

Plaintiff's counsel offered two arguments in support of the chart. First, since Operation Bear Hug was the secret name the defendants had given to their corporate plan, it was not prejudicial to use the bear. From the outset, this argument was in trouble. The second argument was more effective. Counsel argued that a plaintiff presenting a complicated business scheme ought to be allowed at least to list the eight elements of that scheme so the jury could follow the testimony. "I could always go up to the board and just write those items down on butcher paper while the witness testified," counsel argued. Apparently not so, according to many of the judges present. Eight percent ruled that the chart could be admitted with the bear as presented; 92 percent would not admit it. Fifty-six percent felt the chart could be used in closing argument as presented, 43 percent did not. Eighty-eight percent would allow counsel at least to write the list on butcher paper to aid the jury in understanding an expert's testimony, while 12 percent would not. Only 20 percent, however, would allow the butcher paper into evidence.

Admittedly, there is a lack of case law on many, but not all, of these issues. In addition, most of the judges in the audience were being hit with these new evidentiary issues for the first time without briefing and without time to think them through. Nonetheless, can this fully explain the wide disparity in their votes?

What consistency should we expect? In his 1921 Yale lecture entitled "Adherence to Precedent, The Subconscious Element in the Judicial Process," Justice Benjamin N. Cardozo discussed his expectation of judges "when the law has left the situation uncovered by any pre-existing rule." He concluded that "nine times out of ten, if not oftener, the conduct of right-minded men would not have been different if the rule embodied in the decision had been announced by statute in advance."

Keeping in mind Cardozo's expectation of 90 percent agreement when there was no precedent, what would he think of the results of our program? Only one judicial vote fully met the Cardozo standard. What are lawyers supposed to tell their clients about their chances in court? What does all this mean to our system of justice, which is, after all, based upon the fair presentation of information to the finder of fact? There are a number of possible conclusions.

First, we obviously need more appellate decisions in some of these cutting edge areas of evidence law. While that can generally be said for many of the areas affecting us, evidentiary issues so pervade every element of a fair trial that they compel greater attention. Second, with all due respect to the judiciary, more judicial training such as this fine CJA/Rutter Group program would help.

Would further codification or rule-making refine evidentiary questions? Is there reason to rethink the ubiquitous section 352 of the Evidence Code? Sound judicial discretion is appealing as a general concept, but as a lawyer, litigant or criminal defendant, a 50 percent chance of admitting your evidence, depending on which judge you draw, is inimical to a fair judicial system. I'm not sure, however, that redrafted evidence codes can better deal with these problems. The subtlety of evidentiary questions during complicated trials may best be left in the hands of well-informed judges.

This concept of well-informed judges leads me to my final point. Keeping in mind that these were new evidence issues decided by judges on short notice, a fully briefed and argued presentation to these judges might have resulted in greater overall consistency. The hint to the lawyer is that, when you want to present something new in court, you should take care to preview it with the judge well in advance of the moment you move it into evidence. Since judges naturally tend to be conservative about court procedures, you will reduce the risk of reflexive rejection of what may otherwise be perfectly admissible evidence, albeit in a slightly new form. Early presentation of the issue will allow the judge to become comfortable with the idea well before the critical moment of admissibility arrives.

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STEPHEN OROZA

On CREDITORS' RIGHTS

To a greater extent than we generally appreciate, creditors' rights lawyers live and practice in a world governed by beliefs not shared by many judges and juries. This "culture gap" has been felt by any commercial litigator who has ever argued to a Superior Court judge that she should rule against the letter of credit customer who refuses to pay the issuer because the customer was defrauded by the beneficiary. The judge just *knows* that this result is "wrong;" she does not want to hear the artful sophistry of those who argue that this rule is necessary to the utility of the letter of credit and that the letter of credit is necessary to commerce.

The following is a list of beliefs and values that many commercial lawyers take for granted. This concededly partial, subjective and overgeneralized list may be of use in considering how to argue your next case.

Capitalism Hurts

People who take risks earn their rewards and many who take those risks fail painfully. In a capitalist society, these are the rules of the game and the game can be, and often is, cruel. These rules are essential to protecting the legitimate commercial expectations of the parties and, unless those expectations are protected, the system will not work.

For many people, it is understandably hard to ignore the real and compelling pain of the losers in this game because to do so serves a "higher" good. Consider the retired couple who borrow to buy a bakery and find out, too late, that they are hopelessly overleveraged. The temptation is strong for the judge or jury to find, as their lawyer now claims, that the bank analysts who underwrote the loan should have told them that they could not repay it.

If the loan agreement is not enforced, however, the bank must accept the full risk of the business without the prospect of reward that drove the borrower. If this result happens often enough, loan losses force lenders to raise the cost of borrowing prohibitively or leave the market altogether, a result which helps no one.

The Hindsight Factor

Commerce is driven by differences between the way people view the future. If everyone knew what was going to happen, there would be no business deals. In order to protect the legitimate expectations of the parties, the court system must evaluate the transaction as it looked before people knew the outcome.

Often, however, judges and juries evaluate a business deal based not upon the risks the parties agreed to take, but on the ultimate result. This understandable bias causes the system to under-reward the successful players and under-penalize the unsuccessful ones. Thus insolvency courts have considered limiting the claims of purchasers of distressed securities which have risen sharply to the amount they paid for the security; they can see no social utility in "windfall profits." They do not fully appreciate the risk taken by these purchasers, who could have as easily been wiped out.

Likewise, people might try to help the failed bakery owners. Having seen the "downside" risk materialize, they may feel that the retired couple did not get what they " bargained for." What people bargain for, however, is the right to take a chance, not the right to succeed.

The Uncertainty Factor

Ordinary people who walk around in the world do not think much about whether they are being negligent. The law then has to set standards which should be intuitive to many; otherwise people will incur liability for doing something they could not have known was wrong.

Stephen Oroza

By contrast, people in business *have* to know the law applicable to them. They care less about having the law get the intuitively correct answer than about knowing what the answer is. For example, if both the bank and the customer know that a letter of credit issuer has the right to honor a conforming draw on a letter of credit despite a customer-beneficiary dispute, each can protect his interests before the transaction is undertaken. Judges who undermine this rule by imposing their sense of "fairness" on Article 5 change the rules mid-game, a result far less fair than enforcing a well-understood rule which operates harshly in some cases.

Father Knows Best: The Paternalism Factor

People who participate in the capitalist system are *presumed* to understand the laws that govern them. This presumption is *often* incorrect but is essential to the functioning of the market. If business people were excused from their commitments because they are less sophisticated than they should be, there would be no commerce.

By contrast, in the area of consumer protection, the legislature has greatly constrained the risks that consumers will suffer from their ignorance or lack of sophistication by requiring substantial disclosure to consumers and restricting their choices such as, for example, by preventing them from waiving certain rights. In context, few would argue with this result.

Many people, including judges, cannot distinguish between the very different rules which govern business professionals and their consumer counterparts. The desire to protect the foolish, however, is understandable and must be reckoned with.

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The Bily *Decision*

clude that the accountant did know the specific type of transaction reflected by the $500,000 loan. That is, the accountant knew that its opinion would be used by its client to obtain a business loan.

Section 552 makes clear that this expansive construction is inappropriate. The transaction giving rise to the claim for negligent misrepresentation must be "substantially similar" to the transaction which the accountant intended to influence. A loan of $500,000 presumably is not "substantially similar" to a loan of $10,000. A similar point was made in *Industrial Indemnity Co. v. Touche Ross & Co.*, where the court found that neither a preferred stock offering nor a subordinated debenture was a transaction substantially similar to the granting of a line of credit. 13 Cal. App. 4th at 1096. Therefore, an accountant who intended to influence the former transactions could not be sued based on negligent misrepresentations which allegedly caused the losses in the latter transaction.

Negligence vs. Negligent Misrepresentation

A third interesting issue raised by Bily is its impact on nonclients who, though precluded from bringing negligence claims, can still sue for negligent misrepresentation. The impact will be minimal if claims for negligence can be recast easily as claims for negligent misrepresentation. The typical negligence claim charges an accountant with failing to comply with generally accepted auditing standards ("GAAS") and generally accepted accounting principles ("GAAP"). Since it is standard practice for accountants to represent in their audit reports that they have complied with GAAS and GAAP, it is not difficult to conceive of instances where a claim arising from a negligent failure to comply with GAAS and GAAP can be pled as a negligent misrepresentation. It must be wondered, however, whether a negligent misrepresentation claim predicated on an accountant's general representation that, in essence, it has not acted negligently in performing its audit should survive *Bily*.

Regardless of how this issue is resolved, some negligence claims may resist reformulation as claims for negligent misrepresentation. For example, claims are often brought against accountants for negligently failing to disclose weaknesses in a client company's internal control system. Since GAAS and GAAP do not require an accountant to advise third parties of such weaknesses, failure to disclose them could not support a negligent misrepresentation claim. Moreover, accountants are often called upon to perform consulting work for clients. In these cases, an audit report may not be prepared containing representations regarding compliance with GAAS and GAAP. Therefore, even if the consulting work were performed negligently, nonclients would be unable to plead a negligent misrepresentation claim.

Finally, even where nonclients are able to convert negligence claims into claims for negligent misrepresentation, remember that the elements of the claims are different. Claims for negligent misrepresentation, unlike those for negligence, require a showing of justifiable reliance. The need for such a showing will make negligent misrepresentation claims less successful than negligence claims.

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COMING EVENTS

September 22, 1993	MCLE Dinner: *Topic to be announced* Sheraton Palace Hotel Cocktails at 6:00 p.m. Dinner at 7:00 p.m.
October 15-17, 1993	Annual Program: *Trials to the Court* La Quinta Resort near Palm Springs

Call Wendy Cornell (415) 421-6500
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