

Cal-Tax Digest

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Courts



State Gambles, Taxpayers Lose

By Greg Turner

It would be bad enough if this were only your typical story of an outrageous raid on taxpayers' dollars or yet another example of a fee that is actually a tax. However, the incredible award of \$88.5 million in legal costs by a three-member arbitration panel, stemming from a challenge to the state's illegally imposed \$300 smog impact fee, could have far more costly long-term implications for California taxpayers.

The "fee" in question was adopted in 1990 to be placed on all vehicles last registered outside the state unless the vehicle met California's stricter emissions standards. The stated purpose of the legislation was to provide equity to those California taxpayers who purchased more expensive California emission-certified vehicles, to provide funding for environmental programs, and promote good health and safety standards in this state. The Legislature's own lawyer said at the time the tax was of dubious constitutionality.

At \$300 per taxpayer, however, there was little justification to litigate. This is not unlike many questions arising in the area of taxation. Litigation is simply not economical as the costs of going to court far outweigh the amount of tax imposed on an individual taxpayer.

Nevertheless, in 1997 someone did file suit and the Sacramento County Superior Court ruled that the smog impact fee violated the California Constitution (which requires all taxes on motor vehicles except the sales and use tax and the vehicle license fee be dedicated to specific transportation services). Further, the trial court held that the "fee" violated the United States Constitution



*Greg Turner
is general counsel and
legislative director of
the California
Taxpayers'
Association.*

("[t]he effect of this fee is similar to the practice of charging license fees and use taxes on vehicles sold outside California that are higher than the license fees and taxes imposed on vehicles sold inside California. 'The discrimination between interstate and local commerce is plain.... [T]he violation of the commerce clause is patent.' " (*Jordan v. Department of Motor Vehicles*, (1999) 75 Cal. App. 4th 449, 463).

The Department of Motor Vehicles appealed and plaintiffs filed motion with the trial court for attorney's fees. On the motion for attorney's fees, the trial court found that the litigation created a "common fund" and that the attorneys were consequently entitled to be paid a percentage from the fund, much like a class action lawsuit. Finding the fund to be worth an estimated \$364 million (the statute of limitations on refunds was four years), plaintiff's attorneys requested and were granted a 5 percent fee or \$18.194 million.

The Third District Court of Appeal rendered its decision on the DMV's appeal in October of 1999. It sustained the findings of the trial court as to the unconstitutionality of the fee but reversed the trial court's decision to create a common fund, thereby denying the plaintiff's lawyers their percentage of all the refunds the state was legally obligated to refund.

The Legislature and governor recognized the absurdity of having every taxpayer who paid the fee file suit for refund of a \$300 fee and the inequity of denying taxpayers beyond the four-year statute of limitations their refund for what from the outset was criticized as an illegal tax. They passed and signed SB 215 (Karnette-Dunn), appropriating \$665 million to a special fund and waiving the statute of limitations for the stated purpose of providing a refund to all the estimated 1.7 million taxpayers who had paid the tax.

Lobbyists paid by the politically connected lawyers who litigated the case were successful lobbying the governor's office and the Legislature to add the following provision to SB 215 just before it was adopted:

"In addition, the appropriate level of court costs, fees, and expenses in the settlement of the case of *Jordan v. DMV*, shall be determined through binding arbitration, and all of those fees, costs, or expenses shall be paid with funds from the account."

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In July, subsequent to the enactment of SB 215, an arbitration agreement was signed between the plaintiff's attorneys and the Attorney General's Office. Among other things, the agreement provided that the arbitration would be "open" (this allowed the panel to treat the litigation as a common fund despite the Court of Appeal's rejection of this theory as applicable in this type of case), and that there would be no floor and no ceiling on the amount of fees that might be awarded by the panel. Even assuming a common fund was a legitimate option, the trial court limited the award to a percentage of those refunds the state was obligated by law to pay (those within the four-year statute of limitations).

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In November of 2000, the arbitration panel met (three former jurists including former Supreme Court Chief Justice Malcolm Lucas) and took testimony from several expert witnesses concerning the appropriate amount of an attorney fee award in common fund, class action, and private attorney general cases. Keep in mind that the Court of Appeal had invalidated the common fund status of the case. In the end, the arbitration panel awarded plaintiffs attorneys 13.3 percent of the \$665 million appropriated by SB 215, or approximately \$88.5 million for their work in recovering \$1,200 plus interest and penalties for four taxpayers. (Press reports indicate the attorneys requested in excess of \$100 million.)

News of this egregious and unprecedented award began to circulate despite a clause in the arbitration agreement that the entire process was intended to be secret. As a result, Governor Gray Davis asked the panel to reconsider the award. Two of the arbitrators, retired judges Bonnie Lee Martin and John Trotter, replied, "The state chose to gamble and lost."

Correction, the taxpayers lost. And the flippant comment by these former jurists in the context of this award raises serious questions about the legitimacy of this entire process. Unless the courts intervene, a big chunk of what was intended to be a refund to taxpayers will pad the pockets of lawyers. It is ludicrous to say these attorneys deserve \$88.5 million because they worked so hard and the case was so risky. This award was based on a percentage of a fund nearly triple that originally requested at the trial court (13.3 percent vs. 5 percent). Moreover, these lawyers did not secure refunds beyond the statute of limitations as a consequence of their litigation. That came by action of the governor and Legislature. To award the

lawyers fees based on the total amount of refunds would be to base the award on the value of their lobbying effort in Sacramento.

The precedent such a process and exorbitant award sets has long-term implications for California taxpayers that could be far more costly than even this award. Are all questions of tax litigation now going to be certified for common fund or class status giving lawyers a percentage of the purse and an incentive to litigate these questions? As much as taxpayers cheered the ruling on the substantive tax question in this case, the long-term consequences of the treatment of attorney fees may be more than the taxpayers bargained for.

SB 215 has its own problems. The California Constitution restricts the Legislature to one appropriation per bill, except in the budget bill. SB 215 provides that the costs and fees are to be paid "with funds from the account." To avoid this constitutional dilemma, SB 215 might be interpreted to mean that the "costs" were to be paid out of the \$665 million appropriation or to be paid by additional monies from a subsequent appropriation.

The legislative history suggests that the appropriation was of an amount sufficient only to cover the costs of refunding the tax. The \$665 million figure came from DMV's estimate as the amount necessary to cover the actual refunds to be paid. Even DMV's administrative costs were to come from a separate appropriation (see AB 809, Lowenthal).

This raises an interesting question. Did the Legislature appropriate only enough money to pay the refunds, knowing that these lawyers would have their arbitration secretly concluded, the amount of their fee determined and paid to them from the fund before it was exhausted by refund claims, thereby forcing a subsequent appropriation, not for loathsome attorney's fees, but additional refunds to taxpayers?

Aside from the obvious, that an \$88.5 million attorney fee award (which according to Mr. Lucas, the former chief justice, amounted to \$8,800 per hour for the attorneys) is not "an appropriate level" (as required by SB 215), it also amounts to an illegal delegation of legislative authority. Article IV, Section 1 of the California Constitution vests the legislative power of the state in the California Legislature (except the people reserve the right of initiative and referendum). Such legislative power,

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encompassing the power of appropriation, cannot be delegated. Yet, SB 215 delegated to an arbitration panel the authority to determine the amount of an appropriation absent any guidelines for what constituted an "appropriate level" of costs or statement of public purpose, and lacked any limitation whatsoever on the amount that could be awarded.

Assuming that SB 215 was a permissible delegation of power, delegating to the arbitration panel the power to bind the state to any amount of an award, up to and perhaps in excess of the appropriated \$665 million, constituted an illegal gift of public funds. No reasonable person could conclude that an expenditure of \$88.5 million for attorneys fees, having so little relation to any recognized benchmark of hourly billing rates or recognized standards of attorney fee awards for this type of case, has any public purpose and would therefore constitute an illegal gift of public funds under Article XVI, Section 6 of the California Constitution.

Even if one might hypothesize a Legislature willing to pass such a bill of appropriation to award these attorneys \$88.5 million for their efforts, there was no finding of legitimate public purpose. Neither could the Legislature delegate to this or any other arbitration panel the authority to make these determinations in its stead.

Fortunately, this is not over. At Governor Davis' request, Attorney General Bill Lockyer filed suit January 17 in Sacramento County Superior Court. Also at this writing, State Controller Kathleen Connell was refusing to pay the award and State Board of Equalization Member Dean Andal also filed a lawsuit and was pushing the board to challenge the award in court. The California Taxpayers' Association applauds their efforts to protect the taxpayers' purse.

Finally, this whole sorry mess should serve as a lesson to the state's policymakers of what can transpire from an illegal tax. Refunds can be awkward. Those who actually paid them may not be around to get a refund. And lawyers are often the biggest beneficiaries.