WESIERSKI & ZUREK LLP

Defense Law Update

Quarter 2 2001 Irvine/Los Angeles, California Volume 13 No.1

IRS AUDIT STRATEGY

Please allow us to introduce our newest attorney, Jerome Busch, who focuses on tax and estate planning. We present the following article from him on the IRS' decreasing use of audits, a matter unlikely to overlap directly with day to day claims handling but certainly of interest to all of us individually. Should any particular file stand to benefit from Mr. Busch's expertise, we invite you to call him directly any time, and proudly present him as our newest addition to the firm.

The Internal Revenue Service continues to be deeply concerned about their inability to maintain a certain level of audits. From the IRS perspective, the continued drop in audit rates undermines the fairness and the effectiveness of the tax system according to Commissioner Charles O. Rossotti. Not unexpectedly, the proposed IRS solution is to ask for more resources for enforcement. More interestingly, from a taxpayer's perspective, is the fact that at the same time, the IRS plans to gradually shift some of their resources away from enforcement and toward pre-filing activities. Such a reallocation of resources may cause audit rates to decrease further, but the IRS believes that it will make overall taxpayer compliance increase.

Viewed from an IRS perspective, the mission of tax administration is to insure that taxpayers file required returns, report all their income, take only the credits and deductions to which they are entitled, and, finally, pay the taxes owed. The government believes that an important step in meeting that goal is the audit function. In the United States system, the IRS would hopefully create a taxpaying culture in which individuals "voluntarily" and fully comply with the law. The government uses two obvious techniques to encourage compliance - the withholding of taxes at the source and information reporting. The current system of slightly over withholding on wages encourages individual taxpayers to file their returns in order to get their refunds. In filing a return, the IRS believes that taxpayers are more likely to fully comply with their income reporting requirements.

The IRS, as tax administrator, generally takes two approaches to insure compliance. First, fear through the threat or use of sanctions. The implicit assumption behind this approach is that many taxpayers are inclined to cheat, and only the threat of sanctions will ensure compliance. Such a view is similar to the view of many in law enforcement, that society always needs to be reminded of the presence of the police to deter infractions of the law.

The tax authority will use sanctions to send the message that taxpayers must comply voluntarily, or they may be subsequently punished. The sanctions or penalties are used selectively and they range from imposing jail or heavy penalties on a handful of selected violators, to the imposition of small, automatic penalties on taxpayers who make small mistakes. Two examples are a one dollar penalty for each failure to file an information return for dividend payments under $10.00 and a 5% negligence penalty for failing to report certain interest or dividend income.

However, a second approach accepts that most taxpayers are honest and are trying to comply with the law. Under that view, the best way to ensure compliance is to provide prompt and efficient taxpayer service, including providing information on a timely basis. This approach assumes that the tax authority will provide helpful forms and publications, answer inquiries about the rules and specific account information, thereby making it as easy and painless as possible to comply with the rules.

Continued on page 2

IN THIS ISSUE

WESIERSKI & ZUREK NEWS 2

CORPORATE DEFENDANTS WILL NOT BE HELD LIABLE FOR PUNITIVE DAMAGES BASED ON LOW-LEVEL MANAGER'S CONDUCT.......................................3

WESIERSKI & ZUREK IN TRIAL 3

A TORTFEASOR GETS A PROPOSITION 51 OFFSET FOR SUBSEQUENT AGGRAVATION FROM MEDICAL NEGLIGENCE DESPITE RULE THAT TORTFEASORS ARE LIABLE FOR SUBSEQUENT MEDICAL MALPRACTICE...4

WESIERSKI & ZUREK LLP NEWS

W& Z is pleased to introduce the two newest members of the firm, Jerome A. Busch and Sacha Caldemeyer.

Mr. Busch holds a Bachelor of Arts degree from the University of California, Fullerton, a Masters Degree in Taxation from Georgetown University Law Center, and a Juris Doctor degree from Pepperdine. Mr. Busch has expertise in the resolution of tax controversies involving corporations, partnerships, sole proprietorships and individuals and tax issues in the area of corporate, income, estate, and gift taxes.

He is the past president of the Taxation Section of the Orange County Bar Association and was formerly an attorney with the Department of Justice, Tax Division. He has also served in the Judge Advocate General Corp for the U.S. Navy and is presently a Lieutenant Commander in the U.S. Naval Reserve.

You are invited to contact Mr. Busch at the Irvine office for any tax questions or dilemmas you may have.

Ms. Caldemeyer obtained a Bachelor of Arts degree in Environmental Studies/English from the University of the Pacific in 1997. She received her Juris Doctor degree from Whittier Law School in 2000.

Continued from page 1

The IRS has traditionally relied on the enforcement approach to ensure compliance. That means that realistically, the focus is on the 95% of taxpayers who are mostly compliant. The IRS allocates most of its staff to post-filing enforcement activities and the least on pre-filing activities. The IRS states that it collects about 83% of the money it should be collecting through "voluntarily" payments and it collects another 4% through enforcement action. Those numbers are based on the taxpayer compliance measurement program ("TCMP") of a selected sample of 1988 individual tax returns. These numbers, however, are dated because the IRS no longer conducts TCMP audits. Nevertheless, even with the deployment of all enforcement resources, the IRS only collects an additional 4% of revenue.

Partly as a result of the National Commission on Restructuring the IRS and the Internal Revenue Service Restructuring and Reform Act of 1998, a decision was made to reorganize the IRS along customer lines and to encourage the agency to concentrate more on pre-filing activities. For instance, the large and mid-size business operating division, which concentrates on the 170,000 corporations, Subchapter S corporations, and partnerships with more than 5 million dollars in assets, has undertaken a number of initiatives to resolve the tax treatment of issues before the taxpayer is even required to file a return. One of the best known of the initiatives has been in place for more than a decade and is the advanced pricing agreement program that is used to resolve transfer pricing issues in the international tax area.

The IRS has also successfully tested it's pre-filing agreement program and it is now testing a new Industries Issues Resolution Program. The effect of those kinds of programs is thought to be two-fold. First, there will be the shift some compliance resources to pre-filing activities. Second, and more important to the taxpayer than shifting resources, the IRS must either undertake fewer audits or continue the current number of audits, but make them less comprehensive in scope. The IRS believes that this is a viable trade-off. For instance, with the Industry Issue Resolution program, the IRS is trying to identify issues that are frequently challenged on the tax returns of a large group of taxpayers. By solving such questions before there is a filing requirement, the IRS saves enforcement resources later.

Once again, the most important point for the taxpayer is that, whether intended or not, the projected IRS emphasis on pre-filing activities indicates a lessening emphasis on enforcement. This approach will inevitably lead to fewer audits on an annual basis. All in all, the enforcement sector of the IRS will be smaller and weaker for the next few years. The IRS will continue to have problems in enforcing the tax laws as a direct result of the decrease of enforcement activities and the continued decline of audits. That means the IRS must turn more and more to it's pre-filing strategy, such as the industry issue resolution program. Therefore, taxpayers may well benefit from the decline in the number of audits and the decline in the comprehensive nature of individual audits. In addition, taxpayers should benefit from IRS pre-filing strategies in that programs such as the Industry Issue Resolution Program may well resolve certain issues in the taxpayer's favor that have frequently led to audits in the past. Nevertheless, the diminishing possibility of an audit for a taxpayer, along with a the resolution of certain troublesome audit issues, can only be a benefit for taxpayers in the future.

- Jerome A. Busch

CORPORATE DEFENDANTS WILL NOT BE HELD LIABLE FOR PUNITIVE DAMAGES BASED ON LOW-LEVEL MANAGER'S CONDUCT

Corporate defendants will not be held liable for punitive damages based on an employee's conduct unless it is shown that an officer, director or managing agent knew about the employee's misconduct and its malicious character. "Managing agent" is an employee with authority to establish corporate policy (the broad principles and rules which govern corporate conduct)- not a "shift supervisor."

In *Cruz v. HomeBase, et al.,* (2000) 83 Cal.App.4th 160, *rehearing denied,* (2000) 83 Cal.App.4th 935, plaintiff-respondent Cruz was accused by two HomeBase employees, Meraz and Kinsel, of stealing a sheet of plywood. Kinsel was the loss prevention supervisor for the particular store where this incident occurred. Kinsel supervised a few employees, and his discretionary power was limited to detaining and prosecuting low level offenders. Despite Cruz's offer to show his receipt establishing proof of purchase, the employees allegedly proceeded to handcuff him, kick him, push him into a bench, and call him derogatory names. The police arrived, and again, despite showing his receipt, he was taken into custody, stripped, searched, booked, and held until his wife posted bail. He was tried on two misdemeanor counts of battery as a result of this incident, and was acquitted after 10 minutes of jury deliberation.

Cruz thereafter sued HomeBase for battery, false imprisonment, and malicious prosecution, and sought the $9,000 he incurred in attorney's fees to defend himself against the battery charges, as well as general damages and punitive damages. He sought to prove corporate ratification of the employees' conduct by showing that HomeBase continued to employ Meraz and Kinsel without investigation or reprisal for the incident, and that the corporate Loss Prevention Director regularly read reports prepared by Meraz and Kinsel about incidents in the past. However, Cruz never proved that the Loss Prevention Director or other supervisors of Meraz or Kinsel knew of the specific incident involving Cruz. Cruz proceeded on the theory that Kinsel was a managing agent of the corporation whose conduct constituted corporate ratification of the misconduct. After trial, and then retrial of certain issues, Cruz was awarded $65,000 for battery, $200,000 for false imprisonment and malicious prosecution, and $400,000 in punitive damages, with a special finding that HomeBase had ratified the misconduct of its employees.

The Second District Court of Appeal determined that the evidence was insufficient as a matter of law to prove that Kinsel was a managing agent of HomeBase. He had authority over one narrow area (security) of one store in a major chain. There was no evidence that Kinsel had any influence over corporate policies or rules of general application in the corporation. A managing agent exercises substantial discretionary authority over decisions that ultimately determine corporate policy. (*White v. Uliramar, Inc.* (1999) 21 Cal.4th 563, 569). The court contrasted the case to the situation in *White* where a regional manager was found to be a "managing agent' 'because he had ultimate responsibility for running eight stores and their 65 employees. A loss prevention supervisor, by contrast, has limited authority over a single department in a single store.

Further, Cruz had failed to demonstrate that any officers, directors, or managing agents had actual knowledge of the misconduct of Meraz and Kinsel. Absent proof of such actual knowledge (not simply the "opportunity to know"), punitive damages will not be imposed on a corporation based on a theory of ratification. *College Hospital, Inc. v. Superior Court* (1994) 8 Cal.4th 704, 726. The award of punitive damages against HomeBase was therefore reversed by the appellate court.

- Brett Hampton

WESIERSKI & ZUREK LLP IN TRIAL

Jr. Partner, Mark Giannamore, recently tried the case of *Raphel v. Del Nostro*, which involved a three car rear-end collision on the 101 freeway. Defendant alleged that he was cut off by a vehicle, causing him to come to an abrupt stop and rear-end the back of a large pick-up truck. Plaintiff, who was in front of the pick-up truck alleged that he was struck by the truck as a result of the impact by the insured. There were a total of six experts, a police officer and two witnesses who testified. The jury determined that the defendant had been confronted with an emergency situation to wit the vehicle cutting him off and necessitating his rapid lane change and the subject accident occurring. A 12-0 defense verdict was rendered, finding no negligence on the defendant.

A member of the jury was moved to write the following regarding Mr. Giannamore's performance in this trial "Mr. Giannamore presented this case in a very meticulous, concise and professional manner. He was extremely attentive to every detail of the case starting from his intense jury selection, excellent examination of the witnesses, and a strong, convincing closing argument."

A TORTFEASOR GETS A PROPOSITION 51 OFFSET FOR SUBSEQUENT AGGRAVATION FROM MEDICAL NEGLIGENCE DESPITE RULE THAT TORTFEASORS ARE LIABLE FOR SUBSEQUENT MEDICAL

In the recent case of **Marina Emergency Medical Group v. Superior Court** (2000) Daily Journal D.A.R. 11471, the Second District Court of Appeal held that Proposition 51 and the rules of comparative indemnity dictate that an original tortfeasor gets a Proposition 51 offset for subsequent medical malpractice which aggravates the injury. Regardless of whether the subsequent physician is a defendant in the action, the prior tortfeasor is entitled to present evidence of a subsequent physician's negligence, and to have at least general damages reduced in proportion to the original tortfeasor's share of fault. This modifies the rule that an original tortfeasor is liable for subsequent aggravation by medical malpractice.

In **Marina Emergency Medical Group**, plaintiff Charno lacerated his thumb and went to the emergency room of Daniel Freeman Marina Hospital for treatment. Dr. Westerband sutured the thumb. Two days later, Charno consulted with his personal physician, Dr. Solomon. Dr. Solomon referred the plaintiff to a hand surgeon approximately one month later. When the specialist operated on Charno's hand, he discovered two severed nerves and a partially severed tendon. Due to the lapse in time between the injury and the surgery, Charno's range of motion was permanently limited.

Dr. Solomon was voluntarily dismissed from the plaintiff's suit, leaving only Dr. Westerband. Before trial, plaintiff moved in limine to exclude all evidence of Dr. Solomon's subsequent negligence. Plaintiff contended that Dr. Westerband's sole remedy was to file a separate action for indemnity against Dr. Solomon. The trial court agreed with plaintiff and granted the motion, telling defendant that he would be on the hook for not only the original injury, but all subsequent malpractice, with no Proposition 51 offset. The trial court cited the rule in California that the original tortfeasor is liable for all subsequent aggravation from medical malpractice. Before trial could start, defendant filed an emergency writ. The appellate court granted defendant's writ and reversed the order. It found that Dr. Westerband was entitled to present to the jury evidence of Dr. Solomon's subsequent negligence. Held: the jury had to hear such evidence in order to allocate fault for non-economic damages, and the original tortfeasor is entitled to a Proposition 51 offset, at least for general damages, despite the rule about liability for subsequent malpractice.

It is well settled that a tortfeasor who causes personal injury is liable to the injured party, not only for the original injury, but also for any aggravation caused by subsequent negligent medical treatment of the original injury. The law regards the act of the original wrongdoer as a proximate cause of the damages flowing from the subsequent negligent medical treatment and thus holds the original wrongdoer liable for those damages. Nevertheless, California law provides for comparative fault. Proposition 51 limits an individual tortfeasor's liability for non-economic damages to those corresponding to the percentage of fault. Non-economic damages are allocated to each defendant in direct proportion to that defendant's percentage of fault.

The **Marina Emergency Medical Group** court went on to explain that in Charno's case, defendant Dr. Westerband had two options – to pursue a cross-complaint for equitable indemnity or have the jury allocate fault between her and Dr. Solomon so that liability for non-economic damages would be in direct proportion to each doctor's percentage of fault. She chose the latter, and this option was held proper.

Comments

Medical defendants have a $250,000 liability cap on general damages under MICRA. This has traditionally posed a potential problem to non-medical defendants in the same case. If you are in a big case representing the original tortfeasor (whether a motorist, a doctor or whatever) with issues of subsequent aggravation by medical malpractice, your indemnity rights against the doctors are limited by MICRA. However, you should still be able to argue that regardless, you are only liable in the first place for your share of generals under Proposition 51.

- Lisa M. Dale & Paul J. Lipman

Editor

Paul J. Lipman