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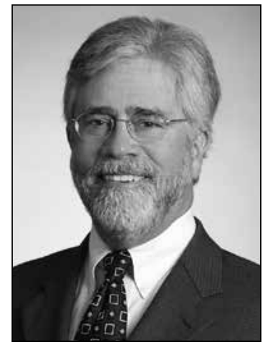
Jim Hill



The Business Law Section (BLS, or the "Section"), and particularly its Executive Committee and its advisors, many of whom are former Chairs of the Section, have been laboring doubly hard this year for our 8,000-plus BLS members, helping our **fifteen BLS standing committees** continue to produce timely publications, education programs, and legislation comments and proposals. As importantly during this 40th anniversary year of the Section, we have been actively engaged in front-line work with all sixteen sections of the State Bar and the CYLA to ensure a thriving future for the BLS and the other sections as we march toward separation from the public agency State Bar and it undergoes restructuring and reform in response to California Supreme Court and legislative mandates. We have made much progress this year helping to gain support from State Bar leadership, as well as necessary cooperation from other key stakeholders within the Legislature in drafting the enabling legislation, and from the California Supreme Court, which oversees the State Bar and, ultimately, all lawyers practicing in California.

As I drafted this Chair's Address, we received amendments introduced on April 6 in the California Legislature to the State Bar "Dues Bill," Senate Bill 36, which, if adopted, will provide for a **historic reorganization of the State Bar of California**. The bill restructures the public agency State Bar to allow it to concentrate more effectively on its core public protection missions of admissions and discipline. The amendments, introduced by Senator Hannah-Beth Jackson, Chair of the Senate Judiciary Committee, will transfer the sixteen sections, together with the California Young Lawyers Association, into a non-profit voluntary entity. Those sections, with more than 60,000 lawyer members (plus the CYLA with its 48,000 members), have operated within the State Bar structure since the sections, including the BLS, were created some forty years ago. Upon separation, the new association of sections will be the largest voluntary association of lawyers in the nation after the venerable American Bar Association.

The reasons for the separation are summarized in Senate Bill 36's legislative findings. Although accurate, those findings only begin to tell the story of an increasingly restrictive environment in which the sections had been forced to operate for many years. Some of the relevant legislative findings are as follows:

> (g) Whereas the regulatory and non-regulatory functions of the State Bar of California are each strengthened by a separation of governance, staff, and budgets that enables the Board of Trustees of the State Bar to focus on its primary mission of public protection through regulatory oversight while **allowing and enhancing the ability of the Sections of the State Bar to advance the public interest** by providing educational programs and materials to members of the State Bar and the public (including low- or no-cost mandatory continuing legal education (MCLE)), proposing legislation, rule changes, regulations, and similar acts, and providing expertise and comments on pending, or proposed legislation, rule changes, regulations, and similar acts, and advancing the competent and ethical practice of law, thereby enhancing protection of the public and access to justice for all.

Key features of that legislation include freeing the sections, as part of the new voluntary association, to begin meeting and **communicating without Bagley-Keene restrictions** and other open meeting laws that have so hampered our activities for the past year. The bar-restructuring legislation ensures that the assets of the sections will be delivered to the new association, including our significant financial reserves, our sources of revenues, our intellectual property, our years of work product, our membership lists, and much more. Little is intended to change in the missions and functions of the sections. Much will improve as the sections are freed from the regulatory restrictions of a governmental agency and can operate more economically and more effectively to serve our members.

At this juncture, a number of the primary stakeholders, including the President of the State Bar, its Board of Trustees, the Chief Justice of California, and a number of the prominent legislators, including Senator Jackson, author of the dues bill, and many of the leaders of the State Bar sections, are working cooperatively to insure a successful separation and **creation of the new non-profit association** in which all of the existing sections will continue their historic functions in an improved, positive, and functioning environment.

While working on the legislative front with other sections, the BLS and other sections have been helping to develop and put into place an **effective transition plan**. Consultants and experts are being engaged to work on the rollout of the new entity and to help all of us more effectively communicate with members about our plans for the future. Thus, expect to receive updates more than just in this Chair's Address, but in all other forms of media available to us.

As we move through this process, our collective task is to prove to you our continuing relevance and value as we provide you substantive case law, legislation, and regulatory updates through timely e-Bulletins, webinars, desk guides, articles, and other education programs. Many of our Standing Committees will be presenting programs at the **Convention of State Bar Sections** (formerly, the educational side of the State Bar Annual Meeting) on August 18-19, 2017 in San Diego, California, where you hopefully will be joining us. At the Convention, you are invited to attend our **BLS Annual Breakfast,** at which we will bestow an outstanding California business lawyer with the BLS's coveted lifetime achievement award, followed by a keynote speaker on a topic of interest to business lawyers. We also invite you, as a member of the BLS, to attend the BLS Standing Committee reception and networking event, where you can mingle and get to know California's leading business lawyers and other honored guests. Finally, throughout the year, you are invited to participate in any of our Standing Committees' regular monthly or bi-monthly meetings, at which important substantive law developments are discussed and at which many Standing Committees offer meaningful continuing legal education programs.

To the extent that you are currently active in the BLS, or for that matter, in any of the other sections, I hope that you will provide support for the hard work that will be necessary to accomplish the separation and creation of the new voluntary organization in which the sections will operate in the future. The sections provide enormously valuable contributions, on so many different levels, to all lawyers in California. In short, this is an important and challenging time of transition. Please let us know how we can better serve you, and join us as we build a new future for the BLS, for its sister sections, and for all California lawyers.

BLN Editorial Board: Message from the Editor

Ken Minesinger

Welcome to Issue 2 2017 of the Business Law News. In addition to an update from the Chair of the business law section, James Hill, this issue of the Business Law News features five insightful articles that I hope will be of interest.

First up is an article by author David Shaneyfelt dealing with large deductible workers' compensation policies and how they can be used as a tool by California employers to reduce the amount they pay in premiums.

Next, we have an article from authors Laura Reathaford and Benjamin Stockman that updates our readers on wage and hour laws when applied to commission-based compensation.

The third article is by author Kevin Sullivan, and reviews meal period waivers in light of the recent California court of appeals decision in *Garard.*

Next is an article from D.C. Toedt on how a recent supreme court of Delaware holding might motivate contract drafters to define the term "commercially reasonable efforts."

Finally, our fifth and final article comes to us from author Robert Wood. Mr. Wood's article educates California business lawyers on how to advise clients when responding to IRS notices.

Finally, I'm thankful for the countless hours spent by our volunteer authors and editors to produce this issue. If you would like to be a part of the Business Law News, either as an author or an editor, please contact me directly at minesinger@gmail.com.

Claims Against the Claims Handlers Under Large Deductible Workers' Compensation Insurance Policies

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David A. Shaneyfelt

Large deductible workers' compensation insurance policies arose in the late 1980s and early 1990s following a market crisis in which employers were unable to obtain required workers' compensation coverage from private insurers. The concept is simple. Employers can greatly reduce the amount of workers' compensation premiums they pay for employees if they agree to assume a large portion of the risk themselves—through a "high deductible" (commonly between $250,000 and $500,000)—after which insurance assumes exposure for amounts above that deductible.[1]

Under this notion, incentives exist for both employers and insurance companies to control costs incurred in managing workers' compensation claims. Because the employer is assuming risk on a dollar-for-dollar basis up to the limit of a high deductible, the employer has an incentive to ensure that workers' compensation claims are handled reasonably. Moreover, the employer has an incentive to keep the claim from exceeding the deductible, because the employer's subsequent risk ratings will normally increase when a claim exceeds the deductible, which will translate into higher premiums in subsequent policy periods. At the same time, once a claim exceeds the deductible, the insurance company has an incentive to handle the claim reasonably, because it is absorbing costs above the deductible.

But the critical feature of large deductible insurance policies is claims handling done for a fee charged to the employer. Because most employers lack personnel or expertise to adjust workers' compensation claims, they are eager to accept the offers of insurance companies to adjust those claims on their behalf. Under the typical arrangement, the insurance company (or its delegatee, a "third party administrator") undertakes the full scope of claims management—investigating the claim, challenging coverage if appropriate, managing medical treatment, reviewing medical bills, negotiating liens, seeking apportionment from third-parties, adjusting reserves, and settling claims.

The insurer advances expenses for such services under security (typically, a letter of credit) that the employer posts in case of default on amounts due. The insurer then bills the employer for services provided, and a tally is kept until the expenses reach the deductible. After the deductible is met, the insurer absorbs all remaining expenses itself (unless the policy arranges for the employer to share some percentage of ongoing expenses). Underwriters at the insurer determine the premiums to be paid, so this arrangement is suitably profitable for the insurer.

But trouble arises when the employer suspects the insurer is not adjusting the claims reasonably. What confidence does the employer have that the insurance company, with its interlocking bureaucracy of contractors and subcontractors and its own scale of profit for claims handling, is adjusting claims reasonably? As far as the employer is thinking, "*It's easy to spend money when it isn't yours*."

Surprisingly little case law exists regarding employers' claims against insurance companies under large deductible insurance policies. The reasons for that are many: the difficulty in proving mismanagement of claims, the ebb and flow of market forces that allow employers and insurance companies to renegotiate policy premiums in subsequent years, an employer's tendency to view losses as "sunk costs," an insurance company's reluctance to pursue collection efforts against an employer beyond a draw of a letter of credit, the existence of mandatory arbitration provisions, and, most importantly, whether the amount at issue is worth the costs of litigation in trying to recover it.

But sometimes the losses at stake compel a judicial resolution. Losses come in at least two ways. First, workers' compensation claims can be expensive to both administer and settle. Multiple claims mean multiple claims management expenses, and if mismanagement has occurred on multiple claims, the employer ends up paying considerable out-of-pocket expenses that it should never have had to pay. For example, claims mismanagement on just twenty claims files that each have a $250,000 deductible can mean losses of up to $5 million. Second, the more claims management expenses an employer incurs, the more its premiums will increase in subsequent policy periods. Workers' compensation premiums are typically set in reference to experience modification rates (called "Ex Mod" rates) assigned to classes of employees. The higher the amount of claim expenses, the higher the Ex Mod rate in subsequent years. Claims mismanagement results in higher premiums because of higher Ex Mod rates. Even a small bump in an Ex Mod rate can result in a significant premium differential, given a sizeable workforce.

In addition, because big workers' compensation claims take years to resolve, amounts wrongly paid over time can result in large interest losses. Finally, the employer can sustain various tangible and consequential losses if the insurer wrongly draws on the letter of credit or other security. When losses like these occur, and the insurance company refuses to acknowledge them, an employer may find it has no choice but to seek recourse through litigation to recover its losses.

A Contract is a Contract

As even the scant case law in this area confirms, general principles of insurance law govern the relationship between the employer and the insurance company accused of claims mismanagement.[2] The relationship is one of contract, and policy terms generally control. What makes claims against an insurance company under a large deductible policy unique is that such policies are a hybrid between first-party and third-party liability insurance.

The policy is a third-party policy to the extent it requires the insurer to defend and indemnify the employer against workers' compensation claims. Workers' compensation policies often contain a clause that provides, "We have the right and duty to defend at our expense any claim, proceeding or suit against you for benefits payable by this insurance." In cases involving a policy with such a clause, the duty to defend is widely recognized under law, and the insurance company is obligated to (a) investigate claims reasonably and promptly; (b) provide a defense if a potential for liability exists; and (c) attempt to effect timely, reasonable settlements of third-party claims within policy limits.[3]

But the policy is also a first-party policy to the extent it promises to pay benefits due, and such benefits run the gamut of claims administration expenses (such as intake, treatment, billing review, and lien negotiation). Although the insurer advances expenses on behalf of the employer, the employer is ultimately responsible for those expenses. In such a case, the employer expects to receive benefits due under the policy and presumes the insurance company will: (a) have made a thorough and prompt investigation of whether the expenses for the insured's benefits are justified; (b) if the expenses are justified, pay the expenses of those benefits without unreasonable delay; and (c) perform services reasonably.[4]

The insurer's duties are express under the terms of the policy or are implied as a matter of law. The insurer must: (1) complete timely and appropriate investigations of claims; (2) manage medical treatment properly; (3) object to claimants seeking treatment for additional unrelated injuries; (4) pursue apportionment from third parties responsible for claimant injuries; (5) charge reasonable rates for reviewing and adjusting medical bills; (6) reasonably set or adjust loss reserves; and (7) settle claims reasonably. If the insurance company breaches one or more of these duties, the employer has a claim for breach of express or implied contract. In such a case, the employer also has a claim for breach of the covenant of good faith and fair dealing, because an implied covenant exists in every contract such that "neither party will do anything which will injure the right of the other to receive the benefits of the agreement."[5]

> [T]he essence of the implied covenant of good faith and fair dealing is that the insurer must refrain from doing anything that will injure the right of the insured to receive the benefits of the insurance agreement, the terms and conditions of which define the duties and performance to which the insured is entitled.[6]

What makes an employer's claim against its insurer for breach of contract unique is that the claim is proved by way of negligence—the insurer owes a duty to manage claims reasonably. The insurer breaches that duty when it fails to adjust claims according to the standard in the insurance industry. However, the claim is not for negligence, because "negligence is not among the theories of recovery generally available against insurers."[7] Such claims are tantamount to claims for professional negligence proven through a claim for breach of contract.[8]

Remedies available to an employer against its insurer for breach of contract and breach of the covenant of good faith and fair dealing include all economic losses sustained, such as (1) losses for overpayment of claims (i.e., the difference between the amount the employer actually paid due to claims mismanagement and the amount the employer would have paid if there were no mismanagement); (2) losses for overpayment of premiums (i.e., the difference between the amount of actual Ex Mod rate and the putative amount of Ex Mod rate); (3) loss of interest for claims expenses wrongfully paid; and (4) losses due to any wrongful draw on a letter of credit or other security, including consequential damages resulting from that draw (such as lost business contracts, bank fees, and other interest).[9] In addition, to the extent the employer can show the insurer's conduct was "unreasonable" in any of the above respects, the employer can recover attorneys' fees.[10] In extreme cases, an employer can claim punitive damages.

Another potential claim an employer may assert is for "unfair business practices" under section 17203 of the California Business and Professions Code. Section 17203 provides, "Any person who engages, has engaged, or proposes to engage in unfair competition may be enjoined in any court of competent jurisdiction." Section 17200 of that Code defines "unfair competition" to include "any unlawful, unfair or fraudulent business act or practice." Arguably, an insurance company that wrongfully and unreasonably mismanages workers' compensation claims engages in "unfair competition" under section 17203. Remedies for violations of section 17203 include restitution and injunctive relief.[11] Moreover, section 1021.5 of the California Code of Civil Procedure authorizes an award of attorneys' fees when a party seeks to enforce important rights affecting the public interest. Arguably, a party is acting in the public interest when the party forces a large insurance company to (a) cease charging excessive and unwarranted claims-related expenses to itself and its favored contractors; and (b) cease imposing higher premiums because of unwarranted increases in an employer's Ex Mod rate.[12]

Not surprisingly, proving that an insurance company's claims management agent mishandled claims involves competing experts who will opine on whether and how the agent mishandled claims and the extent to which such mishandling damaged the employer. An employer that suspects that claims mismanagement has occurred should contact an outside specialist and have that suspicion confirmed before launching into costly litigation.

Limits of Statutes of Limitations

Large deductible insurance policies present a host of untested and thorny issues related to the statute of limitations. Generally, an employer has four years in which to bring an action for breach of contract under California law.[13] Less clear is the statute applicable to actions for breach of the covenant of good faith and fair dealing, because that action is based on a tort, not a contract. Courts have indicated that a two-year statute applies to a claim for a breach of the covenant of good faith and fair dealing.[14] The primary difference between the two types of claim is in the type of damages available to the employer, because, unlike a claim for breach of contract, a claim for breach of the covenant of good faith and fair dealing can entitle the plaintiff to damages for emotional distress, attorneys' fees, and punitive damages.

Under either claim, issues abound. When does the statute of limitations begin to run? A breach of contract accrues when the contract is breached.[15] Thus, in the case of a first-party coverage contract, the claim accrues upon the insurer's unconditional denial of the insured's claim.[16] But this event is unlikely to occur in the context of back-and-forth billing activity and communications between the employer and the insurer regarding a claim. A claim for claims mismanagement is much larger than a claim for improper billing entries. Such a claim addresses the entire handling of the claim, again, akin to a claim for negligence by a professional. Further, such a claim may involve not only a breach of the duty to defend, but incursion of expenses not otherwise owed, or of services rendered improperly.

In claims for professional negligence, an action typically accrues when appreciable harm occurs and, in contract actions, that means when the contract is breached.[17] However, under the "discovery rule," the accrual of a cause of action is postponed "until the plaintiff discovers, or has reason to discover, the cause of action."[18] An employer that suspects claims mismanagement should investigate promptly and determine the facts or risk having the statute run from when the employer first started raising objections to the insurer's conduct.[19] In legal malpractice cases, the statute will be delayed until after the attorney ceases to represent the client in the same case.[20] The "discovery rule" seems plausibly applicable here, because the insurer has effectively undertaken continuous representation of the employer and the employer cannot reasonably be expected to sue its insurance company while that representation remains pending.

Unfortunately, the "discovery rule" fails to provide guidance on whether the statute of limitation runs as to each claim the insurer manages or whether it is tolled until the last act under any claim under the policy—which may well be many years after other individual claims are resolved. Courts might apply the rule applicable to "divisible" contracts: Where a contract is divisible, breaches of its severable parts will give rise to separate causes of action, and the statute begins to run at the time of each breach.[21] In that case, the insurer's negligent claims handling of one claims file may have its own separate (four-year or two-year) statute of limitations that would not toll while the insurer continues to manage other claims files for the employer.

On the other hand, if the insurance company is making the same kinds of errors across multiple claims files, the employer may avail itself of the "continuing violation doctrine," which would allow the employer to recover not only for the actions that took place during the statute of limitations period, but also for the insurer's misconduct that occurred outside the period and across multiple claims files, provided such misconduct is "sufficiently linked" to the insurer's conduct during the limitations period. Because "[e]ach new breach of an obligation provides all the elements of a claim—wrongdoing, harm, and causation," multiple acts of mismanagement on a claims file (or on other claims files) may revive otherwise dead claims.[23]

Finally, these issues are complicated by the different types of claims an employer might assert against the insurer. The statute applicable to an employer's claim that the insurer failed to settle a claim reasonably may be different than the employer's claim that the insurer overcharged the employer for claim expenses. The former is akin to a breach of the duty to defend, while the latter is akin to a breach of the duty to pay benefits due on a policy.

Defenses to Anticipate

Not surprisingly, an insurance company may raise several defenses in response to charges of claims mismanagement. The "account stated" defense argues that the employer is barred from contesting amounts owed because the employer already agreed to the charges on "accounts" established between them. Related defenses include defenses of "voluntary payment" (on grounds the employer already paid the charges) and "waiver" (on grounds the employer waived its right to challenge the charges). Nevertheless, all of these defenses are predicated on the notion that the employer knew of claims mismanagement and failed to act on it—a notion that can be disputed if the employer lacked knowledge of facts that would have enabled it to know that claims mishandling was occurring.

Other defenses include "unclean hands" and "equitable estoppel," in which cases the insurer attacks the employer and accuses the employer of "bad conduct," such as in not reporting workers' compensation claims timely, settling employee claims under the insurer's radar, and withholding information about workplace safety. Such are the usual counter-attacks that occur when one party accuses another party of negligence. They are fact-based issues to be resolved at trial and before a jury that is unlikely to sympathize with the insurer.

Conclusion

An employer may be justified in thinking that an insurance company has found it easier to spend the employer's money when managing workers' compensation claims under a large deductible insurance company. Still, the employer must act on that thinking quickly and cautiously. Further, if the employer's losses are substantial, it must quantify them and pursue them quickly.

Endnotes

1 *See* Workers' Compensation Large Deductible Study, Nat'l Ass'n of Ins. Comm'rs/ Int'l Ass'n of Indus. Accident Bds. and Comm'ns Joint Working Grp. (Mar. 2006), http://www.naic.org/store/free/WCD-OP.pdf.

2 Reported cases on an insurer's liability for claims mismanagement in California are few and old and do not concern large deductible insurance policies. *See, e.g.,* MacGregor Yacht Corp. v. State Compensation Ins. Fund, 63 Cal. App. 4th 448 (1998) (workers' compensation insurer breached duties in failing to conduct follow-up investigations of claims and in denying claims with the statutory sixty-day period); Notrica v. State Compensation Ins. Fund, 70 Cal. App. 4th 911 (1999) (insurer was properly liable for an "unfair business practice" in over-reserving for workers' compensation claims which allowed it to charge higher premiums to the employer); Lance Camper Mfg. Corp. v. Republic Indem. Co. of Am., 90 Cal. App. 4th 1151 (2001) (affirming jury award of $6.3 million in compensatory and punitive damages claim of employer against workers' compensation insurer for improper claims reserves).

3 Comunale v. Traders & Gen. Ins. Co., 50 Cal. 2d 654, 658 (1958). *See also* Merritt v. Reserve Ins. Co., 34 Cal. App. 3d 858, 882 (1973) (In undertaking its duty to defend, an insurance company assumes the duty "to employ competent counsel to represent the assured and to provide counsel with adequate funds to conduct the defense of the suit"); Amato v. Mercury Cas. Co., 53 Cal. App. 4th 828, 831 (1997) ("Breach of an insurer's duty to defend violates a contractual obligation and, where unreasonable, also violates the covenant of good faith and fair dealing, for which tort remedies are appropriate.").

4 Silberg v. Cal. Life Ins. Co., 11 Cal. 3d 452, 461-62 (1974); Cal. Shoppers, Inc. v. Royal Globe Ins. Co., 175 Cal. App. 3d 1, 54-55 (1985).

5 *Comunale*, 50 Cal. 2d at 658-59, 663. *See also MacGregor Yacht Corp.*, 63 Cal. App. 4th at 477-78 (citing Tricor Cal., Inc. v. State Compensation Ins. Fund, 30 Cal. App. 4th 230, 240 (1994)) ("Because the powers so confided in SCIF's discretion will impact the degree of plaintiff's primary burden under the policy, it appears logical that the covenant of good faith and fair dealing indeed requires SCIF to conduct its claims resolution and reserve allocation processes with good faith regard for plaintiff's interests.").

6 Brandwein v. Butler, 218 Cal. App. 4th 1485, 1514-15 (2013) (brackets, emphasis, and internal quotes omitted).

7 Tento Intern., Inc. v. State Farm Fire & Cas. Co., 222 F.3d 660, 664 (9th Cir. 2000) (quoting Sanchez v. Lindsey Morden Claims Svs., Inc., 72 Cal. App. 4th 249, 254 (1999)). *See also* Benavides v. State Farm General Ins. Co., 136 Cal. App. 4th 1241, 1250 (2006) ("[A] bsent coverage, there is no tort liability for improperly investigating a first-party insurance claim whether the insurer's conduct is characterized as an implied covenant breach or negligence.").

8 *See* Everett Assoc., Inc. v. Transcontinental Ins. Co., 159 F. Supp. 2d 1196, 1203-04 (N.D. Cal. 2001) (while "California courts have not treated [an insurer's] negligent investigation as a separate cause of action in negligence," the better approach "is to treat negligent investigation as a predicate for breach of the duty to defend and, if wrongful, a breach of the implied covenant.").

9 *Silberg*, 11 Cal. 3d at 462; Archdale v. Am. Int'l Specialty Lines Ins. Co., 154 Cal. App. 4th, 449, 467 (2007).

10 Brandt v. Sup. Ct., 37 Cal. 3d 813 (1985).

11 Zhang v. Sup. Ct., 57 Cal. 4th 364 (2013).

12 Whether a claim for unjust enrichment may exist is doubtful. While traditional notions would indicate that an insurance company has been "unjustly enriched" by keeping and spending the employer's money unreasonably, courts recently have indicated that the proper remedy is a "quasi-contract claim" seeking restitution, not a stand-alone cause of action for unjust enrichment. Astiana v. Hain Celestial Grp., Inc., 783 F.3d 753 (9th Cir. 2015).

13 Cal. Civ. Proc. Code § 337.

14 § 339(1); Richardson v. Allstate Ins. Co., 117 Cal. App. 3d 8, 13 (1981); Smyth v. USAA Prop. & Cas. Ins. Co., 5 Cal. App. 4th 1470, 1477 (1992).

15 Romano v. Rockwell Int'l, Inc.,14 Cal. 4th 479, 488 (1996).

16 State Farm Fire & Cas. Co. v. Sup. Ct., 210 Cal. App. 3d 604, 609 (1989).

17 *Romano*, 14 Cal. 4th at 488.

18 Fox v. Ethicon Endo-Surgery, Inc., 35 Cal. 4th 797, 807 (2005). *See also* Cal. Civ. Proc. Code § 340.6, which provides that an action for legal malpractice must be commenced "after the plaintiff discovers, or through the use of reasonable diligence should have discovered, the facts constituting the wrongful act or omission."

19 Jolly v. Eli Lilly & Co., 44 Cal. 3d 1103, 1110-11 (1988).

20 *See* Cal. Civ. Proc. Code § 340.6(a)(2) (Generally, time for commencement of legal action against attorney for malpractice shall not exceed four years, except that period shall be tolled during the time "the attorney continues to represent the plaintiff regarding the specific subject matter in which the alleged wrongful act or omission occurred"); *see also* Beal Bank, SSB v. Arter & Hadden, LLP, 42 Cal. 4th 503, 511 (2007) (applying section 340.6(a)(2) to toll claims as to the attorney *and the attorney's former law firm and its attorneys* when the attorney continues to represent the client in the same specific subject matter).

21 Armstrong Petroleum Corp. v. Tri-Valley Oil & Gas Co., 116 Cal. App. 4th 1375, 1388-89 (2004).

22 Richards v. CH2M Hill, Inc., 26 Cal. 4th 798, 812 (2001); Aryeh v. Canon Bus. Sols., Inc., 55 Cal. 4th 1185, 1198 (2013).

23 *Aryeh*, 55 Cal. 4th at 1199.

Avoiding Labor Entanglements for Commission-Earning Employees in a Changing Legal Landscape

Laura Reathaford and Benjamin Stockman

Laura Reathaford is a partner in Venable's Labor and Employment Group. She focuses her practice on management-side employment litigation, with an emphasis on wage and hour collective and class actions, including representative actions under the Private Attorney General Act (PAGA). In addition to defending employers in high-stakes litigation matters, Laura regularly advises clients on employment issues including terminating employees, drafting employee handbooks, and complying with wage and hour laws, as well as leave and disability rules.

Benjamin Stockman is an associate in Venable's Labor and Employment Group. His practice is focused on a broad range of matters involving wage and hour law, employment discrimination, equal pay law, family and medical leave law, disability law, employee discipline and termination, and traditional labor matters, including defending companies in proceedings before the National Labor Relations Board.

Employers have paid salespeople by commission for centuries.[1] Commission pay is popular because it attempts to align the interests of employers and employees in a "win-win" compensation relationship.[2] Companies also like commission-based pay plans because the success of salespeople is easy to track with little supervision.[3] Studies have shown that salespeople generally are more tolerant of risk and favor a compensation arrangement that rewards success with a potential financial upside.[4]

Despite the historical popularity of commission pay, there appears to be a surge of litigation in California targeting employers who pay employees a commission. Several decisions in recent years have complicated life for employers who attempt to navigate California's complex wage and hour laws. For instance, as most California employers are probably aware, they must provide nonexempt employees with a ten-minute rest break for every four hours of work or every major fraction thereof.[5] Employees must also receive compensation for this time even though they technically are not working.[6]

In *Vaquero v. Stoneledge Furniture, LLC*, a California appellate court ruled that employees paid by commission must be *separately* compensated for their rest breaks—even if they are guaranteed the minimum wage for all hours worked.[7] Under Stoneledge's commission agreements, sales employees were paid on a commission basis.[8] If an employee failed to earn an amount of commission equal to at least $12.01 per hour for time worked, then Stoneledge "topped up" the employee's commissions to cover the difference.[9] If in subsequent pay periods the employee earned commissions in excess of $12.01 per hour, Stoneledge charged back the amount it had topped up in the prior pay periods.[10] However, the commission agreements expressly stated that repayment would not be taken if it would result in earnings of less than $12.01 per hour for all hours worked in any week.[11] In other words, employees were always paid at least $12.01 per hour for all hours worked, including all time spent on rest breaks.[12] The trial court granted Stoneledge summary judgment, finding that Stoneledge's commission arrangement and minimum pay threshold guaranteed that employees' rest periods were compensated at least at $12.01 per hour.[13] The appellate court disagreed, finding that the recoupment of the draw from future commissions effectively nullified the hourly pay, which is the only way employees can be paid for rest breaks.[14]

The *Stoneledge* court acknowledged that California law requires separate compensation for rest breaks only if the compensation agreement does not include minimum hourly wages.[15] Had Stoneledge simply paid its salespeople this hourly rate regardless of commissions earned, presumably it would not have violated the rest break rule.[16] According to the court, the problem with Stoneledge's commission agreement was twofold: first, the court believed that the charge-back provision effectively nullified the minimum hourly wage guarantee; and secondly, the court found that it was impossible to determine whether employees earning commission only (i.e., those with sales commissions totaling more than the minimum hourly rate) were compensated for rest breaks.[17]

Curiously, in a prior decision from 2005, this same appellate court had lauded commission pay systems as a long-standing and proper practice under the California Labor Code.[18] In *Steinhebel v. Los Angeles Times Communications, LLC*, the court noted that such practices benefitted employees, because they provided them with present income subject to adjustment based on future commissions.[19] On its face, Stoneledge's charge-back provision seemed consistent with *Steinhebel,* since charge-backs were not implemented if doing so meant decreasing an employee's pay below the $12.01 hourly guarantee.[20] As noted in *Steinhebel,* "prior cases have sanctioned arrangements whereby an employer makes advances on commissions to employees and later reconciles any overpayments."[21] Unfortunately, the *Stoneledge* decision made no reference to *Steinhebel,* and leaves employers with many unanswered questions: for example, whether Stoneledge's compensation agreement would have passed muster under the law without the charge-back provision, or, conversely, whether the agreement would have been proper had Stoneledge merely made a written accounting of rest pay within the commission compensation framework. Although the court did not address these important questions, a procedural point in the case history lends some guidance. Presumably in response to the lawsuit, Stoneledge changed its commission agreement from the system that was challenged in the lawsuit to a system that paid employees a base hourly wage for all hours worked without any draw on future commissions, and provided additional compensation incentives based on sales percentages on top of the hourly wage.[22] The date that Stoneledge instituted this change served as the cutoff for the class action period, which suggests that the parties agreed that this new system complied with California law.[23] The novel and interpretive nature of this decision, and the fact that it reversed the decision in the trial court, makes it ripe for appeal to the California Supreme Court. It remains to be seen whether this decision will ultimately establish a new rule for commission-based employees.

In *Peabody v. Time Warner Cable, Inc.*, the California Supreme Court wrestled with how employers should compensate commissioned employees who are exempt from overtime.[24] Peabody was a former commissioned salesperson who sold cable television advertising for Time Warner.[25] The commission plan paid her the minimum wage ($8.00) for forty hours per week and a commission based on sales at the end of every month.[26] Time Warner treated the plaintiff as an employee exempt from overtime pay based on the rule that commissioned salespeople who earn an hourly rate of one and one-half times the minimum wage ($12.00) are exempt from receiving overtime pay.[27] When Time Warner paid Peabody her commissions at the end of each month, it combined this amount with her minimum hourly wages to reach an average hourly wage above the $12.00 threshold.[28]

The *Peabody* court found this arrangement to be inconsistent with California law.[29] The court held that commissioned employees must be paid at least $12.00 per hour in *each weekly pay period* to qualify for the overtime exemption regardless of whether the commission agreement only provided for commission payments on a monthly basis.[30] According to the court, Time Warner failed to comply with the exemption rule, because commissions can be counted toward the overtime exemption threshold only *in the pay period in which they are earned*.[31] Arguably, this holding makes it much more likely for a commission-based employee's status to change from overtime exempt to nonexempt, depending on how much commission the employee earns from week to week.

As opposed to disputes involving whether commissioned sales people are exempt from overtime, another class of commission cases, such as the examples that follow, arises from claims by nonexempt employees who are paid on an hourly basis and work overtime. Under the Fair Labor Standards Act (FLSA), for example, commissions are payments for hours worked, and must be included in the regular rate for computing overtime.[32] In *Lemus v. H&R Block Enterprises LLC*, plaintiffs alleged that H&R Block failed to include commission in the regular rate of pay for approximately 18,000 tax preparers employed in the state of California.[33] After litigating the case for approximately three years, the plaintiffs eventually settled for $35 million, including approximately $12 million in attorneys' fees.[34] In another case, *Bland, et al v. PNC Bank, N.A.*, PNC Bank recently agreed to a settlement payment totaling $16 million for a collective action of mortgage loan officers under the FLSA.[35] The plaintiffs alleged that the employer violated the FLSA by excluding commissions earned from the calculation of overtime and by deducting overtime pay from subsequent commissions.[36]

In addition to lawsuits, employers may find themselves targeted by federal or state labor departments for failing to properly calculate a regular rate of pay for commission-earning employees. For instance, Texas-based Harris Health System found itself in the crosshairs of a U.S. Department of Labor investigation into systematic wage violations, including a failure to include incentive pay in calculating overtime.[37] Harris Health ultimately agreed to pay more than $4 million to resolve the investigation.[38]

These decisions and settlements have undoubtedly eroded some of the principles that once made commission agreements attractive for employers. Now employers are forced to analyze variations in a commission-based employee's hours and duties on a weekly basis to ensure compliance with overtime and rest break rules, along with maintaining meticulous records to ensure that employees are properly paid.

Generally, the legal landscape is guided by California's well-documented public policy favoring the protection of workers. That said, these cases may cause employers like Stoneledge to move away from commission compensation arrangements most favored by salespeople to pay systems that offer a reduced upside for good sales performance. Rather than navigating the opaque web of case law on commission labor rules and risking penalties as onerous as liquidated damages under the FLSA, for example, employers may opt for a less entrepreneurial approach to sales pay. Ultimately, this more conservative approach hurts employees' pockets more than anything else.

Endnotes

1 Doug J. Chung, *How to Really Motivate Salespeople*, HARV. BUS. REV. (April 2015), https://hbr.org/2015/04/how-to-really-motivate-salespeople.

2 *See id.*

3 *Id.*

4 *Id.*

5 CAL. LAB. CODE § 226.7; Cal. Wage Order No. 7-2001.

6 § 226.7; Cal. Wage Order No. 7-2001.

7 Vaquero v. Stoneledge Furniture, LLC, 9 Cal. App. 5th 98, 117 (Ct. App. 2017), *as modified* Mar. 20, 2017, *review filed* Apr. 10, 2017 (emphasis added).

8 *Id.* at 103.

9 *Id.*

10 *Id.*

11 *Id.*

12 *Id.*

13 *Id.* at 104.

14 *Id.* at 110-15.

15 *Id.*

16 *Id.*

17 *Id.* at 110-16.

18 Steinhebel v. L.A. Times Commc'ns, 126 Cal. App. 4th 696 (Ct. App. 2005).

19 *Id.*

20 *Stoneledge Furniture, LLC*, 9 Cal. App. 5th at 117.

21 *Steinhebel*, 126 Cal. App. 4th at 707.

22 *Stoneledge Furniture, LLC*, 9 Cal. App. 5th at 103.

23 *Id.*

24 Peabody v. Time Warner Cable, Inc., 328 P.3d 1028, 1031-32 (Cal. 2014).

25 *Id.* at 1030.

26 *Id.*

27 *Id.* at 1030-31; Cal. Wage Order No. 4, subdiv. 3(D).

28 *Peabody*, 328 P.3d at 1030-31.

29 *Id.* at 1033.

30 *Id.* at 1032.

31 *Id.* at 1032-33.

32 29 C.F.R. § 778.117.

33 Lemus v. H&R Block Enters., LLC, No. 3:09-cv-03179-SI, Dkt. # 163, (C.A.N.D. Aug. 22, 2012).

34 *Id.*

35 Bland v. PNC Bank, N.A., No. 2:15-cv-01042-AJS, Dkt. # 365 (P.A.W.D. Apr. 11, 2017).

36 *Id.*

37 Jeremy Heallen, *Harris Health Pays $4M In Back Wages to End DOL OT Probe*, LAW360 (Sept. 16, 2013), https://www.law360.com/articles/473174/harris-health-pays-4m-in-back-wages-to-end-dol-ot-probe.

38 *Id.*

California Court of Appeal Reverses Previous Decision and Affirms the Use of Second Meal Period Waivers for Healthcare Employers

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Employers in California—and healthcare employers in particular—have been besieged by wage-hour class actions for more than a decade. They have been sued repeatedly on claims that they failed to comply with the terms of California's Labor Code and Industrial Welfare Commission ("IWC") wage orders. The IWC issues industry-specific wage orders with which employers are expected to comply. The California Supreme Court has confirmed that "wage and hour claims are today governed by two complementary and occasionally overlapping sources of authority: the provisions of the Labor Code, enacted by the Legislature, and a series of eighteen wage orders, adopted by the IWC."[1] Consequently, the failure to comply with the Labor Code or an IWC wage order may lead not only to agency investigations, but to class action lawsuits seeking damages, a variety of penalties, interest, and attorney's fees.

In 2012, the California Supreme Court held that Labor Code section 512 generally requires employers to provide an uninterrupted meal period of at least thirty minutes when an employee works more than five hours in a single workday.[2] An employee may waive that meal period if no more than six hours are worked in that day.[3] And when an employee works more than ten hours in a single workday, California law generally requires employers to provide a second uninterrupted meal period of at least thirty minutes, "except that if the total hours worked is no more than 12 hours, the second meal period may be waived by mutual consent of the employer and the employee only if the first meal period was not waived."[4] (Moreover, "absent waiver, section 512 requires a first meal period no later than the end of an employee's fifth hour of work, and a second meal period no later than the end of an employee's 10th hour of work."[5])

However, employers in the "healthcare industry"[6] have long relied on a provision in IWC Wage Order No. 5[7] that permitted "employees in the healthcare industry"[8] to waive their second meal periods even if they worked longer than twelve hours in a single workday. But in February 2015, the California court of appeal issued a decision that exposed healthcare employers to litigation if they relied upon that very provision in using second meal period waivers.

That decision was *Gerard v. Orange Coast Memorial Medical Center* ("*Gerard I*"),[9] where three employees had sued their hospital employer in a putative class and representative action under California's Private Attorneys General Act ("PAGA"),[10] alleging that the "hospital policy illegally let health care employees waive their second meal periods on shifts longer than 12 hours."[11] Relying on Wage Order No. 5's provision permitting employees in the healthcare industry to waive second meal periods when working more than twelve hours in a day, the trial court granted summary judgment to the employer. But the Fourth District Court of Appeal reversed, concluding that it was improper for an employer to rely upon the language of Wage Order No. 5's second meal period waiver provision. The court of appeal further concluded that the IWC had "exceeded its authority," and declared that "Wage Order No.5, section II(D) is partially invalid tothe extent it authorizes health care workers to waive their second meal periods on shifts longer than 12 hours."[12]

In reaching that conclusion, the *Gerard I* court determined that the IWC had no authority to adopt a regulation that conflicts with the express language of Labor Code section 512(a), which provides as follows:

> An employer may not employ an employee for a work period of more than 10 hours per day without providing the employee with a second meal period of not less than 30 minutes, *except that if the total hours worked is no more than 12 hours, the second meal period may be waived* by mutual consent of the employer and the employee only if the first meal period was not waived.[13]

For this reason, the court of appeal partially invalidated Wage Order No. 5 to the extent it authorized second meal break waivers on shifts longer than twelve hours.

With one exception, the *Gerard I* court determined that the hospital and employees had to litigate whether or not its decision should apply retroactively. That one exception, however, was significant, as the court of appeal ruled

> there is no compelling reason of fairness or public policy that warrants an exception to the general rule of retroactivity for our decision partially invalidating [Wage Order 5]. Plaintiffs are entitled to seek premium pay . . . for any failure by [Orange Coast] hospital to provide mandatory second meal periods before [February 10, 2015] that falls within the governing three-year limitations period.

The premium pay that the court determined the plaintiffs were entitled to seek consisted of one hour of pay at an employee's regular rate of compensation[14] for each employee who worked more than twelve hours and did not get a second meal period—and for each instance there was no second meal period.

Of course, that was quite the troubling development for California healthcare employers that had understandably relied upon the regulation in using second meal period waivers. Realizing the significant impact that *Gerard I* would have on healthcare employers that had relied upon Wage Order No. 5, the Legislature moved quickly to enact Senate Bill 327 (SB 327), which amended Labor Code section 516 to state in pertinent part that "the health care employee meal period waiver provisions in Section 11(D) of [IWC] Wage Orders 4 and 5 were valid and enforceable on and after October 1, 2000, and continue to be valid and enforceable. This subdivision is declarative of, and clarifies, existing law."[15] In enacting SB 327, the Legislature specifically noted in the legislative intent section of SB 327 that it was being adopted because of "the uncertainty caused by a recent appellate court decision"—*Gerard I*—and that "without immediate clarification, hospitals will alter scheduling practices."

While SB 327 was being enacted, the *Gerard I* employer petitioned the California Supreme Court for review of the court of appeal's decision, and review was granted.[16] After SB 327 was enacted, the California Supreme Court directed the court of appeal to vacate its decision in *Gerard I* and to reconsider the case in light of SB 327.[17] The court of appeal then did so in a decision favorable to healthcare employers.

In March 2017, the court of appeal in *Gerard II*[18] issued its published decision, upholding summary judgment for the employer. In making that ruling, the crux issue the court of appeal considered was whether SB 327 applied in that case, and, if so, whether it applied retroactively. Both questions were answered in the affirmative. The *Gerard II* court found that "Senate Bill 327 reinforces our conclusion Wage Order No. 5, section 11(D) is valid. When the Legislature clarifies a statute in response to an appellate court opinion construing it, we must consider whether the clarification applies in the pending case."[19] Applying principles of legislative declaration, the *Gerard II* court concluded "it is apparent Senate Bill 327 merely clarified rather than changed the meaning of sections 512(a) and 516(a),"[20] and that "the obvious import of Senate Bill 327 is the Legislature intended its provisions to apply immediately to existing second meal period waivers, including those at issue here."[21]

The court of appeal further found as follows:

> [T]he Legislature made plain its intent in enacting Senate Bill 327. Again section 2 of Senate Bill 327 added section 516(b) which states: "Notwithstanding subdivision (a), or any other law, including Section 512, the *health care employee meal period waiver provisions in Section 11(D) of [IWC] Wage Orders 4 and 5 were valid and enforceable on and after October 1, 2000, and continue to be valid and enforceable*. This subdivision is declarative of, and *clarifies, existing law*."[22]

The *Gerard II* court concluded:

> In sum, the Legislature's unmistakable focus in Senate Bill 327 was the disruptive effect of our opinion in *Gerard I* on the long-standing and widespread use of second meal period waivers by employees and employers in the health care industry. "By abrogating [our] decision, the Legislature intended to protect those parties' expectations and restore certainty and stability to those transactions." [Citation.] And the obvious import of Senate Bill 327 is the Legislature intended its provisions to apply immediately to existing second meal period waivers, including those at issue here.[23]

Because the *Gerard II* court found that SB 327 "represents a clarification of the law before [its] decision in *Gerard I*, consistent with [its] reconsidered view above, rather than a change in the law," [24] the court concluded that SB 327 acted retrospectively. As a result, the second meal period waivers the plaintiffs had signed were valid and enforceable. Consequently, the *Gerard II* court affirmed the trial court's order granting summary judgment for the employer, denying class certification, and striking class allegations.

The *Gerard II* decision is a welcome development for California healthcare employers who have relied upon IWC Wage Order 5 for second meal period waivers, reinforcing the use of such waivers for employees who work more than twelve hours in a shift.

Endnotes

1 Brinker Rest. Corp. v. Sup. Ct., 53 Cal. 4th 1004, 1026 (2012).

2 *Id.* at 1041.

3 *Id.*

4 *Id.* at 1042 (citing CAL. LAB. CODE § 512(a)).

5 *Id.* at 1041.

6 Wage Order No. 5 defines the "healthcare industry" to mean "hospitals, skilled nursing facilities, intermediate care and residential care facilities, convalescent care institutions, home health agencies, clinics operating twenty-four (24) hours per day, and clinics performing surgery, urgent care, radiology, anesthesiology, pathology, neurology or dialysis." CAL. CODE REGS. tit. 8, § 11050, ¶ 2(J).

7 § 11050.

8 Wage Order No. 5 defines "employees in the healthcare industry" to mean any of the following: "(1) Employees in the healthcare industry providing patient care; or (2) Employees in the healthcare industry working in a clinical or medical department, including pharmacists dispensing prescriptions in any practice setting; or (3) Employees in the healthcare industry working primarily or regularly as a member of a patient care delivery team." § 11050, ¶ 2(G).

9 Gerard v. Orange Coast Mem'l Med. Ctr., 234 Cal. App. 4th 285 (2015) ("*Gerard I*").

10 CAL. LAB. CODE § 2699 *et seq.*

11 *Gerard I*, 234 Cal. App. 4th at 290.

12 *Id.* at 298.

13 CAL. LAB. CODE § 512(a) (italics added in *Gerard I*).

14 § 226.7(c)

15 § 516(b).

16 Gerard v. Orange Coast Mem'l Med. Ctr., 187 Cal. Rptr. 3d 668 (2015).

17 Gerard v. Orange Coast Mem'l Med. Ctr., 208 Cal. Rptr. 3d 271 (2016).

18 Gerard v. Orange Coast Mem'l Med. Ctr., 9 Cal. App. 5th 1204 (2017) ("*Gerard II*").

19 *Id.* at 1211.

20 *Id.* at 1212.

21 *Id.* at 1213.

22 *Id.* at 1212 (italics added in *Gerard II*).

23 *Id.* at 1212–13 (citing W. Sec. Bank v. Sup. Ct., 15 Cal. 4th 232, 245–246 (1997)).

24 *Id.* at 1214.

Commercially Reasonable Efforts: A Recent Delaware Supreme Court Holding Might Motivate Contract Drafters to Define the Term for Themselves

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Contract drafters often use the term *commercially reasonable efforts* in lieu of stating more precise standards of performance. Many clients are drawn to such clauses, which can speed up contract negotiations, even though the vagueness of the term poses a risk of disagreement later. (Clients can sometimes be overconfident that "*we'll just work it out later if the issue ever comes up*"—forgetting that the congenial individuals who negotiated the contract might not be in the same jobs later.)

Williams Cos.: "Commercially reasonable efforts" means "all reasonable efforts"

The Delaware Supreme Court's recent holding in *Williams Cos. v. Energy Transfer Equity*[1] implies that contract drafters might want to specifically define *commercially reasonable effort*, possibly as stated at the end of this note, to reduce the risk that their clients will be caught unawares by a far-stronger commitment than they might have actually intended.

The court remarked that the use of *commercially reasonable efforts* "placed an affirmative obligation on the parties to take ***all*** *reasonable steps*"[2] to achieve the stated objective. (This, even though the contract elsewhere used the term *reasonable best efforts*,[3] which, under the principle of *inclusio unius, exclusio alterius*, might have suggested that the two terms were intended to have different meanings.)

In a dissent on other grounds, Chief Justice Strine opined that *commercially reasonable efforts* is "a comparatively strong" commitment, one that is only "slightly more limited" than *best efforts*.[4] Indeed, in the proceedings below, the chancery court had all but equated the term *commercially reasonable efforts* with *reasonable best efforts*, holding that a party that had made such a commitment had "bound itself to do *those things objectively reasonable to produce* the desired [result]."[5]

But what do clients expect?

Clients might be taken aback by the notion that *commercially reasonable efforts* requires the making of *all* reasonable efforts; if pressed, many clients might rank "efforts" commitments in roughly the following ascending order:

- **Reasonable efforts:** One or more reasonable actions reasonably calculated to achieve a stated objective, *but with no expectation that all possibilities are to be exhausted*. Colloquially, this could perhaps be phrased as, "*I'll give it a shot*."
- **Commercially reasonable efforts:** Those reasonable efforts that reasonable business people would expect to be made, but again not necessarily all such efforts. Or, again colloquially: "*I'll do what professionals would normally do*." In a major lawsuit between the

state of Indiana and IBM, the contract in question defined the term as "taking commercially reasonable steps [circularity, anyone?] and performing in such a manner as a well managed entity would undertake with respect to a matter in which it was acting in a *determined, prudent*, businesslike and reasonable manner to achieve a particular result."[6]

- **Best efforts:** *All reasonable* efforts—as a Canadian court said, "leaving no stone unturned in seeking to achieve the stated objective."[7] Or it could be stated in sports terms: "*I'll bring my "A" game*." (In the U.S., courts sometimes define *best efforts* in terms of diligence, although some case law seemingly equates *best efforts* with mere *reasonable efforts*.[8])

These differences in client expectations about different "efforts" clauses could be illustrated with a hypothetical example. On major U.S. highways, the speed-limit signs often include both maximum and minimum speeds of (say) 70 mph and 45 mph. Let's assume for the sake of argument that those two speeds establish the upper and lower bounds of reasonableness: Anything less than 45 mph is unreasonable, and so too is anything more than 70 mph. On these hypothetical facts, suppose that a trucking company were to agree that its driver would use a certain level of effort to drive a shipment of goods from Point A to Point B on such a highway, where drivers must drive between 45 mph and 70 mph. In good weather with a functioning trucking rig and light traffic, clients might expect the following to apply:

On these facts, would driving at the following speeds be considered:	35 mph	45 mph	60 mph	65 mph	70 mph
Reasonable efforts?	No	Yes	Yes	Yes	Yes
Commercially reasonable efforts?	No	No	Yes?	Yes?	Yes
Best efforts?	No	No	No	No	Yes

Under the Delaware Supreme Court's strict *Williams Cos.* holding, it might be argued that the *commercially reasonable efforts* standard could be met only by driving, say, 68 mph or higher.

W.I.D.D.: When In Doubt, *Define*

Drafters who want a less strict standard than that defined in *Williams Cos.* can consider the following, from the author's *Common Draft* project (a work in progress, available at www.CommonDraft.org):

> **Commercially reasonable efforts: (a)** "Commercially-reasonable efforts," whether or not the term is capitalized, refers to at least those efforts that people experienced in the relevant business would generally regard as sufficient to constitute reasonable efforts in the relevant circumstances. Other uses of the term *commercially reasonable* have corresponding meanings. **(b)** A party does not fail to act in a commercially reasonable manner, or to take commercially reasonable action, solely because it gives preference to its own interests over those of another party.
>
> **Reasonable efforts: (a)** "Reasonable efforts," whether or not the term is capitalized, refers to one or more reasonable actions reasonably calculated to achieve the stated objective. **(b)** Any assessment of reasonable efforts is to give due regard to the information reasonably available, to the relevant person at the relevant time, about (for example) the likelihood of success of specific action(s); the likely cost of other actions; the parties' other interests; the safety of individuals and property; and the public interest. **(c)** A requirement to make reasonable efforts: (1) does not necessarily require taking every conceivable reasonable action; and (2) does not require the obligated party to put itself in a position of undue hardship. **(d)** A party obligated to make reasonable efforts may consider potential cost and potential return when determining what actions it must take to satisfy that obligation.

Alternative: Fast-track dispute handling

What if it's not possible to agree on a definition of *commercially reasonable efforts*? In that case, contract drafters can think about provisions to encourage settlement and reduce the chances of getting bogged down in litigation over the term. Such provisions might include, for example, one or more of the following (adapted from the *Common Draft* project):

- Required status-review conference calls, to reduce the chances of the parties forming misimpressions—and then digging in their heels—due to not talking to each other:

  (a) Each party is to participate in status-review conferences in accordance with this section as reasonably requested by either party.

  (b) Conferences are to be by telephone conference call unless otherwise agreed.

  (c) Conference arrangements are to be made (i) by the requesting party for requested conferences, and (ii) by each party, on an alternating basis, for regularly-scheduled conferences (if any).

  (d) Unless otherwise agreed in writing, each party is to bear its own expenses of status-review conferences.

  (e) A status-review conference may include discussion of some or all of the following "G-PP-AA" agenda items: G - goals of the parties in respect of the Agreement; P - progress to date in achieving those goals; P - problems encountered or anticipated; A - action plans for the future, including for example plans for addressing existing or anticipated problems; and A - assumptions being made, especially any that might prove unwarranted. ...

- A dispute escalation provision, requiring each party, upon request, to "kick upstairs" any dispute that can't be resolved by the working-level personnel:

  (a) Whenever requested in writing by either party, the parties will jointly refer any **"Dispute"**—namely, any dispute arising out of or relating to this Agreement or any transaction or relationship resulting from it—"up," in succession: (i) if necessary, to a total of at least two levels of management; or (ii) if a party has fewer levels "up" remaining in its management structure, to the highest management level (e.g., the CEO). …

- An early neutral evaluation provision along the lines of the process used in the U.S. District Court for the Northern District of California:

  (a) This provision applies whenever a dispute arising out of or relating to the Agreement becomes, or appears reasonably likely to become, the subject of litigation or arbitration.

  (b) At any time before trial (including for this purpose an arbitration hearing), either party may submit the dispute to (nonbinding) early neutral evaluation in accordance with the Early Neutral Evaluation procedures of the American Arbitration Association as then in effect, or such other rules or procedures as the parties may agree.

  (c) Each party is to participate in the early neutral evaluation proceedings in good faith. …

- A mini-trial of disputes to senior management, e.g., using the procedures of the American Arbitration Association:

  IF: An Agreement-Related Dispute appears clearly likely to lead to litigation or arbitration; THEN: (1) Either party may submit the dispute to a non-binding mini-trial in accordance with the Mini-Trial Rules (namely, the then-current mini-trial procedures of the American Arbitration Association); and (2) in the event of such a submission, each party will provide a senior management representative to participate personally in the mini-trial proceedings as called for by the Mini-Trial Rules.

- A baseball-arbitration provision,[9] requesting the court in any litigation to select one of the parties' two competing proposals, without modification, such as the following:

  (b) The dispute is to be decided by "last-offer" arbitration, sometimes known as "baseball" or "pendulum" arbitration, in which: (i) each party submits no more than two proposed determinations of the particular issue; (ii) the tribunal is jointly requested (if a court) or directed (if an arbitral tribunal) to select, as its determination of the particular issue, exactly one of the parties' proposed determinations, in its entirety, without modification; ….

The key feature of baseball arbitration is that the decision maker has no power except to choose between the competing salary proposals presented by the player and the team. That gives each party a powerful incentive to be reasonable in making its proposal. "Because the panel has to choose between one of the two offers, the player and team are both forced to present reasonable offers as the panel will choose the offer that is closer to what they believe is the player's true arbitration value."[10] That, in turn, often gets the parties close enough to be able to bridge the remaining gap on their own.[11]

Author's note: When I was practicing with my law firm, in the space of about one year, three different lawsuits, for three different clients, were settled not long after the parties, at my suggestion, had agreed to baseball arbitration. I had the impression that, after seeing each other's proposals, the business people on each side looked at each other and said, in effect, "*wait a minute—we're not that far apart; we don't need to pay the lawyers and the arbitrator for this.*" And another story: A lawyer friend in Silicon Valley recounted how a client of hers once got into a dispute concerning a contract that she had drafted for the client. She told the client's CEO that the contract required baseball arbitration, and explained what that entailed. The CEO was irritated: "G-dd-mn it, that means I have to be *reasonable*." (My friend added that the parties settled their dispute.)

Conclusion

Defining *commercially reasonable efforts* can help clients avoid unpleasant surprises; if an agreed-in-advance definition isn't feasible, then provisions to help them reach agreement about specific proposals can help the clients advance their long-term business interests.

Endnotes

1 No. 330 [2016], 2017 Del. LEXIS 128 (Mar. 23, 2017).

2 *Id.* at *19 (emphasis added).

3 *See id.* at *3.

4 *Id.* at *27 & n.45 (Strine, C.J., dissenting) (citation omitted).

5 Williams Cos. v. Energy Transfer Equity, L.P., No. 12168, 2016 Del. Ch. LEXIS 92 (June 24, 2016) (emphasis added).

6 Indiana v. IBM Corp., 4 N.E.3d 696, 716 n.12 (Ind. App. 2014), *aff'd*, 51 N.E.3d 150 (Ind. 2016).

7 Atmospheric Diving Sys. Inc. v. Int'l Hard Suits Inc., 89 B.C.L.R. (2d) 356 (1994). Australian and British courts take a similar view. *See, e.g.,* Shawn C. Helms, David Harding & John R. Phillips, *Best Efforts and Endeavours – Case Analysis and Practical Guidance Under U.S. and U.K. Law*, JonesDay.com (2007), http://www.jonesday.com/Best-Efforts-and-EndeavoursCase-Analysis-and-Practical-Guidance-Under-US-and-UK-Law-07-30-2007/; Janet T. Erskine, *Best Efforts versus Reasonable Efforts: Canada and Australia*, McCarthy.ca (2007), http://mccarthy.ca/article_detail.aspx?id=3779.

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How To Respond To IRS Notices

Robert W. Wood

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Everyone must pay federal income taxes. Yet exactly how much you owe, and on exactly how much, is famously complex. All tax returns must be signed under penalties of perjury. That means you have to do your best to report everything fully and honestly. But the grey areas are legion.

For example, exactly when is something income, even though you physically don't have it? What type of proceeds qualifies for long term capital gain rather than ordinary income rates? Which losses are full write-offs, and which ones are limited to offsetting gains? What assets can be written off all at once, and what assets must be capitalized and written off ratably over many years?

These and many other questions come up at tax return time. You must have some answers to be able to file, even if you are leaving many of the details to tax return preparers. But once you sign your name and file, what about the IRS notices that come? How should you react, and in what order?

You can contest many IRS tax bills, although there are times not to. When you disagree with the IRS, procedure is important. You must pay attention to the order in which notices arrive and the specific ways in which you can respond.

1. Most Audits are Via Correspondence. Most audits do not involve sitting across the desk from an IRS agent. Let's say you file your tax return and later receive a notice from the IRS saying it has information that you received $6,000 that you failed to report. It might be due to a Form 1099 you mislaid, one that failed to show up in the mail, or some other bit of information the IRS has that does not match your return.

Usually such a notice will ask you to sign the form and mail it back if you agree. Alternatively, the notice will ask for an explanation of why the information is incorrect. You can contest it—if you do so promptly. You can also agree if the IRS is right.

2. Don't Fight Every Tax Bill. If you know the IRS is correct, don't fight. Likewise, if the IRS is seeking a small amount of tax, you may be better off not fighting it, even if you are right. Just consider whether it is worth it if the dollars are small. Of course, what is a small tax bill can mean different things to different people.

Sometimes, disputing something small can end up triggering other issues that might have best been left alone. So consider that, too. But in most cases, if you get a bill for additional taxes you'll want to preserve your rights. Timelines and procedure are critical.

3. Watch Out for Proposed Deficiencies. The notice described above is not a Notice of Proposed Deficiency. Still, you should answer it. An Examination Report may follow the first notice if you fail to respond. Most tax lawyers call the Examination Report and accompanying letter a "30-day letter." It will say you have 30 days to respond in a so-called administrative "protest." A protest is just a letter.

4. Make Sure You Prepare a Timely Protest. If you receive an IRS Examination Report, make sure you prepare a protest and sign and mail it before the deadline. Keep a copy. Keep proof of mailing too, preferably certified mail to provide verification of mailing and of IRS receipt. Explain yourself thoroughly, and attach documents where they will be helpful.

Your protest should analyze the facts and the law. Put your best foot forward. The IRS may review your protest and agree with you. Even if they don't, how you frame your protest can help later. If you have protested in a timely way, you will normally receive a response that the IRS is transferring your case to the IRS Appeals Division.

5. IRS Appeals Division is Nationwide. The IRS Appeals Division is a separate part of the IRS. Its mission statement is to resolve cases. By definition, these are cases in which the auditor has recommended additional taxes, and the taxpayer disagrees. The Appeals Officer assigned to your case works for the IRS, and in that sense, can never be truly unbiased.

Even so, the IRS Appeals Office is separate, and they try to be impartial and (when they can), to split the baby. This process of working out compromises works surprisingly well. A tax lawyer may be best qualified to handle your case, but an accountant can, too. Alternatively, you can do it yourself.

Just be aware that while it is less expensive to do it yourself, it is also generally less effective. The vast majority of tax cases are resolved at appeals. Usually, you'll be assigned to the Appeals Office closest to you. Offices are throughout the U.S. Sometimes you are assigned to an Appeals Office in some far corner of the country.

This is generally based on the workload of the offices and Appeals Officers. It can also be based on particular tax issues that some offices are handling. If that location doesn't facilitate a face-to-face meeting and you want one, you can ask for the case to be moved to the IRS Appeals Office nearest to you, nearest to your tax lawyer, nearest to your books and records, etc.

The IRS is not required to grant such requests, but they usually do. Most IRS Appeals Officers are happy to get a case they are assigned off their desk and assigned to someone else!

6. Beware a Notice of Deficiency. If you fail to protest, or if you do not resolve your case at IRS Appeals, you'll next receive an IRS Notice of Deficiency. An IRS Notice of Deficiency always comes via certified mail. It can't come any other way. A Notice of Deficiency is often called a "90-day letter" by tax practitioners, because you'll have 90 days to respond.

There used to be many flubs about exactly when that 90 days ran out. So today, the IRS is required to prominently display on page one of the Notice of Deficiency the *actual deadline* for your response. Don't write the IRS to protest a Notice of Deficiency. In fact, only one response to a Notice of Deficiency is permitted: filing a Tax Court petition in the U.S. Tax Court clerk's office in Washington, D.C.

Although it is best to hire a tax lawyer, some taxpayers handle their Tax Court case on their own, *pro se*. There are special simplified procedures available to taxpayers who represent themselves in cases where less than $50,000 in tax is in dispute. Whether you are handling the case yourself or you hire a tax lawyer, however, the U.S. Tax Court cannot hear your case if you miss the 90-day deadline.

7. Tax Court Judges Travel to Your Area. The Tax Court building and clerks are all in Washington, D.C. However, the nineteen Tax Court judges travel to federal courthouses all around the country to conduct trials. You can pick the city where you want your case to be heard when you file your Tax Court petition.

Tax Court procedure and rules of evidence are streamlined, with no jury, and with relaxed rules of evidence. You can call witnesses, and many cases are presented based on a "stipulated record." In it, you and the government agree on certain facts.

8. Your Case Can Go Back to IRS Appeals. Remember, the only way you can respond to a Notice of Deficiency is to file a timely petition in U.S. Tax Court. Fortunately, though, that doesn't mean your case will necessarily be decided in court. An IRS lawyer will file an answer to your Tax Court petition. As with most other answers in litigation, the IRS will generally deny whatever your petition says.

But then, you can ask the IRS lawyer to transfer your case to IRS Appeals. Often, a Notice of Deficiency is issued before a case has ever gone to IRS Appeals. In that sense, it can seem as if the IRS is trying to cut off your right to an appeal. Actually, though, it is usually because of workload, or because the IRS is worried that the statute of limitations on the tax year in question is about to run.

The IRS often issues a Notice of Deficiency to make sure you can't later say the IRS is too late to assess taxes. When this happens, the IRS lawyer will almost always be happy to transfer your case to (or back to) IRS Appeals. This also ties into extensions of the IRS statute of limitations, below.

9. IRS Often Asks You to Extend the Statute. Often, the IRS says it is auditing you, but needs more time. Giving the IRS more time to audit you? It may sound counterintuitive—if not downright crazy—to give the IRS more time, but it is not, as we will see. The IRS

may *ask you* for an extension because they need more time to audit you.

Your first reaction may be to relish the thought of telling the IRS absolutely not! Even a routine tax audit can be expensive and nerve-wracking. The IRS normally has three years to audit, measured from the return due date or filing date, whichever is later. But the three years is *doubled* in a number of cases. For example, the IRS gets six years if you omitted 25 percent or more of your income.

Even worse, the IRS has *no* time limit if you *never* file a return, or if you skip certain key forms (for example, if you have an offshore company but fail to file IRS Form 5471). You have to assume that if the IRS is asking you to extend the statute, the IRS is already monitoring you closely. And for the most part, people usually do *voluntarily* give the IRS more time to audit.

Why would *anyone* do that? It works like this. The IRS contacts you (usually about two and a half years after you file), asking you to extend the statute. Most tax advisers say you should usually agree. If you say "no," or ignore the request, the IRS will assess extra taxes, usually based on an incomplete and quite unfavorable picture.

You might think that you could fail to say yes or no and that the IRS might forget about you. But this is something the IRS is very careful about. The IRS rarely misses issuing a Notice of Deficiency, and you usually will be worse off (often *much* worse off) than if you agreed to the extension. There are exceptions to this rule, but relatively few. And sometimes you can agree to the extension but limit the extra time you give, or even the tax issues at stake. Get a professional to help you weigh your facts.

10. You Can Sometimes Get Extensions, Too. Everyone knows there are automatic six-month extensions to filing your taxes. April 15 can become October 15, although you still must *pay* any taxes due by April 15. But what about extensions when the *IRS* demands a response to a notice or letter within 30 days?

For many notices, the IRS will grant an extension of time to respond. In some cases, though, they can't. For example, when you receive a Notice of Deficiency (90-day letter), you must file in Tax Court within 90 days, and this date cannot be extended. Most other notices are less strict. If you do ask the IRS for an extension, confirm it in writing, and keep a copy. In fact, confirm *everything* you do with the IRS in writing.

11. Some IRS Actions Can Be Undone. It is always best to respond to IRS notices within their stated time frames. Still, it is sometimes possible to undo IRS action after the fact. For example, even after the IRS places a lien on property or levies on a bank account, this can be reversed. However, it is usually harder and more expensive to undo something, and it usually requires professional help.

12. You Can Pay Up, Then Sue. If you do not respond to a Notice of Deficiency within 90 days, and you have an assessment, all is not lost. You will not be able to go to Tax Court, but you can contest the taxes in federal district court or in the U.S. Claims Court. Usually you must pay the taxes first and file a claim for refund. If the refund request is not granted, then you can sue for a refund.

The primary advantage of proceeding in Tax Court is that you need not pay the tax first. In contrast, most taxpayer suits in U.S. District Court or U.S. Claims Court are commenced *after* the tax has been paid. Sometimes, though, you can cleverly shoehorn yourself into one forum even though it might seem that you don't satisfy the rules.

Take the case of *Colosimo v. U.S.*, 630 F.3d 749 (8th Cir. 2011). There, the IRS pursued the company and its owners for payroll taxes. The owners sued in district court for a ruling that they were not "responsible persons" required to pay the payroll taxes. But the owners paid only a fraction of the taxes the IRS was seeking. This was a clever use of the notion that sometimes you can pay only a portion of the tax due, with your suit resolving both pieces of the asserted tax: the part you paid, and the part you didn't.

13. Be Careful. Remember, there are many different types of tax notices, even if you are only talking about the IRS. We have covered a few types of IRS notices here, including a Notice of Deficiency. However, there are many other types of important notices, including liens, levies, and summonses. Forms of response vary, and procedure is important. You're best advised to get some professional help. In general, don't ignore anything you get from the IRS!

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