ADR
LOS ANGELES DAILY JOURNAL
Friday, October 12, 2007

Silencing Liability *by Max Factor III*

It was seven hours into a heated mediation between two businessmen, each of whom were prepared to engage in a self-destructive dissolution of their construction company. "I just don't get it!" the majority partner said. "The federal tax returns and audited financials clearly show the proposed buy-out of your 35 percent share is more than equitable. And, after seven hours of negotiation, we are willing to pay a premium for your minority interest."

"What will make this deal work?" I asked.

The minority partner responded, "I will accept a cash settlement, but it must be based on the set of books he uses for himself and kept in his private safe, and not the set of books he uses to show his wife or his accountant."

This is a story I related to a seminar for the 2005 ABA Dispute Resolution Conference in Los Angeles, titled "Putting Some Good in Goodbyes."

Before I finished the story, my friend Rufus von thulen Rhoades, co-editor of the "Practitioner's Handbook on International Arbitration and Mediation," said, "It wouldn't be very smart of the majority partner or his attorney to acknowledge a second, or third, set of books. State confidentiality privileges do not stop one from reporting federal income tax fraud."

"Something about the Supremacy Clause," I muttered defensively. Louise LaMothe, a co-presenter and former chair of the ABA's Litigation Section agreed.

On Aug. 16, 2007, the 9th U.S. Circuit Court of Appeals in *Babasa v LensCrafters*, 2007 DJDAR 12453, affirmed the 30-year-old precedent of *Breed v U.S. Dist. Ct. for the N. Dist. Of Cal.*, 542 F. 2d 1114 (9th Cir. 1976), that when a question of federal law is at issue, "[s]tate law [as to privileges] may provide a useful referent, but it is not controlling."

This federal policy is not inconsistent with the rulings of the California Supreme Court, even though it has emphasized consistently the public-policy importance of maintaining a strong statutory protection for mediation confidentiality, as in *Rojas v Superior Court*, 33 Cal.4th 407 (2004): " [Confidentiality is essential to effective mediation because it promote[s] a candid and informal exchange regarding events in the past. ...This frank exchange is achieved only if participants know that what is said in the mediation will not be used to their detriment through later court proceedings and other adjudicatory process [citing *Foxgate Homeowners Assn. v Bramalea*, 26 Cal.4th 1 (2001)]."

However, the California Supreme Court notes expressly created statutory and judicially created exceptions to confidentiality. *Foxgate.* One statutory exception is that a mediator may testify as to acts that may "constitute a crime." Evidence Code Section 703.5(b).

Moreover, the *Foxgate* court cites with approval the judicially created exception of *Rinaker v Superior Court*, 62 Cal.App.4th 155 (1998). In *Rinaker*, the court held that, when constitutional due process rights to confront, cross-examine and impeach a witness are involved, the prior inconsistent statements made by a witness at a mediation may be introduced at a subsequent delinquency matter that is a quasi-criminal proceeding. *Foxgate.*

Thus, federal rights may simply trump state confidentiality privileges when the federal rights are deemed sufficiently important. In mediation, participants not uncommonly acknowledge conduct that, if true, may have adverse consequences when

brought to the attention of a federal agency.

Employment cases, as well as partnership and business dissolutions, provide good examples. In a sexual-harassment case, an employee or counsel brings up three or four additional employees who have allegedly been similarly harassed by a supervisor. Sometimes, the employee or counsel call on a case or two of employees who left with confidential settlements involving the same otherwise highly productive supervisor (or perhaps a not-so-productive co-owner).

These cases settle at the same high rates (or higher) than other civil litigation because of the sensitive nature of the information being alleged.

Most often, these settlements include broad confidentiality terms and may include an agreement not to file or encourage any filing of any claim with the Equal Employment Opportunity Commission or the IRS concerning conduct that may have arisen before the written settlement negotiated at the mediation.

Imagine a situation in which a former employee becomes a whistle-blower after settlement. She reports the company's cover-up of repeated sexual harassment of young women. Would the EEOC refuse to consider the claim between an alleged wrongdoer and a whistle-blower victim simply because of a financial settlement, a portion of which is implicitly negotiated as hush money?

Would the IRS refuse to investigate a former business associate's claim of tax fraud because of a confidential agreement? Of course not.

The lesson learned is that mediation confidentiality in California is good public policy for settling civil litigation by encouraging an open exchange of information and protecting the privacy of individuals. Nevertheless, the public policy shield of *Rojas* and *Foxgate* is far from impenetrable for the exercise of federally protected rights or concealing a crime.

This is an area rife with danger for the attorney who is not aware of the limitations to California's statutory mediation privilege. Expressly or implicitly acknowledging a possible violation of federal laws to get everything on the table privately is potentially risky, even if the case settles.

A broad confidentiality clause and hold back of settlement dollars or a liquidated damages clause may not be sufficient to silence a vengeful litigant. It also may not be sufficient to protect the privacy rights of one's client against unproved, potentially unfounded, allegations.

Legal counsel have alternatives besides introducing their client to an experienced counsel who defends clients in federal regulatory investigations.

First, when practical, a serious charge of wrongdoing should be restated as a hypothetical assumption, with a denial, throughout negotiations (for example, "for purposes of argument"). Avoiding offending the charging party by this tactic is a good idea. Thus, you should focus this part of the negotiation outside of the presence of the alleged victim and explain to opposing counsel that this is mediation in which you want to focus on resolution, not on mea culpa.

Second, when a party must have a sincere apology as part of a complete resolution, ensure that the apology takes place in a private discussion between the two parties. This is a safer, more effective approach than an apology in front of legal counsel and insurance representatives. Moreover, the private discussion creates the opportunity for an emotional peace that does not happen with the attorneys as observers.

Three, when settling, remember your basics: Include a clear denial of wrongdoing, and state that consideration is paid in exchange for avoiding the cost of continuing or further litigation and in order to protect the privacy of the client.

Finally, when a public apology is necessary to effect a resolution, temper apologies if at all practical. Ambiguity and euphemisms have a place in dialogue.

Max Factor III *is a professional mediator practicing with PROFESSIONAL Mediation & Arbitration and an adjunct professor of law at the Straus Institute of Dispute Resolution. In September 2007, he will teach a faculty workshop and present to students, faculty and local counsel as the distinguished visitor lecturer at Case Western Reserve University School of Law.*