BEFORE THE

BOARD ACCOUNTABILITY MECHANISMS COMMITTEE

OF THE

INTERNET CORPORATION FOR ASSIGNED NAMES AND NUMBERS

IN RE BOARD ACCOUNTABILITY MECHANISMS COMMITTEE'S REVIEW OF .WEB PURSUANT TO BOARD RESOLUTION 2022.03.10.06

INDEX OF EXHIBITS

FOR REPLY SUBMISSION BY NU DOTCO, LLC AND VERISIGN, INC. TO BAMC'S REQUEST FOR BRIEFING PURSUANT TO BOARD RESOLUTION 2022.03.10.06

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Exhibit No.	Description
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EXHIBIT AC-110

2013 WL 3213051
United States District Court, E.D. Kentucky,
Northern Division, at Ashland.

ASHLAND HOSPITAL CORPORATION d/b/a King's Daughter's Medical Center, Plaintiff
v.
AFFILIATED FM INSURANCE COMPANY, Defendant.

Civil Action No. 11–16–DLB–EBA.
|
June 24, 2013.

Attorneys and Law Firms

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MEMORANDUM OPINION AND ORDER

DAVID L. BUNNING, District Judge.

***1** This matter is before the Court on Plaintiff Ashland Hospital Corporation's Motion In Limine To Exclude The Opinions Of Frank R. Lombardo And Motion For A Hearing (Doc. # 69) and on the *Daubert* Hearing conducted by the Court on May 23, 2013. The instant motion is fully briefed and thus ripe for review. (See Docs. # 90 & 99). For the reasons set forth below, the Court will grant the instant motion.

I. FACTUAL BACKGROUND

A. The Hospital purchases a data storage network

In 2007, Plaintiff Ashland Hospital Corporation, d/b/a King's Daughter's Medical Center ("the Hospital"), contracted with technology company and manufacturer, EMC Corporation, to sell, install and support a computer data storage network known as the DMX4. The DMX4 is the Hospital's "primary computer data repository, which runs a number of essential hospital functions and is critical to patient health and safety." (Doc. # 70–1, at 6). The Hospital used the DMX4 to store all of its electronic records, including medical records, schedules, and lab reports. EMC "markets the unit as having the highest degree of availability—99.999%," (Doc. # 69–1, at 5), and thus the unit's guarantee of information availability is its key feature. EMC installed the DMX4 within one of the Hospital's data centers and monitored it in real-time from a remote location.

B. The Hospital's data center overheats

On March 24, 2010, the air conditioning equipment in the data center failed, causing elevated temperatures (hereinafter "the Overheat Event"). Alarms within the DMX4 alerted EMC that various component parts of the unit had been exposed to increased temperatures. According to EMC, the high temperatures caused several disk drives in the unit to go offline, rendering them unavailable for a period of several hours. During this period, Hospital personnel could not access important information including physician orders, patient schedules, and historical medical records. Certain data was "completely corrupted and had to be restored from a backup." (Doc. # 70–2, at 25).

C. The Manufacturer assesses the potential damage to the data storage network

The Hospital contacted EMC to assess the DMX4's condition. EMC prepared an Event Report which concluded that the unit had been "severely compromised" from exposure to above normal temperatures. (Doc. # 70–3, at 5). Accordingly, EMC advised the Hospital that it could "no longer confirm the long term reliability" of the exposed equipment. (*Id.*). It further advised that the Overheat Event took the unit outside the scope of EMC's standard warranty and maintenance coverage. (*Id.* at 6). It recommended that the Hospital replace the unit "due to the long term reliability and data integrity issues" flowing from the Overheat Event. (*Id.*).

Following EMC's recommendation, in October of 2010 the Hospital replaced the DMX4 with a new system known as "VMAX" at a cost of $1,973,946.40.

D. The Insurer investigates the alleged loss

***2** Promptly following the Overheat Event, the Hospital notified its insurer, Defendant Affiliated FM Insurance Company, of what had occurred. Affiliated FM hired Amir Rubin of LWG Consulting, an electrical engineer, to evaluate the potential damage suffered by the DMX4. Rubin conducted a two-year investigation, which included "(1) visiting the site and meeting with [the Hospital] on three occasions, (2) performing dozens of hours of technical research, (3) reviewing thousands of pages of technical documents and discovery, and (4) attending the deposition of [EMC's Frederick Sproule]...." (Doc. # 69–1, at 7). Two years into his investigation, Rubin concluded that he could not form an expert opinion regarding the DMX4 without further information, including physical testing of the unit. Accordingly, he engaged a third-party firm, Emergent SX, to develop a protocol for testing the DMX4.

E. The Insurer denies coverage

For reasons unexplained, Affiliated FM did not permit Rubin to complete his investigation. Instead, it retained Frank Lombardo, another electrical engineer and a co-employee of Rubin's from LWG Consulting. In less than one month, Lombardo completed an expert report concluding that the DMX4 had not sustained any damage or loss of reliability. Based on Lombardo's report, Affiliated FM denied coverage for the DMX4's alleged loss, and the Hospital thereafter filed the instant declaratory judgment action.

The Hospital now moves to exclude Lombardo's opinions, which are as follows: (1) that the subject DMX4 did not sustain any direct physical loss or direct physical damage as a result of the Overheat Event; (2) that the DMX4 was not exposed to extreme temperatures for an extended period of time; (3) the DMX4 was not compromised; (4) the DMX4 is no less reliable after the incident than it was before the incident; and (5) the replacement VMAX storage array system purchased by KDMC is not of like kind and quality as the DMX4.

On May 23, 2013, the Court held a *Daubert* Hearing on the instant motion at which Lombardo testified and counsel for both parties offered argument.

II. ANALYSIS

Under Federal Rule of Evidence 702, a proposed expert's opinion is admissible if (1) the witness is qualified by knowledge, skill, experience, training or education; (2) the testimony of that expert witness is relevant, meaning that it will assist the trier of fact to understand the evidence or to determine a fact in issue; and (3) the testimony of that expert witness is reliable. *In re Scrap Metal Antitrust Litig.,* 527 F.3d 517, 529 (6th Cir.2008). Since relevance is not disputed here, the Court will only examine Lombardo's qualifications and the reliability of his testimony.

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A. Lombardo is qualified

The Hospital accuses Lombardo of being a "generalist" lacking specific experience evaluating the effect of heat on computer components such as the disk drives housed within the DMX4. However, to be qualified as an expert witness under Rule 702, an expert need not be a "blue-ribbon practitioner [ ] with optimal qualifications" or have "an intimate level of familiarity with every component of a [product] as a prerequisite to offering expert testimony." *Bartlett v. Mutual Pharmaceutical Company, Inc.,* 760 F.Supp.2d 220, 222 (D.N.H.2011). Experts need not even have direct experience with the precise subject matter or product at issue. *Planned Parenthood Cincinnati Region v. Taft,* 444 F.3d 502 (6th Cir.2006) (observing that doctor was qualified to testify on abortions without having performed one); *see also, Berry v. City of Detroit,* 25 F.3d 1342, 1350 (6th Cir.1994) (noting that an aeronautical engineer would be qualified to testify about a bumblebee's flight path based on general flight principles even if he had never seen a bumblebee); *DaSilva v. American Brands, Inc.,* 845 F.2d 356, 361 (1 st Cir.1988) (affirming trial court's decision to permit mechanical engineer to opine on the safety of the design of an industrial mixing machine despite the witness's lack of design experience with that type of machine). For instance, in *Burke v. U–Haul International, Inc.,* the United States District Court for the Western District of Kentucky noted that "federal courts in a number of product liability cases involving engineering experts have permitted an expert witness with general knowledge to give expert testimony where the subject of that testimony related to such general knowledge but the expert had no specialized knowledge of the particular product." No. 3:03CV–32–H, 2006 WL 3043421, at *4 (W.D.Ky. Oct.20, 2006). Experts need only be "qualified as an expert by knowledge, skill, experience, training, or education." Fed.R.Evid. 702.

***3** Lombardo certainly measures up to this standard. He has a bachelor of science degree in electrical engineering, has spent thirty-seven years analyzing losses in electrical equipment as a consultant for the insurance industry both nationally and internationally, and founded a successful engineering firm. He has extensive experience in electronic component reliability testing and failure analysis, including failure analysis of computer systems, and he has participated in over 500 losses involving computer equipment. Furthermore, he has some specific experience evaluating the effects of overheating on storage arrays, including some with DMX4 components, such as Seagate disk drives. For instance, he recently evaluated EMC-manufactured storage arrays that were exposed to elevated temperatures for approximately 36 hours.

The Hospital correctly notes that this is the first DMX4 overheat event Lombardo has ever encountered; that Lombardo has never analyzed the impact of overheating on the annualized failure rate or relative reliability of disk drives; and that he lacks expereince designing heat specifications or designing data storage units like the DMX4. These points do not affect his qualifications, however, because as already noted, one does not need specialized knowledge of the particular product to be qualified as an expert. *See, e.g.. Burke,* 2006 WL 3043421, at *4. Still, these points are relevant to the reliability of Lombardo's opinion, as explained further below.

B. Lombardo's methodology is unreliable

Rule 702 sets forth three factors for determining the reliability of expert testimony. The district court must examine whether: (1) the testimony is based upon sufficient facts or data; (2) the testimony is the product of reliable principles and methods; and (3) the witness has applied the principles and methods reliably to the facts of the case. The district court must make a "preliminary assessment of whether the reasoning or methodology underlying [expert scientific] testimony is scientifically valid and of whether that reasoning or methodology can be applied to the facts in issue." *Daubert v. Merrell Dow Pharm., Inc.,* 509 U.S. 579, 592–93, 113 S.Ct. 2786, 125 L.Ed.2d 469 (1993).

To aide the district court in making its reliability determination, the Supreme Court established a four factor inquiry in *Daubert v. Merrell Dow Pharm., Inc.:* (1) whether a theory can be or has been tested; (2) whether the theory or technique has been subjected to peer review and publication; (3) the known or potential rate of error and the existence and maintenance of standards controlling the technique's operation; and (4) whether the technique or theory has gained a general acceptance within a relevant scientific community. 509 U.S. at 594.

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The district court may, in its discretion, apply the *Daubert* factors even where, as here, the witness at issue is a technical rather than a scientific expert. *Kumho Tire Co., Ltd. v. Carmichael,* 526 U.S. 137, 150–152, 119 S.Ct. 1167, 143 L.Ed.2d 238 (1999). "The trial court must have the same kind of latitude in deciding *how* to test an expert's reliability ... as it enjoys when it decides *whether or not* that expert's relevant testimony is reliable." *Id.* at 152 (italics in original). Regardless of how much weight the district court accords the *Daubert* factors in a particular case, the court's main focus must always be the validity and reliability of the expert's methodology. *Id.* at 158

***4** It is true, as Defendant notes, that with technical experts, the "relevant reliability concerns may focus upon personal knowledge or experience." *Id.* at 150. Nevertheless, "[a] district court is not required to admit expert testimony that is connected to the existing data only by the *ipse dixit* of the expert. A court may conclude that there is simply too great an analytical gap between the data and the opinion proffered." *Nelson v. Tenn. Gas Pipeline Co.,* 243 F.3d 244, 254 (6th Cir.2001) (quoting *General Electric. Co. v. Joiner,* 522 U.S. 136, 146, 118 S.Ct. 512, 139 L.Ed.2d 508 (1997)). The Sixth Circuit has instructed district courts that "[expert] testimony must 'fit' the facts of the case, that is, there must be a connection between the scientific research or test result being offered and the disputed factual issues in the case in which the expert will testify." *Pride v. BIC Corp.,* 218 F.3d 566, 578 (6th Cir.2000) (citing *Daubert,* 509 U.S. at 592).

In particular, where an expert draws an inference from his experience, the proponent must establish "appropriate validation" for the application of the expert's theory to the matter at hand. 1 McCormick on Evidence, § 13 (7th ed.1999); *In re Scrap Metal,* 527 F.3d at 529. The judge's role is to ensure the theory or technique "works":

> The foundation must include a showing of the results when the technique was used on prior occasions ... [n]either the expert's voucher nor general acceptance in the field nor even long term, repeated use of the theory suffices ... It is also clear that it is not enough for the witness to assert in conclusory fashion that she is relying on her general 'expertise,' 'knowledge,' or 'education.' Those considerations can qualify the witness as an expert, but they do not speak to the validity of the expert's theory or technique. To provide a useful expert insight, the witness must identify a more specific technique or theory. The witness must articulate that technique or theory. Otherwise, the witness is venturing nothing more than a guess.

McCormick, *supra.*

Here, Lombardo's opinion that the DMX–4's disk drives were not damaged, compromised, or rendered less reliable is entirely based on two inferences from his experience: (1) the instant Overheat Event was not hot enough or long enough to cause damage or affect the drives' reliability; and (2) if the drives had been damaged, they would have manifested greater failure rates in the weeks and months after the Overheat Event.

As the Court will explain below, despite his qualifications, Lombardo fails to establish appropriate validation for his two techniques or inferences, and fails to reliably apply those inferences to the facts at hand. His first inference—that the drives were exposed to insufficient heat to cause damage—lacks a reliable methodology because it is entirely based on his experience, it is unsupported by studies or reports, it disregards the manufacturer's heat specifications, and it fails to adequately explain data showing that the data center reached potentially damaging temperatures. His second inference—that the drives would have manifested greater failure rates if they had been damaged—lacks a reliable methodology because it too is entirely based on his experience, it fails to account for the disk drives' self-diagnostic error codes, it is unsupported by physical tests of the drives, and it ignores the prior investigation conducted by his business partner, Amir Rubin. In reaching this conclusion, the Court will consider the *Daubert* factors, but accord them less weight because Lombardo is a technical and not a scientific expert.

***5** At the end of this Order, the Court will also examine Lombardo's opinion that the replacement storage unit was not "of like kind and quality" as the DMX4, and explain why that opinion lacks reliability as well.

The Court now turns to examine each of Lombardo's inferences in turn.

1. Lombardo's first inference: the disk drives were not exposed to sufficient heat to cause damage

a. Lombardo bases his first inference entirely on experience and fails to support it with studies or reports

Lombardo opines that the Overheat Event was of "too short a duration" to have caused "any physical loss or physical damage to any of the DMX4's components or which would have affected the long term reliability of the equipment." (Doc. # 71–20, at 8). When asked for clarification at his deposition, he stated that in his experience evaluating overheat events, it takes 10–12 hours to cause disk drive damage at the temperatures experienced by the DMX4. By contrast, he classified the instant three and a half hour overheat event as a "brief excursion." When asked how he defined a brief excursion, he estimated that a brief excursion would be something less than eight to ten hours. At the May 23, 2013 *Daubert* Hearing, the Court asked Lombardo whether he had personally evaluated any overheat events of shorter duration. Lombardo replied that he had; however, he neglected to specify how short these overheat events were, whether these shorter events involved DMX4's (or any type of computer equipment, for that matter), or how these shorter events differed from longer events in terms of their effect on disk drive damage or reliability.

Lombardo's theory is thus connected to the existing data solely by his own say-so. He fails to offer any meaningful distinction between a shorter-term and a longer-term overheat event. Would five hours be long enough? What about seven and a half? Lombardo baldly asserts that eight to ten hours is the magic figure, but fails to offer the Court a reasoned analysis for why this figure is valid. Accordingly, his distinction appears to be highly arbitrary and blends into the realm of guesswork. *See, e.g., Mike's Train House, Inc. v. Lionel, L.L.C.,* 472 F.3d 398, 408 (6th Cir.2007) (expert opinion excluded in part because expert "arbitrarily determined" how much significance to assign to each of the criteria in his methodology). He has simply not demonstrated that his theory can be reliably applied to the much-shorter three and a half hour event at issue here. This lack of "fit" between the expert's theory and the relevant facts is grounds for exclusion.

Furthermore, Lombardo's theory also fails to satisfy the *Daubert* factors. Lombardo has not established that his theory has been tested on a DMX4 in circumstances similar to those here. He has also failed to cite a single study, report, or other authoritative source supporting his specific theory of the relationship between length and degree of heat exposure and a weakening of disk drive reliability. He has not provided the Court with a known or potential rate of error for his theory, or the existence and maintenance of standards controlling the theory's operation. In addition, although he claims that his theory enjoys general acceptance in his field, he has not provided the Court with instances of other experts employing it. His failure to satisfy *Daubert* is another ground for exclusion.

b. Lombardo's first inference disregards the manufacturer's specifications

***6** Lombardo candidly admits that the DMX–4's disk drives reached 66 degrees Celsius, six degrees above the manufacturers's "never exceed" temperature, for a period of three and a half hours. He also concedes that the manufacturer's heat specifications are based on scientific testing conducted during the research and development phase of production. Nevertheless, he asserts that exceeding the manufacturer's specifications in this manner is not necessarily indicative of damage or a lessening of reliability. [1] To support this assertion, he downplays a section in the Manual from the disk drive manufacturer, Seagate, which clearly states that in order to maintain the disk drives' Annualized Failure Rate ("AFR"), the drives should not be operated above 50 degrees Celsius. (Doc. # 70–9, at 40). For example, he notes that according to the Manual, the AFR "may" not be impacted by occasional excursions above 50 degrees Celsius, and that the "maximum allowable [Hard Drive Assembly] case temperature is 60 degrees Celsius." (Doc. # 70–9, at 40). He further notes that the maximum *non-operating* temperature allowed by the Manual is 70 degrees Celsius. (Doc. # 71–20, at 7). After cobbling together these select sections in the Manual, he reasons that even under the manufacturer's specifications, "heat alone is not considered a damaging condition." (*Id.*).

1 These temperatures also violated the vendor specifications and EMC's own internal specifications. (Doc. # 104 at ¶ 19).

Yet, he offers no methodology to support his cavalier disregard of the strict parameters set by the manufacturer. In addition, he admitted in his deposition that he was not aware of any data, studies, research, tests or journals stating that "Seagate drives can get as hot as they did for as long as they did without degrading the annualized failure rate." (Doc. # 69–8, at 53–54). This lack of methodology and lack of supporting literature are grounds to exclude an expert opinion. *See, e.g., Botnick v. Zimmer* 484 F.Supp.2d 715, 720 (N.D.Ohio 2007) (courts "may exclude expert testimony in instances where the methodology employed is either unreliable or entirely absent."); *Nelson v. Tenn. Gas Pipeline Co. .,* 243 F.3d 244, 251 (6th Cir.2001) (holding that the lack of peer review and publication of the expert's methodology was "plainly relevant" to the reliability of his theory).

c. Lombardo's first inference fails to adequately account for information about the data center's temperature

Lombardo asserts that because the Hospital "has not provided any ambient temperature measurement in the [data center] for March 24, 2010 ... no one knows what the temperature in the data center was." (Doc. # 71–20, at 7). However, he then proceeds to assume that the data center's temperature did not exceed 32 degrees Celsius (90 degrees Fahrenheit), the maximum temperature allowed by the manufacturer.

The Sixth Circuit has explained that "[a]n expert's opinion, where based on assumed facts, must find some support for those assumptions in the record. However, mere weaknesses in the factual basis of an expert witness' opinion ... bear on the weight of the evidence rather than on its admissibility." *McLean v. 988011 Ontario, Ltd.,* 224 F.3d 797, 801 (6th Cir.2000) (internal citation and quotation omitted). Assumptions which amount to significant errors may go to admissibility because, as the Committee Notes to Rule 702 state, "any step that renders the analysis unreliable ... renders the expert's testimony unreliable." *In re Scrap Metal,* 527 F.3d at 530 (quoting Fed.R.Evid. 702, Advisory Committee's Notes, 2000 Amendments).

***7** Here, Lombardo's assumption that the data center did not exceed 32 degrees Celsius is not adequately based on facts in the record. He begins by correctly observing that there are only internal temperature readings available (from inside the DMX–4), and no external temperature readings available from the data center itself. He then reasons that if the data center had exceeded 32 degrees, he would have expected all of the DMX4's modules to exceed their maximum operating temperatures. Since 22 modules did not exceed their maximum operating temperature, he concludes that the data center did not exceed 32 degrees. But this conclusion does not adequately explain the fact that 4 modules did exceed their maximum operating temperature. Based on these 4 modules, Plaintiff's expert, Frederick Sproule, estimates that the data center reached between 65 and 70 degrees Celsius (155 to 170 degrees Fahrenheit), *more than twice the maximum temperature permitted by the manufacturer.*

Lombardo effectively ignores this inconvenient evidence in forming his opinion. Failing to consider such relevant facts violates Rule 702's requirement that an expert base his opinions on "sufficient facts or data." In *Lockridge v. Scripto–Tokai Corp.,* for instance, the district court excluded the expert because he "failed to collect all available data prior to making his opinion, and in some instances, selectively disregarded pieces of data to the extent they conflicted with his hypothesis." 2005 U .S. Dist. LEXIS 47962, at *60 (M.D.Tenn.2005); *see also, Concord Boat Corp. v. Brunswick Corp.,* 207 F.3d 1039, 1056 (8th Cir.2000). So too here, Lombardo seems to selectively disregard evidence that the data center temperature was much hotter than 32 degrees Celsius.

2. Lombardo's second inference: the disk drives would have manifested greater failure rates if they had been damaged

a. Lombardo relies entirely on his experience, fails to understand the DMX–4's error codes, and fails to show that his methodology reliably measures a weakening in disk drive reliability

The DMX–4 is a very sophisticated system that can self-diagnose and report certain problems it experiences. (Doc. # 69–3, at 9). Specifically, it contains a Symmetrix platform with software that can "call home [to the manufacturer] with event logs and error codes" that indicate whether components have failed or otherwise suffered potential damage or weakening. (*Id.* at 12–13). The manufacturer, EMC, can monitor these event logs and error codes in real-time, and did so in the instant case. According to Frederick Sproule of EMC, during the Overheat Event at the Hospital, the event logs (called the "Full History Service Log")

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showed that hundreds of DMX–4 components failed from thermal over-temperature conditions. (*Id.* at 13–14). Some drives reported "media errors" meaning that they either could not read new data, or could not have new data written onto them. (*Id.* at 17). Other drives reported hardware errors, including "catastrophic disk drive fault, where it's bypassing—it's telling the link control card that, 'I'm going away, and I can't communicate anymore.' " (*Id.*).

***8** Sproule not only monitored these error codes in real time during the Overheat Event, he worked with a group of 6 to 8 EMC engineers to analyze the codes. The codes require analysis because they are not written in plain English. It requires a cipher to translate the codes into understandable form. (*Id.*) This cipher is written into the Symmetrix software and is available to the EMC engineering staff. (*Id.*) As explained at the *Daubert* hearing, EMC engineers can simply click on the error codes on their computer screens, and a written explanation of the error pops up. After analyzing the error codes generated during the instant Overheat Event, as well as the DMX–4's internal temperatures, Sproule concluded that the damage to the DMX–4 was "severe, extreme, excessive, very damaging ... catastrophic." (Doc. # 69–3, at 52).

Lombardo claims that he too reviewed the DMX–4's Full Service History Log as part of his investigation. But he admitted during his deposition that he could not make sense of the error codes because he did not have the cipher. In his own words, he is "in the dark" about what they mean. (Doc. # 69–8, at 43). Moreover, he has not made a serious attempt to understand them. He did not acquire a copy of the cipher from EMC, and he did not speak to or interview anyone from the EMC about what the codes meant. He further admitted at the *Daubert* hearing that he did not know how hot a DMX4 disk drive had to get before the system reported an over-temperature error code. Thus, his opinion that the DMX4 components did not suffer damage or a loss of reliability is completely uninformed by an analysis of the error codes.

Lombardo argues, in essence, that he did not need to understand the error codes because he was able to understand and assess the meaning of the "dial home" events contained in the Full Service History Log. In fact, he claims that the dial home events represent the most reliable method of determining disk drive damage because they permit one to compare the pre-heat exposure failure rates with post-heat exposure failure rates. In the instant case, EMC reported that between March 24, 2010 and April 9, 2010, there were 20 dial home events, compared to just 13 in the six months prior to the March 24, 2010 overheat event. (Doc. # 70–3, at 5). There were also an additional 17 dial home events between April 9, 2010, and November 5, 2010. (*Id.* at 8). The EMC Event Report cited these increased dial home events as evidence that the DMX4 had been "severely compromised." (*Id.* at 5).

Lombardo disagrees that the dial home events reflect damage to the DMX4. He claims that the vast majority of these dial home service requests were, in his words, "non-failure events," such as "health checks" and "upgrades." (Doc. # 71–20, at 9). He opines that if the drives had been damaged, they would have exhibited greater failure rates resulting in more dial home events and more failed disk drives in the weeks and months following the Overheat Event. He points out, for instance, that only 3 of the DMX4's 245 disk drives required replacement after the Overheat Event. As he explained at the *Daubert* hearing, in his opinion, the best test of whether disk drives have been damaged or rendered less liable is whether they still work after an overheat event.

***9** As an initial matter, the Court questions whether this theory represents a reliable methodology. It may well be that Lombardo's method reliably detects *total disk drive failure,* but it less than clear whether it reliably measures weakening in disk drive *reliability.* For example, Lombardo highlights his experience evaluating disk drive failure that is, in his words, "manifest" (Doc. # 69–8, at 49), such as a 36–hour overheat event that caused "catastrophic failure of disk drives" where there was "a considerable amount of erratic performance by the drives, lost data, dropping in and out of connectivity with the system" and where it became "absolutely clear that the system had become unreliable...." (*Id.* at 47).

The instant case, by contrast, does not involve a 36–hour overheat event with obvious post-event failure rates. As Plaintiff notes, "this is not a case where portions of the DMX4 were melted or disfigured." (Doc. # 99, at 14). Rather, this case involves a much shorter exposure than Lombardo typically evaluates, and the question is whether this shorter exposure negatively effected the annualized failure rate (i.e., the reliability) of the DMX4's disk drives.

By his own admission, Lombardo has never calculated the effect of heat exposure on the annualized failure rate of disk drives in general, and did not do so in this case. It thus appears that he has not tested his theory in a way that can reliably be applied to this case. This lack of testing is yet another ground in favor of excluding his testimony. *See, e.g., Hayes v. MTD Products, Inc.,* 518 F.Supp.2d 898, 900 (W.D.Ky.2007) (excluding expert's testimony in part because he failed to conduct any testing at all). In addition, Lombardo lacks much specific expertise with DMX4's. This is the first DMX4 overheat event Lombardo has ever encountered. He also lacks experience designing heat specifications for units like the DMX–4 (Doc. # 69–8, at 4), understanding the DMX4's designed failure rate (*Id.* at 5), and understanding the DMX4's error-code system and other self-diagnostic capabilities (*Id.* at 5–6). Were he able to show a more extensive expertise with these aspects of the DMX4, it would bolster the reliability of his testimony. *See, e.g., Johnson,* 484 F.3d at 435 (holding that an expert's familiarity with the particular machine at issue can support the reliability of his testimony). His lack of familiarity in this regard calls his methodology into question.

b. Lombardo's methodology is not reliably applied to the facts of this case

Nevertheless, even assuming *arguendo* that Lombardo's methodology is reliable in general, he has not reliably applied it to the particular facts at issue here for four reasons. First, his method entirely fails to account for the manufacturer's error codes which showed that hundreds of DMX–4 components failed from thermal over-temperature conditions. As described above, these codes contain highly specific diagnostic information about what went wrong with the DMX4's disk drives during the Overheat Event. Lombardo could have sought to understand the codes by obtaining the cipher, but did not do so. He also could have interviewed someone from the manufacturer or the Hospital about the codes, or about how the DMX4 functions more generally, but he neglected to interview anyone.

***10** Second, Lombardo could have conducted testing on the drives to confirm his theory. One test he could have performed involves extracting data stored on the disk drives that indicates whether there has been heat damage to the drives. The technology which stores this data, known as "Self–Monitoring Analysis and Reporting Technology" (S.M.A.R.T.), was available in the DMX4. At his deposition, Lombardo admitted he could have done this test but simply did not do it. He conceded that if he had more time and a more generous budget, he would have preferred to test the DMX–4.

Third, Lombardo could have conducted testing on a sampling of the DMX4's disk drives. He admitted at his deposition that it is standard practice to conduct such testing after a heat exposure incident; yet, he did not perform this test here. He claims that he was never granted access to the drives, but he fails to substantiate this claim with any objective evidence. Indeed, Plaintiff asserts that it granted all Defendant's requests for access to the drives.

Lombardo's failure to test a sampling of drives is particularly peculiar in light of the fact that two disk drives—which reported "TEMP_HIGH" error codes—failed and required replacement following the Overheat Event. Lombardo plainly admits that these two drives likely failed because of heat exposure. In his words, "I would associate those two failed drives with the incident ... because it got too hot or whatever." Despite this concession, he downplays these two drives as the "weak sisters within that [disk drive] population," without any evidence to support his claim. This type of speculation and guesswork does not substitute for reasoned analysis. Furthermore, as Plaintiff's counsel pointed out at the *Daubert* hearing, Lombardo essentially posits that although these two drives suffered catastrophic heat failure, the other 242 drives were completely unaffected by the Overheat Event.

Defendant counters that Plaintiff's expert, Frederick Sproule, did not conduct physical testing either. However, Defendant has not moved to exclude Sproule's opinion. Moreover, Sproule did not need to conduct physical testing because he had monitored the error codes in real time, evaluated them with his team of engineers, confirmed that the DMX4's components had been run far outside EMC's heat specifications, and concluded that they had been severely compromised.

Fourth, Lombardo only reviewed a fraction of the information gathered by Defendant's "consultant," Amir Rubin. According to Plaintiff's counsel, Rubin gathered a "deskload" of information during his investigation into the DMX–4, but Defendant only allowed Lombardo to see about one "notebook's worth." As noted above, Rubin's investigation included "(1) visiting the site and meeting with [the Hospital] on three occasions, (2) performing dozens of hours of technical research, (3) reviewing thousands of pages of technical documents and discovery, and (4) attending the deposition of [EMC's Frederick Sproule]....” (Doc. # 69–1, at 7). Following this two-year investigation, Rubin could not form an opinion on whether the DMX–4 had been damaged, and thus he engaged a third-party firm, Emergent SX, to develop a protocol for testing the DMX4. For whatever reason, however, Defendant did not permit Rubin to carry through with this protocol. What's more, Lombardo did not speak with Emergent SX, and did not speak “substantively” with Rubin, opting instead to discuss the case history only. He also failed to review the deposition of Chad Phipps, the Hospital's head of Information Technology.

***11** These four failures—failing to understand the error codes or interview relevant witnesses about the codes, failing to extract the S.M.A.R.T. data, failing to test a sampling of disk drives, and failing to review Rubin's information—show that Lombardo did not approach this case with the intellectual rigor required by Rule 702 and *Daubert.* Instead, he settled for a “convenient form of validation,” much like the expert in *Lockridge v. Scripto–Tokai Corp.,* 2005 U.S. Dist. LEXIS 47962, at *61. In that case, the plaintiff had been injured by a defective utility lighter that ignited while in the off position. *Id.* at *1–2. The court found that the expert's methodology, while perhaps generally reliable, was not reliably applied to the facts of that case. *Id.* at 58–63. The expert had not conducted any tests to validate or refute his theory. *Id.* at 58. In addition, the court found particular fault with the expert's failure to “consult, examine, or otherwise analyze all available evidentiary materials....” *Id.* at 59. The expert had failed to examine physical evidence from the scene of the burning, failed to consult the fire inspector's report, failed to review the plaintiff's medical records, and failed to interview witnesses. *Id.* at 58–60. The court found these failures “fatal to the admission of his testimony.” *Id.* at 61. As the court explained, the expert “did not undertake an appropriate validation of his hypothesis, and while he may very well be an expert in the abstract ... in this case he apparently settled for a convenient form of validation. However, *Daubert* and Rule 702 ... require a more demanding approach to scientific evidence.” *Id.* at 61 (internal quotation omitted).

Like the expert in *Lockridge,* it appears that Lombardo has settled for a “convenient form of validation.” Boiled down to its essence, he centered his entire opinion on whether the DMX4 was still working in the six months following the Overheat Event. Since there were no obvious failures, he concluded there was no damage or even a lack of reliability. However, he did not validate this conclusion through a rigorous investigation. Instead, he selectively disregarded inconvenient information, and formed an opinion in less than four weeks based on inferences from his own experience.

Lombardo's experience cannot substitute for a tested, and testable methodology. Lombardo has provided the Court with no means of gauging the “known or potential rate of error” or the “existence and maintenance of standards controlling [his] technique's operation,” as required by *Daubert.* He has also failed to demonstrate that his theory has been successfully tested under similar circumstances in the past. He thus leaves the Court to rely on his subjective judgments—something the Court cannot and will not do. *See, e.g., Meridia Products Liability Litigation v. Abbott Laboratories,* 447 F.3d 861, 868 (6th Cir.2006) (holding that the expert's opinions were excludable because they forced the court to “rely solely on [the expert's] subjective judgments.”); *Calhoun v. Honda Motor Co., Ltd.,* 738 F.2d 126, 132 (6th Cir.1984) (“There must ... be sufficient facts already in evidence or disclosed by the witness as a result of his investigation to take the testimony out of the realm of guesswork and speculation.”). His failure to reliably apply his methodology to the particular facts of this case means that his opinion should be excluded. *Adams v. Cooper Industries, Inc.,* No. 03–476–JBC, 2007 U.S. Dist. LEXIS 55131, at * 37, 2007 WL 2219212 (E.D.Ky. July 30, 2007).

C. Lombardo's opinion as to replacement value is unreliable

***12** The instant insurance policy provides that if the DMX–4 is damaged and cannot be repaired, Plaintiff could replace it with another data storage unit “of like kind and quality.” (Doc. # 70–4, at 40). The phrase “of like kind and quality” is undefined in the policy. However, the policy does specify that for “[u]nrepairable ... electronic data processing equipment” the basis of valuation is “the cost to replace with equipment that is the most functionally equivalent to that damaged, even if such equipment has technological advantages and/or represents an improvement in function and/or forms part of a program enhancement.” (*Id.*). Following the March 24, 2010 Overheat Event, the Hospital ultimately decided to replace the DMX4 with a new data storage unit known as a VMAX, at a cost $1,973,946.40.

As part of his expert report, Lombardo opines that the VMAX is not "of like kind and quality" as the DMX4. He points out that the VMAX has more than double the storage capacity and total memory capacity as the DMX4. (Doc. # 71–20, at 5). He also notes that the VMAX invoicing includes $92,105 in additional software which did not exist in the DMX4. (*Id.*). He estimates that by reducing the quantity of storage and memory capacity, substituting certain hardware and software components "where advances in technology dictate," and removing the cost of associated service contracts, a replacement VMAX "of like kind and quality" would cost $807,031.87, and a replacement DMX4 "of like kind and quality" would cost $818,076.42 (*Id.* at 5–6). To describe which components the Hospital could have substituted to custom-build a cheaper storage unit, Lombardo attaches an 11–page spreadsheet listing each component and its cost.

The Hospital argues that Lombardo's comparison of the DMX4 and the VMAX is not an expert opinion at all because it involves factual comparisons that are within the purview of a jury. The Hospital thus suggests that Lombardo's opinion is properly characterized as lay testimony. Federal Rule of Evidence 701 provides that lay testimony must not be "based on scientific, technical, or other specialized knowledge within the scope of Rule 702." The Advisory Committee's Notes for the 2000 Amendments to Rule 701 describe lay testimony as that which "results from a process of reasoning familiar in everyday life," and describe expert testimony as that which "results from a process of reasoning which can be mastered only by specialists in the field." Fed.R.Evid. 701, advisory committee's notes for the 2000 Amendments. For instance, a lay witness may testify that a substance appears to be a narcotic, but only an expert witness may testify about how a narcotic is manufactured or distributed within a complex distribution network. *Id.*

The Advisory Committee's Notes on the 1972 Proposed Rules to Rule 702 explain that the common sense test for whether an expert may be used is "whether the untrained layman would be qualified to determine intelligently and to the best possible degree the particular issue without enlightenment from those have a specialized understanding of the subject involved in the dispute." Fed.R.Evid. 702, advisory committee's notes on the 1972 proposed rules.

***13** If Lombardo only proposed to testify about the difference in memory and storage capacity between the DMX4 and the VMAX, the $92,105 software package, and the service contracts, this would not be the subject of expert testimony. The average juror could compare such items without the help of a specialist. However, Lombardo proposes to testify on more complex matters, such as whether very particular hardware and software components could be substituted and still permit the replacement unit to function in substantially the same way as the DMX4. A simple review of Lombardo's 11–page spreadsheet quickly yields the conclusion that the average layman would not be able to "determine intelligently and to the best possible degree" the subject of Lombardo's testimony. The average person simply does not have the specialized knowledge that Lombardo possesses about the inner workings of storage arrays like the DMX4 and the VMAX, including which software packages would and would not function with these systems, and which hardware component upgrades are dictated by "advances in technology." (Doc. # 71–20, at 5–6). These topics fall within the bailiwick of the expert witness.

However, the Hospital correctly notes that Lombardo conceded at his deposition that did not know whether the replacement units he was recommending "were available for sale without delay at the time of [the Hospital's] loss." (Doc. # 69–1, at 36; Doc. # 69–8, at 62). Accordingly, the Hospital convincingly argues that Lombardo's opinion is entirely speculative, and thus violates Rule 702's requirement that expert opinions be relevant and grounded on reliable facts and data. Neither party presents case law to support its argument, and the Court's independent research reveals that case law on this topic is admittedly sparse. One court, however, has held that when determining whether a proposed replacement item is of "like kind and quality" under an insurance policy, courts look to testimony about whether the replacement item is "available in the marketplace." *Seamon v. Acuity,* No. A11–429, 2011 WL 6015355 at *4 (Minn.Ct.App. Dec.5, 2011). Here, it is simply irrelevant and speculative for Lombardo to say that the Hospital could have ordered a cheaper custom-built storage unit when he has no idea whether such a unit was available in the marketplace. Such testimony would not be helpful to the jury.

Therefore, the Court will exclude his expert opinion regarding the custom-built storage unit. With that said, the Court will allow Lombardo to testify as a lay witness as to the about the difference in memory and storage capacity between the DMX4 and the VMAX, and about whether the $92,105 software package and the new service contracts represent an upgrade that is not of "like kind and quality" as the DMX4.

III. CONCLUSION

Accordingly, for the reasons stated herein,

IT IS ORDERED that Plaintiff Ashland Hospital Corporation's Motion In Limine To Exclude The Opinions Of Frank R. Lombardo And Motion For A Hearing (Doc. # 69) is hereby **GRANTED** consistent with the terms and conditions of this Order.

All Citations

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EXHIBIT AC-111

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United States District Court, D. Kansas.

Somsy THONGLEUTH, Plaintiff,
v.
Michael J. ASTRUE, Commissioner of Social Security, Defendant.

Civil Action No. 10–1101–JWL.
|
April 4, 2011.

Attorneys and Law Firms

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Connie R. Dearmond, Office of United States Attorney, Wichita, KS, for Defendant.

MEMORANDUM AND ORDER

JOHN W. LUNGSTRUM, District Judge.

***1** Plaintiff seeks review of a decision of the Commissioner of Social Security (hereinafter Commissioner) denying disability insurance benefits (DIB) and supplemental security income (SSI) under sections 216(i), 223, 1602, and 1614(a)(3)(A) of the Social Security Act. 42 U.S.C. §§ 416(i), 423, 1381a, and 1382c(a)(3)(A) (hereinafter the Act). Finding no error as alleged by Plaintiff, the Commissioner's decision is AFFIRMED.

I. Background

Plaintiff applied for DIB and SSI on January 7, 2009 alleging disability since January 1, 2007. (R. 13, 111–18). The applications were denied initially and upon reconsideration, and Plaintiff requested a hearing before an administrative law judge (ALJ). (R. 13, 44–47, 65). Plaintiff's request was granted, and Plaintiff appeared with counsel for a hearing before ALJ Edmund C. Werre on September 17, 2009. (R. 13, 23–43). At the hearing, testimony was taken from a vocational expert, and from Plaintiff through an interpreter. (R. 23–43). Plaintiff testified that she went to first and second grade in Laos but had no further education, that she had been in the United States twenty years at the time of the hearing, and that she speaks and understands English “A little bit.” (R. 27–28). On November 2, 2009, ALJ Werre issued his decision finding that although Plaintiff has a combination of impairments which is severe, is unable to perform her past relevant work, and is illiterate and unable to communicate in English, there are a significant number of jobs in the national economy that she is able to perform. (R. 13–22). As a result, he found that she is not disabled within the meaning of the Act, and denied her applications. (R. 21–22).

Plaintiff disagreed with the decision, requested Appeals Council review, and submitted a brief to the Council explaining her reasons. (R. 4–9). The Appeals Council considered Plaintiff's reasons, but found no basis under its rules to review the decision, and denied Plaintiff's request for review. (R. 1–3). Therefore, the ALJ's decision is the final decision of the Commissioner. (R. 1); *Blea v. Barnhart,* 466 F.3d 903, 908 (10th Cir.2006). Plaintiff now seeks judicial review of that decision. (Doc. 1).

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II. Legal Standard

The court's jurisdiction and review are guided by the Act. *Wall v. Astrue,* 561 F.3d 1048, 1051–52 (10th Cir.2009) (citing 42 U.S.C. § 405(g)). Section 405(g) of the Act provides that, "The findings of the Commissioner as to any fact, if supported by substantial evidence, shall be conclusive." The court must determine whether the factual findings are supported by substantial evidence in the record and whether the ALJ applied the correct legal standard. *Lax v. Astrue,* 489 F.3d 1080, 1084 (10th Cir.2007); *accord, White v. Barnhart,* 287 F.3d 903, 905 (10th Cir.2001). Substantial evidence is more than a scintilla, but less than a preponderance, and it is such evidence as a reasonable mind might accept to support a conclusion. *Wall,* 561 F.3d at 1052; *Gossett v. Bowen,* 862 F.2d 802, 804 (10th Cir.1988). The court may "neither reweigh the evidence nor substitute [its] judgment for that of the agency." *Bowman v. Astrue,* 511 F.3d 1270, 1272 (10th Cir.2008) (quoting *Casias v. Sec'y of Health & Human Servs.,* 933 F.2d 799, 800 (10th Cir.1991)); *accord, Hackett v. Barnhart,* 395 F.3d 1168, 1172 (10th Cir.2005). The determination of whether substantial evidence supports the Commissioner's decision, however, is not simply a quantitative exercise, for evidence is not substantial if it is overwhelmed by other evidence or if it constitutes mere conclusion. *Gossett,* 862 F.2d at 804–05; *Ray v. Bowen,* 865 F .2d 222, 224 (10th Cir.1989).

***2** An individual is under a disability only if that individual can establish that she has a physical or mental impairment which prevents her from engaging in substantial gainful activity and which is expected to result in death or to last for a continuous period of at least twelve months. *Thompson v. Sullivan,* 987 F.2d 1482, 1486 (10th Cir.1993) (citing 42 U.S.C. § 423(d)); *see also, Knipe v. Heckler,* 755 F.2d 141, 145 (10th Cir.1985) (quoting identical definitions of a disabled individual from both 42 U.S.C. §§ 423(d)(1) and 1382c(a)(3)(A)); *accord, Lax,* 489 F.3d at 1084 (citing 42 U.S.C. §§ 423(d)(1)(A), 1382c(a)(3)(A)). The claimant's impairments must be of such severity that she is not only unable to perform her past relevant work, but cannot, considering her age, education, and work experience, engage in any other substantial gainful work existing in the national economy. 42 U.S.C. §§ 423(d)(2)(A), 1382c(a)(3)(B).

The Commissioner uses a five-step sequential process to evaluate disability. 20 C.F.R. §§ 404.1520, 416.920 (2009); *Wilson v. Astrue,* 602 F.3d 1136, 1139 (10th Cir.2010) (citing *Williams v. Bowen,* 844 F.2d 748, 750 (10th Cir.1988)). "If a determination can be made at any of the steps that a claimant is or is not disabled, evaluation under a subsequent step is not necessary." *Wilson,* 602 F.3d at 1139 (quoting *Lax,* 489 F.3d at 1084). In the first three steps, the Commissioner determines whether claimant has engaged in substantial gainful activity since the alleged onset, whether she has a severe impairment, and whether the severity of her impairment(s) meets or equals the severity of any impairment in the Listing of Impairments (20 C.F.R., Pt. 404, Subpt. P, App. 1). *Williams,* 844 F.2d at 750–51. If claimant's impairment(s) does not meet or equal a listed impairment, the Commissioner assesses residual functional capacity (RFC). 20 C.F.R. § § 404.1520(e), 416.920(e). This assessment is used at both step four and step five of the sequential process. *Id.*

After assessing claimant's RFC, the Commissioner evaluates steps four and five—whether claimant can perform her past relevant work, and whether, when considering vocational factors of age, education, and work experience, claimant is able to perform other work in the economy. *Wilson,* 602 F.3d at 1139 (citing *Lax,* 489 F.3d at 1084). In steps one through four the burden is on claimant to prove a disability that prevents performance of past relevant work. *Blea v. Barnhart,* 466 F.3d 903, 907 (10th Cir.2006); *accord, Dikeman v. Halter,* 245 F.3d 1182, 1184 (10th Cir.2001); *Williams,* 844 F.2d at 751 n. 2. At step five, the burden shifts to the Commissioner to show jobs in the economy within Plaintiff's capacity. *Id.; Haddock v. Apfel,* 196 F.3d 1084, 1088 (10th Cir.1999).

Plaintiff makes four claims of error. She claims the ALJ erred at step two of the sequential evaluation process by finding that Plaintiff's adjustment disorder with depressed mood is not a "severe" impairment; erred between steps three and four, both by failing to properly assess an RFC and by failing to make a proper credibility finding; and erred at step five in finding a significant number of jobs in the national economy which Plaintiff is capable of performing. The Commissioner argues that the ALJ properly evaluated Plaintiff's affective disorder; that substantial evidence supports the ALJ's credibility finding; and that the ALJ properly assessed Plaintiff's RFC and properly made and supported his step five determination. The court finds that the ALJ applied the correct legal standard and substantial evidence supports his decision. The court will address each of Plaintiff's arguments in the order of the sequential evaluation process.

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III. The Step Two Evaluation

***3** The ALJ performed his step two analysis on pages three through five of the decision. (R. 15–17). He concluded at step two that Plaintiff has several impairments which are "severe" within the meaning of the Act: cervical strain and low back pain, plantar fasciitis, and a history of left wrist ganglion cyst. (R. 15). He noted that Plaintiff has also been diagnosed with an adjustment disorder with depressed mood, but that there is no record of treatment, therapy, or hospitalization specifically for that disorder. *Id.* He applied the psychiatric review technique promulgated in 20 C.F.R. § § 404.1520a and 416.920a, and concluded that Plaintiff has "no" mental limitations in the functional area of activities of daily living; has "mild" mental limitations in the functional areas of social functioning and of concentration, persistence, or pace; and has experienced "no" episodes of decompensation. (R. 16). In accordance with 20 C.F.R. §§ 404.1520a(d)(1), and 416.920a(d)(1), he concluded that Plaintiff's mental impairments are not severe. *Id.* He went on to note that the findings in the four broad mental functional areas which result from application of the psychiatric review technique at steps two and three are not a mental RFC assessment, but that he had incorporated the results of that analysis into his RFC assessment. (R. 17).

Plaintiff notes that the threshold for finding a "severe" impairment is *de minimis,* and claims it was error to determine her mental impairments are not severe. This is so, she argues, because the examining psychiatrist, Dr. Schwartz, diagnosed Plaintiff with adjustment disorder with depressed mood; other physicians diagnosed her with depression; and the state agency psychological consultant assessed "moderate" limitations in social functioning and in concentration, persistence, or pace. She argues that the ALJ did not explain how he found mild limitations "when other medical professionals have found greater limitations," and the ALJ is not a medical expert and is not entitled to render his own medical opinion. (Pl.Br.10). The Commissioner argues that the mere presence of a mental impairment does not entitle a claimant to a finding of a severe mental impairment, that the ALJ properly explained his rationale regarding Plaintiff's mental impairments, and his rationale is supported by substantial evidence in the record. The court agrees with the Commissioner.

A mental impairment is not severe if it does not significantly limit plaintiff's mental ability to do basic work activities such as understanding, carrying out, and remembering simple instructions; use of judgment; responding appropriately to supervision, co-workers, and usual work situations; and dealing with changes in a routine work setting. 20 C.F.R. §§ 404.1521, 416.921. The Tenth Circuit has interpreted the regulations and determined that to establish a "severe" impairment or combination of impairments at step two of the sequential evaluation process, plaintiff must make only a "*de minimis* " showing. *Hinkle v. Apfel,* 132 F.3d 1349, 1352 (10th Cir.1997). Plaintiff need only show that an impairment would have more than a minimal effect on her ability to do basic work activities. *Williams,* 844 F.2d at 751. However, she must show more than the mere presence of a condition or ailment. *Hinkle,* 132 F.3d at 1352 (citing *Bowen v. Yuckert,* 482 U.S. 137, 153 (1987)). If an impairment's medical severity is so slight that it could not interfere with or have a serious impact on plaintiff's ability to do basic work activities, it could not prevent plaintiff from engaging in substantial work activity and will not be considered severe. *Hinkle,* 132 F.3d at 1352.

***4** The Commissioner has promulgated a psychiatric review technique for evaluating mental impairments. 20 C.F.R. §§ 404.1520a, 416.920a. In evaluating the severity of mental impairments at step two, the technique provides for rating the degree of functional limitation in each of four broad mental functional areas: activities of daily living; social functioning; concentration, persistence, or pace; and episodes of decompensation. *Id.* §§ 404.1520a(c) 416.920a(c). After rating the degree of limitation in each functional area, the Commissioner determines the severity of plaintiff's mental impairments. *Id.* § § 404.1520a(d), 416.920a(d). When the first three functional areas are rated as "none" or "mild," and the fourth area is rated as "none," the agency will conclude at step two of the sequential evaluation process that plaintiff's mental impairments are not severe "unless the evidence otherwise indicates that there is more than a minimal limitation in [plaintiff's] ability to do basic work activities." *Id.* §§ 404.1520a(d)(1), 416.920a(d)(1).

Here, the ALJ applied the Commissioner's psychiatric review technique, and in accordance with that technique found that Plaintiff's mental impairments are not severe. Plaintiff does not really complain about application of the technique, but argues that her condition meets the *de minimis* standard because she has been diagnosed with certain mental impairments, and the ALJ cannot have properly concluded that she has only mild limitations in social functioning and in concentration, persistence, or pace

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because the state agency psychologist determined she has moderate limitations in those functional areas. As the Commissioner points out, the mere diagnosis of depression or of adjustment disorder with depressed mood is insufficient to establish more than a minimal effect on Plaintiff's mental ability to perform basic work activities. *Hinkle,* 132 F.3d at 1352 ("the claimant must show more than the mere presence of a condition or ailment"). So the real issue is whether the ALJ properly determined that Plaintiff has "mild" limitations in these two functional areas although the state agency psychological consultant opined that she has "moderate" limitations in these areas. The court finds that he properly did so.

In his discussion of the functional areas of social functioning, and of concentration, persistence, or pace, the ALJ acknowledged that Plaintiff had undergone a consultative mental status examination by a psychologist, Dr. Schwartz, and that Dr. Schwartz made findings which might be interpreted differently than the ALJ did:

> The next functional area is social functioning. In this area, the claimant has mild limitation. At the request of the State agency the claimant underwent a mental status examination with Michael Schwartz, Ph.D. who noted that the claimant's affect was sullen and disgusted, and that the claimant stated her mood was angry. Dr. Schwartz opined the claimant appeared to have difficulty getting along with others; however he was uncertain how accurate that assessment was as he did not believe the claimant had fully cooperated in the examination (Exhibit 8F). The claimant testified at hearing that she had no problems getting along with people in the workplace, or otherwise. Based upon consideration of the record as a whole, the undersigned finds that the claimant has at most mild limitation in social functioning as a result of her adjustment disorder with depressed mood.
>
> ***5** The third functional area is concentration, persistence or pace. In this area, the claimant has mild limitation. The claimant reported she had difficulty in memory and concentration (Exhibit 8E). Following a mental status examination, Dr, Schwartz noted the claimant's test results suggested significant difficulties with attention and concentration; however, he questioned the claimant's effort (Exhibit 8F). Despite her impairment the claimant is the primary caretaker for her 12–year–old daughter; has a current driver's license; and reported her primary hobby is watching television all day (Exhibit 8E). There is little in the record to indicate the claimant has significant difficulties in concentration, persistence or pace, and if she does that these difficulties are as a result of her mental impairment, rather than her physical impairments. Based upon consideration of the record as a whole, the undersigned finds that the claimant has at most mild limitation in concentration, persistence or pace as a result of her adjustment disorder with depressed mood.

(R. 16).

As the ALJ's discussion suggests, Dr. Schwartz opined that "[Plaintiff] does appear to have difficulty getting along with others, but I am not sure how cooperative she was, so I do not believe I can make a clear judgement in this regard." (R. 309). The ALJ noted Dr. Schwartz's statement that Plaintiff's "responses would suggest she has some significant difficulties with attention and concentration." *Id.* He noted that Dr. Schwartz questioned Plaintiff's effort in completing the tests. (R. 16) (citing Ex. 8F (R. 308–09)).

As quoted above, the ALJ considered the record as a whole, along with Dr. Schwartz's report and Dr. Schwartz's concern about Plaintiff's cooperation in the examination and the effort with which she responded to testing, and determined that Plaintiff's limitations in social functioning and in concentration, persistence, or pace are "mild." (R. 16). Moreover, as the Commissioner pointed out, Plaintiff reported to her treating nurse-practitioner that her medication was "helping her mood." (Comm'r Br. 11) (citing (R. 334)). The court finds that the ALJ's analysis is supported by substantial evidence in the record, especially Dr. Schwartz's report.

In her reply brief, Plaintiff pointed out that *the ALJ* did not state that Plaintiff's medication was helping her mood, and argues that the Commissioner's assertion of that fact in his brief is merely *post hoc* rationalization which counsel may not create, and upon which the court may not rely to affirm the decision. (Reply 2) (citing *Haga v. Astrue,* 482 Fed.3d 1205, 1207–08 (10th Cir.2007); *Robinson v. Barnhart,* 366 F.3d 1078, 1084–85 (10th Cir.2004); and *Allen v. Barnhart,* 357 F.3d 1140, 1142, 1154 (10th Cir.2004)). As Plaintiff's argument implies, an ALJ's decision should be evaluated based solely on the reasons stated in the decision. *Robinson,* 366 F.3d at 1084. A decision may not be affirmed on the basis of appellate counsel's *post hoc* rationalizations for agency action; *Knipe v. Heckler,* 755 F.2d 141, 149 n. 16 (10th Cir.1985); and a reviewing court may not create *post hoc* rationalizations to explain the Commissioner's treatment of evidence when that treatment is not apparent from the Commissioner's decision. *Grogan v. Barnhart,* 399 F.3d 1257, 1263 (10th Cir.2005). Nonetheless, it is the court's duty to determine whether the Commissioner's decision is supported by substantial evidence in the record. *Lax,* 489 F.3d at 1084; *accord, White,* 287 F.3d at 905.

***6** In light of this duty, Plaintiff reads the restriction on *post hoc* rationalization too broadly. The court may not construct, and here it has not constructed, a rationale for the Commissioner. The ALJ determined "the record as a whole" required finding Plaintiff's limitations in these two functional areas are "at most mild." (R. 16). Since the ALJ made that finding, it is the court's duty to determine whether it is supported by substantial evidence in the record as a whole. As the Commissioner pointed out, the fact Plaintiff reported that her medication helped her mood is one more piece of record evidence which supports the rationale given by the ALJ for his determination. The court need not, indeed may not, ignore that evidence merely because it was not specifically cited in the decision.

Plaintiff also argues that the ALJ erred in finding only "mild" limitations because "The state agency concluded that ... Thongleuth would have moderate limitations" in these two functional areas. (Pl.Br.10). As Plaintiff's argument suggests, the state agency applied the psychiatric review technique at the reconsideration level of adjudication in this case. In doing so, a psychologist, Dr. Carol Adams, reviewed the record evidence, completed both a Psychiatric Review Technique form and a Mental Residual Functional Capacity Assessment form, and found that Plaintiff is "moderately limited" in the two broad functional areas of social functioning and concentration, persistence, or pace. (R. 312–29). Plaintiff's reliance upon these reports, however, is misplaced because the ALJ considered and gave "limited weight to the psychological assessments provided by the State agency." (R. 19). He explained, "These assessments are not consistent with or supported by the record as a whole, and therefore are entitled to little weight." *Id.* Further, Plaintiff provides no argument that the ALJ erred in weighing Dr. Adam's opinions. The court finds no error in the step two analysis.

IV. RFC Assessment

An RFC assessment is made if the ALJ finds at step three of the evaluation process that Plaintiff's condition does not meet or equal the severity of a listed impairment, and that RFC assessment will be used to determine whether Plaintiff can perform work at both step four and step five of the process. 20 C.F.R. § § 404.1520(e), 416.920(e). In assessing RFC, the Commissioner considers a claimant's ability to meet the demands of work despite her impairment(s). *Id.* at §§ 404.1545–1546, 416.945–946. The assessment is based upon all relevant evidence in the record and includes consideration of the limitations caused by all of the claimant's impairments, including impairments which are not "severe" as defined in the regulations. *Id.* at §§ 404.1545(a & e), 416.945(a & e). The assessment considers physical abilities such as sitting, standing, walking, lifting, carrying, pushing, pulling, reaching, handling, stooping, and crouching; and mental abilities such as understanding, remembering, and carrying out instructions; and responding appropriately to supervision, co-workers, and work pressures. *Id.* §§ 404.1545(b & c), 416.945(b & c); *see also* §§ 404.1521, 416.921 (listing examples of basic work activities which may be affected by impairments). At the hearing level, it is the ALJ's responsibility to assess RFC. *Id.* §§ 404.1546(c), 416.946(c).

***7** The Commissioner issued Social Security Ruling (SSR) 96–8p, "To state the Social Security Administration's policies and policy interpretations regarding the assessment of residual functional capacity (RFC) in initial claims for disability benefits." West's Soc. Sec. Reporting Serv., Rulings 143 (Supp.2010). The Ruling includes narrative discussion requirements for an RFC assessment. *Id.* at 149. The discussion is to cite specific medical facts and nonmedical evidence to describe how the evidence supports each conclusion, discuss how the Plaintiff is able to perform sustained work activities, and describe the maximum amount of each work activity the plaintiff can perform. *Id.* The discussion must include an explanation how any ambiguities and material inconsistencies in the evidence were considered and resolved. *Id.* It must include consideration of the credibility of Plaintiff's allegations of symptoms and consideration of medical opinions regarding plaintiff's capabilities. *Id.* at 149–50.

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Because an RFC assessment must include consideration of the credibility of Plaintiff's allegations of symptoms, the court will consider Plaintiff's credibility at this point in its analysis. Plaintiff claims the ALJ erroneously discounted the credibility of Plaintiff's allegations in four respects. She claims the ALJ: (1) failed to consider "the limitations testified to by Thongleuth," (Pl.Br.14); (2) "failed to discuss, much less consider, the side effects of Thongleuth's prescribed medications on her ability to work," (Pl.Br.15); (3) "unfairly and irrationally" used Plaintiff's financial interest to discount her credibility, *id.;* and (4) relied upon inconsistencies which "are not clear evidence of lack of credibility" when Plaintiff's difficulties with English and "the obvious inadequacy of the interpreter" are considered. *Id.* The Commissioner argues that the ALJ applied the proper standard to his credibility determination and that substantial evidence in the record supports his determination, and therefore the determination should be affirmed.

An ALJ's credibility determinations are generally treated as binding on review. *Talley v. Sullivan,* 908 F.2d 585, 587 (10th Cir.1990). "Credibility determinations are peculiarly the province of the finder of fact" and will not be overturned when supported by substantial evidence. *Hackett v. Barnhart,* 395 F.3d 1168, 1173 (10th Cir.2005). Therefore, in reviewing the ALJ's credibility determinations, the court will usually defer to the ALJ on matters involving witness credibility. *Glass v. Shalala,* 43 F.3d 1392, 1395 (10th Cir.1994). "However, '[f]indings as to credibility should be closely and affirmatively linked to substantial evidence and not just a conclusion in the guise of findings.' " *Hackett,* 395 F.3d at 1173(quoting *Huston v. Bowen,* 838 F.2d 1125, 1133 (10th Cir.1988)).

In the narrative discussion of his RFC assessment, the ALJ stated that he had considered all of Plaintiff's allegations of symptoms, summarized the legal standard used in credibility determination, and summarized Plaintiff's allegations and the record medical evidence. (R. 18–19). He then provided a specific analysis relating his credibility finding, and stating four reasons he found Plaintiff's allegations not credible:

> ***8** After careful consideration of the evidence, the undersigned finds that the claimant's medically determinable impairments could reasonably be expected to cause the alleged symptoms; however, the claimant's statements concerning the intensity, persistence and limiting effects of these symptoms and the claimant's allegations of an inability to work *are not credible.* [1] The claimant's allegations are not supported by the medical evidence. The claimant reports chronic severe pain in her neck, back, and hips, yet all testing has been within normal limits. The claimant testified she had severe pain when using her left hand, yet testing revealed only diminished grip strength, and all other testing, including a nerve conduction study, were negative. A trier of fact is required to determine a witness' [s] credibility in consideration of all the circumstances, including the extent to which his [sic] testimony is contradicted or corroborated by other evidence, and any other circumstances that tend to shed light upon her credibility. Additionally, [2] the claimant's financial interest in the outcome and [3] the evidentiary inconsistencies detract from reliance on the claimant's testimony as a basis for decision-making. The undersigned finds that although she has medically determinable severe impairments, these impairments do not cause the degree of limitations alleged by the claimant. When evaluated, the claimant's subjective complaints are found to be [4] exaggerated and inconsistent with the other evidence, including the clinical and objective findings of record and are not a sound basis for decision-making.

(R. 19–20) (emphasis added, numbering added).

Plaintiff's first allegation of error is incomprehensible in the circumstances of this case. She argues, "The ALJ failed to consider the limitations testified to by Thongleuth in making the determination that she can sustain competitive fulltime employment." (Pl.Br.14). Plaintiff does not point to any alleged limitation which was ignored or inadequately considered by the ALJ. Moreover, the ALJ included a summary of Plaintiff's allegations:

> The claimant alleged she is unable to work due to pain in her left hand, neck, hips and left foot. The claimant testified she has weakness on her left side and feels weak and "shaky." The claimant estimated she could stand on her feet approximately 30 minutes before needing to sit; that she could walk around inside a store for 40 to 50 minutes; and that she could sit for about 30 minutes. She reported that after alternating sitting and standing she would need to lie down for an hour. The claimant reported she continues to take pain medication.

(R. 18). The court's review of the record reveals that the ALJ's summary is a fair and adequate summary of Plaintiff's testimony. Clearly the ALJ considered the limitations testified to by Plaintiff, despite her protestation to the contrary.

Plaintiff's second allegation of error (that the ALJ failed to consider or discuss the side effects of her medication) is similarly unpersuasive. As Plaintiff points out, the ALJ did not discuss the side effects of her medication as they might relate to the credibility of her allegations. However, as the Commissioner asserts, there is simply no evidence in the record that Plaintiff's medications produced any side effects. In fact, Plaintiff affirmatively reported that she has no side effects from her medications (R. 217), and she does not allege any side effects in her briefing to the court. If the ALJ's failure to mention side effects was error (and the court doubts it was), Plaintiff has shown no prejudice, and the error was harmless.

***9** In her third allegation of error, Plaintiff claims the ALJ "unfairly and irrationally" used her financial interests to discount her credibility. As Plaintiff argues, the ALJ noted that Plaintiff's financial interest in the outcome detracts from reliance on her testimony as a basis for decision-making. (R. 20). Plaintiff does not explain how this consideration is either unfair or irrational, and cites to no legal authority for the proposition that it is. Certainly Plaintiff will benefit financially from receiving DIB and/or SSI in this case, and this potential gain might serve as a motivating factor to seek benefits by one who is not truly disabled within the meaning of the Act. Moreover, that is not the sole reason, but is one of four reasons given by the ALJ to discount Plaintiff's credibility.

Finally, Plaintiff argues that the ALJ relied upon inconsistencies which "are not clear evidence of lack of credibility." (Pl.Br.15). As quoted above, the fourth reason given by the ALJ for discounting Plaintiff's credibility was that Plaintiff's complaints are "exaggerated and inconsistent with the ... clinical and objective findings of record." (R. 20). Plaintiff does not object to the ALJ's finding that Plaintiff's complaints are exaggerated. Moreover, she does not assert that the ALJ's finding of inconsistencies between her allegations and the record evidence is erroneous. Rather, she points to three examples from the record which in her view suggest that the inconsistencies found by the ALJ are not "clear evidence" of lack of credibility, but are merely misunderstandings resulting from Plaintiff's difficulties with English. (Pl.Br.15–16).

In the first example, Plaintiff relates that "an accurate medical history was difficult to obtain" by Dr. Johnstone who performed an examination on Plaintiff. (Pl.Br.15). Dr. Johnstone was performing a consultation for Dr. Turner, Plaintiff's primary care physician at that time. (R. 229). As Plaintiff suggests, Dr. Johnstone stated that Plaintiff's "English is quite limited," and that "She is not employed, I believe, because of some type of disability involving her lower extremities although I couldn't quite get through the details due to the language barrier." *Id.* However, there is no indication the "language barrier" caused any problem with Dr. Johnstone's treatment of Plaintiff. He stated that he was treating Plaintiff for a "couple of issues"—a recurrent ganglion cyst, and abdominal pain. (R. 229). Nowhere does he indicate that he "couldn't quite get through the details" *as to these two issues,* probably because these issues were important to his treatment of Plaintiff, and he continued to inquire until he received sufficient information and understood the details. The reason for Plaintiff's unemployment however, did not relate to the purpose of Dr. Johnstone's treatment, and he did not need to clarify that issue. In any case, Dr. Johnstone never indicated that the language barrier affected his actual treatment at this time or through the period he treated Plaintiff. (R. 229–230).

***10** In her second example, Plaintiff quotes a sentence from Dr. Turner's treatment notes in which the physician noted, “She is a Laotian and unfortunately the only Laotian speaker in Wichita is an internist, Dr. Bon Nola. It might be worthwhile to have her consult with him at some point.” (Pl.Br.15) (quoting (R. 277)). The complete relevant portion of the quoted treatment note is, “She really does not have any reason for gastroparesis. Wondering about sending her to see a gastroenterologist. She is Laotian and unfortunately the only Laotian speaker in Wichita is an internist, Dr. Bon Nola. It might be worthwhile to have her consult with him at some point.” (R. 277). In context, the point of the note is not that Dr. Turner was having communication difficulties with Plaintiff. Rather, he was wondering about sending Plaintiff to a gastroenterologist, but considering that it might be preferable to send her to an internist who spoke Laotian.

Finally, Plaintiff asserts that using an interpreter throughout the hearing may have confounded the ALJ's credibility evaluation because the interpreter did not repeat Plaintiff's testimony verbatim “but chose to ‘interpret’ [Plaintiff's] responses.” (Pl.Br.16). Specifically, she points to one instance in which the ALJ interrupted the interpreter, and sought clarification. *Id.* (citing (R. 29)). She then asserts that the ALJ's credibility finding was erroneous because of “the obvious inadequacy of the interpreter.” *Id.*

Plaintiff's argument relates to the following colloquy between the ALJ and Plaintiff at the hearing:

Q Have you attempted to work since then?

A No, I'm not, she cannot work at all. No, she cannot even do the housework much—

Q And did she—

A—or hold down a job.

Q Did you work for Sara Lee in the past?

A Yes, she did.

Q Okay. She said more than yes, a yes answer, what did exact—

A Yes, she did work for Sara Lee and then switched back to Rubbermaid.

Q Okay....

(R. 29). This is the only instance in the record where the ALJ interrupted the interpreter, or where there is any indication that the interpreter may not have been translating “verbatim.” The ALJ understood his responsibility to control the hearing and to ensure the integrity of the proceedings, and he was clearly willing to question the interpreter when he sensed a problem. Plaintiff presents no evidence that there was an on-going or continual problem. Moreover, it is revealing to note that Plaintiff does not assert error in the interpretation, the qualifications of the interpreter, or the use of this particular interpreter. Rather, she argues that the *credibility finding of the ALJ* was erroneous because of this “obvious inadequacy of the interpreter.”

None of the three examples cited by Plaintiff relate to the ALJ's credibility determination, and Plaintiff provides no citation to testimony which was misunderstood by the ALJ or misinterpreted by the interpreter, and therefore resulted in an erroneous credibility finding. Plaintiff has shown no error in the ALJ's credibility determination.

***11** With regard to the remainder of the RFC assessment, Plaintiff claims error because (1) the ALJ relied upon an RFC assessment which was not prepared by an acceptable medical source; (2) the ALJ failed to consider how Plaintiff's non-severe mental impairments affected her RFC; (3) the ALJ failed to include limitations regarding Plaintiff's language difficulties; and (4) the ALJ failed to include a narrative discussion describing how the evidence supports each conclusion, citing specific medical facts and non-medical evidence. The Commissioner argues that the RFC assessment was proper.

Plaintiff first argues that the ALJ erred in relying upon the RFC assessment of a Single Decision Maker (SDM) prepared at the initial consideration of Plaintiff's applications. As Plaintiff argues, the weight of persuasive authority is that an SDM opinion is not a medical opinion and is worthy of no weight in an ALJ's analysis. *E.g., Ky v. Astrue,* No. 08–cv–00362–REB, 2009 WL 68760 at *3 (D .Colo. Jan. 8, 2009) ("An SDM is not a medical professional of any stripe, and the opinion of an SDM therefore is entitled to no weight ."); *Stanley v. Astrue,* No. 09–20485–CIV, 2009 WL 3060394 (S.D.Fla. Sept. 24, 2009) (remanding with directions not to rely upon determination by SDM); *Smith v. Astrue,* No. 3:07–cv–1165–J–TEM, 2009 WL 890391 at *11 (M.D.Fla. March 31, 2009) (ALJ improperly classified SDM as physician); *Burnham v. Astrue,* No. 06–124–P–H, 2007 WL 951386 at *2 (D.Me. March 27, 2007) (ALJ wrongly accorded weight to opinion of SDM).

Courts in this district with one exception, have uniformly recognized that an SDM is not a medical professional, and that her opinion is worthy of no weight as a medical opinion. *Greenfield v.. Astrue,* No. 09–1173–WEB, 2010 WL 2132057, *4, n. 5 (D.Kan. Apr. 26, 2010) (Report & Recommendation, adopted May 27, 2010, 2010 WL 2132061); *Cowan v. Astrue,* No. 09–1154–WEB, 2010 WL 2131915, *6 (D.Kan. Apr. 9, 2010) (Report & Recommendation, adopted May 27, 2010, 2010 WL 2132028); *Kempel v. Astrue,* No. 08–4130–JAR, 2010 WL 581900, *7 (D.Kan. Jan. 4, 2010); *Houghtaling v. Astrue,* No. 08–2656–KHV–GBC, slip op. at 2, 3, (D.Kan. Nov. 10, 2009); *but see, Sawyer v. Astrue,* No. 08–2114–KHV, 2009 WL 634666, *7 (D.Kan. March 11, 2009) (relying upon opinion of SDM, among other evidence, as "*medical evidence* that plaintiff can work full-time"). In *Sawyer,* the only Kansas district court case accepting an SDM opinion as medical evidence, the court did not consider whether an SDM was a medical professional or whether such an opinion was worthy of weight as a medical opinion.

Here, the ALJ "considered the opinions of the State agency medical consultants, and [ ] accorded their physical assessments substantial weight." (R. 19). On the other hand, he gave "limited weight to the psychological assessments provided by the State agency." *Id.* Plaintiff asserts that in making this analysis, "the ALJ adopted the findings found in the assessment singed [sic] by Lind [sic] K. Stone, who is identified as a 'SDM.' " (Pl.Br.12) (citing (R. 290–97) ("Physical Residual Functional Capacity Assessment" form, signed by a Single Decision Maker, Linda K. Stone)). Although Plaintiff acknowledges that Ms. Stone's Physical RFC Assessment form was later affirmed by a physician, she argues that the ALJ believed the SDM was also a medical consultant, because he used the plural, "consultants." *Id.* She asserts that this is error requiring remand for a proper evaluation of the opinion of the SDM. *Id.* The Commissioner argues that the RFC assessment form completed by Ms. Stone was "adopted and affirmed by a medical professional," and thereby "became a medical opinion," and it was proper for the ALJ to rely upon that opinion. (Comm'r Br. 14) (citing (R. 310) ("Case Analysis" form, signed by Dr. Siemsen, M.D., affirming RFC "as written")). In her reply brief, Plaintiff argues based upon an unpublished 2009 decision of a court in this district that the ALJ's use of the plural reveals he must have been laboring under the incorrect belief that the SDM was a doctor, which is reversible error. (Reply 2–3) (citing *Toon v. Astrue,* No. 07–1369–MLB, slip op. at 14–16 (D.Kan. Mar. 2, 2009) (Report and Recommendation) *adopted by the district court,* (Mar. 17, 2009)). [1]

1 The Court notes that Plaintiff did not cite to an electronic reporting service, or attach the *Toon* opinion as an exhibit to her brief, as required by local rule. D. Kan. R. 7.6(c). Nonetheless, the court was able to find the Toon opinion on the Lexis electronic reporting service. *Toon v. Astrue,* No. 07–1369–MLB, 2009 U.S. Dist. LEXIS 125221 (D.Kan. Mar. 2, 2009) *adopted by the district court* 2009 U.S. Dist. LEXIS 83928 (Mar. 17, 2009). Counsel is cautioned to follow the local rules in the future.

***12** The court agrees with the Commissioner that the opinion of the SDM was adopted by the reviewing medical consultant at the reconsideration level, and thereby became a "medical opinion" within the meaning of the Act and the regulations, and must be considered and weighed accordingly. The fact that the ALJ used the plural in referring to the "state agency consultants," and thereby mistakenly accorded equal weight to the opinions of the SDM and of the medical consultant which were contained in the same document, is of little significance in the circumstances. As Plaintiff noted, Exhibit 6F, was completed by the SDM on March 16, 2009, and as the opinion of an SDM is not a "medical opinion" within the meaning of the Act and regulations and carries no weight in the ALJ's evaluation of the medical evidence and the medical opinions. However, Plaintiff also admits that when Dr. Siemsen performed his review at the reconsideration level, he stated that "the RFC and and/or [sic] assessment of 3–16–09 is affirmed as written." (R. 310); *see also,* (Pl.Br.12) (noting the SDM opinion "was affirmed by a Gerald Siemsen, M.D.”); (Reply 3) (same). As Plaintiff admits and the Commissioner argues, the SDM opinion was adopted by the medical consultant. The ALJ stated he gave the SDM/medical consultant opinion “substantial weight,” and explained his reasons for assigning that weight:

> Although the State agency medical consultants did not examine the claimant, they provided specific reasons for their opinions about the claimant's residual functional capacity showing that these opinions were grounded in the evidence of record, including careful consideration of the objective medical evidence and the claimant's allegations regarding symptoms and limitations. The opinions are internally consistent and consistent with the evidence as a whole.

(R. 19).

The court's review of the evidence reveals support for the ALJ's rationale. The opinion reveals specific manipulative limitations in handling, fingering, and feeling; and explains what the limitations are, and why they were assessed. (R. 293). The opinion includes a careful discussion of the credibility of Plaintiff's allegations of symptoms. (R. 295). Moreover, the opinion includes an analysis and explanation supporting the RFC assessment with evidence in the record. (R. 297). Plaintiff does not argue that the ALJ's reasons are erroneous, but she argues that the ALJ's analysis must be rejected merely because he attributed “medical source” status to the SDM. She makes this argument despite acknowledging that the medical consultant reviewed and adopted the assessment. To reject the ALJ's analysis of the opinion merely because the opinion was originally authored by an SDM, despite the fact that it was subsequently adopted by a medical consultant, would be to elevate form over substance, and the court is unwilling to do so.

Plaintiff's citation to *Toon,* does not persuade the court otherwise. As Plaintiff argues, the court in *Toon* remanded, at least partly because, “the ALJ erroneously believed that a medical professional had authored the [SDM's RFC assessment] (even though the ALJ may have known that [a medical consultant] had adopted the findings in the Exhibit).” *Toon,* No. 07–1369–MLB, slip op. at 16, 2009 U.S. Dist. LEXIS 125221 at * 20. Nonetheless, several factors present in *Toon* are not present here, and justify a different result. In *Toon,* before the court considered the ALJ's evaluation of the SDM opinion, it had already determined that errors in the ALJ's credibility analysis required remand, and therefore analysis of the SDM/medical consultant opinion was, strictly speaking, unnecessary. *Id.,* slip op. at 5–13, U.S. Dist. LEXIS 125221 at *6–17. In *Toon,* the Commissioner's response brief did not address the SDM/medical consultant opinion, and he did not make, and therefore forfeited, any argument that the ALJ was entitled to rely upon the medical consultant opinion even though the ALJ erroneously believed the SDM was a medical source. *Id.,* slip op. at 15 n. 1, U.S. Dist. LEXIS 125221 at *18 n. 1. Finally, the record in *Toon* revealed that a treating physician had provided a physical RFC assessment to the Appeals Council after the ALJ's decision was made. Moreover, the treating physician's assessment was contrary to the SDM/medical consultant opinion, and the *Toon* court considered that assessment significant in deciding that remand was necessary for proper consideration of the SDM/medical consultant opinion. *Id.,* slip op. at 16 & n. 2, U.S. Dist. LEXIS 125221 at *20 & n. 2 (“in light of the opinion of Dr. Dorey, who had examined the plaintiff and stated that plaintiff had greater restrictions than those found by the ALJ”).

***13** Plaintiff's argument that the ALJ failed to consider how Plaintiff's non-severe mental impairments affected her RFC is primarily a continuation of her step two argument that her mental impairments are severe within the meaning of the Act. She argues that because Dr. Adams found “moderate” limitations in social functioning and in concentration, persistence, or pace; the ALJ should have included specific mental limitations in his RFC assessment. As explained in the step two analysis above, Plaintiff's reliance upon Dr. Adams's reports is misplaced because the ALJ gave “limited weight” to them. Further, Plaintiff does not argue that the ALJ erred in weighing them. Therefore, Plaintiff has shown no specific mental limitations which should have been included in the RFC assessment. Moreover, the ALJ stated he had assessed Plaintiff's RFC “After careful consideration of the entire record.” (R. 18). Since Plaintiff has provided no basis to conclude the ALJ did not do as he said, the court will follow its general practice, which is "to take a lower tribunal at its word when it declares that it has considered a matter." *Hackett,* 395 F.3d at 1173.

Plaintiff next argues that the ALJ failed to include limitations in the RFC regarding Plaintiff's ability to speak English. (Pl.Br.13). Plaintiff shows no error. At finding number eight, the ALJ stated: "The claimant is illiterate and is unable to communicate in English." (R. 20). While the ALJ's RFC assessment was made at finding number five and the finding of illiteracy and inability to communicate in English was made at finding number eight, this is of no significance. In fact, it would be improper to include such factors in an RFC assessment, since RFC relates to physical, mental, and other physiological limitations in the ability to work. 20 C.F.R. § § 404.1545, 416.945. "Illiteracy" and "Inability to communicate in English" on the other hand, are subsumed within the *vocational factor* of "education." 20 C.F.R. §§ 404.1564(b)(1 & 5), 416.964(b)(1 & 5). The regulations provide that vocational factors of age, education, and work experience will not be used until step five of the sequential evaluation process where it is determined whether there are a significant number of jobs which Plaintiff can perform, given her RFC and vocational factors of age, education, and work experience. 20 C.F.R. § § 404.1560, 416.960. The ALJ did not err in failing to include Plaintiff's inability to communicate in English within the RFC assessed.

In her final RFC argument, Plaintiff claims the "ALJ's narrative does not link the medical evidence with the arbitrary limitations found within the RFC. The ALJ simply lists the medical evidence in the record then announces his conclusion without linking the evidence to the RFC." (Pl.Br.13–14). Plaintiff appears to be arguing that the ALJ failed to provide a pinpoint citation to medical evidence in the record for each RFC finding, but that is not the standard required. What is required is that the narrative discussion describe how the evidence supports the RFC conclusions, and cite specific medical facts and nonmedical evidence supporting the RFC assessment. SSR 96–8, West's Soc. Sec. Reporting Serv., Rulings 149 (Supp.2010). The ALJ's narrative discussion of his RFC assessment appears at pages six through eight of his decision (R. 18–20), and in that discussion, he described how the evidence supports his RFC conclusions, and cited the specific medical facts and nonmedical evidence upon which he relied in making his assessment. Moreover, to the extent that the ALJ's analysis at pages three through five of his decision (steps two and three of the evaluation process) relate to his determination not to include mental limitations and not to include greater physical limitations in the RFC assessed, that analysis is also a part of the narrative discussion, citing medical facts and nonmedical evidence upon which he relied in making his assessment. (R. 15–17). As discussed above, the narrative discussion also included consideration of the credibility of Plaintiff's allegations of symptoms, and consideration of the medical opinions. More is not required. Plaintiff has shown no error in the ALJ's RFC assessment.

V. Step Five

***14** In her last allegations of error, Plaintiff claims the ALJ erred at step five of the evaluation process by relying upon the vocational expert (VE) testimony, and gives three reasons supporting her argument. First, she claims the ALJ included nothing in his hypothetical questioning regarding Plaintiff's ability to speak English. She also claims the VE merely speculated regarding the number of jobs available in the economy for someone with the RFC, age, education, and work experience of Plaintiff. Finally, she claims that because the ALJ found Plaintiff is illiterate and unable to communicate in English, and because the representative jobs listed by the VE require "Language:—Level 1" as reflected in the Dictionary of Occupational Titles (DOT), there is a conflict between the DOT and the VE testimony which was not resolved by the ALJ, and remand is necessary for a proper resolution of the conflict. The Commissioner argues there is no conflict with the DOT, but the VE testimony reveals additional information about the representative jobs. He argues the ALJ presented Plaintiff's language level as a range from a quarter to none. Finally, the Commissioner argues that the supposed speculation of the VE relates only to a hypothetical question upon which the ALJ did not rely.

Plaintiff's claim that the ALJ included nothing in his hypothetical regarding Plaintiff's ability to *speak* English ignores the context of this case. As the Commissioner suggests, the ALJ specifically stated that he wanted the VE to assume the hypothetical individual had a "two-year education in Laos with a quarter to none ability to read, write and use numbers." (R. 35). Although the ALJ did not specifically state in his hypothetical that Plaintiff cannot communicate in English, the VE was present at the hearing where he observed that Plaintiff did not speak in English but was speaking (and listening) through an interpreter for the entire hearing. In context with the ALJ's statement that the hypothetical individual had a "two-year education in Laos with a quarter to none ability to read, write and use numbers," it is clear that the hypothetical individual representing Plaintiff was unable to communicate in English. Moreover, the VE demonstrated that he was attending to Plaintiff's testimony when he informed the ALJ that although his work history report showed Plaintiff had a 9th grade education, he wanted to change the file to reflect Plaintiff's testimony that she had a 2nd grade education. (R. 35). In their colloquy in this regard, the ALJ and the VE both accepted Plaintiff's testimony that she had a second grade education in Laos. *Id.*

Plaintiff attempts to interject ambiguity into the hypothetical by stating that, "The ALJ did include the limitation of 'a quarter to none ability to read, write and use numbers,' however there was no indication whether the limited ability to read and write was in English." (Pl.Br.18). Because a limited ability to read and write in Laotian is almost irrelevant to an ability to work in the national economy of the United States, there can be no question that the ALJ found Plaintiff has a quarter to none ability to read, write, and use numbers *in English.* As the regulations cited by the ALJ in regard to Plaintiff's ability to communicate in English make clear:

> ***15** Because English is the dominant language of the country, it may be difficult for someone who doesn't speak and understand English to do a job, regardless of the amount of education the person may have in another language. Therefore, we consider a person's ability to communicate in English when we evaluate what work, if any, he or she can do. *It generally doesn't matter what other language a person may be fluent in.*

20 C.F.R. § § 404.1564(b)(5), 416.964(b)(5) (as cited by the ALJ at (R. 20, finding no. 8)) (emphasis added). Moreover, the ALJ has no expertise, knowledge, or basis for determining what is the extent of Plaintiff's ability to read, write, and use numbers in Laotian, or any other language but English.

Plaintiff's argument (that it is unclear how many jobs are available in the national economy for someone with Plaintiff's RFC, age, education, and work experience) is premised upon Plaintiff's questioning of the VE. (Pl.Br.18) (citing (R. 37–38)). Some background is necessary to understand this argument.

The ALJ presented a hypothetical to the VE which included a limitation to "no more than occasional and repetitive hand motions with the non-dominant left hand," and asked if there were occupations available for such a person at the light and sedentary exertional levels. (R. 35). The VE provided two representative examples at each exertional level, along with the numbers of jobs available for each occupation within the local area, the state, and the nation: (a) light exertional level occupations, (1) marker, with 4,190; 16,490; and 1,817,650 jobs respectively in each region; and (2) racker, with 1,230; 4,810; and 524,440 jobs respectively in each region; and (b) sedentary exertional level occupations, (1) polisher, with 430; 980; and 96,730 jobs respectively in each region; and (2) stuffer, with 810; 5,050; and 368,320 jobs respectively in each region. (R. 37). After the ALJ questioned the VE regarding additional hypothetical scenarios not relevant here, he allowed counsel for Plaintiff to question the expert. (R. 37). Counsel stated he just wanted to clarify the VE's testimony, and proposed a hypothetical similar to the ALJ's first hypothetical but in which the hypothetical individual was limited to occasional handling, fingering, and feeling with the non-dominant hand. (R. 37–38). He asked if the jobs to which the VE testified earlier would remain for such an individual. *Id.* The expert testified that, "those positions would still be available." (R. 38).

Plaintiff's counsel apparently recognized that much sedentary work requires use of both hands, and the following colloquy ensued:

Q Even in the sedentary they would, they don't need the full usage of both hands in a sedentary?

A Not for the jobs that I, I mean, there are jobs in that sedentary job base where they're bilateral. But these two examples, you could do it with the other hand, the non-dominant hand.

Q And how many other jobs would you say there are that you can do? Just representatives.

***16** A Just a percentage, like an erosion?

Q Percentage, yeah.

A There's probably going to be an erosion of at least up to 80 percent of the sedentary job base.

(R. 38). Thereafter, the ALJ attempted to get the VE to quantify the number of jobs represented by the 20 percent of the sedentary occupational base that a hypothetical individual such as Plaintiff can perform, but the VE would not provide a number. He explained that the sedentary occupational base included 137 different jobs or occupations and approximately 20 percent of those jobs or occupations could be performed by a person with the abilities presented in hypothetical number one, but that he could not testify how many position that represented in the national economy without identifying all of the jobs or occupations from the DOT which are actually available to such an individual, determining how many positions are represented by each job or occupation, and then adding all of the positions together to obtain a total. (R. 38–42). Finally, the ALJ proposed that "the 20 percent could be millions of jobs," the expert responded, "Five percent could be millions of jobs, depending on," and the ALJ concluded, "All right, that's what I'm trying to get at." (R. 42).

Based upon this testimony from the hearing, Plaintiff claims it is unclear how many jobs are available in the national economy, that the VE and the ALJ merely speculated that there are a significant number of jobs available in the economy, that the remaining 20 percent of available jobs would be eroded much greater if Plaintiff's ability to communicate in English is taken into account, and therefore, remand is necessary to resolve this error. The Commissioner argues that the VE's testimony related only to the hypothetical presented by Plaintiff's counsel which was not adopted by the ALJ, and consequently, there is no error.

As discussed above, the expert testified that the hypothetical presented by Plaintiff's counsel would not change his testimony. (R. 38). He went on to explain that the requirement to perform sedentary work with one hand and using the non-dominant hand "basically as a helper hand," would erode the sedentary occupational base by "at least up 80 percent." *Id.* Therefore, contrary to the Commissioner's argument, the 80 percent erosion of the sedentary occupational base does apply to the VE testimony regarding occupations relied upon by the ALJ.

The fact that the sedentary occupational base would be eroded up to 80 percent is irrelevant to the ALJ's reliance upon the VE's testimony however, because the VE testified specifically that the representative sedentary jobs of polisher and stuffer are available to an individual such as Plaintiff—with 1,240 positions in the local area, 6,030 positions in the state, and 465,050 positions in the national economy. (R. 36). Plaintiff, appropriately, does not argue that this is not a significant number of jobs in the economy. Moreover, the expert testified that the representative *light* jobs of marker and racker are also available, with 5,420 positions in the local area, 21,750 positions in the state, and 2,342,090 positions in the national economy. (R. 36). The expert's testimony in this regard is clear, and the ALJ's reliance upon that testimony is certainly not based upon mere speculation.

***17** Finally, Plaintiff claims the ALJ erred in finding there is no conflict between the VE's testimony and the DOT. This is so in Plaintiff's view because the ALJ found Plaintiff is illiterate and unable to communicate in English, whereas the representative jobs listed by the VE require "Language:—Level 1" as reflected in the DOT. Plaintiff argues that this constitutes a conflict which was not resolved by the ALJ. The Commissioner argues that no conflict exists because although a conflict might be assumed absent the expert testimony, the role of the VE is to go beyond the confines of the DOT and provide evidence of jobs which are available to a claimant based upon specific, individual abilities and specific positions.

In 1993, the Tenth Circuit recognized that the regulations offer two alternative means of proof of work that exists in the national economy—(1) administrative notice of job data from various publications including the DOT, and (2) use of vocational experts or other specialists. *Gay v. Sullivan,* 986 F.2d 1336, 1340 (10th Cir.1993) (citing 20 C.F.R. §§ 404.1566(d & e)). The court noted that such a construction "comports with existing case law." *Id.* (citing *Warmoth v. Bowen,* 798 F.2d 1109, 1110 (7th Cir.1986); and *Decker v. Harris,* 647 F.2d 291, 298 (2d Cir.1981)). The court went on to explain,

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> what would be the point of vocational testimony (or expert testimony in general) if it could not reach beyond matters already established through administrative (or judicial) notice? Furthermore, the policy reasons mandating prudential limitations on the range of materials that may be noticed directly, without any adversarial scrutiny, do not apply to sources of expert testimony that may be tested by cross-examination.

Id.

Later, in November, 1999 the Tenth Circuit decided that before an ALJ may rely on VE testimony the ALJ has a duty to ask the VE how the testimony corresponds with the DOT and to elicit a reasonable explanation for any conflict. *Haddock,* 196 F.3d at 1089. The court made clear that the DOT does not "trump" VE testimony, but rather that the ALJ has a duty to investigate and get a reasonable explanation before he may rely on VE testimony. *Id.* at 1091. In June, 2000, the Commissioner acquiesced in the *Haddock* decision. Acquiescence Ruling 00–3, West's Soc. Sec. Rep. Serv., Rulings, 402 (Supp.2003). He ultimately published SSR 00–4p, effective December 4, 2000 regarding this issue. West's Soc. Sec. Rep. Serv., Rulings, 242–47 (Supp.2010). In SSR 00–4p, the Commissioner established a policy interpretation for the use of VE testimony and "Other Reliable Occupational Information in Disability Decisions." *Id.* at 243.

In SSR 00–4p, the Commissioner placed two duties on an ALJ. First, the ALJ must "identify and obtain a reasonable explanation for any conflicts between occupational evidence provided by VEs ... and information in the Dictionary of Occupational Titles (DOT), including its companion publication, the Selected Characteristics of Occupations Defined in the Revised Dictionary of Occupational Titles (SCO)." *Id.* Second, the ALJ must "[e]xplain in the determination or decision how any conflict that has been identified was resolved." *Id.* Thus, SSR 00–4p places the affirmative responsibility on the ALJ to "[a]sk the VE ... if the evidence he or she has provided conflicts with information provided in the DOT," and where VE "evidence appears to conflict with the DOT, ... [to] obtain a reasonable explanation for the apparent conflict." *Id.* at 246.

***18** In the hearing, at the end of his examination of the VE, the ALJ asked if there are any inconsistencies between the VE testimony and the DOT, and the VE responded that there are none. (R. 37). In his decision, the ALJ found that, "Pursuant to SSR 00–4p, the vocational expert's testimony is consistent with the information contained in the Dictionary of Occupational Titles. (R. 21).

Plaintiff's claim that there is a conflict requiring remand fails. As required by law and the Social Security Rulings, the ALJ asked if there were inconsistencies between the VE testimony and the DOT. (R. 37). The VE replied that there were none. *Id.* Thus, the ALJ fulfilled his first duty pursuant to SSR 00–4p. Plaintiff cross-examined the expert, and his questioning did not even attempt to suggest that there are conflicts between the VE testimony and the DOT. Plaintiff did not direct the ALJ to record evidence or to admissible authority that there is a conflict despite the VE testimony, and did not argue to the ALJ that the VE testimony was erroneous. Thus, *the administrative record* contains no evidence that the VE testimony and the DOT are inconsistent as alleged by plaintiff before this court, and no hint that the ALJ's second duty pursuant to SSR 00–4p (to explain any apparent conflict) was triggered.

Before this court, plaintiff argues directly from the listings in the DOT, but without pinpoint citation to that authority, that there are, in fact, conflicts between the VE testimony and the DOT. (Pl.Br .17). The court recognizes that an ALJ must take notice of the DOT listings as authoritative information regarding jobs in the economy, and where the ALJ has not, the court in appropriate circumstances will do so.

Neither the ALJ, this court, plaintiff, nor plaintiff's counsel are experts in vocational matters with the expertise to interpret the DOT contrary to the interpretation given by the VE. Plaintiff simply presents no basis in the record evidence, or legal or vocational authority to find otherwise than as testified by the VE. Plaintiff presents no authority whatsoever that any DOT language level requirements regarding the specific occupations and positions at issue here are otherwise than as testified by the VE. While one might argue, as Plaintiff has, that the DOT requires greater literacy than Plaintiff possesses in order to perform these jobs, it has also been noted that "a claimant's 'reliance on the *DOT* as a definitive authority on job requirements is misplaced' because '*DOT* definitions are simply generic job descriptions that offer the approximate maximum requirements for each position, rather than their range.' " *Page v. Astrue,* 484 F.3d 1040, 1045 (8th Cir.2007). Moreover, the purpose of VE testimony is to go beyond matters established by administrative notice. Recognizing "Language: Level 1" as the *maximum* language level required of any position within the occupations included in the DOT listings, the court sees no specific conflict between the information presented in DOT and the VE's testimony. The VE was aware of Plaintiff's language limitations as evidenced by use of the interpreter and as instructed by the ALJ, and testified that there are almost three million positions in the national economy within the representative occupations which Plaintiff has the capability to perform.

***19** Even if the court were to find an apparent conflict, lacking vocational expertise, record evidence, or other admissible authority to establish that a conflict actually exists, the court would be compelled to accept the VE's undisputed testimony. Plaintiff's or her counsel's mere assertion as lay observers that the DOT listings require a different finding than that testified by the expert are insufficient to contravene the direct testimony of the expert. The court may not reweigh the evidence or make its decision based upon evidence outside the record. The only record evidence is the VE testimony that the DOT is consistent with the VE testimony. The ALJ followed the dictates of SSR 00–4p, and the record evidence reveals no conflict between the VE testimony and the DOT. The court finds no error in the ALJ's consequent decision to rely upon the VE testimony.

IT IS THEREFORE ORDERED that judgment be entered in accordance with the fourth sentence of 42 U.S.C. § 405(g) AFFIRMING the Commissioner's decision.

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EXHIBIT AC-112

CONFIDENTIAL

AFILIAS' RESPONSE TO VERISIGN AND NDC'S REQUESTS TO PARTCIPATE AS AMICI CURIAE

JANUARY 28, 2019

https://www.icann.org/en/system/files/files/irp-afilias-claimant-response-to-verisign-amicus-curiae-redacted-28jan19-en.pdf

EXHIBIT AC-113

KeyCite Yellow Flag - Negative Treatment
Distinguished by Tibbs v. Illinois Administrative Office of Illinois Courts, C.D.Ill., February 26, 2016

58 F.3d 1194
United States Court of Appeals, Seventh Circuit.

David KELLER, Plaintiff–Appellant,
v.
UNITED STATES of America, Defendant–Appellee.

No. 94–2633
|
Argued Feb. 28, 1995.
|
Decided June 29, 1995.

Synopsis
Patient who underwent surgery at Veteran's Administration hospital to repair aortic aneurism brought action under Federal Tort Claims Act, and the United States District Court for the Northern District of Illinois, Wayne R. Andersen, J., entered judgment on jury verdict for government. Patient appealed, and the Court of Appeals, Ripple, J., held that: (1) trial court did not abuse its discretion in refusing to instruct jury that negative inference could be drawn from hospital's failure to produce record of blood pump used during procedure, and (2) findings that hospital and physicians did not breach applicable standard of care were supported by evidence.

Affirmed.

Procedural Posture(s): On Appeal.

Attorneys and Law Firms

***1195** Aram A. Hartunian, Hartunian & Associates, Karen A. Keefer (argued), Scott Skaletsky, Skaletsky & Mannis, Chicago, IL, for plaintiff-appellant David Keller.

Linda A. Wawzenski, Asst. U.S. Atty. (argued), Thomas P. Walsh, Asst. U.S. Atty., Office of U.S. Atty., Civ. Div., Chicago, IL, for defendant-appellee U.S.

Before BAUER, COFFEY and RIPPLE, Circuit Judges.

Opinion

RIPPLE, Circuit Judge.

David Keller, who suffered a crippling disability as the result of an operation at a Veteran's Administration Hospital in New Mexico, appeals the denial of his medical malpractice claim against the United States government under the Federal Tort Claims Act, 28 U.S.C. §§ 2671 *et seq.* For the following reasons, we affirm the judgment of the district court.

I

On April 1, 1988, at the Albuquerque Veterans Administration Medical Center in New Mexico, Dr. Stuart Pett [1] repaired a chronic pseudoaneurism (hereinafter "aneurism") in Mr. Keller's descending thoracic aorta. Following the surgery, Mr. Keller displayed paraparesis, which is a neurological impairment consisting of diminished sensation and muscle control. Plaintiff then brought this negligence suit, claiming that the surgeon's failure to assure adequate blood flow before excising the aneurism caused the paraparesis.

***1196** Repair of an aneurism requires clamping the aorta above and below the vessel for a period of time. According to the medical testimony at trial, there are at least three medically accepted clamping methods: (1) "clamp and sew," which involves simply clamping off the aneurism and working as quickly as possible, (2) use of a passive or "Gott" shunt, which utilizes a tube to bypass the site of the operation, and (3) use of a shunt with a pump attached in order to increase the flow of blood. Spinal injury is a recognized potential side-effect of repairing aortic aneurisms because the operation requires interfering with the blood flow to the lower body, including the lower spine. According to Dr. Lawrence Michaelis, [2] the government's expert witness, there is a 3–5% chance that spinal cord injury will result from the operation regardless of the technique used. Dr. Pett chose to use the shunt in conjunction with a Biomedicus centrifugal pump, which has a variable speed setting. [3] However, the pump's output is ultimately limited both by the flow of blood available from the atrium and by the need to supply blood to the upper and lower body. Dr. Pett inserted a canula into the left atrium of Mr. Keller's heart to carry blood to the pump. The pump then would send that blood through another line to the lower descending thoracic aorta. Dr. Pett clamped the aorta above and below the aneurism. The aneurism was repaired, a graft was sewn in, and, after two intercostal arteries were sewn off, the patient was closed up. The aorta was clamped for fifty minutes, and the Biomedicus supplemented circulation for all but five minutes of that time.

Blood flow is measured by a device attached to the pump. It can also be indirectly measured by blood pressure, which, if the resistance created by the walls of the blood vessels remains constant, generally increases as blood flow does. However, if the resistance drops, blood pressure may also drop, even if the blood flow remains the same. During Mr. Keller's operation, various blood pressures were measured by using pressure monitoring lines in Mr. Keller's right arm, his left femoral artery, his neck and the left atrium of his heart.

The medical record contains little evidence concerning the blood flow downstream to Mr. Keller's lower spine during the operation. [4] Since the pump record documenting blood flow was not produced, the parties relied upon blood pressure readings in order to show whether the pump was generating enough blood flow to support the operation. Mr. Keller points to the consistently low blood pressure for more than half of the operation. [5] However, Dr. Michaelis, the government's expert, pointed out that the upstream pressures pumping blood to the upper body were fine. He testified that, if the pump was not drawing blood out of the left atrium, then the pressure in the upper part of the body would have remained extremely high. He also testified that the constant, rather than pulsatile, flow generated by the pump often causes the blood pressure to decrease even if the blood flow did not change.

***1197** After a bench trial, the district court concluded that there was no credible testimony to support a conclusion that there was any breach of the standard of care during the surgery. Before us, Mr. Keller challenges that ruling. Mr. Keller contends that, due to the surgeon's failure to monitor and to use the Biomedicus pump properly, the spinal cord was deprived of an adequate blood supply and paraparesis resulted. More specifically, Mr. Keller submits that the record demonstrates that the blood flow to the lower body was not sufficient and that Dr. Pett must have been negligent because he (1) never learned of the inadequate blood flow, (2) knew about it and cut into the aorta anyway, or (3) failed to start the pump before starting the excision. Mr. Keller asks this court to reverse the district court judgment by holding that the record does support a determination that Dr. Pett was negligent.

II

Following a bench trial, we review the district court's findings concerning questions of fact under a clearly erroneous standard. *Thornton v. Brown,* 47 F.3d 194, 196 (7th Cir.1995). The substantive law of the state where the act or omission occurred governs actions brought under the Federal Tort Claims Act. 28 U.S.C. § 1346(b); *Midwest Knitting Mills Inc. v. United States,* 950 F.2d 1295, 1297 (7th Cir.1991); *see United States v. Muniz,* 374 U.S. 150, 153, 83 S.Ct. 1850, 1853, 10 L.Ed.2d 805 (1963) ("Whether a claim could be made out would depend upon whether a private individual under like circumstances would be liable under state law...."). We therefore apply, as did the district court, the substantive law of New Mexico. The district court's determination of the content of state law is reviewed *de novo. Salve Regina College v. Russell,* 499 U.S. 225, 231, 111 S.Ct. 1217, 1221, 113 L.Ed.2d 190 (1991); *Midwest Knitting Mills,* 950 F.2d at 1298.

The New Mexico Supreme Court has formulated the standard of care for physicians; it is a duty to use "the knowledge, skill and care ordinarily used by reasonably well-qualified doctors of the same field of medicine practicing under similar circumstances...." *Pharmaseal Labs., Inc. v. Goffe,* 90 N.M. 753, 757–58, 568 P.2d 589, 593–94 (1977). Medical malpractice must be shown by expert testimony on the standard of care, unless the question may be determined by the ordinary knowledge of a layman. *Id.,* 90 N.M. 753, 568 P.2d at 594. Although local differences in care are considered as a factor, one which did not play a major role in this case, doctors from other localities may testify as to the standard of care. *Id.* To establish the prima facie case for medical malpractice under the law of New Mexico,

> a plaintiff has the burden of showing that (1) the defendant owed the plaintiff a duty recognized by law; (2) the defendant breached the duty by departing from the proper standard of medical practice recognized in the community; and (3) the acts or omissions complained of proximately caused the plaintiff's injuries.

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Blauwkamp v. University of N.M. Hosp., 114 N.M. 228, 836 P.2d 1249, 1252 (N.M.Ct.App.1992) (citations omitted). With these standards in mind, we now turn to the specific contentions of Mr. Keller.

III

Focusing on the issue of blood flow, Mr. Keller first raises several evidentiary issues. He submits that the government's failure to produce a copy of the pump record entitles him to a negative inference as to whether the pump provided sufficient blood flow. The district court found that the records "cannot be located even though the hospital should have kept them." R. 25 at 5. Notably, the court made no finding of bad faith. Absent a finding that the government willfully destroyed evidence in bad faith, the district court clearly acted within its discretion in declining to infer that the evidence would have been unfavorable to that party.[6] ***1198** We note from the record that there is evidence the university did not keep the pump records, and that there is no evidence that the records were actually destroyed.[7] We therefore conclude that the record adequately supports the determination of the district court.

Mr. Keller also claims, in conclusory fashion with no citation or discussion of federal authority, that Dr. Pett made judicial admissions that bind the United States in this litigation.[8] We need not explore this matter in any depth for two reasons. First, as we have noted many times, it is not the ***1199** responsibility of this court to make arguments for the litigants. *See Beard v. Whitley County REMC,* 840 F.2d 405, 408–09 (7th Cir.1988). In any event, the "admissions" at issue here are not admissions at all. In arguing that the district court erred, Mr. Keller specifically alleges that Dr. Pett admitted (1) that a pressure of 50 is necessary, (2) that, in order to discover if the pump was functioning in time to halt the operation, the physician must check the pump before cutting into the aorta, and (3) that the safety point for interrupting blood flow is 30 minutes, and even an interruption of 20 minutes can be hazardous. Our review of the record indicates that Dr. Pett's statements were misstated or misconstrued. First, the surgeon indicated that a pressure of 50 was a goal, not an absolute requirement. Second, on cross-examination, Dr. Pett agreed that he could check the pump's function before excising the aneurism, but he did not "admit" that he had to check it. And third, Dr. Pett's statements concerning the time limits for safely operating without a pump were part of a general discussion to show that operating with a broken pump is not equivalent to operating without a pump at all.

IV

We now consider Mr. Keller's reasons for asserting that the district court erred in determining that there was no negligence. At this point, it bears repeating that Mr. Keller has the burden of proof. We also must emphasize that the district court was entitled to, and did, make credibility determinations.[9] Although Mr. Keller raises a number of potential factual discrepancies or alternative interpretations of the evidence, in order to prevail, he must establish that the decision of the district court cannot be supported by the evidence. *See, e.g., Trzcinski v. American Cas. Co.,* 953 F.2d 307, 315 (7th Cir.1992) (stating that district court verdict will not be set aside if a reasonable basis exists in the record to support it); *M.T. Bonk Co. v. Milton Bradley Co.,* 945 F.2d 1404, 1407 (7th Cir.1991) (same); *see also Boggan v. Data Systems Network Corp.,* 969 F.2d 149, 150 (5th Cir.1992) (reversing because there was no evidence to support plaintiff's claim of fraudulent inducement).

The thrust of Mr. Keller's argument is that Dr. Pett negligently cut into the aorta even though the blood flow was insufficient. He first claims that the pump was malfunctioning. The district court implicitly found, however, that the pump was working when it found that the low blood pressure resulted from the constant flow of the pump during Mr. Keller's surgery. This finding of fact is not clearly erroneous. Dr. Michaelis testified that, in procedures using the pump, he had seen precipitous drops hundreds of times due to lowered resistance. He also testified that the normal level of the upstream pressure indicated that the pump was drawing blood out of the atrium. We cannot say, therefore, that the evidence does not support a determination that the pump was working.

Mr. Keller also claims that the pump may not have been turned on until after the aorta was opened. The district court found that the pump was turned on after cross-clamping and that there was no evidence that the surgeon had violated the standard of care. The record contains no direct evidence to indicate that Dr. Pett did not check the pump before cutting into the aorta. Nor does the record contain circumstantial evidence that compels the conclusion that the pump was not on. We cannot say that we are left with the definite and firm conviction that a mistake has been made.

Finally, Mr. Keller also contends that the surgeon breached the standard of ***1200** care by proceeding with the surgery despite the low blood pressure. Dr. Michaelis disagreed. Describing the preparatory steps of the operation in detail and the trauma to the body in surgery, he testified that, even at the point of clamping, it would take a very serious development, like a massive heart attack, to require the surgeon to terminate the procedure. The district court, after lengthy examination of the expert witnesses, credited the testimony of Dr. Michaelis on this issue. Our review of the testimony at trial makes clear that the district court's credibility determination, and its conclusion that there was no evidence of a breach in the standard of care, did not constitute clear error.

We must conclude, therefore, that the district court's determination that the attending surgeon did not breach the standard of care is sufficiently supported by the evidence. Accordingly, we cannot disturb its judgment.

Conclusion

For the foregoing reasons, the judgment of the district court is affirmed.

AFFIRMED.

All Citations

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Footnotes

1 Dr. Pett is a board certified cardiothoracic surgeon and associate professor at the University of New Mexico.

2 Dr. Michaelis is a board certified cardiac surgeon, senior vice president for medical affairs at Northwestern Memorial Hospital, and professor of surgery at Northwestern University School of Medicine.

3 We must decide the case on the basis of the description of the surgical procedure presented by the district court and the parties. The record might possibly support a different description of the procedure, but it is not our role to scour the record independently and to characterize the procedure differently from the presentation offered by the parties. It is certainly not our task to make arguments that the parties do not make.

4 The term “downstream” refers to those parts of the body fed by the aorta below the site of the operation. “Upstream” refers to the respective parts of the upper body fed by the aorta above the site of the operation.

5 At 11:30, which was around the time that Dr. Pett applied the clamps to the aorta, the downstream blood pressure dropped to a low level of 18. At 12:05, the downstream pressure was 42. The nurse anesthetist stated that he had probably not recorded any changes in the downstream pressure during this period because it had not altered. Dr. Bass, Mr. Keller's expert, noted that according to the medical record, the pressure had reached 50 by 12:10. In addition, Mr. Keller noted that the pump needed to be adjusted at some point, and that tests revealed acidosis, a lowering of the blood's pH that may indicate poor blood flow.

6 *See BASF Corp. v. Old World Trading Co.,* 41 F.3d 1081, 1098 (7th Cir.1994) (noting that the court was “particularly reluctant” to find that the district court erred by not drawing an inference from missing documents because the district court had made no finding that the documents had been willfully destroyed); *United States v. Esposito,* 771 F.2d 283, 286 (7th Cir.1985) (noting that a finding of bad faith is necessary to an invocation of the spoliation doctrine), *cert. denied,* 475 U.S. 1011, 106 S.Ct. 1187, 89 L.Ed.2d 302 (1986); *S.C. Johnson & Son, Inc. v. Louisville & Nashville R.R.,* 695 F.2d 253, 258–59 (7th Cir.1983) (same). *See also United States v. $94,000.00 in U.S. Currency,* 2 F.3d 778, 787 (7th Cir.1993) (holding, in civil forfeiture case in which government failed to produce document, that district court did not abuse its discretion by refusing to grant sanctions because *inter alia* no contention of bad faith); *Coates v. Johnson & Johnson,* 756 F.2d 524,

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551 (7th Cir.1985) (declining to make inference where documents were destroyed under routine procedures, not in bad faith).

In his reply brief, Mr. Keller, relying on *Nation–Wide Check Corp. v. Forest Hills Distribs., Inc.,* 692 F.2d 214, 218 (1st Cir.1982), claims that the government had an obligation to establish that the documents had been destroyed. Because it did not carry that burden, he contends, he need show only that the government "had notice that the documents were relevant at the time [it] failed to produce them." We cannot accept this argument. *Nation–Wide Check* cannot be read in a principled way as standing for the proposition that, although bad faith is necessary if the documents have been destroyed, a lesser standard is appropriate when the documents are simply missing. Indeed, the First Circuit made a point of noting that the documents at issue in that case had been abandoned in a manner that was "purposeful" and "in knowing disregard" of the claim before the court. *Id.* at 217.

Mr. Keller's assertion concerning the government's failure to produce records makes no effort to rely on New Mexico authority. We note that there are some diversity cases indicating that state law ought to apply. *See, e.g., Allstate Ins. Co. v. Sunbeam Corp.,* 53 F.3d 804, 805 (7th Cir.1995) (products liability action) (noting that the parties agreed that the duty to preserve evidence was governed by state law); *Unigard Security Ins. Co. v. Lakewood Eng'g & Mfg. Corp.,* 982 F.2d 363, 367 (9th Cir.1992) (strict liability/negligence case) (stating that the spoliation counterclaim, brought in diversity, is controlled by state law, but holding that there was no valid spoliation claim). There is some authority that cases under the Federal Tort Claims Act also should use state law. *See Welsh v. United States,* 844 F.2d 1239 (6th Cir.1988) (following state law to consider government's failure to produce evidence within its control; holding that a rebuttable presumption of causation under Kentucky law was proper).

Other cases are less definitive. Another panel of the Ninth Circuit considered the destruction of evidence in a diversity/products liability case to be a straightforward evidentiary ruling which must be reviewed under the abuse of discretion standard. *Glover v. BIC,* 6 F.3d 1318, 1329 (9th Cir.1993) ("A federal trial court has the inherent discretionary power to make appropriate evidentiary rulings in response to the destruction or spoliation of relevant evidence. Such power includes the power where appropriate to order the exclusion of certain evidence."). *See also Eaton Corp. v. Appliance Valves Corp.,* 790 F.2d 874, 878 (Fed.Cir.1986) (reviewing a diversity suit concerning trade secret misappropriations, following the Seventh Circuit's spoliation law, as stated in *S.C. Johnson & Son v. Louisville & Nashville R.R.,* 695 F.2d 253 (7th Cir.1982)); *S.C. Johnson & Son,* 695 F.2d at 258–59 (stating that a court may infer that the evidence would be unfavorable to the destroying party only if the court opines that the evidence was destroyed in bad faith).

The Court of Appeals of New Mexico, in *Bush v. Thomas,* 119 N.M. 54, 888 P.2d 936 (N.M.Ct.App.1994), has stated that "New Mexico has not recognized either negligent or intentional spoliation of evidence as a tort." *Id.,* 119 N.M. 54, 888 P.2d at 939.

7 Dr. Pett testified that he could not say whether the record was kept or not and that he and others had looked diligently for a copy. He also said that neither he, nor the perfusionists that he asked, could recall who acted as perfusionist for the operation. In a letter from defense counsel to Mr. Keller's attorney, which Mr. Keller's attorney read into the record, defense counsel said that the medical center had no perfusionists on staff, but hired them from the University of New Mexico Medical School. Someone at the university told defense counsel that it was common practice not to retain the pump records from surgeries other than heart transplants and that the university also followed this practice.

8 Judicial admissions are formal concessions in the pleadings, or stipulations by a party or its counsel, that are binding upon the party making them. They may not be controverted at trial or on appeal. Indeed, they are "not evidence at all but rather have the effect of withdrawing a fact from contention." Michael H. Graham, *Federal Practice and Procedure: Evidence* § 6726 (Interim Edition); *see also* John William Strong, *McCormick on*

Evidence § 254, at 142 (1992). A judicial admission is conclusive, unless the court allows it to be withdrawn; ordinary evidentiary admissions, in contrast, may be controverted or explained by the party. *Id.* When a party testifying at trial or during a deposition admits a fact which is adverse to his claim or defense, it is generally preferable to treat that testimony as solely an evidentiary admission. Michael H. Graham, *Federal Practice and Procedure* § 6726, at 536–37.

9 The district court specifically determined that Dr. Michaelis, the government's expert, had superior qualifications to Mr. Keller's expert, and that Dr. Michaelis rendered a credible opinion which was better supported by the evidence of record.

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EXHIBIT AC-114

792 F.3d 842
United States Court of Appeals, Seventh Circuit.

VDF FUTURECEUTICALS, INC., Plaintiff–Appellant,
v.
STIEFEL LABORATORIES, INC., et al., Defendants–Appellees.

No. 14–3232
|
Argued May 29, 2015.
|
Decided July 10, 2015.

Synopsis
Background: Patentee brought breach of contract, breach of duty of good faith and fair dealing, unjust enrichment, conversion, and tortious interference with contract claims against a licensee, a former owner of licensee, and company that purchased the licensee, claiming that the sale of the ownership interests in the licensee violated the terms of the licensing agreement. The United States District Court for the Northern District of Illinois, John W. Darrah, J., 2014 WL 2893205, granted partial summary judgment on assignment and advance-royalty claims to defendants. The District Court certified the ruling for immediate appeal.

Holdings: The Court of Appeals, Posner, Circuit Judge, held that:

[1] the Court would exercise jurisdiction over claims certified for immediate appeal;

[2] the sale of licensee to purchaser did not effect an unauthorized assignment of the patent to the purchaser; and

[3] purchaser's payment did not constitute advance royalties that were subject to the patent licensing agreement.

Affirmed.

Procedural Posture(s): On Appeal; Motion for Summary Judgment.

West Headnotes (4)

[1] **Federal Courts** Certification and Leave to Appeal

If a district court does enter final judgment as to one or more, but fewer than all, claims, the judgment is immediately appealable, just like a conventional final judgment, that is, one that winds up the entire case in the trial court, provided that the claim or claims resolved by the judgment do not so overlap claims remaining in the district court as to create needless duplication of effort to resolve the parties' entire dispute. Fed.Rules Civ.Proc.Rule 54(b), 28 U.S.C.A.

8 Cases that cite this headnote

[2] **Federal Courts** Multiple claims

Court of Appeals would exercise jurisdiction over assignment and advance-royalty claims certified by the District Court for immediate appeal in a patentee's action against a licensee and its former and subsequent owners, even though there was some overlap between the claims before the Court of Appeals on appeal and those not yet resolved by the District Court, as all claims arose from the purchase of the licensee, where the overlap was not complete, as the assignment and advance-royalty claims focused on the sale of licensee, while the remaining claims pending in the District Court focused on events that took place after the sale. Fed.Rules Civ.Proc.Rule 54(b), 28 U.S.C.A.

6 Cases that cite this headnote

[3] **Patents** Assignments and sublicenses

The sale of a patent licensee to a new owner did effect an unauthorized assignment of the patent to the purchaser, where the patent licensing agreement placed no restrictions on who could own the licensee, and the licensee remained in existence after its acquisition by the purchaser.

[4] **Patents** Rights and Liabilities of Parties

A company's $8.5 million payment to owners of a limited liability company (LLC) for their stock did not constitute advance royalties that were subject to the LLC's patent licensing agreement, where the licensing agreement stated that royalties were limited to actual sales of patented products by licensee or any sublicensee.

Attorneys and Law Firms

***843** A. Colin Wexler, Stephanie J. Harris, W. Kyle Walther, Goldberg Kohn Ltd., Chicago, IL, for Plaintiff–Appellant.

Anne Grignon, Reed Smith LLP, Los Angeles, CA, Jennifer L. Ilkka, Reed Smith LLP, Chicago, IL, Raymond A. Cardozo, Reed Smith LLP, San Francisco, CA, for Defendants–Appellees.

Before POSNER, EASTERBROOK, and SYKES, Circuit Judges.

Opinion

POSNER, Circuit Judge.

In this needlessly complex case (the plaintiff's complaint is 33 pages long and consists of 184 paragraphs), with federal jurisdiction based on diversity of citizenship and the governing substantive law that of Illinois, the parties are wrangling over a license agreement. The agreement—40 pages of fine print, including numerous amendments—is between the plaintiff, VDF FutureCeuticals, Inc., and one of the three defendants, J & J Technologies, LC (the other two defendants are Stiefel Laboratories, Inc., and Joseph A. Lewis II). VDF has trademark and patent rights in "CoffeeBerry," an extract from the whole fruit (not just the bean) of the coffee plant.

The agreement licensed J & J (managed by defendant Lewis, formerly a 45 percent owner of the company, as was another of the company's three owners) to make and sell CoffeeBerry-based skin-care products to which VDF has the intellectual property rights. In other words, the agreement licensed J & J to "commercialize" VDF's intellectual property. The license required J & J to remit to VDF, as royalties, 15 percent (later raised to a third) of any ***844** revenues that J & J obtained from selling the licensed product, and of any royalties that J & J received from firms to which it granted sublicenses. All the royalties received by VDF would be what are called "running royalties," that is, royalties based on the number of sales by the licensee (J & J), or by sublicensees of the licensed product. Regarding sublicensees, the license permitted J & J to sublicense its rights under the license "in the exercise of [J & J's] sole discretion and judgment" (altered to "in the exercise of its best judgment" by an amendment in 2006).

The license also required J & J to pay VDF, at a minimum, a specified alternative quarterly royalty in order to protect VDF in the event that the running royalties fell below a specified level in particular quarters. The license provided that it could not be assigned without VDF's written permission, but it did not forbid a change of control of J & J, and this omission has turned out to be critical.

The license was issued in 2004. Two years later J & J sublicensed defendant Stiefel, a subsidiary of GlaxoSmithKline. Stiefel was a natural to become involved in VDF's business because it's a manufacturer of dermatological products and VDF hoped CoffeeBerry would become an ingredient of such products.

Four years later, J & J's three owners sold their ownership interests to Stiefel for $8.5 million (a third of which was held back pending VDF's written acknowledgement of the membership change, but we can ignore that detail). J & J thereupon became a Stiefel subsidiary and, VDF claims, obligingly agreed to reduce Stiefel's royalty obligation (remember that Stiefel was J & J's sublicensee) and otherwise hurt itself, for example by abandoning, when Stiefel terminated the sublicense that J & J had given it, the right under the sublicense to a $1 million termination fee.

Stiefel's internal documents state that its reasons for buying J & J's stock rather than taking an assignment of J & J's license from VDF were both to avoid having to get VDF's permission for an assignment and (since Stiefel would now control J & J) to reduce the royalties that Stiefel would have to pay for its marketing of CoffeeBerry. Two months after buying J & J's stock, Stiefel engineered an amendment to the sublicence agreement (that is, the agreement that made Stiefel a sublicensee of J & J) that reduced the alternative minimum royalties that Stiefel owed J & J. The effect was to divert part of the license-revenue stream from VDF and J & J to Stiefel.

Two years later (2012) VDF filed this lawsuit, charging J & J, Stiefel, and Lewis with having committed a variety of unlawful acts. These included multiple breaches of contract, including what VDF contends was the de facto assignment of J & J's license to Stiefel without VDF's approval, breach of the common law duty of good faith and fair dealing in the performance of a contract, failure to use "commercially reasonable efforts to make, use, sell, and otherwise commercialize" the licensed products (in other words, failure to use "best efforts" to promote those products), failure to pay VDF a third of the $8.5 million purchase price for J & J's stock as an advance royalty, and ultimately shutting down J & J's business to cut off royalties to VDF. The complaint also asks that the veil be pierced so that Lewis and Stiefel can be charged with J & J's misdeeds. Those two defendants are further charged with conspiring to appropriate the royalties and other contract payments due VDF under the license agreement. In addition, Lewis is charged with unjust enrichment and conversion as a result of that appropriation and with breach of fiduciary duty to VDF, and Stiefel with tortious interference with the VDF license. And ***845** for good measure all three defendants (Stiefel, Lewis, and J & J) are charged with conspiring to interfere with the license.

The district judge granted summary judgment in favor of the defendants with respect to two of VDF's claims: that the defendants had engineered an unauthorized assignment of the J & J license and that the $8.5 million that Stiefel had paid to acquire J & J was really a purchase of J & J's anticipated sales revenue under the license agreement and a third of that revenue should therefore have gone to VDF as advance royalties.

[1] The district judge certified his ruling for an immediate appeal even though VDF's numerous other claims against the defendants remain pending in the district court unresolved. Fed.R.Civ.P. 54(b) provides that "when an action presents more than one claim for relief ... the court may direct entry of a final judgment as to one or more, but fewer than all, claims ... only if the court expressly determines that there is no just reason for delay." If the court does enter final judgment, the judgment is immediately appealable, just like a conventional final judgment—one that winds up the entire case in the trial court—provided that the claim or claims resolved by the judgment do not so overlap claims remaining in the district court as to create needless duplication of effort to resolve the parties' entire dispute. *Olympia Hotels Corp. v. Johnson Wax Development Corp.,* 908 F.2d

1363, 1366–68 (7th Cir.1990); *Spiegel v. Trustees of Tufts College,* 843 F.2d 38, 44–46 (1st Cir.1988); 10 Wright & Miller, *Federal Practice & Procedure* § 2657 (3d ed.). An example of needless duplication is the appeal to this court of a claim that might be undercut by the resolution of a factual dispute not yet decided by the district court.

[2] There is some overlap in this case between the claims before us on appeal and those yet to be resolved in the district court. The overlap arises from the fact that all the claims ultimately derive from Stiefel's purchase of all the stock of J & J. But the overlap is far from complete, because VDF's assignment and advance-royalty claims, the only ones before us on this appeal, focus on the sale of J & J's stock to Stiefel, while VDF's best-efforts claim, along with related claims pending in the district court (most of which appear to be similar to and may be encompassed by the best-efforts claim), focus on events that took place after the sale of J & J's stock by its owners to Stiefel.

In addition the claims pressed in this appeal have been fully briefed and argued, are ripe for decision, and are easily resolved; as we're about to see, they have no merit and thus were properly dismissed by the district court. Remaining for trial are stronger claims by VDF pending in the district court. The claim for breach of the best-efforts clause in the license agreement is particularly strong because how could J & J be found to have been exerting "commercially reasonable efforts to make, use, sell, and otherwise commercialize" CoffeeBerry, as the license obligated it to do, when as a result of its becoming owned by Stiefel it reduced its royalty payments to VDF without compensation?

Were we to dismiss the appeal we might well see in a subsequent appeal the same two claims before us in this appeal. For even if VDF prevails on other claims in the district court, it might challenge that court's dismissal of the claims before us in the present appeal in the hope of obtaining greater damages by proving more violations.

[3] So we turn to the two claims before us—that the defendants effected an unauthorized assignment to Stiefel of the license ***846** that VDF had granted to J & J and that the $8.5 million that Stiefel paid to acquire J & J was a purchase of J & J's anticipated royalty revenue under the license and so a third of the $8.5 million should have gone to VDF as advance royalties. A fatal problem with the first claim is that by failing to place any restrictions on who could own its licensee J & J, VDF exposed itself to being taken advantage of by a change of ownership at J & J that would result in operating changes and alter its relationship to VDF. Had Stiefel bought J & J's license, or instead bought J & J and dissolved the company so that when the dust settled all that Stiefel would have obtained from the purchase was the license, Stiefel would have violated the terms of the license by obtaining it without VDF's consent. *Baxter Healthcare Corp. v. O.R. Concepts, Inc.,* 69 F.3d 785, 788–89 (7th Cir.1995) (Illinois law). That didn't happen. J & J remained in existence after its acquisition by Stiefel, as VDF's licensee and Stiefel's sublicensor.

It's true as we've seen that the agreement between J & J and Stiefel to reduce the alternative minimum royalties owed by Stiefel to J & J reduced the income that VDF received from the license. But Stiefel's negotiations that had led to this untoward consequence for VDF had been not with J & J but with its three owners. This makes a difference so far as Stiefel's allegedly malign interference with and manipulation of J & J are concerned. A change in ownership is likely to result in a change in operations. That the change in how J & J was operated was adverse to the licensor's interests is why with clearer foresight VDF would have included restrictions in the license on changes in the ownership of its licensee, J & J. Its failure to do so was fatal, because "the courts have held that the sale of all the stock in a closely held corporation whose principal asset is a contract does not violate a nonassignment clause even when the stock is sold to a person to whom, previously, the counterparty had explicitly refused that the contract be assigned. If the counterparty to a contract with a corporation wishes to limit the persons to whom ownership or control of the corporation can be sold, it must do this through specific language to that effect in the contract (a 'change of control' clause); a nonassignment clause will not suffice." Kenneth Ayotte & Henry Hansmann, "Legal Entities as Transferable Bundles of Contracts," 111 *Michigan Law Review* 715, 724 (2013). "[T]he mere change of stock ownership would not nullify a non-assignable license, absent a change in control provision." Elaine D. Ziff, "The Effect of Corporate Acquisitions on the Target Company's License Rights," 57 *Business Lawyer* 767, 789 (2002); see *Baxter Healthcare Corp. v. O.R. Concepts, Inc., supra,* 69 F.3d at 788–89.

Were this not the rule, routine anti-assignment clauses would impede liquidity in the market for corporate control. Sizeable corporations are likely to be party to many contracts, often containing anti-assignment clauses similar to the one in VDF's license to J & J. Were such clauses interpreted to prohibit changes in the control of an acquired corporation, acquirers (such as Stiefel in this case) would have to negotiate (and therefore pay something) for the consent of the licensors of the acquired corporation to any changes in the control of the licensee that the acquirer wanted to make.

This analysis doesn't leave VDF remediless, because the license it granted J & J required J & J to use its best efforts to promote the sale of VDF's products and to remit the royalties generated by those sales to VDF; and J & J, under the influence of Stiefel and Lewis, may have done neither. But that is an issue that the district court has yet to address.

***847** **[4]** VDF's second claim in this appeal is that the $8.5 million that Stiefel paid J & J's owners for their stock constituted advance royalties, a third of which therefore were owed to VDF. Although Stiefel's willingness to pay that price was (as Stiefel's own documents confirm) based on a forecast of J & J's future royalty receipts from sales of CoffeeBerry, the license that VDF had granted J & J limited the royalties that J & J would owe VDF to money "based on the actual sale of [CoffeeBerry] Products by Licensee or its sublicensees which are actually collected by Licensee." J & J's owners sold stock, not CoffeeBerry products, to Stiefel, and they rather than J & J received the $8.5 million that Stiefel paid for their company's stock. VDF's interpretation of the royalty provision in the license would require a seller of corporate stock to pay a portion of the purchase price to the corporation's licensors, a portion estimated from the expected cash flow from exploiting the acquired corporate assets to generate revenue. See Ben McClure, "Digging into the Dividend Discount Model," *Investopedia,* www.investopedia. com/articles/fundamental/04/041404.asp (visited July 9, 2015). Such a requirement, involving complex and contestable financial estimations, would be another impediment to the smooth operation of the market in corporate control.

The appeal, in short, has no merit, and the decision appealed from is therefore

AFFIRMED.

All Citations

792 F.3d 842, 92 Fed.R.Serv.3d 372, 115 U.S.P.Q.2d 1868

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EXHIBIT AC-115

220 F.Supp.3d 450
United States District Court, S.D. New York.

MASSMUTUAL ASSET FINANCE LLC, Plaintiff,
v.
ACBL RIVER OPERATIONS, LLC, Defendant.

16 Civ. 1111
|
Signed 11/28/2016

Synopsis
Background: Assignee of vessel owner brought action against bareboat charterer alleging that sale and transfer of stock of charterer's parent corporation by charterer's grandparent corporation, resulting in change of charterer's grandparent corporation, constituted default under charter agreement's anti-transfer provision. Charterer moved to dismiss for failure to state a claim.

The District Court, Sweet, J., held that sale and transfer of stock of parent corporation was not sale or transfer of charterer, and, thus, such transaction did not constitute default under anti-transfer provision.

Motion granted.

Procedural Posture(s): Motion to Dismiss; Motion to Dismiss for Failure to State a Claim.

Attorneys and Law Firms

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OPINION

Sweet, District Judge.

Defendant ACBL River Operations, LLC (the "Defendant" or "River Ops") has moved pursuant to Rule 12 (b) (6) to dismiss the complaint of plaintiff MassMutual Asset Finance, LLC (the "Plaintiff" or "MassMutual"). Based on the conclusions set forth below, the motion is granted and the complaint is dismissed with prejudice.

Skilled and able counsel have presented the court with a carefully drafted significant agreement which both counsel assert is clear in its language and intent, and supported by the actions of the parties. However, the asserted clarity results in diametrically opposed conclusions. Such is the challenge of the judicial function.

I. Prior Proceedings

In 2008, SunTrust Equipment Finance & Leasing Corp. ("SunTrust") and AEP MEMCO, LLC ("AEP MEMCO") entered into the Charter Agreement (the "Charter") and Charter Supplement No. 1 (the "Supplement"). Compl. ¶ 7. Under the Charter, SunTrust paid $8,805,983 to acquire 17 Rake Covered Hopper Barges (the "Barges") and SunTrust, as the Owner, agreed to bareboat charter the Barges to AEP MEMCO, the Charterer. *Id.* ¶¶ 8–9; Charter, Docket Item ("D.I.") 1–1 at p.1. AEP MEMCO, in turn, agreed to pay SunTrust quarterly rent payments totaling $156,414.51 during the Basic Term of the Charter: July 1, 2008 through June 30, 2027. *Id.* ¶ 9. There is no dispute about these terms or the making of these payments.

Section 13(e) of the Charter states that an Event of Default has occurred if "the Charterer [i.e., River Ops] shall be sold or transferred to, or merged into or consolidated with, any Person without the consent of the Owner [i.e., MassMutual] (not to be unreasonably withheld) (i) who is not an Affiliate, and (ii) whose senior unsecured debt is not rated Investment Grade after the consummation thereof." Compl. ¶ 13; Charter § 13(e). Events of Default give rise to the Owner's rights under Section 14 of the Charter. *Id.*

As of September 2014, MassMutual became the Owner under the Charter pursuant to an assignment agreement with SunTrust, [1] and, at some point prior to the filing of this action, River Ops became the new name for AEP MEMCO. [2] Compl. ¶ 6, 10.

When the Charter and Supplement were executed, River Ops was owned by AEP Resources, which, in turn, was owned by American Electric, a publicly-traded utility. *Id.* ¶ 11. In

November 2015, American Electric sold all of the stock of AEP Resources to Commercial Barge. *Id.* ¶ 12. As a result of the sale, Commercial Barge became the corporate grandparent of River ***453** Ops, while AEP Resources remained the corporate parent of River Ops. *Id.*

The parties do not dispute that MassMutual was not asked for its consent to the sale or transfer of AEP Resources stock. Nor is it in dispute that the senior unsecured debt of Commercial Barge, which was not an Affiliate of River Ops before the transfer, was not rated Investment Grade after consummation. *Id.* ¶ 13. The parties disagree, however, on whether the change in River Ops's corporate grandparent constitutes an Event of Default under Section 13(e). MassMutual contends that it does, and that it triggers MassMutual's rights under Section 14 of the Charter, including the right to receive payment of the Stipulated Casualty Value of the barges and to recover costs and attorneys' fees. *Id.* at ¶¶ 15, 16.

MassMutual filed its complaint (the "Complaint") on February 12, 2016 seeking $8,055,547.26, as well as attorneys' fees, costs, and expenses of asserting a default under Sections 14(a) (5) and 14(b) of the Charter. Compl. ¶ 15. River Ops filed the motion to dismiss under 12(b) (6); the motion was argued and deemed fully submitted on September 15, 2016.

II. The Applicable Standards

1. Standard of Review

The Rule 12(b)(6) standard requires that a complaint plead sufficient facts to state a claim upon which relief can be granted. *Ashcroft v. Iqbal*, 556 U.S. 662, 677–78, 129 S.Ct. 1937, 173 L.Ed.2d 868 (2009); *Bell Atl. Corp. v. Twombly*, 550 U.S. 544, 570, 127 S.Ct. 1955, 167 L.Ed.2d 929 (2007). On a motion to dismiss under Fed. R. Civ. P 12(b)(6), all factual allegations in the complaint are accepted as true, and all reasonable inferences are drawn in the plaintiff's favor. *Littlejohn v. City of N.Y.*, 795 F.3d 297, 306 (2d Cir. 2015); *Mills v. Polar Molecular Corp.*, 12 F.3d 1170, 1174 (2d Cir. 1993). However, "a plaintiff's obligation to provide the grounds of his entitlement to relief requires more than labels and conclusions." *Twombly*, 550 U.S. at 555, 127 S.Ct. 1955 (quotation marks omitted). A complaint must contain "sufficient factual matter, accepted as true, to 'state a claim to relief that is plausible on its face.' " *Iqbal*, 556 U.S. at 663, 129 S.Ct. 1937 (quoting *Twombly*, 550 U.S. at 570, 127 S.Ct. 1955).

A claim is facially plausible when "the plaintiff pleads factual content that allows the court to draw the reasonable inference that the defendant is liable for the misconduct alleged." *Id.* (quoting *Twombly*, 550 U.S. at 556, 127 S.Ct. 1955). In other words, the factual allegations must "possess enough heft to show that the pleader is entitled to relief." *Twombly*, 550 U.S. at 557, 127 S.Ct. 1955 (internal quotation marks omitted).

Additionally, while "a plaintiff may plead facts alleged upon information and belief 'where the belief is cased on factual information that makes the inference of culpability plausible,' such allegations must be 'accompanied by a statement of the facts upon which the belief is founded.' " *Munoz–Nagel v. Guess, Inc.*, No. 12–1312, 2013 WL 1809772, at *3 (S.D.N.Y. Apr. 30, 2013) (quoting *Arista Records, LLC v. Doe 3*, 604 F.3d 110, 120 (2d Cir. 2010)) and *Prince v. Madison Square Garden*, 427 F.Supp.2d 372, 384 (S.D.N.Y. 2006); *see also Williams v. Calderoni*, No. 11–3020, 2012 WL 691832, *7 (S.D.N.Y. Mar. 1, 2012). The pleadings, however, "must contain something more than ... a statement of facts that merely creates a suspicion [of] a legally cognizable right of action." *Twombly*, 550 U.S. at 555, 127 S.Ct. 1955 (quoting 5 CHARLES ALAN WRIGHT & ARTHUR R. MILLER, FEDERAL PRACTICE AND PROCEDURE § 1216 (3d ed. 2004)).

***454** *2. Choice–of–Law*

Pursuant to Section 24(f) of the Charter, federal maritime law governs this dispute. The Charter's choice-of-law provision states: "This Charter Agreement and the rights and obligations of the parties hereunder shall be construed in accordance with and be governed by the maritime laws of the United States and, to the extent the foregoing are not applicable, the laws of the State of New York." Charter § 24(f).

In maritime cases, absent a relevant statute, courts apply "the general maritime law." *East River S.S. Corp. v. Transamerica Delaval, Inc.*, 476 U.S. 858, 864, 106 S.Ct. 2295, 90 L.Ed.2d 865 (1986). The general maritime law consists of primarily federal case precedents, as decided by the Supreme Court and lower federal courts, and includes principles of ordinary contract law. *See id.* at 864–65, 106 S.Ct. 2295 (describing maritime law as "an amalgam of traditional common-law rules, modifications of those rules, and newly created rules."); *see also* 29 JAMES WM MOORE, ET AL., MOORE'S FEDERAL PRACTICE § 707.05 [1] (3d ed. 2016). Absent a relevant federal statute, courts look to "common-law principles of contract interpretation", including as embodied

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by state law. *Critchlow v. First UNUM Lif. Ins. Co. of Am.*, 378 F.3d 246, 256 (2d Cir. 2004); *see also Jerome B. Grubart, Inc. v. Great Lakes Dredge & Dock Co.*, 513 U.S. 527, 545–46, 115 S.Ct. 1043, 130 L.Ed.2d 1024 (1995) ("[E]xercise of federal admiralty jurisdiction does not result in automatic displacement of state law.... [F]ederal admiralty courts sometimes do apply state law.").

3. Principles Governing Contract Interpretation

A court's primary objective in interpreting a contract is to "give effect to the intent of the parties." *Compagnie Financiere de CIC et de L'Union Europeenne v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*, 232 F.3d 153, 157 (2d Cir. 2000); *see also S.R. Int'l Bus. Ins. Co. v. World Trade Ctr. Props., LLC*, 467 F.3d 107, 125 (2d Cir. 2006). The parties' intent should generally be determined using the actual language of the contract and the circumstances surrounding the transaction. *See Compagnie Financiere*, 232 F.3d at 157. "[T]he words and phrases [in a contract] should be given their plain meaning, and the contract should be construed so as to give full meaning and effect to all of its provisions." *Chesapeake Energy Corp. v. Bank of N.Y. Mellon Trust Co., N.A.*, 773 F.3d 110, 114 (2d Cir. 2014) (quoting *Olin Corp. v. Am. Home Assur. Co.*, 704 F.3d 89, 99 (2d Cir. 2012) (internal citation and quotation marks omitted)).

If the parties' intent is unambiguously conveyed by the plain meaning of the agreements, then "interpretation is a matter of law." *Crane Co. v. Coltec Indus., Inc.*, 171 F.3d 733, 737 (2d Cir. 1999) (internal citation and quotation marks omitted). Where a contract is ambiguous, however, a fact issue exists precluding dismissal under Fed. R. Civ. P. 12(b) (6). *Bank of N.Y., N.A. v. Franklin Advisors, Inc.*, 522 F.Supp.2d 632, 637 (S.D.N.Y. 2007) ("The Court's role on a 12(b)(6) motion to dismiss is not to resolve contract ambiguities."). Under New York law, a contract is ambiguous if its terms "could suggest more than one meaning when viewed objectively by a reasonably intelligent person who has examined the context of the entire integrated agreement and who is cognizant of the customs, practices, usages and terminology as generally understood in the particular trade or business." *Chesapeake Energy*, 773 F.3d at 114 (internal citation and quotations omitted).

***455 III. River Ops Was Not Sold or Transferred**

The terms "sold" and "transferred" are not expressly defined in the contract. Thus, these terms should be given their "plain meaning." *See CBS Corp. v. Eaton Corp.*, No. 07 CIV. 11344 (LBS), 2009 WL 4756436, at *3 (S.D.N.Y. Dec. 7, 2009); *Samba Enters., LLC v. Zango, Inc.*, No. 06 CIV. 8171 (DC), 2009 WL 736155, at *3 (S.D.N.Y. Mar. 20, 2009). To determine the plain and ordinary meaning of these terms, dictionary definitions prove useful. *See CBS Corp.*, 2009 WL 4756436, at *4; *Samba Enters.*, 2009 WL 736155, at *3; *In re Delta Air Lines, Inc.*, 381 B.R. 57, 64–65 (S.D.N.Y. 2008) ("A sound method for determining the plain meaning of words is to look at their dictionary definitions."); *Mazzola v. County of Suffolk*, 143 A.D.2d 734, 533 N.Y.S.2d 297, 297 (1988) ("[I]t is common practice for the courts of this State to refer to the dictionary to determine the plain and ordinary meaning of words to a contract.").

Section 13(e) provides that an Event of Default occurs under the Charter where "[t]he Charterer shall be sold or transferred to, or merged into or consolidated with, any Person without the consent of the Owner (not to be unreasonably withheld) (i) who is not an Affiliate, and (ii) whose senior unsecured debt is not rated Investment Grade after the consummation thereof." Charter § 13(e). According to MassMutual, the term "sold" is the past tense of the verb to sell, and sell means "to exchange or deliver for money or its equivalent ... give up or surrender in exchange for price or reward." *Sell*, AMERICAN HERITAGE DICTIONARY (4th ed. 2006). Black's Law Dictionary similarly defines "sale" as "[t]he transfer of property or title for a price." *Sale*, BLACK'S LAW DICTIONARY (10th ed. 2014).

The term "transferred" is the past tense of the verb "transfer." The verb "transfer" means: "1. To convey or remove from one place or one person to another; to pass or hand over from one to another, esp. to change over the possession or control of. 2. To sell or give." *Transfer*, vb., BLACK'S LAW DICTIONARY; *see also Transfer*, AMERICAN HERITAGE DICTIONARY ("To convey or cause to pass from one place person, or thing to another."). The noun form of "transfer" means "[a]ny mode of disposing of or party with an asset or an interest in an asset." *Transfer*, n., BLACK'S LAW DICTIONARY. MassMutual argues that the term "embraces every method—direct or indirect, absolute or conditional, voluntary or involuntary—of disposing of or parting with property." *Id.*

In the context of the Charter, according to MassMutual, River Ops has been "sold" because it has been exchanged, delivered, given up, or surrendered to another in exchange for consideration. Commercial Barge had no ownership interest in River Ops before the AEP Resources sale, but it does after the sale. Likewise, MassMutual argues that River Ops has been "transferred" because American Electric has disposed of its interest in, and control over, River Ops by conveying it to Commercial Barge through the sale of AEP Resources. MassMutual also contends that American Electric recognized that River Ops was effectively being conveyed to Commercial Barge as evidenced by the fact that American Electric identified the Charter as a "material contract" in the sale of AEP Resources to Commercial Barge.

MassMutual also relies on Section 1.2 of the Charter Agreement to assert that Section 13(e) is triggered by a sale, transfer, merger, or consolidation of River Ops, whether affected "directly or indirectly." Even if Section 1.2's reference to "directly or indirectly" could be read into Section ***456** 13(e), it does not transform that anti-transfer provision into a change of control clause or make Section 13(e) applicable here.

MassMutual's contentions require reading into these terms that a sale of a corporate interest anywhere upstream from River Ops also constituted a sale of River Ops itself. In other words, they require reading "sale" and "transfer" to constitute a change of control of River Ops, though there is no relevant change of control provision here. MassMutual did not negotiate or draft Section 13(e), and the intent of the parties that did draft the Charter Agreement is best found in the words they chose to use (and not use). The parties that negotiated Section 13(e) did not use any language that would require consent based on an upstream change of control. Courts routinely refuse to find a change of control provision in contracts that do not use the phrase "change of control." *See* *In re Integrated Res., Inc.*, No. 90–B–10411 (CB), 1990 WL 325414 (Bankr. S.D.N.Y. Oct. 22, 1990) (refusing to find a change of control provision where the parties did not specifically include one).

MassMutual does not support its position with cases where a court has interpreted a contract provision using the word "transfer" to encompass an upstream "change of control" without also specifically using standard change of control language. In both *H–B–S Partnership v. Aircoa Hospitality Services, Inc.*, 137 N.M. 626, 114 P.3d 306, 315 (2005) and *Continental Cablevision v. United Broadcasting*, 873 F.2d 717, 719 (4th Cir. 1989), cited by MassMutual, the relevant contract provisions are interpreted to include change of control provisions because they explicitly reference a change in control.

Courts have rejected the "transfer" argument that MassMutual makes here. For example, in *Cellular Tel. Co. v. 210 E. 86th St. Corp.*, 44 A.D.3d 77, 81, 839 N.Y.S.2d 476 (2007), the court confronted an anti-transfer provision that required consent to "the transfer or other disposition" of more than 25% of the stock of the tenant-subsidiary. The court in Cellular rejected an argument premised on precisely the same reasoning Plaintiff offers here, finding that the "stock was not transferred [by the sale of corporate parents], except in the broadest sense." *Id.* at 82, 839 N.Y.S.2d 476. The *Cellular* court rejected an overbroad definition of "transfer" that would completely transform commonplace anti-transfer provisions into broad change of control provisions. *Id.*; see also, *DirecTV Latin Am., LLC v. Park 610, LLC*, 691 F.Supp.2d 405, 430 (S.D.N.Y. 2010) (rejecting argument that transfer of an interest in joint venture's parent companies was the same as a transfer of interest in the joint venture itself).

MassMutual's proposed definition of "transfer" would encompass the sale or transfer of publicly held stock in American Electric, River Ops' former grandparent, which is a publicly traded company. Opp. at 2. Under Plaintiff's proposed interpretation, every American Electric stock sale would constitute a "transfer" of ownership of River Ops that would trigger Section 13(e).

In part to avoid this result, it is well-established that a corporate parent and subsidiary "possess[ ] a separate existence and [are to be] treated separately from" one another. *Engel v. Teleprompter Corp.*, 703 F.2d 127, 134 (5th Cir. 1983) (finding that changes in ownership, in form, or in control of a parent corporation do not constitute a change in ownership or control of the assets and liabilities of a subsidiary). Similarly, "[a] corporate parent which owns the shares of a subsidiary does not ... own or have legal title to the assets of the subsidiary." ***457** *JPMorgan Chase Bank, N.A. v. Malarkey*, 65 A.D.3d 718, 721, 884 N.Y.S.2d 787 (2009) (quoting *Dole Food Co. v. Patrickson*, 538 U.S. 468, 123 S.Ct. 1655, 155 L.Ed.2d 643 (2003)); *Wallert v. Atlan*, No. 14 CIV. 4099 PAE, 2015 WL 518563 (S.D.N.Y. Feb. 5, 2015) (rejecting the argument that parent corporation owned subsidiary's copyright rights). A contract with a subsidiary does not constitute a contract with the subsidiary's parent. *Hudson Optical Corp. v. Cabot Safety Corp.*, 162 F.3d 1148 (2d Cir. 1998) (finding that parent corporation "had no standing to assert [subsidiary's] legal rights").

MassMutual further argues that Section 13(e) is triggered regardless of who the actor is and, therefore, regardless of whether River Ops is directly involved in the transaction. Because Section 13(e) uses the passive voice, MassMutual contends, the actor involved in the transactions contemplated by Section 13(e) is irrelevant and that the use of passive voice also somehow increases the reach of 13(e) to all upstream transactions. Opp. at 10. To make that argument, Plaintiff focuses on the portion of Section 13(e) that references whether River Ops is sold or transferred to "any Person." Section 13(e) does not require a certain actor; however, it is defined by the object rather than the subject. Therefore, Section 13(e) covers only transactions in which River Ops is "sold or transferred to, or merged into or consolidated with" some (non-Affiliate) Person. Again, if nothing happens to River Ops then Section 13(e) does not reach the transaction.

The use of the phrase "merged into or consolidated with" is meaningful here. The "merged into or consolidated with" phrase only makes sense if a transaction specifically involves River Ops. MassMutual's interpretation of Section 13(e) requires an arbitrary distinction be made between the interpretation of "sold or transferred to" and the interpretation of "merged into or consolidated with" even though those terms appear one right after the other in the same sentence. *La Salle Bank Nat. Ass'n v. CIBC Inc.*, No. 08 CIV. 8426 WHP, 2011 WL 4943341, at *4 (S.D.N.Y. Oct. 17, 2011) (courts construe contract terms in accordance with the meaning of the words that are associated with them). Section 13(e) provides that the contemplated sale, transfer, merger, or consolidation necessarily must involve River Ops.

MassMutual also contends that the Charter Agreement must provide for an Event of Default if River Ops is cut off from its publicly traded corporate grandparent, American Electric. *See* Opp. at 13 (arguing that tying River Ops to American Electric was "the parties' facially obvious reason for drafting Section 13(e)"). MassMutual suggests that the contractually-defined term "Affiliate" must always include a corporate link to American Electric because Plaintiff posits that such a link must have been in the minds of the original parties who negotiated the Charter Agreement. Opp. at 13–14. However, the parties to the Charter Agreement did not define "Affiliate" to require control by American Electric, though they could have, just as they could have included an explicit change of control provision pertaining to the "sale" and "transfer" language.

MassMutual's final argument is that Section 13(e) is a change of control because the Charter Agreement was listed as one of many contracts for which consent "may be required" in an entirely separate agreement. See Opp. at 19. However, over-disclosure via transaction schedules is a commonly employed tactic used by seller's counsel to try to shift risk from seller to buyer. Christopher S. Harrison, MAKE THE DEAL: NEGOTIATING MERGERS AND ACQUISITIONS, 110 (2016). As noted in the preface of the Schedules, however, "[n]o disclosure ***458** in the Schedules shall be an admission or indication ... that the information disclosed is required by the terms of the Agreement to be disclosed." *See* Magnuson Decl., Ex. 1 at p.1. Over–disclosure by seller's counsel in the schedule of contracts that "may" require consent does not change the actual words or meaning of 13(e) as concluded above.

Conclusion

Based upon the conclusions set forth above, the Defendant's motion is granted, and the Complaint is dismissed with prejudice.

All Citations

220 F.Supp.3d 450

Footnotes

1 For ease of reference, MassMutual will be referred to as a party to the Charter, even at times before the transfer of rights from SunTrust to MassMutual.

2 For ease of reference, River Ops will be referred to as the counterparty to the Charter, even at times before the name change. A schematic of the iterations of the River Ops name is as follows: AEP MEMCO, AEP River Ops, ACBL River Ops.

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EXHIBIT AC-116

KeyCite Yellow Flag - Negative Treatment
Distinguished by Aliff v. Vervent, Inc., S.D.Cal., May 27, 2021

974 F.3d 1051
United States Court of Appeals, Ninth Circuit.

Dimitri SHIVKOV, individually and as a trustee of the Phoenix 2010 Revocable Trust; Vassil Zhivkov; Kristina Tsonev; Spectra Services, Inc.; DVS Holdings LLC; Robert C. Miller; Brenda Mae Miller; Bruce G. Robinson; Sara Van Alstyne Robinson; Symphony Homes LLC; Symphony Development Corporation; Keith Butler; Rebecca M. Butler; Eric K. Wilke; Julie T. Wilke; John Linder; Nina Linder; Affilion of Cobre Valley LLC; Affilion of Huntsville PLLC; Affilion of Texas PLLC; Taylor-Wilke Holdings LLC; Traditions Emergency Medicine PA; Treadstone Equity Group LLC; UTA Investments LLC; Boomerang WB LLC; AZ Storage 1 LLC; AZ Storage 2 LLC; Boomerang Sonoran LLC; RV Storage LLC; Stone Haven Lodge LLC; UTA Holdings LLC; Wilke Medical Direction PLLC; 5T Capital Fund II LLC; 5T Capital Holdings LLC; 5T Capital LLC; Ingenuity Auto Leasing LLC; Ingenuity Aviation LLC; Ingenuity Equity Group II LLC; Ingenuity Equity Group III LLC; Ingenuity Equity Group LLC; Ingenuity Leasing Company II LLC; Ingenuity Leasing Company LLC; Ingenuity Matrix, Inc.; Ingenuity Professional Services PLLC; Bourne Tempe Land LLC, on behalf of themselves and all others similarly situated; Paul M. McHale; Cynthia McHale; Keith E. Pereira, Individually and as a trustee of The Blaser Family Revocable Trust Dated March 10, 2006; Kimberly Blaser, Individually and as a trustee of The Blaser Family Revocable Trust Dated March 10, 2006; Brian R. Tiffany; Ryan P. Frank; Katherine S. Frank; Cation LLC; Florida Citrus Holdings LLC; McHale Capital Management LLC; PS Bailey LLC; Blaser Management LLC; Blue Horizon Holdings LLC; Butler Medical Group, Inc.; Devotion Homes LLC; Glass House LLC; Maui Luxury Rentals LLC; Silver Meadow Investing LLC; T & G Investments LLC; Treadstone Core3 LLC; TW Management LLC; Kamaole Luxury Rentals LLC; Kannapali Beach Holdings LLC; Our Retirement LLC; Resiliant LLC; Nadim B. Bikhazi; Karen A. Kostluk-Bikhazi; Bradley S. Bullard; Cathleen M. Bullard; Blake G. Welling; Stephanie G. Welling; Blake Welling MD PC; Brian Tiffany MD PC; Utah Spine Care LLC; Western States Medical LLC; Ogden Clinic Professional Corporation; Borsight, Inc., Plaintiffs-Appellants,
v.
ARTEX RISK SOLUTIONS, INC.; TSA Holdings LLC, FKA Tribeca Strategic Advisors LLC; TBS LLC, DBA PRS Insurance; Karl Huish; Jeremy Huish; Jim Tehero; Arthur J. Gallagher & Company; Debbie Inman; Epsilon Actuarial Solutions LLC; Julie A. Ekdom; AmeRisk Consulting LLC; Provincial Insurance PCC; Tribeca Strategic Accountants LLC; Tribeca Strategic Accountants PLC, Defendants-Appellees.

No. 19-16746
|
Argued and Submitted July 7, 2020 Seattle, Washington
|
Filed September 9, 2020

Synopsis
Background: Individuals and corporate entities that had contracted with insurance management consultants to create captive insurance companies for tax purposes filed putative class action against the consultants claiming, among other things, breach of fiduciary duty, negligence, breach of contract, breach of duty of good faith and fair dealing, and violations of Racketeer Influenced and Corrupt Organizations Act (RICO). The United States District Court for the District of Arizona, Stephen M. McNamee, Senior District Judge, 2019 WL 8806260, compelled arbitration on an individual basis and dismissed. Plaintiffs appealed.

Holdings: The Court of Appeals, Milan D. Smith, Circuit Judge, held that:

consultants owed no duty to point out and fully explain an arbitration clause in agreement;

contract did not expressly negate presumption in favor of post-termination arbitration of disputes;

parties intended to arbitrate claims for negligent tax or legal advice;

as a matter of first impression in the circuit, issue of availability of class arbitration was gateway issue for court, rather than arbitrator, to decide;

parties did not clearly and unmistakably delegate the issue of class arbitration to arbitrator;

contract did not permit class arbitration of claims against consultants; and

non-signatory consultants could compel arbitration of claims brought against them based on negligent tax advice.

Affirmed.

Procedural Posture(s): On Appeal; Motion to Dismiss; Motion to Compel Arbitration.

Attorneys and Law Firms

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J. Michael Low and Paul Gerding, Jr., Kutak Rock, Scottsdale, Arizona, for Defendant-Appellee AmeRisk Consulting LLC.

Michael J. Plati and Michael S. Rubin, Dickinson Wright PLLC, Phoenix, Arizona, for Defendant-Appellee Tribeca Strategic Accountants PLC.

Appeal from the United States District Court for the District of Arizona, Stephen M. McNamee, District Judge, Presiding, D.C. No. 2:18-cv-04514-SMM

Before: MICHAEL DALY HAWKINS, D. MICHAEL FISHER, [*] and MILAN D. SMITH, JR., Circuit Judges.

OPINION

M. SMITH, Circuit Judge:

Plaintiffs [1], some eighty-one individuals and related business entities, variously entered into agreements (the Agreements) with Defendants Artex Risk Solutions, Inc. (Artex) and TSA Holdings, LLC, formerly Tribeca Strategic Advisors, LLC (Tribeca). Pursuant to these Agreements, Artex and Tribeca formed and managed captive insurance companies that Plaintiffs owned, and to which Plaintiffs paid insurance premiums. Plaintiffs claimed the payments as tax-deductible business expenses without recognizing them as taxable income. Although ***1057** this arrangement offered the prospect of tax benefits, that prospect proved fleeting. The IRS audited Plaintiffs, issued delinquency notices, and sought to impose penalties.

After settling with the IRS, Plaintiffs brought this putative class action suit against Defendants. [2] Plaintiffs allege that the captives were illegal and abusive tax shelters, about which Defendants failed to inform or advise Plaintiffs. Plaintiffs' pursuit of this suit, however, faced a roadblock: the Agreements contain an arbitration clause (the Arbitration Clause or Clause). The district court granted Defendants' motion to compel arbitration and dismissed the operative complaint without prejudice. Plaintiffs appeal.

We resolve several issues here. *First*, we hold that the Agreements are not unenforceable on the grounds Plaintiffs raise. Although Plaintiffs assert that Artex and Tribeca breached a fiduciary duty to point out and fully explain an arbitration clause, they identify no state law authority recognizing such a duty. Addressing an issue of first impression in our circuit concerning the survival of arbitration obligations following contract termination, we hold that the Agreements do not expressly negate the presumption in favor of post-termination arbitration or clearly imply that the parties did not intend for their arbitration obligations to survive termination. *Second*, we hold that the Arbitration Clause encompasses all Plaintiffs' claims. *Third*, we join seven of our sister circuits in holding that the availability of class arbitration is a gateway issue that a court must presumptively decide. The Agreements here do not clearly and unmistakably delegate that issue to the arbitrator. Because the Agreements are silent on class arbitration, they do not permit class arbitration. *Finally*, we conclude that all non-signatory Defendants may compel arbitration pursuant to the Agreements. Thus, we affirm.

BACKGROUND

I. The Agreements and the Arbitration Clause

Between 2009 and 2012, the various groups of Plaintiffs retained Artex and Tribeca, both insurance management companies, to provide services concerning the formation and management of captive insurance companies for Plaintiffs. [3] Pursuant to the Agreements, Artex and Tribeca, with support from the other Defendants, conducted feasibility studies concerning the creation of the respective captives, created and managed the captives, calculated the captives' estimated federal tax payments, caused annual federal tax returns for the captives to be prepared and filed, maintained the captives' accounting records, and reinsured the captives.

As is relevant here, the Agreements contain an Arbitration Clause:

> You and we agree that in the event of any dispute that cannot be resolved between the parties, that we will agree to seek to resolve such disputes through mediation in Mesa, Arizona, and if that fails, that all disputes will be subject to binding arbitration in Mesa, Arizona, with arbitrators to be agreed upon by the parties, and if no agreement is reached, then arbitrated by the American ***1058** Arbitration Association (AAA). Each party shall bear its own costs in such mediation and arbitration. To reduce time and expenses, we each waive our right to litigate against one another regarding the services provided and obligations pursuant to this Agreement, and instead you and we have chosen binding arbitration. All claims or disputes will be governed by Arizona law.

Several Agreements also contain a Termination and Withdrawal section, which includes a clause concerning the survival of the terms of that section following termination of the Agreement. [4]

II. This Litigation

After settling with the IRS for tax liability issues arising from deductions that they claimed for the premiums that they paid to the captives, Plaintiffs filed a putative class action complaint in the District of Arizona. In the operative one hundred seventy-page First Amended Complaint (FAC), Plaintiffs raised claims against all Defendants for breach of fiduciary duty, negligence, negligent misrepresentation, disgorgement, rescission, breach of contract and the duty of good faith and fair dealing, fraud, civil conspiracy, aiding and abetting breach of fiduciary duty and fraud, violations of the federal Racketeer Influenced and Corrupt Organizations (RICO) Act, 18 U.S.C. § 1961 *et seq*., and violations of the Arizona RICO statute, Ariz. Rev. Stat. § 13-2301 *et seq*. Defendants moved to compel arbitration, and separately moved to dismiss. The district court granted the motion to compel, ordered Plaintiffs to arbitrate their claims on an individual basis, and dismissed the FAC without prejudice. Plaintiffs timely appealed.

JURISDICTION AND STANDARD OF REVIEW

We have jurisdiction pursuant to 28 U.S.C. § 1291 and 9 U.S.C. § 16(a)(3). *Green Tree Fin. Corp.-Ala. v. Randolph*, 531 U.S. 79, 89, 121 S.Ct. 513, 148 L.Ed.2d 373 (2000); *Johnmohammadi v. Bloomingdale's, Inc*., 755 F.3d 1072, 1074 (9th Cir. 2014). "We review a district judge's order to compel arbitration *de novo*." *Casa del Caffe Vergnano S.P.A. v. ItalFlavors, LLC*, 816 F.3d 1208, 1211 (9th Cir. 2016). We review factual findings for clear error, and the interpretation and meaning of contract provisions de novo. *Nguyen v. Barnes & Noble Inc*., 763 F.3d 1171, 1175 (9th Cir. 2014).

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ANALYSIS

Subject to certain exceptions not at issue here, the Federal Arbitration Act (FAA), 9 U.S.C. § 1 *et seq.*, governs arbitration agreements in contracts involving interstate commerce. "The FAA reflects both a 'liberal federal policy favoring arbitration' ... and the 'fundamental principle that arbitration is a matter of contract,'...." *Kramer v. Toyota Motor Corp.*, 705 F.3d 1122, 1126 (9th Cir. 2013) (quoting *AT&T Mobility LLC v. Concepcion*, 563 U.S. 333, 339, 131 S.Ct. 1740, 179 L.Ed.2d 742 (2011)). "The basic role for courts under the FAA is to determine '(1) whether a valid agreement to arbitrate exists and, if it does, (2) whether the agreement encompasses the dispute at issue.' " *Kilgore v. KeyBank, Nat'l Ass'n*, 718 F.3d 1052, 1058 (9th Cir. 2013) (en banc) (quoting *Chiron Corp. v. Ortho Diagnostic Sys., Inc.*, 207 F.3d 1126, 1130 (9th Cir. 2000)). State law governs the validity, revocability, and enforceability of a contract. *Id.* Federal substantive law ***1059** governs the scope of an arbitration agreement. *Kramer*, 705 F.3d at 1126.

I. The Arbitration Clause is Enforceable

We turn first to the enforceability of the Clause. Pursuant to the FAA, "[a] written provision in any ... contract evidencing a transaction involving commerce to settle by arbitration a controversy thereafter arising out of such contract ... shall be valid, irrevocable, and enforceable, save upon such grounds as exist at law or in equity for the revocation of any contract." 9 U.S.C. § 2. The savings clause of this provision permits a party to challenge an arbitration agreement pursuant to a generally applicable state law contract defense, such as fraud, duress, or unconscionability. *Doctor's Assocs., Inc. v. Casarotto*, 517 U.S. 681, 686–87, 116 S.Ct. 1652, 134 L.Ed.2d 902 (1996); *Kilgore*, 718 F.3d at 1058. "As arbitration is favored, those parties challenging the enforceability of an arbitration agreement bear the burden of proving that the provision is unenforceable." *Mortensen v. Bresnan Commc'ns, LLC*, 722 F.3d 1151, 1157 (9th Cir. 2013). Plaintiffs challenge the enforceability of the Arbitration Clause on two grounds. First, for all Agreements, Plaintiffs argue that Artex and Tribeca breached a state law fiduciary duty concerning arbitration clauses. Second, for only some Agreements, Plaintiffs argue that the Clause did not survive termination of the Agreements. We address each challenge in turn.

A. The Breach of Fiduciary Duty Challenge

Plaintiffs aver that Artex and Tribeca had a fiduciary duty to point out and explain the Arbitration Clause, which they failed to do. Thus, Plaintiffs claim, Artex and Tribeca effectively suppressed its existence in the less than ten-page Agreements that Plaintiffs received and signed, and thereby committed the legal equivalent of fraud. [5] Fraud is a basis to revoke a contract under Arizona law. *U.S. Insulation, Inc. v. Hilro Constr. Co., Inc.*, 146 Ariz. 250, 705 P.2d 490, 493–94 (Ct. App. 1985). However, to show fraud on the ground raised here, Plaintiffs must show that Artex and Tribeca owed the fiduciary duty that Plaintiffs claim exists under Arizona law. We will assume *arguendo* that a fiduciary relationship arose between Plaintiffs and Artex at some point in Defendants' provision of captive insurance services. [6] Even assuming so, Plaintiffs have not shown that, under Arizona law, it would encompass a duty to point out and fully explain an arbitration clause.

Plaintiffs direct us to a federal district court decision interpreting Arizona law. *See* *Katt v. Riepe*, No. CV-14-08042-PCT-DGC, 2014 WL 3720515 (D. Ariz. July 25, 2014). However, "we must adhere to state court decisions—not federal court decisions—as the authoritative interpretation of state law." *Daniel v. Ford Motor Co.*, 806 F.3d 1217, 1223 (9th Cir. 2015). Neither did the underlying Arizona state court decision on which *Katt* relied hint at the ***1060** existence of a duty that would require a contracting party to point out and fully explain an arbitration clause. *See* *Leigh v. Loyd*, 74 Ariz. 84, 244 P.2d 356 (1952); *Lerner v. DMB Realty, LLC*, 234 Ariz. 397, 322 P.3d 909 (Ct. App. 2014). Although these decisions articulated a fiduciary duty to disclose all material facts, that duty arose in the context of the fiduciary relationship between a real estate broker and the broker's principal. *See* *Leigh*, 244 P.2d at 358 ("It is well settled that a confidential relation exists between a real estate agent and his principal," which "impose[s] a duty on [the agent] to disclose the true facts."); *Lerner*, 322 P.3d at 919 ("A [real estate] broker owes a fiduciary duty to disclose material facts to its client."). No such relationship existed here.

The case before us is like one that the Arizona Court of Appeals has already considered. In *Dueñas v. Life Care Centers of America, Inc.*, 236 Ariz. 130, 336 P.3d 763 (Ct. App. 2014), the plaintiff challenged the enforceability of an arbitration agreement by arguing that an asserted fiduciary's failure to obtain the plaintiff's signature for the agreement rendered the agreement unenforceable. *Id.* at 771. The court rejected that argument because the plaintiff had identified no authority establishing that the duties involved in a fiduciary relationship extend to "the purely commercial aspects of their relationship." *Id.* Like the plaintiff there, Plaintiffs fail to identify any Arizona authority that would subject Artex and Tribeca to a fiduciary duty in connection with an arbitration clause. Thus, Plaintiffs have failed to show that the Clause is unenforceable on this ground.

B. The Arbitration Clause Survival Challenge

Plaintiffs next argue that the Arbitration Clause in only *some* of their Agreements is unenforceable because it did not survive termination of the Agreements. [7] Whether a party has agreed to arbitrate disputes following contract termination depends upon whether the arbitration obligations created under that contract remain enforceable. *See Biller v. S-H OpCo Greenwich Bay Manor, LLC*, 961 F.3d 502, 513–14 & n.9 (1st Cir. 2020). We first address the framework applicable to post-termination arbitration and then apply it here.

1. The Applicable Framework

Although the Supreme Court has not addressed the issue of post-termination arbitration of disputes in the FAA context, the Court has addressed this issue in the collective bargaining context. In *Litton Financial Printing Division v. NLRB*, the Court recognized a "presumption in favor of postexpiration arbitration of matters unless 'negated expressly or by clear implication' [for] matters and disputes arising out of the relation governed by contract." 501 U.S. 190, 204, 111 S.Ct. 2215, 115 L.Ed.2d 177 (1991) (quoting *Nolde Bros., Inc. v. Local No. 358, Bakery & Confectionary Workers Union, AFL-CIO*, 430 U.S. 243, 255, 97 S.Ct. 1067, 51 L.Ed.2d 300 (1977)). The Court explained that "[w]e presume as a matter of contract interpretation that the parties did not intend a pivotal dispute resolution provision to terminate for all purposes upon the expiration of the agreement." *Id.* at 208, 111 S.Ct. 2215. For the presumption to apply, the parties' dispute must have "its real source in the contract." ***1061** *Id.* at 205, 111 S.Ct. 2215. This occurs "only where [the dispute] involves facts and occurrences that arose before expiration, where an action taken after expiration infringes a right that accrued or vested under the agreement, *or* where, under normal principles of contract interpretation, the disputed contractual right survives expiration of the remainder of the agreement." *Id.* at 206, 111 S.Ct. 2215 (emphasis added).

Although we have not addressed *Litton*'s application to the FAA context, five sister circuits have. *See Biller*, 961 F.3d at 513; *Breda v. Cellco P'ship*, 934 F.3d 1, 7 (1st Cir. 2019); *Huffman v. Hilltop Cos., LLC*, 747 F.3d 391, 395–96 (6th Cir. 2014); *Wolff v. Westwood Mgmt., LLC*, 558 F.3d 517, 520–21 (D.C. Cir. 2009); *Koch v. Compucredit Corp.*, 543 F.3d 460, 465–66 (8th Cir. 2008); *CPR (USA) Inc. v. Spray*, 187 F.3d 245, 254–56 (2d Cir. 1999), *abrogated on other grounds as explained in Accenture LLP v. Spreng*, 647 F.3d 72, 76 (2d Cir. 2011). We are persuaded that the presumption also applies here. As the Sixth Circuit has explained, "the need for an arbitration provision to have post-expiration effect is intuitive, because if 'the duty to arbitrate automatically terminated upon expiration of the contract, a party could avoid his contractual duty to arbitrate by simply waiting until the day after the contract expired to bring an action regarding a dispute that arose while the contract was in effect.' " *Huffman*, 747 F.3d at 395 (citation omitted). Thus, we also apply the *Litton* framework here.

2. The Application of the *Litton* Presumption Here

We do not doubt that the dispute here has "its real source in the contract," *Litton*, 501 U.S. at 205, 111 S.Ct. 2215, because Plaintiffs raised no argument on this issue in their opening brief and thus waived the issue. *Smith v. Marsh*, 194 F.3d 1045, 1052 (9th Cir. 1999) ("[O]n appeal, arguments not raised by a party in its opening brief are deemed waived."). Plaintiffs argue, however, that the parties expressly negated the presumption, or clearly implied that their arbitration obligations under the Agreements at issue would not survive termination. Plaintiffs point to the following text in the "Termination and Withdrawal" section:

> The terms of this section shall survive the termination of this Agreement and/or the dissolution or other effective termination of the business of [Artex or Tribeca] or the insurance company.

Invoking the doctrine of *expressio unius est exclusio alterius*, Plaintiffs contend that the survival clause contains an exclusive list of the provisions that survive termination which excludes the Arbitration Clause and thus expressly negates the presumption or clearly implies that the parties did not intend for their arbitration obligations to survive termination. *See Herman Chanen Constr. Co. v. Guy Apple Masonry Contractors Inc.*, 9 Ariz.App. 445, 453 P.2d 541, 543 (Ariz.

Ct. App. 1969) ("[T]he expression in a contract of one or more things of a class, implies the exclusion of all things not expressed. ...").

The Sixth Circuit has already addressed the impact of a survival clause on post-termination arbitration obligations. *See Huffman*, 747 F.3d at 394–98. In *Huffman*, the Sixth Circuit determined that the freestanding survival clause there —which included half the agreement's provisions but not the arbitration clause—was insufficient to overcome the presumption in favor of post-termination arbitration. *Id.* Acknowledging that the *expressio unius* doctrine "present[ed] a trick[y] question," the Sixth Circuit determined that "considering the contract *as a whole*—the survival clause and its relationship to the other clauses in the agreement—is the correct way to determine whether the parties unambiguously intended for the arbitration clause to expire with the contract." ***1062** *Id.* at 397 (emphasis added). The Sixth Circuit adopted this mode of analysis due to "the strong federal policy in favor of arbitration," *id.* at 394, pursuant to which a court "resolv[es] *any doubts as to the parties' intentions in favor of arbitration*," *id.* at 395 (quoting *Nestle Waters N. Am., Inc. v. Bollman*, 505 F.3d 498, 503 (6th Cir. 2007)). The Sixth Circuit also noted that the presumption of arbitrability should not be denied for "broadly-worded arbitration clauses" unless it may be said with positive assurance that the arbitration clause is not susceptible of an interpretation that covers the asserted dispute. *Id.*

We are persuaded that looking to the Agreements as a whole is the proper mode of analysis here. The FAA "establishes 'a liberal federal policy favoring arbitration agreements.' " *Epic Sys. Corp. v. Lewis*, ––– U.S. ––––, 138 S. Ct. 1612, 1621, 200 L.Ed.2d 889 (2018) (quoting *Moses H. Cone Mem'l Hosp. v. Mercury Constr. Corp.*, 460 U. S. 1, 24, 103 S.Ct. 927, 74 L.Ed.2d 765 (1983)); *see also Kramer*, 705 F.3d at 1126 (recognizing strong federal policy in favor of arbitration). Although Plaintiffs contend that the Arbitration Clause is not as broadly worded as the clause in *Huffman*, we reject that argument in Part II and thus the scope of the Clause also lends support to looking to the contract as a whole. Finally, Arizona law also looks to the contract as a whole to ascertain the parties' intent. *Elm Ret. Ctr., LP v. Callaway*, 226 Ariz. 287, 246 P.3d 938, 941–42 (Ct. App. 2010) ("To determine the parties' intent, we 'look to the plain meaning of the words as viewed in the context of the contract as a whole.' " (quoting *United Cal. Bank v. Prudential Ins. Co.*, 140 Ariz. 238, 681 P.2d 390, 411 (Ct. App. 1983))).

Looking to the Agreements as a whole, the survival clause is insufficient to expressly negate the presumption in favor of post-termination arbitration or clearly imply that the parties intended for their arbitration obligations to terminate with the Agreements. The Agreements lack an exhaustive survival clause. Instead, the clause here appears in and concerns only the insular terms established by the "Termination and Withdrawal" section. We doubt that the parties intended for an insular survival clause tucked into a section establishing unique obligations and duties upon the termination of the Agreement to comprehensively identify the Agreement terms that would survive termination. [8] That doubt grows here because, as in *Huffman*, the Agreements contain severability and integration clauses outside the section with the survival clause. 747 F.3d at 397. "[I]t is illogical to conclude that upon expiration of the contract, the parties no longer intended" for these provisions to apply. *See id.*

Other provisions of the Agreements also suggest ambiguity about the survival clause on which Plaintiffs rely. The Agreements contain sections that disclaim liability for any underwriting losses and impose general limitations on liability, whether direct or indirect, arising out of, in connection with, or related in any way to an Agreement or services provided pursuant to it. The latter provision expressly precludes certain types of damages that may be recovered, including, in relevant part, punitive damages, taxes and interest due to any taxing authority or government agency, penalties payable to any taxing authority or government agency, and attorneys' fees. These are limitations that ***1063** the parties are unlikely to have intended to terminate with the Agreements, particularly given the broad scope of the limitations on liability and the fact that the limitations plainly concern events that are likely to occur post-termination.

Considering the Agreements as a whole, we cannot find that the parties expressly negated the presumption in favor of post-termination arbitration, or clearly implied that their arbitration obligations would not survive termination. We might have arrived at a different conclusion if the survival clause stated that only the terms of that section and no other terms in the Agreement would survive termination, if the Agreement included a comprehensive survival clause, or even if the Arbitration Clause explicitly stated that it does not survive termination. Of course, the Agreements contain no such language. Because "we cannot say with certainty that the parties did not intend for the arbitration clause to survive expiration of the contract," the parties' arbitration obligations remain intact. *See id.* at 398.

II. The Arbitration Clause Encompasses Plaintiffs' Claims

We turn next to whether the Arbitration Clause encompasses all of Plaintiffs' claims here. "[A] party can be forced to arbitrate only those issues it specifically has agreed to submit to arbitration." *First Options of Chi., Inc. v. Kaplan*, 514 U.S. 938, 945, 115 S.Ct. 1920, 131 L.Ed.2d 985 (1995). "When deciding whether the parties agreed to arbitrate a certain matter ... courts generally ... should apply ordinary state-law principles that govern the formation of contracts." *Id.* at 944, 115 S.Ct. 1920. Under Arizona law, a contract is ambiguous when it "can be reasonably construed in more than one manner." *Leo Eisenberg & Co., Inc. v. Payson*, 162 Ariz. 529, 785 P.2d 49, 52 (1989). "[A]s with any other contract, the parties' intentions control, but those intentions are generously construed as to issues of arbitrability." *Mitsubishi Motors Corp. v. Soler Chrysler-Plymouth, Inc.*, 473 U.S. 614, 626, 105 S.Ct. 3346, 87 L.Ed.2d 444 (1985). In the face of any ambiguity, "under the federal presumption in favor of arbitration, an arbitrator would have jurisdiction to arbitrate claims." *Comedy Club, Inc. v. Improv W. Assocs.*, 553 F.3d 1277, 1285 (9th Cir. 2009).

The Clause provides in the first instance (with emphasis added) that: "You and we agree that in the event of *any dispute* that cannot be resolved between the parties, that we will agree to seek to resolve *such disputes* through mediation ... and if that fails, that *all disputes* will be subject to binding arbitration." Defendants understandably rely on this sweeping language to conclude that the Clause includes all Plaintiffs' claims.

Plaintiffs, however, draw our attention to other language in the Clause which they argue narrows its scope. Plaintiffs focus on the Clause's third sentence: "[t]o reduce time and expenses, we each waive our right to litigate against one another regarding the services provided and obligations pursuant to this Agreement, and instead you and we have chosen binding arbitration." It is a "standard rule of contract interpretation" that "specific terms control over general ones." *United States ex rel. Welch v. My Left Foot Children's Therapy, LLC*, 871 F.3d 791, 797 (9th Cir. 2017) (quoting *S. Cal. Gas Co. v. City of Santa Ana*, 336 F.3d 885, 891 (9th Cir. 2003)); *see also Elm Ret. Ctr., LP*, 246 P.3d at 942 ("[B]ecause specific contract provisions express the parties' intent more precisely than general provisions, specific provisions qualify the meaning of general provisions.").[9] Treating the Clause's third ***1064** sentence as a more specific term concerning scope, we discern that the parties intended to arbitrate "any" and "all disputes" "regarding the services provided and obligations pursuant to this Agreement." So understood, the Clause still remains broad. *See, e.g., Simula, Inc. v. Autoliv, Inc.*, 175 F.3d 716, 720 (9th Cir. 1999) (concluding that a clause encompassing "[a]ll disputes arising in connection with this Agreement" should be construed and applied liberally); *Republic of Nicaragua v. Standard Fruit Co.*, 937 F.2d 469, 479 (9th Cir. 1991) (similar). The district court methodically explained why all of the claims here are subject to arbitration on this reading.

Plaintiffs nonetheless tell us that the district court erred in sending their various non-breach of contract claims to arbitration by pointing to a disclaimer in the Agreements, pursuant to which Artex and Tribeca explained that they "do[ ] not provide any legal, tax, or accounting advice." Plaintiffs aver that "tax or legal advice" was not among the services and obligations under the Agreements, and thus their claims concerning such advice are excluded from arbitration. This argument hinges entirely on the meaning of "tax or legal advice." Curiously, Plaintiffs do not offer *any* interpretation of those terms. Repeating a bare assertion that this phrase excludes their non-contract claims without supporting argument does not make it so.[10] *See Navajo Nation v. U.S. Forest Serv.*, 535 F.3d 1058, 1079 n.26 (9th Cir. 2008) (en banc) ("It is well-established that a bare assertion in an appellate brief, with no supporting argument, is insufficient to preserve a claim on appeal."). Because the Agreements provide that Artex and Tribeca would prepare federal tax returns and calculate estimated tax payments for the captives, Plaintiffs' argument, at best, points to ambiguity that we must resolve in favor of arbitration. *See Comedy Club*, 553 F.3d at 1286. Thus, we still conclude that the Clause encompasses all Plaintiffs' claims.

III. The Availability of Class Arbitration

Plaintiffs brought this suit as a putative class action against Defendants involving "hundreds if not thousands" of class members. The district court, however, ordered individual arbitration. We must determine next (1) whether the availability of class arbitration is a "gateway question" that a court must presumptively decide and, if so, (2) whether the parties nevertheless clearly and unmistakably delegated the issue to the arbitrator, and (3) if not, whether the Agreements permit class arbitration. We address each issue in turn.

A. The Availability of Class Arbitration is a Gateway Issue for a Court to Presumptively Decide

The Supreme Court has distinguished between two categories of issues, each of which has a different presumption as to whether a court or an arbitrator ***1065** should decide them. *See* *Howsam v. Dean Witter Reynolds, Inc.*, 537 U.S. 79, 83, 123 S.Ct. 588, 154 L.Ed.2d 491 (2002); *Martin v. Yasuda*, 829 F.3d 1118, 1122–23 (9th Cir. 2016). In the first category of issues are "potentially dispositive gateway question[s] ... of arbitrability" that "contracting parties would likely have expected a court to ... decide[ ]." *Howsam*, 537 U.S. at 83, 123 S.Ct. 588 (internal quotation marks omitted). "This category includes issues ... such as 'whether the parties are bound by a given arbitration clause' or whether 'an arbitration clause in a concededly binding contract applies to a particular type of controversy.' " *Martin*, 829 F.3d at 1123 (quoting *Howsam*, 537 U.S. at 84, 123 S.Ct. 588). "These disputes are 'for judicial determination unless the parties clearly and unmistakably provide otherwise.' " *Id.* (quoting *Howsam*, 537 U.S. at 83, 123 S.Ct. 588). The second category encompasses "procedural" issues, which are "presumptively not for the judge, but for an arbitrator, to decide." *Id.* (quoting *Howsam*, 537 U.S. at 84, 123 S.Ct. 588). Examples of issues in this category are whether a party has satisfied the arbitral forum's statute of limitations for filing a case, whether a party has satisfied certain requirements of a procedural grievance, and "allegation[s] of waiver, delay, or a like defense to arbitrability." *Howsam*, 537 U.S. at 84–85, 123 S.Ct. 588 (quoting *Moses H. Cone*, 460 U.S. at 25, 103 S.Ct. 927).

The Supreme Court has not had occasion to decide whether the availability of class arbitration is a gateway issue for a court to decide pursuant to this framework. *See* *Lamps Plus, Inc. v. Varela*, ––– U.S. ––––, 139 S. Ct. 1407, 1417 n.4, 203 L.Ed.2d 636 (2019) (not deciding the question because the parties agreed that the issue was one for the court to decide); *Oxford Health Plans LLC v. Sutter*, 569 U.S. 564, 569 n.2, 133 S.Ct. 2064, 186 L.Ed.2d 113 (2013) (not deciding the question because the parties agreed that the issue was one for the arbitrator to decide); *Stolt-Nielsen S.A. v. AnimalFeeds Int'l Corp.*, 559 U.S. 662, 680, 130 S.Ct. 1758, 176 L.Ed.2d 605 (2010) (not deciding the question because the parties entered into a supplemental agreement that expressly assigned the issue of the availability of class arbitration to the arbitration panel).

Seven of our sister circuit courts, however, have concluded that the availability of class arbitration is a gateway question for a court to presumptively decide. [11] *See* *20/20 Commc'ns, Inc. v. Crawford*, 930 F.3d 715, 718–19 (5th Cir. 2019); *Herrington v. Waterstone Mortg. Corp.*, 907 F.3d 502, 506–07 (7th Cir. 2018); *JPay, Inc. v. Kobel*, 904 F.3d 923, 935–36 (11th Cir. 2018); *Catamaran Corp. v. Towncrest Pharmacy*, 864 F.3d 966, 972 (8th Cir. 2017); *Del Webb Cmtys., Inc. v. Carlson*, 817 F.3d 867, 873 (4th Cir. 2016); *Opalinski v. Robert Half Int'l Inc.*, 761 F.3d 326, 334–35 (3d Cir. 2014); *Reed Elsevier, Inc. v. ex rel. LexisNexis Div. v. Crockett*, 734 F.3d 594, 598–99 (6th Cir. 2013). We have also concluded that the availability of class arbitration is a gateway issue in an unpublished and nonprecedential memorandum disposition. *See* *Eshagh v. Terminix Int'l Co.*, 588 F. App'x 703, 704 (9th Cir. 2014).

Faced with whether class arbitration is a gateway question here, we see no reason to create an unnecessary circuit split, or to depart from what we have ***1066** already suggested. We find persuasive the three reasons that the Seventh Circuit has succinctly identified for why class arbitration is a gateway issue. *See* *Herrington*, 907 F.3d at 507–08. The first and second reasons assimilate the issue of class arbitration into what we have already recognized are gateway issues presumptively for a court to decide: "(1) whether there is an agreement to arbitrate between the parties; and (2) whether the agreement covers the dispute." *Brennan v. Opus Bank*, 796 F.3d 1125, 1130 (9th Cir. 2015) (citing *Howsam,* 537 U.S. at 84, 123 S.Ct. 588). The third reason concerns the Supreme Court's treatment of class arbitration. We briefly consider each of these reasons.

The Seventh Circuit has explained first that "[t]he availability of class ... arbitration involves a foundational question of arbitrability: whether the potential parties to the arbitration agreed to arbitrate." *Herrington*, 907 F.3d at 507. This is the familiar gateway question of whether there is an agreement to arbitrate *between the parties*. *See* *Brennan*, 796 F.3d at 1130. Plaintiffs filed a putative class complaint, seeking to represent "hundreds if not thousands of" possible class members. The availability of class arbitration raises the question whether any of those possible class members have actually agreed to arbitration in the first place as well as the question whether the Agreements show that Artex and Tribeca agreed to arbitrate rather than litigate with those members. Thus, answering this question "resolves the foundational question of 'with whom' [Artex and Tribeca] chose to arbitrate." *See* *Herrington*, 907 F.3d at 508 (quoting *Stolt-Nielsen*, 559 U.S. at 683, 130 S.Ct. 1758).

Relatedly, the Seventh Circuit has explained that "whether a contract permits class ... arbitration involves a second ... question of arbitrability: whether the agreement to arbitrate covers a particular controversy." *Id.* This is the familiar gateway question of scope. *See Brennan*, 796 F.3d at 1130. Notably, the Clause here provides that "[y]ou and we agree that in the event of any dispute that cannot be resolved between the parties," "such disputes" will be resolved by mediation and arbitration. The availability of class arbitration raises the question whether Artex and Tribeca agreed to arbitrate particular disputes not only with the Plaintiffs, but also with possible class members. Answering this question resolves the question of whether the parties agreed to arbitrate particular disputes.

Third, and "most important[ly]," the Seventh Circuit has explained that class arbitration belongs to the gateway category because "the structural features of class arbitration make it a 'fundamental' change from the norm of bilateral arbitration." *Herrington*, 907 F.3d at 509 (quoting *Stolt-Nielsen*, 559 U.S. at 686, 130 S.Ct. 1758). The Supreme Court has all but endorsed this reason for treating class arbitration as a gateway issue. According to the Court, class arbitration: (1) "sacrifices the principal advantage of arbitration—its informality—and makes the process slower, more costly, and more likely to generate procedural morass than final judgment," *Concepcion*, 563 U.S. at 348, 131 S.Ct. 1740, (2) "*requires* procedural formality" because "[i]f procedures are too informal, absent class members would not be bound by the arbitration," *id.* at 349, 131 S.Ct. 1740, and (3) "greatly increases risks to defendants," *id.* at 350, 131 S.Ct. 1740. In short, "class-action arbitration changes the nature of arbitration to such a degree that it cannot be presumed the parties consented to it by simply agreeing to submit their disputes to an arbitrator." *Stolt-Nielsen*, 559 U.S. at 685, 130 S.Ct. 1758. As seven circuits have recognized, the Court's discussion of class arbitration is a weighty thumb on the scale in favor of treating class arbitration as a ***1067** gateway issue for a court to presumptively decide. *See 20/20 Commc'ns*, 930 F.3d at 719; *Herrington*, 907 F.3d at 509; *JPay*, 904 F.3d at 933–34; *Catamaran Corp.*, 864 F.3d at 971–72; *Del Webb Cmtys.*, 817 F.3d at 875–76; *Opalinski*, 761 F.3d at 333–34; *Reed Elsevier*, 734 F.3d at 598.

We are not persuaded by Plaintiffs' arguments for why we should not treat the availability of class arbitration as a gateway issue for a court. Plaintiffs rely on a concurrence that is concededly not the law of any circuit. *See Dish Network, L.L.C.*, 900 F.3d at 1252–57 (Tymkovich, C.J., concurring). That concurrence criticizes the third reason we have identified as nothing more than "Supreme Court dicta and good policy." *Id.* at 1255. But when the Court speaks, we should take notice. *See Zal v. Steppe*, 968 F.2d 924, 935 (9th Cir. 1992), *as amended* (July 31, 1992) (Noonan, J., concurring in the result in part and dissenting in part) ("[D]icta of the Supreme Court have a weight that is greater than ordinary judicial dicta as prophecy of what that Court might hold. We should not blandly shrug them off because they were not a holding."). As we have explained, the Supreme Court has repeatedly underscored why class arbitration is different and thus should be treated differently. *See Stolt-Nielsen*, 559 U.S. at 685, 130 S.Ct. 1758; *Concepcion*, 563 U.S. at 348–50, 131 S.Ct. 1740. Naturally, seven circuits have taken notice, and so do we.

Plaintiffs also argue that class arbitration is a procedural issue for an arbitrator to decide in light of the Court's passing references to class actions as "procedures" in *Epic Systems*, 138 S. Ct. at 1624–25, and the fact that the Federal Rules of Civil Procedure treat class actions as procedural. We are not persuaded. As the Seventh Circuit has observed, *Epic Systems* did not decide whether class arbitration is a gateway question, *see Herrington*, 907 F.3d at 506, and thus that decision is not of any help. More fundamentally, that a class action is a "classically" procedural mechanism in federal court under Federal Rule of Civil Procedure 23, *Dish Network, L.L.C.*, 900 F.3d at 1254 (Tymkovich, C.J., concurring), is of no moment here. In the arbitration context, we are concerned with whether *the parties* to the requested arbitration have *agreed* to that particular dispute resolution, and, if so, what the scope of *that agreement* is. *See Stolt-Nielsen*, 559 U.S. at 687, 130 S.Ct. 1758 (underscoring "the consensual basis of arbitration"). Therefore, the relevant metric is not the labeling of a particular mechanism in federal court as "procedural", but rather the categories of gateway issues in reviewing an arbitration agreement that the Court has instructed determine whether an issue is presumptively for a court or an arbitrator to decide absent *further agreement* by the parties. *See Rent-A-Center, West, Inc. v. Jackson*, 561 U.S. 63, 69, 130 S.Ct. 2772, 177 L.Ed.2d 403 (2010) (describing gateway questions for a court as issues "*such as* whether the parties have agreed to arbitrate or whether their agreement covers a particular controversy" (emphasis added)).

We have already explained how the question of the availability of class arbitration interlocks with gateway issues that a court must presumptively decide. Plaintiffs offer no persuasive reason for why we should nevertheless treat class arbitration as akin to the exemplary questions for an arbitrator to presumptively decide, nor do we see one that would warrant a circuit split. *See Howsam*, 537 U.S. at 85, 123 S.Ct. 588 (identifying as "procedural" questions presumptively for an arbitrator as "whether prerequisites such as *time limits*, notice, laches, estoppel, and other conditions precedent to an obligation to arbitrate have been met"); *see also Global Linguist Solutions, LLC v. Abdelmeged*, 913 F.3d 921, 923 (9th Cir. 2019) (reaching ***1068** result partly to avoid an unnecessary circuit split). Thus, we conclude that class arbitration is a gateway issue for a court to presumptively decide.

B. The Parties Did Not Clearly and Unmistakably Delegate the Issue of Class Arbitration to the Arbitrator

Having resolved that class arbitration is a gateway issue, Plaintiffs tell us that the Clause evidences a clear and unmistakable intent to delegate the issue to the arbitrator as follows: (1) the Clause refers to the AAA (*i.e.*, the American Arbitration Association), (2) which renders the AAA Rules applicable, (3) which in turn encompass the AAA's Supplementary Rules, (4) which include Supplementary Rule 3's instruction that "the arbitrator shall determine as a threshold matter ... whether the applicable arbitration clause permits the arbitration to proceed on behalf of or against a class," and (5) thus the parties delegated the issue of class arbitration to the arbitrator.

Plaintiffs' argument touches on a circuit split on whether incorporation of the AAA Rules is sufficient evidence that the parties clearly and unmistakably delegated the issue of class arbitration to the arbitrator. *Compare Catamaran Corp.*, 864 F.3d at 973 (concluding that an arbitration agreement's incorporation of the AAA Rules without specific reference to class arbitration is insufficient); *Chesapeake Appalachia, LLC v. Scout Petroleum, LLC*, 809 F.3d 746, 761 (3d Cir. 2016) (same), *cert. denied*, ––– U.S. ––––, 137 S. Ct. 40, 196 L.Ed.2d 27 (2016), *Reed Elsevier*, 734 F.3d at 599 (concluding that a clause which incorporated the AAA Rules "does not clearly and unmistakably assign to an arbitrator the question whether the agreement permits classwide arbitration"), *with JPay*, 904 F.3d at 936–42 (reasoning that incorporation of the AAA Rules is sufficient and explaining disagreement with Third, Sixth, and Eighth Circuits).

We need not take sides in this circuit split here because Plaintiffs fail to clear a threshold hurdle. The crux of Plaintiffs' argument is our decision in *Brennan v. Opus Bank*. The arbitration clause there provided that "any controversy or claim arising out of this [Employment] Agreement or [Brennan's] employment with the Bank or the termination thereof ... shall be settled by binding arbitration *in accordance with the Rules of the American Arbitration Association*." 796 F.3d at 1128 (alterations in original; emphasis added). We concluded that, at least in a contract between sophisticated parties, "incorporation of the AAA Rules constitutes clear and unmistakable evidence that contracting parties agreed to arbitrate arbitrability." *Id.* at 1130 (internal quotation marks omitted; emphasis added). Thus, we sided with " '[v]irtually every circuit to have considered the issue.' " *Id.* (first alteration in original; quoting *Oracle Am., Inc. v. Myriad Grp. A.G.*, 724 F.3d 1069, 1074 (9th Cir. 2013)). Unlike the arbitration clause in *Brennan*, the Clause does not incorporate the AAA Rules, and thus *Brennan* does not apply.

Unable to identify a textual reference to the AAA Rules, Plaintiffs nonetheless contend that the "obvious and unavoidable implication of an agreement to arbitrate before the AAA is an agreement to submit to the AAA's arbitration rules." But we have never held that a mere reference to the AAA shows clear and unmistakable intent to delegate a gateway issue to an arbitrator, and Plaintiffs identify no authority from any sister circuit holding as much. Even if we thought the "obvious and unavoidable implication" of a reference to the AAA is consent to the AAA Rules when a clause refers only to the AAA, the Clause here does not do so. The Clause ***1069** provides first for mediation, second for arbitration by an arbitrator selected by the parties, and, only if the parties cannot agree on an arbitrator, arbitration before the AAA. We cannot find clear and unmistakable evidence that the parties intended to delegate the gateway issue of class arbitration to the arbitrator by virtue of the AAA Rules when arbitration before the AAA is but the final option in the dispute procedure that the Clause outlines. [12]

In light of the Clause here, Plaintiffs' reliance on *Belnap v. Iasis Healthcare*, 844 F.3d 1272 (10th Cir. 2017), is misplaced. The arbitration clause there provided that *"[t]he arbitration shall be administered by JAMS and conducted in accordance with its Streamlined Arbitration Rules and Procedures (the "Rules"), except as provided otherwise herein*." *Id.* at 1276. Rejecting the plaintiff's argument that the agreement left open the rules that would govern arbitration because the parties could choose another dispute resolution service, the Tenth Circuit explained that "[t]he plain language of the Agreement establishes the JAMS Rules as the default controlling rubric." *Id.* at 1282. The Clause here, however, neither refers to the AAA Rules, nor does it establish those Rules as the "default controlling rubric." *See id.* Although the Clause provides for the possibility that arbitration may occur before the AAA if the parties cannot agree on an arbitrator, "such a possibility is not enough for us to say that" the AAA Rules are the Clause's "ordinary controlling standard." *See id.* Because Plaintiffs do not claim that any other provision demonstrates a clear and unmistakable intent to delegate the availability of class arbitration to the arbitrator, we conclude that the availability of class arbitration remains a gateway issue.

C. The Agreements Do Not Permit Class Arbitration

The final issue that we must decide on class arbitration is straightforward. "Neither silence nor ambiguity provides a sufficient basis for concluding that parties to an arbitration agreement agreed to undermine the central benefits of arbitration itself," *Lamps Plus*, 139 S. Ct. at 1417, namely, "the individualized form of arbitration envisioned by the FAA," *id.* at 1416. As the district court concluded, because the Agreements are silent on class arbitration, they do not permit it. Thus, the court properly compelled individual arbitration pursuant to the Agreements.

IV. The Non-Signatory Defendants May Compel Arbitration

The final issue for us is whether all Defendants may compel arbitration of Plaintiffs' claims. Several Defendants are not signatories to the Agreements (the Non-Signatory Defendants). Although only Jim Tehero and Karl Huish signed the Agreements on Artex and Tribeca's behalf, Plaintiffs concede that these Defendants as well as Jeremy Huish and Arthur J. Gallagher & Co. may compel arbitration. Nevertheless, Plaintiffs argue that no other Non-Signatory Defendant may compel arbitration. [13] We disagree.

***1070** "[A] litigant who is not a party to an arbitration agreement may invoke arbitration under the FAA if the relevant state contract law allows the litigant to enforce the agreement." *Kramer*, 705 F.3d at 1128 (citing *Arthur Andersen LLP v. Carlisle*, 556 U.S. 624, 632, 129 S.Ct. 1896, 173 L.Ed.2d 832 (2009)). Arizona law recognizes alternative estoppel, pursuant to which a non-signatory may compel arbitration of a signatory's claims. *Sun Valley Ranch 308 Ltd. P'ship ex rel. Englewood Props., Inc. v. Robson*, 231 Ariz. 287, 294 P.3d 125, 134–35 (Ct. App. 2012). A non-signatory may compel arbitration when "each of a signatory's claims against a nonsignatory makes reference to or presumes the existence of the written agreement," such that "the signatory's claims arise out of and relate directly to the written agreement." *Id.* at 135 (quoting *CD Partners, LLC v. Grizzle*, 424 F.3d 795, 798 (8th Cir. 2005)). [14] As the district court concluded, all Non-Signatory Defendants may compel arbitration pursuant to this standard. [15]

Plaintiffs' allegations about Defendants' misconduct regarding the captive insurance services presume and "intimately rel[y]" on the existence of the Agreements. *See Kramer*, 705 F.3d at 1132. We have already determined in Part II that Plaintiffs' claims are subject to arbitration even if we construe the Clause as limited to the services and obligations under the Agreements. It follows that Plaintiffs' claims necessarily presume the existence of the Agreements. Indeed, the entire complaint concerns Defendants' captive insurance services, which encompassed the formation, oversight, operation, and management of captive insurance companies for Plaintiffs pursuant to the Agreements. The Agreements also provide that Artex and Tribeca would hire third parties in connection with the services, thus underscoring that the claims presume the existence of the Agreements even for the Non-Signatory Defendants. *See Sun Valley*, 294 P.3d at 135 (finding that the nonsignatory "may nevertheless compel plaintiffs to arbitrate their claims against him" because "the trier of fact will be required to consider the [underlying agreements] in resolving plaintiffs' claims, and [the non-signatory's] conduct is intertwined with that of other defendants who signed the [underlying agreement].").

We are not persuaded by Plaintiffs' counterarguments. Plaintiffs aver that they could bring all their claims against the Non-Signatory Defendants regardless of whether the Agreements existed, and thus alternative estoppel does not apply. This argument proves nothing because it is not the relevant test under Arizona law. *See id.*

Relying on *Kramer*, 705 F.3d at 1133, Plaintiffs argue further that mere allegations of substantially interdependent and concerted misconduct by signatories and non-signatories, standing alone, are insufficient to permit non-signatories to compel arbitration. But in *Kramer* we rejected the non-signatory defendants' invocation of equitable estoppel based only on "sparse portions" of the pleadings concerning interdependent ***1071** conduct by the defendants. *Id.* In contrast, the FAC makes pervasive allegations of concerted conduct by the Defendants. We have also explained why Plaintiffs' claims presume the existence of the Agreements even for the Non-Signatory Defendants. Thus, we conclude that all Non-Signatory Defendants can compel arbitration.

CONCLUSION

For the foregoing reasons, the district court correctly granted Defendants' motion to compel and ordered arbitration of Plaintiffs' claims on an individual basis.

AFFIRMED.

All Citations

974 F.3d 1051, 20 Cal. Daily Op. Serv. 9502, 2020 Daily Journal D.A.R. 9808

Footnotes

* The Honorable D. Michael Fisher, United States Circuit Judge for the U.S. Court of Appeals for the Third Circuit, sitting by designation.

1 Because the Plaintiffs are so numerous, and are each named in the caption, we do not recount the names of all of them in the body of this opinion.

2 In addition to Artex and Tribeca, Plaintiffs sued officers of Artex, Tribeca, and the parent company of Artex, namely, Defendants Karl Huish, Jeremy Huish, Jim Tehero, and Arthur J. Gallagher & Co. Plaintiffs also sued TBS LLC d/b/a PRS Insurance; Debbie Inman (an Artex employee); Epsilon Actuarial Solutions, LLC, Julie A. Ekdom (CEO of Epsilon); AmeRisk Consulting, LLC; Provincial Insurance, PCC; Tribeca Strategic Accountants, LLC; and Tribeca Strategic Accountants, PLC. We refer to all as the "Defendants."

3 Artex acquired Tribeca in 2010.

4 The Agreements of the following Plaintiffs contain this section: Shivkov, Miller, Linder, Bikhazi, Welling, Bullard, Frank, and McHale, as well as their corresponding entities. The Agreements of Plaintiffs Butler, Wilke, Pereira, and Tiffany do not contain this section.

5 Plaintiffs made a similar argument in challenging the Clause as procedurally unconscionable. The district court rejected that argument, finding that that the record demonstrates that "Plaintiffs are sophisticated people and businesses capable of negotiating this type of commercial relationship." The court further explained that although Plaintiffs argued that Artex and Tribeca rushed them into signing the Agreements, only one Plaintiff identified a time frame for signing an Agreement, which spanned "a few weeks." Plaintiffs do not challenge in this appeal the court's determination that the Clause is not unconscionable.

6 Because we assume this relationship, it is unnecessary to address Plaintiffs' request for additional discovery about whether a fiduciary relationship existed.

7 Plaintiffs raise this argument only for Plaintiffs Shivkov, Miller, Linder, Bikhazi, Welling, Bullard, Frank, and McHale, as well as their corresponding entities. Thus, this argument does not apply to Plaintiffs Butler, Wilke, Pereira, and Tiffany.

8 Although Plaintiffs argue that reading the contract as a whole renders the survival clause mere surplusage, that argument circularly justifies not looking to the entire contract by presupposing that the clause has the meaning Plaintiffs ascribe it. The point of the analysis here is to ascertain whether the clause plainly bears that meaning or not.

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9 We will assume that Plaintiffs meant to rely on this standard and directly applicable contract rule because Plaintiffs' reliance on *Mesquite Lake Assocs. v. Lurgi Corp*., 754 F. Supp. 161 (N.D. Cal. 1991), is unpersuasive. Unlike in *Mesquite*, the Clause does not limit its scope through a provision that "any controversy or dispute between the Parties concerning this Agreement and *specifically subject to resolution pursuant to this Article shall be subject to arbitration* ...." *Id.* at 162 (emphasis added).

10 Although Plaintiffs rely on *Khan v. BDO Seidman, LLP*, 404 Ill.App.3d 892, 343 Ill.Dec. 946, 935 N.E.2d 1174 (2010), that case says nothing about the issue here, namely the meaning of the phrase "tax or legal advice" for the Agreements at issue. Thus, apart from the fact that we are not bound by that decision, Plaintiffs' list of factual comparisons with that case does nothing to overcome their failure to offer any meaning of these terms in the Agreements here.

11 The Second and Tenth Circuits have assumed without deciding that the availability of class arbitration is a gateway issue that is presumptively for a court to decide. *See* *Dish Network, L.L.C. v Ray*, 900 F.3d 1240, 1245 (10th Cir. 2018) (acknowledging the consensus among "many circuits" but assuming the issue and concluding that the parties clearly and unmistakably delegated the issue to an arbitrator); *Wells Fargo Advisors, L.L.C. v. Sappington*, 884 F.3d 392, 395 (2d Cir. 2018) (same).

12 Plaintiffs contend that only the non-AAA portions of the Clause are an unenforceable bare agreement to agree and thus the AAA is the default option. The FAA and Arizona's Revised Uniform Arbitration Act, however, *both* permit enforcement of an agreement regarding the method of naming or appointing an arbitrator. *See* 9 U.S.C. § 5; Ariz. Rev. Stat. § 12-1503.

13 The remaining Non-Signatory Defendants include TBS LLC d/b/a PRS Insurance; Debbie Inman; Epsilon Actuarial Solutions, LLC; Julie A. Ekdom; AmeRisk Consulting, LLC; Provincial Insurance, PCC; Tribeca Strategic Accountants, LLC; and Tribeca Strategic Accountants, PLC.

14 Alternative estoppel may also apply when "the relationship between the signatory and nonsignatory defendants is sufficiently close that only by permitting the nonsignatory to invoke arbitration may evisceration of the underlying arbitration agreement between the signatories be avoided." *Sun Valley*, 294 P.3d at 134 (quoting *CD Partners*, 424 F.3d at 798). Because Defendants do not invoke this ground, we decline to address whether Plaintiffs would be estopped on this basis.

15 It is unnecessary for us to resolve the parties' dispute about the standard of review for the district court's decision. Whether we review de novo or for an abuse of discretion, we affirm the district court.

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EXHIBIT AC-117

KeyCite Yellow Flag - Negative Treatment
Distinguished by 510pacificave v. Weiss, Cal.App. 2 Dist., June 29, 2021

245 Cal.App.4th 75
Court of Appeal, Second District, Division 1, California.

BOSTON LLC, Plaintiff and Respondent,
v.
Juan JUAREZ, Defendant and Appellant.

B267267
|
Filed February 25, 2016
|
Petition for Rehearing March 18, 2016
|
Petition for Review Denied May 11, 2016

Synopsis
Background: Landlord sued tenant, who rented apartment under Los Angeles Rent Stabilization Ordinance (LARSO), for unlawful detainer, stemming from tenant's failure to obtain renter's insurance pursuant to rental agreement and landlord's three-day notice to perform or quit. Following bench trial, the Superior Court, Los Angeles County, No. 14U02675, Leland B. Harris, J., ruled in favor of landlord. Tenant appealed. The Superior Court, Appellate Division, No. BV030948, Ricciardulli, J., 240 Cal.App.4th Supp. 28, 93 Cal.Rptr.3d 521, affirmed. The Court of Appeal asserted jurisdiction over the matter pursuant to rule governing transfer authority.

Holdings: The Court of Appeal, Lui, J., held that:

[1] unlawful detainer statute did not create substantive forfeiture right;

[2] forfeiture clause in rental agreement did not foreclose materiality argument or defense;

[3] LARSO's public policy goals outweighed free market and freedom of contract principles allowing landlord to include unilateral forfeiture clause in agreement;

[4] nature of insurance clause weighed against enforcing it; and

[5] tenant's delay in obtaining renter's insurance was not a material breach sufficient to justify forfeiture.

Reversed.

Procedural Posture(s): On Appeal; Judgment.

West Headnotes (11)

[1] **Landlord and Tenant** Scope and standards of review

Whether the law requires material breach to enforce forfeiture clause in residential lease is a question of law which Court of Appeals reviews de novo in the absence of disputed facts.

[2] **Landlord and Tenant** Nature and form

Unlawful detainer statute did not create substantive forfeiture right, but rather statute governed forfeiture procedure; purpose of statute was procedural, statute implemented landlord's property rights by permitting him to recover possession once consensual basis of tenant's occupancy was at an end, and statute did not speak to what kinds of substantive neglect or failure to perform conditions or covenants of lease allowed statute to take effect. Cal. Civ. Proc. Code § 1161(3).

[3] **Landlord and Tenant** Defenses and grounds of opposition in general

Landlord and Tenant Violation of Tenancy

Forfeiture clause in tenant's rental agreement pursuant to Los Angeles Rent Stabilization Ordinance (LARSO), which provided that any failure of compliance or performance under agreement by tenant allowed landlord to forfeit agreement and terminate tenant's right to possession, did not foreclose argument or defense by tenant that breach of agreement must be material to justify forfeiture in landlord's unlawful detainer action, stemming from tenant's failure to obtain renter's insurance, as required under agreement and landlord's three-day notice to perform or quit; despite such clause, materiality requirement still applied, especially where landlord had ability to detect and cure breach far in advance of bringing suit, but chose not to do so. Cal. Civ. Proc. Code § 1161(3).

3 Cases that cite this headnote

[4] **Landlord and Tenant** Breach by lessor

Landlord and Tenant Grounds of action

Whether a particular breach of rental contract will give landlord the right to declare a forfeiture in unlawful detainer action is based on whether breach is material because law sensibly recognizes that, although every instance of noncompliance with a contract's terms constitutes a breach, not every breach justifies treating contract as terminated. Cal. Civ. Proc. Code § 1161(3).

4 Cases that cite this headnote

[5] **Landlord and Tenant** Breach of Covenant or Condition

Landlord and Tenant Grounds of action

Courts allow termination of rental agreement under unlawful detainer statute only if breach can be classified as material, substantial, or total. Cal. Civ. Proc. Code § 1161(3).

4 Cases that cite this headnote

[6] **Landlord and Tenant** Statutes and Municipal Regulations in General

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Courts are bound to uphold Los Angeles Rent Stabilization Ordinance's (LARSO) objectives unless they are patently unenforceable.

[7] **Landlord and Tenant** Breach of Covenant or Condition

Landlord and Tenant Purpose

Los Angeles Rent Stabilization Ordinance's (LARSO) public policy goals of providing stable affordable housing to low-income residents and preventing pretext evictions outweighed free market and freedom of contract principles allowing landlord to include unilateral forfeiture clause in an urban residential rental contract; unilateral forfeiture clause entirely benefited landlord, and permitting landlords with superior bargaining power to forfeit leases based on minor or trivial breaches would have allowed landlords to strategically circumvent LARSO's good cause eviction requirements and disguise pretext evictions under cloak of contract provisions.

5 Cases that cite this headnote

[8] **Landlord and Tenant** Conditions

Because lease condition involving a forfeiture must be strictly interpreted against the party for whose benefit it is created, if lease agreement can be reasonably interpreted so as to avoid forfeiture, it is court's duty to do so. Cal. Civ. Code § 1442.

3 Cases that cite this headnote

[9] **Landlord and Tenant** Property of tenants

Landlord and Tenant Violation of Tenancy

Insurance clause in tenant's rental agreement pursuant to Los Angeles Rent Stabilization Ordinance (LARSO), which provided that landlord did not insure tenant for any personal injury or property damage and that tenant was required to obtain and pay for any insurance coverage necessary to protect him from such damage, was overreaching and unrealistic, and thus nature of clause weighed against enforcing it, especially where enforcing clause would have benefited landlord, the party for whose benefit clause was created, as ground for forfeiting agreement; landlord was precluded from absolving itself for any property damage to tenant by demanding that tenant obtain insurance when that damage could have been caused by landlord or could have been damage landlord was liable for as landlord. Cal. Civ. Code § 1442.

1 Cases that cite this headnote

[10] **Contracts** Questions for Jury

Normally, question of whether a breach of an obligation is a material breach is a question of fact, however, if reasonable minds cannot differ on issue of materiality, issue may be resolved as a matter of law.

5 Cases that cite this headnote

[11] **Landlord and Tenant** Violation of Tenancy

Tenant's slight delay in obtaining renter's insurance pursuant to rental agreement under Los Angeles Rent Stabilization Ordinance (LARSO) and landlord's three-day notice to obtain insurance or quit was not a material breach sufficient to justify forfeiture of agreement; chance that tenant's temporary noncompliance with agreement's insurance clause incited other tenants to not comply with their insurance obligations was insufficient to demonstrate harm justifying forfeiture, tenant's lack of insurance for a mere handful of days after he was noticed did not harm landlord, and giving tenant three-day notice to obtain insurance on the Friday preceding a three-day weekend suggested gamesmanship or retaliatory motives.

See 12 Witkin, Summary of Cal. Law (10th ed. 2005) Real Property, § 703 et seq.

****454** APPEAL from a judgment the Superior Court of Los Angeles County, Leland B. Harris, Judge. Reversed. (Los Angeles County Super. Ct. No. 14U02675; App. Div. No. BV030948)

Attorneys and Law Firms

Public Counsel, Lisa R. Jaskol and Robert J. Reed for Defendant and Appellant.

Neighborhood Legal Services of Los Angeles County, Los Angeles, Alexander Prieto, Eliza Schafler, Lena Silver; Western Center on Law and Poverty, Los Angeles, and Maria Palomares as Amici Curiae on behalf of Defendant and Appellant.

Legal Aid Foundation of Los Angeles, Anna Levine–Gronningsater; Inner City Law Center and Lorraine Lopez as Amici Curiae on behalf of Defendant and Appellant.

Allen R. King, Los Angeles, for Plaintiff and Respondent.

Opinion

LUI, J.

***78** Plaintiff and respondent Boston LLC (Boston) rented defendant and appellant Juan Juarez an apartment under the Rent Stabilization Ordinance of the City of Los Angeles (LARSO) (L.A. Mun. Code, § 151.00 et seq.). Their rental agreement contained a forfeiture clause stating that "*any* failure of compliance or performance by Renter shall allow Owner to forfeit this agreement and terminate Renter's right to possession." (Italics added.) The agreement also contained an insurance clause stating that Juarez "shall obtain and pay for any insurance coverage necessary to protect Renter" "for *any* personal injury or property damage." (Italics added.) After 15 years of Juarez failing to obtain this insurance, Boston gave Juarez a three-day notice to perform or quit. Juarez obtained insurance shortly after the three-day period expired.

Boston then sued Juarez for unlawful detainer. (Super. Ct. L.A. County, No. 14U02675.) The trial court ruled for Boston. Juarez appealed to the ***79** appellate division of the superior court. (Super. Ct. L.A. County, App. Div., No. BV030948.) The appellate division affirmed, holding ****455** that because of the forfeiture clause, Juarez was properly precluded at trial from defending himself on a materiality ground or raising certain affirmative defenses. (*Boston LLC v. Juarez* (2015) 240 Cal.App.4th Supp. 28, 193 Cal.Rptr.3d 521 (*Boston I*).)

We asserted jurisdiction over the matter pursuant to California Rules of Court, rule 8.1002, [1] to settle an important question of law: Whether a tenant's breach of an LARSO rental contract, regardless of the breach's materiality or impact on the landlord, justifies the landlord forfeiting the agreement and terminating tenancy. We hold a tenant's breach must be material to justify forfeiture. Here, the tenant's obligation to obtain and pay for insurance protected the tenant's interest, not the landlord's; accordingly, the tenant's failure to obtain a policy could not have harmed the landlord and therefore was not a material breach of the agreement constituting grounds for forfeiture.

1 Undesignated rule references are to the California Rules of Court.

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BACKGROUND

Juarez rented an apartment in Los Angeles from Boston for more than 15 years under LARSO. Juarez and Boston's rental agreement called for Juarez to obtain renter's insurance. Juarez did not obtain renter's insurance, however. On February 14, 2014, Boston gave Juarez a three-day notice to perform by obtaining renter's insurance or quit.[2] February 14th was a Friday and began a three-day weekend for Presidents' Day, a legal holiday, which was on Monday, February 17th. Likely due to the holiday weekend, Juarez failed to obtain renter's insurance within the three-day period; he did, however, obtain it by February 21st.

2 Juarez, a monolingual Spanish speaker, could not read the notice because it was written in only English.

Boston then sued Juarez for unlawful detainer. Boston argued the rental contract contained a forfeiture clause which allowed it to terminate Juarez's tenancy for any breach, regardless of the breach's materiality. Juarez countered that the law requires a *material* breach to justify forfeiture. Juarez argued he should therefore be allowed to present evidence that his breach was immaterial and, in any event, he was in substantial compliance with the insurance clause. He also asserted a number of affirmative defenses, including retaliation and waiver. The trial court, however, agreed with Boston that the forfeiture clause made any breach by Juarez, regardless of materiality, grounds for Boston to terminate Juarez's tenancy. Juarez agreed to a bench ***80** trial upon the parties stipulating to undisputed facts. The court ruled Juarez had breached the rental agreement by failing to obtain renter's insurance within the three-day notice period and Boston could thereby forfeit the lease. The trial court did not make a determination about the breach's materiality. Juarez appealed to the appellate division, but it affirmed, two to one. We review this matter under rule 8.1002.

DISCUSSION

On appeal, Juarez argues the law demands that a tenant's breach must be material to justify a landlord's forfeiture of a rental contract. We agree. Because we agree, we do not reach his argument that the forfeiture clause constituted an unlawful penalty or whether he should have been allowed to present certain affirmative defenses.

[1] Whether the law requires a material breach to enforce a forfeiture clause in a ****456** residential lease is a question of law which we review de novo in the absence of disputed facts. (*Cohn v. Corinthian Colleges, Inc.* (2008) 169 Cal.App.4th 523, 527, 86 Cal.Rptr.3d 401 [appellate courts exercise “independent judgment” on “pure question[s] of law” where “the facts are not disputed”].)

1. Code of Civil Procedure section 1161, subdivision 3 governs forfeiture procedure and does not create substantive rights

[2] Boston brought its unlawful detainer action under Code of Civil Procedure section 1161, subdivision 3.[3] Section 1161, subdivision 3 establishes that a “tenant of real property ... is guilty of unlawful detainer: [¶] ... [¶] 3. When he or she continues in possession ... after a neglect or failure to perform other conditions or covenants of the lease or agreement under which the property is held ... than the one for the payment of rent, and three days' notice, in writing, requiring the performance of such conditions or covenants, or the possession of the property shall have been served upon him or her ....” On appeal, Boston argues that section 1161, subdivision 3 provides for statutory forfeiture, as opposed to contractual forfeiture, and, therefore, Boston was permitted to forfeit the contract as a matter of law after Juarez failed to obtain insurance within the notice period.

3 Undesignated statutory references are to the Code of Civil Procedure.

Boston is incorrect. Section 1161, subdivision 3 does not create a substantive forfeiture right. Rather, “ ‘[t]he purpose of the unlawful detainer statutes is procedural. The statutes implement the landlord's property rights by permitting him to recover possession once the consensual basis for the ***81** tenant's occupancy is at an end.' " (*Foster v. Britton* (2015) 242 Cal.App.4th 920, 930, 195 Cal.Rptr.3d 800, quoting *Birkenfeld v. City of Berkeley* (1976) 17 Cal.3d 129, 149, 130 Cal.Rptr. 465, 550 P.2d 1001.) This procedural statute does not speak to what kinds of substantive "neglect or failure to perform ... conditions or covenants of the lease" allow the statute to take effect. In the absence of such a statutory directive, we look to case law for the substance of what kinds of breaches allow the procedural statute to take effect.

2. Case law dictates a breach must be material to justify forfeiture

Case law is clear as to what kinds of "failure to perform" justify forfeiture. Courts have consistently concluded that "a lease may be terminated only for a substantial breach thereof, and not for a mere technical or trivial violation." (*Keating v. Preston* (1940) 42 Cal.App.2d 110, 118, 108 P.2d 479 (*Keating*) [discussing breach of implied covenants].) This materiality limitation even extends to leases which contain clauses purporting to dispense with the materiality limitation. For example, in *Randol v. Scott,* a forfeiture clause provided "that 'if default shall be made ****457** in any of the covenants herein contained, then it shall be lawful for the lessor to re-enter the said premises.' " (*Randol v. Scott* (1895) 110 Cal. 590, 593, 42 P. 976 (*Randol*); *id.* at pp. 597–598, 42 P. 976.) Despite the forfeiture clause's language that *any* breach permitted forfeiture, the court refused to allow forfeiture for an "entirely ... trivial" matter, especially when the lessor had permission to enter and inspect the premises at any time, which would have given the lessor the chance to detect, and demand remedy for, the complained-of breach. (*Id.* at pp. 597–598, 42 P. 976.) Similarly, in *Keating,* the lease contained a clause authorizing the lessor "to re-enter the premises ... 'if default shall be made in any of the covenants herein contained.' " (*Keating, supra,* 42 Cal.App.2d at p. 114, 108 P.2d 479, italics omitted.) The court held that even if the offending behavior could be considered a breach, "it was so slight and trivial a violation ... that it [did] not constitute ground for terminating the lease on that account." (*Id.* at p. 117, 108 P.2d 479.) [4]

4 That cases have not specifically spoken on a materiality requirement for forfeiture of residential leases does not mean the well-established materiality requirement does not apply to such leases. On the contrary, residential leases especially should be protected by the materiality requirement due to the parties' unequal bargaining power, as explained further in part 4.a., *post.*

[3] Juarez and Boston's agreement contained a forfeiture clause stating: "Renter's performance of and compliance with each of the terms hereof ... constitute a condition on Renter's right to occupy the Premises and any failure of compliance or performance by Renter shall allow Owner to forfeit this agreement and terminate Renter's right to possession." Boston argues this clause forecloses any materiality argument or defense by Juarez. The above ***82** cases, however, demonstrate that despite such a clause, the materiality requirement still applies. (Accord, *Medico–Dental etc. Co. v. Horton & Converse* (1942) 21 Cal.2d 411, 433, 132 P.2d 457 ["a breach of contractual right in a trivial or inappreciable respect will not justify rescission of the agreement by the party entitled to the benefit in question..."].) This is especially so when, as in *Randol,* Boston had the ability to detect and cure the breach far in advance of bringing suit, but chose to not do so.

3. The substantive law requiring a materiality limitation underlies, and therefore applies to, section 1161, subdivision 3

[4] **[5]** "Although not expressly set forth in Code of Civil Procedure section 1161, subdivision 3," the "requirement" that a " 'breach be substantial' " "is set forth in case law." (*NIVO 1 LLC v. Antunez* (2013) 217 Cal.App.4th Supp. 1, 5, 159 Cal.Rptr.3d 922 (*NIVO 1,*), citing *Keating, supra,* 42 Cal.App.2d at p. 115, 108 P.2d 479.) That is, "[w]hether a particular breach will give a plaintiff landlord the right to declare a forfeiture is based on whether the breach is material." (*NIVO 1,* at p. Supp. 5, 159 Cal.Rptr.3d 922.) This is because " '[t]he law sensibly recognizes that although every instance of noncompliance with a contract's terms constitutes a breach, not every breach justifies treating the contract as terminated. [Citations.] Following the lead of the Restatements of Contracts, California courts allow termination only if the breach can be classified as "material," "substantial," or "total." [Citations.]' " (*Ibid.* quoting *Superior Motels, Inc. v. Rinn Motor Hotels, Inc.* (1987) 195 Cal.App.3d 1032, 1051, 241 Cal.Rptr. 487.)

Although not binding on us, *NIVO 1* demonstrates how courts apply the materiality requirement in section 1161 cases. In *NIVO 1,* a rental agreement required a tenant to obtain renter's insurance. (*NIVO 1, supra,* 217 Cal.App.4th at p. Supp. 3, 159 Cal.Rptr.3d 922.) Under the original contract, the tenant's violation of the insurance clause would result only "in a waiver of the tenant's rights to seek damages against the landlord" (*id.* at p. Supp. 4, 241 Cal.Rptr. 487) in the case of " 'personal property damage or loss' " (*id.* at p. Supp. 3, 241 Cal.Rptr. 487). The landlord attempted to unilaterally modify the rental agreement, however, by adding a forfeiture clause stating: " 'Any failure of compliance or performance by Renter ****458** shall allow Owner to declare a forfeiture of this agreement and terminate Renter's right to possession. Any breach of the contract is a material breach.' " (*Id.* at p. Supp. 4, 241 Cal.Rptr. 487, italics omitted.) The appellate division held that the landlord's attempted unilateral modification in adding the forfeiture clause was illegal under LARSO and consequently disregarded it. (*Ibid.* citing L.A. Mun. Code, § 151.09, subd. A.2(c).) Then, recognizing the materiality requirement, the appellate division upheld the trial court's determination that the tenant's failure to obtain renter's insurance was immaterial. (*NIVO 1,* at pp. Supp. 4–6, 159 Cal.Rptr.3d 922.) The court reasoned "that the failure ***83** to comply with [the] lease provision was a 'trivial breach' because the 'provision benefits the tenant, not the landlord.' " (*Id.* at p. Supp. 5, 241 Cal.Rptr. 487.) Although *NIVO 1* did not analyze the materiality requirement in light of a forfeiture clause, *Randol, supra,* 110 Cal. 590, 42 P. 976, and other cases establish that a materiality requirement would apply even in the face of a forfeiture clause.

Other California authorities recognize a materiality requirement as well. For example, Miller and Starr admonishes that a "landlord cannot terminate the lease unless the tenant's breach of the condition is material or substantial." (10 Miller & Starr, Cal. Real Estate (4th ed. 2015) § 34:181, p. 34-566, citing *NIVO 1, supra,* 217 Cal.App.4th Supp. 1, 159 Cal.Rptr.3d 922.) It continues, "Every default by a tenant does not necessarily justify the landlord's termination of the tenancy," and this "is especially true when the breach involves a nonmonetary covenant in the lease." (10 Miller & Starr, *supra,* § 34:181, p. 34–565.) Witkin concurs that a "[s]ubstantial [b]reach [i]s [r]equired" to invoke a "forfeiture clause." (12 Witkin, Summary of Cal. Law (10th ed. 2005) Real Property, § 668, p. 784–785, italics omitted; *id.* (2015 Supp.) § 668, p. 159, citing *NIVO 1,* at p. Supp. 4, 159 Cal.Rptr.3d 922.) Likewise, the California Practice Guide comments that a " 'trivial' or 'de minimis' breach is not sufficient ground for termination and may be raised an as 'equitable defense' to unlawful detainer." (Friedman et al., Cal. Practice Guide: Landlord-Tenant (The Rutter Group 2015) ¶ 7:130, p. 7-80, citing *NIVO 1,* at p. Supp. 5, 159 Cal.Rptr.3d 922.)

Others states, including Arizona, Illinois, Massachusetts, South Carolina, and Utah, likewise recognize a materiality requirement. (See, e.g., *Foundation Dev. Corp. v. Loehmann's* (1990) 163 Ariz. 438, 443, 788 P.2d 1189, 1194 (*Loehmann's*) [in a commercial lease context, it was unlikely that the Arizona Legislature "intended to permit forfeitures under any and all circumstances, no matter how trivial, inadvertent, non-prejudicial, or technical the breach," given the "important interplay of property and contract law that preceded the enactment of the statute"]; *Wolfram Partnership v. LaSalle Nat. Bank* (2001) 328 Ill.App.3d 207, 262 Ill.Dec. 404, 765 N.E.2d 1012, 1025 ["Regardless of the language used by the parties, a breach, to justify a ... forfeiture of a lease agreement, must have been material or substantial"]; *Banco do Brasil v. 275 Washington Street Corp.* (D.Mass. 2010) 750 F.Supp.2d 279, 292 [quoting and agreeing with *Loehmann's* materiality requirement]; *Kiriakides v. United Artists Communications, Inc.* (1994) 312 S.C. 271, 275, 440 S.E.2d 364, 366 [agreeing with *Loehmann's* after finding that a "majority of courts have concluded that a lease may not be forfeited for a trivial or technical breach even when the parties have specifically agreed that 'any breach' gives rise to the right of termination"]; *Cache County v. Beus* (Utah Ct. App. 1999) 978 P.2d 1043, 1049–1050 [quoting and agreeing with *Loehmann's*].)

**459 *84 4. Public policy and other considerations favor a materiality requirement, especially for an LARSO lease

a. LARSO's public policy goals outweigh freedom to contract and free market rationales in this context

[6] LARSO was born out of the shortage of affordable housing, especially for low-income individuals, in Los Angeles. (L.A. Mun. Code, § 151.01.) It seeks to "safeguard tenants from excessive rent increases" by imposing certain statutory limitations and obligations on landlords which landlords would otherwise not be subject to under normal freedom to contract principles. (*Ibid.*) For example, LARSO prohibits landlords from terminating leases without one of 14 enumerated "good causes." (*Id.,* § 151.09.) We are bound to uphold LARSO's objectives unless they are patently unenforceable. (*People v. Otto* (2001) 26 Cal.4th

200, 209–210, 109 Cal.Rptr.2d 327, 26 P.3d 1061 ["Courts have a ' "duty to uphold a statute unless its unconstitutionality clearly, positively, and unmistakably appears...." ' "].)

In its decision upholding the forfeiture clause, the appellate division focused on Juarez's and Boston's general freedom to contract and held, notwithstanding *NIVO 1* 's and other cases' materiality requirement, " '[i]f contractual language is clear and explicit, it governs ... [citation]' (*Bank of the West v. Superior Court* (1992) 2 Cal.4th 1254, 1264 [10 Cal.Rptr.2d 538, 833 P.2d 545])." (*Boston I, supra,* 240 Cal.App.4th at p. Supp. 34, 193 Cal.Rptr.3d 521.) It reasoned that in Juarez and Boston's case, "[t]he clear and unambiguous terms of [the forfeiture] clause permitted forfeiture of the agreement and termination of the defendant's right to possession based on any breach, regardless of the breach's importance in relation to the entire agreement." (*Id*. at p. Supp. 35, 193 Cal.Rptr.3d 521.)

While the freedom to contract is important, as the appellate division noted, the California Supreme Court has recognized in *Green v. Superior Court* that free market principles, which justify, in part, the freedom to contract, do not apply to urban residential leases, such as Juarez's LARSO lease. (*Green v. Superior Court* (1974) 10 Cal.3d 616, 625, 111 Cal.Rptr. 704, 517 P.2d 1168 (*Green*).) This is because "the severe shortage of low and moderate cost housing has left tenants with little bargaining power ... and thus the mechanism of the 'free market' no longer serves as a viable means for fairly allocating" rights and duties between landlords and tenants. (*Ibid*.) Citing *Green,* courts acknowledge that due to the "unequal bargaining power [between] landlord and tenant resulting from the scarcity of adequate housing in urban areas," tenants in urban residential leases are treated more favorably by courts than lessees in commercial leases where the "parties are more likely to have equal bargaining power." (***85** *Schulman v. Vera* (1980) 108 Cal.App.3d 552, 561, 166 Cal.Rptr. 620; *Henrioulle v. Marin Ventures, Inc.* (1978) 20 Cal.3d 512, 519, 143 Cal.Rptr. 247, 573 P.2d 465 ["tenants are likely to be in a poor position to bargain with landlords"].) [5] Here, Juarez and Boston's ****460** lease reflects the unequal bargaining power recognized by *Green* and other courts in that the unilateral forfeiture clause entirely benefits Boston as the landlord. The forfeiture clause makes *any* breach by Juarez grounds for Boston to forfeit the lease and imposes not only no reciprocal obligation on Boston, it imposes no obligations *at all* on Boston. Granted, Boston would be restricted by general contract principles permitting punishment for Boston's breaches. Under these general contract principles, however, a trivial breach by Boston would likely result in either nominal or negligible damages, which would be of little value to Juarez. (*Avina v. Spurlock* (1972) 28 Cal.App.3d 1086, 1088, 105 Cal.Rptr. 198 [nominal damages are awarded when "there is no loss or injury to be compensated but where the law still recognizes a technical ... breach"].)

5 In addition to unequal bargaining power, tenants often sign form leases without understanding the full import of their terms, and consequently unknowingly sign away important rights. The Legislature has acknowledged in a related context that tenants need protection from " 'unknowing[ly] signing away [such] valuable rights.' " (*Jaramillo v. JH Real Estate Partners, Inc.* (2003) 111 Cal.App.4th 394, 403, 3 Cal.Rptr.3d 525 [referring to Civ. Code, § 1953].)

[7] Permitting landlords like Boston with superior bargaining power to forfeit leases based on minor or trivial breaches would allow them to strategically circumvent LARSO's "good cause" eviction requirements and disguise pretext evictions under the cloak of contract provisions. Such provisions, which enable pretext evictions, are " 'unenforceable on grounds of public policy if ... the interest in its enforcement is clearly outweighed in the circumstances by a public policy against the enforcement of such terms.' " (*Bovard v. American Horse Enterprises, Inc.* (1988) 201 Cal.App.3d 832, 840, 247 Cal.Rptr. 340, quoting Rest.2d Contracts, § 178.) Here, LARSO's public policy goals of providing stable affordable housing to low-income Angelenos and preventing pretext evictions outweigh the free market and freedom to contract principles allowing a landlord to include a unilateral forfeiture clause in an urban residential rental contract.

b. Forfeiture is avoided where possible and forfeiture clauses are strictly construed against the party they benefit

[8] "A condition involving a forfeiture must be strictly interpreted against the party for whose benefit it is created." (Civ. Code, § 1442.) Courts recognize the full import of this rule, reasoning that "[i]f the agreement can be reasonably interpreted so as to avoid the forfeiture, it is our duty to do so." (*Quatman v. McCray* (1900) 128 Cal. 285, 289, 60 P. 855; see also *McNeece v. Wood* (1928) 204 Cal. 280, 284, 267 P. 877, quoting ***86** *Cleary v. Folger* (1890) 84 Cal. 316, 321, 24 P. 280 [" 'Forfeitures ...

are not favored by the courts....' "].) Because the forfeiture clause allegedly made *any* breach by Juarez grounds for Boston to forfeit the contract, all the agreement's clauses, including the insurance clause, should be "strictly interpreted" against Boston.

[9] The insurance clause provides that Boston "does not insure Renter for *any* personal injury or property damage" (italics added) and that Juarez "shall obtain and pay for any insurance coverage necessary to protect Renter" from such damage. This provision is overreaching. Boston cannot absolve itself of liability for "*any* ... property damage" to Juarez by demanding that Juarez obtain insurance when that damage could be caused by Boston itself or could be damage Boston is liable for as a landlord. (Italics added.) In the balance of our analysis, the overreaching and unrealistic nature of the clause weighs against enforcing it, especially when enforcing it would benefit Boston, "the party for whose benefit it [was] created." (Civ. Code, § 1442.)

****461 c. A materiality requirement potentially prevents unmeritorious litigation**

Permitting forfeiture for trivial breaches could unleash a torrent of unmeritorious unlawful detainer litigation. [6] Without the protection of a materiality requirement, tenants potentially are in jeopardy of defending frivolous unlawful detainer actions for trivial breaches. For example, Juarez's lease prevents him from even bringing a musical instrument on the premises, "unless noted in ... Owner's copy of this Agreement." If we upheld the forfeiture clause as Boston argues, Juarez could risk forfeiture of the rental agreement, and eviction, for absurdly trivial reasons, e.g., if he hung a violin with no strings on his wall for decoration because it was a family heirloom or if for a few days he had in his apartment a gift-wrapped plastic piano for a niece's upcoming birthday. Litigation over these types of trivial breaches is not a proper or efficient use of court resources. [7]

6 Bilateral forfeiture clauses, although more favorable to the tenant, also potentially open the floodgates and perhaps to an even greater degree.

7 In addition, an eviction for such a trivial matter would almost certainly be pretext, as no rational landlord would expend the time or resources litigating such a frivolous issue; again, we will not legally provide the basis for pretext evictions.

The appellate division attempted to refute this argument, holding that "[i]n evictions based on three-day notices to perform or quit ... breaches would only constitute valid grounds for eviction if they [a]re not cured within the notice period, meaning tenants could not be evicted based on single incidents...." (*Boston I, supra,* 240 Cal.App.4th at p. Supp. 36, 193 Cal.Rptr.3d 521.) Even if that were true, Juarez would still be subject to the risk of eviction if he refused to ***87** take the decorative, heirloom violin out of his home or if he were out of town, say for a three-day weekend, when a notice about the piano gift was posted. This court will not uphold clauses which could result in such frivolous litigation.

5. Given the facts, Juarez's failure to obtain renter's insurance within the three-day notice period was not a material breach

[10] "Normally the question of whether a breach of an obligation is a material breach ... is a question of fact," however " 'if reasonable minds cannot differ on the issue of materiality, the issue may be resolved as a matter of law.' " (*Brown v. Grimes* (2011) 192 Cal.App.4th 265, 277–278, 120 Cal.Rptr.3d 893, quoting *Insurance Underwriters Clearing House, Inc. v. Natomas Co.* (1986) 184 Cal.App.3d 1520, 1526–1527, 228 Cal.Rptr. 449.)

[11] The primary purpose of renter's insurance is to protect the tenant, not the landlord. As such, Boston has little ground to argue that Juarez's failure to obtain insurance harmed it. For example, Boston does not argue Juarez made claims against it that should have been covered by renter's insurance but were not because Juarez lacked it. Instead, Boston argues it was harmed because there was a *chance* Juarez's noncompliance encouraged other tenants' noncompliance. In the absence of evidence of actual harm, the chance Juarez's temporary noncompliance incited other tenants to not comply with their insurance obligations is insufficient to demonstrate harm justifying forfeiture. (See *Feder v. Wreden etc. Co., Inc.* (1928) 89 Cal.App. 665, 673, 265 P. 386 [a court cannot "overlook[ ]" when a complaint fails to allege actionable harm]; Rest.2d Contracts, *supra,* ch. 16, Introductory Note, ****462** ["The initial assumption" in awarding damages "is that the injured party is entitled to full compensation for his *actual* loss" (italics added)].) Boston also fails to explain how Juarez lacking insurance for a mere handful of days after he

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was noticed harmed Boston, given the 15 years Juarez lacked insurance, a defect which Boston could have easily discovered at any time and demanded Juarez remedy. Also, although technically permissible, Boston giving Juarez the three-day notice to obtain insurance on the Friday preceding a three-day weekend which encompassed a widely celebrated legal holiday smacks of gamesmanship, or possibly even retaliatory motives, in light of the 15 years Boston failed to enforce the insurance clause. Given the facts of this case, Juarez's slight delay in obtaining renter's insurance was not a material breach sufficient to justify forfeiture.

Because Juarez's breach was immaterial, we need not address his arguments that the forfeiture clause constituted an unlawful penalty or that he should have been allowed to present certain affirmative defenses.

***88 DISPOSITION**

The judgment is reversed. Juarez is awarded his costs on appeal under California Rules of Court, rule 8.278.

We concur:

CHANEY, Acting P.J.

JOHNSON, J.

All Citations

245 Cal.App.4th 75, 199 Cal.Rptr.3d 452, 16 Cal. Daily Op. Serv. 2159, 2016 Daily Journal D.A.R. 1927

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EXHIBIT AC-118

217 Cal.App.4th Supp. 1
Appellate Division, Superior Court, California.
Los Angeles County.

NIVO 1 LLC, Plaintiff and Respondent,
v.
Amiteria ANTUNEZ, Defendant and Appellant.

No. BV 030104.
|
July 5, 2013.

Synopsis
Background: Residential landlord brought action against tenant seeking past due rent and possession of property subject to city rent stabilization ordinance. The Superior Court, Los Angeles County, Central Trial Court, No. 12U06657, Rafael A. Ongkeko, J., entered judgment for tenant, and landlord appealed.

Holdings: The Superior Court, Appellate Division, Keosian, J., held that:

[1] rent stabilization ordinance prohibited change of terms to deem any breach a material breach, and

[2] evidence was sufficient to support finding that failure to maintain insurance as an immaterial or trivial breach.

Affirmed.

West Headnotes (8)

[1] **Landlord and Tenant** Insurance

Landlord's unilateral change to residential lease, so as to state that failure to maintain renter's insurance constituted a material breach, was invalid under terms of city rent ordinance, which prohibited a landlord from bringing an unlawful detainer action based on a unilateral change in terms of the tenancy; original terms of the lease provided that a failure to maintain insurance would merely result in a waiver of the tenant's rights to seek damages against the landlord.

[2] **Landlord and Tenant** Breach

Evidence was sufficient to support finding that residential tenant's failure to maintain insurance was an immaterial or trivial breach such that it did not result in a forfeiture of lease agreement; court found that property manager "did not hold up well on cross-examination," that there was no evidence that tenant had anything worth insuring, that the provision benefited the tenant, not the landlord, and that the breach was "used and enforced only by landlord selectively against this tenant, and no others, probably based on her being perceived as a 'problem' tenant who should be charged with as many breaches as possible to see what sticks."

[3] **Contracts** Rescission or termination

Whether a breach is so material as to constitute cause for the injured party to terminate a contract is ordinarily a question for the trier of fact.

1 Cases that cite this headnote

[4] **Appeal and Error** Contracts

A trial court's finding that a contract breach was not material is reviewed under the substantial evidence standard.

1 Cases that cite this headnote

[5] **Landlord and Tenant** Breach of Covenant or Condition

Whether a particular breach will give landlord the right to declare a forfeiture is based on whether the breach is material.

3 Cases that cite this headnote

[6] **Contracts** Failure of Performance or Breach

Although every instance of noncompliance with a contract's terms constitutes a breach, not every breach justifies treating the contract as terminated.

4 Cases that cite this headnote

[7] **Landlord and Tenant** Breach of Covenant or Condition

California courts allow lease termination only if the breach can be classified as material, substantial, or total.

3 Cases that cite this headnote

[8] **Contracts** Effect of breach in general

Contracts Questions for Jury

The distinction between a material and inconsequential breach is one of degree, to be answered, if there is doubt, by the triers of the facts; the courts must weigh the purpose to be served, the desire to be gratified, the excuse for deviation from the letter, and the cruelty of enforced adherence.

See 12 Witkin, Summary of Cal. Law (10th ed. 2005) Real Property, § 526.

1 Cases that cite this headnote

Attorneys and Law Firms

****923** Allen R. King, Los Angeles, for Plaintiff and Appellant.

Sonia Servin and Carol Kim, for Defendant and Respondent.

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*2 OPINION

KEOSIAN, J.

Plaintiff and landlord NIVO 1 LLC appeals the judgment entered in favor of defendant and tenant Amiteria Antunez.

*3 BACKGROUND

On May 29, 2012, plaintiff filed a complaint against defendant Amiteria Antunez seeking past due rent and possession of the property located at 2015 ½ Echo Park Avenue in Los Angeles. [1] Plaintiff alleged that on a date unknown, defendant and plaintiff's agent entered into a month-to-month written agreement wherein defendant ****924** agreed to pay $608 per month, that the tenancy was subject to the City of Los Angeles Rent Stabilization Ordinance (LARSO), and that defendant was personally served with the 3–day notice to pay rent or quit and a 3–day notice to perform covenants or quit on May 17, 2012.

1 The sole issue raised on appeal herein revolves around the provision in the lease agreement requiring the tenant to obtain renter's personal property insurance and whether her failure to obtain such a policy entitled plaintiff to a forfeiture of the agreement and possession of the property. We, therefore, do not address or recite facts relating to the issue of past-due rent.

The 3–day notice to perform stated, "Further, you [sic] in violation of paragraph 17 of your lease agreement—you have failed to maintain a personal property insurance policy." Paragraph 17 of the Residential Lease Agreement provides: "INSURANCE: TENANT must maintain a personal property insurance policy to cover any losses sustained to Tenant's personal property or vehicle. It is acknowledged that LANDORD does not maintain this insurance to cover personal property damage or loss caused by fire, theft, rain, water overflow/leakage, acts of GOD, and/or any other causes ... TENANT'S failure to maintain said policy shall be a complete waiver of TENANT'S right to seek damages against LANDLORD...."

On June 4, 2012, defendant filed an answer asserting various affirmative defenses. The matter came on for court trial on July 6, 2012. Pursuant to Evidence Code section 776, defendant testified that she moved into the premises in 1998 and did not have renter's insurance at that time. Defendant did not obtain renter's insurance after service of the notice to perform covenant or quit. Ann Swain, the property supervisor, testified that on June 23, 2011, she posted and mailed to defendant a notice of change of terms of tenancy. She further testified that defendant failed to comply with the notice and did not obtain renter's insurance.

The court found that defendant's failure to procure and maintain personal property insurance was not a material breach, and as such, could not support a forfeiture of the lease. Judgment was entered for defendants. Plaintiff filed this timely appeal.

*4 DISCUSSION

The Notice of Change of Terms of Tenancy

[1] Plaintiff argues that the trial court failed to apply the change of terms provision to this case. The notice, dated June 23, 2011, sought to change the terms of the lease agreement to render *all* breaches material. The provision states in pertinent part: "3. Renter agrees that Renter's performance of and compliance with each of the terms of the rental agreement constitute a condition on Renter's right to occupy the premises. Any failure of compliance or performance by Renter shall allow Owner to declare a forfeiture of this agreement and terminate Renter's right to possession. *Any breach of the contract is a material breach.*" (Italics added.)

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LARSO, Los Angeles Municipal Code section 151.00 et seq., prohibits a landlord from bringing an unlawful detainer action based on a unilateral change in terms of the tenancy. "A. A landlord may bring an action to recover possession of a rental unit only upon one of the following grounds: ... [¶] 2. The tenant has violated a lawful obligation or covenant of the tenancy and has failed to cure the violation after having received written notice from the landlord, other than a violation based on ... (c) A change in the terms of the tenancy that is not the result of an express written agreement signed by both of the parties. For purposes of this section, a landlord may not unilaterally change the terms of the tenancy under Civil Code Section 827 and then evict the tenant for the violation of the added covenant unless the tenant has *agreed in writing to the additional covenant* ...." (L.A. Mun. Code, § 151.09.A.2(c). Italics added.) The original terms of the lease provided that a failure to maintain insurance would ****925** merely result in a waiver of the tenant's rights to seek damages against the landlord. However, the unilateral change by the plaintiff-landlord sought to alter the terms so that the failure to maintain insurance would be deemed a material breach such that it would result in a forfeiture of the lease agreement. Such a change of terms is invalid under the provisions of LARSO.

The Breach

[2] **[3]** **[4]** The trial court found that defendant's failure to maintain insurance was an immaterial or trivial breach such that it did not result in a forfeiture of the lease agreement. "Whether a breach is so material as to constitute cause for the injured party to terminate a contract is ordinarily a question for the trier of fact." (*Whitney Investment Co. v. Westview Dev. Co.* (1969) 273 Cal.App.2d 594, 601, 78 Cal.Rptr. 302; *Brown v. Grimes* (2011) 192 Cal.App.4th 265, 277, 120 Cal.Rptr.3d 893; *Superior Motels, Inc. v. Rinn Motor Hotels, Inc.* (1987) 195 Cal.App.3d 1032, 1051–1052, 241 Cal.Rptr. 487.) A trial court's ***5** finding that a breach was not material is reviewed under the substantial evidence standard. (*Brown v. Grimes* (2011) 192 Cal.App.4th at p. 279, 120 Cal.Rptr.3d 893) Substantial evidence is evidence that " 'must be of ponderable legal significance ... [and] must be reasonable ..., credible, and of solid value....' [Citation.] The ultimate determination is whether a *reasonable* trier of fact could have found for the respondent based on the whole record. [Citation.]" (*Kuhn v. Department of General Services* (1994) 22 Cal.App.4th 1627, 1633, 29 Cal.Rptr.2d 191.)

[5] **[6]** **[7]** Plaintiff argues in its opening brief that "[t]here is nothing in CCP 1161(3) that requires that the breach be substantial before a tenant can be guilty of unlawful detainer...." Although not expressly set forth in Code of Civil Procedure section 1161(3), this requirement is set forth in case law. (*Keating v. Preston* (1940) 42 Cal.App.2d 110, 115, 108 P.2d 479; *Feder v. Wreden Packing & Provision Co.* (1928) 89 Cal.App. 665, 673, 265 P. 386.) Whether a particular breach will give plaintiff landlord the right to declare a forfeiture is based on whether the breach is material. " 'The law sensibly recognizes that although every instance of noncompliance with a contract's terms constitutes a breach, not every breach justifies treating the contract as terminated. [Citations.] Following the lead of the Restatements of Contracts, California courts allow termination only if the breach can be classified as "material," "substantial," or "total." [Citations.]' " (*Superior Motels, Inc. v. Rinn Motor Hotels, Inc., supra,* 195 Cal.App.3d at p. 1051, 241 Cal.Rptr. 487.)

[8] At trial, the court made the factual determination that defendant's failure to maintain insurance as required by paragraph 17 of the lease was not a material breach. This determination will not be disturbed where the record supports such a finding. The trial court heard testimony from the manager who, "[i]n terms of credibility ... did not hold up well on cross-examination." The court found that there was no evidence that defendant had anything worth insuring. Further, after testimony, the trial court held that the failure to comply with this lease provision was a "trivial breach" because the "provision benefits the tenant, not the landlord." The court found that the trivial breach was "used and enforced only by landlord selectively against this tenant, and no others, probably based on her being perceived as a 'problem' tenant who should be charged with as many breaches as possible to see what sticks." The distinction between a material and inconsequential breach " 'is ****926** one of degree, to be answered, if there is doubt, by the triers of the facts.... We must weigh the purpose to be served, the desire to be gratified, the excuse for deviation from the letter, the cruelty of enforced adherence....' " (*Superior Motels, Inc. v. Rinn Motor Hotels, Inc., supra,* 195 Cal.App.3d at p. 1051, 241 Cal.Rptr. 487.) In the present case, there was substantial evidence from which the court could have found that defendant's failure to maintain personal property insurance did not constitute a material breach.

***6** DISPOSITION

Judgment is affirmed. Defendant is awarded costs on appeal.

WE CONCUR. KUMAR, Acting P.J., and RICCIARDULLI, J.

All Citations

217 Cal.App.4th Supp. 1, 159 Cal.Rptr.3d 922, 13 Cal. Daily Op. Serv. 7275

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EXHIBIT AC-119

KeyCite Yellow Flag - Negative Treatment
Distinguished by Boston LLC v. Juarez, Cal.Super.A.D., October 1, 2015

195 Cal.App.3d 1032, 241 Cal.Rptr. 487

SUPERIOR MOTELS, INC., Plaintiff and Appellant,
v.
RINN MOTOR HOTELS, INC., et al., Defendants and Appellants

No. A025611.
Court of Appeal, First District, Division 4, California.
Oct 29, 1987.

[Opinion certified for partial publication. [1]]

1 Parts II and III (only) are not published, as they do not meet the standards for publication contained in rule 976(b), California Rules of Court.

SUMMARY

In an action by the original lessee to recover possession of commercial premises from its assignee's lessees, based on violation of an anti-receivership clause in the lease by the assignee, through whom defendants claimed derivative right of possession, the trial court rendered judgment for plaintiff, declaring a forfeiture of the lease, and awarding possession and monetary damages to plaintiff. The damages included an award of profits accruing to defendants by their operation of a motel on the premises during the period of their wrongful possession, prejudgment interest, and future damages covering the period from judgment until possession was actually returned. (Superior Court of Santa Clara County, No. 34111, Homer B. Thompson, Judge.).

The Court of Appeal affirmed the judgment, but reversed and remanded for a determination of the correct measure of damages. It held that breach of the anti-receivership clause by defendants' sublessor was material, justifying forfeiture of the sublease, even though defendants were not personally at fault for the breach. It also held that that the trial court properly awarded plaintiff possession and reasonable rent for the entire period of wrongful possession. However, it held that the trial court erred in awarding profits, since they are not synonymous with rental value, and in awarding prejudgment interest and future damages. (Opinion by Poché, Acting P. J., with Channell and Sabraw, JJ., concurring.) ***1033**

HEADNOTES

Classified to California Digest of Official Reports

(1)
Appellate Review § 59--Taking and Perfecting Appeal--Notice of Appeal-- Signature by Party or His Own Counsel.
In an action by the original lessee of motel premises against its assignee, successive sublessees, and an individual, to recover possession of the premises for breach of an anti-receivership clause in the lease, the purported appeal by the individual defendant from the trial court's denial of defendants' motions for new trial and petitions for relief from forfeiture was ineffectual and was subject to dismissal. Although he was represented by separate counsel throughout the proceedings, he failed to file and sign the notice of appeal himself or by his own counsel, as required by Cal. Rules of Court, rule 1(a), but instead attempted to join in the appeal filed by the other defendants, which was signed only by their own attorneys.

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(2)
Judgments § 62--Void Judgments and Collateral Attack--Matter Apparent on Record--Extrinsic Evidence Not Considered.
Evidence wholly extrinsic to the judgment roll for a default judgment may not be considered in determining the validity of the judgment on its face based on alleged jurisdictional infirmity. Therefore, in an action by the original lessee of motel premises to recover possession of the premises from defendant assignee and its sublessees, for breach of an anti-receivership clause in the lease, defendants could not collaterally attack an allegedly void default judgment entered against the assignee in an underlying action, on the asserted ground that the court in that action never had jurisdiction due to plaintiff's failure to serve the complaint upon the assignee's receiver, since the order appointing the receiver, the Nevada statutes under which the receiver was appointed, and the testimony of the receiver, upon all of which defendants relied in advancing their collateral attack, were not part of the judgment roll.

(3a, 3b, 3c, 3d)
Landlord and Tenant § 132--Termination--Breach of Covenant or Condition--Material Breach--As Justifying Forfeiture of Lease.
In an action by the original lessee of motel premises to recover possession of the premises from its assignee and the latter's sublessees, for breach of an anti-receivership clause in the lease by defendants' principal, the trial court properly held that the assignee's breach of the anti- receivership provision was material, justifying forfeiture of the subleases. The anti-receivership provision affected not only the ***1034** lessor's unimpaired receipt of rents, it also protected the value of shares plaintiff received from its assignee as partial compensation for the assignment, and, inasmuch as the plaintiff remained secondarily liable under the original lease even though no longer in possession, the provision protected plaintiff in the event its assignee failed to perform any obligations under the transferred lease.

(4)
Contracts § 44--Performance--Breach--Materiality.
Although every instance of noncompliance with a contract's terms constitutes a breach, not every breach justifies treating the contract as terminated. Termination is allowed only if the breach is material, substantial or total. Where the line is to be drawn between the important and the trivial cannot be settled by a formula; nowhere will change be tolerated, however, if it is so dominant or pervasive as in any real or substantial measure to frustrate the purpose of the contract. Whether a breach is so material as to constitute cause for the injured party to terminate a contract is ordinarily a question for the trier of fact.

(5)
Landlord and Tenant § 10--Leases--Validity--Provision Against Bankruptcy, Insolvency, or Receivership of Lessee.
A lease provision against the bankruptcy, insolvency, or receivership of a lessee protects important interests of the landlord, and is valid and enforceable.

(6)
Contracts § 23--Construction and Interpretation--Attached Documents Construed Together.
In an action for breach of an anti-receivership clause in a commercial lease, the lease and an agreement of the lessee's interest, to which the lease was attached as an “exhibit,” were properly construed together as a single contract, with each provision of that unified contract considered in light of all other provisions.

(7)
Appellate Review § 55--Presenting and Preserving Questions in Trial Court--Adherence to Theory of Case--Exceptions to Rule.
The rule that the appellate court is interested in the decision, rather than the reasons, of the lower court, necessarily means that the doctrine of theory of trial will often be disregarded in order to affirm, not reverse, the judgment. Thus, in an action by a lessee to recover possession of commercial premises from its assignee and the latter's sublessees, for breach of an anti-receivership

clause in the lease by the assignee, plaintiff's failure to raise at trial the issue of the importance of the clause in preserving the value of certain shares of stock it received as part of the consideration for the assignment, did not preclude ***1035** consideration of that issue on appeal, since plaintiff's argument utilized uncontradicted evidence used at trial, was not inconsistent with the trial court's findings as to material breach of the lease, and resulted in affirmance.

(8a, 8b)

Judgments § 89--Res Judicata--Collateral Estoppel--Judgment on Merits.

In an action by a lessee to recover possession of commercial premises subleased to certain defendants by the lessee's assignee, the trial court's finding of a material breach of the lease by violation of an anti- receivership clause therein did not violate the doctrine of full faith and credit, despite the findings and conclusions of a special master appointed by the federal court, in the underlying receivership proceedings, that plaintiff suffered no damage. The only issue before the master was whether to lift a stay on state court litigation between the parties; thus, he was not required to adjudicate the merits of the controversy. Any statements by the master regarding materiality of any breach or damages caused by it were therefore mere dicta, not entitled to collateral estoppel or res judicata effect.

(9)

Judgments § 101--Enforcement--Foreign Judgments--Federal Court--Full Faith and Credit.

Full faith and credit must be given to a final order or judgment of a federal court. Such an order or judgment has the same res judicata or collateral estoppel effect in the courts of this state as it would have in a federal court.

(10a, 10b)

Appellate Review § 56--Presenting and Preserving Questions in Trial Court--Adherence to Theory of Case--Application of Rule.

In an action by a lessee to recover possession of premises subleased by the lessee's assignee, for breach of an anti-receivership provision in the lease, defendant sublessees were precluded on appeal from arguing that the trial court's interpretation and application of the anti-receivership provision constituted an unreasonable restraint on alienation. Defendants' contention was never raised by them in the trial court, and no evidence was introduced relative to the necessity of the provision to protect either the lessor's or the lessee's security interests, and the trial court made no finding on that issue.

(11a, 11b)

Landlord and Tenant § 123--Assignment and Subletting-- Construction and Operation of Subleases--Rights and Liabilities of Subtenant-- Liability for Breach of Anti-Receivership Clause.

In an action by a lessee to recover possession of commercial premises from its assignee and the latter's sublessees, the trial court properly construed an anti-receivership clause in the lease as applicable to all subtenants claiming under the original lessee, not just to tenants in ***1036** actual possession, and thus as applicable to defendant sublessees. The landlord continued to treat the assignee, through whom they obtained derivative right of possession and against whom receivership proceeding's had been filed, as responsible for the rent, plaintiff had an investment interest in the fiscal health of the assignee, and the anti- receivership provision was apparently intended to apply to future transfers, since the lease expressly stated that its terms applied to and bound the successors of all the parties.

(12)

Covenants, Conditions, and Restrictions § 10--Restraints on Alienation--Reasonableness.

Civ. Code, § 711, does not prohibit all restraints on alienation, only those which are unreasonable, that is, not necessary to protect a security or prevent it from being impaired. Reasonableness is a question of fact, whose resolution must be based upon evidence directed to that issue. Reasonableness is determined by comparing the justification for a particular restraint on alienation with the quantum of restraint actually imposed by it, based upon its application in the given case. The greater the quantum of restraint that results from enforcement of a given clause, the greater must be the justification for that enforcement.

(13a, 13b, 13c)
Forfeitures and Penalties § 3--Enforcement--Breach Occurring Through Fault of Third Party--Vicarious Liability.
In an action by the original lessee against its assignee's sublessees, to reenter the subleased premises for breach of anti-receivership clause in the lease by the assignee, through whom defendants held derivative right of possession, the trial court did not abuse its discretion in denying defendants' petition for relief from forfeiture under Civ. Code, §§ 1179, 3275. Although the breach occurred through no fault of defendants by an entity they could not control, and ousting defendants would work hardship on them, they were vicariously liable based on their derivative title. Moreover, plaintiff was also an innocent, injured party, since the security it took from the assignee as part of the consideration for the assignment was virtually destroyed by the assignee's receivership.

[See **Cal.Jur.3d,** Forfeitures and Penalties, § 14; **Am.Jur.2d,** Contracts, § 499.]

(14a, 14b)
Forfeitures and Penalties § 5--Relief--Right to Petition-- Final Judgment of Forfeiture.
A petition by sublessee for relief from loss of their estate by forfeiture of the sublessor's estate, which petition was required by Code Civ. Proc, § 1179, to be filed within 30 days after the forfeiture is declared by a judgment, was not untimely, even though ***1037** made some years after forfeiture was declared by default judgment against the sublessor, in an action it and the sublessees filed by the original lessee. It was not until a separate final judgment was entered against the sublessees in the action that they were unambiguously notified of the loss of their estate, and their petition was timely filed within 30 days thereafter.

(15a, 15b)
Pleading § 34--Answer--Prayer for Relief--Relief Encompassed by Prayer--Relief From Forfeiture.
Sublessees under a commercial lease were entitled to petition for relief from forfeiture of the lease under Civ. Code, § 3275, after judgment was entered against them in an action by the original lease to recover possession, even though they did not specifically invoke § 3275 in their answers, since they did pray for such other relief as the court deemed appropriate. The question of forfeiture figured prominently at trial, and the petition was based upon circumstances known to the trial court from the evidence produced at the trial. Such circumstances combined to defeat the lessee's claim that any failure of either pleading or proof was prejudicial.

(16)
Landlord and Tenant § 123--Rights and Liabilities of Subtenant--Remote Sublessees--Forfeiture of Interest by Forfeiture of Sublessor's Estate.
Forfeiture of a lessee's assignee's estate, declared in a default judgment against it, terminated by operation of law the derivative interests of sublessees claiming under the assignee.

(17)
Forfeitures and Penalties § 5--Relief--Discretion of Trial Court.
The matter of granting or denying an application for relief from a lease forfeiture under Code Civ. Proc., § 1179, is one which lies so largely in the discretion of the trial court that it would require a very clear showing of an abuse of discretion to justify a reversal of the order made thereon. The same standard also governs review of denials of applications for the same relief made pursuant to Civ. Code, § 3275 (relief from forfeiture generally). Equivalency of construction and effect are natural consequences from the statutes' relationship to the same subject.

(18)
Landlord and Tenant § 123--Rights and Liabilities of Subtenant.

A sublessee is bound by the terms and conditions of the original lease; its rights are dependent upon and subject to the sublessor's rights. Rights under the sublease stand or fall with those of the sublessor. ***1038**

(19a, 19b, 19c, 19d, 19e, 19f, 19g, 19h)
Landlord and Tenant § 177--Unlawful Detainer--Damages and Amount of Recovery.
In an unlawful detainer action by the master tenant of subleased commercial premises, the trial court properly held, upon rendering judgment for plaintiff, that plaintiff was entitled to reenter and to receive reasonable rent for the period during which right to possession was denied. It erred, however, in awarding prejudgment interest under Civ. Code, § 3287; that statute did not apply to the damages suffered by plaintiff. It also erred by additionally awarding plaintiff the after-tax net operating profits accruing to defendants by their operation of a motel on the premises, and future damages beyond the date of the judgment until such time as defendants returned possession to plaintiff, since such recoveries are not permitted in unlawful detainer actions.

(20)
Landlord and Tenant § 167--Unlawful Detainer--Nature of Action.
Unlawful detainer is a statutory remedy whose primary feature is its expedited procedure for the recovery of possession of real property wrongfully withheld or detained. To promote that end, both sides are deprived of forms of assistance otherwise available. The landlord's rights and remedies are given in lieu of his common law rights, which included the right to enter and expel the tenant by force.

(21)
Landlord and Tenant § 169--Unlawful Detainer--Defenses and Cross Demands--Preclusion of Cross-complaint.
Since the sole issue before the court in an unlawful detainer action is the right to possession, neither a counterclaim nor a cross-complaint, nor affirmative defenses, are admissible, even though the alleged cause contained therein grows out of the subject matter involved in the original suit. The purpose of the rule is to prevent tenants who have violated the covenants of their leases from frustrating the ordinary and summary remedy provided by statute for the restitution of the premises.

(22a, 22b)
Landlord and Tenant § 177--Unlawful Detainer--Damages and Amount of Recovery--Reasonable Rental Value.
The court in an unlawful detainer action may award arrearages of rent or damages in an amount of the fair and reasonable rental value of the property for the period of time from the notice terminating the tenant's right of possession to judgment. Ordinarily, the agreed rent is evidence of the rental value; however, the rental value may be greater or less than the rent provided for in the lease.

(23a, 23b)
Landlord and Tenant § 177--Unlawful Detainer--Damages and Amount of Recovery--Reasonable Rental Value--Where Not ***1039** Prayed for in Complaint.
In an unlawful detainer action, the trial court properly awarded plaintiff reasonable rent for the entire period that its right to possession was denied, even though the complaint did not expressly pray for rent covering the actual period of unlawful possession up to the time of judgment. Plaintiff's reasonable expectation that the unlawful detainer proceeding would expeditiously determine its entitlement to possession was frustrated when the action was stayed by receivership proceedings, allowing defendants to remain in possession. Thus, even in the absence of request by plaintiff to amend the complaint, the trial court properly updated the complaint to award damages for the rental value of the premises accruing during the years in which the stay was in effect.

(24)
Damages § 28--Failure to Pray for Interest in Complaint.

In a contested action to recover possession of commercial premises from sublessees, the trial court acted within its power at the conclusion of the trial in awarding profits derived from the premises to plaintiff, even though plaintiff did not expressly pray for profits in its complaint. Plaintiff's request in its prayer for "such other and further relief as the court deems just" was sufficient to empower the court to award a species of relief not expressly included in the complaint.

(25)
Damages § 8--Compensatory Damages--Interest.
In a contested action, interest may be awarded if the plaintiff is entitled to it, even though the complaint contains no prayer for interest.

(26a, 26b)
Landlord and Tenant § 177--Unlawful Detainer--Damages and Amount of Recovery--Reasonable Rental Value--Inclusion of Profits.
Profits accruing to the possessor of leased property are not synonymous with rental value. Thus, in an action by the original lessee to recover possession of subleased commercial premises, the trial court erred, upon declaring the forfeiture of defendant sublessees' leasehold interests, in awarding plaintiff the after-tax net operating profits accruing to defendants by their operation of a motel upon the premises, as the measure of the property's reasonable rental value.

(27)
Equity § 5--Scope and Types of Relief--Unlawful Detainer Actions.
Equitable principles may be applied where a forfeiture is sought in an action for unlawful detainer, and such equitable power may be extended into a full examination of all the equities involved, to the extent that exact justice may be done.

(28)
Equity § 6--Principles and Maxims.
A trial court's equity powers are formidable, but must be exercised pursuant to the principle that equity follows the law. ***1040**

(29a, 29b)
Landlord and Tenant § 167--Unlawful Detainer--Action Distinguished From Specific Performance Under Contract.
An action by the original lessee to reenter and recover possession of subleased commercial premises was properly characterized as one for unlawful detainer, not for a specific performance of plaintiff's contractual right of reentry contained in the sublease. Although plaintiff was deprived of the summary advantages of the unlawful detainer remedy when the federal court, in underlying receivership proceedings, imposed a stay on the action, the complaint was captioned as being for unlawful detainer and it complied with the statutory requirements of an unlawful detainer action. Moreover, plaintiff took no action to notify its litigation strategy; it never filed an amended complaint or supplemental proceeding, nor did it commence another action to obtain restitution of the funds collected by defendants while still in possession.

(30)
Landlord and Tenant § 167--Unlawful Detainer--Statutory Nature of Action--Strict Construction--Preclusion of Contract Cause of Action.
An action for unlawful detainer is wholly statutory, and the statute on which it is based is strictly construed. Any relief not authorized by the statute may not be given due to the summary nature of the proceedings. Thus, the landlord is precluded from litigating a cause of action for breach of lease terms other than the unlawful detention, otherwise the landlord's remedy would be an ordinary suit for breach of contract with all the delays that remedy normally involves and without restitution of the demised premises. The same is true for specific performance of the provisions of a lease.

(31)
Appellate Review § 163--Partial Reversal.
The trial court's errors in an unlawful detainer action awarding certain types of unauthorized damages did not require a reversal of the entire judgment, only of those portions of the judgment specifying the erroneous awards to be recovered by plaintiff.

(32)
Damages § 8--Compensatory Damages--Prejudgment Interest--Entitlement as Matter of Law.
Civ. Code, § 3287, subd. (a), does not authorize prejudgment interest as a matter of law where the amount of damages depends upon a judicial determination based upon conflicting evidence.

(33)
Damages § 8--Compensatory Damages--Prejudgment Interest--Discretionary Award--As Limited by Statute to Contract Actions.
Civ. Code, § 3287, subd. (b), regarding discretionary awards of prejudgment interest, applies only to damages based upon a cause of action in contract. Thus, in an unlawful detainer action in which ***1041** judgment was entered for plaintiff, the trial court erred in awarding plaintiff prejudgment interest under § 3287, subd. (b), since defendants' obligation to pay plaintiff reasonable rental value was not based upon a contract, but upon the obligation imposed by law to compensate for occupancy of the premises.

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POCHÉ, Acting P. J.

The primary issues arising out of this complex action involving a commercial lease concern whether the appointment of a receiver for a lessee no longer in possession constitutes a material breach justifying termination of the lease and forfeiture of a sublessee's leasehold interests.

Background and Procedural Sequence

The genesis of this litigation concerns several parcels of real property situated in Sunnyvale, California. Plaintiff Superior Motels, Inc. (Superior) constructed a 100-unit hotel and an adjoining restaurant and cocktail lounge on one of the parcels in 1960. The other parcel remained unimproved. Superior thereafter operated the complex, which was commonly known as the Lamplighter Lodge.

In December of 1967, Superior sold the property and improvements to Lamplighter Properties, which immediately leased them back to Superior. [2] The term of the lease was 20 years, although Superior was granted the privilege to extend it for up to 20 additional years. Superior obligated itself ***1042** to pay monthly rent of $10,000, plus 8 percent of the gross income generated by the hotel, restaurant, and bar if in excess of $400,000. Superior was prohibited from assigning the lease without Lamplighter's written consent. [3]

2 It fairly appears that as part of the sale price Superior received promissory notes aggregating $588,000, which it then pledged to Lamplighter to secure Superior's performance of the lease. As a result of these transactions Superior became a limited partner in Lamplighter. Real Estate Equities, Inc. is Lamplighter's general partner.

3 The assignment provisions of the lease read: "Lessee shall not assign this lease but may sub-let the said premises, or any part thereof, without the writtten consent of the lessor [Lamplighter] first had and obtained. Any sub-lease shall be upon the same terms and conditions contained herein, and the rent payable to the lessor shall be determined as set forth hereinabove, i.e. to the extent that the gross income which would have been received by the lessee, had the premises not been sub-leased, exceeds $400,000.00 per calendar year, the total annual rent payable to lessor shall be increased by eight (8%) per cent of said excess.

"This privilege of sub-letting extends only to the premises on which improvements currently exist, and lessee may not sub-let the unimproved property immediately adjacent to the Lamplighter Lodge without first obtaining the written consent of lessor.

"Any assignment or sub-letting of the adjacent land without such consent shall be void, and shall, at the option of the lessor, terminate this lease. This lease shall not, nor shall any interest therein, be assignable as to the interest of lessee, by operation of law, without the written consent of lessor."

One of the lease's provisions read as follows: "Either (a) the appointment of a receiver to take possession of all or substantially all of the assets of lessee, or (b) a general assignment by lessee for the benefit of creditors, or (c) any action taken or suffered by lessee under any insolvency or bankruptcy act shall constitute a breach of this lease by lessee."

Superior continued operating the complex until 1969. On April 26th of that year, Superior executed an agreement whereby it assigned its interest in the lease to Royal Executive Inns of America, Inc. (REI), a Nevada corporation. Superior received 125,000 shares of REI capital stock and a cash sum to be determined according to a specified formula. The agreement included these provisions:

"7. In the event of any breach or default by REI of any terms or provisions to be performed by the Lessee under its lease with Lamplighter Properties, which it has assumed, Superior will promptly notify REI if and after it has received notice from Lamplighter Properties, and, thereafter, REI shall have fifteen (15) days to correct the deficiencies referred to in Lamplighter's notice. Should REI fail to do so, in addition to the remedies provided by law, Superior shall have the remedies provided in provision 8 following.

"8. In the event of notice by the Lessor to the Lessee of default or breach of the lease agreement, Superior shall have the same rights of enforcement upon breach or default after the expiration of fifteen (15) days notice as it would have if it were the Lessor, including without limitation the right to cure the default, and the right of re-entry, without Court proceedings at the expiration of sixty (60) days after notice of default." ***1043**

Lamplighter consented in writing to this assignment, expressly noting that its consent was not intended to relieve Superior of its obligations as lessee required by the lease. REI then entered into possession and operated the complex (now renamed the Royal Executive Inn) without incident for several years.

REI was one of a number of business entities apparently controlled by REI's chairman, Walter Wencke. Between 1969 and 1974 there followed a bewildering procession of corporate acquisitions, name changes, and restructurings, the specifics of which need not be detailed here. During this period one of REl's reincarnations, The Rinn Corporation, sublet the motel and restaurant to a wholly owned subsidiary named Rinn Motor Hotels, Inc. (Rinn Motor), which in turn subleased the motel to Rinns Sunnyvale Motor Hotel (Rinns Sunnyvale), a joint venture comprised of Rinn Motor and Walter and Dorothy Pabst.[4] The two subleases and the joint venture agreement were all executed on October 1, 1972. In May of 1974, The Rinn Corporation was renamed Sun Fruit, Ltd. (Sun Fruit), which like, REI, was incorporated in Nevada.

4 According to the terms of the joint venture agreement, the Pabsts agreed to contribute $50,000 in consideration for "20% of the entire joint venture interest."

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Following execution of the subleases and the joint venture agreement, Mr. Pabst began managing the motel on behalf of Rinns Sunnyvale. The monthly rent payments required by the 1967 master lease between Lamplighter and Superior were forwarded from Rinns Sunnyvale to Rinn Motor and then to Lamplighter.

Unbeknownst to all, Wencke was systematically looting the companies under his control. When matters began to deteriorate, and after Sun Fruit's remaining directors (i.e., Wencke and Richard Mets) were at an impasse, Wencke applied to a Nevada state court and was appointed Sun Fruit's receiver. [5] The order to this effect was filed August 7, 1975.

5 Wencke subsequently became the subject of extensive proceedings in the federal courts, one of which drily noted with the benefit of hindsight: "Because Nevada does not require a disinterested receiver, Wencke became the receiver." (*Securities & Exch. Com'n.* v. *Wencke* (9th Cir. 1978) 577 F.2d 619, 621.) The same court characterized the receivership as "simply a continuation of Wencke's fraud." (*Id.* at p. 622.) Wencke was eventually convicted of mail fraud and making false statements to the Securities and Exchange Commission. (*United States v. Wencke* (9th Cir. 1979) 604 F.2d 607.)

When the president of Real Estate Equities, Inc., the general partner of Lamplighter (see fn. 2, *ante*, p. 1041), learned of this development he urged Superior's president to invoke the anti-receivership provision of the lease. In a letter dated August 22, 1975, Superior advised Sun Fruit that Lamplighter ***1044** treated the appointment of a receiver as "a violation of the lease," as was the failure to submit an accounting. The letter concluded: "Accordingly, you are hereby notified in accord with Paragraph 8 of our Agreement of April 26, 1969, that if you have not cured these defaults completely within 15 days of this notice, then the undersigned will take over all rights it would have if it were the lessor, and will exercise its right of re-entry as therein provided." In a subsequent letter dated September 4th, Superior identified "an additional breach of the master lease," specifically "that a 20% interest in the lease has been assigned to others" (i.e., the Pabsts) contrary to the lease provision against assignments not approved in writing. (See fn. 3, *ante*, p. 1042.)

After 60 days had elapsed, Superior attempted to exercise its right of reentry but was rebuffed by Pabst and the president of Rinn Motor. The position of the joint venturers was that they had acquired possession by a sublease, which did not require written consent. Moreover, because "Lamplighter Properties has been accepting the rent for nearly three years," Rinns Sunnyvale perceived no "violation of any agreements."

Superior then served a three-day notice to quit possession on November 18th. Cited in the notice as reasons for this action were Sun Fruit's receivership and the fact that Sun Fruit "claims that it has sublet the above premises to Walter Pabst and/or Rinn Motor .... That is why this notice is directed to all such entities [sic]." Superior advised that it "hereby declares to elect [to treat] the lease under which you hold possession ... as forfeited."

Receiving no satisfaction, Superior commenced this action by filing a "Complaint To Appoint Receiver, For Unlawful Detainer, To Regain Possession Of Leasehold And For Declaratory Relief' six days later. Named as defendants were Sun Fruit, Rinn Motor, Walter Pabst, and Rinns Sunnyvale. In addition to declaratory relief regarding the validity of the "transfers" of the lease, and the appointment of a receiver, Superior prayed for "a decree of specific performance of plaintiff's right of entry ... and/or for restitution of said premises and that a writ of possession and any and all other applicable writs issue to aid plaintiff in regaining possession of said premises."

On February 9, 1976, Sun Fruit's default was entered by the clerk of the trial court. On October 1st of that year, the trial court conducted a brief hearing on Superior's request to enter a default judgment against Sun Fruit. Sun Fruit did not appear at the hearing, at the conclusion of which judgment was ordered entered as prayed. The judgment filed that same day ***1045** directed that Superior "shall have and recover possession of the above-described premises from defendant Sun Fruit, Ltd., its officers, agents and employees and all persons holding possession of the premises under or through it or them, and is entitled to a Writ of restitution of said premises from defendant Sun Fruit, Ltd., its officers, agents and employees and all persons holding possession of said premises under or through it or them." The judgment also embodied the trial court's determination that Sun Fruit's leasehold was "hereby declared forfeited."

On December 2-3, 1976, a nonjury trial was conducted on Superior's complaint against Rinn Motor, Rinns Sunnyvale, and Pabst, the remaining defendants (who will be hereafter collectively referred to as such). The trial court received evidence in the form of exhibits and testimony from Wencke, Pabst, and the respective presidents of Superior and Real Estate Equities, Inc. Defendants' general position, as stated in extensive trial briefs, was that forfeiture of their leasehold interests would be inequitable in light of the fact that the only breach of the lease had been committed by Sun Fruit, and that determining their right to possession was not foreclosed by the default judgment against Sun Fruit.

On March 1, 1977, the trial court filed its memorandum of decision announcing the intention to award judgment for Superior. The court and parties were in the course of preparing findings of fact and conclusions of law when they became aware that on March 3d the United States District Court for the Southern District of California had appointed an equity receiver to administer the affairs of Wencke's corporate empire. Sun Fruit, Rinn Motor, and Rinns Sunnyvale were among the entities entrusted to the receiver's stewardship. [6] The district court's order included a stay of ”any proceeding against the entities in receivership“ for the duration of the receivership ”[e]xcept by leave of this Court.“

6 The receiver had in fact been acting in a temporary capacity since January 20, 1977.

In April and May of that year the district court made separate orders confirming that the stay applied to Superior's action in state court, and denying Superior's application for relief from the stay. On May 24, 1977, Wencke's authority to act as receiver was terminated by the Nevada court which had appointed him.

In December of that year, the district court made an order denying another application by Superior for relief from the stay and leave to proceed against ” the entities in receivership.“ On Superior's appeal from this order, the Ninth Circuit concluded that the district court did not abuse its ***1046** discretion either by issuing the blanket stay or in denying Superior's application for exemption, but remanded the matter to the district court for it to consider whether the stay should be modified due to the passage of time. (*Securities & Exch. Com'n. v. Wencke* (9th Cir. 1980) 622 F.2d 1363.)

Once the matter was returned to the district court, a federal magistrate acting as a special master conducted an extensive evidentiary hearing on Superior's renewed application for relief from the stay. In October of 1982 the special master filed ”Findings Of Fact And Conclusions Of Law And Recommendation“ which were adopted by the district court the following month. Superior was thereby granted leave to continue its efforts to obtain possession of the property at the same time that the receiver was moving to have the default judgment against Sun Fruit set aside. [7]

7 In November 1977 the receiver was authorized to commence an action on behalf of Sun Fruit for the purpose of vacating the default judgment entered against Sun Fruit. The receiver filed a complaint seeking this relief later that month, but the receiver took no further steps (such as effecting service on Superior) in the belief that such was contrary to the district court's stay. In accordance with the special master's recommendation, the district court's order expressly authorized the receiver to ”continue“ this litigation. A ”First Amended Complaint For Vacation Of Void Judgment And Injunctive Relief“ was filed by the receiver on November 19, 1982.

The following events occurred in 1983 when proceedings were resumed in the trial court:

On January 14th, the trial court filed its findings of fact and conclusions of law in which it found that neither Rinn Motor nor Rinns Sunnyvale had ”any right or claim to possession of any portion of the premises other than under and through Sun Fruit.“ Although the court's characterization of Rinns Sunnyvale as a ”sub-sublessee“ constituted an implicit rejection of Superior's argument that Rinns Sunnyvale had obtained possession through an invalid assignment, it nevertheless found that the establishment of the Nevada receivership for Sun Fruit ”constituted a material breach by Sun Fruit of its obligations assumed by it upon the transfer to it of Superior's leasehold interest, and entitled Superior to exercise, after the requisite notices on failure of termination of the receivership, its reserved right of re-entry as against Sun Fruit and all persons or entities claiming under or through Sun Fruit." On the basis of these and other findings, the court concluded that Superior was "entitled to immediate possession under its right of re-entry as of ... the date of the filing of the complaint in the within action, to[]wit, November 24, 1975," an accounting, and "to recover from defendants and each of them the amount of the net profits which otherwise would have accrued to and belong to ... Superior." ***1047**

Also on January 14th, the trial court entered an interlocutory judgment declaring Superior's right to possession, which "accrued no later than November 24, 1975." The court further determined that the Sun Fruit-Rinn Motor and the Rinn Motor-Rinns Sunnyvale subleases executed on October 1972 were "terminated and forfeited as of November 24, 1975." Finally, "defendants and each of them are hereby ordered and directed to render a full, true and correct accounting to ... plaintiff of all rents, issues and profits accruing to ... defendants and each of them from the operation of said premises from and after November 24, 1975 to date of delivery of possession to plaintiff, ... jurisdiction being specifically retained to review and approve such accounting, and upon approval of the same, plaintiff is entitled to an order directing said defendants and each of them to pay over to plaintiff the net profits accruing from the operation of said business entities on said premises from and after November 24, 1975." [8]

8 Defendants then filed motions for new trial based on grounds similar to those made once a final judgment was eventually entered and which will be summarized at a later point in the text. After these motions were denied, defendants filed notices purporting to appeal from the interlocutory judgment. Due to the lack of an appealable final judgment (see *Lacey v. Bertone* (1949) 33 Cal.2d 649, 652-654 [203 P.2d 755]; *Rose v. Boydston* (1981) 122 Cal.App.3d 92, 96-97 [175 Cal.Rptr. 836]), those appeals were dismissed.

In early April Superior noticed a "Motion for Review and Approval of Accounting." In their written oppositions defendants objected to the necessity and propriety of a hearing devoted to accounting issues. Defendants urged (among other things) that (1) Superior "has suffered no damage as a result of the alleged breach of the anti-receivership clause," as evidenced by the findings of the federal magistrate adopted by the district court, and (2) Superior was erroneously awarded net profits for the period between trial and the date on which actual possession was surrendered.

On June 24th the trial court conducted an evidentiary hearing on Superior's motion and defendants' objections. After receiving lengthy briefs from the parties with respect to the accounting issues, the trial court on November 3d entered its final judgment to the effect that Superior was entitled to recover "after tax net operating profits" from Rinn Motor and Rinns Sunnyvale in the amount of $886,666, together with prejudgment interest of $189,005. The corresponding amounts assessed against Pabst were $149,161 and $29,483. These sums covered the period from November 24, 1975, to June 1, 1983. The court further concluded that "Plaintiff shall recover from defendants ... all after tax net operating profits received by each said defendant from the subject motel/restaurant premises from and after June 1, 1983, and continuing to the date on which possession of said premises is in fact delivered to plaintiff, together with interest thereon at the rate of 10 ***1048** per cent per annum from the dates received by said defendants until said sums are paid to plaintiff."

In November and December, defendants filed separate motions for new trial and petitions for relief from the forfeiture ordered in the judgment. Covering a number of common and repetitive grounds, these motions and petitions presaged many of the contentions now raised on these appeals. The general themes were twofold.

First, defendants argued that the default judgment obtained by Superior against Sun Fruit was void. They reasoned that an adjudication of Sun Fruit's rights was a prerequisite which had to be adjudicated before their sublessee rights could be forfeited. No valid service having been effected on Sun Fruit, the Nevada receiver (i.e., Wencke) was an indispensable party whose absence was fatal to all subsequent proceedings.

Second, defendants attacked the forfeiture on the ground that Superior had suffered no damage by reason of the breach of the anti-receivership provision between Superior and Sun Fruit, as evidenced by findings by the federal magistrate and the district court to this effect. The breach, which defendants saw as rectified when the Nevada receivership was terminated in 1977, was thus "merely technical or trivial in nature" and "certainly was not the type of breach that would support a forfeiture."

After receiving written opposition by Superior, the trial court on December 15th conducted a hearing at which it heard argument from the parties concerning the motions and petitions. The following day the court denied the motions and petitions in an order which did not elucidate the basis for its rulings.

Timely notices of appeal were filed by Rinn Motor and Rinns Sunnyvale from the judgment and the order denying their respective petitions for relief from forfeiture. (1)**(See fn. 9.)** Pabst also appealed from the judgment. [9] ***1049** Superior has also appealed from the judgment, "but only so far as it fails to award plaintiff pre-tax net operating profits received by defendants from the subject premises on and after November 4 [*sic*: 24], 1975."

9 Pabst labors under the profound misapprehension that he has also appealed from the order denying his petition for relief from forfeiture. He has not. The only notice of appeal from the trial court's order denying defendants' petitions was filed by Rinn Motor and Rinns Sunnyvale "by and through their Federal Equity Receiver, R. N. Gould." The notice, although it does recite that "defendant Walter Pabst also joins in this appeal," is signed by a member of the law firm acting as "Attorneys for R. N. Gould. " Rule 1(a) of the California Rules of Court states with absolute clarity that a notice of appeal "shall be signed by the appellant or by his attorney." Pabst has at all times been represented by separate counsel, and there is nothing whatsoever in the record indicating that his codefendants' attorneys were authorized to file a notice of appeal on his behalf. The notice is therefore wholly ineffectual as the required means of commencing a valid appeal. (*Isom v. Slaughter* (1962) 200 Cal.App.2d 700, 705 [19 Cal.Rptr. 541]; *Edlund v. Los Altos Builders* (1951) 106 Cal.App.2d 350, 357 [235 P.2d 28]; 9 Witkin, Cal. Procedure (3d ed. 1985) Appeal, § 377, pp. 380-381.) This purported appeal must therefore be dismissed (*Edlund* v. *Los Altos Builders, supra*) and the arguments in Pabst's briefs challenging the denial of his petition for relief from the forfeiture will be disregarded accordingly.

Review

I

(2) Defendants are clearly aggrieved by the default judgment entered against Sun Fruit for it constitutes the foundation of the subsequent judgment entered against them. They did not, however, appeal from this judgment, which became final. In recognition of these facts, they have mounted a collateral attack upon the default judgment. According to defendants, because service was made upon Sun Fruit's president Richard Mets and not upon Wencke in his capacity as the receiver appointed by the Nevada court, that service was defective according to Nevada law and the default judgment is consequently void.

Defendants are entitled to press this challenge, based as it is upon a perceived jurisdictional infirmity making the judgment void on its face. (8 Witkin, *op. cit. supra*, Attack on Judgment in Trial Court, §§ 6 [pp. 410-411], 12-13 [pp. 414-417].) They do not, however, appreciate the very stringent rules governing such a claim.

"The validity of the judgment on its face may be determined only by a consideration of the matters constituting part of the judgment roll." (*Johnson v. Hayes Cal Builder, Inc*. (1963) 60 Cal.2d 572, 576 [35 Cal.Rptr. 618, 387 P.2d 394].) "The record is the judgment roll, and upon collateral attack it is the only evidence that can be considered in determining the question of jurisdiction." (*Estate of Wise* (1949) 34 Cal.2d 376, 382 [210 P.2d 497]; see *Brockway v. Heilman* (1967) 250 Cal.App.2d 807, 810 [58 Cal.Rptr. 772].) The judgment roll for a default judgment is statutorily defined as "the summons, with the affidavit or proof of service; the complaint; the request for entry of default with a memorandum indorsed thereon that the default of the defendant in not answering was entered, and a copy of the judgment ...." (Code Civ. Proc., § 670, subd. (a).)

Defendants' contention founders because it is not based upon the judgment roll as so defined. They rely instead on Wencke's order of ***1050** appointment, Nevada statutes governing the powers of a corporate receiver, and Wencke's testimony at trial. This is evidence extrinsic to the judgment roll and thus "is wholly inadmissible, even though it might show that jurisdiction did not in fact exist ...." (*Hogan v. Superior Court* (1925) 74 Cal.App. 704, 708 [241 P. 584].) It is therefore "unavailing for any purpose" (*Willey v. The Benedict Co*. (1904) 145 Cal. 601, 605 [79 P. 270]) and cannot be considered here. (*Sievers v. Pacific*

Gas & Elec. Co. (1943) 57 Cal.App.2d 455, 456 [134 P.2d 850].) The upshot is that defendants have presented no competent evidence to rebut the presumption that the trial court "acted in the lawful exercise of its jurisdiction." (Evid. Code, § 666; see *Johnson v. Hayes Cal Builders, Inc., supra*, 60 Cal.2d 572 at p. 578; *Craney* v. *Low* (1956) 46 Cal.2d 757, 760 [298 P.2d 860]; *Borenstein* v. *Borenstein* (1942) 20 Cal.2d 379, 381 [125 P.2d 465]; *Willey v. The Benedict Co., supra*, at pp. 603-605; *People* v. *Davis* (1904) 143 Cal. 673, 677-678 [77 P. 651]; *Brockway* v. *Heilman, supra*, 250 Cal.App.2d 807 at p. 810.) Their collateral attack fails accordingly.

II, III [10]

10 See footnote, *ante*, page 1032.

. . . .

IV

At the time Superior advised defendants that it was electing to terminate the latter's possessory rights, it cited as its reasons the failure to provide an accounting, the supposedly unauthorized assignment(s) from Sun Fruit, and the fact of Sun Fruit's receivership. The accounting matter was apparently resolved between the parties prior to trial. As previously mentioned, the trial court tacitly determined that defendants had obtained possession via permissible subleases, a determination not now challenged by any of the parties. (3a) This left only the receivership, which the court found "constituted a material breach by Sun Fruit of its obligations assumed by it upon the transfer to it of Superior's leasehold interest, and entitled Superior to exercise ... its reserved right of re-entry as against Sun Fruit and all persons or entities claiming under or through Sun Fruit." Defendants now attack this finding as factually and legally incorrect. (Portions of defendants' arguments implicating the forfeiture aspect of the finding will be addressed in the next section of this opinion.) ***1051**

(A)

(4) The law sensibly recognizes that although every instance of noncompliance with a contract's terms constitutes a breach, not every breach justifies treating the contract as terminated. (See 4 Corbin on Contracts (1951) § 943, pp. 806-807; Farnsworth, Contracts (1982) §§ 8.15-8.16, pp. 607-613; Murray on Contracts (2d rev. ed. 1974) § 167, pp. 322-327; 11 Williston on Contracts (3d ed. 1968) § 1292, pp. 8-9.) Following the lead of the Restatements of Contracts, California courts allow termination only if the breach can be classified as "material," "substantial," or "total." (See *Coughlin v. Blair* (1953) 41 Cal.2d 587, 598-599 [262 P.2d 305]; *Sackett* v. *Spindler* (1967) 248 Cal.App.2d 220, 229 [56 Cal.Rptr. 435]; *Story* v. *San Rafael Military Academy* (1960) 179 Cal.App.2d 416, 417 [3 Cal.Rptr. 847]; *Budget Way etc. Laundry v. Simon* (1957) 151 Cal.App.2d 476, 480-481 [311 P.2d 591]; *Asso. Lathing etc. Co.* v. *Louis C. Dunn, Inc*. (1955) 135 Cal.App.2d 40, 50-51 [286 P.2d 825]; *Smith* v. *Empire Sanitary Dist*. (1954) 127 Cal.App.2d 63, 72-73 [273 P.2d 37].)

Cardozo had occasion to examine the distinction between material and inconsequential breaches in his landmark decision regarding substantial performance of a construction contract. "The courts never say that one who makes a contract fills the measure of his duty by less than full performance. They do say, however, that an omission, both trivial and innocent, will sometimes be atoned for by allowance of the resulting damage, and will not always be the breach of a condition to be followed by a forfeiture." (*Jacob & young v. Kent* (1921) 230 N.Y. 239, 241 [129 N.E. 889, 23 A.L.R. 1429].) "Where the line is to be drawn between the important and the trivial cannot be settled by a formula. 'In the nature of the case precise boundaries are impossible' (2 Williston on Contracts, sec. 841). The same omission may take on one aspect or another according to its setting. Substitution of equivalents may not have the same significance in fields of art on the one side and in those of mere utility on the other. Nowhere will change be tolerated, however, if it is so dominant or pervasive as in any real or substantial measure to frustrate the purpose of the contract .... The question is one of degree, to be answered, if there is doubt, by the triers of the facts .... We must weigh the purpose to be served, the desire to be gratified, the excuse for deviation from the letter, the cruelty of enforced adherence. ... [T]he law will be slow to impute the purpose, in the silence of the parties, where the significance of the default is grievously out of proportion to the oppression of the forfeiture." (*Id*. at pp. 243-244.)

California too accepts that “[w]hether a breach is so material as to constitute cause for the injured party to terminate a contract is ordinarily a ***1052** question for the trier of fact.” (*Whitney Inv. Co. v. Westview Dev. Co.* (1969) 273 Cal.App.2d 594, 601 [78 Cal.Rptr. 302]; accord *Porter v. Arthur Murray, Inc.* (1967) 249 Cal.App.2d 410, 421 [57 Cal.Rptr 554]; *Asso. Lathing etc. Co.* v. *Louis C. Dunn, Inc., supra*, 135 Cal.App.2d 40 at p. 49; *Smith* v. *Empire Sanitary Dist., supra*, 127 Cal.App.2d 63 at p. 73; *Gold Min. & Water Co. v. Swinerton* (1943) 23 Cal.2d 19, 28 [142 P.2d 22].)

With these principles as our background, we turn to defendants' specific arguments.

(B)

(5) A lease provision against the bankruptcy, insolvency, or receivership of a lessee protects important interests of the lessor. The appointment of a receiver often entails drastic disruptive consequences to existing business relationships. (See *Hoover v. Galbraith* (1972) 7 Cal.3d 519, 528 [102 Cal.Rptr. 733, 498 P.2d 981]; *Golden State Glass Corp. v. Superior Ct.* (1939) 13 Cal.2d 384, 393 [90 P.2d 75]; *Barclays Bank of California* v. *Superior Court* (1977) 69 Cal.App.3d 593, 597 [137 Cal.Rptr. 743]; *Cohen v. Herbert* (1960) 186 Cal.App.2d 488, 495 [8 Cal.Rptr. 922].) That a lessee's ability to remain solvent and retain the capacity for unimpeded operation constitutes a relevant and legitimate concern of a lessor is too obvious to require belaboring. (See *Coast Bank* v. *Minderhout* (1964) 61 Cal.2d 311, 316-317 [38 Cal.Rptr. 505, 392 P.2d 265],overruled to the extent inconsistent in *Wellenkamp v. Bank of America* (1978) 21 Cal.3d 943, 953 [148 Cal.Rptr. 379, 582 P.2d 970]; *Central Trust Co. v. Chicago Auditorium* (1916) 240 U.S. 581, 589 [60 L.Ed. 811, 814-815, 36 S.Ct. 412].) Notwithstanding the lessor's primary concern with the uninterrupted payment of rent, such a provision ensures that the lessor is not forced into an involuntary relationship with a tenant not of his choosing. Even if rent continues to be paid, “[t]enant insolvency presents uncertainty and inconvenience which the lessor is understandably anxious to avoid.” (Note, *The Enforceability of Lease Forfeiture-Upon-Bankruptcy Covenants: A Proposal for Damages as an Alternative Remedy* (1976) 49 So.Cal.L.Rev. 339, 360-361, text and fn. 81.) California accepts such provisions as valid and enforceable. (*Farnum v. Hefner* (1889) 79 Cal. 575, 580-581 [21 P. 955]; 4 Miller & Starr, Current Law of Cal. Real Estate (1977 rev.) § 27:100, p. 431.)

(3b) Defendants contend in effect that the sole purpose of the anti-receivership provision of the lease was to assure the payment of rent to Lamplighter, “not to confer a benefit on Superior.” Superior responds that the objects of the provision, when read in conjunction with the 1969 assignment granting Superior a right of reentry, covered not only payment of rent ***1053** but also protection of the value of the REI shares it received in compensation for the assignment. The trial court admitted extrinsic evidence to determine the meaning of the provision, a ruling defendants do not now challenge, and rejected defendants' interpretation of the provision. Only if the contrary construction accepted by the trial court is unreasonable and unsupported by substantial evidence can defendants' contention be sustained. (See *Glendale City Employees' Assn., Inc.* v. *City of Glendale* (1975) 15 Cal.3d 328, 340 [124 Cal.Rptr. 513, 540 P.2d 609]; *Parsons v. Bristol Development Co.* (1965) 62 Cal.2d 861, 865-866 [44 Cal.Rptr. 767, 402 P.2d 839]; *Western Medical Enterprises, Inc. v. Albers* (1985) 166 Cal.App.3d 383, 389 [212 Cal.Rptr. 434]; *Beverly Hills Firemen's Assn., Inc. v. City of Beverly Hills* (1981) 119 Cal.App.3d 620, 629-630 [174 Cal.Rptr. 178].)

The extrinsic evidence admitted by the court was testimony by William Henderson, Superior's president. He testified that he negotiated the provisions of the 1969 agreement with an officer of REI. With reference to paragraphs 7 and 8 of the 1969 agreement (quoted *ante*, p. 1042), Henderson testified: “The reason these clauses are in here is because Lamplighter Properties, the lessor, were [*sic*] still holding us accountable for all of the things contained in the lease, whatever they might be, and this was to try to protect ourselves because we wouldn't have the control and custody of the operation.” Although “the primary concern of the whole thing is the rent,” Henderson (who together with his wife owns all of Superior's stock) was also concerned for the value of the REI shares Superior would receive. The REI official told Henderson that the REI stock “had certain values, ... that it would be restricted for a couple of years[, and that] after a couple of years it would be free trading stock.” “[I]f anything happened, I would be able to come back in my original position to protect my own interests and to fulfill my obligations if I had any, to Lamplighter Properties. ... I had to insert that to protect myself and come back in position.”

(6) The 1967 lease between Lamplighter and Superior was attached as "Exhibit 1" to the 1969 agreement between Superior and REI. Both documents are therefore to be construed as a single contract. (*Merkeley v. Fisk* (1919) 179 Cal. 748, 754 [178 P. 945]; *Housing Authority v. Monterey Senior Citizen Park* (1985) 164 Cal.App.3d 348, 354 [210 Cal.Rptr. 497]; *Heston* v. *Farmers Ins. Group* (1984) 160 Cal.App.3d 402, 417 [206 Cal.Rptr. 585]; *J. A. Payton v. Kuhn-Murphy, Inc*. (1967) 253 Cal.App.2d 278, 281 [61 Cal.Rptr. 575].) Each provision of that unified contract is to be considered in light of all other provisions. (Civ. Code, § 1641; *Bush* v. *California Conservation Corps* (1982) 136 Cal.App.3d 194, 202 [185 Cal.Rptr. 892]; *County of Marin v. Assessment Appeals Bd*. (1976) 64 Cal.App.3d 319, 325 [134 Cal.Rptr. 349].) ***1054**

(3c) Defendants' construction of the anti-receivership provision as affecting only Lamplighter's unimpaired receipt of rents is untenable. The lease included a provision that "The covenants and conditions contained herein shall, subject to the provisions as to assignment, apply to and bind the heirs, successors, executors, administrators and assigns of all of the parties hereto; and all of the parties hereto shall be jointly and severally liable hereunder." [12] A provision in the agreement specified that "REI shall assume and agrees to perform all the obligations of Superior under the lease ... and will hold Superior harmless from any liability thereunder." The conjoint effect of these provisions clearly establishes the continued responsibility of Superior even when it was no longer the tenant in actual possession of the property.

12 It is clear that by force of this provision Superior could be held responsible for the actions and breaches committed by a tenant whose title derived in any fashion from Superior. This potential liability to Lamplighter would itself be more than sufficient to give Superior standing to press this litigation.

Following its assignment of the lease to REI, Superior remained secondarily liable to Lamplighter in the event its assignee or any sublessees failed to perform any of the obligations of the transferred lease. It thus had a contingent liability to Lamplighter should rent not be paid. (See *Kendall v. Ernest Pestana, Inc*. (1985) 40 Cal.3d 488, 500 [220 Cal.Rptr. 818, 709 P.2d 837]; *Samuels v. Ottinger* (1915) 169 Cal. 209, 211-212 [146 P. 638]; *Scott v. Mullins* (1962) 211 Cal.App.2d 51, 55-56 [27 Cal.Rptr. 269].) Henderson's testimony demonstrates beyond any doubt that he was cognizant of this obligation. The testimony of Scott Chandler, the president of Real Estate Equities, the general partner of Lamplighter, establishes that Sun Fruit was very much a part of the transmission of rent even after it had subleased the property. According to Chandler, from 1969 onwards "we were looking to what we thought was the Rinn Corporation, now the Sun Fruit Corporation [*sic*], for the payment of our rent."

It should also be remembered that Superior's assignment of its leasehold interest to REI was not made gratuitously, but as part of a compensated exchange. The compensation Superior received was 125,000 shares of REI stock, stated in the 1969 agreement to have been acquired "for investment purposes." Although the record does not establish the precise worth of the shares, it may safely be assumed that it was considerable. Wencke testified at the trial that the shares were "now ... worthless pieces of paper." He explained that "The creditors' claims vastly exceed the assets of the corporation, so there will be no assets left for shareholders of the corporation." Henderson largely corroborated Wencke's appraisal when he testified that ***1055** "I was unable to sell my stock *when it had a value* because it was restricted, and I still have the stock." (Italics added.)

The consequences of Sun Fruit being placed in the care of a receiver were manifold and manifest. Superior lost the presumed fiscal presence of its assignee, the party to whom Lamplighter was looking for payment of rent. Superior was therefore facing the prospect of resuming actual responsibility for such payments unless and until Sun Fruit emerged from the receivership. (7)**(See fn. 13.),** (3d) More importantly, the valuable consideration received for transfer of its leasehold assignment had become worthless, thus depriving Superior of the benefit of its bargain with REI. [13] (See fn. 14, *post*.) Both of the eventualities feared by Superior which had led to its insistence on an explicit right of reentry had come to pass. The trial court's finding that the receivership was a material breach justifying Superior's exercise of its right of reentry comports with our construction of the contract and is supported by substantial evidence. It is therefore to be sustained. (See *Glendale City Employees' Assn., Inc. v. City of Glendale, supra*, 15 Cal.3d 328 at p. 340; *Western Medical Enterprises, Inc. v. Albers, supra*, 166 Cal.App.3d 383 at p. 389; *Beverly Hills Firemen's Assn., Inc. v. City of Beverly Hills, supra*, 119 Cal.App.3d 620 at pp. 629-630; *Whitney Inv. Co. v. Westview Dev. Co., supra*, 273 Cal.App.2d 594 at p. 601.)

13 Defendants correctly point out the unlikelihood that the trial court's finding was based upon this reasoning because Superior did not raise it at trial. Our response to defendants' criticism against accepting Superior's position is twofold. First, Superior's argument on appeal utilizes uncontradicted evidence introduced at the trial. Second, the argument is not inconsistent with the trial court's finding, which did not identify a particular consequence of the receivership as the material breach. "The rule that the appellate court is interested in the decision rather than the reasons of the lower court necessarily means that the doctrine of theory of trial will often be disregarded in order to *affirm*, not reverse, the judgment." (9 Witkin, *op. cit. supra*, Appeal, § 322, p. 333, original italics.) Application of this principle to acceptance of Superior's argument in support of the judgment is sanctioned by the established practice of this and other courts. (See *Pasadena Medi-Center Associates v. Superior Court* (1973) 9 Cal.3d 773, 779-780 [108 Cal.Rptr. 828, 511 P.2d 1180], text and fn. 6; *Board of Administration v. Superior Court* (1975) 50 Cal.App.3d 314, 319-320 [123 Cal.Rptr. 530]; *Niles Sand & Gravel Co. v. Alameda County Water Dist.* (1974) 37 Cal.App.3d 924, 936, fn. 12 [112 Cal.Rptr. 846]; cf. *Stockton Morris Plan Co. v. Carpenter* (1936) 18 Cal.App.2d 205, 213 [63 P.2d 859].) To this end, and there having been no objection by defendants concerning the precise nature of the detriment suffered by Superior from the appointment of the Nevada receiver, we are authorized to infer in support of the judgment a finding that the impairment of Superior's REI shares constituted damages amounting to a material breach. (See *Hall v. Municipal Court* (1974) 10 Cal.3d 641, 643 [111 Cal.Rptr. 721, 517 P.2d 1185]; *Booth v. Robinson* (1983) 147 Cal.App.3d 371, 377 [195 Cal.Rptr. 130]; *Union Bank* v. *Ross* (1976) 54 Cal.App.3d 290, 297 [126 Cal.Rptr. 646].)

(C)

(8a) Defendants attempt to impeach the trial court's finding of material breach with the findings and conclusions made by the special master and ***1056** adopted by the district court in connection with Superior's successful 1982 motion for relief from the stay previously issued by the district court at the time the federal equity receiver was appointed. Together with the de facto substitution of the Nevada receiver by the federal receiver, defendants claim that these "significant events" conclusively establish that Superior suffered no damage. As they see it, the breach was "merely technical or trivial in nature" and consequently cannot be characterized as material.

The matter of the change in receivers is quickly answered. Defendants' argument, that "the condition complained of, the Nevada receivership of Sun Fruit, had not existed for a period" of more than five years at the time the final judgment was entered, seems to imply that a receiver appointed by a federal court in California is somehow less objectionable than one appointed by a state court in Nevada. Certainly the plain language of the lease provision furnishes no basis for such a distinction. Defendants hint at no evidence suggesting that the termination of the Nevada receivership in the wake of the federal receiver being appointed entailed any reduction of Superior's responsibility as Sun Fruit's rent guarantor, or that it restored the value of the REI shares taken by Superior in exchange for surrendering its leasehold interest. If anything, the appointment of the federal receiver was even more damaging to Superior because of the accompanying stay which put a halt to Superior's nearly completed effort to obtain a judicial resolution of its claimed entitlement to the property. Furthermore, the fact that the federal receiver had been appointed on the application of the Securities and Exchange Commission stands as evidence that Sun Fruit's difficulties were almost certainly not of a minor or transitory nature, a proposition made abundantly plain by subsequent events.

The trial court took judicial notice of the special master's findings and conclusions made in connection with Superior's application that it be exempted from the stay and allowed to conclude this action against defendants. Addressing the question of whether the status quo should be preserved, the master noted that "Prior to the creation of the Nevada receivership, the terms of the master lease ... was [*sic*] adhered to strictly by ... REI and its issue," and that "the provisions of the master lease concerning the payment of rents and monies to Lamplighter Properties have been scrupulously complied with."

With respect to this action, the master stated: "Superior's injury, if any, may be characterized as a deferral or an opportunity to regain a now profitable property interest, that it had previously disposed of, by taking advantage of Walter Wencke's chicanery. If the stay remains in effect, then Superior Motels will simply continue to receive the benefit of its original ***1057** bargain with REI. ... Superior Motel's [*sic*] position as an obligor on the master lease has not been prejudiced in any significant respect." The master's opinion was that "the Wencke receivership ... can[not] be translated into direct injury to Superior Motels."

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Turning to the "litigation between Superior Motels and Sun Fruit[,] Ltd. that is pending and presently stayed," the master characterized it as involving "purely legal issues." The master then recited some of the outstanding issues pertaining to the federal receiver's nascent action to set aside the default judgment entered against Sun Fruit (see fn. 7 and accompanying text, *ante*, p. 1046), and concluded: "This court is unable to predict with certainty how the California State Courts will ultimately decide these issues, but decide them they must."

We cannot accede to defendants' argument that the master's findings and conclusions amount to a conclusive determination that Superior suffered no damage, a determination to which the trial court was required to accord full faith and credit and which Superior is prevented by principles of res judicata and collateral estoppel from contesting. (9) "Full faith and credit must be given to a final order or judgment of a federal court. [Citations.] Such an order or judgment has the same [res judicata or collateral estoppel] effect in the courts of this state as it would have in a federal court." (*Levy v. Cohen* (1977) 19 Cal.3d 165, 172-173 [137 Cal.Rptr. 162, 561 P.2d 252]; see Code Civ. Proc., § 1908; *Younger* v. *Jensen* (1980) 26 Cal.3d 397, 411 [161 Cal.Rptr. 905, 605 P.2d 813]; *Martin v. Martin* (1970) 2 Cal.3d 752, 758-764 [87 Cal.Rptr. 526, 470 P.2d 662]; *Johnson v. American Airlines, Inc*. (1984) 157 Cal.App.3d 427, 430-431 [203 Cal.Rptr. 638].) The extent of such effect is governed by federal law. (See *Martin v. Martin, supra*, at pp. 761-762; Rest.2d Judgments, § 87.)

(8b) It must be remembered that the only issue before the special master (who is obviously the dominant actor even though his actions required ratification by the district court) was whether to lift the stay. His discussion of the parties' respective positions was germane to ascertaining the status quo and to determining whether it would permit resumption of the state court litigation. The master was not, however, required to adjudicate the merits of that controversy, nor did he purport to do so. He made no express reference to the issues of the materiality of any breach or damages caused thereby. In a rather oblique fashion he did make certain observations which could be construed as relating to these issues, but these comments were in the nature of asides. The sole question before him, and the sole matter he determined, was Superior's application to be relieved from the stay. If, as defendants argue, the master was deciding the ultimate question of ***1058** Superior's pending state court action, his recommendation that the stay be lifted in order that that action could be concluded makes no sense.

In light of these circumstances, the master's findings cannot be given the preclusive effect defendants wish. The master's observations concerning issues not necessary for decision of the matter before him may have been conducive to his reasoning, but they were in essence incidental, collateral, and immaterial for that decision. They were, in short, dicta. According to federal law, they therefore do not support either collateral estoppel (*Minnis v. United States Dept. of Agriculture* (9th Cir. 1984) 737 F.2d 784, 786, fn. 1; *Hicks v. Quaker Oats Co*. (5th Cir. 1981) 662 F.2d 1158, 1168) or res judicata. (*Norton* v. *Larney* (1925) 266 U.S. 511, 517 [69 L.Ed. 413, 417, 45 S.Ct. 145]; *Memorex Corp. v. Intern. Business Mach. Corp*. (9th Cir. 1977) 555 F.2d 1379, 1384; cf. *Abraham v. Casey* (1900) 179 U.S. 210, 219-220 [45 L.Ed.2d 156, 160, 21 S.Ct. 88].) Moreover, the only reasonable inference to be drawn from the master's recommendation that Superior be allowed to pursue its action against defendants is that he was refraining from adjudicating the merits of that controversy. This factor would also weigh against the claim defendants now press. (See *United States* v. *Seckinger* (1970) 397 U.S. 203, 206, fn. 6 [25 L.Ed.2d 224, 230, 90 S.Ct. 880]; *In re Pittsburgh & L. E. R. Co., etc*. (3d Cir. 1976) 543 F.2d 1058, 1068; cf. *Cason v. Glass Bottle Blowers Assn*. (1951) 37 Cal.2d 134, 141 [231 P.2d 6, 21 A.L.R.2d 1387]; *Bleeck v. State Board of Optometry* (1971) 18 Cal.App.3d 415, 429 [95 Cal.Rptr. 860].)

V

We now turn to the question of the forfeiture of defendants' leasehold interests declared by the trial court. Defendants' contentions on this issue fall into two general categories—those relating to the proper construction of the anti-receivership provision of the lease and those affecting the denial of the motion(s) for relief from the forfeiture. Our discussion will follow this division.

(A)

Citing the familiar principles that forfeitures are abhorred and that contracts will be strictly construed to avoid them (see Civ. Code, § 1442; *O'Morrow v. Borad* (1946) 27 Cal.2d 794, 800 [167 P.2d 483, 163 A.L.R. 894]; *McNeece* v. *Wood* (1928) 204

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Cal. 280, 283-284 [267 P. 877]; *ABI, Inc.* v. *City of Los Angeles* (1984) 153 Cal.App.3d 669, 681-682 [200 Cal.Rptr. 563]; *Roth v. Department of Veterans Affairs* (1980) 110 Cal.App.3d 622, 628 [167 Cal.Rptr. 552]; *Malone* v. *Western Conf. of Teamsters Pension* ***1059** *Trust* (1980) 110 Cal.App.3d 538, 545 [168 Cal.Rptr. 210, 169 Cal.Rptr. 90]), defendants raise two contentions regarding construction of the anti-receivership provision which they claim should have been resolved in their favor to avoid a forfeiture. (10a) They first contend that the trial court's "interpretation and application" of the anti-receivership provision "constituted an unreasonable restraint on alienation." (11a) They then contend that the provision should have been construed to apply only to a receiver appointed for the tenant in possession. We find neither argument persuasive.

(12) Civil Code section 711 provides: "Conditions restraining alienation, when repugnant to the interest created, are void." This statute does not prohibit all restraints on alienation, only those which are unreasonable, i.e., not necessary to protect a security or prevent it from being impaired. (See *Kendall* v. *Ernest Pestana, Inc., supra*, 40 Cal.3d 488 at p. 498; *Wellenkamp v. Bank of America, supra*, 21 Cal.3d 943 at p. 948; *Tucker v. Lassen Sav. & Loan Assn*. (1974) 12 Cal.3d 629, 636, 639 [116 Cal.Rptr. 633, 526 P.2d 1169].) "Reasonableness is determined by comparing the justification for a particular restraint on alienation with the quantum of restraint actually imposed by it. '[T]he greater the quantum of restraint that results from enforcement of a given clause, the greater must be the justification for that enforcement.'" (*Kendall v. Ernest Pestana, Inc., supra*, citing and quoting *Wellenkamp v. Bank of America, supra*, at p. 949.) Whether a condition is reasonable, i.e., necessary to protect a party's security in a given transaction, is a question of fact, one whose resolution must be based upon evidence directed to that issue. (See *La Sala v. American Sav. & Loan Assn*. (1971) 5 Cal.3d 864, 878-884 [97 Cal.Rptr. 849, 489 P.2d 1113] ["[W]e cannot rule upon the validity of a ... clause in the abstract. ... [i]t is not so much that clause itself as the ... application of it that will effect an invalid restraint on the alienation of property"]; *Cohen v. Ratinoff* (1983) 147 Cal.App.3d 321, 330.)

(10b) The contention defendants now make was never raised by them in the trial court. No evidence was introduced relative to the necessity of the provision to protect either Lamplighter's or Superior's security interests. [14] No finding on that issue was made by the trial court. In these circumstances ***1060** this court cannot resolve defendants' contention in the first instance. (See *La Sala* v. *American Sav. & Loan Assn., supra*, 5 Cal.3d 864 at pp. 878, 882-884.)

14 With its acquisition of a large block of REI stock, Superior exchanged the role of lessee for that of investor. Over and above its concern that REI not default on rent payments to Lamplighter, Superior would have an investor's abiding concern in REI's general financial stability and well-being. Any of the acts specified in the anti-receivership provision would be symptomatic of severe distress falling just short of total collapse and would thus signify a clear and present jeopardy of Superior's investment. The presence of the provision in the original lease undoubtedly reflected Lamplighter's similar concern to protect the security pledged by Superior. (See fn. 2, *ante*, p. 1041.)

(11b) Defendants' contention that the provision should be construed as applicable to tenants in actual possession of leased property is based upon *Flagg v. Andrew Williams Stores, Inc*. (1954) 127 Cal.App.2d 165 [273 P.2d 294]. The plaintiffs in *Flagg* were the assignees of a lease. Paragraph XVI of that lease read: "Neither this Lease nor any interest therein shall be assignable or otherwise transferable by operation of law or by voluntary assignment for the benefit of creditors, it being expressly understood and agreed that said inhibition against involuntary assignment includes and comprehends any and every assignment which might otherwise be effected or accomplished by bankruptcy or receivership, or attachment or execution, or other judicial process or proceedings. If Lessees should file a voluntary petition in bankruptcy, or if Lessees should be adjudicated bankrupt, or if a receiver is appointed of or for Lessees and such receiver is not discharged within sixty (60) days following such appointment, then and in any such event Lessor may, at its option, terminate this Lease by giving written notice of such termination to Lessees."

When the *Flagg* plaintiffs were assigned this lease in 1947, they executed a written agreement with the lessor which deleted this provision and substituted the following: "Lessees shall not assign this lease, nor any right hereunder, nor sublet the premises, nor any part thereof, without the prior written consent of lessor. No consent to any assignment of this lease, or any subletting of said premises shall constitute a waiver or discharge of the provisions of this paragraph, except as to the specific instance covered thereby; nor shall this lease nor any interest therein be assignable by action of law including bankruptcy, both involuntary and voluntary, and no Trustee, Sheriff, Creditors or purchaser at any judicial sale, or any officer of any court or receiver except if appointed as herein specifically provided shall acquire any right under this lease or to the possession or use of the premises or any part thereof without the prior written consent of lessor. Any violation of this term of this paragraph shall at the option of lessor be deemed a breach of this lease."

More than four years later, the assignor was adjudicated bankrupt. The lessor then sought to terminate the Flaggs' lease, whereupon the Flaggs brought an action for declaratory and injunctive relief. According to the *Flagg* opinion:

"The trial court concluded that none of the defendants had a right to terminate the lease by reason of said adjudication of bankruptcy and that ***1061** the lease has not been terminated but continues in full force and effect. We think these conclusions of the trial court entirely correct.

"When interpreting a forfeiture clause we start with the rule announced in section 1442 of the Civil Code: 'A condition involving a forfeiture must be strictly construed against the party for whose benefit it is created.' Of two or more possible constructions, 'the construction which avoids a forfeiture should be favored.' [Citation.] A forfeiture in a lease 'is not favored. It is enforced only where there is such a breach shown as it was the clear and manifest intention of the parties to provide for.' [Citation.] There is persuasive authority to the effect that a clause which forfeits or authorizes the lessor to forfeit the lessee's interest upon bankruptcy of the lessee should, unless its language plainly otherwise requires, be interpreted as referring to the bankruptcy of the tenant in possession; i.e., the bankruptcy of the original lessee if there has been no assignment of his interest in the leasse, or, if there has been an assignment, the bankruptcy of the assignee. [Citations.]

"Accordingly, when on December 2, 1947, MacArthur Properties, Inc., as lessor, approved the assignment to plaintiffs and joined with plaintiffs in deleting the text of paragraph XVI, substituting therefor a provision which for the first time forbade voluntary assignment or subletting without prior written consent of the lessor, coupled with a radical revision of the original involuntary transfer forfeiture clause, the parties to that agreement could, at most, have contemplated transfers (voluntary or involuntary) by the new lessees (plaintiffs herein) and their successors and assigns. It is not conceivable that they had in mind future transfers (voluntary or involuntary) by the original lessees.

"... We are not concerned with the 'liability,' if any, of the original lessees for default in payment of rent or other violation by plaintiffs of the obligations the latter have assumed under the lease. We are concerned with the consequences, if any, to plaintiffs of an adjudication in bankruptcy suffered by the original lessees, or by at least one of them, long after their divestiture of all their right, title and interest in the lease and long after the revision, by the lessor and the assignees, of the forfeiture clause itself. As we have seen, there are, under the circumstances of this case, no untoward consequences to plaintiffs flowing from the bankruptcy adjudication of the original lessees or of any of them." (*Flagg v. Andrew Williams Stores, Inc., supra*, 127 Cal.App.2d 165 at pp. 174-177.)

Although the situation in *Flagg* appears to be resonate with similarities, crucial differences preponderate. Here, the forfeiture provision, which ***1062** should be candidly recognized as such, was never modified but has instead survived the various transfers of the property in its pristine form. The extrinsic evidence recounted in part IV (B), *ante*, is pertinent for several salient points. First, Lamplighter was continuing to treat REI/Sun Fruit as responsible for the payment of rent. Second, Superior's attention for the tenant's fiscal health went beyond the rather abstract concern of a contingent guarantor of rent, to the more important role of an investor vigilant to prevent its investment from being imperiled. Third, unlike *Flagg*, it is more than "conceivable," and indeed is apparent, that the anti-receivership provision was intended to apply to future transfers. Fourth, and most importantly, this case does involve significant "untoward consequences" to the party seeking to enforce the forfeiture provision. Those consequences are the direct result of one of the precise eventualities specified in the provision. A sublessee's receivership is clearly within the anticipated ambit of the provision. This conclusion is reinforced by the provision (quoted *ante*) in the same instrument specifying that its terms shall "apply to and bind the heirs, successors, executors, administrators and assigns of all the parties."

We have no dispute with *Flagg* in the situation the court there confronted. The preceding paragraph, however, demonstrates that a series of fundamentally differing circumstances compels us to concur with the trial court that *Flagg* is distinguishable.

(B)

(13a) Defendants Rinn Motor and Rinns Sunnyvale alone are entitled to contend that the trial court "failed to exercise and abused its discretion in denying [their] petition [ ] for relief from forfeiture." (See fn. 9, *ante*, p. 1048.) This contention cannot prevail.

The petition for relief had a dual statutory basis. The first was Civil Code section 3275, which provides: "Whenever, by the terms of an obligation, a party thereto incurs a forfeiture, or a loss in the nature of a forfeiture, by reason of his failure to comply with its provisions, he may be relieved therefrom, upon making full compensation to the other party, except in case of a grossly negligent, willful, or fraudulent breach of duty."

The second was Code of Civil Procedure section 1179. It reads in pertinent part: "The Court may relieve a tenant against a forfeiture of a lease, and restore him to his former estate, in case of hardship, where application for such relief is made within thirty days after the forfeiture is declared by the judgment of the Court, ... The application may be made by a tenant or sub-tenant, or a mortgagee of the term, or any person interested in the ***1063** continuance of the term. It must be made upon petition, setting forth the facts upon which the relief is sought, and be verified by the applicant. Notice of the application, with a copy of the petition, must be served on the plaintiff in the judgment, who may appear and contest the application. In no case shall the application be granted except on condition that full payment of rent due, or full performance of conditions or covenants stipulated, so far as the same is practicable, be made."

(14a), (15a) We address certain preliminary points before reaching the merits. Superior argues that the petition was properly denied, and may be affirmed here, by reason of untimeliness and inadequate pleading. Superior claims that the petition was untimely because it was not made within 30 days of the default judgment against Sun Fruit as required by Code of Civil Procedure section 1179, and because there was no pleading and proof justifying application of Civil Code section 3275. We find neither claim a fatal disqualification.

(16) It is true that the forfeiture of Sun Fruit's estate declared in the default judgment would terminate by operation of law the derivative interests of Sun Fruit's sublessees. (See *Schafer v. Wholesale Frozen Foods, Inc*. (1966) 242 Cal.App.2d 451, 456 [51 Cal.Rptr. 459]; *Scott* v. *Mullins, supra*, 211 Cal.App.2d 51 at pp. 54-55; *Herman* v. *Campbell* (1948) 86 Cal.App.2d 762, 765-766 [195 P.2d 801].) (14b) Nevertheless, it was not until the final judgment was entered that Rinn Motor and Rinns Sunnyvale were unambiguously notified of the loss of their estates. Their petition was filed within 30 days thereafter, as required by Code of Civil Procedure section 1179. Superior's claim that the default judgment amounted to a final determination of the entitlements of Rinn Motor and Rinns Sunnyvale to possession is at odds with its admission, made in its brief in connection with another point, that its case was proven at trial independently of the default judgment. Superior identifies no authority that the 30-day period specified in section 1179 is jurisdictional, or that any prejudice to it accrued from the timing of the petition once the final judgment was entered. These factors—together with the deep distaste for forfeitures and the fact that any defect in light of the broader scope of Civil Code section 3275 (see *Pehau v. Stewart* (1952) 112 Cal.App.2d 90, 99 [245 P.2d 692]; *Hignell* v. *Gebala* (1949) 90 Cal.App.2d 61, 70 [202 P.2d 378]) would not denude the trial court of all power to entertain a petition for relief— suffice to require rejection of Superior's first argument.

(15b) Superior's second argument is equally unavailing. It is true that Civil Code section 3275 was not specifically invoked in defendants' answers, but they did pray for "such other relief as the Court deems appropriate." ***1064** The question of forfeiture figured prominently at trial, and the petition was based upon circumstances known to the trial court from the evidence produced at the trial. These circumstances combine to defeat Superior's claim that any failure of either pleading or proof was prejudicial. (See Code Civ. Proc., § 580; *Buxbom* v. *Smith* (1944) 23 Cal.2d 535, 542-543 [145 P.2d 305]; *Johnson* v. *Tago, Inc*. (1986) 188 Cal.App.3d 507, 513 [233 Cal.Rptr. 503]; *Selby* v. *Battley* (1957) 149 Cal.App.2d 659, 664-665 [309 P.2d 120]; *Miller* v. *Modern Motor Co*. (1930) 107 Cal.App. 38, 46 [290 P. 122].)

(17) Both of the statutes vest near plenary discretion in the trial court. With respect to an application for relief made pursuant to Code of Civil Procedure section 1179, the court in *Matthews* v. *Digges* (1920) 45 Cal.App. 561 [188 P. 283], stated: "The matter of granting or denying such an application is one which lies so largely in the discretion of the trial court that it would require a very clear showing of an abuse of such discretion to justify a reversal of the order made thereon." (*Id.* at p. 566; see also *Thrifty Oil Co. v. Batarse* (1985) 174 Cal.App.3d 770, 778 [220 Cal.Rptr. 285]; *Hignell v. Gebala, supra*, 90 Cal.App.2d 61 at p. 70; *Olympic Auditorium, Inc. v. Superior Court* (1927) 81 Cal.App. 283, 285 [253 P. 944].) Although no reported decision has expressly so held, there is no reason why the same standard should not also govern review of denials of applications for the same relief made pursuant to Civil Code section 3275. Equivalency of construction and effect are natural consequences from the statutes' relationship to the same subject. (See *Building Material & Construction Teamsters' Union v. Farrell* (1986) 41 Cal.3d 651, 665 [224 Cal.Rptr. 688, 715 P.2d 648]; *B. W. v. Board of Medical Quality Assurance* (1985) 169 Cal.App.3d 219, 231 [215 Cal.Rptr. 130].) "Where the reason is the same, the rule should be the same." (Civ. Code, § 3511.)

(13b) To be rejected at the outset is defendants' claim that the trial court failed to exercise its discretion. Defendants point to nothing in the record which substantiates that assertion, which is rebutted by the trial court's marked liberality in permitting defendants to present extensive written and oral argument on the question.

Turning to the merits, it may be conceded that defendants could have and did present an alluring argument for relief. As they see it, the only express obligations imposed on them were the payment of rent and such gross income percentage amounts as might become due. There is no question that these obligations were, as the special master noted, complied with scrupulously. Defendants have simply abided by the terms of all applicable agreements without giving the least cause for dissatisfaction to either Superior or Lamplighter. At no time have either Rinn Motor or Rinns Sunnyvale been ***1065** the subject of a receivership. They had, if anything, only the most nominal and attenuated connection to the Sun Fruit receiverships. They have been commanded to surrender their well-run and profitable business, and to pay substantial monetary awards, not because of any fault of their own, but solely because of a contractual breach by an entity they could not control.

Yet innocence is not the exclusive province of defendants. Superior appears to have been perfectly content to allow defendants to remain in possession had its investment in Sun Fruit not been endangered. Confronted with clear evidence that the consideration which had prompted it to part with possession of the property had been almost totally obliterated, Superior invoked the protection of a contractual provision intended for this very eventuality. Its conduct was commercially reasonable and contractually justifiable.

Without question, it is troubling to see a business operation terminated through no fault of the operators. Yet vicarious responsibility manifested in such a form inheres in the situation of possession based upon derivative title. (18) "A sublessee is bound by the terms and conditions of the original lease; its rights are dependent upon and subject to the sublessor's rights. ... [R]ights under the sublease stand or fall with those of the sublessor ...." (*Fifth & Broadway Partnership* v. *Kimny, Inc.* (1980) 102 Cal.App.3d 195, 201 [162 Cal.Rptr. 271, 7 A.L.R.4th 580].)

(13c) Had the trial court decided to relieve defendants from the forfeiture, that ruling could not be reversed as an abuse of discretion. Is the converse true? Much of the equities may favor defendants, yet this is not the only concern. Ousting defendants may work a hardship on them, but Superior has been disadvantaged by the virtual destruction of the security it took in exchange for surrendering the premises to Sun Fruit. Defendants have never offered to compensate Superior for the value of its REI shares in order that they could remain in possession. (See Civ. Code, § 3275; *Lincoln v. Narom Development Co.* (1970) 10 Cal.App.3d 619, 625 [89 Cal.Rptr. 128]; *Conforti* v. *Dunmeyer* (1962) 209 Cal.App.2d 41, 47 [25 Cal.Rptr. 504]; *Knight* v. *Black* (1912) 19 Cal.App. 518, 526 [126 P. 512].) Defendants are, in however attenuated a form, unavoidably connected to the party responsible for this dispute. "The trial court had the parties before it and was thus in the position—which this court is not— of determining where the equities between the parties lay. With such determination," which cannot be classed as a very clear showing that the trial court abused its discretion in denying relief from the forfeiture ordered in the final judgment, "we will not attempt to interfere." (*Matthews v. Digges, supra*, 45 Cal.App. 561 at p. 566.) This conclusion is fortified by our decision to reverse the monetary ***1066** awards against defendants. (See part VI, *post*.) The absence of those awards decisively tilts the balance in favor of finding no abuse in the trial court's refusal to relieve defendants from the forfeiture ordered by the judgment.

VI

(19a) With respect to the monetary awards made by the trial court, the parties' positions are predictable. Defendants contend that they go too far; Superior argues on its cross-appeal that they do not go far enough. An appreciation of the nature of unlawful detainer is necessary before attempting a resolution of these issues.

(20) Unlawful detainer is a statutory remedy whose primary feature is its expedited procedure for the recovery of possession of real property wrongfully withheld or "detained." (See *Knowles* v. *Robinson* (1963) 60 Cal.2d 620, 625 [36 Cal.Rptr. 33, 387 P.2d 833]; *Markham* v. *Fralick* (1934) 2 Cal.2d 221, 226-227 [39 P.2d 804].) To promote this end, both sides are deprived of forms of assistance that are otherwise available. "The rights and remedies afforded a landlord by the statutory provisions are given in lieu of his common law rights and remedies which included the right to enter and expel the tenant by force." (*Childs* v. *Eltinge* (1973) 29 Cal.App.3d 843, 853 [105 Cal.Rptr. 864]; accord *Deal v. Municipal Court* (1984) 157 Cal.App.3d 991, 995 [204 Cal.Rptr. 79]; *Custom Parking, Inc. v. Superior Court* (1982) 138 Cal.App.3d 90, 99 [187 Cal.Rptr. 674.) (21) On the other hand, "a general rule has emerged that, since the sole issue before the court is the right to possession, neither a counterclaim nor a cross-complaint, nor affirmative defenses, are [*sic*] admissible in an action in unlawful detainer, even though the alleged cause contained therein grows out of the subject matter involved in the original suit. [Citations.] The purpose of this rule is to prevent tenants who have violated the covenants of their leases from frustrating the ordinary and summary remedy provided by statute for the restitution of the premises." (*Union Oil Co. v. Chandler* (1970) 4 Cal.App.3d 716, 721 [84 Cal.Rptr. 756]; see *Green v. Superior Court* (1974) 10 Cal.3d 616, 632-634 [111 Cal.Rptr. 704, 517 P.2d 1168]; *Markham v. Fralick, supra*, at p. 227.) (22a) As incidents to this relief, the court may also award arrearages of rent or "damages" in an amount of the fair or reasonable rental value of the property for the period of time from the notice terminating the tenant's right of possession to judgment. (See Code Civ. Proc., § 1174, subd. (b);[15] ***1067** *Lehr v. Crosby* (1981) 123 Cal.App.3d Supp. 1, 8-9 [177 Cal.Rptr. 96]; Cal. Eviction Defense Manual (Cont.Ed.Bar 1971) § 15.8, pp. 144-145 and authorities cited.)

15 Code of Civil Procedure section 1174, subdivision (b) provides: "The jury or the court, if the proceedings be tried without a jury, shall also assess the damages occasioned to the plaintiff by any forcible entry, or by any forcible or unlawful detainer, alleged in the complaint and proved on the trial, and find the amount of any rent due, if the alleged detainer be after default in the payment of rent. If the defendant is found guilty of forcible entry, or forcible or unlawful detainer, and malice is shown, the plaintiff may be awarded either damages and rent found due or punitive damages in an amount which does not exceed three times the amount of damages and rent found due. The trier of fact shall determine whether damages and rent found due or punitive damages shall be awarded, and judgment shall be entered accordingly."

(23a) Defendants first complain that the awards were neither sought by Superior in its complaint nor supported by evidence introduced at trial. This contention has elements that are replicative of defendants' previously expressed arguments that Superior suffered no damage and was improperly granted a forfeiture. We discern no reason in this context to depart from our contrary conclusions on these points. (See parts IV and V, *ante*, pp. 1050-1066.) Divested of these elements, the pleading aspect of defendants' contention is without merit.

The trial court treated the question of profits as having been put in issue by Superior's causes of action for specific performance and declaratory relief. Although this is an extremely generous reading of the complaint,[16] the court's interpretation is not insupportable. (24) The court was in any event within its power at the conclusion of the contested trial to award a species of relief not expressly included in the complaint, Superior's request in its prayer for "such other and further relief as the court deems just" being sufficient for this purpose. (See Code Civ. Proc., § 580,; *Singleton v. Perry* (1955) 45 Cal.2d 489, 498-499 [289 P.2d 794]; *Johnson v. Tago, Inc., supra*, 188 Cal.App.3d 507 at p. 513; *Lawrence v. Shutt* (1969) 269 Cal.App.2d 749, 767 [75 Cal.Rptr. 533]; 4 Witkin, Cal. Procedure, *op. cit. supra*, Pleading, § 449, p. 492.) (25) The same is true for interest: "In a

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contested action interest may be awarded, if the plaintiff is entitled thereto, even though the complaint contains no prayer for interest." (*Sanders v. City of Los Angeles* (1970) 3 Cal.3d 252, 263 [90 Cal.Rptr. 169, 475 P.2d 201].)

16 From our reading of the complaint, there is no mention of profits in the specific performance, unlawful detainer, or declaratory relief causes of action pleaded by Superior. The only express references to the issue are in the cause of action for the appointment of a receiver to take possession of the property "and collect the rents, issues and profits thereof" and in the prayer for this form of relief (which was denied by the trial court before the trial).

(19b), (23b) Defendants' contention displays a sublime disregard for reality. At the time it drafted and filed its complaint, Superior was obviously and reasonably anticipating that the unlawful detainer proceeding would ***1068** fulfill its intended function of providing an expeditious mechanism for determining entitlement to possession. This expectation was frustrated, through no fault of Superior, solely because of the district court's extended stay of the proceedings. Defendants remained in possession throughout this enforced hiatus, during which their obligation to pay rent (or reasonable rental value) continued by operation of law. (See *Ellingson v. Walsh, O'Connor & Barneson* (1940) 15 Cal.2d 673, 675 [104 P.2d 507]; *Samuels v. Ottinger, supra*, 169 Cal. 209 at p. 211; *Turell v. Basic Investments, Inc*. (1974) 36 Cal.App.3d 618, 620 [111 Cal.Rptr. 794]; *Samuels* v. *Singer* (1934) 1 Cal.App.2d 545, 553-554 [36 P.2d 1098]; cf. *Ross* v. *City of Long Beach* (1944) 24 Cal.2d 258, 263 [148 P.2d 649].) Confronted with this substantial lapse of time, and even in the absence of request by Superior to amend its complaint, it was proper for the trial court to update the complaint and award damages for the rental value of the premises accruing during the years in which the stay was in effect. (*Nolan* v. *Hentig* (1903) 138 Cal. 281, 283 [71 P. 440]; *Keyes v. Moy Jin Mun* (1902) 136 Cal. 129, 130-131 [68 P. 476]; Mason v. *Wolff* (1870) 40 Cal. 246, 250; *Flournoy* v. *Everett* (1921) 51 Cal.App. 406, 408; *Holland v. Eastern Outfitting Co*. (1911) 16 Cal.App. 441, 442-443 [117 P. 562].)

(26a) In its amended statement of decision the trial court identified the basis for its award: "Under equitable principles, plaintiff is entitled to the after tax net operating profits received by ... defendants in possession of the subject premises from November 24, 1975 to the date possession ... is in fact delivered to plaintiff as compensation for the loss incurred because of the failure to receive possession of said premises." (27) Defendants rather perfunctorily assert in effect that the court erred in calling equity into play. [17] This is untenable. The court had the undoubted power to take note of such considerations. "Equitable principles apply particularly where a forfeiture is sought in an action for unlawful detainer." (*Roth v. Morton's Chefs Services, Inc*. (1985) 173 Cal.App.3d 380, 387 [218 Cal.Rptr. 684]; accord *Schweiger* v. *Superior Court* (1970) 3 Cal.3d 507, 514 [90 Cal.Rptr. 729, 476 P.2d 97]; *Union Oil Co.* v. *Chandler, supra*, 4 Cal.App.3d 716 at p. 722.) The California Supreme Court long ago recognized the broad scope of equity in unlawful detainer actions: "'If such an equitable power is in a court in cases of this class, of which we have no doubt, no reason is apparent why such equitable power may not be extended into a full examination of all the equities involved, to the end that exact justice may be done.'" (*Schubert v. Lowe* (1924) 193 Cal. 291, 295 [223 P. 550], citing and quoting *Gray* v. *Maier & Zobelein Brewery* (1906) 2 Cal.App. 653, 658 [84 P. 280].) ***1069** Accordingly, equity was legitimately employed by the trial court in fashioning appropriate relief. Whether the relief actually awarded can be upheld is, however, an entirely different matter.

17 Most of defendants' claim is devoted to arguing that the equities favored them and that right to possession should not have been forfeited. This claim was dealt with in part V, *ante*.

(28) This court recently had occasion to state: "A trial court's equity powers are formidable ... but must be exercised pursuant to the principle that equity follows the law." (*Johnson v. Tago, Inc., supra*, 188 Cal.App.3d 507 at p. 518.) (19c) The heart of defendants' remaining contentions is that the trial court's award of "after tax net operating profits" exceeded the legally permissible recovery in several respects. Specifically, they urge that the trial court erred in (1) awarding net profits as the equivalent of the property's fair rental value; (2) enhancing the award with prejudgment interest; and, (3) extending the award of net profits beyond entry of the judgment until the date possession was surrendered. Each of these claims is well taken.

(22b) The measure of damages to which a landlord is entitled for an unlawful detainer is the reasonable rental value of the property. (See *Stockton Morris Plan Co. v. Carpenter, supra*, 18 Cal.App.2d 205 at p. 210; *Samuels v. Singer, supra*, 1 Cal.App.2d 545 at p. 554; *Lehr v. Crosby, supra*, 123 Cal.App.3d Supp. 1 at p. 9; *Glouberman v. Coffey* (1955) 138 Cal.App.2d Supp. 906,

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907-908 [292 P.2d 681]; cf. Civ. Code, § 3334.) “Ordinarily, it might be said that the agreed rent is evidence of the rental value, but ... such rental value may be greater or less than the rent provided for in the lease.” (*Harris v. Bissell* (1921) 54 Cal.App. 307, 312-313 [202 P. 453]; accord *Lehr v. Crosby, supra*; see *Karp v. Margolis* (1958) 159 Cal.App.2d 69, 75 [323 P.2d 557]; *D'Amico* v. *Riedel* (1949) 95 Cal.App.2d 6, 9 [212 P.2d 52]; *Haig* v. *Hogan* (1947) 82 Cal.App.2d 876, 878 [187 P.2d 426].)

(19d), (26b) No evidence was introduced concerning the reasonable rental value of the property. Upon declaring the forfeiture of defendants' leasehold interests, the trial court appears to have thereafter proceeded on the premise that all “rents, issues and profits” were the measure of the property's reasonable rental value. This was error.

In *People v. Gustafson* (1942) 53 Cal.App.2d 230 [127 P.2d 627], the court construed former Political Code section 3773, which gave the State Controller the power “to lease and rent and to receive and collect all rents, issues and profits arising in any manner from property” which had been ***1070** deeded to the state for nonpayment of taxes. After noting that “the phrase 'rents, issues and profits' has a well understood meaning and refers to rents collected by the party in possession, and/or the net profits accruing to him from said property, and *not to the rental value or the value of use and occupation*,” the court concluded that “the right to 'receive and collect all rents, issues and profits' conferred by section 3773 of the Political Code is clearly distinguishable from a right to exact payment for use and occupancy, ...” (*Id.* at pp. 239-240, italics added.) Although *Gustafson* is not controlling, its distinction between reasonable rental value and “rents, issues and profits” is absolutely clear and directly relevant for present purposes. Profits are not synonymous with rental value.

(29a) Superior stoutly maintains that the judgment it holds is not for unlawful detainer but for restitution incident to specific performance of its contractual right of reentry. At this point Superior may well wish that this were so. The incontestable reality is otherwise. The caption of Superior's complaint identified it as being “for unlawful detainer.” After reciting pertinent factual circumstances Superior alleged that “the foregoing constitutes unlawful detainer within the terms and meaning of ... Code of Civil Procedure Section 1161.” Attached as an exhibit to Superior's complaint was the “Three Day Notice To Quit” sent to Sun Fruit. The text of that notice expressly stated that the notice was “[p]ursuant to Code of Civil Procedure Section 1161.”

(30) “[F]or many years the California courts have adhered to the principle that the unlawful detainer statute is strictly construed and that relief not authorized by that statute may not be given due to the summary nature of the proceedings.” (*Castle Park No. 5* v. *Katherine* (1979) 91 Cal.App.3d Supp. 6, 9 [154 Cal.Rptr. 498]; accord *Saberi v. Bakhtiari* (1985) 169 Cal.App.3d 509, 515 [215 Cal.Rptr. 359]; see *Chase v. Peters* (1918) 37 Cal.App. 358, 360 [174 P. 116] [“The mode and measure of the plaintiff's recovery are ... limited”].) Collateral matters are excluded (see *E. S. Bills, Inc. v. Tzucanow* (1985) 38 Cal.3d 824, 830 [215 Cal.Rptr. 278, 700 P.2d 1280]), particularly those seeking damages for breaches of lease provisions. “It is well settled that damages allowed in unlawful detainer proceedings are only those which *result from* the unlawful detention and accrue during that time. [Citation.] Although a lessee guilty of unlawful detention may have also breached the terms of the lease contract, damages resulting therefrom are not necessarily damages resulting from the unlawful detention. As such, [a lessor] is precluded from litigating a cause of action for these breaches in unlawful detainer proceedings.” (*Vasey* v. *California Dance Co*. (1977) 70 Cal.App.3d 742, 748 [139 Cal.Rptr. 72], italics in original; see ***1071** *Roberts v. Redlich* (1952) 111 Cal.App.2d 566, 569 [244 P.2d 933].) “An unlawful detainer action is not based upon contract [citations]; it is a statutory proceeding and is governed solely by the provisions of the statute creating it.” (*Fifth & Broadway Partnership v. Kimny, Inc., supra*, 102 Cal.App.3d 195 at p. 200.) Those statutory requirements “must be followed strictly, otherwise a landlord's remedy is an ordinary suit for breach of contract with all the delays that remedy normally involves and without restitution of the demised property.” (*Cal-American Income Property Fund IV v. Ho* (1984) 161 Cal.App.3d 583, 585 [207 Cal.Rptr. 532].) The same is true for specific performance of the provisions of a lease. (See *Mobil Oil Corp. v. Handley* (1978) 76 Cal.App.3d 956, 965-967 [143 Cal.Rptr. 321], text and fn. 1.)

(29b) That the circumstances of this case are highly unusual, if not unique, may be conceded. It is true that defendants had notice that their leasehold interests were imperiled once the trial court filed its memorandum of decision on March 1, 1977. The federal receiver was appointed a mere two days later. This severely restricted defendants' freedom of maneuver: operation of the premises was a valuable asset entrusted to the receiver, whose subsequent actions demonstrate to a near-certainty that he would not consent to its being relinquished. Defendants were in effect compelled to remain in possession. Nevertheless, defendants continued to pay rent. The long freeze imposed by the district court obviously entailed a complete nullification of the summary advantages of the unlawful detainer remedy. No action, however, was taken by Superior to modify its litigation strategy accordingly. Superior's complaint was never amended, nor was it superseded by a supplementary pleading. There is no evidence that Superior commenced another action, whether for mesne profits, constructive trust, or otherwise, to obtain restitution of the funds defendants had collected while still in possession. In short, Superior sought unlawful detainer and nothing but unlawful detainer. Superior's response to the prolonged delay was to cover its inertia by formulating a position totally at odds with the goals and purposes of unlawful detainer. Superior was more than happy to claim the benefits of that statutory remedy, yet it now attempts to avoid its corresponding limitations. Superior's rights are delimited by the detainer it sought and obtained.

(19e) For the reasons previously discussed, the trial court correctly concluded that Superior was entitled to regain possession of the property. Superior was also entitled to receive a reasonable rental value for the property during the period that its right to possession was denied. It was not entitled to automatic awards of the “rents, issues and profits” collected by ***1072** defendant because, as we have seen, that criterion is not synonymous with reasonable rental value. (See *People* v. *Gustafson, supra*, 53 Cal.App.2d 230 at p. 239.) Net profits may be an appropriate measure of damages in a breach of contract action (see *Mayes v. Sturdy Northern Sales, Inc*. (1979) 91 Cal.App.3d 69, 84 [154 Cal.Rptr. 43]), but it was error to import this standard into an unlawful detainer action and thereby supplant the standard of reasonable rental value. The error in making the awards granted to Superior cannot be justified by reference to equitable principles (see *Johnson v. Tago, Inc., supra*, 188 Cal.App.3d 507 at p. 518; *Balassy* v. *Superior Court* (1986) 181 Cal.App.3d 1148, 1153 [226 Cal.Rptr. 817]) and must be considered prejudicial. (Cal. Const., art. VI, § 13; Code Civ. Proc., § 475; *Chase v. Peters, supra*, 37 Cal.App. 358 at pp. 362-363.) (31) This error does not require a reversal of the entire judgment, only those portions of the judgment specifying the awards to be recovered by Superior. This limited reversal will be accompanied with a remand with directions for the trial court to determine and fix the reasonable rental value of the premises during which Superior was entitled to possession, taking into account the monthly rent payments already made by defendants. [18] We now address Superior's remaining contentions for the trial court's guidance on the remand.

18 In *Harris v. Bissell, supra*, 54 Cal.App. 307, the defendant lessee breached a lease by planting a crop of grain on land to be used for pasturing sheep. A judgment in unlawful detainer for the plaintiff lessor awarded him damages consisting of the rent specified by the lease *and* the net value of the crop. This was held to be excessive, because “'defendant would be paying rent to the plaintiff for the privilege of raising a crop for plaintiff.'” (*Id*. at p. 312.) We commend this holding to the trial court for its consideration on the remand.

(19f) With respect to the matter of prejudgment interest, the trial court's award had a dual basis. The court concluded that Superior “is entitled to prejudgment interest in this action as a matter of right” pursuant to Civil Code section 3287, subdivision (a), and that “[a]lternatively, a discretionary award ... is appropriate” according to subdivision (b) of that statute. [19] Defendants contend that neither of these purported grounds supports the award. (32), (19g) As regards subdivision (a), defendants are correct. “This section does not authorize prejudgment interest as a matter of law where the amount of damages depends upon a judicial ***1073** determination based upon conflicting evidence.” (*Polster, Inc. v. Swing* (1985) 164 Cal.App.3d 427, 434 [210 Cal.Rptr. 567]; accord *Iverson v. Spang Industries, Inc*. (1975) 45 Cal.App.3d 303, 311 [119 Cal.Rptr. 399].) The amount of the reasonable rental value to be determined by the trial court falls within this rule. (*Stockton Morris Plan Co. v. Carpenter, supra*, 18 Cal.App.2d 205 at pp. 213-214; *Samuels v. Singer, supra*, 1 Cal.App.2d 545 at pp. 554-555; cf. *Sullivan v. Wellborn* (1948) 32 Cal.2d 214, 220 [195 P.2d 787]; *Karp v. Margolis, supra*, 159 Cal.App.2d 69 at pp. 75-76; *Rose v. Hecht* (1949) 94 Cal.App.2d 662, 665-666 [211 P.2d 347].) (33) As regards subdivision (b), that provision applies only to “damages based upon a cause of action in contract ....” Defendant's obligation to pay Superior reasonable rental value is not based upon a contract, but upon the obligation imposed by law to compensate for occupancy of the premises. (See *Ellingson v. Walsh, O'Connor & Barneson, supra*, 15 Cal.2d 673 at p. 675; *Samuels v. Ottinger, supra*, 169 Cal. 209 at p. 211; *Fifth & Broadway Partnership v. Kimny, Inc., supra*, 102 Cal.App.3d 195 at p. 200.) Prejudgment interest is thus not allowed by either subdivision of Civil Code section 3287.

19 Civil Code section 3287 provides in pertinent part: “(a) Every person who is entitled to recover damages certain, or capable of being made certain by calculation, and the right to recover which is vested in him upon a particular day, is entitled also to recover interest thereon from that day, except during such time as the debtor is prevented by law, or by

> the act of the creditor from paying the debt. This section is applicable to recovery of damages and interest from any such debtor, ...
>
> "(b) Every person who is entitled under any judgment to receive damages based upon a cause of action in contract where the claim was unliquidated, may also recover interest thereon from a date prior to the entry of judgment as the court may, in its discretion, fix, but in no event earlier than the date the action was filed."

(19h) Also meritorious is defendants' argument that the trial court erred by ordering them to pay "future damages" beyond the date of the judgment until such time as they return possession of the premises to Superior. Such recovery is not permitted in unlawful detainer. (*Cavanaugh v. High* (1960) 182 Cal.App.2d 714, 722-723 [6 Cal.Rptr. 525]; *Roberts v. Redlich, supra*, 111 Cal.App.2d 566 at pp. 569-570; *Pfitzer v. Candeias* (1921) 53 Cal.App.737, 741 [200 P. 839]; *Lehr v. Crosby, supra*, 123 Cal.App.3d Supp. 1 at p. 10.)

A final contention by defendants concerns a computational error in fixing the awards. In light of our decision to reverse and remand the portions of the judgments affecting the awards, this contention becomes moot. The same is true for Superior's cross-appeal.

Those portions of the judgment providing that plaintiff Superior shall recover from defendants Rinn Motor, Rinns Sunnyvale, and Walter Pabst "after tax net operating profits received by said defendants from the subject premises from November 24, 1975 to June 1, 1983, ... and continuing to the date on which possession of said premises is in fact delivered to plaintiff, together with interest thereon at the rate of 10 per cent per annum from the dates received by said defendants until said sums are paid to plaintiff" are reversed. The cause is remanded to the trial court with directions to determine the reasonable rental value of the premises for that period. The ***1074** judgment is affirmed in all other respects. The order denying relief from forfeiture is also affirmed. The purported appeal from that order by defendant Walter Pabst is dismissed. The parties shall bear their respective costs on appeal.

Channell, J., and Sabraw, J., concurred.

A petition for a rehearing was denied November 25, 1987, and the petition of plaintiff and appellant for review by the Supreme Court was denied January 20, 1988. ***1075**

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EXHIBIT AC-120

KeyCite Yellow Flag - Negative Treatment
Distinguished by Western World Insurance Company v. Professional Collection Consultants, C.D.Cal., March 24, 2016

127 Cal.App.4th 457
Court of Appeal, Second District, Division 5, California.

James E. MITCHELL, Individually and as Trustee of the Mitchell Family Trust, Plaintiff and Appellant,
v.
UNITED NATIONAL INSURANCE COMPANY, Defendant and Respondent.

No. B170364.
|
March 8, 2005.

Synopsis
Background: Insured filed action against his insurer after his fire insurance policy was rescinded for misrepresentations on application. The Superior Court of Los Angeles County, No. BC279342, Elizabeth A Grimes, J., granted summary judgment for insurer. Insured appealed.

Holdings: The Court of Appeal, Mosk, J., held that

[1] misrepresentations did not have to be intentional, and

[2] that the misrepresentations were material.

Affirmed

West Headnotes (17)

[1] **Judgment** Nature of summary judgment

The purpose of the law of summary judgment is to provide courts with a mechanism to cut through the parties' pleadings in order to determine whether, despite their allegations, trial is in fact necessary to resolve their dispute. West's Ann.Cal.C.C.P. § 437c.

5 Cases that cite this headnote

[2] **Judgment** Presumptions and burden of proof

On motion for summary judgment, once defendant has shown there is no merit to a cause of action, the burden shifts to the plaintiff to show that a triable issue of one or more material facts exists as to that cause of action or as to a defense to the cause of action; if the plaintiff does not make such a showing, summary judgment in favor of the defendant is appropriate. West's Ann.Cal.C.C.P. § 437c(p)(2).

6 Cases that cite this headnote

[3] **Judgment** Weight and sufficiency

In order to obtain a summary judgment, all that the defendant need do is to show that the plaintiff cannot establish at least one element of the cause of action, and defendant need not himself conclusively negate any such element. West's Ann.Cal.C.C.P. § 437c(p)(2).

1 Cases that cite this headnote

[4] **Appeal and Error** Plenary, free, or independent review

Appeal and Error Review using standard applied below

On appeal from a summary judgment, an appellate court makes an independent assessment of the correctness of the trial court's ruling, applying the same legal standard as the trial court in determining whether there are any genuine issues of material fact or whether the moving party is entitled to judgment as a matter of law. West's Ann.Cal.C.C.P. § 437c.

9 Cases that cite this headnote

[5] **Appeal and Error** Review of lower court's proceedings concerning question

Court of Appeal reviews the trial court's evidentiary rulings made in connection with a summary judgment motion for abuse of discretion. West's Ann.Cal.C.C.P. § 437c.

23 Cases that cite this headnote

[6] **Insurance** Property or Title Insurance

To void a fire insurance policy based on the insured's violation of the standard form policy's fraud and concealment provision, the false statement must have been knowingly and willfully made with the intent, express or implied, of deceiving the insurer; the materiality of the statement will be determined by the objective standard of its effect upon a reasonable insurer. West's Ann.Cal.Ins.Code §§ 2070, 2071.

7 Cases that cite this headnote

[7] **Appeal and Error** Nature or Subject-Matter of Issues or Questions

An appellate court has discretion to consider an issue raised for the first time on appeal if it presents a pure question of law on undisputed evidence, such as the applicability of a statute.

2 Cases that cite this headnote

[8] **Administrative Law and Procedure** Plain, literal, or clear meaning; ambiguity or silence

Statutes Extrinsic Aids to Construction

When statutory language is susceptible of more than one reasonable interpretation, courts look to a variety of extrinsic aids, including the ostensible objects to be achieved, the evils to be remedied, the legislative history, public policy, contemporaneous administrative construction, and the statutory scheme of which the statute is a part.

[9] **Insurance** Standardized policies

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The requirement in the Insurance Code that a fire insurance policy be on a standard form does not preclude the application of regulatory statutes. West's Ann.Cal.Ins.Code § 2070.

2 Cases that cite this headnote

[10] **Statutes** Construction of Revised Statutes and Codes

Different statutes within the same code should be interpreted to be consistent.

[11] **Insurance** Policies considered as contracts

Despite the significant statutory prescription of fire insurance policy terms, insurance contracts are treated as voluntary contracts rather than legislative enactments, since they derive their force and efficacy from the consent of the parties. West's Ann.Cal.Ins.Code § 2070.

3 Cases that cite this headnote

[12] **Insurance** Property or Title Insurance

The fraud and concealment provision in the standard fire insurance policy, as prescribed by the Insurance Code, and requiring the insurer to prove a misrepresentation was willful in order to void the policy, does not affect the application of regulatory provisions allowing the insurer to rescind the policy in the event of a negligent or unintentional misrepresentation. West's Ann.Cal.Ins.Code §§ 331, 359, 2071.

See Croskey et al., Cal. Practice Guide: Insurance Litigation (The Rutter Group 2003) ¶ 5:169 (CAINSL Ch. 5-F).

27 Cases that cite this headnote

[13] **Insurance** Materiality

The materiality of a misrepresentation in an insurance application is determined by its probable and reasonable effect upon the insurer, which is a subjective test, the critical question being the effect truthful answers would have had on the insurer, not on some average reasonable insurer; the misrepresentation need not relate to the loss ultimately claimed by the insured. West's Ann.Cal.Ins.Code § 334.

39 Cases that cite this headnote

[14] **Insurance** Property or Title Insurance

Questions on a fire insurance application were material, and insured's misrepresentations in his answers justified insurer's rescission of policy; questions concerned the ownership, size and condition of the building, the nature of the business to be conducted, its payroll and receipts, and the existence of insurance under an insurer of last resort plan, and were factors impacting either the underwriting decision or the amount of the premium and coverage. West's Ann.Cal.Ins.Code §§ 331, 359.

33 Cases that cite this headnote

[15] **Insurance** Duty to investigate

Underwriter had no obligation to verify the accuracy of the representations by insured in application for fire insurance.

9 Cases that cite this headnote

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[16] **Insurance** In general; effect

An insurer does not waive its right to rescind a policy on the ground of false representations if it was unaware of the falsity of those representations.

9 Cases that cite this headnote

[17] **Judgment** Matters of fact or conclusions

In action by insured against fire insurer, who rescinded policy following loss for insurer's misrepresentations on his application, declaration opposing summary judgment, stating opinions of insured's expert concerning materiality of misrepresentations, was inadmissible as being based on speculation about what insurer's underwriter knew or should have known, considered, or concluded.

See 1 Witkin, Cal. Evidence (4th ed. 2000) Opinion Evidence, § 30.

17 Cases that cite this headnote

Attorneys and Law Firms

****629** Law Office of Mann & Elias; Imad Y. Elias, Beverly Hills, for Plaintiff and Appellant.

Nielsen, Haley & Abbott LLP; James C. Nielsen, San Francisco, August L. Lohuaru, Los Angeles, for Defendant and Respondent.

Opinion

MOSK, J.

***463** We hold that an insurer may, under Insurance Code sections 331 and 359, rescind a fire insurance policy based on an insured's negligent or unintentional misrepresentation of a material fact in an insurance application, notwithstanding the *willful* misrepresentation clause included in the required standard form fire insurance policy (Ins. Code §§ 2070 and 2071). Because there was undisputed evidence that the insurer relied upon the misstatements of material facts in the insured's application for insurance, we affirm the summary judgment.

BACKGROUND

Plaintiff and appellant James E. Mitchell, individually and as Trustee of the Mitchell Family Trust (Mitchell), appeals the trial court's entry of summary judgment in favor of defendant and respondent United National Insurance Company (United National) in Mitchell's action for breach of contract, breach of the implied covenant of good faith and fair dealing, and declaratory relief. Mitchell individually was the named insured under an insurance policy issued by United National that provided coverage for a commercial building owned by the Mitchell Family Trust (the building).

During the policy period, the building was destroyed by arson. The arsonist, an acquaintance of Mitchell's, perished in the fire. In the ensuing investigation, United National discovered several purported misrepresentations in Mitchell's application for insurance, rescinded the policy, and offered to return Mitchell's premium. Mitchell refused to accept the return of his ****630** premium and filed this action. United National moved for summary judgment on two alternative grounds: material misrepresentations in the application for ***464** insurance gave United National the right, under Insurance Code sections 331 and 359, to rescind the policy; and the policy's dishonest act exclusion barred coverage because Mitchell's representative, to whom Mitchell had entrusted the property, intentionally set fire to the property. The trial court granted summary judgment on both grounds.

Mitchell purchased the building in February 2000 in the name of his trust. On April 11, 2000, Mitchell's brokers submitted an application for insurance to Debra Messina of Excess & Surplus Lines Insurance Brokers, Inc., an authorized underwriter for United National. The application stated that (1) the property to be insured consisted of a 3,420-square-foot commercial building; (2) the building was to be used by Mitchell as a "video production studio and offices"; (3) the business to be conducted in the building had $20,000 in payroll and generated $300,000 in receipts; (4) there was no existing insurance on the building; (5) the building had no uncorrected fire code violations; (6) the building had a burglar alarm; and (7) Records & Records & Filmworks, Inc. (later changed to James E. Mitchell) was the purchaser of the building.

In fact, (1) the building was less than 2,000 square feet; (2) the business conducted in the building had no officers or employees, was used only to film a music video for two days in May or June of 2000, and was leased to a tenant who operated a garment business; (3) the business in the building generated approximately $6,500 in receipts from February 2000 to the time of the fire; (4) the building was insured by the California FAIR Plan, an insurer of "last resort"; (5) the building was subject to a City of Los Angeles abatement order stating that the building could not be occupied without a clearance or repaired without a permit and contained such deficiencies as being open to unauthorized entry, littered with combustible debris, excessive dry weeds or vegetation, broken windows, damaged or missing doors, damaged exterior wall covering, damaged interior wall and ceiling covering, and deteriorated flooring (and no permit had been obtained for corrective work on these deficiencies); (6) the building had no burglar alarm; and (7) the building was owned by the Mitchell Family Trust.

In July 2000, Mitchell rented the property to a tenant who operated a garment manufacturing business. In August 2000, a city inspector cited the tenant for failure to obtain a certificate of occupancy, and Mitchell was forced to release the tenant from the lease and return most of the rent payments. The property was vacant on November 22, 2000, the date of the fire.

According to Mitchell, before the property was damaged by the fire, he met Carl Robinson, who represented himself as a business consultant with a prospective buyer for the property, and gave Robinson the keys to the ***465** property for the purpose of showing it to the prospective buyer. On November 22, 2000, while Mitchell was in Chicago, Robinson set fire to the building and was killed in the ensuing blaze.

Mitchell filed a claim for losses under the policy. United National denied the claim on the ground that it had rescinded the policy based on material misrepresentations in Mitchell's application for insurance. Mitchell filed this action against United National and the brokers who assisted Mitchell in preparing the application ****631** for insurance.[1] In his first amended complaint, Mitchell admitted that the application for insurance submitted to United National "contained inaccuracies" that caused United National to rescind the policy, but claimed that those inaccuracies were not material and were solely the fault of his brokers.

1 The action against the brokers was dismissed.

In its motion for summary judgment, United National argued that Mitchell had made material misrepresentations in his application for insurance and that United National was entitled, under Insurance Code sections 331 and 359, to rescind the policy. United National maintained that the materiality of the representations was determined under a subjective standard from the insurance underwriter's perspective, and not upon an objective "reasonable insurer" standard. United National's motion was supported primarily by the declaration of its underwriter, Debra Messina, who stated that she issued an insurance policy for the building based on the representations contained in Mitchell's application for insurance. Ms. Messina further stated in her declaration that the size and condition of the building, as well as its proposed use as an owner-occupied business, were important factors in rating the risk to be insured against and in deciding whether or not to issue an insurance policy. She declared that had she known that there were uncorrected fire code violations, that the building was substantially smaller than had been represented in the insurance application, and that the property was not to be used as studios and offices for Mitchell's own music video

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company, she either would have underwritten the policy differently or declined to underwrite it altogether. She also stated that the existence of prior insurance coverage under the California FAIR Plan was an important underwriting consideration because such coverage indicated past problems in acquiring insurance. She explained that the California FAIR Plan is an insurer of "last resort," affording coverage to property owners who have been rejected by traditional insurance carriers and who are thus unable to obtain insurance in the normal market. She stated that she would have undertaken further investigation had she known the property was insured under the California FAIR Plan.

Mitchell's opposition to United National's motion was supported by his own declaration and the declaration of an expert, Kelly Rossi, an insurance ***466** broker. In his declaration, Mitchell stated that he intended to use the property to make music videos and that he showed the property on several occasions to recording artists for this purpose, but that he was only able to rent the property for two to three days for one music video. Mitchell further stated that he had no knowledge of any uncorrected code violations with respect to the property or that the proper permits had not been obtained for repairs and improvements made to the property.

Ms. Rossi stated in her declaration that the purported misrepresentations in Mitchell's application for insurance "were not material to Messina in her underwriting of this policy." With regard to coverage under the California FAIR Plan policy, Ms. Rossi opined that "Messina did not believe this matter to be material" because the representation that there was no insurance on the property "is as big or even bigger 'red flag' " than coverage under the FAIR Plan. Ms. Rossi also said that as to the changes in the use of the building and absence of a central alarm system, Ms. Messina should have conducted further inquiry. ****632** Mitchell argued that the failure to do so constituted a waiver of these issues.

United National filed evidentiary objections to Mitchell's declaration, arguing that the declaration contradicted Mitchell's prior sworn testimony. United National objected to Ms. Rossi's declaration as improperly based on speculation and conjecture. The trial court sustained in part the objections to Mitchell's declaration and all of the objections to Ms. Rossi's declaration, noting that Ms. Rossi "purported to state as fact that which she had no competence to declare. She doesn't know what was in Ms. Messina's mind, and she is incompetent to testify to what was subjectively material to Ms. Messina."

The trial court granted summary judgment in United National's favor, finding "as a matter of law on the undisputed facts that the information sought by United's underwriter and denied to it by plaintiff's false answers and omissions was material to United's decision to provide insurance coverage. The uncontradicted evidence of United's underwriter confirms the importance that United attached to the information. Under these circumstances, the materiality of plaintiff's concealment is established as a matter of law." The trial court further concluded, "in addition, coverage is excluded because the loss was the consequence of the dishonest act (arson) of plaintiff's authorized representative to whom he entrusted the property for the purpose of showing it to a potential buyer (Robinson)."

*467 DISCUSSION

A. Standard of Review

[1] Summary judgment is granted when a moving party establishes the right to the entry of judgment as a matter of law. (Code Civ. Proc., § 437c, subd. (c).) "The purpose of the law of summary judgment is to provide courts with a mechanism to cut through the parties' pleadings in order to determine whether, despite their allegations, trial is in fact necessary to resolve their dispute." (*Aguilar v. Atlantic Richfield Co.* (2001) 25 Cal.4th 826, 843, 107 Cal.Rptr.2d 841, 24 P.3d 493.)

[2] **[3]** A defendant moving for summary judgment meets its burden of showing there is no merit to a cause of action if that party has shown that one or more elements of the cause of action cannot be established or that there is a complete defense to that cause of action. (Code Civ. Proc., § 437c, subd. (p)(2).) Once the defendant has made such a showing, the burden shifts to the plaintiff to show that a triable issue of one or more material facts exists as to that cause of action or as to a defense to the cause of action. (*Aguilar v. Atlantic Richfield Co., supra,* 25 Cal.4th 826, 849, 107 Cal.Rptr.2d 841, 24 P.3d 493.) If the plaintiff does not make such a showing, summary judgment in favor of the defendant is appropriate. In order to obtain a summary judgment, "all that the defendant need do is to show that the plaintiff cannot establish at least one element of the cause of action .... [T]he defendant need not himself conclusively negate any such element ...." (*Id.* at p. 853, 107 Cal.Rptr.2d 841, 24 P.3d 493.)

[4] **[5]** On appeal from a summary judgment, an appellate court makes "an independent assessment of the correctness of the trial court's ruling, applying the same legal standard as the trial court in determining whether there are any genuine issues of material fact or whether the moving party is entitled to judgment as a matter of law." (*Iverson v. Muroc Unified School Dist.* (1995) 32 Cal.App.4th 218, 222, 38 Cal.Rptr.2d 35.) We review the trial court's evidentiary rulings made in connection with a summary judgment motion for abuse of discretion. (*Walker v.* ****633** *Countrywide Home Loans, Inc.* (2002) 98 Cal.App.4th 1158, 1169, 121 Cal.Rptr.2d 79.)

B. Rescission Based on Misrepresentation

1. Insurance Code Sections 331 and 359

United National based its right to rescind the policy on Insurance Code sections 331 and 359. Insurance Code section 331 states: "Concealment, whether intentional or unintentional, entitles the injured party to rescind ***468** insurance." Insurance Code section 359 similarly provides: "If a representation is false in a material point, whether affirmative or promissory, the injured party is entitled to rescind the contract from the time the representation becomes false."

Insurance Code sections 331 and 359 are part of a larger statutory framework that imposes "heavy burdens of disclosure" "upon both parties to a contract of insurance, and any material misrepresentation or the failure, whether intentional or unintentional, to provide requested information permits rescission of the policy by the injured party." (*Imperial Casualty & Indemnity Co. v. Sogomonian* (1988) 198 Cal.App.3d 169, 179–180, 243 Cal.Rptr. 639 (*Imperial*).) [2] Insurance Code section 332, for example, requires each party to an insurance contract to disclose, "in good faith, all facts within his knowledge which are or which he believes to be material to the contract ...." The disclosure obligations imposed by these statutes are directed specifically at the formation of the insurance contract. Insurance Code section 334 states: "Materiality is to be determined not by the event, but solely by the probable and reasonable influence of the facts upon the party to whom the communication is due, in forming his estimate of the disadvantages of the *proposed contract,* or in making his inquiries." (Ins.Code, § 334, italics added.) Insurance Code section 356 provides: "The completion of the contract of insurance is the time to which a representation must be presumed to refer."

2 The relevant provisions of the Insurance Code, also cited by the court in *Imperial, supra,* 198 Cal.App.3d at page 180, footnote 8, 243 Cal.Rptr. 639, are:

" § 330. *Concealment defined.* Neglect to communicate that which a party knows, and ought to communicate, is concealment.

" § 331. *Effect of concealment.* Concealment, whether intentional or unintentional, entitles the injured party to rescind insurance.

" § 332. *Required disclosure.* Each party to a contract of insurance shall communicate to the other, in good faith, all facts within his knowledge which are or which he believes to be material to the contract and as to which he makes no warranty, and which the other has not the means of ascertaining.

" § 334. *Materiality.* Materiality is to be determined not by the event, but solely by the probable and reasonable influence of the facts upon the party to whom the communication is due, in forming his estimate of the disadvantages of the proposed contract, or in making his inquiries.

" § 356. *Time of reference.* The completion of the contract of insurance is the time to which a representation must be presumed to refer.

" § 358. *Falsity.* A representation is false when the facts fail to correspond with its assertions or stipulations.

" § 359. *Effect of material false representation.* If a representation is false in a material point, whether affirmative or promissory, the injured party is entitled to rescind the contract from the time the representation becomes false.

> " § 360. *Materiality.* The materiality of a representation is determined by the same rule as the materiality of a concealment."

Requiring full disclosure at the inception of the insurance contract and granting a statutory right to rescind based on concealment or material ***469** misrepresentation at that time safeguard the parties' freedom to contract. "[An insurance company] has ****634** the unquestioned right to select those whom it will insure and to rely upon him who would be insured for such information as it desires as a basis for its determination to the end that a wise discrimination may be exercised in selecting its risks." (*Robinson v. Occidental Life Ins. Co.* (1955) 131 Cal.App.2d 581, 586, 281 P.2d 39.)

Courts have applied Insurance Code sections 331 and 359 to permit rescission of an insurance policy based on an insured's negligent or inadvertent failure to disclose a material fact in the application for insurance (see, e.g., *Telford v. New York Life Ins. Co.* (1937) 9 Cal.2d 103, 105, 69 P.2d 835; *Dinkins v. American National Ins. Co.* (1979) 92 Cal.App.3d 222, 232, 154 Cal.Rptr. 775; *Thompson v. Occidental Life Ins. Co.* (1973) 9 Cal.3d 904, 915–916, 109 Cal.Rptr. 473, 513 P.2d 353; *Williamson & Vollmer Engineering, Inc. v. Sequoia Ins. Co.* (1976) 64 Cal.App.3d 261, 273, 134 Cal.Rptr. 427), including an application for a policy affording coverage against fire loss. (*Imperial, supra,* 198 Cal.App.3d at p. 182, 243 Cal.Rptr. 639 [summary judgment affirmed in favor of insurer based on right to rescind fire policy because of insured's misrepresentations in insurance application].) One authority has noted that under Insurance Code sections 331 and 359, "misstatement or concealment of 'material' facts is ground for rescission *even if unintentional.* The insurer need not prove that the applicant-insured actually intended to deceive the insurer." (Croskey, et al., Cal. Practice Guide: Insurance Litigation (The Rutter Group 2004) (Croskey) ¶ 5:169, p. 5–32.4; see also *Thompson v. Occidental Life Ins. Co., supra,* 9 Cal.3d at pp. 915–916, 109 Cal.Rptr. 473, 513 P.2d 353.) One court has said that materiality is determined under "a *subjective* test; the critical question is the effect the truthful answers would have had on [the insurer], not on some 'average reasonable' insurer." (*Imperial, supra,* 198 Cal.App.3d at p. 181, 243 Cal.Rptr. 639.)

2. Insurance Code Sections 2070 and 2071

Insurance Code section 2070 provides: "All fire policies on subject matter in California shall be on the standard form, and, except as provided by this article shall not contain additions thereto. No part of the standard form shall be omitted therefrom except that any policy providing coverage against the peril of fire only, or in combination with coverage against other perils, need not comply with the provisions of the standard form of fire insurance policy or Section 2080; provided, that coverage with respect to the peril of fire, when viewed in its entirety, is substantially equivalent to or more favorable to the insured than that contained in such standard from fire insurance policy." [3]

3 Insurance Code section 2080 states: "Except as otherwise provided in this article, clauses imposing specified duties and obligations upon the insured and limiting the liability of the insurer may be attached to the standard form. Such clauses shall be in the rider or riders attached to the standard form of policy and shall be in type as provided in Section 2073."

[6] ***470** The California Standard Form Fire Insurance Policy is set forth at Insurance Code section 2071. [4] The standard ****635** form policy contains the following provision concerning an insured's concealment or misrepresentation of a material fact: "Concealment, fraud: This entire policy shall be void if, whether before or after a loss, the insured has willfully concealed or misrepresented any material fact or circumstance concerning this insurance or the subject thereof, or the interest of the insured therein, or in case of any fraud or false swearing by the insured relating thereto." To void a policy based on the insured's violation of the standard form policy's fraud and concealment provision, "the false statement must have been knowingly and willfully made with the intent (express or implied) of deceiving the insurer. The materiality of the statement will be determined by the *objective* standard of its effect upon a *reasonable* insurer." (*Cummings v. Fire Ins. Exchange* (1988) 202 Cal.App.3d 1407, 1414–1415, fn. 7, 249 Cal.Rptr. 568 [voiding fire insurance policy based on insured's fraudulent claim for policy benefits].) An insurer's right to void a fire insurance policy under Insurance Code section 2071 is therefore more limited than the right to rescind accorded by Insurance Code sections 331 and 359.

4 "The first Standard Fire Policy law was enacted in Massachusetts in 1873. New York enacted its first legislation on the subject in 1886, followed by the 1891 policy and the current 1943 policy. Between 1873 and 1942, many different

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Standard Fire policies were used in the several states. The Standard Fire Policy adopted by law in New York State in 1943 has been approved by the majority of the states, in some instances with minor modifications. Thus, the New York Standard Fire policy has been eventually a nationwide standard." (Property and Liability Insurance Handbook (John D. Long & Davis W. Gregg, eds., 1965), p. 59.) The current California standard form fire insurance policy is based on the standard fire policy adopted in New York in 1943 with some modifications. (Beach Vasey, Legislative Secretary, mem. to Governor Earl Warren, June 2, 1949 re Sen. Bill No. 1282 (Stats.1949, ch. 556).)

C. Insurance Code Sections 2070 and 2071 Do Not Preclude Rescission Under Insurance Code Sections 331 and 359

[7] Even though we are affirming the summary judgment on a ground relied upon by the trial court (Code Civ. Proc., § 437c, subd. (m)(2))—i.e. that Insurance Code sections 331 and 359 apply—we gave the parties an opportunity to address by letter brief the application of Insurance Code sections 2070 and 2071. Mitchell argues in his letter brief, for the first time on appeal, that the fraud and concealment provision of the standard form policy set forth in Insurance Code section 2071, and required by Insurance Code section 2070, limits an insurer's right to rescind a fire insurance policy based on misrepresentations in an insurance application to circumstances when the insured has willfully concealed or misrepresented a material fact. Although this issue was not argued before the trial court, an appellate court ***471** has discretion to consider an issue raised for the first time on appeal if it presents a pure question of law on undisputed evidence, such as the applicability of a statute. (*Waller v. Truck Ins. Exchange, Inc.* (1995) 11 Cal.4th 1, 24, 44 Cal.Rptr.2d 370, 900 P.2d 619.) We exercise the discretion to do so here.

There is no authority to support Mitchell's argument that the fraud and concealment provision in Insurance Code section 2071, and not Insurance Code sections 331 or 359, governs the right to rescind a fire insurance policy based on misrepresentations in the insurance application, apart from the following statement in one insurance treatise: "The apparent effect of [the fraud and concealment] provision [in the standard form fire insurance policy] is that a fire insurance policy cannot be rescinded for merely negligent omissions or misstatements in the application." (Croskey, supra, ¶ 5:171, p. 5–33.) The issue of whether section 2071—requiring willful misrepresentation to void a fire insurance policy—conflicts with Insurance Code sections 331 and 359—permitting rescission of an insurance policy for a negligent or unintentional ****636** misrepresentation—or whether the statutes may be reconciled, appears to be one of first impression.

[8] To address this issue, we apply certain fundamental rules of statutory interpretation. "We begin with the fundamental premise that the objective of statutory interpretation is to ascertain and effectuate legislative intent. [Citations.] To determine legislative intent, we turn first to the words of the statute, giving them their usual and ordinary meaning. [Citations.] When the language of a statute is clear, we need go no further. However, when the language is susceptible of more than one reasonable interpretation, we look to a variety of extrinsic aids, including the ostensible objects to be achieved, the evils to be remedied, the legislative history, public policy, contemporaneous administrative construction, and the statutory scheme of which the statute is a part. [Citations.]" (*Nolan v. City of Anaheim* (2004) 33 Cal.4th 335, 340, 14 Cal.Rptr.3d 857, 92 P.3d 350.)

Insurance Code section 2070 states that "[n]o part of the standard form shall be omitted" unless "that coverage with respect to the peril of fire, when viewed in its entirety, is substantially equivalent to or more favorable to the insured than that contained in such standard form fire insurance policy." Thus, fire insurance policies must contain certain standard terms that guarantee a minimum level of coverage. That provision does not exclude the application of other statutory provisions, such as Insurance Code sections 331 and 359, which govern the disclosure obligations between insurer and insured with respect to all types of insurance policies. It makes no sense to exclude a fire insurance contract from the protections, benefits, and obligations afforded by other statutes. (See Ins.Code, § 41 ["All insurance in this State is governed by the provisions of this code"].)

***472** Neither the fraud and concealment provision of Insurance Code section 2071 nor Insurance Code section 2070 mandating the standard form purport to restrict the application of Insurance Code sections 331 and 359 to fire insurance policies. In this respect, there is no reason to treat fire insurance policies differently than other types of insurance policies. [5] Most insurance policies provide coverage for more than just fire.

5 One authority states, however, that, "courts, departing from the law of marine insurance, now have generally adopted the view that the concealment of a material fact, when not made the subject of express inquiry by the insurers, must be intentional to avoid the fire policy." (Sowers, Concealment, Misrepresentation, Fraud or False Swearing in The Fire Insurance Contract: Its History and Interpretation (1922 The Insurance Society of New York) pp. 96–97.) Here, the application itself makes express inquiries.

[9] Insurance Code sections 331, 359, and 2070 were enacted together (Stats.1935, ch. 145, p. 505, § 331; p. 506, § 359; p. 596, § 2070), [6] and must therefore be harmonized with each other. (*People v. Murphy* (2001) 25 Cal.4th 136, 142, 105 Cal.Rptr.2d 387, 19 P.3d 1129 [courts must harmonize " 'various parts of the statutory enactment ... by considering the particular clause or section in the context of the statutory framework as a whole' "].) The requirement in Insurance Code section 2070 that a fire insurance policy be on a standard form does not preclude the application ****637** of regulatory statutes, such as Insurance Code sections 331 and 359.

6 California law provided for a standard form fire insurance policy in 1909. (Stats.1909, ch. 267, p. 404.) Neither that form nor the form enacted in 1935 (Stats.1935, ch. 145, pp. 596–603) required a willful misrepresentation or concealment to void the policy. The current form was enacted in 1949 (Stats.1949, ch. 556, p. 955, § 2).

[10] Different statutes within the same code should be interpreted to be consistent. (*Board of Retirement of the Kern County Employees' Retirement Association v. Bellino* (2005) 126 Cal.App.4th 781, 24 Cal.Rptr.3d 384; see also *Pacific Southwest Realty Co. v. County of Los Angeles* (1991) 1 Cal.4th 155, 167, 2 Cal.Rptr.2d 536, 820 P.2d 1046.) Accordingly, that the standard form policy does not provide for the consequences of a non-willful misrepresentation or concealment should not be read to prevent the application of other Insurance Code provisions that do.

[11] Freedom of contract and the right of an insurer to make an informed decision whether or not to insure a given risk are strong policy considerations that support more liberal rescission rights for misrepresentations made at the inception of the insurance contract. As one authority has noted: "Despite the significant statutory prescription of fire insurance policy terms, contracts of this kind are treated as voluntary contracts rather than legislative enactments, since they derive their force and efficacy from the consent of the parties." (10 Couch on Insurance (3d ed.1998) § 149:3, p. 149–10.)

***473** Both Insurance Code sections 331 and 359 and the fraud and concealment provisions of the standard form policy prescribed by Insurance Code section 2071 apply to misrepresentations made at any time. But Insurance Code sections 331 and 359 normally govern the parties' obligations during formation of the insurance contract, and allow an insurer to *rescind* a fire insurance policy based on an insured's negligent or unintentional concealment or misrepresentation of a material fact. The standard fraud and concealment provision of the standard fire insurance policy required by Insurance Code section 2071 typically is exercised in connection with a claim for policy benefits. (See, e.g., *Cummings v. Fire Insurance Exchange, supra,* 202 Cal.App.3d 1407, 249 Cal.Rptr. 568.) Under Insurance Code section 2071, willful concealment or misrepresentation results in a *voiding* of the policy.

[12] We conclude that the fraud and concealment provision in the standard policy, as prescribed by Insurance Code section 2071 and requiring the insurer to prove a misrepresentation was willful in order to void the policy does not affect the application of Insurance Code sections 331 and 359, allowing the insurer to rescind the policy in the event of a negligent or unintentional misrepresentation. Accordingly, Insurance Code section 2071 did not preclude United National from exercising its rights under Insurance Code sections 331 and 359 to rescind the policy based on negligent or unintentional misrepresentations in Mitchell's application for insurance. [7]

7 In New York, as in California, an insurer has the statutory right to rescind an insurance policy based on material misrepresentation in an insured's application for insurance. (N.Y. Ins. Law § 3105; *Republic Ins. Co. v. Masters, Mates & Pilots Pension Plan* (2d Cir.1996) 77 F.3d 48, 52–53.) Courts in New York have applied this statutory rescission right to a fire insurance policy (*Curanovic v. New York Central Mutual Fire Ins. Co.* (2003) 307 A.D.2d 435, 762 N.Y.S.2d 148,

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150–151), even though the New York standard fire insurance policy contains a fraud and concealment provision identical to that in the California standard form policy, voiding the policy in the event of the insured's *willful* concealment or misrepresentation of a material fact (N.Y. Ins. Law § 3404). In *Curanovic,* the court held there was insufficient evidence of materiality. (See *McLaughlin v. Nationwide Mutual Fire Insurance Company* (2004) 8 A.D.3d 739, 777 N.Y.S.2d 773, 774 ["material misrepresentation, even if innocent or unintentional, is sufficient to warrant a rescission of the policy"]; *Nationwide Mut. Fire Ins. Co. v. Pascarella* (N.D.N.Y.1998) 993 F.Supp. 134, 136.)

****638 D. Misrepresentation of Material Facts**

In the instant case, there was undisputed evidence that Mitchell's application for insurance contained misstatements of fact concerning the size and use of the building, the existence of building code violations, and the existence of insurance coverage for the property. [8] Mitchell, in his first amended complaint, conceded that the application submitted to United National "contained inaccuracies." He also acknowledged in other testimony and filings that the ***474** application contained incorrect information, but he asserted that any such inaccuracies were unintentional and immaterial and that United National waived its right to rescind.

8 Although the parties disputed whether Mitchell had misrepresented his ownership interest in the property, because there is undisputed evidence that Mitchell's application for insurance contained other factual misstatements, we need not determine whether representations concerning ownership of the property were false, and if so, whether they were material for purposes of rescinding the policy.

[13] The materiality of a misrepresentation is determined by its probable and reasonable effect upon the insurer. (Ins.Code, § 334.) The misrepresentation need not relate to the loss ultimately claimed by the insured. (*Torbensen v. Family Life Ins. Co.* (1958) 163 Cal.App.2d 401, 405, 329 P.2d 596.) The test for materiality is whether the information would have caused the underwriter to reject the application, charge a higher premium, or amend the policy terms, had the underwriter known the true facts. (*Old Line Life Ins. Co. v. Superior Court* (1991) 229 Cal.App.3d 1600, 1604, 281 Cal.Rptr. 15 [" 'The most generally accepted test of materiality is whether or not the matter misstated could reasonably be considered material in affecting the insurer's decision as to whether or not to enter into the contract, in estimating the degree or character of the risk, *or in fixing the premium rate thereon* ' [Citations.]"]; *Holz Rubber Co., Inc. v. American Star Ins. Co.* (1975) 14 Cal.3d 45, 61, 120 Cal.Rptr. 415, 533 P.2d 1055 ["Materiality is determined by the probable and reasonable effect that truthful disclosure would have had upon the insurer in determining the advantages of the proposed contract. [Citations.] Essentially, we must decide whether the insurer was misled into accepting the risk or fixing the premium of insurance. [Citations.]"].) "This is a *subjective* test; the critical question is the effect truthful answers would have had on [the insurer], not on some 'average reasonable' insurer." (*Imperial, supra,* 198 Cal.App.3d at p. 181, 243 Cal.Rptr. 639; see also *Cummings v. Fire Ins. Exchange, supra,* 202 Cal.App.3d at pp. 1414–1415, fn. 7, 249 Cal.Rptr. 568; *Coca Cola Bottling Co. v. Columbia Casualty Ins. Co.* (1992) 11 Cal.App.4th 1176, 1189, fn. 4, 14 Cal.Rptr.2d 643.)

Mitchell argues that whether the misrepresentations in his application were material is necessarily a question of fact. An authority has written that "[c]ourts are split on whether the insured's answers to questions in the insurance application must be regarded as material as a matter of law, or whether their materiality is a question of fact in each case." (Croskey, *supra,* ¶ 5:208, p. 5–40.1; compare *Ransom v. Penn. Mutual Life Ins. Co.* (1954) 43 Cal.2d 420, 427, 274 P.2d 633 ["An incorrect answer on an insurance application [is not grounds for rescission] where the true facts, if known, would not have made the ****639** contract less desirable to the insurer"] and *Thompson v. Occidental Life Ins. Co.* (1973) 9 Cal.3d 904, 916, 109 Cal.Rptr. 473, 513 P.2d 353 ["the trier of fact is not required to believe the 'post mortem' [[*sic*] postloss] testimony of an insurer's agent that insurance would have ***475** been refused had the true facts been disclosed"] with *Cohen v. Penn Mut. Life Ins. Co.* (1957) 48 Cal.2d 720, 726, 312 P.2d 241 ["The fact that defendant put the questions in writing and asked for written answers was itself proof that it deemed the answers material"].) [9]

9 The general rule is that "materiality is generally a question of fact unless the 'fact misrepresented is so obviously unimportant that the jury could not reasonably find that a reasonable man would have been influenced by it.' " (*Engalla v. Permanente Medical Group, Inc.* (1997) 15 Cal.4th 951, 977, 64 Cal.Rptr.2d 843, 938 P.2d 903; *Persson v. Smart*

Inventions, Inc. (2005) 125 Cal.App.4th 1141, 1164, 23 Cal.Rptr.3d 335; but see 5 Witkin, Calif. Procedure (4th ed. 1997) Pleadings, § 674, p. 133 [materiality a question of law].)

In *Imperial, supra,* 198 Cal.App.3d at page 179, 243 Cal.Rptr. 639, the court suggested that the issue of materiality of a misrepresentation in an insurance application may be one of law by stating, " 'The fact that the insurer has demanded answers to specific questions in an application for insurance is in itself usually sufficient to establish materiality as a matter of law.' [Citations.]" The court also stated when there is undisputed evidence that false information was given in an application for insurance and the insurer issued a policy in reliance upon this information, the materiality of a misrepresentation or concealment may be established as a matter of law. (*Id.* at p. 182, 243 Cal.Rptr. 639.) Yet, the court gave some indication of possible factual issues in a determination of materiality by stating, "Defendants offer us no evidentiary assistance on this point [materiality], but content themselves with the naked argument that since a jury might 'disbelieve' all of the uncontradicted evidence presented by [the insurer], they are entitled to a trial on the question of materiality." The court went on to say that materiality was established by "the nature of the insurance coverage which defendant sought, the quality and quantity of the information which was not disclosed," in addition to the fact that the insurer "specifically requested the information on its application and therefore relied upon it in issuing the policy." (*Id.* at pp. 181–182, 243 Cal.Rptr. 639.)

It seems unreasonable to conclude that an incorrect answer to any question on an insurance application automatically would constitute a material misrepresentation for purposes of rescission. For example, there might be instances when the question on the application is not relevant to an underwriting decision or the answer is such that the insurance company could not have relied upon it. Thus, we can conceive of situations when the issue of materiality might be a factual one. No such factual issues are presented here.

[14] **[15]** The application questions in this case plainly impact decisions on whether to insure and the premium to charge. In his response to defendant's statement of undisputed material facts, Mitchell admitted that questions concerning the ownership, size and condition of the building, the nature of the business to be conducted, and its payroll and receipts, and the existence of insurance under ***476** the FAIR Plan were factors impacting either the underwriting decision or the amount of the premium and coverage, and that his answers to these questions may have affected the decision to bind coverage and the amount of the premium. United National's representative, Ms. Messina, said she relied upon Mitchell's answers to the questions, including the condition of ****640** the building, its use, and whether it was covered by insurance. Contrary to Mitchell's argument, Ms. Messina had no obligation to verify the accuracy of the representations. (*Robinson v. Occidental Life Ins. Co., supra,* 131 Cal.App.2d at p. 585, 281 P.2d 39 [in connection with an insurance application "[i]t was not incumbent upon [insurer] to investigate [insured's] statements made to the examiner. It was [insured's] duty to divulge fully all he knew"].)

The evidence of materiality of the misrepresentations is uncontradicted. The application was for significant insurance covering the peril of fire. The information sought went directly to questions of insurability, risk, and premium. The insured admitted that there were misrepresentations on the application, and that the insurer considered the information important to its underwriting decisions. Under these circumstances, a reasonable trier of fact could not find that the representations in this case were not material. (See *Aguilar v. Atlantic Richfield Co., supra,* 25 Cal.4th at p. 856, 107 Cal.Rptr.2d 841, 24 P.3d 493 [court may determine on summary judgment motion what evidence could show or imply to a reasonable trier of fact]; *Imperial, supra,* 198 Cal.App.3d at p. 181, 243 Cal.Rptr. 639.)

E. No Waiver of Right To Rescind

[16] Mitchell argues that the misstatements contained in his application for insurance were such that they should have prompted United National's underwriter to investigate matters further and that by failing to investigate, United National waived its right to rescind the policy. "Waiver is the intentional relinquishment of a known right. [Citations.] An insurer does not waive its right to rescind a policy on the ground of false representations if it was unaware of the falsity of those representations. [Citations.]" (*Lunardi v. Great–West Life Assurance Co.* (1995) 37 Cal.App.4th 807, 824, 44 Cal.Rptr.2d 56; see Ins.Code, § 336 ["The right to information of material facts may be waived, either (a) by the terms of the insurance or (b) by neglect to make inquiries as to such facts, where they are distinctly implied in other facts of which information is communicated"].)

In support of his waiver argument, Mitchell offered the declaration of his expert, Ms. Rossi. The trial court ruled that declaration inadmissible, a ruling we affirm, as discussed *post.* But even if Ms. Rossi's declaration was admissible, she did not dispute that information sought by United National concerning ownership and size of the building, the type of business to be conducted and its payroll and receipts, existing insurance coverage, and the ***477** existence of uncorrected code violations and a functioning alarm system was relevant to the underwriting decision.

Ms. Rossi opined that if United National's underwriter, Ms. Messina, truly believed this information was important, she would have undertaken further investigation. Ms. Rossi cites no facts, however, that should have alerted the underwriter of the need to investigate Mitchell's representations concerning the size of the building, the payroll and receipts of the business to be conducted in it, the existence of an alarm system, or code violations. There is no evidence that Ms. Messina knew these representations were untrue. As noted, an insurer has the right to rely on the insured's answers to questions in the insurance application without verifying their accuracy. (*Robinson v. Occidental Life Ins. Co., supra,* 131 Cal.App.2d at p. 585, 281 P.2d 39.)

Ms. Rossi asserted that Mitchell's representation concerning the absence of insurance coverage for the building was "as big ****641** or [an] even bigger 'red flag' " than coverage under a California FAIR Plan policy and should have prompted Ms. Messina to investigate this representation further. Even if the failure to investigate this issue caused United National to waive the right to rescind its policy based on Mitchell's misrepresentation concerning insurance coverage, it had ample grounds for rescinding the policy based on other misrepresentations in Mitchell's application. Accordingly, United National did not waive its right to rescind the insurance policy.

F. Evidentiary Rulings

Mitchell contends the trial court improperly excluded the declaration of his expert, Ms. Rossi, offered to show that the misrepresentations in Mitchell's insurance application were not material to the underwriter and that United National waived its right to rescind by failing to investigate certain facts. It might be possible to submit evidence, even expert evidence, that would create a triable issue of fact as to whether an insurer reasonably relied on certain representations or that representations were not material. For example, evidence of industry practice might conceivably have some relevance, even though it has been said that the test of materiality of and reliance on a representation in an insurance application is a "subjective" one. (*Imperial, supra,* 198 Cal.App.3d at p. 181, 243 Cal.Rptr. 639.)

[17] Ms. Rossi's opinions, however, purported to state what Ms. Messina allegedly knew or should have done. She expressly stated that her opinion is ***478** that the representations at issue "were not material to Messina in her underwriting of this policy." Also, much of Ms. Rossi's declaration dealt with the issue of waiver, i.e., that the representations could not have been reasonably relied upon by United National's underwriter, Ms. Messina, because she should have investigated certain matters further. These conclusions were based on speculation about what Ms. Messina knew, considered, or concluded.

Evidence Code section 801, subdivision (b) restricts expert testimony to opinions based on "matter ... perceived by or personally known to the witness" when that matter "is of a type that reasonably may be relied upon by an expert in forming an opinion ...." "[A]n expert opinion based on speculation or conjecture is inadmissible." (*Lockheed Litigation Cases* (2004) 115 Cal.App.4th 558, 564, 10 Cal.Rptr.3d 34; see Cal. Law Revision Com. com., § 801, p. 10 ["irrelevant or speculative matters are not a proper basis for an expert's opinion"].) The trial court was within its discretion to conclude that Ms. Rossi's opinions were not based on reliable "matter." (Evid.Code, § 801, subd. (b); 1 Witkin, Cal. Evidence (4th ed. 2000) Opinion Evidence, § 30, p. 560.)

Even if materiality could be a question of fact, testimony as to what someone else considered material is the type of speculation that a trial court may, in its discretion, exclude as not being appropriate opinion evidence. Moreover, without abusing its discretion, the trial court could have determined that much of Ms. Rossi's discussion of what the underwriter should have done constituted inadmissible conclusions. (1 Witkin, Cal. Evidence, *supra*, § 89, pp. 636–637 ["judge retains discretion to disallow question on ultimate issue"]; *Walker v. Countrywide Home Loans, Inc., supra,* 98 Cal.App.4th at p. 1169, 121 Cal.Rptr.2d 79.)

Even if Ms. Rossi's declaration had been admitted in evidence, her opinions, even if accepted, do not establish that all of Ms. Messina's considerations and determinations were unreasonable under the circumstances. Ms. Rossi admitted that some of the information sought by United National ****642** in the application for insurance was relevant to underwriting the risk or setting the amount of the premium. She also did not dispute that Mitchell's responses concerning the size and ownership of the building, the payroll and receipts of the business conducted, and the existence of insurance were false. She concluded that there was "very little reliance on the representations made in the application"—a conclusion that concedes there was some reliance on the representations. And she acknowledged that at least one misrepresentation affected the amount of premium and coverage. Accordingly, Ms. Rossi's declaration, even if considered, would not create a triable issue of fact as to materiality or waiver.

*479 CONCLUSION

The undisputed evidence showed that there were material misrepresentations in Mitchell's application for insurance. United National had the right to, and did, rescind the policy based on these misrepresentations. (Ins.Code, §§ 331, 359.) The trial court therefore properly granted summary judgment. Because we uphold the summary judgment on this basis, we need not determine whether the policy's dishonest act exclusion barred coverage in this case.

DISPOSITION

The judgment is affirmed. United National is awarded its costs on appeal.

We concur. TURNER, P.J., and ARMSTRONG, J.

All Citations

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EXHIBIT AC-121

KeyCite Yellow Flag - Negative Treatment
Declined to Follow by U.S. v. Evseroff, 2nd Cir.(N.Y.), June 26, 2013

649 F.3d 1276
United States Court of Appeals,
Federal Circuit.

THERASENSE, INC. (now known as Abbott Diabetes Care, Inc.) and Abbott Laboratories, Plaintiffs–Appellants,
v.
BECTON, DICKINSON AND COMPANY, and Nova Biomedical Corporation, Defendants–Appellees,
and
Bayer HealthCare LLC, Defendant–Appellee.

Nos. 2008–1511, 2008–1512, 2008–1513, 2008–1514, 2008–1595.
|
May 25, 2011.

Synopsis
Background: Patentee brought action against competitors alleging infringement of patent directed toward disposable blood glucose test strips for diabetes management. The United States District Court for the Northern District of California, Martin J. Jenkins, J., 560 F.Supp.2d 835, granted summary judgment of noninfringement and anticipation in part. The District Court, William H. Alsup, J., 565 F.Supp.2d 1088, following bench trial, granted judgment of obviousness and inequitable conduct. Patentee appealed. Panel unanimously upheld district court's judgments of noninfringement and invalidity, 593 F.3d 1289. Patentee petitioned for rehearing en banc. Petition was granted and judgment of panel vacated, 374 Fed.Appx. 35.

Holdings: The Court of Appeals, Rader, Chief Judge, held that:

[1] a finding that a misrepresentation or omission amounts to gross negligence or negligence under a "should have known" standard does not satisfy the inequitable conduct intent requirement, abrogating *Driscoll v. Cebalo,* 731 F.2d 878, 885 and *Orthopedic Equip. Co., Inc. v. All Orthopedic Appliances, Inc.,* 707 F.2d 1376;

[2] a district court should not use a "sliding scale," where a weak showing of intent may be found sufficient for inequitable conduct based on a strong showing of materiality, and vice versa, abrogating *Am. Hoist & Derrick Co. v. Sowa & Sons, Inc.,* 725 F.2d 1350;

[3] a district court may not infer intent solely from materiality, but, instead, a court must weigh the evidence of intent to deceive independent of its analysis of materiality;

[4] to meet the clear and convincing evidence standard, the specific intent to deceive must be the single most reasonable inference able to be drawn from the evidence;

[5] when there are multiple reasonable inferences that may be drawn, intent to deceive cannot be found;

[6] the patentee need not offer any good faith explanation unless the accused infringer first proves a threshold level of intent to deceive by clear and convincing evidence;

[7] the materiality required to establish inequitable conduct is but-for materiality; and

[8] remand was required.

Affirmed in part, vacated in part, and remanded.

O'Malley, Circuit Judge, filed opinion concurring in part and dissenting in part.

Bryson, Circuit Judge, filed dissenting opinion, in which Gajarsa, Dyk, and Prost, Circuit Judges, joined.

Reinstating Parts I, III, and IV of panel decision reported at 593 F.3d 1289, which affirmed district court's judgment of obviousness, noninfringement, and anticipation, respectively.

Procedural Posture(s): On Appeal; Motion for Summary Judgment.

West Headnotes (27)

[1] **Patents** Patent Found Unenforceable for Inequitable Conduct

Inequitable conduct is an equitable defense to patent infringement that, if proved, bars enforcement of a patent.

187 Cases that cite this headnote

[2] **Patents** Patent Found Unenforceable for Inequitable Conduct

Inequitable conduct regarding any single claim renders the entire patent unenforceable.

35 Cases that cite this headnote

[3] **Patents** Patent Found Unenforceable for Inequitable Conduct

Unlike other deficiencies, inequitable conduct cannot be cured by patent reissue or reexamination.

11 Cases that cite this headnote

[4] **Patents** Patent Found Unenforceable for Inequitable Conduct

The taint of a finding of inequitable conduct can spread from a single patent to render unenforceable other related patents and applications in the same technology family.

33 Cases that cite this headnote

[5] **Patents** Exceptional cases in general

Prevailing on a claim of inequitable conduct often makes a patent case “exceptional,” leading potentially to an award of attorney fees. 35 U.S.C.A. § 285.

13 Cases that cite this headnote

[6] **Privileged Communications and Confidentiality** Criminal or other wrongful act or transaction; crime-fraud exception

In a patent case, a finding of inequitable conduct may prove the crime or fraud exception to the attorney-client privilege.

33 Cases that cite this headnote

[7] **Patents** Intent to deceive in general

To prevail on a claim of inequitable conduct, the accused infringer must prove that the patentee acted with the specific intent to deceive the Patent and Trademark Office (PTO); a finding that the misrepresentation or omission amounts to gross negligence or negligence under a "should have known" standard does not satisfy this intent requirement; abrogating *Driscoll v. Cebalo,* 731 F.2d 878, 885 and *Orthopedic Equip. Co., Inc. v. All Orthopedic Appliances, Inc.,* 707 F.2d 1376.

122 Cases that cite this headnote

[8] **Patents** Intent to deceive in general

Patents Evidence

In a patent case alleging inequitable conduct involving nondisclosure of information, clear and convincing evidence must show that the applicant made a deliberate decision to withhold a known material reference; in other words, the accused infringer must prove by clear and convincing evidence that the applicant knew of the reference, knew that it was material, and made a deliberate decision to withhold it.

212 Cases that cite this headnote

[9] **Patents** Determination

In a patent case alleging inequitable conduct, a district court should not use a "sliding scale," where a weak showing of intent may be found sufficient based on a strong showing of materiality, and vice versa; abrogating *Am. Hoist & Derrick Co. v. Sowa & Sons, Inc.,* 725 F.2d 1350.

20 Cases that cite this headnote

[10] **Patents** Evidence

In a patent case alleging inequitable conduct, a district court may not infer intent solely from materiality, but, instead, a court must weigh the evidence of intent to deceive independent of its analysis of materiality.

77 Cases that cite this headnote

[11] **Patents** Intent to deceive in general

In a patent case alleging inequitable conduct, proving that the applicant knew of a reference, should have known of its materiality, and decided not to submit it to the Patent and Trademark Office (PTO) does not prove specific intent to deceive.

169 Cases that cite this headnote

[12] **Patents** Evidence

In a patent case alleging inequitable conduct, a district court may infer intent from indirect and circumstantial evidence; however, to meet the clear and convincing evidence standard, the specific intent to deceive must be the single most reasonable inference able to be drawn from the evidence, in that the evidence must be sufficient to require a finding of deceitful intent in the light of all the circumstances.

314 Cases that cite this headnote

[13] **Patents** Evidence

In a patent case alleging inequitable conduct, when there are multiple reasonable inferences that may be drawn, intent to deceive cannot be found.

105 Cases that cite this headnote

[14] **Federal Courts** Inferences from evidence

District court's factual findings regarding what reasonable inferences may be drawn from the evidence are reviewed for clear error.

1 Cases that cite this headnote

[15] **Patents** Evidence

In a patent case alleging inequitable conduct, because the party alleging inequitable conduct bears the burden of proof, the patentee need not offer any good faith explanation unless the accused infringer first proves a threshold level of intent to deceive by clear and convincing evidence; the absence of a good faith explanation for withholding a material reference does not, by itself, prove intent to deceive.

53 Cases that cite this headnote

[16] **Patents** Materiality in general

As a general matter, in a patent case, the materiality required to establish inequitable conduct is but-for materiality; when an applicant fails to disclose prior art to the Patent and Trademark Office (PTO), that prior art is but-for material if the PTO would not have allowed a claim had it been aware of the undisclosed prior art.

265 Cases that cite this headnote

[17] **Patents** Materiality in general

Patents Evidence

In a patent case alleging inequitable conduct, when assessing the materiality of a withheld reference, a court must determine whether the Patent and Trademark Office (PTO) would have allowed the claim if it had been aware of the undisclosed reference; in making this patentability determination, the court should apply the preponderance of the evidence standard and give claims their broadest reasonable construction.

94 Cases that cite this headnote

[18] **Patents** Materiality in general

In a patent case alleging inequitable conduct, even if a district court does not invalidate a claim based on a deliberately withheld reference, the reference may be material if it would have blocked patent issuance under the different evidentiary standards of the Patent and Trademark Office (PTO).

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22 Cases that cite this headnote

[19] **Patents** Patent Found Unenforceable for Inequitable Conduct

As an equitable doctrine, inequitable conduct hinges on basic fairness; the remedy imposed by a court of equity should be commensurate with the violation.

6 Cases that cite this headnote

[20] **Patents** Patent Found Unenforceable for Inequitable Conduct

Because inequitable conduct renders an entire patent, or even a patent family, unenforceable, as a general rule, this doctrine should only be applied in instances where the patentee's misconduct resulted in the unfair benefit of receiving an unwarranted claim; enforcement of an otherwise valid patent does not injure the public merely because of misconduct, lurking somewhere in patent prosecution, that was immaterial to the patent's issuance, and a patentee obtains no advantage from misconduct if the patent would have issued anyway.

31 Cases that cite this headnote

[21] **Patents** Materiality in general

In a patent case alleging inequitable conduct, when the patentee has engaged in affirmative acts of egregious misconduct, such as the filing of an unmistakably false affidavit, the misconduct is material.

76 Cases that cite this headnote

[22] **Patents** Materiality in general

Because neither mere nondisclosure of prior art references to the Patent and Trademark Office (PTO) nor failure to mention prior art references in an affidavit constitutes affirmative egregious misconduct, claims of inequitable conduct that are based on such omissions require proof of but-for materiality.

58 Cases that cite this headnote

[23] **Patents** Materiality in general

In a patent case alleging inequitable conduct, a court is not bound by the definition of materiality in Patent and Trademark Office (PTO) rules, which lack but-for materiality. 37 C.F.R. § 1.56.

49 Cases that cite this headnote

[24] **Patents** Determination

In patent case alleging inequitable conduct, remand was required for district court to determine whether Patent and Trademark Office (PTO) would not have granted patent but for patentee's failure to disclose briefs to European Patent Office (EPO); in particular, district court had to determine whether PTO would have found declaration by patentee's director of research and development, and accompanying submission by patent attorney, unpersuasive in overcoming obviousness rejection over patentee's prior patent if it had disclosed EPO briefs.

4 Cases that cite this headnote

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[25] **Patents** Determination

In patent case alleging inequitable conduct, remand was required for district court to determine whether there was clear and convincing evidence demonstrating that patentee's director of research and development and patent attorney knew of briefs to European Patent Office (EPO), knew of their materiality, and made conscious decision to not disclose them in order to deceive Patent and Trademark Office (PTO), since court had found intent to deceive based on absence of good faith explanation for failing to disclose EPO briefs and court had relied upon "should have known" negligence standard in reaching its finding of intent.

6 Cases that cite this headnote

[26] **Patents** In general; utility

US Patent 4,225,410, US Patent 4,545,382. Cited as Prior Art.

18 Cases that cite this headnote

[27] **Patents** In general; utility

US Patent 5,820,551, US Patent 6,143,164, US Patent 6,592,745. Cited.

Attorneys and Law Firms

***1279** John M. Whealan, of Silver Spring, MD argued for plaintiffs-appellants on rehearing en banc. With him on the brief were Rohit K. Singla and Peter A. Detre, Munger, Tolles & Olson LLP, of San Francisco, CA; and Jeffrey I. Weinberger, of Los Angeles, CA; Jeffrey A. Lamken and Michael G. Pattillo, Jr., MoloLamken LLP, of Washington, DC. Of counsel were Chantal M. D'Apuzzo, Fred A. Rowley, Jr., Andrew W. Song and Donald W. Ward, Munger, Tolles & Olson LLP, of Los Angeles, CA.

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Jeffrey D. Mills, King & Spalding LLP, of Austin, TX, for amicus curiae Association of Citizens for Patent Protection in the Public Interest on rehearing en banc. With him on the brief was Brian C. Banner.

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Dan L. Bagatell, Perkins Coie Brown & Bain, P.A., of Phoenix, AZ, for amicus curiae Intel Corporation on rehearing en banc. Of counsel on the brief was Tina M. Chappell, Intel Corporation, of Chandler, AZ.

Before RADER, Chief Judge, NEWMAN, LOURIE, BRYSON, GAJARSA, LINN, DYK, PROST, MOORE, O'MALLEY, and REYNA, Circuit Judges.

Opinion

Opinion for the court filed by Chief Judge RADER, in which Circuit Judges NEWMAN, LOURIE, LINN, MOORE, and REYNA join in full, and in which Circuit Judge O'MALLEY joins in part V.

Concurring-in-part and dissenting-in-part opinion filed by Circuit Judge O'MALLEY.

Dissenting opinion filed by Circuit Judge BRYSON, in which Circuit Judges GAJARSA, DYK, and PROST join.

RADER, Chief Judge.

The United States District Court for the Northern District of California found U.S. Patent No. 5,820,551 ("the ′551 patent") unenforceable due to inequitable conduct. *Therasense, Inc. v. Becton, Dickinson & Co.,* 565 F.Supp.2d 1088 (N.D.Cal.2008) ("*Trial Opinion* "). Therasense, Inc. (now Abbott Diabetes Care, Inc.) and Abbott Laboratories (collectively, "Abbott") appeal that judgment. This court vacates and remands for further proceedings consistent with this opinion.

I

The ′551 patent involves disposable blood glucose test strips for diabetes management. These strips employ electrochemical sensors to measure the level of glucose in a sample of blood. When blood contacts a test strip, glucose in the blood reacts with an enzyme on the strip, resulting in the transfer of electrons from the glucose to the enzyme. A mediator transfers these electrons to an electrode on the strip. Then, the electrons flow from the strip to a glucose meter, which calculates the glucose concentration based on the electrical current.

The ′551 patent claims a test strip with an electrochemical sensor for testing whole blood without a membrane over the electrode:

> 1. A single use disposable electrode strip for attachment to the signal readout circuitry of a sensor to detect a current representative of the concentration of a compound in a drop of a whole blood sample comprising:
>
> a) an elongated support having a substantially flat, planar surface, adapted for releasable attachment to said readout circuitry;
>
> b) a first conductor extending along said surface and comprising a conductive element for connection to said readout circuitry;
>
> c) an active electrode on said strip in electrical contact with said first conductor and positioned to contact said whole blood sample;
>
> d) a second conductor extending along said surface comprising a conductive element for connection to said read out circuitry; and
>
> e) a reference counterelectrode in electrical contact with said second conductor and positioned to contact said whole blood sample,
>
> *wherein said active electrode is configured to be exposed to said whole blood sample without an intervening membrane or other whole blood filtering member ....*

***1283** ′551 patent col. 13 l.29–col. 14 l.3 (emphasis added). "Whole blood," an important term in the claim, means blood that contains all of its components, including red blood cells.

In the prior art, some sensors employed diffusion-limiting membranes to control the flow of glucose to the electrode because the slower mediators of the time could not deal with a rapid influx of glucose. Other prior art sensors used protective membranes to prevent "fouling." Fouling occurs when red blood cells stick to the active electrode and interfere with electron transfer to the electrode. Protective membranes permit glucose molecules to pass, but not red blood cells.

Abbott filed the original application leading to the ′551 patent in 1984. Over thirteen years, that original application saw multiple rejections for anticipation and obviousness, including repeated rejections over U.S. Patent No. 4,545,382 ("the ′382 patent"), another patent owned by Abbott. The ′382 patent specification discussed protective membranes in the following terms: "Optionally, but preferably when being used on live blood, a protective membrane surrounds both the enzyme and the mediator layers, permeable to water and glucose molecules." Col.4 ll.63–66. "Live blood" refers to blood within a body.

In 1997, Lawrence Pope, Abbott's patent attorney, and Dr. Gordon Sanghera, Abbott's Director of Research and Development, studied the novel features of their application and decided to present a new reason for a patent. Pope presented new claims to the examiner based on a new sensor that did not require a protective membrane for whole blood. Pope asserted that this distinction would overcome the prior art ′382 patent, whose electrodes allegedly required a protective membrane. The examiner requested an affidavit to show that the prior art required a membrane for whole blood at the time of the invention.

To meet this evidentiary request, Dr. Sanghera submitted a declaration to the U.S. Patent and Trademark Office ("PTO") stating:

> [O]ne skilled in the art would have felt that an active electrode comprising an enzyme and a mediator would require a protective membrane if it were to be used with a whole blood sample.... [O]ne skilled in the art would not read lines 63 to 65 of column 4 of U.S. Patent No. 4,545,382 to teach that the use of a protective membrane with a whole blood sample is optionally or merely preferred.

J.A. 7637. Pope, in submitting Sanghera's affidavit, represented:

> The art continued to believe [following the ′382 patent] that a barrier layer for [a] whole blood sample was necessary....
>
> One skilled in the art would *not* have read the disclosure of the [′382 patent] as teaching that the use of a protective membrane with whole blood samples was optional. He would not, especially in view of the working examples, have read the "optionally, but preferably" language at line 63 of column [4] as a technical teaching but rather mere patent phraseology.
>
> ....
>
> There is no teaching or suggestion of unprotected active electrodes for use with whole blood specimens in [the ′382 patent]....

J.A. 7645–46.

Several years earlier, while prosecuting the European counterpart to the ′ 382 patent, European Patent EP 0 078 636 ("EP ′636"), Abbott made representations to the European Patent Office ("EPO") regarding the same "optionally, but preferably" language in the European specification. ***1284** On January 12, 1994, to distinguish a German reference labeled D1, which required a diffusion-limiting membrane, Abbott's European patent counsel argued that their invention did not require a diffusion-limiting membrane:

> *Contrary to the semipermeable membrane of D1, the protective membrane optionally utilized with the glucose sensor of the patent is [sic] suit is not controlling the permeability of the substrate* .... Rather, in accordance with column 5, lines 30 to 33 of the patent in suit:
>
> > "Optionally, but preferably when being used on live blood, a protective membrane surrounds both the enzyme and the mediator layers, permeable to water and glucose molecules."
>
> See also claim 10 of the patent in suit as granted according to which the sensor electrode has an outermost protective membrane (11) permeable to water and glucose molecules.... Accordingly, *the purpose of the protective membrane of the patent in suit, preferably to be used with in vivo measurements, is a safety measurement to prevent any course [sic] particles coming off during use but not a permeability control for the substrate.*

J.A. 6530–31 (emphases added).

On May 23, 1995, Abbott's European patent counsel submitted another explanation about the D1 reference and EP ′636.

> "Optionally, but preferably when being used on live blood, a protective membrane surrounds both the enzyme and the mediator layers, permeable to water and glucose molecules."
>
> *It is submitted that this disclosure is unequivocally clear. The protective membrane is optional, however, it is preferred when used on live blood in order to prevent the larger constituents of the blood, in particular erythrocytes from interfering with the electrode sensor. Furthermore it is said, that said protective membrane should not prevent the glucose molecules from penetration, the membrane is "permeable" to glucose molecules.* This teaches the skilled artisan that, whereas the [D1 membrane] must ... control the permeability of the glucose ... the purpose of the protective membrane in the patent in suit is not to control the permeation of the glucose molecules. For this very reason *the sensor electrode as claimed does not have (and must not have) a semipermeable membrane in the sense of D1.*

J.A. 6585 (first and third emphases added).

II

In March 2004, Becton, Dickinson and Co. ("Becton") sued Abbott in the District of Massachusetts seeking a declaratory judgment of noninfringement of U.S. Patent Nos. 6,143,164 ("the ′164 patent") and 6,592,745 ("the ′745 patent"). Becton's product was a blood glucose test strip, the BD Test Strip. Abbott countersued Becton in the Northern District of California alleging that Becton's strip infringed the ′164, ′745, and ′551 patents. The District of Massachusetts then transferred its case to the Northern District of California. Abbott then sued Nova Biomedical Corp. ("Nova"), Becton's supplier, alleging infringement of the patents asserted in Abbott's suit against Becton. In August 2005, Abbott also sued Bayer Healthcare LLC ("Bayer"), alleging that its Microfill and Autodisc blood glucose strips infringed the ′551 and ′745 patents. The Northern District of California consolidated all of the cases.

The district court granted summary judgment of noninfringement of all asserted claims in the ′164 and ′745 patents. *Therasense, Inc. v. Becton, Dickinson & Co.,* 560 F.Supp.2d 835, 854, 880 (N.D.Cal.2008). The district court also found nearly ***1285** all of the asserted claims of the ′745 patent invalid due to anticipation. *Id.* at 880.

Following a bench trial, the district court determined that claims 1–4 of the ′551 patent were invalid due to obviousness in light of the ′382 patent and U.S. Patent No. 4,225,410 ("the ′410 patent"). *Trial Opinion* at 1127. The central issue for obviousness was whether the prior art would have disclosed a glucose sensor without a membrane for whole blood to a person of ordinary skill in the art. The district court found that the ′382 patent disclosed sensors in which "a protective membrane was optional in all cases except the case of live blood, in which case the protective membrane was preferred—but not required." *Id.* at 1103. Of primary relevance here, the district court held the ′551 patent unenforceable for inequitable conduct because Abbott did not disclose to the PTO its briefs to the EPO filed on January 12, 1994 and May 23, 1995. *Id.* at 1127.

Abbott appealed the judgments of invalidity, unenforceability, and noninfringement. *Therasense, Inc. v. Becton, Dickinson & Co.,* 593 F.3d 1289 (Fed.Cir.2010), *vacated,* 374 Fed.Appx. 35 (Fed.Cir.2010). A panel of this court unanimously upheld the district court's judgments of noninfringement and invalidity. *Id.* at 1311. On unenforceability, the panel also affirmed, but with a dissent. *Id.* at 1312–25 (Linn, J., dissenting).

Recognizing the problems created by the expansion and overuse of the inequitable conduct doctrine, this court granted Abbott's petition for rehearing en banc and vacated the judgment of the panel. *Therasense,* 374 Fed.Appx. at 35. This court now vacates the district court's inequitable conduct judgment and remands.

III

[1] Inequitable conduct is an equitable defense to patent infringement that, if proved, bars enforcement of a patent. This judge-made doctrine evolved from a trio of Supreme Court cases that applied the doctrine of unclean hands to dismiss patent cases involving egregious misconduct: *Keystone Driller Co. v. General Excavator Co.,* 290 U.S. 240, 54 S.Ct. 146, 78 L.Ed. 293 (1933), *Hazel–Atlas Glass Co. v. Hartford–Empire Co.,* 322 U.S. 238, 64 S.Ct. 997, 88 L.Ed. 1250 (1944), *overruled on other grounds by Standard Oil Co. v. United States,* 429 U.S. 17, 97 S.Ct. 31, 50 L.Ed.2d 21 (1976), and *Precision Instrument Manufacturing Co. v. Automotive Maintenance Machinery Co.,* 324 U.S. 806, 65 S.Ct. 993, 89 L.Ed. 1381 (1945).

Keystone involved the manufacture and suppression of evidence. 290 U.S. at 243, 54 S.Ct. 146. The patentee knew of "a possible prior use" by a third party prior to filing a patent application but did not inform the PTO. *Id.* at 243, 54 S.Ct. 146. After the issuance of the patent, the patentee paid the prior user to sign a false affidavit stating that his use was an abandoned experiment and bought his agreement to keep secret the details of the prior use and to suppress evidence. *Id.* With these preparations in place, the patentee then asserted this patent, along with two other patents, against Byers Machine Co. ("Byers"). *Keystone Driller Co. v. Byers Mach. Co.,* 4 F.Supp. 159 (N.D.Ohio 1929). Unaware of the prior use and of the cover-up, the court held the patents valid and infringed and granted an injunction. *Id.* at 160.

The patentee then asserted the same patents against General Excavator Co. and Osgood Co. and sought a temporary injunction based on the decree in the previous Byers case. *Keystone,* 290 U.S. at 242, 54 S.Ct. 146. The district court denied the injunctions but made the defendants post bonds. *Id.* The defendants discovered and introduced evidence of the ***1286** corrupt transaction between the patentee and the prior user. *Id.* at 243–44, 54 S.Ct. 146. The district court declined to dismiss these cases for unclean hands. *Id.* On appeal, the Sixth Circuit reversed and remanded with instructions to dismiss the complaints. *Id.* The Supreme Court affirmed. *Id.* at 247, 54 S.Ct. 146.

The Supreme Court explained that if the corrupt transaction between the patentee and the prior user had been discovered in the previous Byers case, "the court undoubtedly would have been warranted in holding it sufficient to require dismissal of the cause of action." *Id.* at 246, 54 S.Ct. 146. Because the patentee used the Byers decree to seek an injunction in the cases against General Excavator Co. and Osgood Co., it did not come to the court with clean hands, and dismissal of these cases was appropriate. *Id.* at 247, 54 S.Ct. 146.

Like *Keystone, Hazel–Atlas* involved both the manufacture and suppression of evidence. 322 U.S. at 240, 64 S.Ct. 997. Faced with "apparently insurmountable Patent Office opposition," the patentee's attorneys wrote an article describing the invention as a remarkable advance in the art and had William Clarke, a well-known expert, sign it as his own and publish it in a trade journal. *Id.* After the patentee submitted the Clarke article to the PTO in support of its application, the PTO allowed a patent to issue. *Id.* at 240–41, 64 S.Ct. 997.

The patentee brought suit against Hazel–Atlas Glass Co. ("Hazel–Atlas"), alleging infringement of this patent. *Id.* at 241, 64 S.Ct. 997. The district court found no infringement. *Id.* On appeal, the patentee's attorneys emphasized the Clarke article, and the Third Circuit reversed the district court's judgment, holding the patent valid and infringed. *Id.* The patentee then went to great lengths to conceal the false authorship of the Clarke article, contacting Clarke multiple times, including before and after Hazel–Atlas's investigators spoke to him. *Id.* at 242–43, 64 S.Ct. 997. After Hazel–Atlas settled with the patentee, the patentee paid Clarke a total of $8,000. *Id.* These facts surfaced in a later suit, *United States v. Hartford–Empire Co.,* 46 F.Supp. 541 (N.D.Ohio 1942). *Hazel–Atlas,* 322 U.S. at 243, 64 S.Ct. 997.

On the basis of these newly-discovered facts, Hazel–Atlas petitioned the Third Circuit to vacate its judgment, but the court refused. *Id.* at 243–44, 64 S.Ct. 997. The Supreme Court reversed. *Id.* at 251, 64 S.Ct. 997. The Supreme Court explained that if the district court had learned of the patentee's deception before the PTO, it would have been warranted in dismissing the patentee's case under the doctrine of unclean hands. *Id.* at 250, 64 S.Ct. 997. Likewise, had the Third Circuit learned of the patentee's suppression of evidence, it also could have dismissed the appeal. *Id.* Accordingly, the Supreme Court vacated the judgment against Hazel–Atlas and reinstated the original judgment dismissing the patentee's case. *Id.* at 251, 64 S.Ct. 997.

In *Precision,* the patentee suppressed evidence of perjury before the PTO and attempted to enforce the perjury-tainted patent. 324 U.S. at 816–20, 65 S.Ct. 993. The PTO had declared an interference between two patent applications, one filed by Larson and the other by Zimmerman. *Id.* at 809, 65 S.Ct. 993. Automotive Maintenance Machinery Co. ("Automotive") owned the Zimmerman application. *Id.* Larson filed his preliminary statement in the PTO proceedings with false dates of conception, disclosure, drawing, description, and reduction to practice. Later, he testified in support of these false dates in an interference proceeding. *Id.* at 809–10, 65 S.Ct. 993.

Automotive discovered this perjury but did not reveal this information to the PTO. ***1287** *Id.* at 818, 65 S.Ct. 993. Instead, Automotive entered into a private settlement with Larson that gave Automotive the rights to the Larson application and suppressed evidence of Larson's perjury. *Id.* at 813–14, 65 S.Ct. 993. Automotive eventually received patents on both the Larson and Zimmerman applications. *Id.* at 814, 65 S.Ct. 993. Despite knowing that the Larson patent was tainted with perjury, Automotive sought to enforce it against others. *Id.* at 807, 65 S.Ct. 993.

The district court found that Automotive had unclean hands and dismissed the suit. *Id.* at 808, 65 S.Ct. 993. The Seventh Circuit reversed. *Id.* The Supreme Court reversed the Seventh Circuit's decision, explaining that dismissal was warranted because not only had the patentee failed to disclose its knowledge of perjury to the PTO, it had actively suppressed evidence of the perjury and magnified its effects. *Id.* at 818–19, 65 S.Ct. 993.

IV

The unclean hands cases of *Keystone, Hazel–Atlas,* and *Precision* formed the basis for a new doctrine of inequitable conduct that developed and evolved over time. Each of these unclean hands cases before the Supreme Court dealt with particularly egregious misconduct, including perjury, the manufacture of false evidence, and the suppression of evidence. *See Precision,* 324 U.S. at 816–20, 65 S.Ct. 993; *Hazel–Atlas,* 322 U.S. at 240, 64 S.Ct. 997; *Keystone,* 290 U.S. at 243, 54 S.Ct. 146. Moreover, they all involved "deliberately planned and carefully executed scheme[s] to defraud" not only the PTO but also the courts. *Hazel–Atlas,* 322 U.S. at 245, 64 S.Ct. 997. As the inequitable conduct doctrine evolved from these unclean hands cases, it came to embrace a broader scope of misconduct, including not only egregious affirmative acts of misconduct intended to deceive both the PTO and the courts but also the mere nondisclosure of information to the PTO. Inequitable conduct also diverged from the doctrine of unclean hands by adopting a different and more potent remedy—unenforceability of the entire patent rather than mere dismissal of the instant suit. *See Precision,* 324 U.S. at 819, 65 S.Ct. 993 (dismissing suit); *Hazel–Atlas,* 322 U.S. at 251, 64 S.Ct. 997 (noting that the remedy was limited to dismissal and did not render the patent unenforceable); *Keystone,* 290 U.S. at 247, 54 S.Ct. 146 (affirming dismissal of suit).

In line with this wider scope and stronger remedy, inequitable conduct came to require a finding of both intent to deceive and materiality. *Star Scientific Inc. v. R.J. Reynolds Tobacco Co.,* 537 F.3d 1357, 1365 (Fed.Cir.2008). To prevail on the defense of inequitable conduct, the accused infringer must prove that the applicant misrepresented or omitted material information with the specific intent to deceive the PTO. *Id.* The accused infringer must prove both elements—intent and materiality—by clear and convincing evidence. *Id.* If the accused infringer meets its burden, then the district court must weigh the equities to determine whether the applicant's conduct before the PTO warrants rendering the entire patent unenforceable. *Id.*

This court recognizes that the early unclean hands cases do not present any standard for materiality. Needless to say, this court's development of a materiality requirement for inequitable conduct does not (and cannot) supplant Supreme Court precedent. Though inequitable conduct developed from these cases, the unclean hands doctrine remains available to supply a remedy for egregious misconduct like that in the Supreme Court cases.

As inequitable conduct emerged from unclean hands, the standards for intent to deceive and materiality have fluctuated over time. In the past, this court has ***1288** espoused low standards for meeting the intent requirement, finding it satisfied based on gross negligence or even negligence. *See Driscoll v. Cebalo,* 731 F.2d 878, 885 (Fed.Cir.1984) ("Where they knew, or should have known, that the withheld reference would be material to the PTO's consideration, their failure to disclose the reference is sufficient proof of the existence of an intent to mislead the PTO."); *Orthopedic Equip. Co., Inc. v. All Orthopedic Appliances, Inc.,* 707 F.2d 1376, 1383–84 (Fed.Cir.1983) (requiring only gross negligence to sustain a finding of intent). This court has also previously adopted a broad view of materiality, using a "reasonable examiner" standard based on the PTO's 1977 amendment to Rule 56. *See Am. Hoist & Derrick Co. v. Sowa & Sons, Inc.,* 725 F.2d 1350, 1362 (Fed.Cir.1984); *see also* 37 C.F.R. § 1.56 (1977) (a reference is material if "there is a substantial likelihood that a reasonable examiner would consider it important in deciding whether to allow the application to issue as a patent"). Further weakening the showing needed to establish inequitable conduct, this court then placed intent and materiality together on a "sliding scale." *Am. Hoist,* 725 F.2d at 1362. This modification to the inequitable conduct doctrine held patents unenforceable based on a reduced showing of intent if the record contained a strong showing of materiality, and vice versa. In effect, this change conflated, and diluted, the standards for both intent and materiality.

This court embraced these reduced standards for intent and materiality to foster full disclosure to the PTO. *See id.* at 1363. This new focus on encouraging disclosure has had numerous unforeseen and unintended consequences. Most prominently, inequitable conduct has become a significant litigation strategy. A charge of inequitable conduct conveniently expands discovery into corporate practices before patent filing and disqualifies the prosecuting attorney from the patentee's litigation team. *See* Stephen A. Merrill et al., Nat'l Research Council of the Nat'l Academies, *A Patent System for the 21st Century* 122 (2004). Moreover, inequitable conduct charges cast a dark cloud over the patent's validity and paint the patentee as a bad actor. Because the doctrine focuses on the moral turpitude of the patentee with ruinous consequences for the reputation of his patent attorney, it discourages settlement and deflects attention from the merits of validity and infringement issues. Committee Position Paper, *The Doctrine of Inequitable Conduct and the Duty of Candor in Patent Prosecution: Its Current Adverse Impact on the Operation of the United States Patent System,* 16 AIPLA Q.J. 74, 75 (1988). Inequitable conduct disputes also "increas[e] the complexity, duration and cost of patent infringement litigation that is already notorious for its complexity and high cost." Brief and Appendix of the American Bar Ass'n as Amicus Curiae at 9.

[2] **[3]** **[4]** Perhaps most importantly, the remedy for inequitable conduct is the "atomic bomb" of patent law. *Aventis Pharma S.A. v. Amphastar Pharm., Inc.,* 525 F.3d 1334, 1349 (Fed.Cir.2008) (Rader, J., dissenting). Unlike validity defenses, which are claim specific, *see* 35 U.S.C. § 288, inequitable conduct regarding any single claim renders the entire patent unenforceable. *Kingsdown Med. Consultants, Ltd. v. Hollister Inc.,* 863 F.2d 867, 877 (Fed.Cir.1988). Unlike other deficiencies, inequitable conduct cannot be cured by reissue, *Aventis,* 525 F.3d at 1341, n. 6, or reexamination, *Molins PLC v. Textron, Inc.,* 48 F.3d 1172, 1182 (Fed.Cir.1995). Moreover, the taint of a finding of inequitable conduct can spread from a single patent to render unenforceable other related patents and applications in the same technology family. *See, e.g., Consol. Aluminum* ***1289** *Corp. v. Foseco Int'l Ltd.,* 910 F.2d 804, 808–12 (Fed.Cir.1990). Thus, a finding of inequitable conduct may endanger a substantial portion of a company's patent portfolio.

[5] **[6]** A finding of inequitable conduct may also spawn antitrust and unfair competition claims. *See Dow Chemical Co. v. Exxon Corp.,* 139 F.3d 1470, 1471 (Fed.Cir.1998) (unfair competition claim); *Walker Process Equip., Inc. v. Food Mach. & Chem. Corp.,* 382 U.S. 172, 178, 86 S.Ct. 347, 15 L.Ed.2d 247 (1965) (antitrust action for treble damages). Further, prevailing on a claim of inequitable conduct often makes a case "exceptional," leading potentially to an award of attorneys' fees under 35 U.S.C. § 285. *Brasseler, U.S.A. I, L.P. v. Stryker Sales Corp.,* 267 F.3d 1370, 1380 (Fed.Cir.2001). A finding of inequitable conduct may also prove the crime or fraud exception to the attorney-client privilege. *See In re Spalding Sports Worldwide, Inc.,* 203 F.3d 800, 807 (Fed.Cir.2000).

With these far-reaching consequences, it is no wonder that charging inequitable conduct has become a common litigation tactic. One study estimated that eighty percent of patent infringement cases included allegations of inequitable conduct. Committee Position Paper at 75; *see also* Christian Mammen, *Controlling the "Plague": Reforming the Doctrine of Inequitable Conduct,* 24 Berkeley Tech. L.J. 1329, 1358 (2009). Inequitable conduct "has been overplayed, is appearing in nearly every patent suit, and is cluttering up the patent system." *Kimberly–Clark Corp. v. Johnson & Johnson,* 745 F.2d 1437, 1454 (Fed.Cir.1984). "[T]he habit of charging inequitable conduct in almost every major patent case has become an absolute plague. Reputable lawyers seem to feel compelled to make the charge against other reputable lawyers on the slenderest grounds, to represent their client's interests adequately, perhaps." *Burlington Indus., Inc. v. Dayco Corp.,* 849 F.2d 1418, 1422 (Fed.Cir.1988); *see also Abbott Labs. v. Sandoz, Inc.,* 544 F.3d 1341, 1358 (Fed.Cir.2008); *Multiform Desiccants, Inc. v. Medzam, Ltd.,* 133 F.3d 1473, 1482 (Fed.Cir.1998); *Magnivision, Inc. v. Bonneau Co.,* 115 F.3d 956, 960 (Fed.Cir.1997); *Allied Colloids Inc. v. Am. Cyanamid Co.,* 64 F.3d 1570, 1578 (Fed.Cir.1995); *Molins,* 48 F.3d at 1182.

Left unfettered, the inequitable conduct doctrine has plagued not only the courts but also the entire patent system. Because allegations of inequitable conduct are routinely brought on "the slenderest grounds," *Burlington Indus.,* 849 F.2d at 1422, patent prosecutors constantly confront the specter of inequitable conduct charges. With inequitable conduct casting the shadow of a hangman's noose, it is unsurprising that patent prosecutors regularly bury PTO examiners with a deluge of prior art references, most of which have marginal value. *See* Brief for the United States as Amicus Curiae at 17 (submission of nine hundred references without any indication which ones were most relevant); Brief of the Biotechnology Industry Organization as Amicus Curiae at 7 (submission of eighteen pages of cited references, including five pages listing references to claims, office actions, declarations, amendments, interview summaries, and other communications in related applications). "Applicants disclose too much prior art for the PTO to meaningfully consider, and do not explain its significance, all out of fear that to do otherwise risks a claim of inequitable conduct." ABA Section of Intellectual Property Law, *A Section White Paper: Agenda for 21st Century Patent Reform* 2 (2009). This tidal wave of disclosure makes identifying the most relevant prior art more difficult. *See* Brief for the United States as Amicus Curiae at 1 (submission of "large numbers of prior art references of questionable materiality ***1290** ... harms the effectiveness of the examination process"). "This flood of information strains the agency's examining resources and directly contributes to the backlog." *Id.* at 17–18.

While honesty at the PTO is essential, low standards for intent and materiality have inadvertently led to many unintended consequences, among them, increased adjudication cost and complexity, reduced likelihood of settlement, burdened courts, strained PTO resources, increased PTO backlog, and impaired patent quality. This court now tightens the standards for finding both intent and materiality in order to redirect a doctrine that has been overused to the detriment of the public.

V

[7] **[8]** To prevail on a claim of inequitable conduct, the accused infringer must prove that the patentee acted with the specific intent to deceive the PTO. *Star,* 537 F.3d at 1366 (citing *Kingsdown,* 863 F.2d at 876). A finding that the misrepresentation or omission amounts to gross negligence or negligence under a "should have known" standard does not satisfy this intent requirement. *Kingsdown,* 863 F.2d at 876. "In a case involving nondisclosure of information, clear and convincing evidence must show that the applicant *made a deliberate decision* to withhold a *known* material reference." *Molins,* 48 F.3d at 1181 (emphases added). In other words, the accused infringer must prove by clear and convincing evidence that the applicant knew of the reference, knew that it was material, and made a deliberate decision to withhold it.

This requirement of knowledge and deliberate action has origins in the trio of Supreme Court cases that set in motion the development of the inequitable conduct doctrine. In each of those cases, the patentee acted knowingly and deliberately with the purpose of defrauding the PTO and the courts. *See Precision,* 324 U.S. at 815–16, 65 S.Ct. 993 (assertion of patent known to be tainted by perjury); *Hazel–Atlas,* 322 U.S. at 245, 64 S.Ct. 997 (a "deliberately planned and carefully executed scheme to defraud" the PTO involving both bribery and perjury); *Keystone,* 290 U.S. at 246–47, 54 S.Ct. 146 (bribery and suppression of evidence).

[9] **[10]** **[11]** Intent and materiality are separate requirements. *Hoffmann–La Roche, Inc. v. Promega Corp.,* 323 F.3d 1354, 1359 (Fed.Cir.2003). A district court should not use a "sliding scale," where a weak showing of intent may be found sufficient based on a strong showing of materiality, and vice versa. Moreover, a district court may not infer intent solely from materiality. Instead, a court must weigh the evidence of intent to deceive independent of its analysis of materiality. Proving that the applicant knew of a reference, should have known of its materiality, and decided not to submit it to the PTO does not prove specific intent to deceive. *See Star,* 537 F.3d at 1366 ("the fact that information later found material was not disclosed cannot, by itself, satisfy the deceptive intent element of inequitable conduct").

[12] [13] [14] Because direct evidence of deceptive intent is rare, a district court may infer intent from indirect and circumstantial evidence. *Larson Mfg. Co. of S.D., Inc. v. Aluminart Prods. Ltd.,* 559 F.3d 1317, 1340 (Fed.Cir.2009). However, to meet the clear and convincing evidence standard, the specific intent to deceive must be "the single most reasonable inference able to be drawn from the evidence." *Star,* 537 F.3d at 1366. Indeed, the evidence "must be sufficient to *require* a finding of deceitful intent in the light of all the circumstances." *Kingsdown,* 863 F.2d at 873 (emphasis added). Hence, when there are multiple reasonable inferences that may be drawn, intent to deceive cannot be ***1291** found. *See Scanner Techs. Corp. v. ICOS Vision Sys. Corp.,* 528 F.3d 1365, 1376 (Fed.Cir.2008) ("Whenever evidence proffered to show either materiality or intent is susceptible of multiple reasonable inferences, a district court clearly errs in overlooking one inference in favor of another equally reasonable inference."). This court reviews the district court's factual findings regarding what reasonable inferences may be drawn from the evidence for clear error. *See Star,* 537 F.3d at 1365.

[15] Because the party alleging inequitable conduct bears the burden of proof, the "patentee need not offer any good faith explanation unless the accused infringer first ... prove[s] a threshold level of intent to deceive by clear and convincing evidence." *Star,* 537 F.3d at 1368. The absence of a good faith explanation for withholding a material reference does not, by itself, prove intent to deceive.

VI

In the past, this court has tried to address the proliferation of inequitable conduct charges by raising the intent standard alone. In *Kingsdown,* this court made clear that gross negligence alone was not enough to justify an inference of intent to deceive. 863 F.2d at 876. *Kingsdown* established that "the involved conduct ... must indicate sufficient culpability to *require* a finding of intent to deceive." *Id.* (emphasis added). This higher intent standard, standing alone, did not reduce the number of inequitable conduct cases before the courts and did not cure the problem of overdisclosure of marginally relevant prior art to the PTO. To address these concerns, this court adjusts as well the standard for materiality.

In *Corona Cord Tire Co. v. Dovan Chemical Corp.,* the Supreme Court considered the materiality of a patentee's misrepresentation to the PTO. 276 U.S. 358, 373–74, 48 S.Ct. 380, 72 L.Ed. 610 (1928). The patentee had submitted two affidavits, falsely claiming that the invention had been used in the production of rubber goods when in fact only test slabs of rubber had been produced. *Id.* Because the misrepresentation was not the but-for cause of the patent's issuance, the Court held that it was immaterial and refused to extinguish the patent's presumption of validity:

> Production of rubber goods for use or sale was not indispensable to the granting of the patent. Hence the affidavits, though perhaps reckless, were not the basis for it or essentially material to its issue. The reasonable presumption of validity furnished by the grant of the patent, therefore, would not seem to be destroyed.

Id. at 374, 48 S.Ct. 380. Although *Corona Cord* does not address unclean hands, the precursor to inequitable conduct, it demonstrates the Court's unwillingness to extinguish the statutory presumption of validity where the patentee made a misrepresentation to the PTO that did not affect the issuance of the patent. *Corona Cord* thus supports a but-for materiality standard for inequitable conduct, particularly given that the severe remedy of unenforceability for inequitable conduct far exceeds the mere removal of a presumption of validity.

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[16] **[17]** **[18]** This court holds that, as a general matter, the materiality required to establish inequitable conduct is but-for materiality. When an applicant fails to disclose prior art to the PTO, that prior art is but-for material if the PTO would not have allowed a claim had it been aware of the undisclosed prior art. Hence, in assessing the materiality of a withheld reference, the court must determine whether the PTO would have allowed the claim if it had been aware of the undisclosed reference. In making this patentability determination, the court should apply the preponderance ***1292** of the evidence standard and give claims their broadest reasonable construction. *See* Manual of Patent Examining Procedure ("MPEP") §§ 706, 2111 (8th ed. Rev.8, July 2010). Often the patentability of a claim will be congruent with the validity determination—if a claim is properly invalidated in district court based on the deliberately withheld reference, then that reference is necessarily material because a finding of invalidity in a district court requires clear and convincing evidence, a higher evidentiary burden than that used in prosecution at the PTO. However, even if a district court does not invalidate a claim based on a deliberately withheld reference, the reference may be material if it would have blocked patent issuance under the PTO's different evidentiary standards. *See* MPEP §§ 706 (preponderance of the evidence), 2111 (broadest reasonable construction).

[19] **[20]** As an equitable doctrine, inequitable conduct hinges on basic fairness. "[T]he remedy imposed by a court of equity should be commensurate with the violation." *Columbus Bd. of Educ. v. Penick,* 443 U.S. 449, 465, 99 S.Ct. 2941, 61 L.Ed.2d 666 (1979). Because inequitable conduct renders an entire patent (or even a patent family) unenforceable, as a general rule, this doctrine should only be applied in instances where the patentee's misconduct resulted in the unfair benefit of receiving an unwarranted claim. *See Star,* 537 F.3d at 1366 ("[j]ust as it is inequitable to permit a patentee who obtained his patent through deliberate misrepresentations or omissions of material information to enforce the patent against others, it is also inequitable to strike down an entire patent where the patentee committed only minor missteps or acted with minimal culpability"). After all, the patentee obtains no advantage from misconduct if the patent would have issued anyway. *See Keystone,* 290 U.S. at 245, 54 S.Ct. 146 ("The equitable powers of the court can never be exerted in behalf of one ... who by deceit or any unfair means has *gained an advantage.*") (emphasis added) (internal citations omitted). Moreover, enforcement of an otherwise valid patent does not injure the public merely because of misconduct, lurking somewhere in patent prosecution, that was immaterial to the patent's issuance.

[21] **[22]** Although but-for materiality generally must be proved to satisfy the materiality prong of inequitable conduct, this court recognizes an exception in cases of affirmative egregious misconduct. This exception to the general rule requiring but-for proof incorporates elements of the early unclean hands cases before the Supreme Court, which dealt with "deliberately planned and carefully executed scheme[s]" to defraud the PTO and the courts. *Hazel–Atlas,* 322 U.S. at 245, 64 S.Ct. 997. When the patentee has engaged in affirmative acts of egregious misconduct, such as the filing of an unmistakably false affidavit, the misconduct is material. *See Rohm & Haas Co. v. Crystal Chem. Co.,* 722 F.2d 1556, 1571 (Fed.Cir.1983) ("there is no room to argue that submission of false affidavits is not material"); *see also Refac Int'l, Ltd. v. Lotus Dev. Corp.,* 81 F.3d 1576, 1583 (Fed.Cir.1996) (finding the intentional omission of declarant's employment with inventor's company rendered the affidavit false and that "[a]ffidavits are inherently material"). After all, a patentee is unlikely to go to great lengths to deceive the PTO with a falsehood unless it believes that the falsehood will affect issuance of the patent. *See id.* at 247, 64 S.Ct. 997 (pointing out that patentee's lawyers "went to considerable trouble and expense" to manufacture false evidence because they believed it was needed to obtain issuance of the patent). Because neither mere nondisclosure of prior art references to the PTO nor failure to mention ***1293** prior art references in an affidavit constitutes affirmative egregious misconduct, claims of inequitable conduct that are based on such omissions require proof of but-for materiality. By creating an exception to punish affirmative egregious acts without penalizing the failure to disclose information that would not have changed the issuance decision, this court strikes a necessary balance between encouraging honesty before the PTO and preventing unfounded accusations of inequitable conduct.

The concurrence mischaracterizes this exception for affirmative egregious acts by limiting it to the example provided—the filing of an unmistakably false affidavit. Based on this misunderstanding, the concurrence asserts that this court's test for materiality is unduly rigid and contrary to Supreme Court precedent. In actuality, however, the materiality standard set forth in this opinion includes an exception for affirmative acts of egregious misconduct, not just the filing of false affidavits. Accordingly, the general rule requiring but-for materiality provides clear guidance to patent practitioners and courts, while the egregious misconduct exception gives the test sufficient flexibility to capture extraordinary circumstances. Thus, not only is this court's approach sensitive to varied facts and equitable considerations, it is also consistent with the early unclean hands cases—all of which dealt with egregious misconduct. *See Precision,* 324 U.S. at 816–20, 65 S.Ct. 993 (perjury and suppression of evidence); *Hazel–Atlas,* 322 U.S. at 240, 64 S.Ct. 997 (manufacture and suppression of evidence); *Keystone,* 290 U.S. at 243, 54 S.Ct. 146 (bribery and suppression of evidence).

The concurrence appears to eschew the use of *any* test because, by definition, under any test for materiality, a district court could not find inequitable conduct in cases "where the conduct in question would not be defined as such [under the test]." Although equitable doctrines require some measure of flexibility, abandoning the use of tests entirely is contrary to both longstanding practice and Supreme Court precedent. Courts have long applied rules and tests in determining whether a particular factual situation falls within the scope of an equitable doctrine. *See, e.g., Winter v. Natural Res. Def. Council, Inc.,* 555 U.S. 7, 129 S.Ct. 365, 374, 172 L.Ed.2d 249 (2008) (four-factor test for preliminary injunctions); *eBay Inc. v. MercExchange, L.L.C.,* 547 U.S. 388, 391, 126 S.Ct. 1837, 164 L.Ed.2d 641 (2006) (four-factor test for permanent injunctions); *Gutierrez v. Waterman S.S. Corp.,* 373 U.S. 206, 215, 83 S.Ct. 1185, 10 L.Ed.2d 297 (1963) ("the test of laches" requires both unreasonable delay and consequent prejudice). Moreover, the Supreme Court has made clear that such tests serve an important purpose in limiting the discretion of district courts.

> [C]ourts of equity must be governed by rules and precedents no less than the courts of law ... [because] the alternative is to use each equity chancellor's conscience as a measure of equity, which alternative would be as arbitrary and uncertain as measuring distance by the length of each chancellor's foot....
>
> After all, equitable rules that guide lower courts reduce uncertainty, avoid unfair surprise, minimize disparate treatment of similar cases, and thereby help all litigants....

Lonchar v. Thomas, 517 U.S. 314, 323, 116 S.Ct. 1293, 134 L.Ed.2d 440 (1996) (internal quotations omitted). This court therefore rejects the view that its test—albeit flexible enough to capture varying manifestations of egregious and abusive conduct—is inappropriate in the context of the way inequitable conduct has metastasized.

[23] This court does not adopt the definition of materiality in PTO Rule 56. As ***1294** an initial matter, this court is not bound by the definition of materiality in PTO rules. *See Merck & Co., Inc. v. Kessler,* 80 F.3d 1543, 1549–50 (Fed.Cir.1996) ("[T]he broadest of the PTO's rulemaking powers ... does NOT grant the Commissioner the authority to issue substantive rules."); *see also* 57 Fed.Reg.2021 (Jan. 17, 1992) (The PTO stated that Rule 56 "do[es] not define fraud or inequitable conduct."). While this court respects the PTO's knowledge in its area of expertise, the routine invocation of inequitable conduct in patent litigation has had adverse ramifications beyond its effect on the PTO. As discussed above, patent prosecutors, inventors, courts, and the public at large have an interest in reining in inequitable conduct. Notably, both the American Bar Association and the American Intellectual Property Law Association, which represent a wide spectrum of interests, support requiring but-for materiality (which is absent from Rule 56).

This court has looked to the PTO's Rule 56 in the past as a starting point for determining materiality. *See Am. Hoist,* 725 F.2d at 1363. Rule 56 has gone through several revisions, from the "fraud" standard in its original promulgation in 1949 to the "reasonable examiner" standard in 1977 to the current version, which includes any information that "refutes or is inconsistent with" any position the applicant took regarding patentability. *See* 37 C.F.R. § 1.56 (1950); 37 C.F.R. § 1.56 (1977); 37 C.F.R. § 1.56 (1992). Tying the materiality standard for inequitable conduct to PTO rules, which understandably change from time to time, has led to uncertainty and inconsistency in the development of the inequitable conduct doctrine. *See, e.g., Digital Control, Inc. v. Charles Mach. Works,* 437 F.3d 1309, 1316 (Fed.Cir.2006) (applying 1977 version of Rule 56); *Bruno Independent Living Aids, Inc. v. Acorn Mobility Servs., Ltd.,* 394 F.3d 1348, 1352–53 (Fed.Cir.2005) (applying 1992 version of Rule 56). Experience thus counsels against this court abdicating its responsibility to determine the boundaries for inequitable conduct.

This court declines to adopt the current version of Rule 56 in defining inequitable conduct because reliance on this standard has resulted in the very problems this court sought to address by taking this case en banc. Rule 56 provides that information is material if it is not cumulative and:

(1) It establishes, by itself or in combination with other information, a prima facie case of unpatentability of a claim; or

(2) It refutes, or is inconsistent with, a position the applicant takes in:

(i) Opposing an argument of unpatentability relied on by the Office, or

(ii) Asserting an argument of patentability.

37 C.F.R. § 1.56. Rule 56 further provides that a "prima facie case of unpatentability is established when the information compels a conclusion that a claim is unpatentable ... *before any consideration is given to evidence which may be submitted in an attempt to establish a contrary conclusion of patentability.*" *Id.* (emphasis added). The first prong of Rule 56 is overly broad because information is considered material even if the information would be rendered irrelevant in light of subsequent argument or explanation by the patentee. Under this standard, inequitable conduct could be found based on an applicant's failure to disclose information that a patent examiner would readily agree was not relevant to the prosecution after considering the patentee's argument. Likewise, the second prong of Rule 56 broadly encompasses anything that could be considered marginally relevant to patentability. If an applicant were to assert that his invention would have been non-obvious, for example, anything bearing any relation to obviousness could be found material under the ***1295** second prong of Rule 56. Because Rule 56 sets such a low bar for materiality, adopting this standard would inevitably result in patent prosecutors continuing the existing practice of disclosing too much prior art of marginal relevance and patent litigators continuing to charge inequitable conduct in nearly every case as a litigation strategy.

The dissent's critique of but-for materiality relies heavily on definitions of materiality in other contexts. Contrary to the implication made in the dissent, however, but-for proof *is* required to establish common law fraud. Common law fraud requires proof of reliance, which is equivalent to the but-for test for materiality set forth in this opinion. *See* 37 C.J.S. *Fraud* § 51 ("the reliance element of a fraud claim requires that the misrepresentation actually induced the injured party to change its course of action"); *Restatement (Second) of Torts* § 525 (1977) (fraud requires that the party "relies on the misrepresentation in acting or refraining from action"); *see, e.g., Exxon Mobil Corp. v. Ala. Dept. of Conservation & Natural Res.,* 986 So.2d 1093, 1116 (Ala.2007) (reliance element of fraud "can be met only if the plaintiff does, or does not do, something that the plaintiff would or would not have done but for the misrepresentation of a material fact"); *Alliance Mortgage Co. v. Rothwell,* 10 Cal.4th 1226, 1239, 44 Cal.Rptr.2d 352, 900 P.2d 601 (Cal.1995) (same); *Luscher v. Empkey,* 206 Neb. 572, 576, 293 N.W.2d 866 (Neb.1980) (same); *Spencer v. Ellis,* 216 Or. 554, 561, 339 P.2d 1116 (Or.1959) (same). The remaining examples in the dissent, where but-for materiality is not required, have limited relevance to inequitable conduct. While but-for materiality may not be required in every context, it is appropriate for inequitable conduct in light of the numerous adverse consequences of a looser standard.

Moreover, if this court were to consider standards of materiality in other contexts, the most analogous area of law is copyright. *See Sony Corp. of Am. v. Univ. City Studios, Inc.,* 464 U.S. 417, 439, 104 S.Ct. 774, 78 L.Ed.2d 574 (1984) (finding it appropriate to draw an analogy between copyrights and patents "because of the historic kinship between patent law and copyright law"). But-for proof is required to invalidate both copyrights and trademarks based on applicant misconduct. *See* 17 U.S.C. § 411(b)(1) (copyright); *Citibank, N.A. v. Citibanc Group, Inc.,* 724 F.2d 1540, 1544 (11th Cir.1984) (trademarks). The dissent concedes that "but for" materiality is required to cancel a trademark but contends that it is not required to invalidate federal registration of a copyright. Various courts have held otherwise. *See* 2 Melville B. Nimmer & David Nimmer, *Nimmer on Copyright* § 7.20 [B][1] (rev. ed.2010) ("plaintiff's failure to inform the Copyright Office of given facts is without substance, to the extent that the Office would have registered the subject work even had it known those facts"). Moreover, the Copyright Act has codified this "but for" requirement, making clear that copyright registration is sufficient to permit an infringement suit, even if the certificate of registration contains inaccurate information, unless "the inaccuracy of the information, if known, would have caused the Register of Copyrights to refuse registration." 17 U.S.C. § 411(b)(1); *see also* 2 *Nimmer on Copyright* § 7.20[B][2] (explaining that the materiality "standard [set forth in the 2008 amendment to the Copyright Act] is well in line with the construction of the Act prior to this amendment").

VII

[24] In this case, the district court held the ′551 patent unenforceable for inequitable conduct because Abbott did not disclose briefs it submitted to the EPO regarding the European counterpart of the ′382 patent. *Trial Opinion* at 1127. Because ***1296** the district court found statements made in the EPO briefs material under the PTO's Rule 56 materiality standard, not under the but-for materiality standard set forth in this opinion, this court vacates the district court's findings of materiality. *Id.* at 1113, 1115. On remand, the district court should determine whether the PTO would not have granted the patent but for Abbott's failure to disclose the EPO briefs. In particular, the district court must determine whether the PTO would have found Sanghera's declaration and Pope's accompanying submission unpersuasive in overcoming the obviousness rejection over the ′382 patent if Abbott had disclosed the EPO briefs.

[25] The district court found intent to deceive based on the absence of a good faith explanation for failing to disclose the EPO briefs. *Id.* at 1113–16. However, a "patentee need not offer any good faith explanation unless the accused infringer first ... prove[s] a threshold level of intent to deceive by clear and convincing evidence." *Star,* 537 F.3d at 1368. The district court also relied upon the "should have known" negligence standard in reaching its finding of intent. *See Trial Opinion* at 1113 ("Attorney Pope knew or should have known that the withheld information would have been highly material to the examiner"). Because the district court did not find intent to deceive under the knowing and deliberate standard set forth in this opinion, this court vacates the district court's findings of intent. *Id.* at 1113–16. On remand, the district court should determine whether there is clear and convincing evidence demonstrating that Sanghera or Pope knew of the EPO briefs, knew of their materiality, and made the conscious decision not to disclose them in order to deceive the PTO.

For the foregoing reasons, this court vacates the district court's finding of inequitable conduct and remands for further proceedings consistent with this opinion. This court also reinstates Parts I, III, and IV of the panel decision reported at 593 F.3d 1289, affirming the district court's judgment of obviousness, noninfringement, and anticipation, respectively. The judgment below is

AFFIRMED–IN–PART, VACATED–IN–PART, and REMANDED–IN–PART.

COSTS

Each party shall bear its own costs.

O'MALLEY, Circuit Judge, concurring in part and dissenting in part.
Patent practitioners regularly call on this court to provide clear guidelines. They seek to know under precisely what circumstances governing principles will be applied, and precisely how they will be applied. While precision may be in the nature of what patent practitioners do, and the desire for defining rules in the scientific world understandable, the law does not always lend itself to such precision. Indeed, when dealing with the application of equitable principles and remedies, the law is imprecise by design.

I understand and admire the majority's desire to respond to practitioners' calls for precision and clarity. I also understand its concern with perceived litigation abuses surrounding assertions of inequitable conduct. I believe, however, that the majority responds to that call and addresses those concerns in ways that fail to acknowledge and remain true to the equitable nature of the doctrine it seeks to cabin.

I respectfully dissent from those portions of the majority opinion which describe the test it directs lower courts to apply in assessing materiality and which vacates and remands for further inquiry the materiality determinations made by the district court in this case. As explained ***1297** below, I concur in the remainder of the majority's decision and judgment.

I.

I concur in the majority's decision to vacate and remand the judgment of the district court with instructions to reconsider its finding of inequitable conduct. Specifically, because the district court understandably referred to standards governing its intent determination drawn from our prior case law, the district court should be given the opportunity to assess, in the first instance, whether the evidence, and its credibility determinations, support a finding of a specific intent to deceive. In this regard, like the other dissenters, I agree with the majority's holding that, as a prerequisite to a finding of inequitable conduct, a district court must find that the conduct at issue is of "sufficient culpability to require a finding of intent to deceive." *Kingsdown Med. Consultants, Ltd. v. Hollister Inc.,* 863 F.2d 867, 876 (Fed.Cir.1988). In making this determination, intent to deceive and materiality must be found separately. District courts may not employ a "sliding scale," nor may they infer intent from materiality alone. [1] Finally, I agree that a district court may infer intent from indirect and circumstantial evidence, but only where it is "the single most reasonable inference able to be drawn from the evidence." Maj. Op. at 1290 (quoting *Star Scientific Inc. v. R.J. Reynolds Tobacco Co.,* 537 F.3d 1357, 1366 (Fed.Cir.2008)).

1 While I join this portion of the majority opinion (Part V), I do so with the understanding that the majority does not hold that it is impermissible for a court to consider the level of materiality as circumstantial evidence in its intent analysis. As in all other legal inquiries involving multiple elements, the district court may rely on the same items of evidence in both its materiality and intent inquiries. A district court must, however, reach separate conclusions of intent and materiality and may not base a finding of specific intent to deceive on materiality alone, regardless of the level of materiality.

II.

It is at this point that my views, respectfully, diverge from those of both the majority and the other dissenters. This is so because, when addressing the types of conduct that should be deemed of sufficient concern to allow for a finding of inequitable conduct, both the majority and dissent strain too hard to impose hard and fast rules.

"The essence of equity jurisdiction has been the power of the Chancellor to do equity and to mould each decree to the necessities of the particular case." *Weinberger v. Romero–Barcelo,* 456 U.S. 305, 312, 102 S.Ct. 1798, 72 L.Ed.2d 91 (1982) (quoting *Hecht Co. v. Bowles,* 321 U.S. 321, 329, 64 S.Ct. 587, 88 L.Ed. 754 (1944)). While courts of equity "must be governed by rules and precedents no less than the courts of law," *Lonchar v. Thomas,* 517 U.S. 314, 323, 116 S.Ct. 1293, 134 L.Ed.2d 440 (1996), "[f]lexibility rather than rigidity has distinguished" equitable jurisdiction, *Weinberger,* 456 U.S. at 312, 102 S.Ct. 1798. "Equity eschews mechanical rules; it depends on flexibility." *Holmberg v. Armbrecht,* 327 U.S. 392, 396, 66 S.Ct. 582, 90 L.Ed. 743 (1946).

Traditional notions of equitable relief apply with equal force in the context of patents. *eBay Inc. v. MercExchange, LLC,* 547 U.S. 388, 393–94, 126 S.Ct. 1837, 164 L.Ed.2d 641 (2006) (holding that a categorical rule of granting an injunction to a prevailing patent holder abrogates a district court's discretion in granting equitable relief and runs afoul of traditional principles of equity). We have long recognized that the doctrine of inequitable conduct is based in equity. *Kingsdown,* 863 F.2d at 876 ("[T]he ultimate question of whether inequitable conduct occurred is equitable in nature."). Despite this longstanding ***1298** principle, both the majority and dissenting opinions eschew flexibility in favor of rigidity. Both opinions suggest tests for materiality to apply in all cases. Their respective materiality inquiries are black or white, while equity requires judicial consideration of shades of gray.

The majority defines materiality under a but-for test, with an exception for intentionally false affidavits filed with the PTO.[2] Maj. Op. at 1291–93. The dissent, on the other hand, defines materiality according to Rule 56. Both tests fail to provide district courts with flexibility to find inequitable conduct in an extraordinary case where the conduct in question would not be defined as such under either test. This result is contrary to the very nature of equity and centuries of Supreme Court precedent. I cannot, accordingly, lend support to either of the immutable tests proposed by my colleagues.

2 The majority responds to this characterization, and to the general criticism in this opinion, by defining its test more broadly and acknowledging a degree of flexibility within its four corners. For that, I applaud the majority. I do not think, however, that this additional explanation is sufficient to address all of the concerns expressed in this opinion. I remain of the view that the test I propose here is the most consistent with the doctrine's origins.

While the majority states that, despite the strictures of the test it adopts, "the unclean hands doctrine remains available to supply a remedy for egregious misconduct like that in the Supreme Court cases," that statement does not address the concerns I express here.[3] Maj. Op. at 1287–88. Since, as the majority painstakingly explains, the doctrine of inequitable conduct we are defining grew out of those "unclean hands" cases, the asserted dichotomy is a false one. *See Consol. Aluminum Corp. v. Foseco Int'l, Ltd.,* 910 F.2d 804, 812 (Fed.Cir.1990) ("Indeed, what we have termed 'inequitable conduct' is no more than the unclean hands doctrine applied to particular conduct before the PTO.") (citations omitted). There is no support—and the majority cites none—for the proposition that inequitable conduct is somehow independent of the unclean hands principles the Supreme Court described and explained in its trilogy of cases. The remainder of the majority opinion makes clear, moreover, that the majority's purpose, and that of the test it adopts, is to delimit and narrow the contours of the unclean hands doctrine when applied to the application process before the PTO, not to acknowledge flexibility in it.[4]

3 Indeed, this language raises some additional concerns. If "unclean hands" remains available in cases of PTO misconduct, charges of unclean hands could simply supplant the very allegations of inequitable conduct the majority seeks to curb.

4 At the other end of the spectrum, the dissent's acknowledgement that a district court retains discretion *to decline* to find inequitable conduct even in the face of evidence of materiality and intent is similarly insufficient to undercut the unyielding nature of the test for inequitable conduct it adopts. It clearly does not allow, for instance, for a finding of inequitable conduct for conduct not encompassed by Rule 56.

We should adopt a test that provides as much guidance to district courts and patent applicants as possible, but, in doing so, we may not disregard the equitable nature of the inquiry at hand. Thus, we must make clear that, while we believe the test we offer encompasses virtually all forms of conduct sufficient to warrant a finding of inequitable conduct, we leave open the possibility that some form of intentional misconduct which we do not currently envision could warrant equitable relief. This approach respects the Supreme Court's recognition that courts of equity "exercise judgment in light of prior precedent, but ***1299** with awareness of the fact that specific circumstances, often hard to predict in advance, could warrant special treatment in an appropriate case." *Holland v. Florida,* 560 U.S. 631, 130 S.Ct. 2549, 2563, 177 L.Ed.2d 130 (2010).

Consistent with the flexible nature of equity jurisdiction, moreover, we should recognize that determining the proper remedy for a given instance of inequitable conduct is within the discretion of district courts, subject, of course, to statutory constraints. *Keystone Driller Co. v. Gen. Excavator Co.,* 290 U.S. 240, 245–46, 54 S.Ct. 146, 78 L.Ed. 293 (1933) ("[Courts of equity] are not bound by formula or restrained by any limitation that tends to trammel the free and just exercise of discretion."); *Mills v. Elec. Auto–Lite Co.,* 396 U.S. 375, 386, 90 S.Ct. 616, 24 L.Ed.2d 593 (1970) ("In selecting a remedy the lower courts should exercise the sound discretion which guides the determinations of courts of equity, keeping in mind the role of equity as the instrument for nice adjustment and reconciliation between the public interest and private needs as well as between competing private claims.") (internal quotations and citations omitted). While we have held previously that a finding of inequitable conduct renders unenforceable all claims of the wrongly procured patent and, in certain circumstances, related patents, this singular remedy is neither compelled by statute, nor consistent with the equitable nature of the doctrine.[5] Accordingly, I would overrule those cases and hold that, in the exercise of its discretion, a district court may choose to render fewer than all claims unenforceable, may simply dismiss the action before it, or may fashion some other reasonable remedy, so long as the remedy imposed by the court is "commensurate with the violation." *Columbus Bd. of Educ. v. Penick,* 443 U.S. 449, 465, 99 S.Ct. 2941, 61 L.Ed.2d 666 (1979); *see also Hecht,* 321 U.S. at 329, 64 S.Ct. 587 ("The essence of equity jurisdiction has been the power of the Chancellor to do equity and to mould each decree to the necessities of the particular case."); *Miller v. French,* 530 U.S. 327, 360, 120 S.Ct. 2246, 147 L.Ed.2d 326 (2000) ("These cases recognize the importance of permitting courts in equity cases to tailor relief ... to the exigencies of particular cases and individual circumstances. In doing so, they recognize the fact that *in certain circumstances justice requires the flexibility necessary to treat different cases differently—the rationale that underlies equity itself.*") (Breyer, J., dissenting) (emphasis added). Allowing for flexibility in the remedy would reduce the incentive to use inequitable conduct as a litigation tactic and address many of the concerns that trouble my colleagues and were expressed by Abbott and certain amici in these *en banc* proceedings. [6]

5 While the 1952 Act codified the defense of unclean hands in paragraph (1) of 35 U.S.C. § 282, it did not specify a remedy. *See* 35 U.S.C. § 282 (providing that "unenforceability" is a defense to an infringement action); P.J. Federico, "Commentary on the New Patent Act," 75 J. PAT. & TRADEMARK OFF. SOC'YY 161, 215 (1993) (explaining that paragraph (1) includes "equitable defenses such as laches, estoppel and unclean hands"). The statute, thus, provides no guidance as to whether, in its equitable discretion, a court may render some, but not all, claims unenforceable. In *J.P. Stevens & Co. v. Lex Tex, Ltd.,* 747 F.2d 1553 (Fed.Cir.1984), we cited cases collected from a treatise for the proposition that inequitable conduct renders all of a patent's claims unenforceable. *Id.* at 1561. None of those cases, however, are binding on this court and, for the reasons stated above, I find this proposition inconsistent with the power of the Chancellor to "mould" each decree to the necessities of the particular case.

6 One of the evils described by Abbott and amici is the possibility of an order barring enforcement of a patent based on misrepresentation of an applicant's "small entity status." To the extent unenforceability may be too harsh in such circumstances—a point on which I do not opine—district courts would have discretion to fashion some lesser remedy to address that form of intentional deception.

***1300** III.

To provide guidance to district courts to aid in the exercise of their discretion in inequitable conduct inquiries—beyond the Supreme Court's direction that "any willful act concerning the cause of action which rightfully can be said to transgress equitable standards of conduct is sufficient cause for the invocation of the maxim by the chancellor," *Precision Instrument Mfg. Co. v. Auto. Maint. Mach. Co.,* 324 U.S. 806, 814–16, 65 S.Ct. 993, 89 L.Ed. 1381 (1945)—I believe such guidance should reflect the concerns expressed by the Supreme Court in the case trilogy from which the doctrine emerged. As the Court said in *Precision,* at minimum, equity requires that, when seeking the public benefit of a government sponsored monopoly, applicants must act "fairly and without fraud or deceit." *Id.* Similarly, in *Hazel–Atlas Glass Co. v. Hartford–Empire Co.,* 322 U.S. 238, 64 S.Ct. 997, 88 L.Ed. 1250 (1944), the Court found that, regardless of the impact of such conduct on patentability, the doors of equity should be closed to a patentee who presented to the patent office, as impartial, an article it authored. *Id.* at 247, 64 S.Ct. 997.

With this general guidance in mind, I believe conduct should be deemed material where: (1) but for the conduct (whether it be in the form of an affirmative act or intentional non-disclosure), the patent would not have issued (as Chief Judge Rader explains that concept in the majority opinion); (2) the conduct constitutes a false or misleading representation of fact (rendered so either because the statement made is false on its face or information is omitted which, if known, would render the representation false or misleading); or (3) the district court finds that the behavior is so offensive that the court is left with a firm conviction that the integrity of the PTO process as to the application at issue was wholly undermined. In adopting such a test, I also believe we should confirm, as explained above, that the equitable nature of the doctrine demands that this test provide guidance only—albeit firm guidance—to district courts with respect to the exercise of their discretion in the face of inequitable conduct claims.

For the reasons ably articulated by the majority, I do not believe we should direct district courts to use Rule 56 as the measure of materiality in this context. As the majority points out, among other things, it is both too vague and too broad—leaving room for findings of inequitable conduct in circumstances not sufficiently egregious to fall within the bounds of the Supreme Court trilogy from which the doctrine emerged. I also cannot agree completely with the test proposed by the majority. Given the scope and complexity of PTO proceedings, misconduct can and does occur outside the context of written affidavits. In certain circumstances, regardless of the impact on patent issuance, such misconduct is sufficiently egregious that, when accompanied by the requisite intent to deceive, it could support a finding of inequitable conduct. Indeed, in *Hazel–Atlas,* the article in question was not presented to the PTO through an affidavit. 322 U.S. at 240–41, 64 S.Ct. 997. Both tests, moreover, fail to allow room to address conduct beyond their contours which equity should not ignore.

IV.

Applying the test I propose, or any reasonable test for materiality that comports with Supreme Court precedent, I would affirm the district court's finding that the ***1301** nondisclosure of information in this case was material. Indeed, I believe the omissions here qualify as material under the majority's "but-for plus" standard and that, even accepting that test as the governing standard, a remand on the issue of materiality is neither necessary nor appropriate.

As the other dissenters note, whether the prior art taught that glucose sensors could be used to test whole blood without a protective membrane was a key focus of the PTO examiner's patentability inquiry. After requesting permission to submit extrinsic evidence in response to a rejection from the PTO, Abbott submitted a sworn declaration from its expert Dr. Gordon Sanghera accompanied by statements from its counsel Lawrence Pope. Both contained representations to the examiner regarding what they alleged to be the appropriate understanding of the critical prior art reference with which the examiner was concerned. Among other things, they asserted unequivocally that one skilled in the art would not have read the prior art to say that use of a protective membrane with whole blood samples was optional. Omitted from these declarations was the fact that Abbott had made contrary representations on this same matter to the European Patent Office ("EPO") in connection with the earlier prosecution of a European patent application. There, Abbott represented that it was "unequivocally clear" that the same prior art language meant that the protective membrane was, in fact, optional.

The district court concluded that these nondisclosures were "highly material" because "they centered on the precise sentence in question [in the prior art reference], its meaning and what it taught." *Therasense, Inc. v. Becton, Dickinson & Co.,* 565 F.Supp.2d 1088, 1112 (N.D.Cal.2008). More specifically, the district court found:

> This is unlike the situation where a reference is already before an examiner who can draw his or her own conclusions as to what it teaches and is able to discount spin offered by counsel. *See Innogenetics, N.V. v. Abbott Labs.,* 512 F.3d 1363, 1379 (Fed.Cir.2008). Although the key sentence itself was indeed before Examiner Shay, the inquiry had shifted to a point of extrinsic evidence. That is, Examiner Shay had acquiesced to Attorney Pope's request to resort to extrinsic evidence to show that the sentence would have been understood by skilled artisans differently than its words suggested. Having received permission to supply extrinsic evidence, Attorney Pope was duty-bound to present any inconsistent extrinsic information known to him. In the arena of extrinsic evidence, the examiner was unable to fend for himself. He had no way of knowing what, if any, contrary extrinsic information had been left out of the Sanghera declaration. He was completely dependent on Attorney Pope and Dr. Sanghera to fully disclose any extrinsic information, pro and con, known to them on the factual point covered by the submission.

Id. The district court's materiality conclusions were thorough and correct. They should be affirmed.

V.

I do not weigh in on the policy debate between the majority and the dissenters. There are merits to the concerns expressed by each, and they may be relevant, in varying degrees, to the exercise of a court's discretion in a particular case. Policy concerns cannot, however, justify adopting broad legal standards that diverge from doctrines explicated by the Supreme Court. A desire to provide immutable guidance to lower courts and parties similarly is not sufficient to justify the ***1302** court's attempt to corral an equitable doctrine with neat tests.

To the extent there are concerns with litigation abuses surrounding the improper use of this otherwise important doctrine, there are vehicles available to the district court to address those concerns. Careful application of the pleading requirements set forth in *Exergen Corp. v. Wal–Mart Stores, Inc.,* 575 F.3d 1312 (Fed.Cir.2009), early case management techniques designed to ferret out and test unsupported inequitable conduct claims, orders to stay discovery or consideration of such claims pending all other determinations in the case, or even sanctions, are all tools district courts can employ where appropriate.

For these reasons, I concur in part in and dissent in part from the decision the majority announces today. I would leave to district courts the discretion to apply this equitable doctrine to the unique circumstances with which they are presented, while encouraging them to keep in sight their obligation to guard against abuses of it.

BRYSON, Circuit Judge, with whom GAJARSA, DYK, and PROST, Circuit Judges, join, dissenting.

I

There is broad consensus that the law of inequitable conduct is in an unsatisfactory state and needs adjustment. In recent years, differing standards have been applied in determining whether particular conduct rises to the level of inequitable conduct sufficient to render a patent unenforceable. That doctrinal uncertainty has had adverse consequences both for patent litigation and for the PTO. In litigation, counterclaims of inequitable conduct have been raised in too many cases and have proved difficult to resolve. In the PTO, the lack of a clear and uniform standard for inequitable conduct has led some patent prosecutors to err on the side of "overdisclosure" in order to avoid the risk of rendering all claims of an otherwise valid patent unenforceable because of the omission of some marginally relevant reference. As a result, examiners have frequently been swamped with an excess of prior art references having little relevance to the applications before them.

These problems can be traced, at least in part, to doctrinal uncertainty on three points: First, what standard of intent should be applied in assessing an allegation that an applicant has made false representations or failed to disclose material facts to the PTO. Second, what standard of materiality should be applied to such misrepresentations or nondisclosures. Third, whether there should be a "sliding scale" under which a strong showing of either materiality or intent should be able to make up for a weaker showing on the other element.

There is substantial agreement as to the proper resolution of two of those three issues. First, the parties to this case and most of the amici agree that proof of inequitable conduct should require a showing of specific intent to deceive the PTO; negligence, or even gross negligence, should not be enough. Second, the parties and most of the amici agree that a party invoking the defense of inequitable conduct should be required to prove both specific intent and materiality by clear and convincing evidence; there should be no "sliding scale" whereby a strong showing as to one element can make up for weaker proof as to the other.

However, on the remaining issue—the proper standard to apply in determining whether the conduct at issue is sufficiently material to render the patent in suit unenforceable—there is sharp disagreement. That disagreement is what divides the court in this case. The majority takes the position that nondisclosures should be ***1303** deemed sufficiently material to trigger the defense of inequitable conduct only if, had the matter in question been disclosed, the applicant would not have obtained a patent. That position, however, marks a significant and, I believe, unwise departure from this court's precedents. Since its first days, this court has looked to the PTO's disclosure rule, Rule 56, 37 C.F.R. § 1.56, as the standard for defining materiality in inequitable conduct cases involving the failure to disclose material information. In its current form, that rule provides that information is material not only if it establishes a prima facie case of unpatentability, but also if it refutes or is inconsistent with a position the applicant takes before the PTO with respect to patentability. I would adhere to the materiality standard set forth in the PTO's disclosure rule for two basic reasons: First, the PTO is in the best position to know what information examiners need to conduct effective and efficient examinations, i.e., what information is material to the examination process. Second, the higher standard of materiality adopted by the majority will not provide appropriate incentives for patent applicants to comply with the disclosure obligations the PTO places upon them.

Twenty-three years ago, in *Kingsdown Medical Consultants v. Hollister, Inc.,* this court was faced with conflicting precedents regarding the "intent" requirement of the doctrine of inequitable conduct. The court resolved those conflicts in an en banc decision that all members of the court joined. 863 F.2d 867 (Fed.Cir.1988) (en banc). The court held that even proof of "gross negligence" is not sufficient to satisfy the intent to deceive requirement. Instead, the court concluded that in order for particular conduct to justify holding a patent unenforceable, the conduct in question, "viewed in light of all the evidence, including evidence indicative of good faith, must indicate sufficient culpability to require a finding of intent to deceive." *Id.* at 876.

The *Kingsdown* court did not find it necessary to address the proper standard for determining materiality, because that issue had been addressed in earlier cases. Four years before *Kingsdown,* a five-judge panel opinion in *J.P. Stevens & Co. v. Lex Tex Ltd.,* 747 F.2d 1553 (Fed.Cir.1984), had addressed the materiality requirement and made the following observations, which have remained the law until today: First, the court endorsed the principle, previously adopted by our predecessor court, that inequitable conduct is broader than common law fraud. *Id.* at 1559 (citing *Norton v. Curtiss,* 433 F.2d 779, 793 (CCPA 1970)). Second, the court explained that inequitable conduct could be based on the failure to disclose material information as well as the submission of false material information. *Id.* Third, the court stated that the disclosure requirement set forth in PTO Rule 56, 37 C.F.R. § 1.56 (1984), established "the appropriate starting point" because that standard "most closely aligns with how one ought to conduct business with the PTO." *J.P. Stevens,* 747 F.2d at 1559. In so doing, the court referred to its earlier opinion in *Driscoll v. Cebalo,* 731 F.2d 878, 884 (Fed.Cir.1984), where the court had stated that PTO Rule 56 "essentially represents a codification of the 'clean hands' maxim as applied to patent applicants." Moreover, just a year before the decision in *Kingsdown,* the court in *Gardco Manufacturing, Inc. v. Herst Lighting Co.,* 820 F.2d 1209, 1214 (Fed.Cir.1987), had reiterated that Rule 56 set forth the appropriate standard for determining the materiality of undisclosed information in an inequitable conduct case.

Since that time there have been occasional departures from the holding in *Kingsdown* as to the requisite level of ***1304** intent to establish inequitable conduct. As to materiality, however, the court has consistently held that the PTO's Rule 56 sets the proper baseline for determining materiality, although there has been some variation in our decisions with regard to which version of the PTO's rule applies in particular cases.

The appropriate cure for departures from the principles of inequitable conduct that were put in place at the time of *Kingsdown* would be to reaffirm those principles, as summarized above. The majority, however, has taken a far more radical approach. With respect to the issue of materiality, the majority has adopted a test that has no support in this court's cases and is inconsistent with a long line of precedents dating back to the early years of this court. The effect of the majority's new test, moreover, does not merely reform the doctrine of inequitable conduct, but comes close to abolishing it altogether. I respectfully dissent from that aspect of the court's decision. In my view, what is needed is not to jettison the doctrine of inequitable conduct, but simply to reaffirm the principles set down in the early years of this court in light of the provisions of the current PTO disclosure rule, and require adherence to those principles. As applied to the duty of an applicant or attorney to disclose material information in the course of prosecuting a patent application, those principles can be summarized as follows:

1. Inequitable conduct requires proof, by clear and convincing evidence, that the applicant or attorney intended to mislead the PTO with respect to a material matter.

2. Materiality is measured by what the PTO demands of those who apply for and prosecute patent applications. The disclosure standard that the PTO expects those parties to comply with is set forth in the current version of the PTO's Rule 56. Under that standard, inequitable conduct requires proof that the information at issue either established, by itself or in combination with other information, a prima facie case of unpatentability, or was inconsistent with a position taken by the applicant before the PTO with respect to patentability.

3. Intent to mislead and materiality must be separately proved. There is no "sliding scale" under which the degree of intent that must be proved depends on the strength of the showing as to the materiality of the information at issue.[1]

1 It is important to distinguish between relaxing the required proof of intent if the proof of materiality is strong, which is impermissible, as opposed to considering the degree of materiality as relevant to the issue of intent, which is appropriate, particularly given that direct evidence of intent, such as an admission of deceptive purpose, is seldom available. *See Cargill, Inc. v. Canbra Foods, Ltd.,* 476 F.3d 1359, 1366 (Fed.Cir.2007); *Ferring B.V. v. Barr Labs., Inc.,* 437 F.3d 1181, 1190–91 (Fed.Cir.2006); *GFI, Inc. v. Franklin Corp.,* 265 F.3d 1268, 1274 (Fed.Cir.2001); *Paragon Podiatry Lab., Inc. v. KLM Labs., Inc.,* 984 F.2d 1182, 1189 (Fed.Cir.1993); *Merck & Co. v. Danbury Pharmacal, Inc.,* 873 F.2d 1418, 1422 (Fed.Cir.1989).

These principles not only are consistent with our law on inequitable conduct but, if implemented consistently, should be sufficient to address the practical problems that have arisen under the current regime. While the majority is correct that inequitable conduct claims have been raised too often in the past, there are less Draconian means of addressing that problem than those proposed by the majority. First, the refinements to the doctrine suggested here would be likely to significantly reduce the frequency with which the defense is raised. Second, this court has recently held that the strict pleading requirements of Fed.R.Civ.P. 9(b) apply to counterclaims of inequitable conduct, requiring detailed factual ***1305** averments and not merely notice pleading with respect to such claims. Such pleading requirements are likely to discourage baseless counterclaims. *See Exergen Corp. v. Wal–Mart Stores, Inc.,* 575 F.3d 1312, 1326–29 (Fed.Cir.2009). Third, assertions of inequitable conduct that lack factual and legal support can be controlled by trial courts through application of the sanctions provided by Fed.R.Civ.P. 11. Finally, as this court has repeatedly held, the doctrine of inequitable conduct is an equitable doctrine, and even when the elements of intent and materiality are satisfied, it remains for the district court to determine, in the exercise of its equitable judgment, whether, "in light of all the particular circumstances, the conduct of the patentee is so culpable that its patent should not be enforced." *LaBounty Mfg., Inc. v. U.S. Int'l Trade Comm'n,* 958 F.2d 1066, 1070 (Fed.Cir.1992).

With regard to the problem of "over-disclosure" of large numbers of marginally relevant references in the course of patent prosecution, the PTO in its amicus brief expresses confidence that strict judicial adherence to the "clear and convincing" standard by which accused infringers must prove specific intent to deceive the PTO will largely solve that problem. Since the problem of over-disclosure directly affects the PTO, there is no reason not to credit the PTO's assertion that a tightening of the intent element of the inequitable conduct doctrine should be sufficient to address the problem and that a drastic modification of the materiality element not only is not required, but would be contrary to the PTO's interest in efficient examinations.

II

The majority holds that a failure to disclose information is "material" for purposes of inequitable conduct only if it satisfies the "but for" test; i.e., the conduct must be such that, but for the conduct, the claims would have been found unpatentable. This is not a tweak to the doctrine of inequitable conduct; it is fundamental change that would have the effect of eliminating the independent role of the doctrine of inequitable conduct as to disclosure obligations except in limited circumstances. This court has repeatedly rejected the "but for" test as too restrictive in light of the policies served by the inequitable conduct doctrine. *See Merck & Co. v. Danbury Pharmacal, Inc.,* 873 F.2d 1418, 1421 (Fed.Cir.1989); *see also Purdue Pharma L.P. v. Endo Pharms. Inc.,* 438 F.3d 1123, 1132 (Fed.Cir.2006); *Hoffmann–LaRoche, Inc. v. Promega Corp.,* 323 F.3d 1354, 1368 (Fed.Cir.2003);

Molins PLC v. Textron, Inc., 48 F.3d 1172, 1179–80 (Fed.Cir.1995); *A.B. Dick Co. v. Burroughs Corp.,* 798 F.2d 1392, 1396 (Fed.Cir.1986). Those policies dictate that it should continue to do so.

As the PTO persuasively argues in its amicus brief, the "but for" standard for materiality is too restrictive to serve the purposes that the doctrine of inequitable conduct was designed to promote. If a failure to disclose constitutes inequitable conduct only when a proper disclosure would result in rejection of a claim, there will be little incentive for applicants to be candid with the PTO, because in most instances the sanction of inequitable conduct will apply only if the claims that issue are invalid anyway. For example, under the "but for" test of materiality, an applicant considering whether to disclose facts about a possible prior use of the invention would have little reason to disclose those facts to the PTO. If the applicant remained silent about the prior use, the patent issued, and the prior use was never discovered, the applicant would benefit from the nondisclosure. But even if the prior use was discovered during litigation, the failure to disclose would be held to constitute inequitable conduct only if the ***1306** prior use otherwise rendered the relevant claims invalid. The applicant would thus lose nothing by concealing the prior use from the PTO, because he would not be at risk of losing the right to enforce an otherwise valid patent.

In that situation, particularly if the opportunity to obtain a valuable patent is at stake, there will be no inducement for the applicant to be forthcoming. If the applicant withholds prior art or misleadingly discloses particular matters and succeeds, he obtains a patent that would not have issued otherwise. Even if the nondisclosure or misleading disclosure is later discovered, under the majority's rule the applicant is no worse off, as the patent will be lost only if the claims would otherwise be held invalid. So there is little to lose by following a course of deceit. It is no indictment of the uprightness and professionalism of patent applicants and prosecutors as a group to say that they should not be subjected to an incentive system such as that. After all, it has long been recognized that "an open door may tempt a saint." Given the large stakes sometimes at issue in patent prosecutions, a regime that ensures that a dishonest but potentially profitable course of action can be pursued with essentially no marginal added risk is an unwise regime no matter how virtuous its subjects.

It is unrealistic to expect that other means will provide an effective deterrent to ensure that material information will not be withheld during patent prosecutions. The PTO advises us that the prospect of enforcing the duty of disclosure other than through the threat of inequitable conduct claims is not possible or practical. The prospect of agency disciplinary action for disclosure violations is unrealistic, the PTO explains, because the Office is required by statute to file any charges within five years, *see* 28 U.S.C. § 2462, and it seldom learns of inequitable conduct within that period of time. In addition, the PTO explains that it rarely has access to relevant facts regarding inequitable conduct, because it lacks investigative resources. As a result, the PTO has concluded that a court is the best forum in which to consider alleged breaches of the disclosure duty in the context of an inequitable conduct defense. *See* Patent and Trademark Office Implementation of 37 C.F.R. § 1.56, 1095 Off. Gaz. Pat. & Trademark Office 16 (Oct. 11, 1988).

III

Aside from its practical infirmities, the "but for" standard adopted by the majority is inconsistent with the duty that the Supreme Court and the PTO have both described as applying to those who seek patents in the ex parte application process.

A

The doctrine of inequitable conduct has its origins in a trilogy of Supreme Court decisions dating back to the 1930s. The first of the three cases, *Keystone Driller Co. v. General Excavator Co.,* 290 U.S. 240, 54 S.Ct. 146, 78 L.Ed. 293 (1933), applied the equitable principle of "unclean hands" in a case in which a patentee's representative had obtained a false affidavit and taken other steps to avoid the disclosure of a possibly invalidating prior use of the patented invention. The patentee obtained a favorable decree in an infringement action against a different defendant and then relied on that decree in obtaining preliminary injunctions against the defendants in the cases before the Court.

The Supreme Court found the connection between earlier and later cases to be sufficient "to show that plaintiff did not come with clean hands" in the later cases. Based on that finding, the Court concluded that the previous misconduct justified the ***1307** dismissal of the complaints in those cases. In reaching that determination, the Court did not find it necessary to decide whether the evidence of prior use that the plaintiff had suppressed would have had the effect of invalidating the patent. It was enough that the improper conduct had "immediate and necessary relation to the equity [that the patentee sought] in respect of the matter in litigation." 290 U.S. at 245, 54 S.Ct. 146.

A decade later, in *Hazel–Atlas Glass Co. v. Hartford–Empire Co.,* 322 U.S. 238, 64 S.Ct. 997, 88 L.Ed. 1250 (1944), the Supreme Court again held a patent unenforceable, this time in part because of misconduct by the patentee before the Patent Office in obtaining the patent. The patentee, encountering resistance to issuance of the patent by the Patent Office, arranged for the publication of an article in a trade publication that described the invention as a remarkable advance in the field. The article purported to be the product of a disinterested party, even though it was actually written by one of the patentee's lawyers. The patent ultimately issued. The article was also used in court, where it assisted the patentee in obtaining a favorable judgment from an appellate court. The patentee subsequently went to considerable lengths to ensure that the truth regarding the authorship of the article would not emerge. The efforts at concealment failed, however, and the accused infringer sought relief in the lower court based on the misconduct.

Because the misconduct was discovered after the expiration of the term of court during which the judgment in question was entered, the Supreme Court invoked the doctrine of after-discovered fraud, which permitted a court to revisit a judgment even after the end of the term in which it was entered, if the circumstances "are deemed sufficiently gross to demand a departure from rigid adherence to the term rule." 322 U.S. at 244, 64 S.Ct. 997. The Court found that standard to be satisfied on the facts before it.

In response to the argument that the article in question was not "basic" to the issues in litigation, the Supreme Court stated that the circumstances did not "call for such an attempted appraisal." 322 U.S. at 247, 64 S.Ct. 997. The Court explained: "Hartford's officials and lawyers thought the article material. They conceived it in an effort to persuade a hostile Patent Office to grant their patent application, and went to considerable trouble and expense to get it published." *Id.* The Court added that Hartford's fraud "had its genesis in the plan to publish an article for the deliberate purpose of deceiving the Patent Office.... Had the District Court learned of the fraud on the Patent Office at the original infringement trial, it would have been warranted in dismissing Hartford's case." *Id.* at 250, 64 S.Ct. 997. Significantly, the Court did not regard the issue of Hartford's conduct as turning on whether the fraudulent conduct was the "but for" cause of the issuance of the patent. The Court stated that it would have come to the same conclusion even if the statements from the fraudulently procured article were actually true. *Id.* at 247, 64 S.Ct. 997. "But for" causation was not necessary to finding materiality. Instead, the Court focused on the patentee's "deliberate purpose of deceiving the Patent Office" as the core reason for refusing to enforce the patentee's rights in the patent.

A year later, the Supreme Court again addressed the issue of the effect of misconduct during proceedings before the Patent Office on subsequent patent enforcement actions in court. That case, *Precision Instrument Manufacturing Co. v. Automotive Maintenance Machinery Co.,* 324 U.S. 806, 65 S.Ct. 993, 89 L.Ed. 1381 (1945), ***1308** arose following an involved sequence of events, the upshot of which was that Automotive obtained rights to a patent knowing that the original applicant had made false statements pertaining to the dates of conception and reduction to practice of the claimed invention. The Supreme Court held the patent unenforceable, applying the doctrine of unclean hands against the patent owner based on its knowledge of the misconduct that occurred during the prosecution of the patent.

The Court explained that the sort of misconduct necessary to trigger a court's refusal to aid "the unclean litigant" need not be "of such a nature as to be punishable as a crime or as to justify legal proceedings of any character. Any willful act concerning the cause of action which rightfully can be said to transgress equitable standards of conduct is sufficient cause for the invocation of the maxim by the chancellor." 324 U.S. at 815, 65 S.Ct. 993. The Court added that "where a suit in equity concerns the public interest as well as the private interests of the litigants this doctrine assumes even wider and more significant proportions." *Id.*

The enforcement of a patent, the Court stated, is a matter "concerning far more than the interests of the adverse parties. The possession and assertion of patent rights are 'issues of great moment to the public.' " *Id.* In a statement that has served as the basis for the subsequent development of the doctrine of inequitable conduct, the Court added that "[t]he far-reaching social and economic consequences of a patent ... give the public a paramount interest in seeing that patent monopolies spring from backgrounds free from fraud or other inequitable conduct." *Id.* at 816, 65 S.Ct. 993.

The Court refused to enforce Automotive's patent because it concluded that Automotive "knew and suppressed facts that, at the very least, should have been brought in some way to the attention of the Patent Office." 324 U.S. at 818, 65 S.Ct. 993. The Court explained, "Those who have applications pending with the Patent Office or who are parties to Patent Office proceedings have an uncompromising duty to report to it all facts concerning possible fraud or inequitableness underlying the applications in issue.... Public interest demands that all facts relevant to such matters be submitted formally or informally to the Patent Office, which can then pass upon the sufficiency of the evidence. Only in this way can that agency act to safeguard the public in the first instance against fraudulent patent monopolies." Because Automotive had prosecuted the patent application and obtained the patent "without ever attempting to reveal to the Patent Office or to anyone else the facts it possessed concerning the application's fraudulent ancestry," the Court concluded that Automotive "has not displayed that standard of conduct requisite to the maintenance of this suit in equity." *Id.* at 819, 65 S.Ct. 993.

As in the *Keystone* and *Hazel–Atlas* cases, the Supreme Court in the *Precision Instrument* case did not look to whether the conduct in question would have rendered the plaintiff's application unpatentable. In holding all of Automotive's patents to be unenforceable, the Court found it was enough that the plaintiff had intentionally withheld information from the Patent Office that should have been submitted so that the Patent Office could consider it. There was no suggestion in the Court's opinion that the dismissal of the action would be appropriate only if, but for the conduct, the patent would not have issued.

The principles set down by the Court in *Keystone, Hazel–Atlas,* and *Precision Instrument* can be summarized as follows: (1) the public has a special interest in seeing that patent monopolies "spring ***1309** from backgrounds free from fraud or other inequitable conduct"; (2) as a corollary to that public interest, patent applicants "have an uncompromising duty to report to [the Patent Office] all facts concerning possible fraud or inequitableness underlying the applications"; (3) all facts relevant to such matters must be submitted to the Patent Office, "which can then pass upon the sufficiency of the evidence"; (4) the intentional failure to disclose to the Patent Office that a patent application is tainted by fraud is sufficient cause to justify not enforcing the patent; and (5) the misconduct in question need not constitute actionable fraud; it is sufficient if the conduct constitutes a willful act that violates standards of equitable conduct in dealing with the Patent Office. [2]

2 Two decades before the *Keystone–Hazel–Precision* trilogy, the Supreme Court considered the effect of misstatements made during prosecution on the validity of a patent on a method for vulcanizing rubber. *Corona Cord Tire Co. v. Dovan Chem. Corp.,* 276 U.S. 358, 48 S.Ct. 380, 72 L.Ed. 610 (1928).

Before the Patent Office, the inventor attempted to swear behind a reference by submitting affidavits averring an earlier date of conception and reduction to practice for his invention. The inventor asserted that he had successfully used the claimed method "in the vulcanization of rubber goods," and one of his fellow chemists stated that the method had been used "in the actual vulcanization of rubber goods, such as hose, tires, belts, valves and other mechanical goods." *Id.* at 373, 48 S.Ct. 380. In fact, at the time referred to in the affidavits the inventor had used his method only on test slabs of rubber. The Court noted that whether the claimed method was used in the production of useful articles was not relevant to the asserted claims, and it therefore held that the false affidavit, while reckless, was not "the basis for" or "essentially material to" the issuance of the patent. The Court therefore declined to invalidate the asserted claims on that ground. *Id.* at 374, 48 S.Ct. 380.

Although the majority cites *Corona* as support for its narrow interpretation of the materiality requirement for inequitable conduct, *Corona* is of little relevance to that issue. *Corona* predates the creation of the inequitable conduct doctrine and has never been cited by the Supreme Court in any case addressing unclean hands or inequitable conduct. Apart from the fact that the decision addressed the issue of validity, rather than enforceability, the Court's decision was based on its conclusion that the affidavit in question was not material because what mattered was that the method had been used to

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vulcanize rubber, not that it had been used to vulcanize rubber that was in turn used to make particular goods. Given that the nature of the rubber objects that the inventor vulcanized was not relevant to the issues before the Patent Office, it is not surprising that the Court found the error not to be material. In any event, the Court's choice of language—stating that the affidavits "were not the basis for [the issuance of the patent] or essentially material to its issue," is not restricted to a "but for" test, but suggests a broader standard for materiality.

Shortly after the decisions in the *Keystone, Hazel–Atlas,* and *Precision Instrument* cases, the Supreme Court made a further observation that bears directly on the responsibilities of attorneys and applicants who appear before the PTO. The Court endorsed the statement that, "By reason of the nature of an application for patent, the relationship of attorneys to the Patent Office requires the highest degree of candor and good faith. In its relation to applicants, the Office ... must rely upon their integrity and deal with them in a spirit of trust and confidence...." *Kingsland v. Dorsey,* 338 U.S. 318, 319, 70 S.Ct. 123, 94 L.Ed. 123 (1949). Because the PTO lacks the investigative and research resources to look behind representations by applicants and their counsel, it necessarily relies on those representations as to many facts that arise during the prosecution of patent applications, including experimental results obtained by the applicants, the state of the prior art, and the knowledge of persons of skill in the art in the field in question. Some of these facts will be uniquely in the hands of the applicant ***1310** and, as a practical matter, undiscoverable by an examiner at the PTO. For those reasons, the PTO has imposed a duty on applicants to provide examiners with information that is material to patentability.

B

The PTO has defined the disclosure obligation for those involved in patent prosecutions in its Rule 56, which the PTO has promulgated under its statutory authority to establish regulations that "govern the conduct of proceedings in the Office." 35 U.S.C. § 2(b). When Rule 56 was first promulgated in 1949, the portion of the rule that addressed inequitable conduct provided that "any application fraudulently filed or in connection with which any fraud is practiced or attempted on the Patent Office, may be stricken." 37 C.F.R. § 1.56 (1950).

The Court of Customs and Patent Appeals construed the PTO's disclosure rule in its 1970 decision in *Norton v. Curtiss,* 433 F.2d at 779. The court in that case upheld the Commissioner's authority to strike a patent application for fraud on the PTO in violation of the PTO's Rule 56. Interpreting the term "fraud" in Rule 56, the court began by noting that the term should not be limited to the kind of fraud that would be independently actionable as a tort or crime (which the court referred to as "technical fraud"). Instead, the court explained that "fraud" as used in the Rule included "a wider range of 'inequitable' conduct" that would justify holding a patent unenforceable. *Id.* at 793. Defining fraud more broadly for the purpose of Rule 56 was justified, the court ruled, because "applicants before the Patent Office are being held to a relationship of confidence and trust to that agency. The indicated expansion of the concept of 'fraud' manifests an attempt by the courts to make this relationship meaningful." *Id.*

In language paralleling the Supreme Court's discussion in *Kingsland v. Dorsey,* the *Norton* court recognized "a relationship of trust between the Patent Office and those wishing to avail themselves of the governmental grants which that agency has been given authority to issue." 433 F.2d at 793. In light of the ex parte nature of patent prosecution, the number of applications filed, and the limited capacity of the PTO "to ascertain the facts necessary to adjudge the patentable merits of each application," the court stated that the "highest standards of honesty and candor on the part of applicants presenting such facts to the office are ... necessary elements in a working patent system." *Id.* at 794. For that reason, the court approved of "the expansion of the types of misconduct for which applicants will be penalized." *Id.*

In light of those policies, the court explained that the test for materiality "cannot be applied too narrowly if the relationship of confidence and trust between applicants and the Patent Office is to have any real meaning," and that findings of materiality should not be limited to those cases in which the true facts, if they had been known, "would most likely have prevented the allowance of the particular claims at issue." 433 F.2d at 795. In such cases, the claims at issue "would probably be invalid, in any event," and the question whether the patent was unenforceable "would really be of secondary importance." *Id.* Accordingly,

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the court concluded that a proper interpretation of the materiality element must include factors other than the patentability of the claims at issue, including "the subjective considerations of the examiner and the applicant." *Id.*

In 1977, the PTO substantially revised Rule 56 to make more explicit the disclosure obligations imposed on patent applicants. ***1311** Patent Examining and Appeal Procedures, 41 Fed.Reg. 43,729, 43,730 (proposed Oct. 4, 1976). The 1977 version of the rule imposed a "duty of candor and good faith" on those involved in the preparation or prosecution of patent applications and required them "to disclose to the Office information they are aware of which is material to the examination of the application." The rule defined information as "material" if there was "a substantial likelihood that a reasonable examiner would consider it important in deciding whether to allow the application to issue as a patent."

Shortly after this court's creation, the court began addressing inequitable conduct claims raised in the course of patent infringement litigation. From the outset, the court looked to the PTO's Rule 56 as setting an appropriate standard for the materiality prong of the doctrine of inequitable conduct. *See Am. Hoist & Derrick Co. v. Sowa & Sons, Inc.,* 725 F.2d 1350, 1363 (Fed.Cir.1984) ("The PTO 'standard' is an appropriate starting point for any discussion of materiality"; failure to satisfy that disclosure obligation, combined with an intent to deceive the PTO, can render a patent unenforceable); *J.P. Stevens,* 747 F.2d at 1559 (adopting the materiality requirement from Rule 56); *Gardco,* 820 F.2d at 1214 (Rule 56 is "appropriate starting point for determining materiality") (quotation omitted); *Fox Indus., Inc. v. Structural Pres. Sys.,* 922 F.2d 801, 803 (Fed.Cir.1990) (adopting Rule 56 standard for materiality). In particular, the court endorsed the use of that standard as the proper test for materiality when an appropriate level of intent was shown. *See Specialty Composites v. Cabot Corp.,* 845 F.2d 981, 992 (Fed.Cir.1988) ("Nondisclosed or false information is material if there is a substantial likelihood that a reasonable examiner would have considered the omitted reference or false information important in deciding whether to allow the application to issue as a patent."); *Halliburton Co. v. Schlumberger Tech. Corp.,* 925 F.2d 1435, 1440 (Fed.Cir.1991) ("Information is material if there is 'substantial likelihood that a reasonable examiner would consider it important in deciding whether to allow the application to issue as a patent.' ") (citing the 1977 version of PTO Rule 56).

In the ensuing years, this court has regularly referred to the "reasonable examiner" test as the standard for measuring materiality in cases raising claims of inequitable conduct. *See, e.g., Golden Hour Data Sys., Inc. v. emsCharts, Inc.,* 614 F.3d 1367, 1373–74 (Fed.Cir.2010); *Leviton Mfg. Co. v. Universal Sec. Instruments, Inc.,* 606 F.3d 1353, 1358–59 (Fed.Cir.2010); *Astrazeneca Pharms. LP v. Teva Pharm. USA, Inc.,* 583 F.3d 766, 773 (Fed.Cir.2009); *Dayco Prods., Inc. v. Total Containment, Inc.,* 329 F.3d 1358, 1363 (Fed.Cir.2003) (citing cases). Under that test, the court has consistently ruled that a false statement or nondisclosure may be material for purposes of an inequitable conduct determination even if the invention in question would otherwise be patentable. *See, e.g., Digital Control, Inc. v. Charles Mach. Works,* 437 F.3d 1309, 1314 (Fed.Cir.2006); *Li Second Family Ltd. P'ship v. Toshiba Corp.,* 231 F.3d 1373, 1380–81 (Fed.Cir.2000); *PerSeptive Biosystems, Inc. v. Pharmacia Biotech, Inc.,* 225 F.3d 1315, 1322 (Fed.Cir.2000); *A.B. Dick,* 798 F.2d at 1397.

In 1992, the PTO revised Rule 56, adopting what it called a "clearer and more objective definition of what information the Office considers material to patentability." Duty of Disclosure, 57 Fed.Reg.2021, 2023 (Jan. 17, 1992). As revised in 1992, the current version of Rule 56 imposes a duty on individuals associated with the filing and prosecution of an application to disclose to the Office all information known to be material to patentability as defined in ***1312** the rule. Rule 56(a). The rule then states that information is "material" if it is "not cumulative to information already of record or being made of record in the application" and

(1) It establishes, by itself, or in combination with other information, a prima facie case of unpatentability of a claim; or

(2) It refutes, or is inconsistent with, a position the applicant takes in:

(i) Opposing an argument of unpatentability relied on by the Office, or

(ii) Asserting an argument of patentability.

The first part of Rule 56(b) requires the applicant to provide information that, at least absent explanation or further supplementation, would compel the conclusion that the invention is unpatentable. The rule explains that a "prima facie case of unpatentability" is established "when the information compels a conclusion that a claim is unpatentable under the preponderance of the evidence, burden-of-proof standard, giving each term its broadest reasonable construction consistent with the specification, and before any consideration is given to evidence which may be submitted in an attempt to establish a contrary conclusion of patentability." In adopting the rule, the PTO explained that it intended for applicants to submit references, of which they were aware, that would render the pending claims unpatentable over the references. Proposed Rules, 56 Fed.Reg. 37,321, 37,324 (Aug. 6, 1991). The PTO added that it is the role of the examiner, not the applicant, to analyze the sufficiency and weight of a rebuttal argument. See *id.* The intent standard imposed by Rule 56 and adopted by this court answers the majority's concerns regarding the breadth of the first part of Rule 56(b). That provision applies only to applicants who act with the specific intent to deceive the PTO by withholding prior art that is so powerful as to render the pending claims invalid in the absence of further explanation.

It is the second part of the rule, Rule 56(b)(2), to which the appellants object. That part of the rule requires the applicant to provide information that is inconsistent with or refutes a position taken by the applicant before the office. Rule 56(b)(2) clearly goes beyond a "but for" test and is therefore the focus of the dispute in this case.

At the time it adopted the 1992 revision to Rule 56, the PTO considered the possibility of adopting a "but for" test of materiality of the sort that the majority has adopted today. The Office rejected that test, concluding that adopting such a narrow standard "would not cause the Office to obtain the information it needs to evaluate patentability so that its decisions may be presumed correct by the courts." The PTO added that if it did not have the needed information, "meaningful examination of patent applications will take place for the first time in an infringement case before a district court." Duty of Disclosure, 57 Fed.Reg. at 2023.

In the aftermath of that change, this court has frequently treated the PTO's new version of the rule as setting forth the proper standard for materiality, in cases involving claims of failure to disclose material information, at least for applications processed after 1992. In *Bruno Independent Living Aids, Inc. v. Acorn Mobility Services, Ltd.,* 394 F.3d 1348 (Fed.Cir.2005), the court quoted the 1992 version of Rule 56 and held that for patents prosecuted while that version of the rule was in effect, "we evaluate the materiality of the [undisclosed matter] under the standard set forth in the applicable amended rule." *Id.* at 1352–53; *see also Hoffmann–LaRoche,* 323 F.3d at 1368 n. 2. The court added that "we give deference to the PTO's formulation at the time an application is being prosecuted before an examiner ***1313** of the standard of conduct it expects to be followed in proceedings in the Office." *Bruno,* 394 F.3d at 1353; *see also Bd. of Educ. v. Am. Bioscience, Inc.,* 333 F.3d 1330, 1343 (Fed.Cir.2003); *Purdue Pharma L.P.,* 438 F.3d at 1129; *Monsanto Co. v. Bayer Bioscience N.V.,* 514 F.3d 1229, 1237 (Fed.Cir.2008); *Taltech Ltd. v. Esquel Enters. Ltd.,* 604 F.3d 1324, 1333 (Fed.Cir.2010). As it did before 1992, the court has continued to make clear that it does not apply a "but for" test for materiality. *See Golden Hour Data Sys.,* 614 F.3d at 1374; *Hoffmann–LaRoche,* 323 F.3d at 1368; *Molins PLC,* 48 F.3d at 1179–80.

On occasion, when addressing the issue of materiality, this court has referred to both the 1977 standard and the 1992 standard that supplanted it as pertinent to the definition of materiality. *See, e.g., Digital Control,* 437 F.3d at 1316. The court has done so in light of the fact that, as the PTO has explained, the 1992 standard was not meant to signal a sharp departure from the 1977 standard. Yet while the two standards were not meant to be dramatically different, the court has recognized that the PTO regards the 1992 standard as setting forth a clearer and more precise statement of the disclosure necessary to conducting efficient examinations. *See Rothman v. Target Corp.,* 556 F.3d 1310, 1323 (Fed.Cir.2009); *Purdue Pharma L.P.,* 438 F.3d at 1129; *Pharmacia Corp. v. Par Pharm., Inc.,* 417 F.3d 1369, 1373 (Fed.Cir.2005).

The PTO has explained that the 1992 amendment was proposed "to address criticism concerning a perceived lack of certainty in the materiality standard." M.P.E.P. § 2001.04. The revised rule was intended "to provide greater clarity and hopefully minimize the burden of litigation on the question of inequitable conduct before the Office, while providing the Office with the information necessary for effective and efficient examination of patent applications." *Id.* Moreover, in its brief in this case the PTO has urged this court to adopt the standard set forth in the current PTO Rule 56 as the standard for material nondisclosures rather than referring to both the 1992 standard and the “reasonable examiner” standard from the 1977 version of the Rule.

Because the PTO is the best judge of what information its examiners need to conduct effective examinations, the PTO's definition of materiality is entitled to deference in determining whether the failure to disclose particular information during patent prosecution constitutes inequitable conduct. Moreover, because the PTO has refined the materiality standard in setting forth what it expects of applicants and their representatives, there is no need for courts to apply a broader test of materiality in adjudicating inequitable conduct claims, as doing so could at least theoretically result in the imposition of sanctions for a failure to disclose matters that the PTO does not require to be disclosed. [3] ***1314** This is not to suggest that any disclosure requirement that the PTO might have devised would serve as a predicate for an inequitable conduct charge. Because inequitable conduct is an equitable doctrine applied by courts, and not simply a mechanism for judicial enforcement of PTO rules, the scope of the court-made doctrine is not inseparably tied to the breadth of the PTO's disclosure rules. However, the basic purposes of both the inequitable conduct doctrine and Rule 56 are the same, and the disclosure duties that the PTO imposes on applicants, which are defined by Rule 56, are reasonably calculated to produce the disclosure necessary to promote efficient conduct of examinations and to discourage the types of omissions and misrepresentations that (if made intentionally) raise equitable concerns. In these circumstances, considerations of efficiency and economy encourage us to embrace the PTO's approach. So long as it reasonably aligns with our own equitable calculus, we should defer to the PTO's assessment of its needs and treat intentional breaches of the PTO's disclosure rules as providing a basis for a finding of inequitable conduct. *See Bruno Indep. Living,* 394 F.3d at 1353.

3 The PTO's Rule 56 deals with the “duty to disclose information material to patentability” and does not explicitly address affirmative false statements to the PTO made by parties prosecuting a patent application. In some instances, as in this case, a false or misleading affirmative statement also violates the disclosure requirement, because when a party makes a statement that is inconsistent with the party's own prior statement, the failure to disclose the prior statement constitutes a failure to disclose information that “refutes, or is inconsistent with, a position the applicant takes” in asserting patentability or opposing an argument of unpatentability relied on by the PTO. Rule 56(b)(2). An affirmative false statement that does not separately violate the disclosure rules may nonetheless be contrary to the broader “duty of candor and good faith” referred to in paragraph (a) of Rule 56, which is imposed on “each individual associated with the filing and prosecution of a patent application.” *See Nilssen v. Osram Sylvania, Inc.,* 504 F.3d 1223, 1231–32 (Fed.Cir.2007); *Dayco Prods.,* 329 F.3d at 1363–64.

The majority holds that the “but for” test does not apply to “affirmative acts of egregious misconduct.” It then adds that neither “nondisclosure of prior art references to the PTO nor failure to mention prior art references in an affidavit constitutes affirmative egregious misconduct” under any circumstances. As this case illustrates, it is often difficult to draw a line between nondisclosure and affirmative misrepresentation. For example, is a submission to the PTO that purports to describe the state of the prior art but knowingly omits the closest prior art an “affirmative act” of misconduct or merely a “non-disclosure of information”? Even the *Hazel–Atlas* case, which the majority describes as an example of egregious misconduct, could be regarded as an instance of nondisclosure, as the problem identified by the Supreme Court was the failure to disclose that the article in question was actually written by an attorney for the patentee. The distinction between “affirmative acts” and “nondisclosure” is thus apt to become fertile ground for litigation in the future, not to mention the distinction between “egregious” misconduct and misconduct that is assertedly less than “egregious.” Contrary to the statement in Judge O'Malley's separate opinion, nothing in this opinion rejects the application of the doctrine of inequitable conduct (or “unclean hands”) as applied to other forms of misconduct, in litigation or otherwise. This case deals with the consequences of nondisclosure in violation of the duty of disclosure imposed by the PTO's Rule 56, and this opinion is directed solely to the role of the doctrine of inequitable conduct in that context.

C

The materiality standard set forth in Rule 56, as adopted in 1977 and refined in 1992, is not an idiosyncratic contrivance of the PTO; quite the contrary, it is consistent with the materiality standard that is applied in a wide variety of other analogous contexts. Although the relationship between the PTO and patent applicants is unusual in our law, it is nonetheless appropriate to look to the way the concept of materiality is applied in other areas, as disclosure obligations and requirements of candor are imposed on parties in a wide variety of settings.

Securities law provides a particularly instructive analogy, as proxy issuers and corporate insiders often have access to information relevant to a stockholder's decision that even the most diligent investor could not discover. Similarly, a patent applicant is often in a better position than the examiner to know of relevant art or potentially invalidating circumstances, such as prior use. Notably, in the securities law context, a nondisclosure is typically regarded as material without the need to prove reliance. Thus, for example, in the case of those who have an affirmative ***1315** duty of disclosure to investors under the securities laws and who fail to comply with that duty, the Supreme Court has held that "positive proof of reliance is not a prerequisite to recovery. All that is necessary is that the facts withheld be material in the sense that a reasonable investor might have considered them important in the making of [the investment] decision." *Affiliated Ute Citizens v. United States,* 406 U.S. 128, 153–54, 92 S.Ct. 1456, 31 L.Ed.2d 741 (1972). The Supreme Court recently reaffirmed that standard in *Matrixx Initiatives, Inc. v. Siracusano,* ––– U.S. ––––, 131 S.Ct. 1309, 179 L.Ed.2d 398 (2011). In a passage that addressed concerns similar to those raised in this case, the Court explained that it had adopted the "reasonable investor" standard to ensure that investors would have access to information important to their investment decisions, while being "careful not to set too low a standard of materiality, for fear that management would bury the shareholders in an avalanche of trivial information." *Id.* at 1318 (quotations and citations omitted).

The Supreme Court has adopted a similar materiality standard—and rejected a "but for" test for materiality—in the context of section 14(a) of the Securities Exchange Act of 1934, regarding proxy solicitations. *See TSC Indus., Inc. v. Northway, Inc.,* 426 U.S. 438, 96 S.Ct. 2126, 48 L.Ed.2d 757 (1976). There, the Court stated that an omitted fact is material "if there is a substantial likelihood that a reasonable shareholder would consider it important in deciding how to vote." *Id.* at 449, 96 S.Ct. 2126. Significantly, for our purposes, the Court added that the proper standard

> does not require proof of a substantial likelihood that disclosure of the omitted fact would have caused the reasonable investor to change his vote. What the standard does contemplate is a showing of a substantial likelihood that, under all the circumstances, the omitted fact would have assumed actual significance in the deliberations of the reasonable shareholder.

Id.

Even in criminal proceedings that require proof of materiality, such as prosecutions under the federal mail and wire fraud statutes, 18 U.S.C. §§ 1341, 1343, a "but for" test of materiality is not applied. Those laws penalize not only affirmative misrepresentations, but also the concealment of material facts. *United States v. Olatunji,* 872 F.2d 1161, 1167 (3d Cir.1989); *United States v. O'Malley,* 707 F.2d 1240, 1247 (11th Cir.1983). When a charge of mail or wire fraud is based on the nondisclosure of material information in violation of a duty to disclose, proof of materiality does not require a showing of actual reliance on the part of the victim; all that is required is proof that the nondisclosure or concealment be capable of influencing the intended victim. *See Neder v. United States,* 527 U.S. 1, 16, 24–25, 119 S.Ct. 1827, 144 L.Ed.2d 35 (1999). *See also United States v. Riley,* 621 F.3d 312, 332–33 (3d Cir.2010) (nondisclosed relationship between mayor and purchaser of city property was material "even if the relationship would not have per se barred [the purchase]."); *United States v. Szur,* 289 F.3d 200, 211–12 (2d Cir.2002) (securities broker owed duty to customers to disclose that broker would earn "exorbitant" commission on trades; such information was material for the purpose of the wire fraud statute because it would have been "relevant to a customer's decision to purchase the stock"); *United States v. Bronston,* 658 F.2d 920, 926 (2d Cir.1981) (concealment of information that defendant is under a duty to disclose is material if the nondisclosure "could or does result in harm" to the victim).

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The same principles have been applied to nondisclosures of material information ***1316** in civil matters, even civil matters that have been regarded as having grave personal consequences. In a denaturalization proceeding, for example, a "concealment or misrepresentation" made in the course of the naturalization process is considered "material" under 8 U.S.C. § 1427(a) if it has "a natural tendency to influence the decisions of the Immigration and Naturalization Service"; it is not necessary to show that the nondisclosure or misrepresentation in question actually had such an effect. *See Kungys v. United States,* 485 U.S. 759, 772, 108 S.Ct. 1537, 99 L.Ed.2d 839 (1988). The Supreme Court noted in that case that it "has never been the test of materiality that the misrepresentation or concealment would *more likely than not* have produced an erroneous decision, or even that it would *more likely than not* have triggered an investigation." *Id.* at 771, 108 S.Ct. 1537 (emphasis in original).

Even with respect to the common law action for fraud, deceit, and misrepresentation, which is more exacting than the doctrine of inequitable conduct, see *J.P. Stevens & Co.,* 747 F.2d at 1559, the "but for" test does not apply to the element of materiality. In that setting, as the Restatement of Torts explains, a matter is material if "a reasonable man would attach importance to its existence or nonexistence in determining his choice of action," or if the maker of the representation "knows or has reason to know that its recipient regards or is likely to regard the matter as important in determining his choice of action." *Restatement (Second) of Torts* § 538 (1977); *see Neder v. United States,* 527 U.S. 1, 22 & n. 5, 119 S.Ct. 1827, 144 L.Ed.2d 35 (1999) (citing the Restatement as setting forth the materiality requirement for common-law fraud). In order for a material misrepresentation to satisfy the causation requirement needed for an award of damages, it is necessary for the plaintiff to show reliance on the misrepresentation. However, the "but for" test does not apply even to tort actions for damages, as it is not necessary for the plaintiff to show "that he would not have acted or refrained from acting as he did unless he had relied on the representation." *Restatement (Second) of Torts* § 546, cmt. b. In none of these settings has the test for materiality been set at the high "but for" level adopted by the majority in this case. [4]

4 The majority argues that the "but for" test is applied in both copyright and trademark law to claims of fraudulent registration. To the contrary, in the copyright context, courts have rejected the "but for" test in favor of a rule that a federal registration will be invalidated if the claimant willfully misstates or fails to state a fact that, if known, "*might have* occasioned a rejection of the application." *Eckes v. Card Prices Update,* 736 F.2d 859, 861–62 (2d Cir.1984) (emphasis added); *see generally* 2 Melville B. Nimmer & David Nimmer, *Nimmer on Copyright* § 7.20 [B][1], at 7–212, 4(1) & n. 21 (rev. ed. 2010) ("If the claimant wilfully misstates or fails to state a fact that, if known, might have caused the Copyright Office to reject the application, [it] may be ruled invalid.") (citing numerous cases). In 2008, Congress adopted a "but for" test to govern the effect of errors on the right to bring a civil action and the right to heightened remedies, *see* 17 U.S.C. § 411 (Supp. III 2009), but that provision was not made applicable to the presumption of copyright validity set forth in 17 U.S.C. § 410(c), which remains subject to the pre–2008 standards. *See* 2 *Nimmer on Copyright* § 7.20[B][1], at 7–212.4(2) n. 25.2.

As for trademarks, it is true that in deciding whether fraud on the PTO will result in the cancellation of a mark on the federal register, courts apply a "but for" test of materiality. *See, e.g., Orient Express Trading Co. v. Federated Dep't Stores, Inc.,* 842 F.2d 650, 653 (2d Cir.1988) (defining material fact as "one that would have affected the PTO's action on the applications"); *Citibank, N.A. v. Citibanc Grp., Inc.,* 724 F.2d 1540, 1544 (11th Cir.1984) (requiring "false, material statement by the plaintiff of a fact that would have constituted grounds for denial of the registration had the truth been known."). As the author of the leading treatise on trademark law has pointed out, however, cancellation of a mark from the federal register does not extinguish the trademark rights of the mark's owner or defeat the owner's right to sue infringers. 6 J. Thomas McCarthy, *McCarthy on Trademarks and Unfair Competition* § 31.60 (4th ed.2008).

Unlike the effect of a trademark registration, the issuance of a patent grants a right which, but for the examination and allowance at the PTO, would not exist. For those reasons, as McCarthy has explained, the "standard of disclosure and hence of 'fraud' in the procurement of federal trademark registrations should be, and is, quite different from that in patent procurement. The stringent standard[s] of disclosure applicable to patent applications are ... not appropriate to applications for trademark registration." *Id.* at § 31.65 (internal quotation and citation omitted).

***1317** The course charted by the majority is thus contrary to the Supreme Court decisions that gave rise to the doctrine of inequitable conduct, to a long line of our own precedent, and to the principles of materiality that courts have applied in other

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contexts. Under this court's new rule, an applicant who conceals information with the intent to deceive the PTO will be free to enforce his patent unless it can be proved by clear and convincing evidence that the patent would not have issued but for the fraud. Even though the majority justifies its new rule in part by asserting that it will improve the prosecution of patents before the PTO, I am convinced that the new rule is likely to have an adverse impact on the PTO and the public at large, a view that —significantly—is shared by the PTO itself.

IV

The facts of this case, as found by the district court, illustrate why the materiality standard of Rule 56 is a suitable test for inequitable conduct claims based on disclosure violations. A central issue during the examination that led to the issuance of the ′551 patent was whether the prior art had taught that glucose sensors could be used to test whole blood without a protective membrane. The examiner focused on whether the prior art ′382 patent taught the use of sensors without membranes. On its face, the ′382 patent seemed to teach that sensors could be used without membranes when testing whole blood because the specification of the ′382 patent, when discussing the use of sensors with whole blood, stated the following:

> Optionally, but preferably when being used on live blood, a protective membrane surrounds both the enzyme and the mediator layers, permeable to water and glucose molecules.

′382 patent, col. 4, ll. 63–66. A central issue before the examiner was whether the use of the term "optionally" in that passage indicated that it was possible to use the sensors in whole (or live) blood without a protective membrane.

The district court found that the persons involved in prosecuting the ′551 application, Abbott's attorney Lawrence Pope and its expert, Dr. Gordon Sanghera, made representations to the examiner that the pertinent passage in the ′382 patent should not be taken at face value. In particular, Dr. Sanghera submitted a declaration in which he stated that even though the ′ 382 patent referred to the use of a protective membrane surrounding the enzyme and mediator layers of the glucose meter as "optionally, but preferably" present, "one skilled in the art would have felt that an active electrode comprising an enzyme and a mediator would require a protective membrane if it were to be used with a whole blood sample." For that reason, he stated, he was "sure that one skilled in the art would not read [the ′382 patent] to teach that the use of a protective membrane with a whole blood sample is optionally or merely preferred." Mr. Pope, the prosecuting attorney, added his own remarks ***1318** when submitting Dr. Sanghera's declaration. He stated: "One skilled in the art would not have read the disclosure of the [′382 patent] as teaching that the use of a protective membrane with whole blood samples was optional. He would not, especially in view of the working examples, have read the optionally, but preferably language ... as a technical teaching but rather mere patent phraseology." Mr. Pope added: "There is no teaching or suggestion of unprotected active electrodes for use with whole blood specimens in [the ′382] patent or the other prior art of record in this application." Shortly after those submissions were made, the examiner allowed the claims for a membraneless sensor.

The problem, the district court found, is that Abbott had made directly contradictory representations to the European Patent Office ("EPO") concerning the teaching of the ′382 patent in connection with the prosecution of a European patent application and had not disclosed those contradictory representations to the PTO. Before the EPO, Abbott represented that the European counterpart to the ′382 patent referred to a "protective membrane optionally utilized with the glucose sensor of the patent," and that the membrane was "preferably to be used with in vivo measurements." With specific reference to the language from the patent reciting the use of the protective membrane "optionally, but preferably when being used on live blood," Abbott told the EPO: "It is submitted that this disclosure is unequivocally clear. The protective membrane is optional, however, it is preferred when used on live blood in order to prevent the larger constituents of the blood, in particular erythrocytes from interfering with the electrode sensor."

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The district court found that Abbott's representations to the EPO contradicted its representations to the PTO, made through Dr. Sanghera and Mr. Pope. The court's finding on that issue, made after a detailed analysis of the representations to the two bodies, cannot be held to be clearly erroneous. The district court also found that Abbott's failure to disclose to the examiner that it had made inconsistent statements to the EPO regarding the teaching of the ′382 patent was highly material. In particular, the court found that the failure to disclose the inconsistency in those statements was the kind of nondisclosure covered by PTO Rule 56, as being nondisclosure of information "inconsistent with a position the applicant takes in ... [a]sserting an argument of patentability." That finding, too, cannot be regarded as clearly erroneous in light of the central role of the pertinent portion of the ′382 patent in the examination of the application that led to the issuance of the ′ 551 patent.

Turning to the issue of intent, the district court found that Abbott's failure to disclose material information was intentional, i.e., it was made with the specific intent to deceive the PTO. The district court heard live testimony from Mr. Pope and Dr. Sanghera and conducted a detailed analysis of their testimony in light of the record. Based on that analysis, the court concluded that their efforts to justify their conduct were unpersuasive. The court found that Mr. Pope and Dr. Sanghera were aware of the contrary representations made to the EPO and consciously chose to withhold them from the PTO. The court carefully considered their explanations for their failure to disclose the references and found each witness's explanation to be lacking. The court discredited Mr. Pope's explanation that he understood the term "unequivocally clear" in the EPO submission to relate to the permeability of the membrane, not to the text immediately following the words "unequivocally clear," where it is plainly stated that the membrane is optional. The court was ***1319** not persuaded by Mr. Pope's statement that he believed "optionally, but preferably" meant, in the context of patents, "optionally, but always."

The court then considered possible alternative reasons for Mr. Pope's decision not to disclose the contradictory EPO statements, such as the possibility that Mr. Pope had misunderstood the meaning of the terms "whole blood" and "live blood." Ultimately, however, the district court could identify no plausible reason for the nondisclosure and therefore found that Mr. Pope had acted with deceptive intent. That finding, based on the court's consideration of Mr. Pope's demeanor and overall credibility, as well as the court's analysis of the record as a whole, cannot be said to be clearly erroneous.

For similar reasons, the court found that Dr. Sanghera also acted with intent to deceive the PTO. The court considered and rejected the possibility that Dr. Sanghera believed that Mr. Pope, Abbott's counsel before the PTO, would disclose the material information. The court began by finding that Dr. Sanghera's declaration before the PTO contained representations that were misleading by omission. The court explained that finding as follows:

> He did not have to take this extra step. Having done so, he was obligated to avoid intentional deception. His sworn statements to the PTO about the meaning of the "optionally but preferably" sentence were known by him to be inconsistent with his own company's statements to the EPO—statements he had himself helped craft.

As to Dr. Sanghera's testimony that he believed that statements he made to the PTO did not contradict the statements made to the EPO, the court found that Dr. Sanghera knew that a representation had been made to the EPO that the ′326 patent did not require a membrane when used with whole blood. Noting that Dr. Sanghera's trial testimony had been impeached by his prior inconsistent statements on certain points, and finding that Dr. Sanghera exhibited an "unconvincing trial demeanor," the district court found that he acted with the requisite intent to deceive. As in the case of Mr. Pope, the district court's findings as to Dr. Sanghera are not clearly erroneous.

Viewed in light of the district court's findings, this case is a compelling one for applying the principles of inequitable conduct. The district court found that Abbott's representatives deliberately withheld material from the PTO that directly refuted Abbott's contention that one skilled in the art would have believed that the ′382 patent taught that a membrane was required for whole blood analysis. Abbott's inconsistent position on the teachings of this critical reference falls squarely within the scope of information of the sort referred to in PTO Rule 56(b)(2), i.e., information that "refutes, or is inconsistent with, a position the applicant takes in ... [a]sserting an argument of patentability." Given the examiner's focus on the issue of whether the protective membrane in the prior art patent was optional or not, the issue was of critical importance in the prosecution of the application that issued as the ′551 patent, even though the undisclosed information, if revealed, may not have resulted in the rejection of the claims at issue. Accordingly, the district court made all the findings necessary to support its holding that the ′551 patent was unenforceable for inequitable conduct.[5] Because ***1320** the district court's factual findings are not clearly erroneous and because its legal analysis comports with the proper role of the doctrine of inequitable conduct in patent law, the district court's judgment that the ′551 patent is unenforceable for inequitable conduct should be affirmed.

5 Understandably relying on this court's prior case law, the district court stated at one point that Mr. Pope "knew or should have known" that the withheld information would have been highly material to the examiner, and at another point the court referred to "balancing the levels of materiality and intent." Although those remarks suggest a looser standard than that advocated here, they do not undermine the district court's ruling on inequitable conduct, because the district court elsewhere made findings that clearly satisfied the requirements of the more restrictive standard for inequitable conduct set forth above. In particular, the court found that Mr. Pope "acted with specific intent to deceive Examiner Shay and the PTO," that Mr. Pope and Dr. Sanghera "made a conscious and deliberate decision to withhold disclosure to the PTO of these prior statements" to the EPO, and that both of them "knew that the EPO materials made affirmative statements inconsistent with the declaration and the attorney remarks [to the PTO]." With respect to Dr. Sanghera, the court found that he "consciously made sworn statements to the [PTO] that were deliberately misleading." With respect to the issue of "balancing," moreover, the district judge did not find it necessary to balance intent against materiality, because he explicitly found that the evidence was strong as to both materiality and intent.

I respectfully dissent.

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EXHIBIT AC-122

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United States Court of Appeals, Ninth Circuit.

QUIDEL CORPORATION, Plaintiff - Appellant,
v.
SIEMENS MEDICAL SOLUTIONS USA, INC., Siemens Healthcare Diagnostics, Inc., Defendants – Appellees.
Laboratory Corporation of America Holdings, Intervenor.

No. 20-55933
|
Argued and Submitted September 2, 2021 Pasadena, California
|
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Appeal from the United States District Court for the District of Southern California, San Diego Cynthia A. Bashant, District Judge, Presiding, No. 3:16-cv-03059-BAS-AGS

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Before: NGUYEN, BENNETT, and R. NELSON, Circuit Judges.

Dissent by Judge BENNETT

MEMORANDUM [*]

[*] This disposition is not appropriate for publication and is not precedent except as provided by Ninth Circuit Rule 36-3.

***1** In this false advertising case, Appellant Quidel Corporation ("Quidel") challenges the district court's grant of summary judgment for Appellees, Siemens Medical Solutions USA, Inc. and Siemens Healthcare Diagnostics Inc. ("Siemens"), on their Lanham Act false advertising claims (§ 43(a)), unfair competition claims (Cal. Bus. & Prof. Code § 17200), False Advertising Law claims (Cal. Bus. & Prof. Code § 17500), and intentional interference with prospective economic advantage claims. [1] We have jurisdiction under 28 U.S.C. § 1291 and we affirm. [2]

[1] The parties and the district court have treated the state law claims as rising and falling with the Lanham Act claim. We do the same. *See Cleary v. News Corp.*, 30 F.3d 1255, 1262-63 (9th Cir. 1994).

[2] None of Quidel's claims were waived. We also agree with the district court that the false advertising and unfair competition claims were not precluded or preempted by the Federal Food, Drug, and Cosmetic Act ("FDCA").

1. There is no triable issue on materiality as to the laboratories. Even if Siemens' advertising of its assay, Immulite, was false, it was not material to the laboratories'—LabCorp and Sonic/CPL—decision to purchase Immulite and not Quidel's assay, Thyretain. The laboratories "are the ones who pay Quidel and Siemens for the [assays]; once a physician orders a[n assay], the lab ships it and pays the manufacturer for that [assay]." *Quidel Corp. v. Siemens Med. Sols. USA, Inc.*, No. 16-CV-3059-BAS-AGS, 2020 WL 4747724, at *5 (S.D. Cal. Aug. 17, 2020). There is no direct evidence in the record for which a reasonable juror could find that Siemens' allegedly false statements were material to the decision-making processes of the two laboratory customers. The testimony of the lab representatives for LabCorp and Sonic/CPL establishes that the challenged statements in Siemens' materials—scientific presentations, press releases, and other documents like the DocAlert and Instructions for Use ("IFU") package insert [3] —are not likely to have "influence[d] purchasing decisions." *TrafficSchool.com, Inc. v. eDriver Inc.*, 653 F.3d 820, 828 (9th Cir. 2011).

3 Immulite's IFU read in part: "TSHR autoantibody (TRAb) assays do not distinguish between TSI and TBI. The IMMULITE ... TSI assay utilizes ... receptors ... for the specific detection of thyroid stimulating autoantibodies."

As to Sonic, its decision to switch from Thyretain to Immulite was clearly influenced by a comprehensive, internal validation process. Testimony from Dr. Mark Silberman establishes that its validation study was based on rigorous procedure and protocol independent of any marketing materials. For example, Dr. Silberman testified that he "does not believe that any of [Siemens'] press releases had any impact on the lab's decision to assess and validate [Immulite]" and that "[p]rior to the adoption of [Immulite]" he "did not review statements on [Siemens'] website about the assay." *Quidel Corp. v. Siemens Med. Sols. USA, Inc.*, No. 16-CV-3059-BAS-AGS, 2019 WL 5320390, at *7 (S.D. Cal. Oct. 21, 2019). Quidel's cherry-picking of isolated and selective quotes from Dr. Silberman's testimony to argue that Sonic/CPL "relied on the package insert" and Siemens' communications that indicated Immulite is a TSI assay only and not a TRAb assay, does not establish a genuine issue of material fact on materiality. Rather, this evidence goes to whether Siemens' allegedly false statements "deceived or had the tendency to deceive a substantial segment of its audience." *Newcal Indus., Inc. v. Ikon Off. Sol.*, 513 F.3d 1038, 1052 (9th Cir. 2008). The dissent suggests that inferences can be made from these statements to establish deception. Diss. at 3–4. But such inferences would not be reasonable, as required to defeat summary judgment. And we must not elide otherwise distinct Lanham Act elements. *See also William H. Morris Co. v. Grp. W, Inc.*, 66 F.3d 255, 257 (9th Cir. 1995).

***2** As to LabCorp, its decision to switch from Thyretain to Immulite was clearly influenced by an internal validation process. Dr. Andre Valcour explained how LabCorp's analytic evaluation involved "FDA submitted data," exhaustive literature review and its own procedures for independent verification of the assay's performance. At most, statements reflecting the lab representatives' reliance on information in the package insert and internal debate by the laboratories' decision-makers pertain to the required element of deception, not materiality. *See Southland Sod Farms v. Stover Seed Co.*, 108 F.3d 1134, 1139 (9th Cir. 1997). The extensive vetting completed by these sophisticated experts leading to their eventual purchase of Siemens' assay overcomes Quidel's position that the challenged statements amount to conflicting evidence on materiality. In other words, the nature of the audience—highly-skilled and credentialed professionals—is such that representations about the type and quality of an assay are not reasonably likely to influence their purchasing decisions even if it attracted the labs' primary interest.

2. There is no triable issue on actual injury based on allegedly false advertising to the physicians. *See Harper House, Inc. v. Thomas Nelson, Inc.*, 889 F.2d 197, 210 (9th Cir. 1989). The district court properly rejected both of Quidel's damages theories as to the physicians. First, as the district court previously found, "Quidel cannot claim that its damages are caused by the lab carrying the product which in turn leads to the physicians ordering the product from the lab," *Quidel Corp.*, 2020 WL 4747724, at *5, because it is "the labs [that] decided which product to carry on their own, not as a result of Siemens." *Id.* Second, having determined that Quidel did not satisfy its obligations under Federal Rule of Civil Procedure 26, and that such error was not harmless, the district court did not abuse its discretion when it barred Quidel from presenting its alternative damages theory under Rule 37. *See Yeti by Molly, Ltd. v. Deckers Outdoor Corp.*, 259 F.3d 1101, 1106 (9th Cir. 2001).

An "award of profits with no proof of harm" is "appropriate in false *comparative* advertising cases, where it's reasonable to presume that every dollar defendant makes has come directly out of plaintiff's pocket." *TrafficSchool.com, Inc.*, 653 F.3d at 831.

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The presumption is inapplicable when, as here, the "advertising does not directly compare defendant's and plaintiff's products." *Id.*

The record shows that Siemens did not engage in false advertising to the physicians, comparative or otherwise. Siemens informed the physicians through its 2016 DocAlert message that its Immulite assay detects stimulating antibody "preferentially" —*i.e.*, with bias—in favor of stimulating over blocking antibodies. The record demonstrates that use of the term "preferentially" in this instance is accurate. Had Siemens informed the physicians that Immulite detects stimulating antibody "only," as it represented elsewhere, then the statement would be false. *See also Southland Sod Farms*, 108 F.3d at 1139. While the 2016 DocAlert message specifically referenced Thyretain and informed physicians about Immulite—the information that identified "Thyretain" was not challenged as false. [4] But even if Siemens' representations were false, the advertisement is not a comparative one. The alleged false statements must be misleading in context—given comparative factors like pertinent market, graphics, and language. *Cf. U-Haul Int'l, Inc. v. Jartran, Inc.*, 681 F.2d 1159, 1159-60 (9th Cir. 1982) (holding false representation in a comparative advertising campaign for truck and trailer services where select advertisements featured pictures of the competitor's product and other advertising that did not mention the competitor or use pictures of its product but made "implicit[ ] compar[isons]"). And Quidel does not dispute the actual comparative statement here about the assays' performance data—on clinical sensitivity and specificity—which was FDA-approved. [5] In fact, construing the DocAlert as a whole counsels against narrowing in on the one bullet-point phrase that references Thyretain's data in comparison to Immulite's (98.6 % as compared to 92%). The overall message conveyed by the DocAlert is the quality and characteristics of Immulite that improve management of Graves' disease. The document includes six bullet point phrases, aside from multiple headers and an introductory paragraph. Taken in context of all the DocAlert's features, the FDA-approved content that references Quidel cannot serve as the basis for a false comparative advertising claim.

4 Quidel's opposition to the motion to dismiss stated: "The [Complaint] ... does not allege that the name of the IMMULITE Assay nor its sensitivity and specificity data are false," and Quidel acknowledges that it "is not challenging Immulite's name and performance data."

5 The DocAlert, sent to physicians, contained the following allegedly false statements: "TRAb tests are not designed to discriminate stimulating, blocking, and neutral antibodies often present in [Graves' disease] patients. The IMMULITE ... assay is specifically engineered to preferentially detect stimulating antibody." The DocAlert also specifically mentioned Thyretain: "Superior clinical sensitivity for diagnosis of Graves' disease (98.6%) vs. Thyretain bioassay (92%)." The FDA pre-approved the sensitivity and specificity data which Siemens was required to include in the IFU.

***3** Because Quidel "failed to present sufficient evidence upon which a reasonable factfinder could conclude that [it] w[as] injured as a result of" Siemens allegedly false advertising to the physicians," *Southland Sod Farms*, 108 F.3d at 1145, summary judgment was warranted. [6]

6 To be sure, "a competitor need not prove injury when suing to enjoin conduct that violates section 43(a)." *Harper House, Inc.*, 889 F.2d at 210. But Quidel has not met the elements for a permanent injunction. *See eBay, Inc. v. MercExchange, L.L.C.*, 547 U.S. 388, 391 (2006).

AFFIRMED.

BENNETT, Circuit Judge, dissenting:
I respectfully dissent because proper application of summary judgment standards compels the conclusion that summary judgment is inappropriate.

I.

Appellant Quidel Corporation ("Quidel") sells Thyretain, an assay (blood test) that it claims detects only thyroid stimulating immunoglobulins ("TSI"). Appellees Siemens Medical Solutions USA, Inc. and Siemens Healthcare Diagnostics, Inc. (together, "Siemens") sell Immulite, a competing assay. Two laboratories, Sonic Healthcare USA ("Sonic") and Laboratory Corporation of America Holdings ("LabCorp"), switched from purchasing Thyretain to Immulite.

Quidel sued Siemens, alleging that Siemens engaged in false or misleading advertising by stating or implying that Immulite is a "TSI only" assay. According to Quidel, Immulite is not a "TSI only" assay; it is a "TRAb" [1] assay because it detects both TSI and thyroid blocking immunoglobulins ("TBI"). Quidel brought Lanham Act false advertising claims based on Siemens's alleged false advertising directed at laboratories and physicians. [2] Although the district court found a triable issue on falsity, it granted summary judgment on the Lanham Act claim related to the laboratories because Quidel had failed to show a triable issue on the element of materiality. [3] The district court also granted summary judgment on the Lanham Act claim related to the physicians because Quidel had failed to show a triable issue on the element of injury.

1 TRAb stands for thyroid-stimulating hormone receptor antibody.

2 The elements of a Lanham Act § 43(a) false advertising claim are:

> (1) a false statement of fact by the defendant in a commercial advertisement about its own or another's product; (2) the statement actually deceived or has the tendency to deceive a substantial segment of its audience; (3) the deception is material, in that it is likely to influence the purchasing decision; (4) the defendant caused its false statement to enter interstate commerce; and (5) the plaintiff has been or is likely to be injured as a result of the false statement, either by direct diversion of sales from itself to defendant or by a lessening of the goodwill associated with its products.

Southland Sod Farms v. Stover Seed Co., 108 F.3d 1134, 1139 (9th Cir. 1997) (footnote omitted).

3 I agree with the district court that there are triable issues of fact as to falsity.

I would reverse and remand as to all claims because, construing the evidence in the light most favorable to Quidel, there are triable issues on materiality and injury. [4] *See Southland Sod Farms v. Stover Seed Co.*, 108 F.3d 1134, 1138 (9th Cir. 1997).

4 Like the majority, I would treat the state law claims as rising and falling with the Lanham Act claims.

II.

***4** Materiality is a required element of a false advertising claim under the Lanham Act. *Id.* at 1139. A statement is material if "it is likely to influence the purchasing decision." *Id.* This means that "plaintiffs are not required to present evidence that defendants' misrepresentation actually influenced consumers' purchasing decisions, but that it was *likely* to influence them." *Cashmere & Camel Hair Mfrs. Inst. v. Saks Fifth Ave.*, 284 F.3d 302, 313 (1st Cir. 2002). "[M]ateriality focuses on whether the false or misleading statement is likely to make a difference to purchasers." *Id.* at 312 n.10. Thus, statements that concern "important factors in consumer purchasing decisions" can be material, *ThermoLife Int'l, LLC v. Gaspari Nutrition Inc.*, 648 F. App'x 609, 615 (9th Cir. 2016), and a statement "need not be the only basis for the consumer's decision" to be material, *Oil Heat Inst. of Or. v. Nw. Nat. Gas*, 708 F. Supp. 1118, 1123 (D. Or. 1988).

Drawing all reasonable inferences in Quidel's favor, Siemens's statements that expressly or impliedly communicated that Immulite is a TSI assay and not a TRAb assay were material to the laboratories' decision to switch from Thyretain to Immulite. Dr. Silberman, a Sonic representative, testified that whether Immulite was a TSI assay was an important factor to Sonic and that Sonic wanted to replace Thyretain with another TSI assay, not with a TRAb assay. Similarly, Dr. Valcour, a LabCorp representative, testified that LabCorp wanted a TSI assay and would not have been interested in Immulite if it were a TRAb assay. Quidel also submitted evidence that scientists within LabCorp did not want to switch to Immulite because it appeared to be a TRAb assay. And in advertising Immulite, Siemens repeatedly highlighted the distinction between TSI and TRAb.

A rational juror could easily infer from this evidence that whether Immulite was a TSI assay was an important factor to the laboratories—one *likely to influence* their decisions—and that Siemens made the representations it did because it knew the distinction between TSI and TRAb was important *to the purchasers.* Indeed, that the laboratories were only interested in a TSI assay to replace Thyretain supports that the laboratories would not have even considered Immulite had Siemens advertised it as a TRAb assay. Put another way, a juror could easily find that Siemens's statements were likely to influence the laboratories' purchasing decision because its statements attracted the laboratories and prompted them to conduct their own tests before ultimately purchasing Immulite. [5] Siemens's alleged false statements were the catalyst that led to the purchasing decision and therefore likely influenced the purchasing decision. Thus, I would find a triable issue on materiality.

5 I note that even if the laboratories' purchasing decision may have been partly influenced by their own testing, that fact would not preclude a juror from concluding that Siemens's statements were likely to (and did, at least in part) influence their purchasing decision. *See Oil Heat Inst. of Or.*, 708 F. Supp. at 1123.

The majority reaches a contrary conclusion by fully crediting Dr. Silberman's and Dr. Valcour's testimonies that the laboratories' decision to switch to Immulite resulted from the laboratories' internal validation processes, not Siemens's alleged false statements. Maj. at 2–5. But a reasonable juror could reject this testimony given that the laboratories' witnesses had strong incentives to give testimony validating their prior decisions. The laboratories' sophisticated experts would be reluctant to admit that they had been deceived and had incorrectly recommended switching to Immulite. More importantly, the majority ignores the evidence discussed above, which supports the inference that Siemens's alleged false statements were material to the laboratories. But even if the majority were correct in fully crediting the testimonies on summary judgment, thereby rejecting the inferences that favor the *non-moving* party, summary judgment for Siemens would still be improper. Even fully crediting the testimonies, a rational juror could surely find that these crucial representations were *likely to influence* the purchasing decisions. [6]

6 Even if a jury were to determine (were the question relevant) that the laboratories ultimately purchased based on their own tests, that doesn't matter to whether the representations were *likely to influence* the purchasing decisions. Indeed, even in the light most favorable to the *moving* party, it would be difficult for anyone to seriously claim that the purchasing decisions would have been the same had Siemens represented what Quidel claims is the truth (even with puffery): "Immulite—An exceptional TRAb assay!"

III.

***5** The parties agree that a presumption of injury could apply to the Lanham Act false advertising claim related to the physicians if: (1) Quidel and Siemens operate in a two-player market, *or* (2) Siemens engaged in false comparative advertising. *See TrafficSchool.com, Inc. v. Edriver Inc.*, 653 F.3d 820, 831 (9th Cir. 2011); *see also ThermoLife Int'l*, 648 F. App'x at 616; *Munchkin, Inc. v. Playtex Prods., LLC*, 600 F. App'x 537, 537–38 (9th Cir. 2015).

Even though the parties agree that a presumption of injury could apply if Quidel and Siemens operate in a two-player market and the district court ruled on the issue, the majority fails to address it. The evidence supports that the parties operate in a two-player market. As discussed above, Sonic and LabCorp wanted to replace Thyretain with Immulite. The laboratories did not want to replace Thyretain with a TRAb assay. Because the laboratories considered *only* Immulite and *not* TRAb assays, a factfinder could reasonably infer that Quidel and Siemens operate in a two-player market—the TSI player market. Quidel's survey evidence, which shows that a majority of the physicians surveyed are likely to order both a TSI assay and a TRAb assay for a patient, also supports the inference that TSI and TRAb assays are complements, not competitors, and therefore Thyretain and Immulite do *not* compete with TRAb assays. Based on this evidence, I would find that there is a triable issue on whether Quidel and Siemens operate in a two-player market.

There is also a triable issue on whether the 2016 DocAlert message was a false comparative advertisement. The DocAlert message contained the allegedly false statements, which communicated that Immulite was a TSI assay and not a TRAb assay: "TRAb tests are not designed to discriminate stimulating, blocking, and neutral antibodies often present in [Graves' disease] patients. The Immulite ... assay is specifically engineered to preferentially detect stimulating antibody." [7] Appellant's Excerpts of Record at 398. The DocAlert message also expressly mentioned Thyretain and compared Immulite to Thyretain: "[Immulite's] [s]uperior clinical sensitivity for diagnosis of Graves' disease (98.6%) vs. *Thyretain* bioassay (92%)." Appellant's Excerpts of Record at 398 (emphasis added). Viewing the DocAlert as a whole and in Quidel's favor, a factfinder could conclude that it was a false comparative advertisement because it falsely communicated that Immulite, like Thyretain, is a TSI assay (not a TRAb assay), and Immulite is better than Thyretain. The majority errs by failing to construe the DocAlert as a whole and in favor of Quidel. Maj. at 7–8. *Cf. Southland Sod*, 108 F.3d at 1139 ("When evaluating whether an advertising claim is literally false, the claim must always be analyzed in its full context.").

7 As the district court found, there is a triable issue on whether these statements were false given Quidel's evidence: "Plaintiff's expert Dr. Gupta opine[d] that Immulite is unable to distinguish between TSI ... and TBI.... [S]he believes Immulite 'is not specific for TSI as claimed.' " Thus, viewing this evidence in Quidel's favor, the statements in the DocAlert were false.

Because there are triable issues on whether the parties operate in a two-player market and whether Siemens engaged in false comparative advertising, there is also a genuine dispute about whether a presumption of injury applies. The district court therefore erred in granting summary judgment on the Lanham Act claim related to the physicians. [8]

8 Because a presumption of injury could apply to the Lanham Act claim, I would reverse the district court's holding that Quidel cannot establish the harm necessary to support a permanent injunction. I note that under the newly amended version of 15 U.S.C § 1116(a), it appears that Quidel, if successful on its Lanham Act claims, might obtain permanent injunctive relief without affirmative proof that it suffered irreparable harm. *See* 15 U.S.C. § 1116(a) ("A plaintiff seeking any such injunction shall be entitled to a rebuttable presumption of irreparable harm upon a finding of a violation identified in this subsection in the case of a motion for a permanent injunction...."); *see* Consolidated Appropriations Act, 2021, Pub. L. No. 116-260, § 226(a), 134 Stat. 1182, 2208 (2020).

***6** In sum, the majority's decision rests on the improper application of summary judgment standards. The majority ignores evidence favorable to Quidel and fails to draw all reasonable inferences in Quidel's favor. I therefore respectfully dissent. [9]

9 I agree with the majority that none of Quidel's claims were waived and that its false advertising and unfair competition claims were not precluded or preempted by the Federal Food, Drug, and Cosmetic Act. Maj. at 2 n.2.

All Citations

Not Reported in Fed. Rptr., 2021 WL 4622504

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EXHIBIT AC-123

KeyCite Yellow Flag - Negative Treatment

Declined to Extend by Chinese Yellow Pages Co. v. Chinese Overseas Marketing Service Corp., Cal.App. 2 Dist., December 30, 2008

41 Cal.2d 587, 262 P.2d 305

Supreme Court of California

CLARENCE W. COUGHLIN et al., Respondents,

v.

JOHN H. BLAIR et al., Appellants.

L. A. No. 22740.

Oct. 20, 1953.

HEADNOTES

(1a, 1b)

Agency § 167--Relation Between Agent and Third Person-- Liability of Agent.

Rule that agent who acts for disclosed principal and is dealt with by third party as agent does not ordinarily incur personal liability is inapplicable where language of realty purchase agreement which he signed opposite word "agent" indicates that parties intended he should be personally liable for surveying and for installing improvements.

See **Cal.Jur.2d,** Agency, § 132; **Am.Jur.,** Agency § 314 et seq.

(2)

Agency § 177--Relation Between Agent and Third Person--Instruments in Agent's Name--Evidence.

If fact of agency appears in an integrated contract and there is no unambiguous expression of intention either to make or not make agent a party thereto, extrinsic evidence is admissible to show intention of parties.

(3a, 3b)

Husband and Wife § 152--Agency--Evidence.

Where word "agent" appears before name of person signing realty purchase agreement and there is a blank following word "owner," but reference to signer's wife as person who would receive down ***588** payment as liquidated damages suggests that she is the principal, and where instrument also contains language indicating that husband was to be liable as party to contract for surveying and for installing improvements, so that it cannot be definitely ascertained from instrument whether he signed solely as agent or personally assumed obligation to perform contract, extrinsic evidence is admissible to determine intention of parties.

(4)

Vendor and Purchaser § 364--Recovery of Damages by Purchaser--Nonsuit.

Where person who signed realty purchase agreement opposite word "agent" stated that "he would pave" road to property involved and, in response to purchaser's question regarding time the utilities and pavement would be installed, stated "probably by September everything would be in shape because he had invested $185,000 in bulldozing and he wanted to get started getting his money out of the tract so he was not going to lose any time in proceeding with the improvements in the tract," and where such person was joined as a defendant in purchasers' action against lot owner for breach of agreement to install such improvements, trial court properly denied such defendant's motion for a nonsuit.

(5)

Vendor and Purchaser § 363(3)--Recovery of Damages by Purchaser-- Evidence.
In purchasers' action against lot owner and her husband, who had signed purchase agreement opposite word "agent," for breach of agreement to install utilities and pave road to property involved, court's determination that it was intention of parties that husband be personally liable for performance of contract is sustained by testimony of his brother, who acted as husband's agent and received a commission on sale of lot, that husband gave plaintiffs an agreement that he would pave road within a year, that he promised to put the gas and electricity in at a certain time, and that he said in one year's time "he thought he would have it all in."

(6)
Agency § 211--Undisclosed Agency--Election to Hold Principal or Agent.
Rule that party suing on contract may be forced to elect between judgment against an undisclosed principal and judgment against his agent is inapplicable where evidence discloses that defendant was not only a party to a realty purchase agreement but that he also acted as an agent, and deposit receipt at least indirectly identified lot owner as his principal.

See **Cal.Jur.2d,** Agency, § 171; **Am.Jur.,** Agency, § 204.

(7)
Stipulations § 18--Effect as Estoppel.
A stipulation at outset of trial that person signing realty purchase agreement acted as agent for lot owner and that he had full authority to act as such agent precludes such lot owner's successor in interest from successfully contending that lot owner was an undisclosed principal and that, by obtaining a judgment against signer of agreement for breach of contract to install improvements, ***589** plaintiffs elected to release lot owner's successor in interest from liability.

(8)
Damages §11
Past and Prospective Dama ges.
In action for damages for total breach of contract, distinction between permanent and temporary injury has no relevance, and plaintiff in that action recovers all his damages, past and prospective.

(9)
Damages § 214--Judgment--Effect.
A judgment for plaintiff in action for total breach of contract absolves defendant from any duty, continuing or otherwise, to perform contract; the judgment for damages is substituted for wrongdoer's duty to perform contract.

(10)
Damages § 72--Total Breach of Contract.
If there is a total breach of contract, plaintiffs may properly bring an action for all their damages, general and special; since any subsequent action for additional damages would be successfully opposed by plea of res judicata, plaintiffs' injury is necessarily permanent.

(11)
Damages § 72--Partial Breach of Contract.
If breach of contract is partial only, injured party may recover damages for nonperformance only to time of trial and may not recover damages for anticipated future nonperformance.

(12)
Contracts § 241--Breach--Total or Partial Breach.

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If a breach of contract is total, injured party may treat it as partial unless wrongdoer has repudiated contract.

(13)

Contracts § 241--Breach--Total or Partial Breach.

The circumstances of each case determine whether injured party may treat breach of contract as total.

(14)

Contracts § 241--Breach--Total or Partial Breach.

If injured party has fully performed his obligations under bilateral contract, courts usually treat a breach as partial unless it appears that performance of agreement is unlikely and that injured party may be protected only by recovery of damages for value of promise.

(15)

Vendor and Purchaser § 152--Performance of Contract--Breach.

Plaintiffs suing for breach of realty purchase agreement to install utilities and pave road to property involved were justified in treating defendants' nonperformance as a total breach of contract, where after delay of one year, despite plaintiffs' repeated requests, defendants had not installed improvements called for by contract, where it was uncertain when if ever they would do so, and where their conduct justified plaintiffs' belief that performance was either unlikely or would be forthcoming only when it suited defendants' convenience.

(16)

Damages § 72--Breach of Contract.

Unless a statute otherwise specifically provides, proper measure of damages for breach ***590** of contract is amount which will compensate party aggrieved for all detriment proximately caused thereby, or which, in ordinary course of things, would be likely to result therefrom. (Civ. Code, § 3300.)

See **Cal.Jur.,** Damages, § 77 et seq.; **Am.Jur.,** Damages, § 43 et seq.

(17)

Vendor and Purchaser § 365(2)--Recovery of Damages by Purchaser-- Measure of Damages.

Under realty purchase contract calling for installation of improvements that would greatly increase value of plaintiffs' property, if work were to be done on plaintiffs' property the proper measure of damages for breach of contract would ordinarily be reasonable cost to plaintiffs of completing work.

(18)

Vendor and Purchaser § 365(2)--Recovery of Damages by Purchaser-- Measure of Damages.

When improvements called for by realty purchase agreement are to be made on property that is not owned by party injured by breach of agreement and he is unable to complete work himself, the proper measure of damages, subject to restrictions of Civ. Code, §§ 3300, 3359, is difference in value of property with and without promised performance, since that is contractual benefit of which injured party is deprived.

(19)

Vendor and Purchaser § 365(1)--Recovery of Damages by Purchaser-- Amount of Recovery.

In purchasers' action for breach of realty purchase agreement to install utilities and pave road to property involved, defendants were not entitled to credit for performance of part of their contractual obligations on the ground that the theory that the work was performed while plaintiffs treated the breach as partial, where it could not be ascertained from the record whether or not defendants performed the work before or after plaintiffs filed their complaint.

(20)
Damages § 72--Breach of Contract.
If injured party accepts or urges performance by promisor, he will not be allowed to obtain damages on theory that performance has not been made.

(21)
Vendor and Purchaser § 365(1)--Recovery of Damages by Purchaser-- Amount of Recovery.
In purchasers' action for breach of realty purchase agreement to install utilities and pave road to property involved, defendants should not receive credit for performance after complaint was filed and before action came to trial, where plaintiffs did not urge performance after complaint was filed and they could not prevent it, since by commencing action they fully and fairly informed defendants that instead of performance they sought money damages for value of defendants' promise and thereafter defendants were absolved from all duties under contract to furnish improvements, any subsequent work to that end being entirely voluntary and not performance of a contract then existent.

(22)
Contracts § 241--Breach--Rights of Wrongdoer.
Parties who have totally breached a contract cannot force performance on injured parties. ***591**

(23)
Damages § 72--Breach of Contract.
Damages are awarded in action for breach of contract to give injured party benefit of his bargain and insofar as possible to place him in same position he would have been had promisor performed contract.

(24)
Damages § 72--Breach of Contract.
Damages must be reasonable and promisor is not required to compensate injured party for injuries that he had no reason to foresee as probable result of his breach when he made contract. (Civ. Code, § 3300.)

(25)
Vendor and Purchaser § 365(1)--Recovery of Damages by Purchaser-- Damages for Loss of Use and Increased Building Costs.
Purchasers of realty who are awarded damages for difference in value of lot with and without improvements in their action for breach of agreement to install utilities and pave road to property involved are entitled to damages for loss of use and increased building costs preceding date they treated such breach as total, that is, date when they instituted action, but they are not entitled to this additional award during period between date that complaint was filed and date of trial, since defendants were no longer obliged to perform during that period and any delay in utilization of property after plaintiffs filed complaint was chargeable to them, not to defendants.

(26)
Damages § 38--Interest--In Action on Contract.
In action for breach of agreement to install improvements on certain realty, interest prior to judgment cannot be awarded under Civ. Code, § 3287, where amount of damages cannot be ascertained except on conflicting evidence.

(27)

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Evidence § 398--Extrinsic Evidence--In Aid of Interpretation.
In action for breach of agreement to pave a road, extrinsic evidence is admissible to determine what parties meant by "paving." (Code Civ. Proc., § 1860.)

(28)
Vendor and Purchaser § 363(3)--Recovery of Damages by Purchaser-- Evidence.
In purchasers' action for breach of realty purchase agreement to install utilities and pave road to property involved, a finding that difference between market value of property with and without performance of contract was $9,500 is sustained by testimony of expert witnesses who gave their valuation of property with and without improvements, their valuations with improvements necessarily contemplating improvements installed by a responsible person.

(29)
Vendor and Purchaser § 363(3)--Recovery of Damages by Purchaser-- Evidence.
In purchasers' action for breach of realty purchase agreement to install utilities and pave road to property involved, a finding that breach of such agreement was deliberate is sustained by one defendant's admission that he did not make deposit required by gas company before it would extend its gas line to plaintiffs' lot, although he had financial ability to do so; by defendants' failure to accept city's offer to install electricity ***592** to plaintiffs' lot without cost to defendants if they would waive claim to certain other rights under their contract with city; and by defendants' failure to install permanent paving because they took position that only temporary paving was required by contract.

(30)
Vendor and Purchaser § 363(3)--Recovery of Damages by Purchaser-- Evidence.
In purchasers' action for breach of realty purchase agreement to install utilities and pave road to property involved, court's conclusion that but for breach plaintiffs would have been able to take advantage of lower building costs at time contemplated is sustained by evidence that plaintiffs told defendant on day contract was signed that they intended to build a "three bedroom, rambling house with a playhouse and swimming pool," that such a house would exceed 1,500 square feet, that they intended to build "the following spring," the time when performance was specified in contract, and that they actually employed an architect and received plans from him.

SUMMARY

APPEAL from a judgment of the Superior Court of Los Angeles County. J. T. B. Warne, Judge. * Affirmed in part and reversed in part with directions.

* Assigned by Chairman of Judicial Council.

Action for damages for breach of realty purchase contract to install utilities and pave road to property involved. Judgment for plaintiffs affirmed as to award of general damages; reversed with directions as to award of special damages for loss of use of property and from increase in building costs.

COUNSEL
Charles Reagh for Appellants.
Krystal & Paradise and Robert E. Paradise for Respondents.

TRAYNOR, J.

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Louise Blair, wife of defendant John Blair, owned a tract of land on the hills overlooking Hollywood. Part of the tract had been subdivided. Lot 7, the parcel involved in the present litigation, is in an unsubdivided part of the tract. It is at the apex of a triangular hill and has an exceptional view and privacy. In May, 1948, when the contract involved in this action was executed, Lot 7 was graded and had access to the public streets by means of a dirt road to Nichols Canyon Road, about 3,725 feet away. Gas and electricity had not been installed nearer than the intersection of Nichols Canyon Road and the dirt road leading to Lot 7.

Plaintiffs Clarence Coughlin and Cathleen Coughlin, husband ***593** and wife, viewed the lot several times with defendant John Blair. They informed him that they wished to purchase the lot and to build a residence thereon within the following year. They told him that, "We were ready to sign for the property at his price provided he would agree that paving would be installed, electricity and gas would be installed, all within one year from the date of the agreement; that he would have the lot surveyed and staked, all of which was to be at his cost and at no cost to us." John Blair was willing to sell the property on those terms. Accordingly, on May 30, 1948, the parties executed on a deposit receipt form the contract set forth in the footnote.[1] Plaintiff Clarence Coughlin testified that he first became aware of Mrs. Blair's name after he had looked at the deposit receipt. An escrow was opened in the name of Louise Blair. Plaintiffs paid the full purchase price of $14,000 and received a deed from Louise Blair. The deed granted plaintiffs Lot 7, with a "nonexclusive Easement for Ingress and Egress and for driveway purposes" to Nichols Canyon Road.

1 "Received from *Clarence W. Coughlin & Cathleen L., Married*
Date May 30th, 1948
Address *106 N. Maple Dr. Bev. Hill Cr. 18642* the sum of $1000.00 being a part payment on *Lot 7 in pros. Tract 15175 Metes & Bound Disp.* (Subject to Restrictions and Reservations of Record) At price of *$14000* payable $__________ cash (including the within payment) balance payable as follows: *$7500 in Escrow 5500 Balance on or before July 15th 1948. Gas & Pavement & Elec. to be put at no cost to buyer within 1 yr from above date also to be surveyed by Jno. H. Blair at once.* Balance of first payment, to-wit: __________ dollars to be deposited in escrow within __________ days from above date and failing to make such payments, above amount paid is retained by and forfeited to *Louise Blair* as liquidated damages. Purchaser agrees to purchase said property at above price and terms. Agent reserves the right to refund payment if unsatisfactory to owner.
Dated this *30* day of *May, 1948* at *Los Angeles,* California
Clarence W. Coughlin Purchaser — Agent *John H. Blair*
Cathleen L. Coughlin Purchaser — Per___
I accept above sale and agree to pay ___ commission of ___
Dated ___ — Owner ___"
(Italics represent terms written in the blank spaces on printed form.)

On May 30, 1949, the date that performance was due under the contract, the paving had not been done and neither gas nor electricity had been brought to the lot. During the following year plaintiffs wrote four letters to defendant John Blair demanding performance. Defendants did not repudiate the contract; nor did they perform their obligations thereunder. ***594** They did put temporary paving on part of the road to Lot 7 in the fall or winter of 1949. Plaintiffs' last letter, on April 1, 1950, stated that they would institute an action, if the contract was not performed within 30 days. On May 24, 1950, plaintiffs brought this action. They did not seek rescission or specific performance. Instead, they sought damages for the difference in value of the property with and without the performance promised in the contract, and special damages for the loss of the use of the property and for the increase in building costs since the date performance was due.

At some time in 1950 permanent paving was installed on the road to Lot 7 for a distance of 1,200 feet commencing from the Nichols Canyon Road. In May of 1950 a gas line was installed over the same 1,200 feet. It cannot be ascertained from the record whether or not these installations preceded the filing of the complaint; in any event, at that time about half only of the remaining 2,525 feet of the road had even temporary paving and gas and electricity had not been brought to the lot. At the time of the trial, April 20, 1951, the road was in the same condition. No further work on the gas line was done until the week before

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trial, when workmen began laying a line in the direction of Lot 7. Electricity was installed to a point adjoining Lot 7 in August, 1950. There is nothing to show that plaintiffs requested or accepted performance after the complaint was filed.

Louise Blair was named as a defendant in the complaint, but died a few days before trial. Before her death she had conveyed to defendant Marion Conger real property of which Lot 7 was a part, and Mrs. Conger agreed to assume Louise Blair's obligations to plaintiffs arising from the agreement of sale. The parties stipulated that the case should proceed with Marion Conger substituting as successor to Louise Blair. The trial court concluded that both defendants, John Blair and Marion Conger, were personally liable for the breach of the contract. Plaintiffs recovered judgment for $9,500 general damages, the difference between the market value of the property on May 30, 1949, and the market value it would have had at that time had the contract been performed, $2,300.37 special damages for the loss of use of the lot, measured by loss of use of the $14,000 paid by plaintiffs and computed at 7 per cent from May 30, 1949, to the date of trial, and $3,700 special damages for the increase of construction costs between June, 1949, and the date of trial.

Defendants appeal, contending: (1) John Blair is not personally ***595** liable for nonperformance of the contract; (2) if the judgment against John Blair is affirmed, the judgment against Marion Conger must be reversed; (3) the award of damages is not sustained by the evidence and allows plaintiffs a double recovery; and (4) several material findings of the trial court are not supported by the evidence.

1. *Liability of John Blair.*

(1a) Defendant John Blair contends that he signed the contract as an agent only and is not personally liable thereunder. He relies on the rule that an agent who acts for a disclosed principal and is dealt with by the third party as an agent does not ordinarily incur personal liability. (See, 2 Cal.Jur.2d, Agency, § 132, and cases cited.) That rule is inapplicable here. (2) If the fact of agency appears in an integrated contract, and there is no unambiguous expression of an intention either to make or not to make the agent a party thereto, extrinsic evidence is admissible to show the intention of the parties. (Rest., Agency, § 323(2); *Carlesimo v. Schwebel,* 87 Cal.App.2d 482, 488 [197 P.2d 167]; *Otis Elevator Co. v. Berry,* 28 Cal.App.2d 430, 433 [82 P.2d 704]; *cf. Patterson v. John P. Mills etc,. Inc.,* 203 Cal. 419, 421 [264 P. 759].) (3a) In the present case the word "agent" appears before John Blair's signature to the contract and there is a blank following the word "owner." The reference to Louise Blair as the person who would receive the down payment as liquidated damages suggests that she is the principal. (1b) The words "Gas & Pavement & Elec. to be put at no cost to buyer within 1 yr from above date also to be surveyed by Jno H. Blair at once" indicate that the parties intended that John Blair should be personally liable for the surveying and also for installing the improvements. (3b) Thus, the contract gave plaintiffs notice that John Blair was an agent and indirectly disclosed the identity of the principal but it also contains language indicating that he was to be liable as a party to the contract. Since it cannot be definitely ascertained from the instrument whether John Blair signed solely as an agent or personally assumed the obligation to perform the contract, extrinsic evidence was admissible to determine the intention of the parties. (*Carlesimo v. Schwebel, supra,* 87 Cal.App.2d 482, 487-489.)

(4) Plaintiffs conducted all negotiations with John Blair at the tract office, marked with a sign "Blair Hills Estates." John Blair stated that "he would pave" the road to Lot 7 ***596** and, in response to Mr. Coughlin's question regarding the time the utilities and pavement would be installed, stated "probably by September everything would be in shape because he had invested $185,000 in bulldozing and he wanted to get started getting his money out of the tract so he was not going to lose any time in proceeding with the improvements in the tract." In the light of this evidence the trial court properly denied defendant John Blair's motion for a nonsuit. (5) Evidence later adduced [2] also supports the trial court's determination that it was the intention of the parties that John Blair be personally liable for performance of the contract. Eugene Blair, who was the brother of John Blair and who acted as the latter's agent and received a commission on the sale of the lot, testified, "At the time of my deal with Mr. Coughlin it was no argument or discussion about the paving. Mr. Blair give them an agreement that he would pave it within a year. ... Mr. Blair promised to put the gas and electricity in at a certain time, a certain time if he could do it. ... Mr. Blair set it down in the form that I drew up and said in one year's time he thought he would have it all in."

2 Defendant John Blair stated at the close of plaintiff's case that he would "stand on his motion for a nonsuit" and would not introduce evidence on his behalf. Defendant Marion Conger introduced evidence to defend the action against her and, on cross-examination, plaintiffs elicited additional evidence supporting their case. That evidence may be considered by an appellate court in reviewing the sufficiency of the evidence to support the trial court's determination that it was the intention of the parties that John Blair be personally liable for performance of the contract. (See *Peters v. Southern Pac. Co.,* 160 Cal. 48, 52-53 [116 P. 400].)

2. *Liability of Marion Conger.*

(6) Defendant Marion Conger contends that affirmance of the judgment against John Blair necessitates reversal of the judgment against her. She relies on several cases holding that a party suing on a contract may be forced to elect between a judgment against an undisclosed principal and a judgment against his agent. (*Klinger v. Modesto Fruit Co., Inc.,* 107 Cal.App. 97, 100 [290 P. 127]; *McDevitt v. Corriea (Chas.) & Bros.,* 70 Cal.App. 245, 254 [233 P. 381]; *Ewing v. Hayward,* 50 Cal.App. 708, 717 [195 P. 970]; contra: *Montgomery v. Dorn,* 25 Cal.App. 666, 670 [145 P. 148]; *Jewell v. Colonial Theater Co.,* 12 Cal.App. 681, 685 [108 P. 527]; *McKee v. Cunningham,* 2 Cal.App. 684, 688 [84 P. 260]; see *Craig v. Buckley,* 218 Cal. 78, 81 [21 P.2d 430]; ***597** Rest., Agency, § 201(1); 39 Cal.L.Rev. 409.) That rule is inapplicable here. The evidence discloses that John Blair was not only a party to the contract but that he also acted as an agent, and the deposit receipt at least indirectly identified Louise Blair as his principal. (Rest., Agency, §§ 144, 146, 184; see, *Geary St. etc. R. Co. v. Rolph,* 189 Cal. 59, 65-66 [207 P. 539].) Even if we assume that Louise Blair was an undisclosed principal the trial court properly refused to require plaintiffs to make an election.

(7) At the outset of the trial it was stipulated that John Blair, in signing the agreement, "acted as agent for Louise Blair, that he had full authority to act as such agent, and that his act bound her." It was further stipulated that Marion Conger, as successor in interest to Louise Blair, deceased, "expressly assumes and agrees to pay and discharge any and all liabilities or obligations claimed or asserted by plaintiffs against defendants in the above entitled action, if and as adjudicated in this action." Counsel for defendants stated, "I stipulated [that this document] bound Mrs. Blair but I do not stipulate it bound Mr. Blair. He signed as agent and he is not bound except as agent." Counsel for plaintiffs replied, "I accept counsel's stipulation as far as it goes. We, of course, contend Mr. Blair was bound, that he acted not only as agent for his wife but also acted individually." Marion Conger's liability was conceded by the stipulation. She cannot now successfully contend that Louise Blair was an undisclosed principal and that by obtaining judgment against John Blair plaintiffs elected to release her from liability. (*Williams v. General Ins. Co.,* 8 Cal.2d 1, 5 [63 P.2d 289]; *Stanton v. Santa Ana Sugar Co.,* 84 Cal.App. 206, 210 [257 P. 907].) Plaintiffs were entitled to rely on the stipulation and to try the case on the assumption that it remained for them only to prove that John Blair was also liable.

3. *Damages.*

Defendants contend that the trial court allowed plaintiffs excessive damages by awarding them $9,500 general damages for the difference between the market value of the property with and without the performance due under the contract. Their first ground of attack is that plaintiffs failed to show that the injury was permanent. Defendants assert that they performed part of their obligations under the contract before the action came to trial and that they will perform the remainder of their obligations in the future. They conclude ***598** that since plaintiffs will thus have the improvements, they would be allowed a double recovery if they also recovered damages for failure to get the improvements.

(8) The distinction defendants would draw between a permanent and a temporary injury has no relevance in a case involving a total breach of contract. In an action for damages for such a breach, the plaintiff in that one action recovers all his damages, past and prospective. (*Abbott v. 76 Land & Water Co.,* 161 Cal. 42, 47-48 [118 P. 425]; *Van Horne v. Treadwell,* 164 Cal. 620, 622 [130 P. 5]; see, Corbin on Contracts, § 946.) (9) A judgment for the plaintiff in such an action absolves the defendant from any duty, continuing or otherwise, to perform the contract. (*Noble v. Tweedy,* 90 Cal.App.2d 738, 744 [203 P.2d 778].) The judgment for damages is substituted for the wrongdoer's duty to perform the contract. (Rest., Contracts, § 313, com. *c*; *South Memphis Land Co. v. McLean Hardwood Lbr. Co.,* 179 F. 417, 426 [102 C.C.A. 563].)

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(10) If there was a total breach of contract, plaintiffs properly brought their action for all their damages, general and special; since any subsequent action for additional damages would be successfully opposed by the plea of res judicata, plaintiffs' injury is necessarily permanent. It would be anomalous for a court in the very judgment that substitutes a money award for defendants' performance, and divests the court of the power in the future to require performance or to award additional damages for breach, also to determine whether or not the defendant will nevertheless render the performance from which he is absolved. Defendants rely on *Spaulding v. Cameron,* 38 Cal.2d 265 [239 P.2d 625], where we held that in an action to abate a nuisance a plaintiff could not recover both an injunction abating a nuisance and damages on the theory that the nuisance was permanent. That case would be in point here, if plaintiffs had obtained both damages for a total breach and a decree of specific performance requiring defendants to perform, or if defendants were still obliged to perform the contract. (See *Wichita Falls Electric Co. v. Huey* (Tex.Civ.App.), 246 S.W. 692, 694-695.)

(11) If the breach is partial only, the injured party may recover damages for nonperformance only to the time of trial and may not recover damages for anticipated future nonperformance. (See *Rischard v. Miller,* 182 Cal. 351, 353 [188 P. 50]; Rest., Contracts, § 313.) (12) Furthermore, even if a breach is total, the injured party may treat it as partial, ***599** unless the wrongdoer has repudiated the contract. (*Fresno Canal & Irr. Co. v. Perrin,* 170 Cal. 411, 415 [149 P. 805]; Rest., Contracts, § 317(2).) (13) The circumstances of each case determine whether the injured party may treat a breach of contract as total. (See, *American Type etc. Co. v. Packer,* 130 Cal. 459, 463 [62 P. 744]; *Clarke Contracting Co. v. City of New York,* 229 N.Y. 413, 419-420 [128 N.E. 241]; *Helgar Corp. v. Warner's Features,* 222 N.Y. 449, 453-454 [119 N.E. 113]; Corbin on Contracts, § 946.) (14) If, as in the present case, the injured party has fully performed his obligations under a bilateral contract, courts usually treat a breach as partial unless it appears that performance of the agreement is unlikely and that the injured party may be protected only by recovery of damages for the value of the promise. (*Gold Min. & Water Co. v. Swinerton,* 23 Cal.2d 19, 29-30 [142 P.2d 22]; Rest., Contracts, § 316.)

Plaintiffs contend that there was a total breach on May 30, 1949, the date that performance was due under the contract. Even if plaintiffs could have treated the breach as total at that time, it is clear that they elected not to do so, for during the following year they kept urging defendants to perform.

(15) A different situation was presented on May 24, 1950, when plaintiffs brought the present action. At that time performance was one year overdue. By seeking damages for the difference in the value of their property with and without performance, plaintiffs gave notice that they would no longer treat defendants' continued failure to perform as a partial breach. Defendants could not reasonably expect plaintiffs to continue indefinitely to treat the breach as partial. Even if a breach might be considered partial at the time performance is due, there is a limit to the time a promisee must thereafter await performance. The trial court could reasonably conclude that that limit was reached here. It was not shown that despite defendants' delay, plaintiffs would be assured of getting the improvements. (*Cf. South Memphis Land Co. v. McLean Hardwood Lbr. Co.,* 179 F. 417, 426 [102 C.C.A. 563].) Despite repeated requests by plaintiffs, defendants had not installed the improvements called for by the contract. It was uncertain when if ever they would do so. Although defendants had not expressly repudiated the contract, their conduct clearly justified plaintiffs' belief that performance was either unlikely or would be forthcoming only when it suited defendants' convenience. Plaintiffs were not required to endure that uncertainty or to await that convenience and ***600** were therefore justified in treating defendants' nonperformance as a total breach of the contract. (See *Gold Min. & Water Co. v. Swinerton, supra*; *Walker v. Harbor Business Blocks Co.,* 181 Cal. 773, 780-781 [186 P. 356]; *Losei Realty Co. v. City of New York,* 254 N.Y. 41, 47 [171 N.E. 899].)

The question remains whether the court applied a proper measure of damages. (16) Unless a statute otherwise specifically provides, the proper measure of damages for the breach of a contract "is the amount which will compensate the party aggrieved for all the detriment proximately caused thereby, or which, in the ordinary course of things, would be likely to result therefrom." (Civ. Code, § 3300.) Damages must, however, "be reasonable, and where an obligation of any kind appears to create a right to unconscionable and grossly oppressive damages, contrary to substantial justice, no more than reasonable damages can be recovered." (Civ. Code, § 3359.) In the present case the contract called for installation of improvements that would greatly increase the value of plaintiffs' property. The consideration was paid in advance. (17) If the work were to be done on

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plaintiffs' property the proper measure of damages would ordinarily be the reasonable cost to plaintiffs of completing the work. (*Taylor v. North Pac. Coast R. Co.,* 56 Cal. 317, 320; *Adams v. Hiner,* 46 Cal.App.2d 681, 683 [116 P.2d 630]; *cf. Avery v. Fredericksen & Westbrook,* 67 Cal.App.2d 334, 336 [154 P.2d 41]; see Corbin on Contracts, §§ 1089-1091.) (18) A different rule applies, however, when the improvements are to be made on property that is not owned by the injured party. In that event the injured party is unable to complete the work himself and, subject to the restrictions of sections 3300 and 3359 of the Civil Code, the proper measure of damages is the difference in value of the property with and without the promised performance, since that is the contractual benefit of which the injured party is deprived. (*Knoch v. Haizlip,* 163 Cal. 146, 154 [124 P. 998]; *South Memphis Land Co. v. McLean Hardwood Lbr. Co.,* 179 F. 417, 423-424 [102 C.C.A. 563]; *Hyatt v. Wiggins,* 178 Ark. 1085 [13 S.W.2d 301, 303].)

In the present case the contract was to be performed entirely on property that is not owned by plaintiffs. Plaintiffs did have a nonexclusive easement thereover. Defendants, however, had reserved an easement and right of way over the road, with the right of "constructing, maintaining, repairing, and operating the same." Plaintiffs proved their damages on the theory that the proper measure was the difference in ***601** value of Lot 7 with and without the promised performance. Defendants did not contend at the trial or on appeal that plaintiffs had the right to pave the road and install the gas line and electricity thereon, or that they would be able independently of defendants to get the improvements. In this state of the record, we are of the opinion that the trial court invoked the proper rule for measuring the general damages. (*Cf. Herzog v. Grosso, ante,* pp. 219, 226 [259 P.2d 429].)

The question arises whether the measure of damages applied by the court includes a double recovery on the ground that it allows damages on the assumption that there had been no performance by defendants whereas plaintiffs got the benefit of defendants' part performance during the period plaintiffs treated the breach as partial. If there were no performance by defendants between May 30, 1949, and May 24, 1950, there can be no doubt that the award of $9,500 damages was proper. If, on the other hand, defendants performed part of their contractual obligations to plaintiffs' benefit during the period that plaintiffs treated the breach as partial, defendants should be allowed credit therefor, since it would be manifestly unjust to allow plaintiffs to induce defendants to render such performance, and then to award plaintiffs damages as if it had not occurred.

The performance claimed by defendants breaks down into three activities: (1) at some time in the fall or winter of 1949, temporary paving was placed on 1,225 feet of the road to the edge of Lot 7; (2) at some unspecified date in 1950 permanent paving was installed on 1,200 feet of the road to Lot 7, commencing at the Nichols Canyon Road, leaving 1,300 feet of the road with a dirt surface and the remaining 1,225 feet of the road with temporary paving only; and (3) at an unspecified date in May of 1950 a gas line was installed over the same 1,200 feet of road, leaving a 2,525-foot gap between the end of the line and plaintiffs' lot.

Insofar as installation of the temporary paving is concerned, the record discloses that the benefit thereof to plaintiffs was included in the valuations made of the property. Witnesses Holabird and Vollmer testified that they had viewed the property shortly before the trial and that their appraisals were predicated on the condition of the road as it then existed.

(19) Plaintiffs contend that the amount of permanent paving and the amount of gas line installed did not enhance the value of the lot, on the ground that a gap of 2,525 feet left the lot as useless and its value as unchanged as a gap of ***602** 3,725 feet. The testimony of the valuation experts that without the improvements contracted for the lot was useless, lends some support to this contention. In any event, since it cannot be ascertained from the record whether or not defendants installed the permanent paving and the gas line over the 1,200 feet of road before or after plaintiffs filed their complaint, we must conclude that defendants failed to establish that they were entitled to credit therefor on the ground that this work was performed during the time plaintiffs treated the breach as partial.

The next question presented is whether defendants should receive credit for performance after the complaint was filed and before the action came to trial. In addition to the installation of the 1,200 feet of gas line and permanent paving, discussed above, defendants installed electricity to the edge of Lot 7 in August of 1950, more than two months after the complaint was filed, and began laying gas lines at a point 2,500 feet from the lot and in its general direction about a week before trial. It was not shown

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that it was certain that the gas line would be brought to the edge of the lot. Neither party introduced evidence to show by what amount the installation of electricity without performance of the other obligations of the contract increased the value of the lot. Did the trial court err in applying its measure of damages in the absence of such evidence?

Ordinarily this question does not arise. (20) If the injured party accepts or urges performance by the promisor, he will not be allowed to obtain damages on the theory that performance has not been made. If the wrongdoer cannot induce the injured party to accept performance, he will ordinarily not perform. The record does not show why defendants chose to continue performance after the action was brought. [3] (21) Plaintiffs did not urge performance after the complaint was filed, and they could not prevent it. By commencing the action they fully and fairly informed defendants that instead of performance they sought money damages for the value of defendants' promise. Unless plaintiffs indicated that they were again willing to treat the breach as partial, the remedial rights provided by law were substituted for the rights under the contract. (Rest., Contracts, § 313, com. *c.*) Thereafter defendants were absolved from all ***603** duties under the contract to furnish improvements. Subsequent work to that end would not be performance of a contract then existent but would be entirely voluntary. If prompted by defendants' self-interest in the sale of other lots, such gratuitous benefit, wholly speculative on the record, would not constitute unjust enrichment to plaintiffs. (22) Parties who have totally breached a contract cannot force performance on the injured parties.

3 It is suggested in the briefs (but on the record this is entirely speculative) that defendants may have had contractual obligations to other purchasers of lots or wished to increase the value of their unsold lots.

Defendants next contend that if the award of $9,500 is upheld, the award for loss of use of the property, $2,300.37, and the award for the increase in building costs, $3,700, must be reversed.

(23) Damages are awarded in an action for breach of contract to give the injured party the benefit of his bargain and insofar as possible to place him in the same position he would have been in had the promisor performed the contract. (*Coburn v. California Portland Cement Co.,* 144 Cal. 81, 84 [77 P. 771]; *Noble v. Tweedy,* 90 Cal.App.2d 738, 745 [203 P.2d 778].) (24) Damages must be reasonable, however, and the promisor is not required to compensate the injured party for injuries that he had no reason to foresee as the probable result of his breach when he made the contract. (Civ. Code, § 3300; *California Press Mfg. Co. v. Stafford Packing Co.,* 192 Cal. 479, 483 [221 P. 345, 32 A.L.R. 114]; see Corbin on Contracts, § 1007.)

Plaintiffs informed defendants at the time the contract was made that they were buying the lot as a site for a residence and that they needed the gas, electricity, and permanent paving installed within a year. Defendants were in the business of selling lots as residence sites and were fully aware of the consequences of delay in their performance. They knew that the lot was less valuable without than with the improvements, and that plaintiffs would be deprived of the use of the lot for building purposes so long as the contract was not performed. They also knew that an increase in building costs would add to the cost of the residence plaintiffs contemplated building on the lot. Had the contract been performed, plaintiffs would have had not only a more valuable lot than they now have but the use of that lot from the date performance was due for the erection of their residence. By defendants' breach of the contract, plaintiffs are not only left with a lot that is less valuable than it would have been had the contract been performed but they have been deprived of the use of the improved lot they bargained for and are faced ***604** with increased building costs that would have been avoided had the contract been performed. (25) The award of damages for the difference in the value of the lot with and without the improvements compensates for the loss in the value of the lot. It does not compensate for the loss of use of the lot or the increased building costs. Accordingly, plaintiffs are entitled to damages for the loss of use [4] and the increased building costs preceding the date they treated the breach as total, in addition to the $9,500. (*Tally v. Ganahl,* 151 Cal. 418, 424 [90 P. 1049]; *Henderson v. Oakes-Waterman, Builders,* 44 Cal.App.2d 615, 617-618 [112 P.2d 662].)

4 The trial court measured damages for loss of use at the rate of 7 per cent per annum on the $14,000 purchase price paid in advance. Neither party questions loss of use of the money as a proper measure of damages for loss of use of the property. Plaintiffs did not appeal and defendants have claimed no prejudice.

The trial court erred, however, by including in the award damages for loss of use and increase in building cost during the period between the date that the complaint was filed and the date of trial. Damages for delay during that period could be awarded only if defendant still had duties to perform. When plaintiffs filed their complaint, however, they elected to treat the breach as total and to substitute their remedies under the law for their rights under the contract. As we have seen, defendants were no longer obliged to perform and could not force performance on plaintiffs. Any delay in utilization of the property thereafter was chargeable to plaintiffs, not to defendants. (See *Bomberger v. McKelvey,* 35 Cal.2d 607, 614 [220 P.2d 729]; *Atkinson v. District Bond Co.,* 5 Cal.App.2d 738, 745 [43 P.2d 867]; *Richardson v. Davis,* 116 Cal.App. 388, 390 [2 P.2d 860].) Defendants cannot be required to pay damages designed to give plaintiffs the benefit of their bargain as of the time of total breach, and also to pay damages because they did not thereafter do things they were no longer under any duty to do and for which they would get no credit.

(26) By its award of damages, the trial court in effect attempted to compensate plaintiffs for the delay between the time they were entitled to damages and the time they were actually awarded damages in the form of the judgment. Such compensation is ordinarily given in the form of interest. Under section 3287 of the Civil Code, interest could not be awarded here, since the amount of damages could not be ascertained except on conflicting evidence. (*Lineman v. Schmid,* 32 Cal.2d 204, 212 [195 P.2d 408, 4 A.L.R.2d 1380].) ***605**

The award for loss of use between the date of the complaint and the date of trial cannot, therefore, be sustained. Although, as we have seen, plaintiffs may recover damages for the amount that building costs increased between the date specified for performance in the contract and the date that the complaint was filed, the only finding on the subject is that costs increased $3,700 between the date that performance was due and the date of trial. A retrial on that issue is therefore necessary. (*Royer v. Carter,* 37 Cal.2d 544, 551 [233 P.2d 539].)

4. *Findings of the Trial Court.*

Defendants contend that the evidence does not support the finding that the term "paving" in the contract was intended by the parties to be "permanent paving conforming to the specifications of the City of Los Angeles for that area" and that such paving was a " 'plant mix' of three inches of rock, sand, and asphalt." (27) Extrinsic evidence was admissible to determine what the parties meant by "paving." (Code Civ. Proc., § 1860; *Woodbine v. Van Horn,* 29 Cal.2d 95, 104 [173 P.2d 17]; *Wachs v. Wachs,* 11 Cal.2d 322, 325 [79 P.2d 1085]; *Snyder v. Holt Mfg. Co.,* 134 Cal. 324, 328 [66 P. 311].) Plaintiff Clarence Coughlin testified that defendant John Blair stated at the time that the contract was executed that the pavement would be "State specifications, asphalt with asphalt shoulders." An expert witness subsequently testified that "city specifications" in the area called for three inches of rock and gravel. During the expert's testimony, the trial judge stated to defendants' counsel, "The testimony, if I understand it, is it was to be paved according to the City's specifications." Counsel replied, "That is the testimony so far." It thus appears that the case was tried on the understanding that "state specifications" and "city specifications" were the same thing, and defendants cannot successfully contend on appeal that the finding is not supported by the evidence.

(28) Defendants next contend that the evidence does not support the finding that the difference between the market value of the property with and without performance of the contract was $9,500. Expert witnesses called by plaintiffs so testified, but defendants attack their valuations on the ground that the witnesses said they would not change their estimates "if they knew that some respectable person was under obligation to install electricity, gas, and paving." The contention is without merit. The witnesses gave their valuations ***606** of the lot with and without the improvements. Their valuations of the lot with improvements necessarily contemplated the improvements called for by the contract installed by a responsible person. Defendants' objection goes, not to the soundness of the appraisal, but to the question discussed above, whether defendants can avoid liability for the difference in the value of the lot with and without improvements if they should complete the improvements some time in the future.

(29) Defendants contend that the evidence does not support the finding that, "The breach of said agreement by defendants was deliberate." That finding is material insofar as it bears on the question whether the breach was total or partial. Defendant John Blair admitted in his deposition, which was admitted in evidence and considered by the trial court in reaching its decision, that he did not make the deposit required by the gas company before it would extend its gas line to plaintiff's lot, although he had the

financial ability to make the deposit. He stated that the electricity was not installed because of a dispute between defendants and the city department of light and power over the interpretation of a contract between defendants and the city. At one point the city offered to install electricity to plaintiffs' lot without cost to defendants, if defendants would waive a claim to certain other rights under their contract with the city. Defendants would not agree. Defendants did not install permanent paving because they took the position that only temporary paving was required by the contract. It thus appears that defendants had the ability to perform the contract but for reasons they thought to their advantage refused to do so. The finding that the breach was "deliberate" is supported by substantial evidence.

Defendants finally attack the finding that the "construction cost of a 'minimum house' (i.e., a house built at minimum cost having an area not exceeding 1500 square feet, the minimum building restrictions applicable to the lot purchased by plaintiffs) increased during the period from June, 1949, to the date of trial in the sum of $3,750.00. Plaintiffs have suffered special damage resulting from the increase of construction costs on a 'minimum house' as above defined in the amount of $3,750.00." Although, as previously pointed out, a new trial is required on this issue, the question may recur at the retrial and it is therefore necessary that we pass on defendants' contention.

(30) There is testimony that the building costs of a "minimum house" had increased by $3,750. Defendants contend, ***607** however, that there is no proof that the damages were foreseeable or that they were caused by their breach. Plaintiffs told defendant John Blair on the day that the contract was signed that they intended to build a "three bedroom, rambling house with a playhouse and swimming pool." It was testified that such a house would exceed 1,500 square feet. Defendants were thus informed of the use to which plaintiffs intended to put the property and the award of damages may not be attacked for lack of notice to defendants. (*Reliance Accept. Corp. v. Hooper-Holmes Bureau,* 139 Cal.App. 607, 613 [34 P.2d 762].) Defendants contend that plaintiffs "never seriously contemplated building at all" and that, accordingly, plaintiffs failed to show that but for the breach, they would have taken advantage of lower costs. At the time the contract was signed, however, plaintiffs stated that they intended to build "the following spring," the time when performance was specified in the contract. Plaintiffs actually employed an architect in June, 1949, and received plans from him in the fall of 1950. The record sustains the conclusion that but for the breach plaintiffs would have been able to take advantage of lower building costs in June, 1950.

To the extent that it awards $9,500 general damages with interest thereon and costs, the judgment is affirmed. To the extent that it awards special damages for loss of use of the property and special damages resulting from the increase in building costs, the judgment is reversed, and the cause is remanded to the trial court to determine the damages resulting from loss of use of the property and from the increase in building costs between June 1, 1949 and May 24, 1950. Defendants are to bear the costs of this appeal.

Gibson, C. J., Shenk, J., Edmonds, J., Carter, J., Schauer, J., and Spence, J., concurred. ***608**

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EXHIBIT AC-124

564 F.Supp.2d 503
United States District Court,
E.D. North Carolina,
Western Division.

James M. GALLAGHER, as Trustee for and on behalf of National Packaging Solutions Group Trust, et al., Plaintiffs,
v.
SOUTHERN SOURCE PACKAGING, LLC, Defendant.

No. 5:06–CV–114–D.
|
March 14, 2008.

Synopsis
Background: Trustee of liquidation trust for packaging company brought action against putative buyer, alleging breach of asset purchase contract between company and buyer. Parties cross-moved for summary judgment.

[Holding:] The District Court, Dever III, J., adopted report and recommendation of William A. Webb, United States Magistrate Judge, which held that trustee was in privity with company for purposes of enforcing contract.

Motions denied.

Procedural Posture(s): Motion for Summary Judgment.

West Headnotes (6)

[1] **Contracts** Rights and Liabilities on Breach

Under Indiana doctrine of "first material breach," party first guilty of material breach of contract may not maintain action against other party or seek to enforce contract against other party, should that party subsequently breach contract.

2 Cases that cite this headnote

[2] **Contracts** Discharge of contract by breach

Where Indiana doctrine of first material breach applies, non-breaching party is relieved of any further contractual obligations.

2 Cases that cite this headnote

[3] **Assignments** Consent of debtor

Under Indiana law, since anti-assignment clauses are restrictions on alienation, they must be strictly construed against party urging restriction.

[4] **Assignments** Consent of debtor

Under Indiana law, prohibition on assignment does not prohibit assignment of claims for money damages for non-performance.

1 Cases that cite this headnote

[5] **Assignments** Consent of debtor

Under Indiana law, anti-assignment provision in contract is unenforceable against assignee unless different intention is manifested.

1 Cases that cite this headnote

[6] **Corporations and Business Organizations** Persons entitled to sue; standing

Trustee of liquidation trust for packaging company was in privity with company with respect to asset purchase contract between company and putative buyer, for purposes of trustee's action against buyer under Indiana law, seeking to enforce contract; although contract contained general anti-assignment provision, there was no language specifically forbidding assignment of right arising out of due performance or of right to collect damages for breach.

1 Cases that cite this headnote

Attorneys and Law Firms

***504** Clifton L. Brinson, Peter J. Marino, Smith & Jernigan, Raleigh, NC, for Plaintiffs.

James L. Gale, Smith Moore LLP, Raleigh, NC, for Defendant.

ORDER

JAMES C. DEVER III, District Judge.

On July 18, 2007, Magistrate Judge Webb issued a Memorandum and Recommendation ("M & R") recommending that the court deny defendant Southern Source Packaging, LLC's ("Southern Source") motion for summary judgment in this breach of contract action. The contract dispute concerns a deferred payment of $1.5 million in an asset purchase agreement. Plaintiffs James M. Gallagher ("Gallagher") and National Packaging Solutions Group ("NPSG") (collectively, "plaintiffs") claim that Southern Source owes the money, and Southern Source denies this claim. Southern Source timely objected to the M & R, and plaintiffs responded. In addition, plaintiffs moved for summary judgment, and Southern Source responded. On March 5, 2008, the court heard oral argument.

***505** As discussed below, the court overrules Southern Source's objection, adopts the M & R, and denies Southern Source's motion for summary judgment. The court also denies plaintiffs' motion for summary judgment without prejudice. Nevertheless, because the court has serious doubts about Southern Source's alleged entitlement to avoid paying the $1.5 million to Gallagher and because those doubts revolve around Southern Source's alleged expert witness on damages, the court will permit plaintiffs to file a motion to exclude Southern Source's expert report and testimony on damages and then to renew plaintiffs' motion for summary judgment.

I.

NPSG and Southern Source are packaging companies. *See* Am. Compl. ¶¶ 8, 3033. On September 24, 2004, NPSG and Southern Source entered into a contract (the "Sale Agreement") wherein Southern Source agreed to purchase nearly all of NPSG's assets. For purposes of the present dispute, the Sale Agreement contained three important provisions. First, it contained a choice of law provision selecting Indiana law. *See* Def.'s Mem. in Supp. of Def.'s Mot. for Summ. J. Ex. A [D.E. 25–2], art. 18, ¶ I, p. 22. Second, it contained a deferred payment provision wherein Southern Source would pay NPSG $1.5 million on September 30, 2005. *Id.* at art. 3, ¶ B, p. 3. [1] Finally, it contained the following anti-assignment clause:

1 In relevant part, the deferred payment provision reads as follows: "Buyer shall pay One Million Five Hundred Thousand Dollars ($1,500,000.00) to the Sellers on the date that is twelve (12) months following the Closing Date, which amount shall be reduced dollar for dollar by ... any Losses as defined in [Article] 13 [of the Sale Agreement]...." Def.'s Mem. in Supp. of Def.'s Mot. for Summ. J. Ex. A [D.E. 25–2], art. 3, ¶ B, p. 3.

> [N]either party shall assign this Agreement or any rights under this Agreement to any person without the prior written consent of the other, which consent may be withheld by either party hereto in its respective sole discretion, except that Buyer may assign all rights and obligations under this Agreement to a limit [sic] partnership or limited liability company in which Buyer is a general partner or member. Any other attempted or purported assignment or transfer of this Agreement by a party without such consent of the other party shall be null and void.
>
> *Id.* at art. 18, ¶ D, p. 21 [hereinafter "Anti–Assignment Clause"].

In December 2004, NPSG and its secured creditors created a trust for the benefit of NPSG's remaining secured creditors. *See* Am. Compl. ¶¶ 14–15. The sole purpose of the trust was to liquidate NPSG's assets. *Id.* ¶ 1. NPSG assigned its right to receive the $1.5 million deferred payment from Southern Source to the trust. *Id.* ¶ 14. Gallagher heads the trust. *See id.* ¶¶ 1617. Thereafter, Southern Source claimed that NPSG had misled it and refused to pay the $1.5 million.

On March 10, 2006, Gallagher filed a breach of contract action to recover the $1.5 million. Southern Source responded, inter alia, that it need not pay Gallagher because the assignment to him was null and void under the Anti–Assignment Clause. *See* M & R 4 ("Defendant argues that Plaintiff Gallagher lacks standing to be named as a Plaintiff in this matter because Defendant did not provide consent to the assignment of the Sale Agreement to the Trust."). Southern Source also argued that because NPSG had made misrepresentations at the time of the sale concerning certain price increases that caused Southern Source to enter into the Sale Agreement and thereafter to incur ***506** losses, Southern Source was relieved of its obligation to pay the $1.5 million. *See* Am. Compl. ¶¶ 2022; Def.'s Mem. in Supp. of Def.'s Mot. for Summ. J. Ex. A [D.E. 25–2], art. 3, ¶ B, p. 3 (providing that the $1.5 million payment "shall be reduced dollar for dollar" if Southern Source suffers certain enumerated losses).

On March 30, 2007, Southern Source moved for summary judgment and argued that the Anti–Assignment Clause barred Gallagher's claim. On June 8, 2007, the court referred defendant's motion for summary judgment to Judge Webb. *See* 28 U.S.C. § 636(b)(1).

On June 13, 2007, the court entered an order permitting Gallagher to amend his complaint to add NPSG as a plaintiff. On June 26, 2007, Gallagher filed an amended complaint, and NPSG was added as a plaintiff.

On July 18, 2007, Judge Webb issued an M & R concerning Southern Source's motion for summary judgment. Judge Webb concluded that NPSG's transfer was not void under the Anti–Assignment Clause because of Restatement (Second) of Contracts § 322 (1981). That section provides in relevant part: "A contract term prohibiting an assignment of rights under the contract, unless a different intention is manifested, ... does not forbid assignment of a right to damages for breach of the whole contract or a right arising out of the assignor's due performance of his entire obligation...." Restatement (Second) of Contracts § 322(a)(2)(1981). Judge Webb concluded that NPSG's assignment to Gallagher of NPSG's right to receive the $1.5 million payment was either the assignment of "a right to damages" or the assignment of a right arising out of NPSG's "due performance of [the] entire obligation," and that the "null and void" provision in the final sentence of the Anti–Assignment Clause did not apply. *See* M & R 6 ("[T]here is no language in the Sale Agreement specifically forbidding assignment of a right arising out of due performance, or of the right to collect damages for breach."). Further, Judge Webb concluded that Southern Source could not avail itself of section 322(a)(2)'s language distinguishing times when "a different intention is manifested" because the Anti–Assignment Clause's "null and void" provision refers only to an assignment or transfer of "this Agreement." *See id.* Thus, Judge Webb recommended that the court deny Southern Source's motion for summary judgment.

II.

"The Federal Magistrates Act requires a district court to 'make a de novo determination of those portions of the [magistrate judge's] report or specified proposed findings or recommendations to which objection is made.' " *Diamond v. Colonial Life & Acc. Ins. Co.,* 416 F.3d 310, 315 (4th Cir.2005) (quoting 28 U.S.C. § 636(b)(1)) (emphasis removed). For those portions of the magistrate judge's report where no objection applies, "a district court need not conduct a de novo review, but instead must only satisfy itself that there is no clear error on the face of the record in order to accept the recommendation." *Id.* (quotation omitted). The district court may "accept, reject, or modify, in whole or in part, the findings or recommendations made by the magistrate judge." 28 U.S.C. § 636(b)(1).

The parties agree that Restatement (Second) of Contracts § 322 applies to their dispute about the Anti–Assignment Clause, but disagree on how it applies. The court's research reveals no Indiana cases addressing Restatement (Second) of Contracts § 322. Nevertheless, *Traicoff v. Digital Media, Inc.,* 439 F.Supp.2d 872 (S.D.Ind.2006), provides guidance. In ***507** Traicoff, the court could not locate any Indiana cases reflecting how Indiana would treat an anti-assignment clause prohibiting the assignment of "the contract." *Id.* at 879. In resolving the issue and predicting how the Indiana Supreme Court would resolve the issue, the court examined Restatement (Second) of Contracts § 322, the leading commentators, and Indiana's version of the Uniform Commercial Code ("UCC"). *See id.* at 879–80.

Because there are no Indiana cases on point, this court looks to the sources cited in *Traicoff.* First, the commentary to Restatement (Second) of Contracts § 322 notes that the two purposes of anti-assignment clauses are (1) to ensure that the counterparty receives personal performance from the would-be assignor where material, and (2) to protect the counterparty from the danger of double liability to both the would-be assignor and would-be assignee. *See* Restatement (Second) of Contracts § 322 cmt. a, b (1981). Second, Professor Corbin notes that anti-assignment clauses "must be clear and plain and should be strictly construed contra proferentem." 9 Arthur Linton Corbin et al., *Corbin on Contracts* § 873 (interim ed., rev. vol.2002); *see also Traicoff,* 439 F.Supp.2d at 879–80 (analyzing various contract law treatises, which advocate the same principle). Finally, Indiana's UCC provides that "[a] right to damages for breach of the whole contract or a right arising out of the assignor's due performance of his entire obligation can be assigned despite agreement otherwise." Ind.Code § 26–1–2–210(2). [2]

2 Because the Sale Agreement does not involve a sale of goods, this UCC provision is not dispositive. *Cf., e.g., Whitaker v. T.J. Snow Co.,* 151 F.3d 661, 665 (7th Cir.1998) (using Indiana uniform commercial code for guidance and noting that "[a]rticle 2 of the UCC applies only to sales of goods").

Indiana courts would strictly construe the Anti–Assignment Clause to ensure that it serves only to protect the non-assigning party from losing material personal performance and from the danger of double liability. Here, as Judge Webb noted, the "null and void" provision of the Anti–Assignment Clause does not address whether the right to damages upon breach or the right to payment arising out of NPSG's due performance may be assigned. *Cf.* M & R 6 ("Although the provision mentions 'this Agreement'..., there is no language in the Sale Agreement specifically forbidding assignment of a right arising out of due performance or of the right to collect damages for breach."). Moreover, the policy rationales underlying anti-assignment clauses are not implicated. NPSG's personal performance is immaterial, and the recipient of the $1.5 million is fungible. Relatedly, there is no risk of double liability because NPSG has stated that payment is due only to Gallagher.

The Anti–Assignment Clause and Restatement (Second) of Contracts § 322 appear to doom Southern Source's argument that NPSG's transfer was void. Accordingly, Southern Source argues that the damages / due performance exceptions to anti-assignment clauses apply only when the rights being assigned have already vested because the contract is no longer executory. *See* Def.'s Obj. 1. Southern Source argues that the Sale Agreement was still executory because a second agreement called the Transitional Services Agreement ("TS Agreement") was still executory. *See id.* at 45. In making this argument, Southern Source contends that Indiana law treats contemporaneous agreements as one in the same, and argues that the TS Agreement is contemporaneous with the Sale Agreement and thereby still executory. *Id.* at 5–6. Thus, Southern ***508** Source contends that the damages / due performance exceptions do not apply because the right to payment which they represent had not vested. *See id.*

Plaintiffs respond that Indiana law does not contain any vesting requirement for the damages / due performance exceptions. *See* Pls.' Resp. to Def.'s Obj. 4–6. Plaintiffs also contend that the TS Agreement is not contemporaneous with the Sale Agreement, because it was dated two weeks after the Sale Agreement. *Id.* at 3–4.

The court rejects Southern Source's attempt to construe the Restatement anti-assignment clause exceptions to include a vesting requirement. Under Indiana law, it is the Anti–Assignment Clause itself that must be strictly construed. Nothing in Indiana law supports reading a vesting requirement into the Restatement exceptions. Moreover, as explained earlier, the court agrees with Judge Webb that NPSG's transfer was not void under the Anti–Assignment Clause. Accordingly, Southern Source's motion for summary judgment is denied. [3]

3 In light of this conclusion, the court need not resolve the parties' argument about whether the TS Agreement is contemporaneous with the Sale Agreement.

III.

On July 30, 2007, plaintiffs filed a motion for summary judgment. Plaintiffs argue: (1) Southern Source was required to pay $1.5 million; (2) Southern Source did not pay; and (3) Southern Source has no justification for failing to pay. *See* Pls.' Mem. in Supp. of Pls.' Mot. for Summ. J. 9–12. Southern Source does not dispute that it did not pay, but argues that it was not required to pay the $1.5 million for various reasons. *See* Def.'s Am. Mem. in Opp'n to Pls.' Mot. for Summ. J. 9–21. Specifically, Southern Source contends that it need not pay the deferred $1.5 million, because Gallagher lacks standing due to the Anti–Assignment Clause. *Id.* at 10–12. Because the court has rejected this argument, the court will not address it further. Alternatively, Southern Source argues that it need not pay, because even if the assignment to Gallagher is not void, the assignment is nonetheless a material breach of the Sale Agreement. *See id.* at 12. Southern Source then argues that under Indiana's doctrine of first material breach, NPSG's breach was material and relieved Southern Source of any obligation to pay the $1.5 million. *See id.* at 12–14. Finally, Southern Source argues that it need not pay because NPSG made misrepresentations at the time of the sale concerning certain price increases that caused Southern Source to incur losses that offset the deferred payment on a "dollar for dollar" basis, thereby relieving Southern Source of its obligation to pay the $1.5 million. *See id.* at 16–17.

A.

The parties dispute who breached first and whether any breach was material. Plaintiffs argue that Southern Source breached when it failed to pay the $1.5 million when due. Southern Source responds that NPSG materially breached when it first assigned its right to receive the $1.5 million to Gallagher.

[1] **[2]** Under Indiana law, the elements of a breach of a contract claim are (1) a contract, (2) the other party's breach, and (3) damages. *See, e.g., Rogier v. Am. Testing & Eng'g Corp.,* 734 N.E.2d 606, 614 (Ind.Ct.App.2000). Under the Indiana doctrine of first material breach, "[a] party first guilty of a material breach of contract may not maintain an action against the other

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party or seek to enforce the contract against the other party should that party subsequently breach the contract." *Licocci* ***509** *v. Cardinal Assocs., Inc.,* 492 N.E.2d 48, 52 (Ind.Ct.App.1986). Where the doctrine of first material breach applies, the non-breaching party is relieved of any further contractual obligations. *See Dreibelbiss Title Co., Inc. v. MorEquity, Inc.,* 861 N.E.2d 1218, 1220–21 (Ind.Ct.App.2007) (lender was not required to give notice of foreclosure action to title insurer as required by contract because title insurer committed first material breach); *Sallee v. Mason,* 714 N.E.2d 757, 761–63 (Ind.Ct.App.1999) (employer could not enforce covenant not to compete because employer committed first material breach by making accountant work hours beyond those specified in contract); *Licocci,* 492 N.E.2d at 52–54 (employer could not enforce covenants not to compete because employer committed first material breach by failing to pay commissions when due); *cf. Frazier v.Mellowitz,* 804 N.E.2d 796, 803 (Ind.Ct.App.2004) (noting that the breach must not only be material, but also must be incurable before the non-breaching party will be discharged from all contractual obligations). Therefore, summary judgment should be denied to plaintiffs if there is a genuine issue of material fact about whether the doctrine of first material breach applies.

For purposes of evaluating Southern Source's first material breach argument, the court will assume, without deciding, that plaintiffs breached the Sale Agreement when NPSG assigned the payment right to Gallagher. The question then becomes whether this alleged breach was material. Indiana courts look to the Restatement (Second) of Contracts to determine whether a breach is material. *See Frazier,* 804 N.E.2d at 802–04 (tracing Indiana materiality decisions in light of the two Restatements, and using the Restatement (Second) as the legal framework to determine materiality of breach). Restatement (Second) of Contracts § 241 (1981) states that materiality depends on the circumstances, and that five factors are significant: (1) the extent to which the injured party will be deprived of its reasonably-expected benefit; (2) the extent to which the injured party can be compensated for that deprivation; (3) the extent to which the nonperforming party will suffer a forfeiture; (4) the likelihood that the nonperforming party will cure; and (5) whether the nonperforming party acted in good faith.

Although materiality under Indiana law is sometimes a jury question, [4] no rational jury could conclude that NPSG's assignment of the payment right to Gallagher was a material breach. Southern Source argues that the breach was material because Southern Source needed to deal with the same NPSG officials who were involved in negotiating the Sale Agreement, and no one else. *See* Def.'s Am. Mem. in Opp'n to Pls.' Mot. for Summ. J. 15; Thomas Bennett Aff. ¶¶ 6–7 [D.E. 25–5] (noting that Southern Source wanted to work through any problems with someone who had intimate knowledge of the transaction, and that "negotiations with Mr. Gallagher were not productive" because he was not an original party and therefore lacked knowledge of the negotiations). In response, plaintiffs cite evidence that NPSG, the original seller, is merely a shell company with no remaining employees, and it thus would have been impossible for Southern Source to work with the NPSG ***510** personnel who negotiated the Sale Agreement instead of Gallagher. *See* Pls.' Reply in Supp. of Pls.' Mot. for Summ. J. 9 n. 5; Decl. of Kevin J. Lavin ¶ 7 [D.E. 27] ("The NPSG personnel who negotiated the Agreement are no longer employees of NPSG.").

4 *See Innovative Piledriving Prods., LLC v. Unisto Oy,* No. 1:04–CV–453–TS, 2006 WL 1843498, at *5–*6 (N.D.Ind. June 30, 2006) (unpublished) (denying summary judgment where first material breach doctrine was materially disputed); *Columbus Reg'l Hosp. v. Patriot Med. Tech., Inc.,* No. IP 01–1404–C K/H, 2004 WL 392938, at *2–*3 (S.D.Ind. Feb. 11, 2004) (unpublished) (same).

At oral argument, Southern Source admitted that nowhere in either the Sale Agreement or the TS Agreement is there any language suggesting that Southern Source had a right to continue working with the same NPSG personnel involved in negotiating the Sale Agreement. Indeed, as plaintiffs contended at oral argument, Southern Source could have negotiated for an "essential personnel clause" in either the Sale Agreement or the TS Agreement, but it did not do so. Further, as plaintiffs noted at oral argument, even if Southern Source had a unilateral, unstated expectation that it could work out any issues with the same NPSG personnel involved in negotiating the Sale Agreement, that expectation was unreasonable. Everyone involved in the transaction knew that NPSG was going out of business. No rational jury could find that Southern Source had a reasonable expectation of being able to work with the same NPSG personnel who negotiated the Sale Agreement. As for the other four factors described in Restatement (Second) of Contracts § 241, they also do not support Southern Source's position. There is no genuine issue of material fact as to whether the doctrine of first material breach applies, and Southern Source may not avert plaintiffs' motion for summary judgment on this basis.

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B.

Southern Source next argues that plaintiffs' motion for summary judgment should be denied because there is a genuine dispute of material fact about whether NPSG personnel misrepresented the status of various price increases imposed on NPSG customers during the due diligence for the Sale Agreement. Plaintiffs respond that there were no misrepresentations. The crux of this dispute revolves around whether Southern Source is entitled to a "dollar for dollar" reduction of the $1.5 million payment for "Losses as defined in [Article] 13" of the Sale Agreement. *See* Def.'s Mem. in Supp. of Def.'s Mot. for Summ. J. Ex. A [D.E. 25–2], art. 3, ¶ B, p. 3. Southern Source argues that such "Losses" would include "Losses" arising out of NPSG's alleged misrepresentation of certain financial information referenced in Article 8, paragraph K of the Sale Agreement. *See id.* at art. 8, ¶ K, p. 10; *id.* at art. 13, ¶ A, pp. 16–17. The alleged misrepresentations concern whether NPSG sales personnel had gotten NPSG customers to agree to higher prices in 2004 to account for increased production costs.

At this time, the court need not consider this dispute about the alleged misrepresentation because, even if NPSG personnel did misrepresent the status of the price increases, Southern Source must still justify its refusal to pay the deferred $1.5 million payment by proving its misrepresentation-related losses on a "dollar for dollar" basis. Accordingly, to avoid summary judgment for plaintiffs, Southern Source must point to competent evidence in the record from which a rational jury could find that Southern Source suffered misrepresentation-related losses that warrant a dollar-for-dollar offset to the $1.5 million.

At oral argument, Southern Source conceded that the only evidence in the record supporting its claim regarding the amount of its alleged misrepresentation-related losses is the testimony and report of ***511** Charles Mueller ("Mueller").[5] The parties dispute whether Southern Source offered Mueller as an expert or a lay witness, whether Mueller's "supplementation" of his report was timely under the court's scheduling order, and whether Mueller is competent to testify about Southern Source's alleged misrepresentation-related losses.

5 At oral argument, Southern Source suggested that the affidavit of David Hunt also provides evidence of damages. However, Hunt bases his affidavit testimony on the results of Mueller's report. *See* David Hunt Aff. 2 [D.E. 51–10]. Hunt's affidavit testimony is therefore inseparable from Mueller's report, and cannot provide competent evidence of damages without Mueller's report.

The court concludes that Southern Source purports to offer Mueller as an expert witness. At oral argument, Southern Source contended that, perhaps, it should not have identified Mueller as an expert witness, but rather submitted his report as a summary of voluminous writings under Federal Rule of Evidence 1006. The court rejects this argument. Southern Source admitted at oral argument that it identified Mueller as an expert witness in its discovery responses and produced Mueller's report under Federal Rule of Civil Procedure 26(a)(2). *See also* Pls.' Mem. in Supp. of Pls.' Mot. for Summ. J. Ex. D [D.E. 44–5]; Def.'s Am. Mem. in Opp'n to Pls.' Mot. for Summ. J. Ex. J [D.E. 51–12]. Further, plaintiffs deposed Mueller as an expert, and Southern Source thereafter supplemented Mueller's expert report. The court concludes that Southern Source offered Mueller as an expert witness, not as a lay witness presenting a summary of voluminous information under Federal Rule of Evidence 1006.

Turning to Mueller's report and testimony, plaintiffs' memoranda extensively attack Mueller's methodology and testimony. *See* Pls.' Mem. in Supp. of Pls.' Mot. for Summ. J. 12–22; Pls.' Reply in Supp. of Pls.' Mot. for Summ. J. 3–8. Plaintiffs, however, have not filed a motion to exclude Mueller's report or testimony under Federal Rules of Civil Procedure 37 or 56(e), or under Federal Rules of Evidence 401 or 702. Accordingly, out of an abundance of caution, the court will deny plaintiffs' motion for summary judgment without prejudice. *See, e.g., Cortes–Irizarry v. Corporacion Insular de Seguros,* 111 F.3d 184, 188–89 (1st Cir.1997) (court should generally receive briefing before excluding expert evidence as inadmissible). Nonetheless, the court has serious doubts about whether the Mueller report and testimony provide competent evidence of Southern Source's alleged misrepresentation-related losses. Indeed, the court notes that Mueller has repeatedly testified that he expresses no opinion on lost revenue. *See* Charles Mueller Dep. [D.E. 45–2], at 101:24–102:3 ("Q: I recognize you've told me before that the multiplier

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and lost revenue columns are not your work and you're not expressing an opinion one way or the other on those. Correct? A: That's correct."); *id.* at 57:7–57:14 ("I don't know—I don't know what a right number is. I just know that based on parameters that are given to me I'm to put things in a bucket."); *id.* at 6:17–6:19 ("I did not put in the multipliers or come up with lost revenue. I generated the sales within each bucket."). Further, the court notes that, without the Mueller report and testimony, there would be no competent evidence in the record from which a rational jury could conclude that Southern Source suffered any losses sufficient to offset its obligation to pay the $1.5 million. *Cf. Ruffin v. Shaw Indus., Inc.,* 149 F.3d 294, 303 (4th Cir.1998) ("Defendants' motion to strike the affidavit and testimony of [plaintiff's expert] will be granted ... because [the expert's] opinion testimony ***512** would not be admissible under [Fed.R.Evid.] 702 Without such evidence, plaintiffs have failed to raise a genuine issue of fact on an essential element of ... their claims ...."); *cf. also Group Health Plan, Inc. v. Philip Morris USA, Inc.,* 344 F.3d 753, 757–61 (8th Cir.2003) (affirming exclusion of evidence from damages expert).

In order to permit the parties to fully brief whether to exclude Mueller's report and testimony, the court will permit plaintiffs to move to exclude the Mueller report and testimony. *See* Fed.R.Civ.P. 37 & 56(e); Fed.R.Evid. 401 & 702; *Ruffin,* 149 F.3d at 296. Plaintiffs' motion also should address (1) whether the "supplementation" of the Mueller report was timely, and (2) whether either the original or the "supplemented" version of the Mueller report provides competent evidence of Southern Source's alleged misrepresentation-related losses. In plaintiffs' motion, plaintiffs also may renew their motion for summary judgment.

IV.

As explained above, defendant's objection to the M & R is overruled, the court adopts the M & R, and defendant's motion for summary judgment is DENIED. Additionally, plaintiffs' motion for summary judgment is DENIED without prejudice. Plaintiffs shall have until April 1, 2008, to submit a motion to exclude the Mueller report and testimony. As a part of that motion, plaintiffs also may renew their motion for summary judgment. Defendant's response and plaintiffs' reply are due in accordance with the Local Rules.

SO ORDERED.

MEMORANDUM AND RECOMMENDATION

WILLIAM A. WEBB, United States Magistrate Judge.

This Cause comes before the Court upon Defendant's Motion for Summary Judgment **[DE's 24–25].** Plaintiffs have responded to this motion **[DE–26]** and Defendant has filed a reply **[DE–28].** On June 13, 2007, in light of the Court's ruling on Plaintiffs' motion to file an amended complaint and motion to intervene, all parties were instructed to file supplemental memoranda on the issues presented in the Motion for Summary Judgment **[DE–30].** The parties have done so **[DE's 38–39]** and the matter is now ripe for adjudication. Pursuant to 28 U.S.C. 636(b)(1), this matter is before the undersigned for the entry of a Memorandum and Recommendation. For the following reasons, it is HEREBY RECOMMENDED that Defendant's Motion for Summary Judgment be DENIED.

I. BACKGROUND

On September 17, 2004, Defendant entered into an agreement ("Sale Agreement") to purchase certain assets of Plaintiffs National Packaging Solutions Group, Inc., Pettyjohn Packaging, Inc. and Custom Container Corp. ("Sellers"). Defendant promised in the Sale Agreement to make a deferred payment of $1,500,000.00 ("Deferred Payment") to the Sellers on September 30, 2005. The Sale Agreement specifically provides that it should be construed in accordance with and governed by the laws of the State of Indiana. **[DE 25–2, Art. 18, ¶ I, pg. 22]**

Three months after the execution of the Sale Agreement, the Sellers transferred, assigned, and delivered all of their rights, titles and interests in certain assets of Sellers, including any amounts due to the Sellers pursuant to the Sale Agreement, to the National Packaging Solutions Group Trust ("Trust"). According to Defendant, this assignment violated the terms of the Sale Agreement because Sellers did not obtain the prior written consent of Defendant. ***513** Specifically, the Sale Agreement provides:

> *Successors and Assigns.* This Agreement shall bind and inure to the benefit of the parties and their successors and assigns; provided, that neither party shall assign this Agreement or any rights under this Agreement to any other person without the prior written consent of the other, which consent may be withheld by either party hereto in its respective sole discretion, except that Buyer may assign all rights and obligations under this Agreement to a limit partnership or limited liability company in which Buyer is a general partner or member. Any other attempted or purported assignment or transfer of this Agreement by a party without such consent of the other party shall be null and void.
>
> **[DE 25–2, Art. 18, ¶ D, pg. 21]**

Defendant failed to make the Deferred Payment when due. However, Defendant contends that because it suffered damages as a result of untrue representations and warranties made by Sellers it was not required to make the Deferred Payment. Plaintiff James M. Gallagher, as trustee of the Trust, sought to recover the unpaid sum by filing the Original Complaint in this matter **[DE–1].** On June 26, 2007, an Amended Complaint was filed which added Sellers as named Plaintiffs **[DE–33].**

II. ANALYSIS

Summary judgment is appropriate when there exists no genuine issue of material fact and the moving party is entitled to judgment as a matter of law. Fed.R.Civ.P. 56(c); *Anderson v. Liberty Lobby, Inc.,* 477 U.S. 242, 247, 106 S.Ct. 2505, 91 L.Ed.2d 202 (1986). The party seeking summary judgment bears the burden of initially coming forward and demonstrating the absence of a genuine issue of material fact. *Celotex Corporation v. Catrett,* 477 U.S. 317, 106 S.Ct. 2548, 91 L.Ed.2d 265 (1986); *Ross v. Communications Satellite Corp.,* 759 F.2d 355, 364 (4th Cir.1985). The moving party can bear his burden either by presenting affirmative evidence, or by demonstrating that the nonmovant's evidence is insufficient to establish his claim. *Celotex,* 477 U.S. at 331, 106 S.Ct. 2548 (Brennan, J., dissenting). Once the moving party has met its burden, the non-moving party must then affirmatively demonstrate that there is a genuine issue which requires trial. *Matsushita Electrical Industrial Co., Ltd. v. Zenith Radio Corp.,* 475 U.S. 574, 587, 106 S.Ct. 1348, 89 L.Ed.2d 538 (1986). As a general rule, the non-movant must respond to a motion for summary judgment with affidavits, or other verified evidence, rather than relying on his complaint or other pleadings. *Celotex,* 477 U.S. at 324, 106 S.Ct. 2548; *see also, Williams v. Griffin,* 952 F.2d 820, 823 (4th Cir.1991). In the summary judgment determination, the facts and all reasonable inferences must be viewed in the light most favorable to the non-movant. *Anderson,* 477 U.S. at 255, 106 S.Ct. 2505. Construction of a written contract is a question of law for which summary judgment is particularly appropriate. *Ramirez v. Am. Family Mut. Ins. Co.,* 652 N.E.2d 511, 514(Ind.Ct.App.1995).

In the instant motion for Summary Judgment, Defendant seeks the dismissal of Plaintiff Gallagher from this action. Defendant argues that Plaintiff Gallagher lacks standing to be named as a Plaintiff in this matter because Defendant did not provide consent to the assignment of the Sale Agreement to the Trust. Therefore, Defendant asserts that Plaintiff Gallagher is neither a party to the Sale Agreement nor in privity with those who are parties to the Sale Agreement. *Daimler Chrysler Corporation* ***514** *v. Franklin,* 814 N.E.2d 281, 285–86 (Ind.App.2004)(stranger to the contract is not in privity with parties to contract). Under Indiana law, generally only those who are parties to a contract or those in privity with a party have a right to enforce the contract. *Indiana Gaming Co. v. Blevins,* 724 N.E.2d 274, 277 (Ind.App.) *trans. denied,* 735 N.E.2d 235 (2000). However, Plaintiffs argue that a prohibition of assignment of rights under the contract does not prohibit assignment of claims for money damages for nonperformance.

[3] [4] [5] Indiana common law recognizes the assignment of contractual rights. *Chrysler Fin. Co., LLC v. Ind. Dep't of State Revenue,* 761 N.E.2d 909, 912 (Ind.Tax 2002). The general rules of contract interpretation apply in construing assignment agreements. *Downing v. Dial,* 426 N.E.2d 416, 419 (Ind.App.1981). Specifically:

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> When construing the meaning of a contract, our primary task is to determine and effectuate the intent of the parties. First, we must determine whether the language of the contract is ambiguous. The unambiguous language of a contract is conclusive upon the parties to the contract and upon the courts. If the language of the instrument is unambiguous, the parties' intent will be determined from the four corners of the contract ... We read the contract as a whole and will attempt to construe the contractual language so as not to render any words, phrases, or terms ineffective or meaningless. *Whitaker v. Brunner,* 814 N.E.2d 288, 293–94 (Ind.App.2004)(internal quotations and citations omitted).

However, because anti-assignment clauses are a restriction on alienation, they must be strictly construed against the party urging the restriction. *Elzinga & Volkers, Inc. v. LSSC Corp.,* 838 F.Supp. 1306, 1313 (N.D.Ind.1993) Likewise, the "case law of most states is in accord that a prohibition on assignment does not prohibit assignment of claims for money damages for nonperformance." *Id.* at 1314 (collected citations omitted). The Restatement (Second) of Contracts further explains:

> A contract term prohibiting assignment of rights under the contract, unless a different intention is manifested ... does not forbid assignment of a right to damages for breach of the whole contract or a right arising out of the assignor's due performance of his entire obligation ... gives the obligor a right to damages for breach of the terms forbidding assignment but does not render the assignment ineffective ...
>
> Restatement (Second) of Contracts § 322(2)(a).

Thus "an antiassignment provision in a contract is unenforceable against an assignee unless a different intention is manifested." *Bank of America, N.A. v. Moglia,* 330 F.3d 942, 948 (7th Cir.2003)(*citing* Restatement (Second) of Contracts § 322(2)). Each party cites § 322(2) as supporting their position. Plaintiffs argue that § 322(2)(a) is dispositive because "[t]he only right being assigned by [Sellers] is a right arising out of [Seller's] due performance-namely, the right to the deferred payment in the amount of $1.5 million." **[DE–26, pg. 2–3].** Likewise, the Original Complaint filed by Plaintiff Gallagher asserts, *inter alia,* a breach of contract claim. However, Defendant argues that the parties manifested an intention to prohibit an assignment for a right arising out of Sellers' due performance or for breach of contract.

[6] The antiassignment provision of the Sale Agreement states "that neither party shall assign this Agreement or any rights under this Agreement to any other ***515** person without the prior written consent of the other" **[DE 25–2, Art. 18, ¶ D, pg. 21].** Although the provision mentions "this Agreement" and "any rights under this Agreement", there is no language in the Sale Agreement specifically forbidding assignment of a right arising out of due performance or of the right to collect damages for breach. Nor has Defendant forwarded any other evidence to indicate the parties' intention was different. Accordingly, the undersigned finds that the parties have not manifested a different intention which would supercede the default provisions of § 322(2). Rather, this situation is precisely that which is anticipated by the Restatement (Second) of Contracts. Namely, "rights" are prohibited from being assigned, but nothing in the record specifically addresses a right arising out of due performance or the right to collect damages for breach. *See also* Restatement (Second) of Contracts § 322, illus. 1 & 2.

In addition, Defendant itself has cited with approval cases which indicate that parties drafting a antiassignment provision must be clear whether its terms apply to: 1) the assignment of rights; 2) the assignment of duties; or 3) both. *Traicoff v. Digital Media, Inc.,* 439 F.Supp.2d 872, 879 (S.D.Ind.2006). The antiassignment clause in question initially states that it prohibits the transfer of the Sale Agreement or any rights under it. However, when later describing which assignments are rendered null and void it only mentions assignments of "the Agreement." *See* Restatement (Second) of Contracts § 322(2)(b). Regardless, the antiassignment provision of the Sale Agreement does not divest Plaintiff Gallagher of standing to sue in this matter. On the contrary, Plaintiff Gallagher is in privity with Sellers. *Polinsky v. Violi,* 803 N.E.2d 684, 687 (Ind.App.2004)(describing privity of contract as "a mutual or successive relationship as to the same right of property, or an identification of interest of one person with another as to represent the same legal right"). Accordingly, Defendant's Motion for Summary Judgment is meritless.

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III. CONCLUSION

For the aforementioned reasons, it is RECOMMENDED that Defendant's Motion for Summary Judgment **[DE–24]** be DENIED.

SO RECOMMENDED in Chambers at Raleigh, North Carolina this 18th day of July, 2007.

All Citations

564 F.Supp.2d 503

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EXHIBIT AC-125

44 Cal.App.5th 1147

Review Granted

Court of Appeal, Fourth District, Division 2, California.

Lynn GRANDE, Plaintiff and Respondent,

v.

EISENHOWER MEDICAL CENTER, Defendant;

Flexcare, LLC, Intervener and Appellant.

Eisenhower Medical Center, Petitioner,

v.

The Superior Court of Riverside County, Respondent;

Lynn Grande, Real Party in Interest.

E068730, E068751

|

Filed 02/06/2020

Synopsis

Background: Nurse assigned to work at medical center by temporary staffing agency brought putative class action against medical center, asserting claims for wage and hour violations. Staffing agency intervened, asserting that nurse could not bring separate lawsuit against medical center because she had settled claims against them in prior class action against agency. Following bench trial on medical center's res judicata and waiver defenses, the Superior Court, Riverside County, No. RIC1514281, Sharon J. Waters, J., entered order based on its ruling that medical center was not a released party under settlement agreement for the previous class action and could not avail itself of doctrine of res judicata. Medical center appealed and filed petition for writ of mandate.

Holdings: The Court of Appeal, Slough, J., held that:

[1] res judicata did not bar the action, and

[2] medical center was not a released party under settlement agreement for previous lawsuit.

Affirmed; petition denied.

Ramirez, Presiding Justice, filed dissenting opinion.

Procedural Posture(s): On Appeal; Judgment.

West Headnotes (17)

[1] **Appeal and Error** — De novo review

Appeal and Error — Judge as factfinder below

In reviewing a judgment based upon a statement of decision following a bench trial, Court of Appeal reviews questions of law de novo, and reviews the trial court's findings of fact for substantial evidence.

[2] **Appeal and Error** Judge as factfinder below in general

In reviewing judgment based upon statement of decision following bench trial, Court of Appeal liberally construes findings of fact to support the judgment and considers the evidence in the light most favorable to the prevailing party, drawing all reasonable inferences in support of the findings.

[3] **Parties** Persons Who May Be Joined

Parties who are jointly and severally liable on an obligation, whether resulting from tort, breach of contract, or other obligation, may be sued in separate actions.

[4] **Res Judicata** Res Judicata

Under the doctrine of res judicata, a final judgment on the merits in a prior litigation may prevent relitigation of the same cause of action in a second suit between the same parties or parties in privity with them.

1 Cases that cite this headnote

[5] **Res Judicata** Identity

As applied to questions of issue and claim preclusion, privity requires the sharing of an identity or community of interest, with adequate representation of that interest in the first suit, and circumstances such that the nonparty should reasonably have expected to be bound by the first suit.

1 Cases that cite this headnote

[6] **Res Judicata** Identity

A nonparty alleged to be in privity, for res judicata purposes, must have an interest so similar to the party's interest that the party acted as the nonparty's virtual representative in the first action.

1 Cases that cite this headnote

[7] **Res Judicata** Class actions

Temporary nurse staffing agency and its client were not in privity, and thus, res judicata did not bar nurse's putative class action lawsuit, asserting claims for wage and hour violations that occurred during her employment at client's medical center, which were same claims that were asserted in previous suit against agency, since agency's and client's interests were not so close to identical that client should have reasonably been expected to be bound by the first suit.

1 Cases that cite this headnote

[8] **Res Judicata** Identity

What courts are required to ask in determining whether a party and nonparty are in privity for res judicata purposes is whether they shared an identity or community of interest, with adequate representation of that interest in the first suit, under circumstances where the nonparty should reasonably have expected to be bound by the first suit.

1 Cases that cite this headnote

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[9] **Res Judicata** Necessity of identity

First step in deciding whether res judicata, or claim preclusion, applies is to determine whether the prior and current lawsuits involve the same causes of action, and it is only after court answers that question affirmatively that it gets to question of parties' relationship to the claim.

[10] **Compromise, Settlement, and Release** Particular Modes of Settlement or Release, Construction of

Settlement agreements incorporated into a judgment are construed under the rules governing the interpretations of contracts generally.

[11] **Contracts** Intention of Parties

Basic goal of contract interpretation is to give effect to the parties' mutual intent at the time of contracting.

[12] **Contracts** Language of contract

When a contract is reduced to writing, the parties' intention is determined from the writing alone, if possible.

[13] **Appeal and Error** Construction, interpretation, and application in general

When no extrinsic evidence is introduced, or when the competent extrinsic evidence is not in conflict, the appellate court independently construes the contract.

[14] **Appeal and Error** Construction, interpretation, and application in general

When the competent extrinsic evidence is in conflict, and thus requires resolution of credibility issues, any reasonable construction of a contract following a trial will be upheld if it is supported by substantial evidence.

[15] **Compromise, Settlement, and Release** Labor and Employment

Temporary nurse staffing agency's client, a medical center, was not a "released party" under settlement agreement in which nurses released class wage and hour claims against agency and other categories of people and entities, as would preclude nurses' putative class action against client from proceeding in trial court where settlement's long list of "released parties," which included people and entities based on their relation to agency, such as affiliates, affiliated companies, and employees, could not reasonably be read to include clients, joint employers, joint obligors, or other similar language which could reasonably be read to include hospitals to which nurses had been assigned.

1 Cases that cite this headnote

[16] **Contracts** Presumptions and burden of proof

Where words in an agreement have a definite legal meaning, court presumes the parties intended them to have their ordinary legal meaning, unless a contrary intent appears in the instrument.

1 Cases that cite this headnote

[17] **Corporations and Business Organizations** Related corporations in general

Terms "affiliate" and "affiliated company" refer to a relationship that is closer than a mere arm's length contractual relationship.

Witkin Library Reference: 7 Witkin, Cal. Procedure (5th ed. 2008) Judgment, § 457 [Test: Whether Party Is "Sufficiently Close."]

****326** APPEAL from the Superior Court of Riverside County. Sharon J. Waters, Judge. Affirmed. (Super.Ct.No. RIC1514281) ORIGINAL PROCEEDINGS; petition for writ of mandate. Sharon J. Waters, Judge. Petition denied.

Attorneys and Law Firms

Downey Brand, Cassandra M. Ferrannini, and Bradley C. Carroll, Sacramento, for Intervener and Appellant.

The Dion-Kindem Law Firm and Peter R. Dion-Kindem, Woodland Hills; The Blanchard Law Group and Lonnie C. Blanchard, III, for Plaintiff, Respondent, and Real Party in Interest.

Sheppard, Mullin, Richter & Hampton, Richard J. Simmons, and Ruben D. Escalante, Los Angeles, as Amicus Curiae on behalf of Defendant and Petitioner Eisenhower Medical Center.

No appearance for Respondent.

OPINION

SLOUGH, J.

****327** ***1151** FlexCare, LLC (FlexCare), a temporary staffing agency, assigned Lynn Grande to work as a nurse at Eisenhower Medical Center (Eisenhower). According to Grande, during her employment at Eisenhower, FlexCare and Eisenhower failed to ensure she received her required meal and rest breaks, wages for certain periods she worked, and overtime wages.

Grande was a named plaintiff in a class action lawsuit against FlexCare brought on behalf of FlexCare employees assigned to hospitals throughout California. Her own claims were based solely on her work on assignment at Eisenhower. FlexCare settled with the class, including Grande, and Grande received $162.13 for her injuries, plus a class representative incentive bonus of $20,000. Grande executed a release of claims, and the trial court entered a judgment incorporating the settlement agreement.

About a year later, Grande brought a second class action alleging the same labor law violations, this time against Eisenhower, who was not a party to the previous lawsuit. FlexCare intervened in the action asserting Grande could not bring the separate lawsuit against Eisenhower because she had settled her claims against them in the prior class action. The trial court held a trial limited to questions as to the propriety of the lawsuit, and ruled Eisenhower was not a released party under the settlement agreement and could not avail itself of the doctrine of res judicata because the hospital was neither a party to the prior litigation nor in privity with FlexCare.

***1152** Eisenhower filed a petition for a writ of mandate and FlexCare appealed the trial court's interlocutory order. We affirm the trial court and deny the petition because Eisenhower and FlexCare were not in privity, preventing Eisenhower from blocking Grande's claims under the doctrine of res judicata, and Eisenhower was not a released party under the settlement agreement.

I

FACTS

A. *The Parties and the Lawsuits*

FlexCare is a temporary nurse staffing agency which employs nurses and assigns them to work on a temporary basis as supplemental staff at California hospitals. FlexCare serves nearly 200 hospitals in California, and Eisenhower was one of those clients. FlexCare employed Grande and assigned her to Eisenhower, where she worked from February 6 to February 14, 2012.

FlexCare and Eisenhower defined their respective relationships to the temporary nurses in a contract called a staffing agreement. According to the agreement, nurses were employees of FlexCare and not employees of the hospital. The agreement gave FlexCare "exclusive and total legal responsibility as the employer of Staff ... includ[ing], but not ... limited to, the obligation to ensure full compliance ****328** with and satisfaction of (1) all state and federal payroll, income and unemployment tax requirements, (2) all state and federal wage and hour requirements, (3) all workers' compensation insurance requirements, (4) overtime, premium pay and all employee benefits, and (5) all other applicable state and federal employment law requirements arising from [FlexCare's] employment of Staff, the assignment of Staff to [Eisenhower] and/or the actual work of Staff at [Eisenhower]." FlexCare was also responsible for screening candidates for placement and ensuring they met certain minimum standards.

However, Eisenhower maintained control over the temporary nurses in the performance of their jobs. The hospital assessed their competency during an orientation program. The hospital also could require nurses to take its medication and clinical skills test. It also retained discretion to make decisions about the nurses' assignments and to terminate nurses for poor performance. Finally, the agreement required nurses to conform with hospital policies and procedures.

Under the staffing agreement, Eisenhower paid FlexCare based on the hours the temporary nurses worked. FlexCare in turn paid nurses under their separate travel nurse agreements. The staffing agreement required temporary ***1153** nurses to use the hospital's time and attendance system. The travel nurse agreement required Grande to report her hours worked to FlexCare after obtaining approval from Eisenhower. Specifically, the contract said she must "accurately report actual hours worked and fax or e-mail time sheet weekly with appropriate facility representative and Consultant signature."

The rate schedule attached to the staffing agreement provided Eisenhower would pay FlexCare $71 per hour for registered nurses, plus overtime of $20 per hour for hours worked in excess of 12 hours in a day. Under the travel nurse's agreement, FlexCare would pay Grande a base rate of $26.40 per hour, $39.60 per hour for hours worked over 40 hours in a week, and $50 per hour after working 48 hours in a week. She was also to receive a $497 weekly meals and incidentals per diem and a weekly housing per diem of $805. Her per diem payments could be reduced if she failed to work at least 48 hours per week.

The staffing agreement also purported to define the relationship between FlexCare and Eisenhower. First, it stipulated there was no agency relationship between the parties. "[FlexCare] is performing the services and duties hereunder as an independent contractor and not as an employee, agent, partner of or joint venture with Hospital. Hospital retains professional and administrative responsibility for the services rendered." Second, the agreement required FlexCare to indemnify Eisenhower under certain circumstances—for claims and losses in connection with any FlexCare breach of the agreement or violation of statute or regulation, except those resulting from FlexCare's negligence, [1] as well as for claims and losses predicated on a finding temporary nurses were joint employees of FlexCare and Eisenhower.

1 The provision is not a paragon of contractual draftsmanship. It says FlexCare agrees "to indemnify and hold harmless Hospital ... from any and all claims, losses, demands, fees, attorneys fees or expenses, causes of action, costs, damages, and expenses ... resulting from or arising in connection with any breach by [FlexCare] of any provision of this Agreement,

> the violation of any statute, rule, regulation, or order or an intentional, reckless, or negligent act or omission by [FlexCare], other than [those] that arise out of or are attributable to the negligent act or omission of [FlexCare]."

After her assignment with Eisenhower ended, Grande brought claims for wage ****329** and hour violations, first against FlexCare, and later—separately—against Eisenhower. In both cases, she alleged failures on the part of defendants to pay wages earned, to provide lawful meal and rest periods, to pay wages for meal and rest periods, to pay waiting time wages, and to provide required itemized wage statements. Both complaints alleged violations of various provisions of the Labor Code and violations of the unfair competition law (UCL) (Bus. & Prof. Code, § 17200) with the labor violations as predicates.

***1154** Both cases were purported class actions. In the first, filed in Santa Barbara County Superior Court by a coplaintiff on January 30, 2012, the named plaintiffs purported to represent all persons who were nonexempt nursing employees of FlexCare beginning January 30, 2008. The class consisted of all nurses FlexCare employed and assigned to work at any health care facility in California. The original named plaintiff was employed by FlexCare and assigned to work at the Lompoc Valley Medical Center, and based her claims on her treatment during that assignment. The complaint in the Santa Barbara action was amended to add Grande as a named plaintiff, and her allegations were based on her employment at Eisenhower. But Eisenhower didn't intervene and was never made a defendant in the Santa Barbara case.

In December 2015, Grande filed a second putative class action in Riverside County Superior Court, this time alleging claims against Eisenhower. In the Riverside case, Grande purported to represent all persons who were "non-exempt employees who were staffed by [Eisenhower] through third party registries, temporary employment services, temporary employment agencies, staffing agencies and services, or other employment agencies." Thus, in contrast to the Santa Barbara case, the class consisted of all nurses *any staffing agency* employed and assigned to work specifically *at Eisenhower.* The class period differed too; in the Riverside case it covered claims arising from December 2011 to the date of trial. Like the Santa Barbara case, however, Grande's individual claims were based on her work at Eisenhower from February 6 to February 14, 2012, and asserted a UCL claim based on the same predicate wage and hour violations. Neither FlexCare nor any other staffing agency was named as a defendant.

B. *Settlement of the Santa Barbara Case*

The Santa Barbara case settled before the Riverside case commenced. In January 2014, the parties entered an agreement under which FlexCare agreed to pay up to $750,000 to the class. The settlement included a stipulation that Grande and her coplaintiff represented a certified class of "[a]ll persons who at any time from or after January 30, 2008 through the date of Preliminary Approval were non-exempt nursing employees of FlexCare, LLC employed in California." After the claims administration process, FlexCare paid approximately $700,000. Grande signed the settlement agreement and received $20,000 as a representative incentive award plus $162.13 (net of taxes) as a class member. The settlement was incorporated into a final judgment on April 8, 2015.

The final judgment ordered "the Released Claims of each and every Class member and Settlement Class Member, respectively, are and shall be deemed to be conclusively released as against the Released Parties," and "All Class ***1155** members, as of the Effective Date, are hereby forever barred and enjoined from prosecuting Released Claims against the Released Parties." The agreement defines the "Released Claims" as "any and all claims ... which have been or could have reasonably ****330** been asserted in the [Santa Barbara] Action or in any other state or federal court, administrative tribunal, or in arbitration or similar proceeding, based upon, or arising out of, or related to the allegations in the [Santa Barbara] Action during the Class Period."

The settlement named as "Released Parties" FlexCare and the other named defendants, who were affiliates and officers of FlexCare. The settlement also included standard language releasing the named defendants' "present and former subsidiaries, affiliates, divisions, related or affiliated companies, parent companies, franchisors, franchisees, shareholders, and attorneys, and their respective successors and predecessors in interest, all of their respective officers, directors, employees, administrators, fiduciaries, trustees and agents, and each of their past, present and future officers, directors, shareholders, employees, agents, principals, heirs, representatives, accountants, auditors, consultants, insurers and reinsurers, and their counsel of record." The settlement did not release Eisenhower or any other client of FlexCare by name, nor did it release the category of FlexCare's clients.

An attorney for the Santa Barbara plaintiffs later testified FlexCare's potential liability in the Santa Barbara action was "in excess of $10 million" and said FlexCare's counsel provided evidence to plaintiffs' counsel showing "they would not have the ability to pay any large judgment substantially in excess of the settlement amount." The plaintiffs agreed to the lesser settlement amount of $750,000, based on FlexCare's "financial viability." The settlement contains a statement that, in addition to the standard concerns about the expense, duration, and uncertainty of litigation, the "Named Plaintiffs and Class Counsel also have taken into account ... the difficulties and delays inherent in such litigation, including the financial ability of the Defendants to respond to any judgment that may be obtained against them if the claims are successful." An attorney for the Santa Barbara plaintiffs later testified his clients did not intend to release Eisenhower. However, a FlexCare representative testified he did intend the release to extend to Eisenhower. He said the release was intended to mean FlexCare was "done with this ... done with all of it for everybody."

C. *The Dispute over the Effect of the Santa Barbara Settlement on This Case*

A month after Grande filed this case, Eisenhower demanded FlexCare indemnify it against her claims. Eisenhower's counsel sent FlexCare a letter along with the complaint and the staffing agreement between the two ***1156** companies. They pointed out FlexCare "expressly agreed to 'hold [Eisenhower] harmless, pay the entire cost of [Eisenhower's] legal defense, and fully indemnify [Eisenhower] against any and all legal claims asserted against [Eisenhower] or [Eisenhower's] employees, and/or liability imposed against [Eisenhower] or [Eisenhower's] employees that are predicated in any matter [*sic*] on a finding by any court, enforcement agency, government entity, arbitrator or other adjudicator that Staff are joint employees of [FlexCare] and [Eisenhower].' " Eisenhower asserted Grande's claims were based on both companies' "alleged failure to fulfill its obligations under the Labor Code as Plaintiff's and other proposed class members' joint employers," and therefore "request[ed] that FlexCare indemnify and hold Eisenhower harmless for the claims made against it by Plaintiff, including the payment of its defense costs," under the terms of their staffing agreement.

****331** FlexCare intervened in the Riverside case and sought a declaration that (1) Eisenhower was a released party under the Santa Barbara settlement and (2) the judgment in Santa Barbara precludes Grande's causes of action against Eisenhower in Riverside. On Eisenhower's motion, the trial court bifurcated the released party and res judicata issues from all other issues and held a limited bench trial.

After trial, the court ruled Eisenhower was not a released party. The court reached that conclusion based on the language of the settlement, which did not mention Eisenhower or the category of FlexCare's hospital clients. Instead, the settlement named FlexCare, its officers and a corporate alter ego, and then added standard settlement language to release general categories of people and groups, like affiliated companies, principals or agents of FlexCare. The court held Eisenhower didn't fit any of these categories; most pertinent to this appeal, the court concluded Eisenhower was not a "related or affiliated company" or an "agent" of FlexCare under the released parties clause of the settlement.

The court also ruled Grande's claims against Eisenhower were not barred by res judicata because Eisenhower was not in privity with FlexCare. It noted the complaint alleged the two companies were joint employers, who typically are jointly and severally liable. The agreement also indicates independent, but joint and several liability. Since the Supreme Court had recently held joint and several obligors are not considered to be in privity for purposes of res judicata, the court concluded FlexCare and Eisenhower weren't in privity and res judicata didn't preclude Grande's second lawsuit against Eisenhower. The court therefore entered judgment in favor of Grande and against FlexCare on FlexCare's complaint in intervention.

FlexCare appealed. At Eisenhower's request, the trial court certified its statement of decision as appropriate for writ review. (***1157** Code Civ. Proc., § 166.1.) Eisenhower filed a petition for writ of mandate. This court stayed proceedings in the trial court and consolidated the appeal with the writ proceeding.

II

ANALYSIS

FlexCare and Eisenhower founded their arguments for reversal on the claim that the trial court erred in concluding Eisenhower was neither an affiliated company nor an agent of FlexCare. They argue the companies' relationship establishes both that Eisenhower was a released party under the agreement and that the parties were in privity. They argue that means the judgment in the Santa Barbara case both bars (under the settlement) and precludes (under res judicata) Grande's claims against Eisenhower in this case.

[1] **[2]** "In reviewing a judgment based upon a statement of decision following a bench trial, we review questions of law de novo, and we review the trial court's findings of fact for substantial evidence." (*Durante v. County of Santa Clara* (2018) 29 Cal.App.5th 839, 842, 240 Cal.Rptr.3d 302.) We liberally construe findings of fact "to support the judgment and we consider the evidence in the light most favorable to the prevailing party, drawing all reasonable inferences in support of the findings." (*Ibid.*)

A. *Res Judicata Does Not Apply Because the Companies Are Not in Privity*

According to the Restatement Second of Judgments, a "judgment against one person liable for a loss does not terminate a claim that the injured party may have ****332** against another person who may be liable therefor." (Rest.2d Judg., § 49.) "When the claimant thus brings consecutive actions against different persons liable for the same harm, the rendition of the judgment in the first action does not terminate the claims against other persons who may be liable for the loss in question. The judgment itself has the effect of officially confirming the defendant's obligation to make redress, an obligation which under the substantive law coexists with that of the other obligor. No reason suggests itself why the legal confirmation of one obligation should limit or extinguish the other." (*Id.*, com. a.)

[3] Our Supreme Court recently recognized this as "a bedrock principle of contract law." (*DKN Holdings LLC v. Faerber* (2015) 61 Cal.4th 813, 818, 189 Cal.Rptr.3d 809, 352 P.3d 378 (*DKN*).) "Parties who are jointly and severally liable on an obligation may be sued in separate actions." (*Ibid.*) "It ***1158** has long been settled that contracting parties who are severally liable, or subject to joint and several liability, may be sued in the same action *or in separate actions* at the plaintiff's option. [Citations.] The plaintiff 'does not lose the right to the several liability of a several obligor until the obligation is fully satisfied,' notwithstanding that he may have obtained a judgment against other severally liable obligors." (*Id.* at p. 820, 189 Cal.Rptr.3d 809, 352 P.3d 378.) The rule is not limited to contract claims. "The rule that there are separate claims against each obligor applies whether the obligation results from a tort, a breach of contract, or other obligation." (Rest.2d Judg., § 49, com. a.)

As the Supreme Court explained in *DKN*, the rule used to be different. "At common law, when multiple parties promised the same performance, they were presumed to be jointly obligated absent a clear indication otherwise. [Citation.] Parties who are jointly liable are each responsible for their share of a total obligation. When enforcement was sought, the common law rule required that *all* jointly liable parties be joined in a single suit that would determine the total amount of their shared liability." (*DKN, supra*, 61 Cal.4th at p. 820, 189 Cal.Rptr.3d 809, 352 P.3d 378.) However, the old compulsory joinder rule had unwanted results, most notably that some plaintiffs couldn't obtain relief because they couldn't reach all the jointly liable parties. (*Ibid.*) "California and nearly all other states have passed statutes to ameliorate the harshness of the common law's compulsory joinder rule. [Citation.] The typical solution was to convert 'joint' obligations into 'joint and several' obligations." (*Ibid.*)

As the Restatement explains, the older rules under which "rendition of judgment against one of several obligors sometimes had the effect of extinguishing a claim against another ... [were] based on the notion that a 'joint' obligation could be enforced only through a single action, and so an action against one of the obligors was deemed to result in merger of the claim in the judgment. Other rules having like effect were expressed in terms of requiring an 'election of remedies.' Both types of rules were often justified as a means of preventing double recovery for the loss involved. These rules are now obsolete. Double recovery is

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foreclosed by the rule that only one satisfaction may be obtained for a loss that is the subject of two or more judgments. [Citation.] Requiring that a single action be brought or that the injured party make an election of remedies also formerly had justification insofar as it precluded relitigation of matters previously adjudicated, particularly the issue of the amount of damages sustained. This objective is now accomplished by the modern rule that a claimant may not relitigate ****333** issues determined adversely to him in a prior action against another adversary, including issues relating to the damage he has sustained." (Rest.2d Judg., § 49, com. a.) California has adopted these modern rules against double recovery and relitigation of issues decided adversely against a party. (E.g., ***1159** *Milicevich v. Sacramento Medical Center* (1984) 155 Cal.App.3d 997, 1001-1003, 202 Cal.Rptr. 484; *Vandenberg v. Superior Court* (1999) 21 Cal.4th 815, 828, 88 Cal.Rptr.2d 366, 982 P.2d 229.)

[4] Thus, the general rule is a plaintiff may sue parties separately, whether they are independently liable or jointly and severally liable. Under the doctrine of res judicata, however, a final judgment on the merits in a prior litigation may "prevent[ ] relitigation of the same cause of action in a second suit between the same parties or parties in privity with them." (*Mycogen Corp. v. Monsanto Co.* (2002) 28 Cal.4th 888, 896, 123 Cal.Rptr.2d 432, 51 P.3d 297.) Thus, a defendant not party to a prior lawsuit may bar subsequent litigation of a claim already decided in the prior case against another defendant. Such preclusion is appropriate only where the two defendants are in "privity."

[5] **[6]** The Supreme Court articulated the basic test for privity in *DKN.* "As applied to questions of preclusion, privity requires the sharing of 'an identity or community of interest,' with 'adequate representation' of that interest in the first suit, and circumstances such that the nonparty 'should reasonably have expected to be bound' by the first suit. [Citation.] A nonparty alleged to be in privity must have an interest so similar to the party's interest that the party acted as the nonparty's ' " 'virtual representative' " ' in the first action." (*DKN, supra*, 61 Cal.4th at p. 826, 189 Cal.Rptr.3d 809, 352 P.3d 378.) We conclude FlexCare and Eisenhower don't stand in that kind of relationship.

For starters, the Supreme Court held in *DKN* the fact that two parties are joint and several obligors is not enough to put them in privity for purposes of issue or claim preclusion. (*DKN, supra*, 61 Cal.4th at p. 826, 189 Cal.Rptr.3d 809, 352 P.3d 378.) That is so because "[t]he liability of each joint and several obligor is separate and independent, not vicarious or derivative." (*Ibid.*) This holding is binding on us.

The recent decision in *Serrano v. Aerotek, Inc.* (2018) 21 Cal.App.5th 773, 230 Cal.Rptr.3d 802 (*Serrano*) explains why this is the proper holding and why it should control this case. In *Serrano*, Aerotek was a staffing agency and placed temporary employees, like Serrano, with clients, like Bay Bread. Aerotek had in place an employee handbook, which set out, among other things, the agency's meal break policy for the temporary employees it placed with Bay Bread and other employers. Bay Bread had its own meal break policy for its own employees, which differed. In practice, Bay Bread required Aerotek employees to follow Bay Bread's policy, with the result that the plaintiff and others did not receive meal breaks consistent with California employment law. Serrano filed a class action lawsuit against Aerotek and Bay Bread alleging meal break violations. (*Id.* at p. 778, 230 Cal.Rptr.3d 802.) The trial court granted summary judgment in Aerotek's favor based on the undisputed evidence it ***1160** "provided Serrano with compliant meal periods, based on evidence that it 'adopted a lawful meal period policy' " which Serrano had received and Serrano's statement that she was "unaware of any actions taken by Aerotek to prevent her from taking meal periods." (*Id.* at p. 780, 230 Cal.Rptr.3d 802.) The undisputed evidence also showed Aerotek's contract with Bay Bread required the client company to comply with applicable laws and Aerotek trained its temporary ****334** employees on meal breaks and required them to notify it if they were being prevented from taking meal breaks. The court concluded nothing more is required of staffing agencies when they provide temporary employees to other companies, so it granted summary judgment for Aerotek. (*Id.* at pp. 780-781, 230 Cal.Rptr.3d 802.)

Serrano argued the trial court erred by granting summary judgment because Aerotek could be vicariously liable for Bay Bread's separate violations. (*Serrano, supra*, 21 Cal.App.5th at p. 782, 230 Cal.Rptr.3d 802.) The Court of Appeal assumed, without deciding, that the two companies were joint employers, but concluded "whether an employer is liable for a coemployer's violations depends on the scope of the employer's own duty under the relevant statutes, not 'principles of agency or joint and several liability.' " (*Id.* at p. 784, 230 Cal.Rptr.3d 802.) The court therefore concluded Aerotek could be liable only for its own breach of duty, not vicariously based on a joint employer's liability.

Serrano teaches that joint employers are not vicariously liable for each other's Labor Code violations, but liable for their own conduct. One result here, as in *Serrano*, is that staffing agencies and their clients are likely to have very different interests in defending against wage and hour claims. One joint employer can escape liability by pursuing a factual defense even though that defense leaves the other joint employer exposed to liability. The difference in incentives precludes finding the companies are adequate representatives for privity purposes. Here, FlexCare could have gone to trial in the Santa Barbara case defending itself on the theory that Eisenhower committed the wage and hour violations, while it had fulfilled its own duties to its employees. Eisenhower could not be bound by such a finding under the doctrine of issue preclusion precisely because the two companies' legal interests diverged. In other words, FlexCare and Eisenhower were not closely enough aligned to be in privity. (*DKN, supra*, 61 Cal.4th at p. 826, 189 Cal.Rptr.3d 809, 352 P.3d 378.)

[7] The fact that the staffing agreement requires FlexCare to indemnify Eisenhower under some circumstances does not change the analysis. Those provisions of the staffing agreement put FlexCare and Eisenhower at legal odds with each other as much as they bring them together. Eisenhower has telegraphed its intent to argue in this case that FlexCare must indemnify it against any liability based on a finding that the two parties were joint employers. FlexCare's incentive is to establish Eisenhower is liable under a ***1161** theory that doesn't implicate the indemnity clause. Ultimately, FlexCare may fail to do so, but it is clear the two companies have disparate legal interests in the case and cannot act as each other's virtual representatives.

Res judicata may bar a claim brought against an indemnitee where the same claim has already been pursued against the indemnitor. However, that rule applies only "when the indemnitor is, in the first action, acting *in its capacity as indemnitor.* If the indemnitor is sued for its own actions and is not sued as an indemnitor for the acts of another, the rationale favoring preclusion no longer holds." (*F.T.C. v. Garvey* (9th Cir. 2004) 383 F.3d 891, 898.) Here Grande sued FlexCare based on labor law violations FlexCare committed on its own. She didn't allege it was derivatively or vicariously liable as Eisenhower's indemnitor.

FlexCare and Eisenhower argue we should find them in privity with each other because their status as joint employers means they are agents of each other. They rely for this position on ****335** *Garcia v. Pexco* (2017) 11 Cal.App.5th 782, 788, 217 Cal.Rptr.3d 793 (*Garcia*), but the case is inapposite. *Garcia* involved an attempt by a nonparty to enforce an arbitration clause in an employment agreement. The Court of Appeal recognized an exception to the general rule against allowing such nonparty enforcement "when a plaintiff *alleges* a defendant acted as an agent of a party to an arbitration agreement." (*Ibid.*, italics added.) In *Garcia*, the plaintiff affirmatively alleged the party and the nonparty were "acting as agents of one another." (*Ibid.*) Here, Grande's pleadings don't allege the companies stand in an agency relationship. Moreover, because we are reviewing a judgment after a bench trial rather than interpreting an arbitration agreement, we're not concerned with the pleadings, but the actual relationship of the two companies. (*Durante v. County of Santa Clara, supra*, 29 Cal.App.5th at p. 842, 240 Cal.Rptr.3d 302.) Thus, the limited holding of *Garcia* has no bearing on the issue presented in this case.

As to the actual relationship of the companies, the trial court found, in the context of interpreting the settlement agreement, that neither FlexCare nor Eisenhower was an agent of the other. As the court noted, " ' "[W]hether an agency relationship has been created or exists is determined by the relation of the parties as they in fact exist by agreement or acts [citation], and the primary right of control is particularly persuasive." ' " (Statement of Decision, p. 17, quoting *Jackson v. AEG Live, LLC* (2015) 233 Cal.App.4th 1156, 1184, 183 Cal.Rptr.3d 394.) Here, FlexCare and Eisenhower affirmatively disavowed any agency relationship in their contract, which says FlexCare "is performing the services and duties hereunder as an independent contractor and not as an employee, agent, partner of or joint venture with Hospital." The contract notes specifically "[Eisenhower] retains professional and administrative responsibility for the services rendered." Moreover, as the trial court noted, there was no evidence Eisenhower ever acted as FlexCare's agent or vice versa. On the contrary, Eisenhower ***1162** maintained control over the temporary nurses in the performance of their jobs. It assessed their competency during an orientation program, could require nurses to take its medication and clinical skills test, and retained discretion to make decisions about the nurses' assignments and to terminate nurses for poor performance. In addition, the staffing agreement made clear nurses were required to conform with the hospital's policies and procedures. These facts show FlexCare and Eisenhower operated independently, and constitute substantial evidence supporting the trial court's finding that neither company was an agent of the other.

Finally, FlexCare and Eisenhower argue we should follow the recent decision of *Castillo v. Glenair, Inc.* (2018) 23 Cal.App.5th 262, 232 Cal.Rptr.3d 844 (*Castillo*). There, the Second District, Division Two held a class of workers cannot "bring a lawsuit against a staffing company, settle that lawsuit, and then bring identical claims against the company where they had been placed to work." (*Id.* at p. 266, 232 Cal.Rptr.3d 844.) The Second District concluded the staffing agency and the client were in privity with each other for purposes of the wage and hour claims. (*Ibid.*)

We are not bound by the decision of the Second District. (*The MEGA Life & Health Ins. Co. v. Superior Court* (2009) 172 Cal.App.4th 1522, 1529, 92 Cal.Rptr.3d 399; 9 Witkin, Cal. Procedure (5th ed. 2008) Appeal, § 498, pp. 558-559.) However, because stare decisis serves the important interests of stability in the law and predictability of decisions, we ordinarily follow the decisions of other districts, unless ****336** we have good reason to disagree. (*Ibid.*) In this case, departure from *Castillo* is justified because the court failed to apply the test for privity articulated in *DKN.* As a result, its conclusion that the staffing agency and its client were in privity is not supported.

[8] What courts are required to ask in determining whether a party and nonparty are in privity is whether they shared " 'an identity or community of interest,' with 'adequate representation' of that interest in the first suit," under circumstances where the nonparty " 'should reasonably have expected to be bound' by the first suit." (*DKN, supra*, 61 Cal.4th at p. 826, 189 Cal.Rptr.3d 809, 352 P.3d 378.) The *Castillo* court didn't ask that question. Instead, following *Cal Sierra Development, Inc. v. George Reed, Inc.* (2017) 14 Cal.App.5th 663, 223 Cal.Rptr.3d 506, the court asked whether the "subject matter of the litigation ... was the same as that at the center of the [prior] dispute" and whether the party and the nonparty "shared the same relationship to the subject matter." [2] (***1163** *Castillo, supra*, 23 Cal.App.5th at p. 279, 232 Cal.Rptr.3d 844.) Employing that standard, the court concluded the two companies were in privity because "[t]he subject matter of this litigation is the same as the subject matter of the [prior, settled] *Gomez* litigation—namely, both cases involve the same wage and hour causes of action arising from the same work performed by the same [staffing agency] employees (the Castillos) at [the staffing agency's] client company" (*id.* at pp. 279-280, 232 Cal.Rptr.3d 844) and both the client and the staffing agency "were involved in and responsible for payment of the Castillos' wages." (*Id.* at p. 280, 232 Cal.Rptr.3d 844.)

2 The test *Castillo* applies traces to an aside in a South Carolina Supreme Court case. (See *Cal Sierra Development, Inc. v. George Reed, Inc., supra*, 14 Cal.App.5th at p. 674, 223 Cal.Rptr.3d 506, citing *Manning v. South Carolina Dept. of Highway and Public Transportation* (4th Cir. 1990) 914 F.2d 44, 48.) But the test isn't properly a test for privity even in South Carolina. That state's Supreme Court wrote, "The term 'privy,' when applied to a judgment or decree, means one so identified in interest with another that he represents the same legal right. One in privity is one whose legal interests were litigated in the former proceeding." (*Richburg v. Baughman* (1986) 290 S.C. 431, 351 S.E.2d 164, 166.) The language certain courts have plucked from *Richburg* emphasized that privity "does not embrace relationships between persons or entities, but rather it deals with a person's relationship to the subject matter of the litigation" only in response to the litigants' argument that a parent and child were in privity with each other just by virtue of their relationship to each other. (*Ibid.*)

[9] Respectfully, this is not the correct analysis. The first step in deciding whether res judicata (claim preclusion) applies is to determine whether the prior and current lawsuits involve the same causes of action. (*Mycogen Corp. v. Monsanto Co., supra*, 28 Cal.4th at p. 896, 123 Cal.Rptr.2d 432, 51 P.3d 297.) It's only after we answer that question affirmatively, that we get to the question of the parties' relationship to the claim. If the person or entity seeking preclusive effect was not a party to the first litigation, we must then focus on their relationship to the party and the subject matter of the litigation, asking whether their interests are *so close to identical* that the nonparty should have reasonably expected to be bound by the prior judgment even though not a party. By focusing overmuch on whether the subject matter of the litigation is the same, the *Castillo* court nearly collapses the second element (same parties) into the first (same claims). The court then justified finding a sufficiently close relationship on the fact that both companies were involved in paying the plaintiffs their wages. That's simply not a ****337**

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sufficient basis for finding a client and staffing agency to be in privity. As the court explained in *Serrano*, a staffing agency and a client may both be "involved in" the payment of wages, yet be independently liable for wage and hour violations. We therefore depart from the reasoning in *Castillo*, conclude FlexCare and Eisenhower were not in privity, and affirm the trial court.

B. *Eisenhower Is Not a Released Party Under the Settlement Agreement*

Eisenhower and FlexCare also argue the trial court erred by determining Eisenhower was not a released party under the settlement agreement.

[10] **[11]** **[12]** **[13]** **[14]** Settlement agreements incorporated into a judgment are construed under the rules governing the interpretations of contracts generally. (***1164** *In re Marriage of Iberti* (1997) 55 Cal.App.4th 1434, 1439, 64 Cal.Rptr.2d 766.) "The basic goal of contract interpretation is to give effect to the parties' mutual intent at the time of contracting. [Citations.] When a contract is reduced to writing, the parties' intention is determined from the writing alone, if possible." (*Founding Members of the Newport Beach Country Club v. Newport Beach Country Club, Inc.* (2003) 109 Cal.App.4th 944, 955, 135 Cal.Rptr.2d 505.) "When no extrinsic evidence is introduced, or when the competent extrinsic evidence is not in conflict, the appellate court independently construes the contract. [Citations.] When the competent extrinsic evidence is in conflict, and thus requires resolution of credibility issues, any reasonable construction [following a trial] will be upheld if it is supported by substantial evidence." (*Iqbal v. Ziadeh* (2017) 10 Cal.App.5th 1, 8, 215 Cal.Rptr.3d 684 (*Iqbal*).)

Under these familiar standards, the question we must decide is whether the language of the release shows the parties intended to release Eisenhower and other hospital clients of FlexCare. The settlement release clause says the "Class Members release the Released Parties from the Released Claims. Class Members agree not to sue or otherwise make a claim against any of the Released Parties that is in any way related to the Released Claims." If the settlement defined "Released Party" by naming Eisenhower, as it named FlexCare and several other individual parties, we would have to conclude Grande had settled her claims against the hospital. But the definition of "Released Parties" doesn't do that. It names "FlexCare, LLC, Vantus, LLC, Christopher Truxal, Travis Mannon, Michael Kenji Fields, and Nathan Porter" as the parties subject to the release.

[15] The settlement includes a long list of categories of people and entities who also fall within the definition of "Released Parties" based on their relationship to the named parties. Also released are "all present and former subsidiaries, affiliates, divisions, related or affiliated companies, parent companies, franchisors, franchisees, shareholders, and attorneys, and their respective successors and predecessors in interest, all of their respective officers, directors, employees, administrators, fiduciaries, trustees and agents, and each of their past, present and future officers, directors, shareholders, employees, agents, principals, heirs, representatives, accountants, auditors, consultants, insurers and reinsurers, and their counsel of record." Despite the broad language, none of the categories appears broad enough to encompass FlexCare's clients as a group.

The list does not include words such as clients, joint employers, joint obligors, or other similar language which could reasonably be read to include the hospitals to which the plaintiff class members had been assigned. As Grande points out, if FlexCare ****338** and the class representatives had intended to ***1165** release Eisenhower, they could have included as a Released Party, "any client of FlexCare as to whom any class member may have provided services through FlexCare." The fact that they did not do so weighs in favor of finding Eisenhower was not released. (*Hess v. Ford Motor Co.* (2002) 27 Cal.4th 516, 527, 117 Cal.Rptr.2d 220, 41 P.3d 46 ["The failure of the Release to specifically name Ford even though the signatories to the Release had counsel and were aware of [the plaintiff's] claims against Ford also suggests that the Release did not cover those claims"].)

FlexCare and Eisenhower argue the definition of Released Parties does include Eisenhower—and presumably the other hospital clients—because it releases FlexCare's "related or affiliated companies." They argue Eisenhower was a related or affiliated company because they were "connected" in some way, namely in that FlexCare provided temporary nursing staff to Eisenhower under a contract. Under settled principles of contractual interpretation, Eisenhower would be protected against liability under the release only if Grande and FlexCare intended to cover Eisenhower as one of the parties' affiliates. (*Iqbal, supra*, 10 Cal.App.5th at p. 9, 215 Cal.Rptr.3d 684.)

[16] **[17]** Where words have a definite legal meaning, we presume the parties intended them to have their ordinary legal meaning, unless a contrary intent appears in the instrument. (*Weinreich Estate Co. v. A.J. Johnston Co.* (1915) 28 Cal.App. 144, 146, 151 P. 667 ["legal terms are to be given their legal meaning unless obviously used in a different sense"].) The term "affiliate company" is known to mean a "[c]ompany effectively controlled by another company. A branch, division, or subsidiary." (Black's Law Dictionary (6th ed. 1990) p. 58.) Other sources confirm the same meaning for the term "affiliate." (See *Iqbal, supra*, 10 Cal.App.5th at p. 9, 215 Cal.Rptr.3d 684 [collecting sources which "indicate the common meaning of an affiliate generally is one who is dependent upon, subordinate to, an agent of, or part of a larger or more established organization or group"].) We conclude the terms "affiliate" and "affiliated company" are unambiguous and "refer[ ] to a relationship that is closer than a mere arm's length contractual relationship." (*Ibid.*; see also *Satterfield v. Simon & Schuster, Inc.* (9th Cir. 2009) 569 F.3d 946, 955 ["The plain and ordinary meaning of 'affiliate' supports this definition as 'a company effectively controlled by another or associated with others under common ownership or control' "].)

There is no indication in the settlement agreement or otherwise that the parties had some other meaning in mind. It is plain from the staffing agreement, the stipulation, and other extrinsic evidence that the two companies are not related or affiliated in this sense. Indeed, the parties stipulated specifically that Eisenhower was not a division, subsidiary, parent, franchisor, ***1166** franchisee, or shareholder of the named Released Parties. Under the uncontested facts of the case, then, Eisenhower and FlexCare are not affiliated companies as a matter of law.

Nor can the inclusion of the term "related," in the category "related or affiliated company" expand the meaning of the phrase to include the relationship FlexCare and Eisenhower did have—a contractual relationship for the supply of temporary workers. "Related company" means essentially the same thing as "affiliated company." (Cambridge Business English Dictionary [defining "related company" as "a company that controls or is controlled by another company, often one that is in the same business group"].)

****339** FlexCare and Eisenhower also argue Eisenhower was a released party because it was a principal or agent of FlexCare. They base their argument largely on the assertion that the trial court assumed they were joint employers and the court in *Garcia, supra*, 11 Cal.App.5th at p. 788, 217 Cal.Rptr.3d 793, held joint employers are necessarily agents of each other. As we discussed above, this argument is not persuasive. *Garcia* does not stand for the proposition that joint employers are agents of each other as a matter of law.

It is important to read all these terms in the context of the entire list of released parties. Courts should adopt a restrictive meaning of a listed item if acceptance of a broader meaning would make the item markedly dissimilar to the other items in the list. (*People ex rel. Lungren v. Superior Court* (1996) 14 Cal.4th 294, 307, 58 Cal.Rptr.2d 855, 926 P.2d 1042.) A corollary holds " ' "[w]here general words follow the enumeration of particular kinds or classes of persons or things, the general words will, unless a contrary intent is manifested, be construed as applicable only to persons or things of the same general nature or class as those specifically enumerated." ' " (*Huverserian v. Catalina Scuba Luv, Inc.* (2010) 184 Cal.App.4th 1462, 1468-1469, 110 Cal.Rptr.3d 112.) Here, the release begins by listing specific entities and persons. Besides FlexCare, it specifically releases the company's corporate parent as well as partners and officers of the company. The general terms that follow—subsidiaries, divisions, parent companies, shareholders, attorneys, officers, directors, employees, administrators, fiduciaries, and trustees—identify categories of persons or entities who, like the specifically named parties, either exercise control over FlexCare or act on their behalf. Thus, construing the terms "affiliate," "related or affiliated companies," and "agents" more broadly than their standard legal sense is inconsistent with the definition of Released Party as a whole.

The trial evidence also weighs against concluding the parties were in a principal-agent relationship. "Agency is the fiduciary relationship that arises when one person (a 'principal') manifests assent to another person (an ***1167** 'agent') that the agent shall act on the principal's behalf and subject to the principal's control, and the agent manifests assent or otherwise consents so to act." (Rest.3d Agency, § 1.01.) The trial court concluded there was no evidence Eisenhower ever acted as FlexCare's agent or vice versa. Eisenhower maintained control over the temporary nurses in the performance of their jobs. It assessed their competency during an orientation program, retained discretion to require nurses to take its medication and clinical skills test, and had authority under the contract to make decisions about the nurses' assignments, including whether to terminate them for poor performance. In addition, the staffing agreement made clear nurses were required to conform with the hospital's policies and procedures and use the hospital's time and attendance system. In addition, the travel nurse agreement required Grande to report her hours worked to FlexCare after obtaining approval from Eisenhower. Finally, FlexCare's corporate representative testified FlexCare didn't control Eisenhower and said he didn't know whether Eisenhower exercised control over FlexCare. These facts support the trial court's finding that FlexCare and Eisenhower did not exercise control over each other, and provide sufficient support for the trial court's finding that neither company was an agent of the other.[3] (*Iqbal, supra*, 10 Cal.App.5th at p. 8, 215 Cal.Rptr.3d 684.)

3 Though a representative of FlexCare did testify he understood the settlement to release Eisenhower, there's no evidence he expressed this intention to anyone, and undisclosed, subjective intent is irrelevant to interpreting the release's language objectively. (*Founding Members of the Newport Beach Country Club v. Newport Beach Country Club, Inc., supra*, 109 Cal.App.4th at p. 955, 135 Cal.Rptr.2d 505.)

****340** We're left with the fact that the staffing agreement between FlexCare and Eisenhower disavows any agency relationship between them. "[FlexCare] is performing the services and duties hereunder as an independent contractor and not as an employee, agent, partner of or joint venture with Hospital. Hospital retains professional and administrative responsibility for the services rendered." That provision, while not dispositive of the relationship, is the best evidence we have regarding whether the parties understood the companies to be in a principal-agent relationship, and strongly counsels against overruling the trial court and reading into the agreement a release of Eisenhower.

For all these reasons, we affirm the trial court's determination that Eisenhower is not a Released Party under the terms of the settlement agreement and allow the Riverside putative class action to proceed in the trial court.

*1168 III

DISPOSITION

We affirm the trial court's judgment against FlexCare and deny Eisenhower's petition for a writ of mandate. Our previous stay order will be dissolved when this opinion becomes final. Eisenhower and FlexCare shall bear Grande's costs.

Raphael, J., concurred.

Ramirez, P.J., Dissenting
Recently, *Castillo v. Glenair, Inc.* (2018) 23 Cal.App.5th 262, 232 Cal.Rptr.3d 844 held — on facts essentially identical to those here — that a settlement agreement between a staffing company and its employees barred those employees from asserting the same claims against the staffing company's client. Specifically, it held that the client was the staffing company's agent, and therefore within the scope of the release that the employees had given. (*Id.* at pp. 281-282, 285-286, 232 Cal.Rptr.3d 844.) It also held, alternatively, that the staffing company and the client were in privity for purposes of res judicata. (*Id.* at pp. 278-282, 286-287, 232 Cal.Rptr.3d 844.)

The majority deems *Castillo* to be irreconcilable with *DKN Holdings LLC v. Faerber* (2015) 61 Cal.4th 813, 189 Cal.Rptr.3d 809, 352 P.3d 378. (Maj. opn. at pp. 331–33, 334–35, 335–36.) *Castillo* itself, however, considered this very argument (and reconsidered it on rehearing), but rejected it. (*Castillo v. Glenair, Inc., supra*, 23 Cal.App.5th at pp. 280, 287, 232 Cal.Rptr.3d 844.) Likewise, the majority relies on *Serrano v. Aerotek, Inc.* (2018) 21 Cal.App.5th 773, 230 Cal.Rptr.3d 802. (Maj. opn. at

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pp. 333–34, 336–37.) *Castillo*, however, concluded that "*Serrano* is procedurally, factually and legally distinct ...." (*Castillo v. Glenair, Inc., supra*, at p. 286, 232 Cal.Rptr.3d 844; see also *id.* at pp. 285-286, 232 Cal.Rptr.3d 844.)

I would follow *Castillo*, as a matter of stare decisis. *Castillo* at least has the virtue of stating clear rules on which parties on all sides can easily rely going forward. I do not find *Castillo* to be so plainly wrong as to justify creating a split of authority in this area.

All Citations

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d. Involuntary transfer. In accordance with common usage, assignment and delegation in this Chapter include only transfers made or powers created by virtue of a manifestation of intention of the assignor or obligor. The manifestation may be made to the assignee or the person delegated or to another person on his behalf, but transfers made and powers created by operation of law are excluded. Such transfers and powers, including transfers to and powers of an executor, administrator, trustee in bankruptcy or receiver by virtue of his office, are in general beyond the scope of this Restatement. As to the equitable remedies of constructive trust, equitable lien, and subrogation, which sometimes operate much like an assignment, see Restatement of Restitution §§ 160–62; Restatement of Security § 141.

REPORTER'S NOTE

See 3 Williston, Contracts §§ 404, 407 (3d ed. 1960); 4 Corbin, Contracts §§ 859–64 (1951); Holdsworth, The History of the Treatment of *Choses* in Action by the Common Law, 33 Harv. L. Rev. 997 (1920); Corbin, Assignment of Contract Rights, 74 U. Pa. L. Rev. 207 (1926). 1 Gilmore, Security Interests in Personal Property Ch. 7 (1965), 2 id. Ch. 41 (1965).

Comment a. On the elimination, in the 1972 Amendments to the Uniform Commercial Code, of the term "contract right," and its inclusion within "account," see Uniform Commercial Code, Appendix II, § 9-106 Reasons for 1972 Change, and Reporter's Note to the Introductory Note to this Chapter.

Comment c. For some of the problems caused by unclear analysis (by both the parties and the court) of a transaction alleged to be an assignment, see University Caseworks Systems v. Bahre, 172 Ind. App. 624, 362 N.E.2d 155 (1977). For an analysis that would have been clearer and easier had "delegation" been used in the place of "assignment," see Smith v. Wrehe, 199 Neb. 753, 261 N.W.2d 620 (1978).

Comment d. For a distinction between the impermissible assignment of a personal injury claim (§ 317 Comment c and Illustration 8) and the permissible subrogation of an insurer advancing payment, see Western Cas. and Sur. Co. v. Bowling, 39 Colo. App. 357, 565 P.2d 970 (1977); Higgins v. Allied American Mut. Fire Ins. Co., 237 A.2d 471 (D.C. Ct. App. 1968); Annot., 19 A.L.R.3d 1054 (1968).

TOPIC 1. WHAT CAN BE ASSIGNED OR DELEGATED

§ 317. Assignment of a Right

(1) An assignment of a right is a manifestation of the assignor's intention to transfer it hy virtue of which the assignor's right to performance by the obligor is

extinguished in whole or in part and the assignee acquires a right to such performance.

(2) A contractual right can be assigned unless

(a) the substitution of a right of the assignee for the right of the assignor would materially change the duty of the obligor, or materially increase the hurden or risk imposed on him by his contract, or materially impair his chance of obtaining return performance, or materially reduce its value to him, or

(b) the assignment is forbidden by statute or is otherwise inoperative on grounds of public policy, or

(c) assignment is validly precluded by contract.

Comment:

a. "Assignment." The word "assignment" is sometimes used to refer to the act of the owner of a right (the obligee or assignor) purporting to transfer it, sometimes to the resulting change in legal relations, sometimes to a document evidencing the act or change. In this Chapter "assign" and "assignment" refer to an act which has the effect stated in Subsection (1). To avoid ambiguity, such an assignment is said to be "effective"; a similar act which does not have the stated effect is referred to as an "attempted" or "purported" assignment. In either case the actor is referred to as the "assignor" and the transferee or intended or purported transferee is referred to as the "assignee."

Illustrations:

1. A has a right to $100 against B. A assigns his right to C. A's right is thereby extinguished, and C acquires a right against B to receive $100.

2. A purports to assign to C a right to receive $100 from B. A has no such right. The assignment is ineffective, and C can recover damages from A under the rules stated in § 333.

b. Assignment to obligor. A purported assignment by a creditor to his debtor of the indebtedness owed by the debtor is not covered by this Chapter. Such an "assignment" may or may not be effective to extinguish the assignor's right and thus to discharge the debtor; it cannot create in the debtor a right to performance by himself. Compare § 9.

c. Historical note. As is indicated in the Introductory Note to this Chapter, the historic common-law rule that a chose in action could not be assigned has largely disappeared. It remains applicable to some non-contractual rights, particularly claims for damages for personal injury, and to certain claims against the Government. This Section is limited by § 316 to contractual rights, and the historic rule now has very limited application to such rights. Except as stated in this Section, they may be effectively assigned. Notwithstanding the historical background, recourse need no longer be had to the law merchant, to doctrines peculiar to courts of equity, or to the concept of a power of attorney irrevocable because coupled with an interest. The restrictions in paragraphs (2)(a) and (c) rest on the basic principle that rights based on agreement are limited by the agreement.

d. Material variation. What is a material variation, an increase in burden or risk, or an impairment of the obligor's expectation of counter-performance under paragraph (2)(a) depends on the nature of the contract and on the circumstances. Both assignment of rights and delegation of performance are normal and permissible incidents of many types of contracts. See, for example, as to contracts for the sale of goods, Uniform Commercial Code § 2–210 Comment. When the obligor's duty is to pay money, a change in the person to whom the payment is to be made is not ordinarily material. Compare § 322; Uniform Commercial Code § 9–318. But if the duty is to depend on the personal discretion of one person, substitution of the personal discretion of another is likely to be a material change. The clause on material impairment of the chance of obtaining return performance operates primarily in cases where the assignment is accompanied by an improper delegation under § 318 or § 319: if the obligor is to perform in exchange for the promise of one person to render a return performance at a future time, substitution of the return promise of another impairs the obligor's expectation of counter-performance. But in cases of doubt, adequate assurance of due performance may prevent such an impairment. Compare § 251; Uniform Commercial Code § 2–609.

Illustrations:

3. B contracts to support A for the remainder of A's life. A cannot by assignment confer on C a right to have B support C.

4. B contracts to support A for the remainder of A's life. B commits a material breach of the contract, and A assigns his right of action to C. The assignment is effective.

5. B contracts to sell to A for three years 250 tons of ice a week, and A contracts to pay on delivery a stated price per ton. A assigns his right under the contract to C. The assignment is

effective. C's right to delivery is conditional on payment, but payment by C satisfies the condition.

6. B sells his business to A and makes a valid contract not to compete. A sells the business to C and assigns to C the right to have B refrain from competition. The assignment is effective with respect to competition with the business derived from B. The good will of the business, with contractual protection against its impairment, is treated as an assignable asset.

e. Public policy and statutory limitations. The rules for promises and other terms of an agreement stated in Chapter 8 apply by analogy in determining whether an assignment is inoperative on grounds of public policy under paragraph (2)(b) of this Section. Additional statutory restrictions are common. Uniform Commercial Code § 5–116 prevents assignment of the right to draw under a letter of credit unless the credit is expressly designated as transferable or assignable, and renders ineffective an assignment of the beneficiary's right to proceeds until the letter of credit or advice of credit is delivered to the assignee. As is stated in the Statutory Note preceding § 316, wage-assignment statutes often contain a variety of limitations, and there are statutes forbidding or limiting the assignment of rights under government contracts.

Illustrations:

7. For value A, a public official, assigns to C salary or fees already earned and also his unearned salary for the ensuing month. The assignment of the earned salary or fees is effective, in the absence of a contrary statute, but the assignment of unearned salary is against public policy.

8. A contracts with B, a physician, for medical services, and later claims that B's negligence in performing the services caused personal injury to A in violation of B's contractual duty to use due care. A assigns the claim to C. The assignment is ineffective.

9. A, a retired officer of the United States Army, borrows money from C and as security for the loan assigns to C whatever is due or shall become due to A as retired pay. The assignment is ineffective except as permitted by statute under regulations prescribed by the Secretary of the Army.

f. Contractual prohibition. The effect of a term in a contract forbidding the assignment of rights arising under the contract is the subject of § 322. Such a term may resolve doubts as to whether an assignment violates paragraph (2)(a) of this Section. Where it seems to forbid an assignment clearly outside the scope of paragraph (2)(a), it may be read restrictively to permit the assignment, or to give the obligor a claim against the assignor rather than a defense against the assignee, or the term may be invalid by statute or decision. See Uniform Commercial Code §§ 2-210, 9-318. Even if the term gives the obligor a defense against the assignee, the assignment is usually partially effective as an assignment conditional on the assent of the obligor.

REPORTER'S NOTE

Subsection (1) is based on former §§ 149(1) and 150(1). The distinction in those sections between "assignment" and "effective assignment" is eliminated. Subsection (2) contains the substance of former § 151.

See 3 Williston, Contracts §§ 404, 412, 417-23 (3d ed. 1960); 4 Corbin, Contracts §§ 857, 861, 864-79 (1951 & Supp. 1971).

Comment a. Illustration 1 is a revision of Illustration 1 to former § 150. Illustration 2 is new; for discussions of what may be assigned, see Stathos v. Murphy, 26 A.D.2d 500, 276 N.Y.S.2d 727 (1966), aff'd, 19 N.Y.2d 883, 281 N.Y.S.2d 81, 227 N.E.2d 880 (1967); Factors Etc., Inc. v. Creative Card Co., 444 F. Supp. 279 (S.D.N.Y. 1977).

Comment d. Illustration 3 is new; compare duPont de Bie v. Vredenburgh, 490 F.2d 1057 (4th Cir. 1974) in which the right to accrued but unpaid support payments was held assignable. Illustrations 4 and 5 were substantially Illustrations 3 and 2 respectively to former § 151. As to Illustration 5, compare Crane Ice Cream Co. v. Terminal Freezing & Heating Co., 147 Md. 588, 128 A. 280 (1925); Comment 4 to Uniform Commercial Code § 2-210. For other discussions of when assignment may or may not be barred because it materially would vary the obligor's burden or risk, see, e.g., FinanceAmerica Private Brands v. Harvey E. Hall, Inc., 380 A.2d 1377 (Del. Super. Ct. 1977); Munchak Corp. v. Cunningham, 457 F.2d 721 (4th Cir. 1972); cf. Union Bond and Trust Co. v. M and M Wood Working Co., 256 Or. 384, 474 P.2d 339 (1970). Illustration 6 is substantially based on Illustration 4 to former § 151; see also T.E. Moor & Co. v. Hardcastle, 421 S.W.2d 126 (Tex. Civ. App. 1967), ref. n.r.e.

Comment e. Illustration 7 was substantially Illustration 7 to former § 151. Illustration 8 is new. Illustration 9 is based on Illustration 5 to former § 151; the applicable statute is 37 U.S.C. § 701 (1976). For a discussion of the interpretation of purported assignments to avoid statutory bars, see Stathos v. Murphy, 26 A.D.2d 500, 276 N.Y.S.2d 727 (1966), aff'd, 19 N.Y.2d 883, 281 N.Y.S.2d 81, 227 N.E.2d 880 (1967).

Comment f. See Annots., 75 A.L.R.3d 1184 (1977); 59 A.L.R.3d 244 (1974).

EXHIBIT AC-127

CONFIDENTIAL

STRUBBE DECLARATION

DECEMBER 17, 2018

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