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NYLitigator

A publication of the Commercial and Federal Litigation Section of the New York State Bar Association

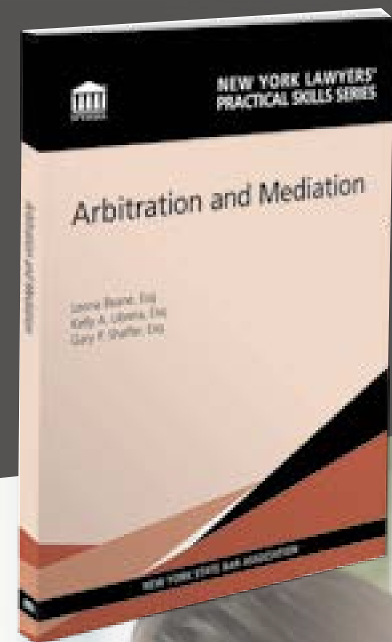
International Arbitration: Can Section 1782 Be Used to Gather Evidence in Aid of Foreign Arbitrations?

Fair or Foul?: NYC's Regulation Barring Enforcement of Personal Guaranties for COVID-19-Era Rents

Facts About IRS Audits to Keep You Out of Trouble

PUBLICATIONS

Arbitration and Mediation



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The views expressed in the articles in this publication are not endorsed by the Commercial and Federal Litigation Section, unless so indicated.

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Message From the Section Chair

By Daniel K. Wiig

Several years ago, I attended my first event as a bar association "leader." It was a "Meet the Bar Associations" program at a New York City law school, where representatives from various bar associations participated in a panel discussion to extol the benefits of membership.

Following the discussion, the law school served lunch. During the "eat and greet" portion of the program, one of the law students came up to me and asked—bluntly—"So, what's in it for me?"

Good question—and I did not have a good answer.

I realized in a post mortem analysis that I gave a canned and, yes, incoherent answer, similar to an ill-prepared guest on a news program. While perhaps giving a bit more specificity than my panel colleagues and myself provided during the earlier segment, I am not sure if my response prompted the student to join or avoid bar association membership, but a quick look on LinkedIn (we did the customary social media connection after our meeting) reflects this person never practiced law…

Fortunately, with the progression of time came a bit more wisdom.

I cannot emphasize enough the enormous dividends that Section members can earn through involvement in our Section—specifically by taking on a leadership role. Note that I chose my words carefully here by specifying *leadership*. Too often, I have seen individuals attend bar events with the belief that somehow their mere presence sipping a cocktail or engaging in light banter will translate into a job offer, client referral, plum appointment, or whatever pot of gold they hope to seize at the end of the rainbow. While the first step in participation is undoubtedly attendance, it is that next step—flexing your leadership muscle—that truly makes the difference.

Daniel K. Wiig

With committees covering a broad range of practice areas and programs offered each year from CLEs to shaping the law through the issuance of comments on proposed rules, there is ample opportunity for Section members to contribute something measurable and meaningful that will simultaneously enhance her or his curriculum vitae. Whether you organize a panel discussion, plan a practice-area specific networking event, or co-author an amicus brief, you can demonstrate your intelligence and ability to complete an assigned task successfully. We humans tend to associate positive traits with people whom we view positively. As such, your active, dedicated participation will leave a positive impression on your fellow members—your professional colleagues—from which only positive things can follow.

To avoid any doubt that my prior comments are mere aspirational thoughts, all we need to do is look at the recent activity of our active Section members in leading our profession to see the macro and micro benefits that flow from such activity.

Commercial & Federal Litigation Section

Events & Activities

For decades, volunteers have been developing and presenting seminars, preparing rich collections of written materials and raising the bar for legal practice in New York. We're happy to provide continuing education programming and events for our Section members, and hope you will join us as we continue to add more to our schedule.

Visit **NYSBA.ORG/COMFED** and click on "Upcoming Events" tab for more info.

Take a look at what's coming up next...

View From The Bench: A Conversation With Michael J. Garcia, Associate Judge Of The Court Of Appeals
June 14, 2022 | 12:30 p.m. – 1:30 p.m. | Virtual

How A Single Cyber Attack Can Put Your Firm Out Of Business And The Five Steps To Protect Yourself – Video Replay
June 16, 2022 | 12:00 p.m. –1:00 p.m.
1.0 MCLE Credit | Virtual

Comprehensive Commercial Arbitration Training For Arbitrators And Counsel
July 11-13, 2022 | 9:00 a.m. – 5:00 p.m.
24.5 MCLE Credits | Virtual

Taking The Lead: Excellence In The Courtroom
November 10, 2022 | 5:30 p.m. – 8:00 p.m.
1.0 MCLE Credit | In-Person

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Maryann Stallone and Yi-Hsin Wu, co-chairs of our Mentoring Committee, have paired mentors and mentees to help foster long-term professional relationships and are planning fun social events such as a cocktail-making classes.

Our Publications Committee, headed by Marcella Jayne and Moshe Boorosan, are helping members share their expertise and get recognized by providing resources to help members draft articles for inclusion in both the *NYLitigator* and the *Newsletter*.

Joame Alsime, Suzanne Messner and Mara Afzali, district leaders for, respectively, Brooklyn, Syracuse and Albany, hosted insightful "Bench-Bar" *fora* with the Commercial Division Justices of these districts, helping to bridge the gap between practitioners and the bench.

The Creditor's Rights and Bankruptcy Litigation Committee has been on fire with Alan Brody and Sheryl Giugliano at the helm, with programing on Cannabis Financing, a CLE on developing regulations on debt collection activities, and hosting Judge Elizabeth Stong (EDNY, Bankr.) for an installment of our "View from the Bench" series.

Not only does Hamutal Lieberman co-chair her firm's trademark practice (she's a 2013 grad), but she tirelessly serves as Chair of ComFed Programming, coordinating all programming efforts of our committees.

With a focus on young lawyers, Viktoriya Liberchuk, Kevin Quaratino, Mahnoor Misbah and Michael Rivera, Co-Chairs of our Young Lawyers and State Court Counsel Committees, recruited Justices from the Appellate Division, First Department to provide insight and advice to young attorney embarking on an appellate practice.

Vice Chair Anne Sekel organized a top-notch 2022 Annual Meeting, of which you can read more in the most recent issue of the *Newsletter*.

Chair-Elect Ignatius Grande is coordinating our 2022 Spring Meeting. The first such in-person gathering of each in what seems like an eternity, Ignatius is working to ensure both creative and information programming and an enjoyable respite from the daily grind.

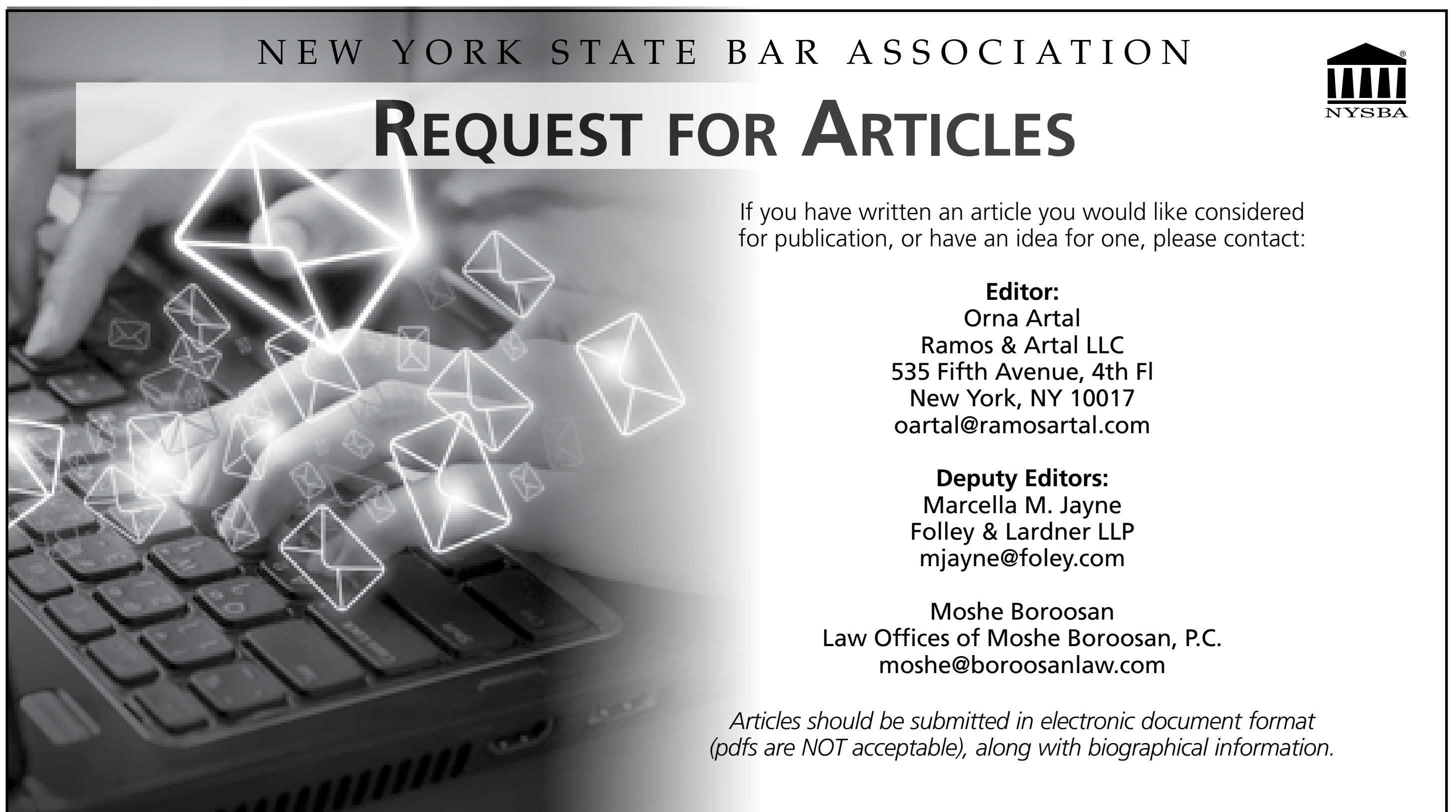
Finally, I would be remised if I did not mention Orna Artal, the editor of the *NYLitigator*. Orna does an outstanding job in assembling this publication, and has often been one of the Section's unsung heroes. Well, here's a song to Orna . . . .

I hope this brief note, highlighting the dedication of a few of our Section leaders, gives you the impetus to take on a greater role in our Section. As I have oft-stated since I began my term as Section Chair, please contact me at any time to discuss anything you like.

Wishing you well and looking forward to further collaboration.

Dan Wiig

Section Chair



International Arbitration: Can Section 1782 Be Used To Gather Evidence in Aid of Foreign Arbitrations?

By Clara Flebus

I. Introduction

On March 23, 2022, the United States Supreme Court heard oral argument on whether 28 U.S.C. § 1782—a statute that permits litigants to invoke the authority of United States courts to render assistance in gathering evidence for use in a "foreign or international tribunal"—may be relied upon to obtain discovery in aid of international private commercial arbitrations seated outside the United States. The issue came up in two consolidated cases, *ZF Automotive US, Inc. v Luxshare, Ltd.*, a direct appeal from the Eastern District of Michigan (Sixth Circuit), and *AlixPartners, LLP v. The Fund for Protection of Investors' Rights in Foreign States*, from the Second Circuit.[1]

The Circuit Courts of Appeals are currently split as to the meaning of the phrase "foreign or international tribunal" in section 1782. The Second, Fifth and Seventh Circuits have held that the language does not encompass private commercial arbitral tribunals, while the Fourth and Sixth Circuits have ruled that it does.[2] At issue in *ZF Automotive* was a request for evidence to be used in a private commercial arbitration to be commenced in Germany, under the rules of a German arbitral institution. In that case, the district court granted limited discovery in support of the arbitration. By contrast, *AlixPartners* dealt with an investor-state arbitration initiated in Lithuania pursuant to a bilateral investment treaty (BIT) between Russia and Lithuania and under the UNCITRAL rules. There, the Second Circuit, which held in prior cases that section 1782 is not available for private international arbitration, affirmed the lower court's grant of discovery, reasoning that the BIT arbitration panel qualified as a "foreign or international tribunal" within the purview of section 1782.

The U.S. Supreme Court granted *certiorari* in the foregoing cases following the stipulated dismissal of *Servotronics, Inc. v. Rolls-Royce PLC*, a prior case on applicability of section 1782 which settled prior to oral argument.[3] This article will highlight the circuit courts' reasonings, as well as the arguments before the U.S. Supreme Court, for supporting inclusion or exclusion of foreign arbitrations when delimiting the scope of applicability of section 1782.

II. Background

A. Section 1782

In its current form, § 1782(a) of Title 28 of the United States Code provides, in relevant part, that "[t]he district court of the district in which a person resides or is found may order him to give his testimony or statement or to produce a document or other thing for use in a proceeding in a foreign or international tribunal . . . upon the application of any interested person."[4] Enacted in 1948, the statute originally empowered the district courts to designate persons to preside at depositions "to be used in any *civil action* pending in any court in a foreign country with which the United States is at peace."[5] Merely a year later, the text was amended by inserting "*judicial proceeding*" in lieu of "civil action."[6] Subsequently, Congress created a Commission on International Rules of Judicial Procedure with the purpose of investigating ways to improve judicial cooperation between the United States and foreign countries in light of rapidly growing cross-border commerce worldwide. In 1964, the commission recommended, and Congress adopted, an extensive revision of section 1782. Relevantly, the words "in any judicial proceeding pending in any court in a foreign country," were deleted and replaced with the phrase "in a proceeding in a *foreign or international tribunal*," which remains unchanged to date.[7] The Senate report accompanying the 1964 revision explained that the word "tribunal," absent in the prior text, was used to clarify that "assistance is not confined to proceedings before conventional courts," but extends also to "administrative and quasi-judicial proceedings."[8] It is undisputed that the new text was inserted to expand the scope of coverage. The question is how broadly federal courts must interpret the reference to "tribunal" in the statute. The revised section 1782 also expanded the scope of discovery, as it provided the district courts with the authority to compel the production of documents and other tangible evidence, in addition to testimony of witnesses, from individuals and entities within the jurisdiction and continues to serve that purpose today.[9]

B. The *Intel* case

In the seminal case of *Intel Corp. v. Advanced Micro Devices, Inc.*, the U.S. Supreme Court charted a roadmap for resolving applications brought under section 1782.[10] Advanced Micro Devices, Inc. (AMD), a leading company in the microprocessor industry, requested a court order in the district court for the Northern District of California directing Intel to produce documents to be used in an investigation conducted by the Directorate-General for Competition of the Commission of the European Communities, an administrative body that enforces European competition laws and regulations. The investigation was prompted by an antitrust complaint AMD had filed with the Directorate-General alleging that Intel violated European competition law.

The U.S. Supreme Court set forth a two-step analysis which starts with a three-factor test to determine if the statutory requirements of section 1782 are met. The inquiry of whether the discovery is for use in a proceeding before a "foreign or international tribunal" is one of the three statutory requirements. The other two requirements are that the target of the discovery must reside or be found within the territorial jurisdiction of the court and the application must be made by an interested person.[11] If the application satisfies those three preconditions, the district court has authority, but is not required, to grant the request for discovery and will arrive at a decision after considering and balancing four additional discretionary factors, which are not discussed here for brevity.[12]

Relevant to the topic of this article, the *Intel* Court determined that section 1782 could be used to provide assistance to a complainant in a European Commission proceeding because the proceeding, albeit not a judicial one *per se*, would lead to a dispositive ruling (i.e., dismissal of the complaint or imposition of penalties for violating the competition law) reviewable in the Court of First Instance and the European Court of Justice.[13] Adopting a "functional" approach, the Court found that the Directorate-General was a "quasi-judicial agenc[y]" with a proof-gathering function, which qualified as a tribunal "to the extent that it act[ed] as a first-instance decisionmaker."[14]

To buttress its conclusion, the Court quoted in passing an article authored by Professor Hans Smit, a drafter of the 1964 revision of section 1782, in which he stated that the term "tribunal" in the statute "includes investigating magistrates, administrative and *arbitral tribunals*, and quasi-judicial agencies, as well as conventional civil, commercial, criminal, and administrative courts."[15] This reference, in *dicta*, to "arbitral tribunals" began to cast doubt on the decisions of those circuit courts that had held that section 1782 cannot be used to assist in discovery in support of foreign private arbitrations.[16]

For purposes of clarity, the specific question of whether a private international commercial arbitration tribunal qualifies as a "tribunal" under section 1782 was not before the *Intel* Court, which considered only whether the Directorate-General for Competition, a public entity, was a tribunal within the meaning of section 1782. In addition, it bears noting that the applicability of section 1782 to investor-state arbitration, rather than private arbitration, appears to be less controversial. For example, district courts "have regularly found that arbitrations conducted pursuant to Bilateral Investment Treaties, and specifically by the ICSID, qualify as international tribunals under § 1782 and are not private arbitrations."[17] Moreover, arbitrations pursuant to investment treaties "are not merely private arrangements" and are contemplated by the statute because "they are [arbitrations] sanctioned by their governments."[18] Ordinarily, applications for discovery in aid of investment treaty arbitrations may be granted if they meet the other factors set forth in *Intel*.[19] Nonetheless, the U.S. Supreme Court has granted *cer-*

tiorari in *AlixPartners*, which concerns an application in aid of an arbitration constituted under a BIT between Russia and Lithuania, as mentioned at the beginning of this article.

III. The Circuit Split

A. Diverging Opinions

In 1999, five years prior to *Intel*, the Second Circuit found in *National Broadcasting Co. [NBC] v. Bear Stearns & Co.*, that the phrase "foreign or international tribunal" was "ambiguous" as to the inclusion of private arbitrations.[20] In *NBC*, the Second Circuit determined that section 1782 did not encompass a commercial arbitration administered by the International Chamber of Commerce (ICC), which is a private institution based in Paris (France). The court interpreted the legislative history of the 1964 revision of the statute as showing that Congress "intended to cover governmental or intergovernmental arbitral tribunals and conventional courts and other state-sponsored adjudicatory bodies."[21] Significantly, though, the court concluded from "[t]he *absence* of any reference to private dispute resolution proceedings such as arbitration" that Congress "did not consider them in drafting the statute."[22] Additionally, the court noted that "[o]pening the door to" section 1782 discovery in support of a private commercial arbitration "would undermine one of the significant advantages of arbitration," which is "its asserted efficiency and cost-effectiveness," and therefore it would "arguably conflict with the strong federal policy favoring arbitration as an alternative means of dispute resolution."[23]

In sum, the Second Circuit decided that the 1964 revision broadened the scope of section 1782's applicability to tribunals established by governments, but did not extend it to private commercial arbitration tribunals sitting outside the United States.[24] The same year the Fifth Circuit agreed with that interpretation in the case of *Republic of Kazakhstan v. Biedermann International*.[25] Even after *Intel*, the holding in *NBC* that private arbitral panels are not within the coverage of section 1782 remained binding law in the Second Circuit. That view was recently reaffirmed in the *In re Guo* decision, which is discussed separately below.[26]

In sharp contrast, the Sixth Circuit held, as a matter of first impression in 2019, that unambiguously "the word 'tribunal' includes private commercial arbitral panels established pursuant to contract and having the authority to issue decisions that bind the parties."[27] In *Abdul Latif Jameel Transportation Co. v. FedEx Corp.*, the underlying dispute arose from a contract pursuant to which Abdul Latif Jameel Transportation Co. (ALJ), a Saudi corporation, agreed to be FedEx International's delivery service partner in Saudi Arabia. After the parties executed the contract, the parent of FedEx International acquired a competitor in the delivery-services market in Saudi Arabia. Allegedly, ALJ received no warning about the impending acquisition before signing the contract with FedEx International.[28] The relationship between the parties soured and FedEx International commenced an arbitration against ALJ in Dubai (United Arab Emirates), pursuant to the contract's arbitration clause. In turn, ALJ brought a section 1782 application to take discovery from FedEx Corporation, a U.S.-based entity, and sought to subpoena documents and the deposition testimony of a corporate representative of that corporation. In its analysis, the Sixth Circuit relied upon several dictionary definitions of "tribunal" as well as the "courts' longstanding usage" of that word, forgoing legislative history. The court determined "not only that one permissible meaning of 'tribunal' includes private arbitrations but also that that meaning is the best reading of the word in th[e] context [of section 1782]."[29] Accordingly, the Sixth Circuit found that the arbitration commenced in Dubai, under the rules of the Dubai International Financial Centre-London Court of International Arbitration (DIFC-LCIA), qualified for assistance under section 1782.[30]

In 2020, ruling for the first time on this issue, the Fourth Circuit agreed with the Sixth Circuit and concluded in *Servotronics, Inc. v. Boeing Co.*, that a private commercial arbitration, such as one initiated in London (England) under the rules of the Chartered Institute of Arbitrators (CIArb), pursuant to an arbitration clause in a long-term agreement between two manufacturing companies, is a proceeding in a "foreign tribunal" for purposes of section 1782.[31] The underlying dispute concerned the responsibility for losses incurred when an airplane engine manufactured by Rolls-Royce PLC caught fire during testing. Servotronics manufactured and supplied a valve to Rolls-Royce, which installed it in an engine that Rolls-Royce manufactured and supplied to the Boeing Company for incorporation into a new airplane. While Boeing was testing the engine at its plant in South Carolina, the engine caught fire, causing damage to the airplane. After Rolls-Royce settled Boeing's claim for damages, it sought indemnification from Servotronics, the manufacturer of the valve, alleging that a valve malfunction caused the fire. When Servotronics rejected the claim, Rolls-Royce commenced an arbitration in London, as required by the long-term agreement between the parties.[32] Thereupon, Servotronics made an application under section 1782 in the district court for the District of South Carolina to obtain testimony from three Boeing employees who resided in South Carolina. The district court denied the request on the ground that the arbitral panel in London was not a "foreign tribunal" as contemplated by section 1782.[33] On appeal, however, the Fourth Circuit reversed, finding that the statutory preconditions were satisfied, and remanded the matter to the lower court to weigh the four discretionary factors set forth by the U.S. Supreme Court in *Intel*.[34]

Interestingly, the same dispute underlying *Servotronics, Inc. v. Boeing Co.*, prompted Servotronics to file a section 1782 application in the district court for the Northern District of Illinois, requesting a subpoena compelling Boeing to produce documents for use in the same London arbitration. The subpoena was initially granted, but subsequently quashed, and Servotronics filed an appeal. Notably, only a few months after *Servotronics, Inc. v. Boeing Co.*, the Seventh Circuit reached the opposite conclusion than

the Fourth Circuit in evaluating a request for discovery stemming from the same foreign arbitration proceeding. In *Servotronics, Inc. v. Rolls-Royce PLC*, the Seventh Circuit held, as a matter of first impression, that section 1782 does not authorize the district court to compel discovery for use in a private foreign arbitration.[35] In its analysis, the court evaluated dictionary definitions of "tribunal," the statutory context, the legislative history, and a potential conflict with the regime established by the Federal Arbitration Act (FAA), which authorizes an arbitration panel, and not the parties, to compel witness testimony and production of documents.[36] The Seventh Circuit noted that, unlike the FAA, section 1782 permits not only foreign tribunals, but also litigants and interested persons, to seek discovery orders from district courts. It observed that if the word "tribunal" was interpreted to include arbitral panels, then litigants in foreign arbitrations would have access to more expansive discovery than litigants in domestic arbitrations.[37] Thus, the court found it "hard to conjure a rationale for giving parties to foreign private arbitrations such broad access to federal-court discovery assistance in the United States while precluding such discovery assistance for litigants in domestic arbitrations."[38]

B. *In re Guo*'s Functional Approach

In 2020, the Second Circuit's *In re Guo* decision provided a framework to analyze whether a given arbitral tribunal resembles more a foreign private arbitral body, and thus is outside the scope of section 1782, or is closer to a state-sponsored adjudicatory body, which qualifies for section 1782 discovery assistance.[39] *In re Guo* dealt with a request to obtain discovery in aid of an arbitration in China, constituted under the China International Economic and Trade Commission (CIETAC). Hanwei Guo, an investor in three companies that operated in the Chinese music streaming market, asserted that through a series of misleading, extortionate and fraudulent transactions, he sold his shares in the companies for less than they were allegedly worth. Following several mergers, the companies became part of Tencent Music, one of the largest music streaming services in the world and listed on the New York Stock Exchange. Guo initiated arbitration against Tencent and its affiliates before CIETAC, claiming that he had been defrauded and he was entitled to be paid compensation and to have his equity stake restored.[40] He then sought section 1782 discovery in the Southern District of New York to obtain information concerning the alleged fraud from four investment banks that had acted as underwriters for Tencent in anticipation of its IPO on the New York Stock Exchange.[41]

The district court denied Guo's application. On appeal, Guo argued, *inter alia*, that the CIETAC arbitration qualified as an arbitration under a state-sponsored adjudicatory body and thus was covered by section 1782.[42] After all, CIETAC was originally established by the government of the People's Republic of China as part of the China Council for the Promotion of International Trade (CCPIT), its administrative leadership now is appointed by the CCPIT, and both CIETAC and CCPIT receive limited funding from the Chinese government.[43]

The Second Circuit clarified that the "foreign or international tribunal" inquiry is not resolved by looking to the "governmental or nongovernmental *origins* of the administrative entity in question."[44] Rather, the inquiry is "whether the body in question possesses the *functional attributes* most commonly associated with private arbitration."[45] Accordingly, the Second Circuit laid out a functional test to determine whether a tribunal is private or state-sponsored. To understand the nature of a tribunal, a court should consider a range of factors, including "the degree of state affiliation and functional independence possessed by the entity, as well as the degree to which the parties' contract controls the panel's jurisdiction."[46]

Assessing CIETAC's state affiliation and functional independence, the court observed that currently CIETAC "functions essentially independently of the Chinese government in the administration of its arbitration cases;" it "maintains confidentiality from all non-participants during and after arbitration, limiting opportunities for *ex parte* intervention by state officials," and it "offers parties a pool of arbitrators [to choose from] who are not selected by any entity other than CIETAC" and are independent of the Chinese government.[47] The court next evaluated the degree to which the Chinese government has authority to intervene to alter the outcome of an arbitration after the panel has rendered a decision. It found that "[b]ecause the provisions of Chinese law relied on by Guo [i.e., the applicant] merely control the enforceability of arbitrations in China in almost the same manner and to the same extent as the FAA in the United States, they do not convert CIETAC arbitrations into state-sponsored endeavors."[48] Finally, the court turned to the nature of the jurisdiction possessed by the arbitral panel and found that a CIETAC panel "derives its jurisdiction exclusively from the agreement of the parties and has no jurisdiction except by the parties' consent."[49] The court went on to explain that, by contrast, state-sponsored tribunals "often possess some degree of government-backed jurisdiction that one party may invoke even absent the other's consent."[50] All these factors, along with the parties' ability to select their own arbitrators, suggested that CIETAC, despite its state affiliation, was a private arbitral body. Thus, the court concluded that the CIETAC proceeding was best categorized as a private commercial arbitration for which section 1782 assistance was unavailable in the Second Circuit.

IV. Cases Currently Before the U.S. Supreme Court

A. Sixth Circuit: *ZF Automotive US, Inc. v Luxshare, Ltd.*

This case arose from a business dispute between ZF Automotive US, Inc., a Michigan-based automotive parts manufacturer and indirect subsidiary of ZF Friedrichshafen

AG, a German corporation, and Luxshare, Ltd., a Chinese-owned electronics manufacturer based in Hong Kong. In 2017, ZF Automotive agreed to sell two business units to Luxshare for approximately $1 billion. The parties executed a purchase agreement in Germany, which contained an arbitration clause providing that all disputes in connection with the agreement would be resolved by a panel of three arbitrators seated in Munich (Germany), under the Arbitration Rules of the German Institution of Arbitration (DIS). Later, Luxshare claimed that ZF Automotive had concealed material negative information about the profitability of the business units during sales negotiations. Planning to initiate arbitration in Germany to pursue its fraud claims, Luxshare brought an application for discovery pursuant to section 1782 in the district court for the Eastern District of Michigan. Luxshare asked for subpoenas to depose two ZF Automotive executives—a former vice president and the current chief of operations officer, both of whom resided in Michigan—on the grounds that they participated directly in the due-diligence process and were aware of the undisclosed information.[51] The district court granted the application for the subpoenas, which were served on ZF Automotive and the two individuals.[52]

ZF Automotive sought to quash the subpoenas on the grounds, *inter alia*, that the DIS arbitration was not a proceeding in a "foreign or international tribunal" within the meaning of Section 1782. A federal magistrate judge quickly acknowledged Sixth Circuit binding precedent holding that Section 1782 applies to private commercial arbitral tribunals. The magistrate judge "trimmed" the discovery requests applying *Intel's* discretionary factors, and determined that Luxshare was permitted to depose either the former vice president or the COO, but not both.[53] After the district court judge overruled ZF Automotive's objections to the previously issued order granting limited discovery, Luxshare brought a motion to compel discovery, which was granted, while ZF Automotive's concurrent motion to stay was denied.[54] To keep fighting the discovery order, ZF Automotive filed an appeal.

ZF Automotive asked the U.S. Supreme Court to review the question of whether section 1782 authorizes the federal courts to order discovery for use in a "purely private foreign commercial arbitration proceeding conducted by private parties, and private arbitrators, pursuant to a private contract."[55]

B. Second Circuit: *AlixPartners, LLP v. The Fund for Protection of Investors' Rights in Foreign States*

This dispute stems from the nationalization and bankruptcy of a private bank, AB Bancas Snoras ("Snoras"), located in Lithuania. In 2011, the Lithuanian regulatory authorities investigated Snoras and found that it was unable to meet its obligations. As a result, Snoras was nationalized by the Bank of Lithuania (the central bank), which appointed Simon Freakley, a New York resident and CEO of New York-based consulting firm AlixPartners, LLP, as Snoras' temporary administrator. In that role, Freakley issued a report finding that Snoras' liabilities were greater than its assets. Relying on Freakley's report, the regulatory authorities commenced bankruptcy proceedings, which led to a Lithuanian court declaring Snoras to be bankrupted.[56]

In 2019, the Fund—a Russian corporation and assignee of a Russian national who sought to recover compensation for the expropriation of his controlling share in Snoras—commenced an arbitration against Lithuania pursuant to a bilateral investment treaty titled the Agreement Between the Government of the Russian Federation and the Government of the Republic of Lithuania on the Promotion and Reciprocal Protection of the Investments. Article 6 of the treaty provided that investments of the nationals of one state made on the territory of the other state "shall not be subject to expropriation, nationalisation or other measures equivalent to expropriation or nationalisation."[57] The treaty set forth several methods to resolve disputes between one state and the investors of the other state.[58] Following those provisions, the Fund elected to commence an *ad hoc* arbitration in accordance with the UNCITRAL Arbitration Rules. The Fund and Lithuania each selected a member of a three-arbitrator panel and were to choose the third member together.

During that process, the Fund filed an application in the district court for the Southern District of New York for discovery from Freakley and AlixPartners relating to Freakley's role in the expropriation of Snoras for use in the arbitration proceedings against Lithuania and pending in Lithuania. Specifically, the Fund sought to require Freakley and AlixPartners to produce documents and submit to depositions. The district court granted the request and authorized the Fund to issue subpoenas for the requested documents.[59] At this juncture, the court found that the arbitration at issue fell into the category of "foreign or international tribunal[s]" as intended in section 1782, because it was "created by treaty and designed to structure relations

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between two sovereign nations."[60] AlixPartners made a motion for reconsideration, which the court denied.[61]

The Second Circuit affirmed the order compelling discovery on appeal.[62]

Subsequently, AlixParners appealed the decision to the U.S. Supreme Court, asking to consider the question of whether an *ad hoc* arbitration to resolve a commercial dispute between two parties is a "foreign or international tribunal" under section 1782 "where the arbitral panel does not exercise any governmental or quasi-governmental authority."[63]

V. A Hot Bench

At oral argument, ZF Automotive, AlixPartners and the Office of the Solicitor General (U.S. Department of Justice), as *amicus curiae*, argued in favor of a narrow interpretation of section 1782, while Luxshare and the Fund contended that the statute should be interpreted more broadly.[64]

The U.S. Supreme Court first heard from counsel for Petitioner ZF Automotive, who argued that section 1782's text, structure and history make clear that the statute does not apply to private foreign commercial arbitrations. He explained that the phrase "foreign tribunal" is key to the analysis because that combination of words naturally refers to government tribunals, much like the expression "foreign leader" refers to government leaders. Chief Justice Roberts expressed some skepticism at whether the term "tribunal," which is broad enough to carry a governmental connotation, necessarily excludes any other tribunal without that connotation. He observed that "arbitral bodies function as a tribunal" and "it is natural to refer to them that way," adding that the word "foreign" placed before "tribunal" simply means that the arbitral body is a tribunal located in a foreign country. Justice Breyer stated that, while the drafters were probably thinking of foreign government and quasi-judicial agencies, the statutory language can be interpreted more broadly, especially because business disputes now are increasingly resolved in commercial arbitration rather than in court. He asked, as a practical matter, "What's the problem? Why not treat [foreign arbitrations] the same way as these quasi-judicial [tribunals]? . . . Purpose is similar. Language, similar. Nothing says you can't." In response, counsel pivoted to policy issues. He argued that a broad interpretation of the statute would cause unintended consequences such as flooding the district courts with discovery applications, undermining the goal of having streamlined arbitration proceedings, surprising parties overseas with burdensome and time-consuming U.S.-style discovery, and asymmetrically disadvantaging American business. Justice Breyer, however, seemed unpersuaded by doomsday arguments and noted that courts have several ways of preventing a broader interpretation "from getting out of hand," including a modification of the *Intel* factors, so as to require that discovery is available only if sought by the tribunal itself.

Next, counsel for petitioner AlixPartners argued that an arbitral tribunal qualifies for assistance under section 1782 only if the decisionmakers that constitute that tribunal owe both their existence and powers to a treaty between or among sovereign nations, which, he said, was not the case in *AlixPartners*. He contended that the treaty between Russia and Lithuania did not create nor empower the *ad hoc* arbitration panel to resolve investor disputes. Instead, the panel derived its authority from the parties' consent to arbitrate. According to counsel, the treaty gave the investor an option "to escape from the courts . . . from a governmental adjudicator, to have a resolution that is short of governmental implication." From this perspective, the treaty assured the investor that, if he chose the arbitration option, no governmental decision-maker would be involved in the outcome decision. Justice Sotomayor pointedly asked whether there was any difference between the treaty designating the adjudicators versus the treaty empowering the investors to choose the adjudicators. Counsel responded that once the parties select the panel, the proceeding is akin to any other arbitration and there is no governmental role. He further argued that the language of section 1782 focuses on the decision-making body itself (the "tribunal"), and not on its origin (a treaty). However, he explained that if the adjudicatory body was established by a treaty and was staffed with government employees, who are agents of the two countries that are parties to the treaty, "you start to have an international tribunal" within the ambit of section 1782.

Justice Breyer commented he was having "trouble" with the issues. He noted that the current Restatement of U.S. Law of International Commercial and Investor-State Arbitration, and other experts in the field, take the position that section 1782 should encompass private commercial arbitration. Meanwhile, the U.S. government rejects that view, and there is still no clear jurisprudential test to determine whether, in a close case, an arbitral tribunal is a governmental or non-governmental entity covered by section 1782.

In his argument, the Deputy Solicitor General focused on the purpose of the statute, stating that it was "specifically designed to promote comity with other governments by improving existing practice of judicial assistance in litigation. Arbitration is an alternative to litigation. It is not a form of litigation." In the government's view, the statute does not authorize discovery assistance either for private commercial arbitration or treaty-based, investor-state arbitration. These two types of arbitration are the same for purposes of section 1782's applicability, because in investor-state arbitration "there is a standing offer to arbitrate from the government . . . If the private investor accepts that offer, there is an agreement to arbitrate formed. At that point, the foreign government is stepping out of its governmental role, just like when a sovereign waives sovereign immunity, it is becoming a private person or just like a private person." According to counsel, the test should be whether the adjudicatory body is "directly established by two governments" and "exercise[s]

official power conferred by those two governments" and "on behalf of those governments."

Justice Kagan asked why applying the statute to private commercial arbitration would not advance international comity. The Deputy Solicitor General explained that, in domestic arbitration, section 7 of the FAA allows only the arbitrator to request information and there is no pretrial discovery. In contrast, if section 1782 was read to include arbitration, the U.S. would be endorsing a system permitting "discovery anywhere in the world between a government and an investor that the United States government has no responsibility for." This would expose U.S. litigants to discovery abroad and "could upset a foreign government with no benefit [or] comity interchange for the United States." He argued that the question about the scope of section 1782 is a political one and should be resolved by Congress, because "when it comes to international comity, often what the United States wants to do is to do something reciprocal, to adopt something and hope other countries will do it, which is what the 1964 [revision of the statute] was about."

Counsel for respondent Luxshare emphasized that

> [p]roviding assistance to commercial arbitral tribunals seated in other countries promotes cross-border commercial arbitration and international comity. It allows foreign tribunals . . . to make better informed evidence-based decisions . . . it encourages other countries, in turn, to reciprocate by assisting arbitral tribunals [in the United States], [and it] promotes this county's pro-arbitration policy.

Counsel stated that there are a number of safeguards to the statute's application. For example, the parties can opt out by agreeing not to seek discovery, and arbitral institutions can prohibit or limit discovery in their arbitration rules. Justice Gorsuch asked why the Court should not let Congress deal with issues involving comity and foreign affairs. Counsel replied that the Court should use the most natural meaning of the word "tribunal," as interpreted in *Intel*, which is "an adjudicatory body [with] the authority to make a final ruling subject only to court review."

Counsel for respondent The Fund for Protection of Investors' Rights in Foreign States addressed the government's comity concerns and stated that "a number of sovereigns have invoked section 1782 in connection with Bilateral Investment Treaty disputes," and not only private investors seeking to obtain third-party discovery. He argued that comity "is a question of respecting international tribunals created by sovereigns or imbued with authority by sovereigns and . . . assisting them." He explained that the dispute in *Luxshare* is fundamentally international in nature, because the question for the arbitral panel is whether Lithuania breached its treaty obligation to Russia that it would not take Russian investors' property without prompt and adequate compensation. The actual investor commencing the arbitration is not a party to the treaty, which contains reciprocal promises between sovereign nations. Counsel pointed out that, as a practical matter, if a BIT tribunal was not considered within the scope of section 1782, parties would still try to obtain discovery by filing a request before initiating the arbitration, and they would tell the district court they have not decided yet whether the dispute will be submitted to arbitration or the courts, as many treaties provide investors with dispute resolution options.

VI. Conclusion

Numerous amicus briefs were submitted in connection with the two consolidated cases, showing that the legal community is deeply divided on the issue of applicability of section 1782 to arbitral proceedings seated outside the United States. Among others, Professor George A. Bermann argued that section 1782 applies to both international commercial arbitration and treaty-based investor-state arbitration. In a joint brief, the ICC and the U.S. Council for International Business did not take a position in favor or against the availability of the statute in private commercial arbitration, but argued that before denying or granting a section 1782 discovery application, a U.S. court should afford a very high degree of deference to the arbitral tribunal's views on the discovery sought. During oral argument, the Supreme Court justices asked wide-ranging questions, but left little clues as to which arguments they found most persuasive. Justice Breyer ventured to say that there will be "matching problems no matter what" the Court decides. The U.S. Supreme Court will likely issue an opinion by the end of summer 2022.

Endnotes

1. *See* U.S. Supreme Court's orders granting *certiorari* and consolidating cases in *ZF Automotive US, Inc. v. Luxshare, Ltd.*, 142 S. Ct. 637 (Dec. 10, 2021)(appeal 21-401), and *AlixPartners, LLP v. The Fund for Protection of Investors' Rights in Foreign States*, 142 S. Ct. 638 (Dec. 10, 2021)(appeal 21-518).
2. *See National Broad. Co. v. Bear Stearns & Co.*, 165 F.3d 184 (2d Cir. 1999); *In re Guo*, 965 F.3d 96 (2d Cir. 2020); *Republic of Kazakhstan v. Biedermann Int'l*, 168 F.3d 880 (5th Cir. 1999); *Servotronics, Inc. v. Rolls-Royce PLC*, 975 F.3d 689 (7th Cir. 2020); *Servotronics, Inc. v. Boeing Co.*, 954 F.3d 209 (4th Cir. 2020); *Abdul Latif Jameel Transp. Co. v. FedEx Corp.*, 939 F.3d 710 (6th Cir. 2019).
3. *See Servotronics, Inc. v. Rolls-Royce PLC*, 142 S. Ct. 54 (September 29, 2021) (dismissing *certiorari*).
4. 28 U.S.C. § 1782.
5. *Intel Corp. v. Advanced Micro Devices, Inc.*, 542 U.S. 241, 247-248 (2004).
6. *Id.* at 248 (emphasis added).
7. *Id.* at 248-249 (emphasis added).
8. *Id.* at 249.
9. *See id.* at 248.
10. *Intel Corp. v. Advanced Micro Devices, Inc.*, 542 U.S. 241 (2004).
11. In sum, the statutory factors are whether (1) the person from whom discovery is sought resides (or is found) in the district of the district court to which the application is made; (2) the discovery is for use in a foreign proceeding before a foreign or

international tribunal; and (3) the application is made by a foreign or international tribunal or any interested person. *See Kiobel v. Cravath, Swaine & Moore LLP*, 895 F.3d 238, 243 (2d Cir. 2018).

12. The four discretionary factors outlined in *Intel* are (1) whether "the person from whom discovery is sought is a participant in the foreign proceeding," in which case "the need for § 1782(a) aid generally is not as apparent as it ordinarily is when evidence is sought from a nonparticipant" in the foreign proceeding; (2) "the nature of the foreign tribunal, the character of the proceedings underway abroad, and the receptivity of the foreign government or the court or agency abroad to U.S. federal-court judicial assistance;" (3) "whether the § 1782(a) request conceals an attempt to circumvent foreign proof-gathering restrictions or other policies of a foreign country or the United States;" and (4) whether the request is "unduly intrusive or burdensome" and should be "rejected or trimmed." *Intel*, 542 U.S. at 264-265.
13. *See Intel*, 542 U.S. at 255.
14. *Id*. at 258. *Intel* also clarified other aspects of section 1782. It held that non-litigants may be "interested person[s]" entitled to bring a discovery application; that a foreign proceeding need *only* be "within reasonable contemplation," rather than "imminent;" and that the statute does not contain an implicit "foreign-discoverability requirement." *Id.* at 256-257, 258-259, 260-263.
15. *Id*. at 258 (quoting Hans Smit, *International Litigation Under the United States Code*, 65 Colum. L. Rev. 1015, 1026 n.71 [1965]) (emphasis added).
16. *See* James H. Carter & John Fellas, International Commercial Arbitration In New York, 351 (Oxford University Press 2016).
17. *In re ENI S.p.A.*, No. 20-mc-334-MN, 2021 WL 2985171, at *5 (D.Del. July 15, 2021).
18. *Islamic Republic of Pak. v. Arnold & Porter Kaye Scholer LLP*, Misc. Action No. 18-103 (RMC), 2019 WL 1559433, at *7 (D.D.C. Apr. 10, 2019).
19. *See In re Republic of Turk.*, Civil Action No. 19-20107 (ES) (SCM), 2020 WL 4035499, at *3 (D.N.J. July 17, 2020); *In re Chevron Corp.*, 709 F. Supp. 2d 283, 291 (S.D.N.Y. 2010) ("[T]he arbitration here at issue is not pending in an arbitral tribunal established by private parties. It is pending in a tribunal established by an international treaty, the BIT between the United States and Ecuador, and pursuant to UNCITRAL rules."); *OJSC Ukrnafta v. Carpatsky Petroleum Corp.*, No. 3:09 MC 265 (JBA), 2009 WL 2877156, at *4 (D. Conn. Aug. 27, 2009) ("A reasoned distinction can be made between arbitrations such as those conducted by UNCITRAL, a body operating under the United Nations and established by its member states, and purely private arbitrations established by private contract."); *In re Oxus Gold PLC*, MISC No. 06-82-GEB, 2007 WL 1037387, at *5 (D.N.J. Apr. 2, 2007) (adopting magistrate judge's holding that arbitration panel constituted foreign tribunal because "[t]he Arbitration at issue in this case, between two admittedly private litigants, is . . . being conducted within a framework defined by two nations and is governed by [the UNCITRAL rules].").
20. *National Broad. Co. v. Bear Stearns & Co.*, 165 F.3d 184, 188 (2d Cir. 1999).
21. *Id.* at 190.
22. *Id.* at 189 (emphasis added).
23. *Id.* at 190-191.
24. *See id.* at 190.
25. *Republic of Kazakhstan v. Biedermann Int'l*, 168 F.3d 880 (5th Cir. 1999).
26. *See* i*n re Guo*, 965 F.3d 96, 104-105 (2d Cir. 2020) (clarifying that the "*NBC*'s holding remains good law").
27. *Abdul Latif Jameel Transp. Co. v. FedEx Corp.*, 939 F.3d 710, 723 (6th Cir. 2019).
28. *See id.* at 714-715.
29. *Id.* at 726-727.
30. *See id.* at 730-731. The Sixth Circuit, however, did not grant the application directly. Having determined that the district court "may" grant section 1782 assistance, the matter was remanded to the district court to weigh the four discretionary factors outlined in *Intel*.
31. *See Servotronics, Inc. v. Boeing Co.*, 954 F.3d 209, 216 (4th Cir. 2020).
32. *See id.* at 210-211.
33. *See id*. at 211.
34. *See id*. at 216.
35. *Servotronics, Inc. v. Rolls-Royce PLC*, 975 F.3d 689 (7th Cir. 2020).
36. *See* 9 U.S.C. § 7.
37. *See Servotronics, Inc. v. Rolls-Royce PLC*, 975 F.3d at 695.
38. *Id.*
39. *In re Guo*, 965 F.3d 96 (2d Cir. 2020).
40. *See id.* at 100.
41. *See id.* at 101. The targets of Guo's section 1782 application were: Deutsche Bank Securities Inc.; J.P. Morgan Securities LLC; Merrill Lynch, Pierce, Fenner & Smith Incorporated; and Morgan Stanley & Co. LLC.
42. *Id.* at 101.
43. *See id.* at 100-101.
44. *Id*. at 107.
45. *Id*. (emphasis added).
46. *Id*.
47. *Id*.
48. *Id*. at 108.
49. *Id*.
50. *Id*.
51. *See* Brief for Respondent Luxshare, Ltd., 2022 WL 576858, at *4-5 (Feb. 23, 2022).
52. *See* Brief for Petitioner ZF Automotive US, Inc., 2022 WL 256966, at *11-12 (Jan. 24, 2022).
53. *See Luxshare, Ltd. v. ZF Automotive US, Inc.*, 2021 WL 2154700, at *14 (E.D. Michigan, Southern Division May 5, 2021).
54. *Luxshare, Ltd. v. ZF Automotive US, Inc.*, 555 F. Supp. 3d 510, 514 (E.D. Michigan, Southern Division 2021).
55. Brief for Petitioner ZF Automotive US, Inc., 2022 WL 256966, at *i (Jan. 24, 2022).
56. *The Fund for Protection of Investors' Rights in Foreign States v. AlixPartners*, LLP, 5 F.4th 216, 221 (2d Cir. 2021).
57. *Id.*
58. Article 10 of the treaty provided that either party to the dispute may elect to submit the dispute to one of four venues: a) a competent court or court of arbitration of the contracting party in which territory the investments are made; b) the Arbitration Institute of the Stockholm Chamber of Commerce; c) the Court of Arbitration of the ICC; or d) an *ad hoc* arbitration in accordance with the UNCITRAL Arbitration Rules. *See id.* at 221.
59. *See The Fund for Protection of Investors' Rights in Foreign States v. AlixPartners*, LLP, 2020 WL 3833457 (S.D.N.Y. July 8, 2020).
60. *Id.* at *2, n.1.
61. *See The Fund for Protection of Investors' Rights in Foreign States v. AlixPartners*, LLP, 2020 WL 5026586 (S.D.N.Y. Aug. 25, 2020).
62. *See The Fund for Protection of Investors' Rights in Foreign States v. AlixPartners*, LLP, 5 F.4th 216, 221 (2d Cir. 2021).
63. Brief for Petitioner AlixPartners, LLP, 2022 WL 256973, at *i (Jan. 24, 2022).
64. A complete transcript of the oral argument held on March 23, 2022, in both cases is available at: https://www.supremecourt.gov/oral_arguments/argument_transcripts/2021/21-401_9ol1.pdf.

Fair or Foul?: New York City's Regulation Barring Enforcement of Personal Guaranties for COVID-19-Era Rents

by Katharine S. Santos and David Yu

Enacted in response to the economic downturn during COVID-19, New York City Administrative Code § 22-1005 bars landlords from enforcing certain personal guaranties given on commercial leases during a 16-month blackout period between March 7, 2020 and June 30, 2021. The regulation has been challenged in federal court as unconstitutional, but in the meantime the courts are applying the provision in lawsuits by landlords attempting to collect unpaid commercial rents from guarantors. The decided cases, some of which have already wended their way to the Appellate Division of the Supreme Court of the State of New York, provide a good roadmap for landlords trying to recoup their own devastating losses during the pandemic.

Section 22-1005 and Underlying Executive Orders

Section 22-1005 prevents large numbers of landlords from recovering unpaid rent from individuals who are commercial lease guarantors if "[t]he default or other event causing such natural persons to become wholly or partially personally liable for such obligation occurred between March 7, 2020 and June 30, 2021, inclusive."[1] The regulation is not unlimited, however. It applies neither to corporate guarantors nor to properties outside New York City.[2]

Moreover, the regulation only pertains to guarantors for three specific categories of commercial tenants:

(a) tenants that were "required to cease serving patrons food or beverages for on-premises consumption or to cease operation" under former Governor Cuomo's Executive Order 202.3,

(b) tenants classified as "a non-essential retail establishment subject to in-person limitations" under Executive Order 202.6, and

(c) tenants that were "required to close to members of the public" under Executive Order 202.7.[3] The interpretation of the regulation thus depends on the terms of the underlying executive orders.

Signed on March 16, 2020, Executive Order 202.3 states that "[a]ny restaurant or bar in the state of New York shall cease serving patrons food or beverage on-premises effective at 8 pm on March 16, 2020, and until further notice shall only serve food or beverage for off-premises consumption." The Executive Order further states that "[a]ny gym, fitness centers or classes, and movie theaters shall also cease operation effective at 8 pm on March 16, 2020 until further notice."[4] New York City restaurants were gradually allowed to resume on-premises dining in a limited capacity. Gyms and fitness centers were also permitted to re-open, with some restrictions, prior to the end of the regulatory blackout period.[5]

Executive Order 202.6, signed two days after Executive Order 202.3, orders businesses and nonprofit entities to "reduce the in-person workforce at any work locations by 50% no later than March 20 at 8 p.m.," except for "[a]ny essential business or entity providing essential services or functions." The only types of businesses singled out and specifically identified as "essential retail" are grocery stores and pharmacies, although any business could seek an opinion from the Empire State Development Corporation to be declared essential.[6]

Executive Order 202.7 adds that "[e]ffective March 21, 2020 at 8 p.m. . . . all barbershops, hair salons, tattoo or piercing parlors and related personal care services will be closed to members of the public."[7]

Due to the specific limitations of the executive orders it references, Section 22-1005 therefore applies mainly to "restaurants, bars, gyms, fitness centers, movie theaters, non-essential retail stores, barbershops, hair salons, nail salons, tattoo or piercing parlors, and related personal care services" in New York City during the height of COVID-19.[8]

When Section 22-1005 first took effect on May 26, 2020, it was set to expire on September 30 of the same year. As the pandemic worsened rather than improved, growing public concern led the regulation to be amended on September 28, 2020 to extend the blackout period to March 31, 2021. The term was extended again on April 25, 2021 to the current date of June 30, 2021, with the clarification that the amendments would apply retroactively.[9]

In enacting the regulation, the New York City Council focused on the concern that small business owners would need to close their doors permanently, leading the council to predict that "the economic and social damage caused to the city will be greatly exacerbated and will be significantly worse than if these businesses are able to temporarily close and return."[10] Despite the focus on small business owners, the City Council did not appear to consider the plight of small-scale and individual landlords who similarly faced mounting expenses and plummeting revenues during the pandemic. Moreover, the law as written seemingly applies "without regard to the financial circumstances of the tenant, the guarantor, or the landlord."[11]

Open and Shut Cases

A pair of decisions from the Appellate Division of the Supreme Court of the State of New York, First Department suggests that courts will carefully examine the underlying economic realities in determining a guarantor's liability to pay COVID-10-era rents.

In *iPayment, Inc. v. Silverman*, the landlord brought a motion for summary judgment in lieu of complaint under CPLR 3213 against the guarantors on a commercial sublease. The trial court denied the motion, converted the action to a plenary proceeding, and ordered the parties to go forward with discovery.[12] The First Department unanimously reversed, holding that "Plaintiff established its entitlement to summary judgment by submitting defendants' guaranty and evidence of their failure to pay" and directing the clerk to enter judgment for plaintiff in the amount of $464,362.50 plus late charges and default interest pursuant to the lease.[13] The court reasoned that:

> While the prohibition on the enforcement of commercial lease guaranties against natural persons under Administrative Code of City of N.Y. § 22-1005 applies to businesses that were required to "cease operation" or "close to members of the public" under executive orders 202.3, 202.6, or 202.7, . . . defendants never asserted that the nonparty subtenant ceased operations or closed to the public as a result of those orders.[14]

The First Department similarly reversed the trial court's *sua sponte* dismissal of a complaint against a tenant and its guarantor for rental arrears.[15] *558 Seventh Ave. Corp. v. Times Square Photo, Inc.* dealt with a lease for an electronic sales and repair store, presumably a non-essential retail store within the meaning of the regulation. Although the landlord did "not dispute that the tenant's business . . . was shuttered for a period as a result of pandemic-related executive orders," the tenant and guarantor "acknowledge[d] that they eventually reopened for curbside service and that they were able to gain access to the premises during the period of nonpayment."[16]

On appeal, the First Department reinstated the complaint, determining that plaintiff was entitled to summary judgment against the tenant for the rental arrears. Examining the impact of Section 22-1005 on the landlord's claims against the guarantor, the court concluded that since the complaint alleged liability "under the guaranty for periods outside the statute, the parties should be permitted to make their respective factual showings at the trial."[17]

iPayment, Inc. and *558 Seventh Ave. Corp*. together suggest that courts will take seriously the intent of the regulation to aid the businesses most harmed by the effect of the executive orders. In particular, judicial decisions may turn on whether such businesses stayed open or shut during the pandemic.

It's All in the Timing

The First Department continued developing its jurisprudence with respect to § 22-1005 in a surprising decision rendered in November of last year. In *3rd and 60th Associates Sub LLC v. Third Avenue M & I, LLC,* a New York City restaurant and its landlord had entered into a stipulation of settlement providing for certain payments to be made by March 1, 2020. As is common, the stipulation included a cure provision, under which the tenant had three business days to cure its non-payment after being given a default

notice. The tenant did not make full payment by March 1, 2020, and the landlord subsequently sent a default notice on Friday, March 6, by overnight delivery. The stipulation provided that a default notice sent by overnight delivery would be deemed given on the following business day, in this case Monday, March 9. The tenant's cure period thus did not end until several days after the blackout period commenced under § 22-1005.[18]

When the landlord brought suit to enforce the lease guaranty, Justice Andrew Borrok of the New York County Supreme Court Commercial Division granted the guarantors' motion to dismiss, citing § 22-1005. On appeal, the Appellate Division agreed with the motion court's determination that:

> the statute provides that, regardless of when a tenant's lease default occurred, the critical time frame for determining when the protections of Administrative Code § 22-1005 attach is the time of the "event causing such natural persons to become . . . liable," which, in this case, necessarily included the cure period set forth in the parties' stipulation.[19]

The appellate court observed that "the relevant cure period could not have begun to run any sooner than the next business day after it was sent by overnight mail," and that "to hold otherwise would invalidate the stipulation, for which plaintiff presents no basis to do."[20] Landlord thus could recover nothing on the guaranty.

The lower court decision in *ELO Group LLC v. Stir Fry Cuisine, Inc.* reached the opposite result on contrary facts.[21] In *ELO Group*, "plaintiff established that the corporate defendant defaulted under the lease prior to March 7, 2020," and that "[t]herefore, Section 22-1005 does not prevent plaintiff from enforcing the guaranty against the individual defendant." The court added that "it is of no moment that the restaurant continued to fail to pay rent after March 7, 2020, as there remains no dispute that the restaurant was in default prior to that date."[22]

Based on the principle that "a commercial tenant is generally entitled to collect rent for the duration of a lease term, so long as the premises has not [been] relet," the court awarded a judgment for rents due all the way through April 1, 2021, just prior to when plaintiff filed its motion for summary judgment.[23]

Splitting the Baby

Landlords do not always face an all-or-nothing result as in the *3rd and 60th* and *ELO Group* decisions above. Some courts (and litigants) have shown a willingness to "split the baby."

In one of the few decisions on § 22-1005 to emanate from a court in the Second Department, the Supreme Court for the County of Kings considered a suit brought against a non-essential retail store tenant and its guarantor for nonpayment pursuant to a 10-year lease agreement.[24] In *267 Development, LLC v. Brooklyn Babies and Toddlers, LLC*, the court initially denied the landlord's motion for summary judgment and granted the defendants' cross-motion for summary judgment based on NYC Administrative Code § 22-902 (a)(11)(14), which characterizes "attempting to enforce a personal liability provision that the landlord knows or reasonably should know is not enforceable pursuant to section 22-1005" as commercial tenant harassment.[25]

The landlord moved to re-argue, clarifying that it did not seek to recover rents from the guarantor for any months during the blackout period and arguing that the court had therefore misapplied the cited provisions of the Administrative Code.[26] The court granted reargument and vacated its prior decision, holding that "only claims [against guarantors] for arrears that occurred during the covered period are barred by the new law" and that landlord's strategic choice to limit its claims resulted in "no violation of NYC Admin. Code § 22-902(a)(11)(14)."[27]

In a different case brought before the Supreme Court for the County of New York, the judge took it upon himself to do what plaintiff did voluntarily in *Brooklyn Babies*. In *725 Holding Corp. v. Genova,* the landlord filed a motion for summary judgment in lieu of complaint to recover from the guarantor $333,424,15 in back rents due from the restaurant tenant through September 28, 2020. Tenant's first default occurred on October 22, 2019.[28] Defendant did not oppose or otherwise respond to plaintiff's motion.[29] Nonetheless, based on its reading of § 22-1005, the court *sua sponte* severed "damages up to and including November 26, 2019 from plaintiff's request for damages for all days thereafter" and awarded plaintiff "$92,035.05 due up to and including November 26, 2019, only."[30]

It is difficult to tell from the written opinion why the court in *725 Holding Corp*. chose to sever plaintiff's claim for damages in the way it did. But the two decisions in *725 Holding Corp.* and *Brooklyn Babies* suggest that it may be a wise strategy for landlords to excise claims for rental arrears during the blackout period from the total amount sought from a guarantor lest the courts react in unanticipated and possibly unsatisfactory ways.

Future Viability of Section 22-1005

In *Melendez v. City of New York,* several landlords brought suit against New York City and city officials to have § 22-1005 declared unconstitutional as a violation of the Contracts Clause.[31] When the U.S. District Court for the Southern District of New York granted the city's motion to dismiss the landlords' amended complaint for failure to state a claim, the landlords appealed to the U.S. Court of Appeals for the Second Circuit.

The Second Circuit reversed the district court's dismissal of the landlords' claims regarding § 22-1005, concluding that "plaintiffs state a sufficiently plausible Con-

tracts Clause challenge."[32] The court added that the code provision "substantially undermines the landlord's contractual bargain, interferes with his reasonable expectations, and prevents him from safeguarding or ever reinstating rights to which he was entitled during a sixteen-month period."[33] Briefly weighing the city's public interest concerns against landlords' contract rights, the appellate panel ultimately concluded that "the question of legitimate public purpose cannot now be decided as a matter of law for either party and would benefit from further record development."[34]

The constitutionality, and ultimately the fairness, of § 22-1005 is thus still an open question. Meanwhile, landlords and tenants in New York City continue struggling to find their way to a new normal.

Endnotes

1. NYC Admin. Code § 22-1005(2).
2. *Id*. § 22-1005 (a guaranty provision "in a commercial lease or other rental agreement involving ***real property located within the city***" that imposes liability on "one or more natural persons who are not the tenant . . . shall not be enforceable ***against such natural persons***" (emphasis added)).
3. *Id.* § 22-1005(1).
4. N.Y. Exec. Order No. 202.3 (Mar. 16, 2020). The Order directs video lottery gaming facilities and casino gaming facilities to cease operation as well.
5. N.Y. Exec. Order Nos. 202.61 (Sept. 9, 2020), 202.68 (Oct. 6, 2020), 202.70 (Oct. 20, 2020), 202.81 (Dec. 11, 2020), 202.93 (Feb. 11, 2021), 202.96 (Feb. 26, 2021) 202.96, 202.104 (Apr. 26, 2021).
6. N.Y. Exec. Order No. 202.6 (Mar. 18, 2020).
7. N.Y. Exec. Order No. 202.7 (Mar. 19, 2020).
8. Council of City of NY, Intro. No. 2083-A to Local Law 98/2020, § 1(a)(3) (Sept. 28, 2020).
9. *Id.* § 1(a)(7); Council of City of NY, Intro. No. 2243-A to Local Law 50/2021, §§ 1(a)(7) & 4 (Apr. 25, 2021).
10. Council of City of NY, Intro. No. 2083-A to Local Law 98/2020, § 1(a)(6); Council of City of NY, Intro. No. 2243-A to Local Law 50/2021, § 1(a)(6).
11. *Melendez v. City of New York*, 16 F.4th 992, 1005 (2nd Cir. 2021).
12. *iPayment, Inc. v. Silverman*, Index No. 652238/2020, 2020 WL 4517772 (Sup. Ct, N.Y. Co. July 28, 2020) (Bannon, J.), *rev'd*, 192 A.D.3d 586, 146 N.Y.S.3d 51 (1st Dep't 2021).
13. *iPayment, Inc. v. Silverman*, 192 A.D.3d at 587, 146 N.Y.S.3d at 51-52.
14. *Id.* at 587, 146 N.Y.S.3d at 52.
15. *558 Seventh Ave. Corp. v. Times Square Photo, Inc.*, 194 A.D.3d 561, 149 N.Y.S.3d 55 (1st Dep't 2021).
16. *Id.* at 561-62, 149 N.Y.S.3d at 56.
17. *Id.*, 149 N.Y.S.3d at 56-57.
18. *3rd and 60th Associates Sub LLC v. Third Avenue M & I, LLC*, 199 A.D.3d 601, 157 N.Y.S.3d 434, 436 (1st Dep't 2021).
19. *Id*. at ___, 157 N.Y.S.3d at 435.
20. *Id*. at ___, 157 N.Y.S.3d at 436. Unlike in *558 Seventh Ave. Corp.*, where the landlord alleged defaults both before and during the blackout period, the only default under the stipulation of settlement occurred after the blackout period began. *Id.*
21. *ELO Group LLC v. Stir Fry Cuisine, Inc.*, Index No. 158453/2020, 2022 WL 26784 (Sup. Ct., N.Y. Co. Jan. 26, 2022).
22. *Id.* at *2.
23. *Id.* at *1-*2; *see also ELO Group LLC v. Stir Fry Cuisine, Inc.*, Index No. 158453/2020, 2021 WL 1944643, at *1 (Sup. Ct., N.Y. Co. May 12, 2021).
24. *267 Development, LLC v. Brooklyn Babies and Toddlers, LLC*, Index No. 510160/2020, 2021 WL 963955 (Sup. Ct., Kings Co. Mar. 15, 2021), *vacated on reargument*, 2021 WL 3371187 (July 26, 2021).
25. *Brooklyn Babies*, 2021 WL 963955, at *2-*3.
26. *Brooklyn Babies*, 2021 WL 3371187, at *1.
27. *Id.*
28. *725 Holding Corp. v. Genova*, Index No. 655705/2020, 2021 WL 1711555, at *1 (Sup. Ct., N.Y. Co. Apr. 27, 2021).
29. *Id.* at *2.
30. *Id*. at *1-*2.
31. *Melendez*, 16 F.4th at 996. Plaintiffs also sought to have the commercial tenant harassment provisions of NYC Administrative Code § 22-901 declared an unconstitutional limit on commercial free speech and void for vagueness. The appellate court affirmed dismissal of plaintiffs' challenges to § 22-901. *Id.*
32. *Id.* at 1032.
33. *Id*. at 1033.
34. *Id*. at 1036.

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Tax Mistakes in Legal Settlements

By Robert W. Wood

We all pay taxes, and we all talk about them, especially how we wish they were lower. A surprising number of people also express tax opinions to others. Lawyers often speak with authority, but sometimes, they make tax comments that turn out to be less than accurate. Here are some of the more common tax mistakes I've heard:

1. "Putting the money in our lawyer client trust account isn't taxable. It can't be taxed until we take it out of our trust account."

Actually, when settlement monies go into a lawyer's trust account, it is treated for tax purposes as received by the lawyer and received by the client. It is actual receipt of fees to the lawyer, and constructive receipt of the client's share to the client. If a case settles and funds are paid to the plaintiff's lawyer trust account, both the client and the lawyer can be taxed.

2. "My client can't be taxed on money in our trust account. It isn't received by the client until I pay the client."

This is a variation of #1. Taxes can often precede actual physical receipt. The IRS says a lawyer is the agent of his client, so absent exceptional circumstances, the client is treated as receiving funds when the lawyer does. It can create problems when settlement funds arrive in late December, but the client's check isn't dispatched until January. It may be possible to treat it as January income, and documentation can help. But if push comes to shove, the IRS can say it was payment in December.

3. "If a settlement agreement calls for payment in the future, the client has constructive receipt now."

Actually, you *can* call for payment in the future in many common circumstances without triggering taxes before the payment is made. Suppose that a client agrees orally to settle a case in December, but specifies in the settlement agreement that the money will be paid in January. Is the amount taxable in December or January? The answer is January.

The mere fact that the client *could* have agreed to take the settlement in December does not mean the client has constructive receipt. The client is free to condition the execution of a settlement agreement on the payment later. The key will be what the settlement says *before* it is signed. But if you sign the settlement agreement first and *then* ask for a delay in payment, you have constructive receipt.

4. "Don't worry, the defendant won't issue a Form 1099 for this."

Be careful, you never *really* know what IRS Forms 1099 will be issued unless the settlement agreement makes it clear. Do you know if the defendant has your law firm's or your clients tax ID number? If a Form 1099 is issued in January, you usually will not be able to convince the defendant to undue it without express tax language in the settlement agreement that negates a Form 1099.

If the settlement agreement is explicit and negates a Form 1099, you can say that the Form 1099 *breaches* the settlement agreement. In my experience, defendants always fix this quickly, issuing a corrected Form 1099. In contrast, if the settlement agreement is not explicit, you are out of luck. Forms 1099 are issued for most legal settlements, except payments for personal physical injuries and for capital recoveries.

5. "I have to pay tax on the lawyer's fees I receive, so the IRS can't possibly tax the plaintiff on the same legal fees. That would be unconstitutional."

Both the client and the lawyer have to take the legal fees into income, and that is not unconstitutional. In *Commissioner v. Banks,* 543 U.S. 426 (2005), the U.S. Supreme Court held that plaintiffs in contingent fee cases generally must recognize gross income equal to 100% of their recoveries. Even if the lawyer is paid separately by the defendant, and even if the plaintiff receives only the net settlement after legal fees, 100% of the money is *treated as* received by the plaintiff.

This harsh tax rule usually means that plaintiffs must figure out a way to *deduct* their legal fees. Of course, the legal fees are gross income to the lawyer too. It may not seem fair, but this isn't double taxation, and it isn't unconstitutional.

6. "The defendant can't issue a Form 1099 to the plaintiff for 100% of the settlement, and issue another Form 1099 to the plaintiff lawyer for 100%. That would be double reporting of income."

Wrong again. In fact, the IRS regulations on Forms 1099 expressly say that defendants should usually issue *two* Forms 1099 each for 100% of the money when the defendant does not know exactly how much each is receiving. If the defendant issues a joint check to the lawyer and the client, the plaintiff will usually receive a Form 1099 for 100%, and so will the lawyer.

7. "Your damages are for pain and suffering so they are tax free."

The phrase "pain and suffering" may mean something under state tort law. But this well-worn phrase doesn't mean much in the tax law. In fact, far from being a helpful phrase for tax purposes, the IRS generally treats it is code for emotional distress, and that is not enough for tax-free treatment. To be tax-free, compensatory damages must be for personal physical injuries or physical sickness.

Only they are tax free under section 104 of the tax code. But exactly what injuries are "physical" turns out to be messy. Stay away from ambiguous "pain and suffering" language in settlement agreements. Ideally, you want the defendant to pay on account of personal physical injuries, physical sickness and emotional distress therefrom.

8. "Emotional distress damages are not taxable."

This mistake remains surprisingly prevalent, even though Congress amended section 104 of the tax code back in 1996 to state that emotional distress damages are taxable. That's right, emotional distress damages are usually fully taxable. Only if the emotional distress emanates from *physical* injuries or *physical* sickness are the damages tax free. That's why you might commonly see the phrase "physical injuries, physical sickness and emotional distress therefrom" in settlement agreements.

That sounds simple, but exactly what injuries are "physical" turns out to be messy. If you make claims for emotional distress, your damages are taxable. If you claim that the defendant caused you to become physically sick, those damages should be tax free. Yet if *emotional distress causes* you to be physically sick, even that physical sickness will not spell tax-free damages. That is because the emotional distress came first, the sickness is a byproduct of the emotional distress.

In contrast, if you are physically sick or physically injured, and your sickness or injury itself *produces* emotional distress, those emotional distress damages should be tax free. It is a confusing and nuanced subject. It also seems highly artificial, and can depend on which words someone might use. In the real world, of course, these lines are hard to draw, and sometimes can seem contrived.

In fact, of all the tax issues facing litigants, this one is probably the thorniest. Plaintiffs often think that their headaches and insomnia should lead to tax-free dollars. But you need to have something more serious that is a real physical sickness. Post traumatic stress disorder is probably enough to be physical, although there is no tax case yet that expressly so holds.

9. "If you lose money or property, sue to recover it but don't have a net gain, you can't be taxed."

This mistake sounds perfectly logical. If you lost something worth $1M and only get back $500,000, how could you possibly be taxed? Unfortunately, you can still be taxed even if you don't break even in the case. It seems counterintuitive, but you can be taxed even when you have not gotten back all your losses. How can that be, you might ask?

In investment loss and property damage or destruction cases, taxpayers need to consider their tax basis in the property, as well as its fair market value. For example, suppose that you had a million-dollar stock portfolio that was churned by your investment adviser, dropping its value to $200,000. That sounds like an $800,000 loss, right? If you recover say $500,000, isn't it clear that you can't be taxed?

Before you give a knee jerk answer, we need to know your *tax basis* in the property. You had a $1M stock portfolio, and let's say that you previously paid $1M for these investments. Thus, that was your tax basis *and also* the fair market value of the investments. In that event, you still lost money, so you would probably use the $500,000 to reduce your tax basis in the assets. However, what if your tax basis in the $1M portfolio was only $100,000?

In other words, you had $900,000 in untaxed capital gain before the mismanagement. You lost money when your investment adviser misstepped, but if you get back $500,000, with only a $100,000 tax basis, you have a big gain and taxes to pay. That is true even though you had a portfolio with a market value of $1M that was mismanaged, and even though you only got a *portion* of your money back.

The same kind of thing happens with other property cases, such as wildfire cases and many others. Where there are taxes to pay, in some cases there may be section 1033 involuntary conversion benefits possible.

10. "If a plaintiff law firm receives an IRS Form 1099 for 100% of a settlement, the law firm must pay tax on 100%, even if it immediately pays out 60% to the plaintiff."

No, the plaintiff law firm merely pays tax on its fee, 40% in this example. The confusion often centers on IRS Form 1099. Generally, amounts paid to a plaintiff's attorney as legal fees are includable in the income of the plaintiff, even if paid directly to the plaintiff's attorney by the defendant. For tax purposes, the plaintiff is considered to receive the gross award, including any portion that goes to pay legal fees and costs.[1]

The IRS rules for Form 1099 reporting bear this out. Under current Form 1099 reporting regulations, a defendant or other payer that issues a payment to a plaintiff and a lawyer must issue two Forms 1099. The lawyer should receive one Form 1099 for 100% of the money. The client should also receive a Form 1099, also for 100%.

The lawyer's Form 1099 will usually be a gross-proceeds Form 1099, with the amount included in box 10 of Form 1099-MISC. Gross proceeds paid to an attorney are currently reported in Box 10 of Form 1099-MISC. However, until 2020, they were reported in Box 14 of Form 1099-MISC; the change came when new Form 1099-NEC were created for independent contractors.

Lawyers should take note that gross proceeds reporting (Box 10 of Form 1099-MISC) is the best reporting for a lawyer. Money reported as gross proceeds paid to a lawyer is not classified as income by the IRS. That is, unlike Form 1099-MISC box 3 (other income) or Form 1099-NEC, the IRS does not match the taxpayer ID number for gross proceeds paid to an attorney and match with the lawyer's tax return to be sure it is income.

A portion of the payment reported to the lawyer may be income to the lawyer. However, the amount could also be for a real estate closing or some other client purpose. The IRS does not track amounts reported as gross proceeds paid to an attorney on Form 1099 in the way it treats say "other income" on from 1099-MISC Box 3. Therefore, the lawyer should simply report whatever portion of the reported payment (if any) is income to the lawyer.

Conclusion

Talking about taxes is natural, but be careful. There are many elements involved in resolving lawsuits and pre-litigation disputes. For lawyers and especially for clients, the situation can be difficult and emotionally charged. Extra tax uncertainties can add to the pressure, especially when they turn out to be big and unpleasant surprises later. Be careful out there.

Endnote

1. *See Commissioner v. Banks*, 543 U.S. 426 (2005).

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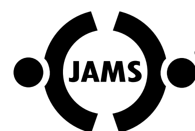

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New Jersey's "Entire Controversy Doctrine": A Trap for the Unwary New York Litigator

By Leonard Benowich and Michael McDonough

New York litigators are familiar with the rules of claim and issue preclusion, *res judicata* and collateral estoppel, and with the compulsory counterclaim requirements in the Federal Rules.[1] But few of us are familiar with New Jersey's "Entire Controversy Doctrine" (ECD), which can have broader preclusive effect than those familiar doctrines and a potentially determinative impact on unasserted claims in litigation that originated or is pending in New Jersey.

For this reason, a New York lawyer handling a case that originated or is pending in New Jersey, or which involved multiple or successive litigations between the same parties, where one suit is in New York and the other in New Jersey, must be aware of the ECD. Application of the ECD can be fatal.

The ECD

The ECD "is essentially New Jersey's specific, and idiosyncratic, application of traditional *res judicata* principles";[2] it precludes "all claims arising out of the same controversy that could have been raised in the earlier action, including those involving different legal theories or requesting alternative relief."[3] The purpose of the doctrine is "to avoid the delay and wasteful expense of the multiplicity of litigation which results from the splitting of a controversy."[4] The ECD encompasses "not only defenses but affirmative claims that could and should, be brought as counterclaims."[5] "The entire controversy doctrine has evolved 'to eliminate delay, prevent harassment of a party and unnecessary clogging of the judicial system, avoid wasting the time and effort of the parties, and promote fundamental fairness'."[6] But the ECD is broader than the principles of *res judicata* familiar to New York litigators.

The ECD is codified in Rule 4:30A of New Jersey's Court Rules[7]:

> Non-joinder of claims required to be joined by the entire controversy doctrine shall result in the preclusion of the omitted claims to the extent required by the entire controversy doctrine.

The ECD precludes subsequent assertion of claims that could—or should—have been asserted in the earlier litigation.[8] For the ECD to apply, the claims in the two (or more) actions must: (a) arise from related facts or the same transaction or series of transactions between the parties; (b) be known or ripe at the time first litigation is pending;[9] and (c) end with an adjudication or resolution on the merits in the first litigation.[10]

The ECD "'stems directly from the principles underlying the doctrine of res judicata or claim preclusion.' . . . However, '[t]he doctrine is a broad one, more preclusive

than both res judicata and the Restatement [(Second) of Judgments]'."[11] It generally requires parties to an action to raise all transactionally related claims in that same action.[12] New Jersey courts utilize the ECD to "'impel litigants to consolidate their claims arising from a single controversy whenever possible'"[13] so as to avoid "'piecemeal decisions and to promote judicial efficiency and the reduction of delay.'"[14] The ECD "embodies the principle that the adjudication of a legal controversy should occur in one litigation in only one court; accordingly, all parties involved in a litigation should at the very least present in that proceeding all of their claims and defenses that are related to the underlying controversy."[15]

Although the ECD "has 'evolved through a series of decisions' and rule amendments,"[16] it nevertheless "remains an equitable doctrine" whose application is left to judicial discretion based on the factual circumstances of individual cases.[17] "The polestar for the application of the entire controversy rule is judicial fairness."[18]

For a time, New Jersey's courts had extended the ECD to include mandatory party joinder, which meant that if there was a transactionally related party that was not named as a litigant in the initial matter, a subsequent action against the excluded party would be barred under the ECD.[19] But because of the difficulties caused by mandatory joinder—a consideration recognized in some New York cases when deciding whether to apply the ECD[20]—the New Jersey Rules of Court were amended to eliminate mandatory party joinder, except in certain instances.[21]

The ECD is not applied rigidly. As one New York court has observed, "in applying the entire controversy doctrine, one of a court's primary concerns is fairness to the parties."[22]

The ECD generally can be invoked when a prior action was commenced in New Jersey and adjudicated or resolved on the merits and a later action is pending or commenced in New York. Because, in certain instances, application of the ECD requires a final judgment in New Jersey, New York courts generally apply the ECD as an incident of the New Jersey judgment.

The ECD in New York Courts

New York courts have given the ECD relatively broad application, in tort, commercial and matrimonial cases, and in many instances, they have barred claims that could otherwise be maintained in a New York court.

PRPJ Bergen Inc. v. Plate[23] is one of the earliest New York cases to address the ECD. That case involved three actions all arising out of the same common nucleus of facts and transactions. Judge Lasker began his decision stating "[t]hese motions concern the most appropriate forum for the litigation of three lawsuits all arising from claims of fraud in the sale and financing of certain New Jersey real estate projects. Two of the claims are pending before this Court, and one is pending in the District of New Jersey."[24] There were subtle differences in the actions.

The New York first-filed action alleged that the main defendants, "Plate and certain of his affiliates and companies ("Plate Entities")[,] promoted and sold to plaintiffs certain fraudulent real estate investments. Damages are sought with respect to two Plate projects located in New Jersey: the Park River Towers project and the Marina Vista project."[25] "The basic difference between the second New York action and the first one is that plaintiffs name UJB [United Jersey Bank], the plaintiff in the New Jersey action, and eight UJB former or present officers as defendants in the second action."[26]

Observing that "the New York and New Jersey lawsuits are essentially mirror images of each other,"[27] Judge Lasker found that "considerations of judicial economy and the threat of inconsistent results dictate that the cases be handled by only one court."[28] The dispute was over "whether the cases should be consolidated in New Jersey or New York."[29] Judge Lasker concluded that the "dispute presents a question of whether New Jersey's 'entire controversy' doctrine should apply. The product of case law, the doctrine provides that all claims relating to a particular controversy must be brought in the initial proceeding, and if they are not, will be foreclosed in later proceedings."[30] UJB, a defendant in the New Jersey case, argued that the ECD "mandates transfer to the New Jersey court because it is the only court authorized to decide the foreclosure issues and therefore the only court capable of resolving all the issues in this case."[31] Judge Lasker side-stepped the issue and held that "[w]ithout deciding whether the doctrine in fact applies, it is plain that the New Jersey court is better fitted than this Court to judge its applicability to this case."[32]

The question of the applicability of the ECD was squarely addressed by Judge Keenan a year later in *Union Muffler Corp. v. Midas Intern. Corp.*[33] The plaintiff in that case had been a Midas Muffler franchisee in Irvington, New Jersey, since 1965. The plaintiff signed a revised franchise agreement in 1973 and in November 1982 the defendant informed the plaintiff that defendant intended to open a new Midas Muffler shop in its town. The plaintiff objected that the proposed location was too close to its franchise location and would have an adverse impact on its business. The defendant nonetheless subsequently awarded a new franchise to a third party in Irvington. Plaintiff sued in New Jersey state court seeking to enjoin the opening of the new franchise. After several months of litigation, the parties settled the New Jersey action by executing and filing a stipulation of dismissal with prejudice. Four years later, the plaintiff filed suit in the Southern District asserting claims for RICO, fraud, breach of the franchise agreement, violation of New Jersey's Franchise Practices Act and other common law claims. The defendants moved to dismiss on the grounds of *res judicata* "because the prior state-court suit between Union Muffler and Midas in New Jersey state court was dismissed with prejudice."[34] Importantly, Judge

Keenan recognized that, in determining the *res judicata* effect of a state court decision on a subsequent federal claim, "the federal court must apply the claim preclusion law of the state that made the first disposition."[35]

> Under New Jersey law, res judicata or claim preclusion is governed by the entire-controversy doctrine, which requires a plaintiff in a civil action to "seek complete relief for vindication of the wrong he charges" in that single suit. [Citation omitted.] New Jersey courts interpret this doctrine as foreclosing subsequent litigation not only of claims actually litigated but of all claims arising out of the same controversy that could have been raised in the earlier action. "The entire controversy doctrine applies both to subsequent actions asserting different legal theories and those requesting alternative relief." *Printing Mart-Morristown, Inc. v Rosenthal*, 650 F. Supp. 1444, 1447 (D.N.J. 1987), *aff'd* 856 F.2d 184 (3d Cir. 1988).[36]

Judge Keenan pointed out that in *Printing Mart-Morristown, Inc.*, the Third Circuit rejected the argument "that RICO claims brought in a subsequent lawsuit should not be barred by a dismissal of an earlier state court proceeding because plaintiff had alleged predicate acts that occurred after the earlier judgment."[37] Even though the federal complaint alleged predicate acts that occurred after the New Jersey action was dismissed, Judge Keenan rejected that argument, relying on the Third Circuit's statement that "the entire controversy doctrine bars subsequent litigation even where the allegedly unlawful 'transaction,' . . . is of a continuous and ongoing nature such that new violations ("predicate acts") occur over time."[38]

The plaintiff argued that the ECD did not apply because it could not have asserted a RICO claim in the New Jersey litigation as it: (a) had yet to sustain any damages, and (b) only sought injunctive relief. But Judge Keenan rejected those arguments, holding that the ECD "bars a subsequent action arising from the same transaction regardless of the assertion of different legal theories or alternative forms of relief."[39] "The fact that plaintiff seeks damages here rather than injunctive relief is therefore irrelevant."[40]

One "exception" to the rule that ongoing litigation may preclude a subsequent litigation involving the same parties and transactions is where the latter case is for prevailing party attorneys' fees. The ECD "does not bar defendants from filing a separate action in a court of competent jurisdiction for the recovery of fees under the Franchise Agreement because the defendants could not assert they were the 'prevailing parties' until the first case was resolved and because they did everything procedurally possible to preserve their right to seek fees."[41]

More recently, in *Beatie and Osborn LLP v. Bogert*,[42] the parties, all lawyers, had been "co-counsel on hundreds of personal injury cases."[43] The plaintiffs filed suit in the Southern District for repayment of loans they made to Bogert which were to have been repaid at the conclusion of that New Jersey litigation. They were also parties to a New Jersey lawsuit in which Bogert, the defendant in that case as well, had filed a third-party complaint against the same plaintiffs (as third-party defendants in New Jersey). The New Jersey Superior Court granted the plaintiffs' (as third-party defendants) motion for summary judgment against Bogert.

Bogert moved to dismiss the New York action as barred by the ECD. Judge Cote wrote:

> In determining whether a subsequent claim should be barred under [the NJECD], the central consideration is whether the claims against the different parties arise from related facts or the same transaction or series of transactions . . . . There is no requirement that there be a commonality of legal issues. *Wadeer v. New Jersey Mfrs. Ins. Co*., 220 N.J. 591, 605 (2015) (citations omitted). Courts should also consider whether applying the NJECD is fair "to the court system as a whole, as well as to all parties."*Id.*[44]

Judge Cote granted the motion dismiss, finding that the "claims arise out of the same relationships and transactions at issue in the [New Jersey] litigation . . . . [And t]he plaintiffs do not contend that they could not have filed a counterclaim against Bogert for repayment."[45]

The ECD can also support a motion to stay a New York action pending the completion of an ongoing New Jersey action. In *Rong Chen v. Yeung*,[46] the plaintiffs, employees of the defendant, had commenced an action for wages in New Jersey District Court. After they learned that the defendant may have been engaged in a possible fraudulent conveyance of real property in New York, they commenced suit in Supreme Court. Defendant moved to dismiss under the ECD, and for a stay of discovery.

Justice Mills granted the motion to dismiss to the extent of staying the action pending resolution of the New Jersey wage action. While the court recognized that the ECD "has been held to be a preclusionary principle intended to prevent the fractionalization of litigation, requiring all claims between the parties arising out of, or relating to, the same occurrence to be determined in a single action," Justice Mills also noted that the ECD "bars only successive lawsuits involving related claims; *it does not bar claims that are pending in different courts at the same time*."[47]

Claims for indemnification and/or contribution raise interesting issues under the ECD. Under the New Jersey Joint Tortfeasor's Contribution Act, as is the case under

New York law, a joint tortfeasor may recover contribution from other joint tortfeasors for any excess it pays over its pro rata share. Although a contribution claim normally does not arise "until a tortfeasor has paid more than his pro rata share, the [ECD] and judicial economy militate for the claim being asserted in the underlying tort action."[48] But that same rule has also been applied to bar such claims that were not asserted in the underlying New Jersey action. In *Fireman's Fund Ins. Co. v. Allied Programs Corp.,* Judge Haight wrote that "[u]nder the [ECD], a cross claim for contribution is apparently required to be asserted in the primary action or it will be barred from assertion in a subsequent action."[49] Judge Haight applied the ECD to bar a previously unasserted claim for indemnification—even though he found "no case involving the application of the [ECD] to a claim for indemnity"[50]—concluding that "I can see no reason for concluding that [an indemnity claim] should be accorded different treatment under the [ECD] than a claim for contribution."[51]

In *In re Slater*,[52] Bankruptcy Judge Beatty reviewed the law on the ECD in New York, found it to be "more preclusive than *res judicata*," and held that under the ECD "a claim for contribution that is not asserted in the original action is barred in any later action. Federal courts have applied New Jersey's [ECD] to bar claims not asserted in a prior action."[53]

Equitable Considerations and the ECD

Several New York courts have rejected dismissal motions, citing the equitable purposes of the ECD. As the Third Circuit noted in *Rycoline Products, Inc. v. C & W Unlimited,*[54] the ECD "is a flexible concept whose polestar is judicial fairness" and "[a]pplication of the rule . . . is discretionary and clarification of the limits of the doctrine is best left to case-by-case determination."[55]

For example, in *Gorelik v. Gorelik,* the parties, the sole owners of a corporation, "Prompt," had been divorced in a New Jersey action, where their respective interests in Prompt had been addressed. In the New Jersey action, Ms. Gorelick had moved for and obtained the appointment of a forensic accountant but Mr. Gorelick had refused to cooperate and provide all information sought by the accountant relating to the parties' corporations and their business affairs. The parties settled the New Jersey divorce action with a Stipulation of Settlement that provided, among other things, that they intended to "settle all disputes and questions pertaining *solely* to their marriage,"[56] and the settlement was "a complete and final resolution of the rights, entitlements, liabilities and responsibilities of the parties as they pertain to the marriage, including, when applicable, alimony, child support, equitable distribution of marital assets, payment of debts and attorneys fees."[57] The stipulation also provided that Mr. Gorelick would retain ownership of "Prompt, and both parties agreed to cooperate with any investigation stemming from Prompt Enterprises and its sale."[58]

In the New York action, Mr. Gorelick sued his former wife, alleging that she had

> converted, for personal use, insurance premium payments made to Prompt as part of Prompt's business. Mr. Gorelik and Prompt also allege that Ms. Gorelik diverted these payments to the other co-defendants in this [New York] action, and that the absence of these payments from Prompt's escrow account caused a potential purchaser of Prompt to withdraw from the purchase of Prompt.[59]

Relying on the ECD, Ms. Gorelik moved to dismiss. Justice Demarest denied the motion. Justice Demarest pointed out that "Prompt, and the defendants other than Ms. Gorelik, were not parties to the [New Jersey] matrimonial action. Since the party injured by Ms. Gorelik's alleged actions was Prompt, the real plaintiff in this action is Prompt, not Mr. Gorelik, whose rights are derived from those of Prompt," and "the duties Ms. Gorelik is alleged to have violated did not arise from the marital relationship, but rather were owed to Prompt because of Ms. Gorelik's shareholder/employment relationship with Prompt."[60]

Justice Demarest found that "Mr. Gorelik thus did not have any clear notice that he would have been required to litigate the present claims in the New Jersey divorce action,"[61] and the "evidence presented with respect to the claims addressed in the New Jersey proceeding also demonstrates that Mr. Gorelik did not expressly raise his current claims as part of the equitable distribution process."[62] Justice Demarest also read the parties' Settlement Agreement as "expressly preserving Mr. Gorelik's right to maintain a separate action relating to Prompt's claims."[63]

> In sum, this court finds that it would be unfair to plaintiffs to bar this action based on the entire controversy doctrine given that: (1) Prompt was not a party to the divorce proceeding; (2) the current action relates to violations of duties owed to Prompt; (3) there is no clearly applicable case law that would have required Mr. Gorelik to have litigated his current claims as part of the New Jersey divorce proceeding; (4) Mr. Gorelik did not expressly raise his current claims as part of any equitable distribution determination in the New Jersey action; and (5) the Agreement does not cover Prompt's current claims, or, at the very least, Mr. Gorelik' counsel understood that the current claims were not to be covered by the Agreement.[64]

In *Ekinici v. GNOC Corp.*,[65] Judge Gleeson rejected an ECD-based motion to dismiss a New York action in which the plaintiff, who ran up and defaulted on a debt at the Hilton hotel in New Jersey, asserted violation of Fair Debt

Collection Practices Act (FDCPA), finding that the earlier New Jersey action, for breach of contract, "ar[o]se from different controversies and different sets of core facts."[66] In the first case, GNOC sued Ekinici in New Jersey state court and obtained a default judgment on its claim that he ran up a debt of $5,000. In the second, New York, action, Ekinici claimed that the hotel's counsel's collection letter violated the FDCPA. Judge Gleeson began his analysis by recognizing that:

> Under New Jersey law, the entire controversy doctrine encompasses virtually all causes, claims, and defenses relating to a controversy and requires, at a minimum, that all parties to a suit bring all affirmative claims, counterclaims, cross-claims, and defenses out of the underlying controversy . . . . New Jersey courts invoking the doctrine have made clear that it is the core set of facts that provides the link between distinct claims against the same parties and triggers the requirement that they be determined in one proceeding.[67]

But Judge Gleeson denied GNOC's motion to dismiss, finding that application of the ECD is "flexible" and "discretionary" and should be guided by the "polestar" of "judicial fairness"[68]—which he found lacking in that case:

> GNOC's contention that the state court proceeding and the FDCPA claim comprise the same controversy arising from the same set of facts goes too far. I do not believe that a New Jersey court would find that the prior default judgment would bar Ekinici's FDCPA claim because the two claims arise from different controversies and different sets of core facts. GNOC's default judgment was based on Ekinici's activities at the Hilton that culminated in his $5,000 debt. Ekinici's FDCPA claim is based solely on the wording of the dunning letter, an event later in time and different in kind.[69]

Entire Controversy Orders

As the above case law demonstrates, the ECD is routinely, but not necessarily rigidly applied. Rather, a court must consider the facts and equities of each particular case to determine the applicability of the ECD.

But there is a pro-active way by which counsel can try to insulate a client from the potentially harsh consequences of the ECD: the Entire Controversy Order.

The (New York) lawyer aware of and concerned about application of the ECD and its potentially determinative preclusive effect can seek an Entire Controversy Order from the (New Jersey) court that presided (or is presiding) over the dispute. An Entire Controversy Order, if granted, expressly reserves the claim for a future action: "[A] party whose constituent claim arises during the pendency of the action risks its loss unless he apprises the court and his adversary of its existence and submits to judicial discretion the determination of whether it should be joined in that action or reserved."[70]

Endnotes

1. Fed. R. Civ. P. 13.
2. *Techno-Comp, Inc. v. Arcabascio*, 130 F. Supp. 3d 734, 740 (E.D.N.Y. 2015) (quoting *Rycoline Products, Inc. v. C & W Unlimited,* 109 F.3d 883, 886 (3d Cir. 1997)).
3. *Beatie & Osborn LLP v. Bogert*, No. 17CV1047(DLC), 2017 WL 2937702, at *2 (S.D.N.Y. July 10, 2017) (quoting *Stochastic Decisions, Inc. v. DiDomenico*, 995 F.2d 1158, 1170 (2d Cir. 1993)).
4. *Marine Office of America Corp. v. J.E. Brenneman Co*., No. 91 Civ. 0663 (JSM), 1992 WL 8247, at *2 (S.D.N.Y. 1992) (quoting *Woodward-Clyde Consultants v. Chemical and Pollution Sciences, Inc*., 523 A.2d 131 (N.J. 1987)).
5. *Marine Office of America Corp.*, 1992 WL 8247, at *2.
6. *Cogdell v. Hospital Ctr.*, 116 N.J. 7, 15, 560 A.2d 1169 (NJ 1989) (quoting *Barres v. Holt, Rinehart and Winston, Inc.*, 74 N.J. 461, 466, 378 A.2d 1148 (N.J. 1977) (Schreiber, J., dissenting), *superseded by statute on other grounds as stated in Rickett v. Barry,* 775 F.3d 611, 613-14 (3d Cir. 2015)).
7. N.J. Ct. R. 4:30A; *see also* N.J. Ct. R. 4:7-1, which addresses the filing of counterclaims mandated by the ECD; and N.J. Ct. R 4:5-1, which requires litigants to certify as to whether there are any other pending or contemplated litigations/arbitrations between the parties and whether any non-parties should be joined in the litigation.
8. *Sanders v. Sanders*, No. 20-CV-5621 (VEC), 2021 WL 4392053, at *6 n.14 (S.D.N.Y. Sept. 24, 2021).
9. *Thurman v. Lindenwold Ctr. LLC,* No. A–5364–12T4, 2015 WL 998716, at *6 (N.J. App. Div. Mar. 9, 2015) ("[t]he entire controversy doctrine is inapplicable to, and does not apply to bar component claims either unknown, unarisen or unaccrued at the time of the original action."); *Techno-Comp, Inc.*, 130 F. Supp. 3d at 740.
10. *See, e.g., Dimitrakopoulos v. Borrus, Goldin, Foley, Vignuolo, Hyman & Stahl, P.C.*, 237 N.J. 91, 114-115, 203 A.3d 133 (N.J. 2019); *Carrington Mortg. Servs., LLC v. Moore*, 464 N.J. Super. 59, 69, 243 A.3d 293 (N.J. App. Div. 2020); *Allstate N.J. Ins. Co. v. Cherry Hill Pain & Rehab. Inst.*, 389 N.J. Super. 130, 140, 911 A.2d 493 (N.J. App. Div.2006), *certif. denied*, 190 N.J. 254 (N.J. 2007).
11. *Bank Leumi USA, v. Kloss*, 243 N.J. 218, 227, 233 A.3d 536 (N.J. 2020) (citations omitted).
12. *Carrington Mortg. Servs., LLC*, 464 N.J. Super. at 67–68.
13. *Dimitrakopoulos*, 237 N.J. at 98 (quoting *Thornton v. Potamkin Chevrolet*, 94 N.J. 1, 5 (N.J. 1983)).
14. *Carrington Mortg. Servs., LLC*, 464 N.J. Super. at 67–68.
15. *Techno-Comp, Inc.*, 130 F. Supp. 3d at 740 (quoting *Wadeer v. New Jersey Mfrs. Ins. Co.*, 220 N.J. 591, 605, 110 A.3d 19 (N.J. 2015)).
16. *700 Highway 33 LLC v. Pollio*, 421 N.J. Super. 231, 235, 23 A.3d 446 (N.J. App. Div. 2011) (citation omitted).
17. *Bank Leumi USA*, 243 N.J. at 227.
18. *Allstate New Jersey Insurance Co.*, 389 N.J. Super. at 140.
19. *Cogdell*, 116 N.J. at 26.

20. *See, e.g.*, *Gorelik v. Gorelik*, 35 Misc. 3d 1213(A), at *3, 951 N.Y.S.2d 86 (Sup. Ct. Kings Cty. 2012):

    > Despite the broad scope of facts that may be deemed related for purposes of the entire controversy doctrine, the doctrine is ameliorated by the requirement that the court consider fairness to the parties in its application, and by the fact that the doctrine no longer encompasses the joinder of parties . . . . (Citations omitted.)

21. *See* Pressler & Vinero Current N.J. Court Rule cmt. 1 on Rule 4:30A.
22. *Gorelik*, 35 Misc. 3d121(A), at *4.
23. 774 F. Supp. 200 (S.D.N.Y. 1991).
24. *Id*. at 202.
25. *Id*.
26. *Id*.
27. *Id*. 203.
28. *Id*.
29. *Id*.
30. *Id*. at 204.
31. *Id*.
32. *Id*.
33. No. Civ. 1522 (JFK), 1992 WL 6180, at *1 (S.D.N.Y. Jan. 3, 1992).
34. *Id*. at *2.
35. *Id*.; *see also Migra v. Warren City Sch. Dist. Bd of Educ*., 465 U.S. 75, 81 (1984); *Stochastic Decisions, Inc*, 995 F.2d at 1170 (citing 28 U.S.C. § 1738).
36. *Id*.
37. *Id*. at *3.
38. *Id*. at *3 (quoting *Printing Mart-Morristown, Inc*., 650 F. Supp. at 1449); *compare Stochastic Decisions, Inc*, 995 F.2d at 1171 (where Second Circuit affirmed district court's refusal to apply ECD, finding that most of activity in later case "occurred after the entry of the judgment in the [earlier case], so it cannot plausibly be claimed that the claims presented in the instant litigation should have been brought in the [earlier case].").
39. *Id*. at *3
40. *Id*.
41. *Sokoloff v. Gen. Nutrition Cos., Inc*., No. 00 Civ. 641, 2001 WL 536072, at *8 (D. N.J. May 21, 2001).
42. No. 17 cv 1047 (DLC), 2017 WL 2937702, at *1 (S.D.N.Y. July 10, 2017).
43. *Id*. at *1.
44. *Id*. at *2.
45. *Id*.; *see also Perini v. Leo*, 147 A.D.3d 877 (2d Dep't 2017) (granting summary judgment, under both ECD and res judicata, dismissing action commenced by Perini, defendant in New Jersey action brought by Leo, seeking repayment on promissory note).
46. 33 Misc. 3d 886 (Sup. Ct. N.Y. Cty. 2011).
47. *Id*. at 837 (emphasis added) (quoting *Kaselaan & D'Angelo Associates, Inc. v. Soffian*, 290 N.J. Super. 293, 299, 675 A.2d 705 (App. Div. 1996)); see also *In re Peaktop Techs (USA), Inc. Shareholder Derivate Litigation*, No. 06 Civ. 8228 (JSR), 2007 WL 700826, at *3 n. 2 (S.D.N.Y. March 6, 2007) (holding ECD does not apply to suits pending simultaneously in New York and New Jersey).
48. *Bendar v. Rosen*, 247 N.J. Super. 219, 237, 588 A.2d 1264 (N.J. App. Div. 1991) (quoted in *Akhenaten v. Najee, LLC*, 2009 WL 794485 (S.D.N.Y. Mar. 27, 2009)).
49. *Fireman's Fund Ins. Co. v. Allied Programs Corp.,* No. 92 Civ. 7505 (CSH), 1993 WL 481344, *10 (S.D.N.Y Nov. 17, 1993).
50. *Id*.
51. *Id*. at *11.
52. No. 03-16647 (PCB), 2008 WL 755015 (Bankr. S.D.N.Y. Mar. 19, 2008).
53. *Id*. at *3 (footnote omitted).
54. 109 F.3d 883 (3d Cir. 1997).
55. *Id*. at 886.
56. 35 Misc 3d 1213(A), at *1.
57. *Id*.at *2
58. *Id*. at *2.
59. *Id*. at * 1.
60. *Id*. at *3.
61. *Id*. at *4.
62. *Id*.
63. *Id*.
64. *Id*. at *5.
65. No. 02-CV-3928, 2002 WL 31956011, at *2 (E.D.N.Y. Dec. 31, 2002).
66. *Id*. at *2.
67. *Id*.
68. *Id*. (quoting *Rycoline Prods., Inc.,* 109 F.3d 886).
69. *Id*.; *see also Shemia v. E. Works LLC*, No. 513080/2018, 2020 WL 94800, *4 (Sup. Ct. Kings Cty. Jan. 6, 2020):

    > The central consideration in determining whether a successive claim is barred by the entire controversy doctrine is whether the claims arise from a core set of related factual circumstances [citation omitted]. In the absence of such a factual nexus, a party is not required to join all of his claims in a single action.

70. *Dilorio v. Structural Stone & Brick*, 368 N.J. Super. 134-139, 845 A.2d 658 (N.J. App. Div. 2004) (quoting *Brown v. Brown,* 208 N.J. Super. 372, 382, 506 A.2d 29 (N.J. App. Div. 1986)).

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Facts About IRS Audits To Keep You Out of Trouble

By Robert W. Wood

It would be very satisfying to say, "Sorry, IRS, you are too late to audit me!" It can save you stress and expense, and avoid having to prove that you were entitled to a deduction or find receipts. The IRS statute of limitations is important for heading off audit trouble, whether you are an individual, corporation, partnership, nonprofit organizations and individuals are consistent. Here's what you need to know.

Myth #1: The IRS Has Three Years, and Then You're Home Free

Not really. It is true that the main federal tax statute of limitations runs three years after you file your tax return. But there are many exceptions that give the IRS six years or longer. Timing can be critical. If your tax return is due April 15, but you file early, the normal statute runs three years after the *due* date. Filing early does not start the three years to run. If you get an extension and file on October 15, your three years runs from then. If you file late and *do not* have an extension, the statute runs three years following your actual (late) filing date.

The statute is six years if your return includes a "substantial understatement of income." Generally, this means you have left off more than 25% of your gross income. Suppose that you earned $200,000 but only reported $140,000? You omitted more than 25%, so that means you can be audited for six years.

The circumstances can matter too. Maybe this was unintentional or reporting in reliance on a good argument that the extra $60,000 wasn't your income. That means the six-year statute applies. But be aware that the IRS *could* argue that your $60,000 omission was fraudulent.

If so, the IRS gets an unlimited number of years to audit, as we will see. What about not an omission of income, but overstated deductions? The six-year statute of limitations does not apply if the underpayment of tax was due to the overstatement of deductions or credits.

Myth #2: Only Omitting 25% of Your Income Triggers Six Years

Actually, the 25% is a practical one. For years, there was litigation over what it *means* to *omit* income from your return. Taxpayers and some courts said "omit" means leave off, as in don't report. But the IRS said it was much broader.

Example: You sell a piece of property for $3 million, claiming that your basis (what you invested in the property) was $1.5 million. In fact, your basis was only $500,000. The effect of your basis overstatement was that you paid tax on $1.5 million of gain, when you should have paid tax on $2.5 million.

In *U.S. v. Home Concrete & Supply, LLC*,[1] the Supreme Court slapped down the IRS, holding that overstating your basis is *not* the same as *omitting* income. The Supreme Court said three years was plenty for the IRS to audit. But Congress *overruled* the Supreme Court and gave the IRS six years in such a case, so that is the current law. Six years can be a long time.

Myth #3: No Return or Fraudulent Return

The IRS has no time limit if you never file a return, or if it can prove civil or criminal fraud. If you file a return, can the IRS ever claim that your return didn't count, so that the statute of limitations never starts to run? Yes. If you don't sign your return, the IRS does not consider it a valid tax return. That means the three years can never start to run.

Another big no-no is if altering the 'penalties of perjury' language at the bottom of the return where you sign. If you alter that language, it also can mean that the tax return does not count. Such a move may sound like tax protester statement. However, some well-meaning taxpayers forget to sign, or may unwittingly change the penalties of perjury wording. Some other taxpayers just miss a form to end up in audit purgatory.

Myth #4: Foreign Income, Foreign Gifts and Assets Are the Same

Nope, this kind foreign income and assets are different to the IRS, and they trigger tougher rules. The IRS is still going after offshore income and assets in a big way, and that dovetails with another IRS audit rule. The three years is also doubled if you omitted more than $5,000 of foreign income (say, interest on an overseas account).

This rule applies even if you disclosed the existence of the account on your tax return, and even if you filed an FBAR reporting the existence of the account. This six years

matches the audit period for FBARs. FBARs are offshore bank account reports that can carry civil and even criminal penalties far worse than those for tax evasion.

Certain other forms related to foreign assets and foreign gifts or inheritances are also important. If you miss one of these forms, the statute is extended. In fact, the statute never runs. If you receive a gift or inheritance of over $100,000 from a non-U.S. person, you must file Form 3520. If you fail to file it, your statute of limitations never starts to run.

IRS Form 8938 was added to the tax law by FATCA, the Foreign Account Tax Compliance Act. Form 8938 requires U.S. filers to disclose the details of foreign financial accounts and assets over certain thresholds. This form is separate from FBARs, and is normally filed with your tax return.

The thresholds for disclosure can be as low as $50,000, so it pays to check out the filing requirements for your situation. Higher thresholds apply to married taxpayers filing jointly, and U.S. persons residing abroad. But the forms are nothing to ignore. If you are required to file Form 8938 and skip it, the IRS clock never even starts to run.

Myth #5: U.S. and Foreign Companies Are Treated the Same

Not hardly. If you own part of a foreign corporation, it can trigger extra reporting, including filing an IRS Form 5471. It is an understatement to say this form is important. Failing to file it means penalties, generally $10,000 per form. A separate penalty can apply to each Form 5471 filed late, incomplete or inaccurate. This penalty can apply even if no tax is due on the whole tax return. That is harsh, but the rule about the statute of limitations is even harsher.

If you fail to file a required Form 5471, your entire tax return remains open for audit indefinitely. This override of the normal three year or six-year IRS statute of limitations is sweeping. The IRS not only has an indefinite period to examine and assess taxes on items relating to the missing Form 5471. In addition, the IRS can make any adjustments to the entire tax return, with no expiration until the required Form 5471 is filed.

You can think of a Form 5471 a bit like the signature on your tax return. Without the form, it is almost as if you didn't file a return. Forms 5471 are not only required of U.S. shareholders in controlled foreign corporations. They are also required when a U.S. shareholder acquires stock resulting in 10% ownership in any foreign company. The harsh statute of limitation rule for Form 5471 was enacted in 2010, part of the same law that brought us FATCA, the Foreign Account Tax Compliance Act.

Myth #6: Limits for Amended Tax Returns

If you want to amend your tax return, you must do it within three years of the original filing date. You might think that amending a tax return would restart the IRS's three-year audit statute, but it doesn't. However, where your amended tax return shows an *increase* in tax, and when you submit the amended return within 60 days before the three-year statute runs, the IRS only has 60 days after it receives the amended return to make an assessment. This narrow window can present planning opportunities. In contrast, an amended return that does not report a net increase in tax does not trigger an extension of the statute.

Myth #7: Time Limits on Tax Refunds

Getting money back from the IRS is hard. If you pay estimated taxes, or have tax withholding on your paycheck but fail to file a return, you generally have only two years (not three) to try to get it back. Suppose you make tax payments (by withholding or estimated tax payments), but you have not filed tax returns for five years. When you file those long-past-due returns, you may find that overpayments in one year may not offset underpayments in another. This is painful, resulting in lost tax money, and it catches many taxpayers unaware.

Myth #8: It's a Mistake To Give the IRS More Time

On the contrary, usually if the IRS wants more time to audit you, you should generally agree. The IRS must normally examine a tax return within three years, unless one of the exceptions discussed here applies. The IRS tracks the three-year statute, but the IRS may need more time to audit.

The IRS may contact you asking you to sign a form extending the statute. It can be tempting to say no, but saying no is often a mistake.

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It usually prompts the IRS to send a notice assessing extra taxes, without taking the time to thoroughly review your explanation of why you do not owe more. The IRS may make very unfavorable assumptions. Thus, most tax advisers tell clients to agree to the requested extension. You may, however, be able to limit the scope of the extension to certain tax issues, or to limit the time (say, an extra year).

Myth #9: Counting the Years Is Easy

Counting three years is easy, but it can be tough to apply the statute and to count those three years in some cases. For example, sayan IRS notice is sent to a partnership, but not to its individual partners. The partnership tax rules may give the IRS extra time. In other cases, the statute may be "tolled" (held in abeyance) by an IRS John Doe summons, even though you have no notice of it.

A John Doe summons is issued not to taxpayers but to banks and other third parties who have relationships with taxpayers. You may have no actual notice that the summons was issued. Yet it can extend *your* statute of limitations. This can occur if a promoter has sold you on a tax strategy. The IRS may issue the promoter a summons asking for all the names of his client/customers. While he fights turning those names over, the statute of limitations clock for all of those clients is stopped.

Another situation in which the IRS statute is tolled is where the taxpayer is outside the United States. If you flee the country for years and return, you may find that your tax problems can spring back to life.

Myth #10: You Don't Need To Worry About the States

Actually, state tax filings matter a lot. The IRS may audit first and the state later, or the reverse. They are usually connected. Some states have the same three- and six-year statutes as the IRS. Some have their own, like California, where the basic tax statute of limitations is four years, not three. In California if the IRS adjusts your federal return, you are *required* to file an amended return to match up what the feds did. If you don't, the California statute will *never* run out.

In most states, if you never file a return, the state statute never starts to run. That means thinking about your exposure. In California, for example, if you move out, filing non-resident returns just to report California source income to start California's statute can be wise. There can be many tricky interactions between state and federal statutes of limitations.

Myth #11: Proof of Filing Isn't Important

Actually, being able to prove exactly when you filed and exactly what forms were included can be critical. For that reason, keep scrupulous records, including proof of when you mailed your returns. The difference between winning and losing may depend on your records. The vast majority of IRS disputes are settled, and getting a good or mediocre settlement can hinge on your records too. The statute usually begins to run when a return is filed, so keep certified mail or courier confirmation.

If you file electronically, keep all the electronic data, plus a hard copy of your return. As for record retention, many people feel safe about destroying receipts and backup data after six or seven years. However, never destroy old tax returns. Keep copies forever. Also, do not destroy old receipts if they relate to basis in an asset.

For example, receipts for home remodeling 15 years ago are still relevant, as long as you own the house. You may need to prove your basis when you later sell it, and you will want to claim a basis increase for the remodeling 15 years back. For all these reasons, be careful and keep good records.

Conclusions

An audit can involve targeted questions and requests on particular items only. Alternatively, audits can cover the waterfront, asking for proof of virtually every line item. Even if you do your best with your taxes, taxes are horribly complex.

Innocent mistakes can sometimes be interpreted as suspect, and digging into the past is rarely pleasant. Records that were at your fingertips when you filed might be buried or gone even a few years later, so the stakes can be large.

Tax lawyers and accountants are used to monitoring the duration of their clients' audit exposure, and so should you. It pays to know how far back you can be asked to prove your income, expenses, bank deposits and more. Watch the calendar until you are in the clear.

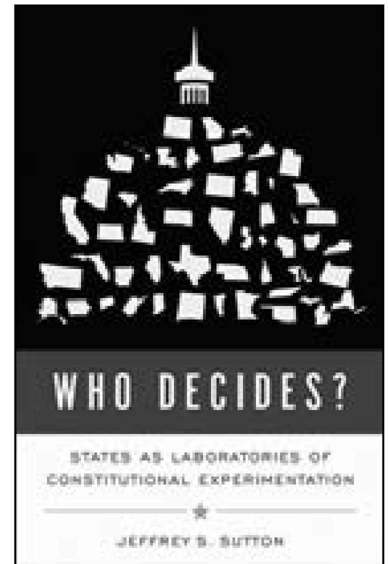
Endnote

1. *U.S. v. Home Concrete & Supply, LLC*,132 S. Ct. 1836 (2012).

Book Review—*Who Decides? States as Laboratories of Constitutional Experimentation*

Jeffrey S. Sutton, Oxford University Press, 2022

By Desmond C.B. Lyons



In "Who Decides? States as Laboratories of Constitutional Experimentation" (Oxford University Press, 2022), Jeffrey S. Sutton, chief judge of the Sixth Circuit Court of Appeals, picks up where he left off in his last book, "51 Imperfect Solutions: States and the Making of American Constitutional Law" (Oxford University press, 2018). Judge Sutton's thesis is that state courts should be looked to more often to decide important and controversial issues and that doing so might relieve the unfair burden placed on federal courts and their ever-expanding jurisdiction. With a crisp and engaging writing style, Judge Sutton uses the structure of our state and federal governments as a backdrop to present a thorough analysis of judicial approaches to issues arising in both the executive and legislative branches, showing the contrast in federal and state court decisions and the merits of judicial federalism—the idea of state courts having a leading role as judicial "laboratories of innovation."

The idea of judicial federalism is not new and Judge Sutton is perhaps its most articulate champion to date. In a 1984 speech given at Case Western Reserve School of Law, the late Supreme Court Justice Sandra Day O'Connor quoted Justice Hugo Black's definition of judicial federalism as a "system where there is sensitivity to the legitimate interests of both State and National Governments, and in which the National Government . . . endeavors [to protect federal rights and federal interests] in ways that will not unduly interfere with the legitimate activities of the States." As Judge Sutton recognizes, striking the right balance between the federal and state interests is the challenge.

In "Who Decides?", Judge Sutton criticizes state court judges' reflexive mirroring of federal court constitutional precedents, "lockstepping," while also analyzing the role of judges as umpires versus gerrymanderers. Judge Sutton calls judicial review "in its most extreme forms [maybe] . . . the greatest kind of gerrymandering ever known," a threat which he sees as corrosive to our democracy. He writes "the typical American, I fear, has come to think of judicial interpretations of our constitutions as another form of gerrymandering—another way, perhaps the most extreme way, for one group or another to get what they want at the expense of their political opponents—and at the expense of large swaths of the American people." Judge Sutton sees the ever-increasing contentiousness of federal court confirmations as "depressing" but "rational" given the power federal judges exercise. The Supreme Court, he argues, should not be seen as an "Oracle of Truth" that we treat as "the only supreme court in country capable of offering an insightful solution to a difficult problem." The solution, according to Judge Sutton, lies in a bar well educated in state constitutional law and state courts sufficiently confident in their own constitution that they are willing to decide issues on that basis.

"Who Decides?" offers a thorough analysis of the distinctions between state and federal court approaches to issues arising in the executive and legislative branches of government. In a comprehensive overview of the differences among the states and the federal government's approaches to executive power, Judge Sutton looks at the origins of the unitary executive model of our federal government and the plural executive models in each of the states. Citing John Locke's truism that "legislative power exists to make laws, not legislators," Judge Sutton expresses skepticism, and a good deal of caution, with the growth of the administrative state and the current trend toward expanded deference to agency regulations under *Chevron*.

Judge Sutton also does a deep dive into the history of federal court efforts to limit state legislative power, beginning with the Yazoo land fraud case in 1810, the first case in which the Supreme Court invalidated a state statute, all the way to single subject and clear title requirements for legislation in state constitutions. As a judge sitting in a village court in New York, I appreciated especially Judge Sutton's entire chapter entitled "Federalism Within Federalism" in which he discusses the innovative role local governments and local courts can play in our system. Often the work of local courts gets overlooked. However, as the courts closest to the people, town and village courts throughout the country work out new approaches to myriad legal challenges each day.

Finally, Judge Sutton looks at the constitutional amendment process in state and federal constitutions and sees the process in the states as far more responsive to the changing wishes of a self-governing nation. Noting our federal constitution was designed to prevent concentrations of power, he finds it ironic, if not a drafting oversight, that the incredibly

arduous process of constitutional amendment leaves federal courts as the unchecked arbiters of constitutional rights. "Did the Framers appreciate everyone else's imperfections but their own? All constitutions eventually become monuments to humility," Sutton writes. However, Judge Sutton is keenly aware of the imperative to strike the right balance lest a constitution too easily amended becomes quasi-legislation and not a governing framework.

The skeptical reader will have questions. While the limits on state court innovation above and beyond the federally set floor is theoretically unlimited, what happens to state court precedent when the federal floor shifts? What remedies are there for those affected by the floor falling out from under them? Are we prepared to accept inconsistent results among the states? Would an enhanced judicial federalism lead to more divisions in the nation, or fewer? Political solutions and judicial appeals take time. State constitutional amendments take even longer. Was Judge Hand correct when he posited that justice delayed is justice denied? What consequences would there be to individual litigants? What are the economic consequences to judicial federalism? All valid questions, and questions for which Judge Sutton has answers.

In all, Judge Sutton's work is an invaluable contribution to the judicial federalism project that should be required reading for lawyers, judges, and anyone interested in the role of the courts in our lives.

Judge Desmond C.B. Lyons is the village justice for the Village of Irvington, NY, where he has served since 2010. Judge Lyons presides over hundreds of criminal and civil matters each year. Judge Lyons also serves as an accessible magistrate in Westchester County, and as acting village justice in the Village of Mamaroneck. When not on the bench, Judge Lyons is a full-time litigator and outside general counsel to non-profits and other domestic and international entities. In his more than 25 years of practice, Judge Lyons has litigated and tried cases in state and federal court, appellate courts and administrative tribunals. A longtime member of the Westchester County Bar Association, Judge Lyons is also very active in state and federal bar associations. Judge Lyons also serves as an adjunct professor at Fordham University, where he teaches in the law and ethics area of the Gabelli School of Business. He is actively involved in his local community, where he was recently awarded the Dave Wade Heart of Gold Award by Abbott House, a not-for-profit that serves families with complex needs.

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NEW YORK STATE BAR ASSOCIATION
COMMERCIAL AND FEDERAL LITIGATION SECTION
COMMENT ON POSSIBLE AMENDMENTS TO
FEDERAL RULES OF CIVIL PROCEDURE
RULES 15, 72, and 87

The Federal Procedure Committee of the Commercial and Federal Litigation Section of the New York State Bar Association takes this opportunity to provide its input as to possible amendments to the Federal Rules of Civil Procedure.

First, we believe that the proposed amendment to F. R. Civ. P. 15 clarifying when an amendment as of right must be made, and the proposed amendment to Rule 72 mandating that service of a Magistrate Judge's recommended disposition and, if appropriate, proposed findings of fact, be made by electronic filing on the docket rather than by mail to be salutary and desirable.

As to the proposed adoption of Rule 87, empowering the Judicial Conference to declare a Civil Rules Emergency, we note that our Committee had provided a comment last year when requested as to suggestions for possible amendments to the Federal Rules in the event of a national emergency. Our comment had been predicated on the assumption that any National Emergency to be addressed by any contemplated rules changes would be similar to the one that was being experienced last year when the request for comment was made: nationwide in scope, and of a sufficient severity to cause the closure of public access to the federal courts. We made our suggestions with that assumption in mind.

Proposed Rule 87 would permit the Judicial Conference to declare a Rules Emergency without an Executive branch determination that such an emergency exists, either nationally or locally. Indeed, there is no expressed criteria by which the Judicial Conference can determine that such an emergency exists. We have concerns about such an approach.

While we are appreciative of the separation of powers and the authority vested in the Judicial Conference by virtue of the Rules Enabling Act, we believe that Rule 87, if adopted, should contain explicit criteria under which the Judicial Conference may determine that an Emergency, either national or local, exists.

Respectfully submitted,

New York State Bar Association
Commercial and Federal Litigation Section
Daniel K. Wiig, Section Chair

December 7, 2021

Approved by the Commercial & Federal Litigation Section Executive Committee, December 7, 2021

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NEW YORK STATE BAR ASSOCIATION
COMMERCIAL AND FEDERAL LITIGATION SECTION
COMMENT ON SENATE BILL 4730/ASSEMBLY BILL 2543[1]

SUMMARY

The Office of the Governor has asked for comments on Senate Bill 4730/Assembly Bill 2543 ("S.4730/A.2543" or "Bill"), which amends provisions in the New York False Claims Act, N.Y. State Fin. L. §§ 187-194 ("NYFCA" or "Act"), to impose liability for certain individuals and businesses that intentionally and illegally fail to file tax returns. The Commercial and Federal Litigation Section of the New York State Bar Association ("Section") strongly recommends that the Bill be signed into law, as further explained below.

COMMENT

I. OVERVIEW

The Section is comprised of a wide cross-section of practitioners, including members in the private and public sectors, solo practitioners, and members of small, mid-size, and large law firms, who actively litigate in state and federal courts in New York and adjacent states, and in national and international forums. Thus, in offering the following comments, the Section is drawing on a broad range of experience.

II. THE BILL

As explained in the State Senate Introducer's Memorandum In Support, the Bill would "amend[] section 189 of the State Finance Law by repealing subsection 4(a)(iii) to make individuals and corporations with a net income or sales of over $1 million liable under the False Claims Act for knowingly and illegally failing to file tax returns that cost the state or local government at least three hundred fifty thousand dollars in lost revenue."[2]

III. CONCLUSION

The Section strongly recommends that the Bill be signed into law. The Bill would strengthen the NYFCA's purpose of combatting fraud against the State by closing a loophole that permits wealthy businesses and individuals to evade the Act's reach by knowingly failing to file tax returns. In doing so, the Bill would promote greater tax fairness for individuals and businesses who file honest and correct New York tax returns, increase available resources for New York to address tax violations, and assist New York in its recovery of unpaid taxes.

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1 Opinions expressed in this memorandum are those of the Section and do not represent the opinions of the New York State Bar Association unless and until the memorandum has been adopted by the Association's House of Delegates or Executive Committee.

2 Senator Liz Krueger, Bill Number S.4730, New York State Senate Introducer's Memorandum In Support (Feb. 11, 2021).

The NYFCA allows the State of New York, a New York local government, or whistleblowers supervised by the State or local government, to file a civil action against individuals or corporations that defraud the State. In 2010, the NYFCA was amended so that individuals and corporations that filed false tax returns or other false records and statements were liable under the NYFCA if they met certain monetary thresholds. In 2013, the NYFCA was again amended to expand liability to individuals and corporations that knowingly concealed or knowingly and improperly avoided obligations to pay money to the State or a local government. However, a loophole was included in the 2013 amendment, which stated that this provision did not extend to tax frauds. As a result, individuals and businesses that file false tax returns are liable under the NYFCA, whereas *individuals and businesses that fail to file any tax returns at all are able to escape liability*.

This loophole serves no legitimate purpose and weakens the NYFCA. It puts honest, tax-paying, New York businesses at a competitive disadvantage insofar as it fails to impose liability on out-of-state corporations that hide New York-source income and then knowingly and illegally fail to file New York tax returns. In addition, it discourages whistleblowers from coming forward with evidence of wealthy individuals or corporations that violate the law by failing to file New York tax returns.

The New York State Bar Association has a long history of support for legislation to enact and strengthen the NYFCA. It has also recognized that whistleblower enforcement is an important part of the NYFCA's statutory framework. In 2006, the Section adopted a Resolution reiterating the Bar Association's longstanding endorsement of enacting the NYFCA and emphasized the importance of including whistleblower provisions in the law. In 2010, the Bar Association expressed its support for the 2010 amendment in a letter to the Governor, noting that the amendment would strengthen the NYFCA, enhance the State's ability to recover financial losses due to fraud against the government, and further protect the interest of the people of the State of New York. If enacted, S.4730/A.2543 would further these same goals.

For these reasons, the Section strongly recommends that the Bill be signed into law.

Respectfully submitted,

New York State Bar Association Commercial and Federal Litigation Section 12/7/21
Daniel K. Wiig, Section Chair

Approved by the Commercial & Federal Litigation Section Executive Committee, 12/7/21

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