Case No. S241471

IN THE SUPREME COURT OF CALIFORNIA

Michael McClain, Avi Feigenblatt
and Gregory Fisher,
Plaintiffs, Appellants and Petitioners,
vs.
Sav-On Drugs, et al.,
Defendants and Respondents.

PETITIONERS' REPLY BRIEF ON THE MERITS

After a Decision of the Court of Appeal
Second Appellate District, Division 2
Case Nos. B265011 and B265029
Affirming a Judgment Of Dismissal Following
An Order Sustaining Demurrer Without Leave to Amend
Los Angeles County Superior Court, Case Nos. BC325272 and BC327216
Honorable John Shepard Wiley

Service on the Attorney General and the Los Angeles District Attorney
Required by Bus. & Prof. Code § 17209 and
Cal. Rules of Court, Rule 8.29(a), (b), and (c)(1)

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TABLE OF CONTENTS

TABLE OF AUTHORITIES

Page(s)

CASES

STATUTES

Petitioners submit this reply to the Answer Briefs on the Merits filed by Respondent Retailers and the California Department of Tax and Fee Administration ("CDTFA"). In this brief where a reference could be to either the CDTFA, the SBE, or both depending on the time frame at issue, they are sometimes referred to as "the State Agency" or "the State Agencies." Petitioners' Opening Brief on the Merits in this Court is cited as "OBOM." All citations to Respondents' briefs are to their Answer Briefs on the Merits in this Court unless otherwise indicated.

I. REPLY TO RESPONDENTS' ARGUMENTS REGARDING THE CONSTITUTIONALITY OF THE RULINGS BELOW.

Respondents relegate their constitutional arguments to the end of their Answer Briefs. (CDTFA at 43-50; Retailers at 53-57.) Petitioners will instead address the constitutional issues at the outset of this brief so they are clearly in mind when evaluating the parties' divergent interpretations of Civil Code §1656.1, Tax Code §6901.5, and *Javor v. State Bd. of Equalization* (1974) 12 Cal.3d 790 ("*Javor*").

A. By Rewriting Civil Code §1656.1's Rebuttable Presumption into an Irrebuttable Presumption, *McClain* and the Retailers' Arguments Would Make the Collection of All Sales Tax Reimbursement Unconstitutional.

By way of background, Petitioners argued in their Opening Brief on the Merits that the Court Of Appeal's decision (*McClain v. Sav-On Drugs*, (2017) 9 Cal. App. 5th 684 ("McClain')) would make the rebuttable presumption of Civil Code §1656.1 irrebuttable and would thereby destroy the consensual basis for sales tax reimbursement that this Court held was required in *National Ice & Cold Storage Co. v. Pacific Fruit Express Co.* (1938) 11 Cal.2d 283 ("*National Ice*"). (OBOM at 43.) The constitutionally-required consensual basis for retailer collection of sales tax

reimbursement was subsequently statutorily required as well by Civil Code §1656.1. (OBOM at 10-11.)

The Retailers' counter-argument is instructive. The Retailers' do not discuss or even cite this Court's decision in *National Ice* which was the progenitor of Civil Code §1656.1. Much less do the Retailers attempt to answer the question that troubled this Court in *National Ice*, which was "By what legal principle is it constitutional for the Tax Code to obligate a purchaser to reimburse a retailer for sales taxes that are legally levied upon the retailer alone?" (OBOM at 10.) *See, e.g., Oksner v. Superior Court of Los Angeles County* (1964) 229 Cal. App. 2d 672, 684 ("Due process forbids the seizure of one man's property for satisfaction of the debt of another.")

Instead, the only response of Respondents to this serious constitutional question is the following:

> Plaintiffs assert that dismissing their claim under section 1656.1 would render the entire tax system unconstitutional. (OBOM:43.) In fact, upholding Plaintiffs' contract claim would do so.
>
> * * * *
>
> Plaintiffs' contract claim under section 1656.1 would disrupt, not promote, the orderly tax collection process in California, thereby giving rise to an unconstitutional attempt to enjoin or interfere with the lawful collection of a tax.

(Retailers at 49-50.)

Obviously, the Retailers' counter-argument is not in any way a rebuttal to "Petitioners' assert[ion] that dismissing their claim under section 1656.1 would render the entire tax system unconstitutional." Rather, the Retailers' counter-argument is a transparent attempt to change the subject to a different constitutional argument that the CDTFA makes in its Answer Brief. (CDTFA at 38-39 ["Allowing such claims would undermine the

fundamental purpose of Section 32: to "avoid unnecessary disruption of public services that are dependent on that revenue."].)[1]

Thus, the Respondents have no answer to the most basic question in this case: *If not customer consent*, then by what legal principle is it constitutional for the Tax Code to obligate customers to reimburse retailers for sales taxes that are legally levied upon the retailers alone? This Court answered that question 80 years ago in *National Ice*: there simply is no such legal principle other than customer consent. (*See National Ice* at 292 ["such declaration of [unconstitutionality] is not intended to indicate the illegality of authority which may be lodged in a retailer to 'pass on' the tax to a purchaser with the latter's consent thereto, either expressly or impliedly given." (emphasis added)].) The Legislature reached the same conclusion 40 years ago when it adopted Civil Code §1656.1 ("Whether a retailer may add sales tax reimbursement to the sales price of the tangible personal property sold at retail to a purchaser depends solely upon the terms of the agreement of sale.) (Emphasis added.)

Perhaps realizing that the statutory scheme would indeed be unconstitutional if Petitioners were not allowed at least to pursue the Retailer Defendants pursuant to §1656.1, the Board itself has stated it takes no position on whether Petitioners can or cannot pursue the retailers for breach of contract pursuant to §1656.1:

> The Department addresses plaintiffs' sales tax reimbursement refund claim (Fifth Cause of Action), which names the Department and a set of retailers as defendants. Plaintiffs did not name the Department as a defendant to their breach of contract claim (First Cause of Action); the Department therefore leaves the

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[1] The CDFTA's argument under California Constitution, article XIII, section 32, is refuted at pp. 46-49, *infra.*

briefing on the viability of this claim largely to retailer defendants.

(CDTFA at n.2, p.15.)

B. By Denying Customers Any Recourse To Recover Excess Sales Tax Reimbursement From The State Agencies, *McClain* And Respondents' Arguments Would Make Tax Code §6901.5 Unconstitutional.

1. Reply to the CDFTA's Arguments Regarding the Takings Clause.

The CDTFA's entire argument for inapplicability of the Takings Clause to Tax Code §6901.5 is encapsulated in a single footnote on the last page of its brief:

> [A] State's exercise of its taxing power, standing alone, does not implicate the Takings Clause." (*Koontz v. St. Johns River Water Management Dist.* (2013) __ U.S. __, 133 S.Ct. 2586, 2600-2601 [collecting cases]; see also *Houck v. Little River Drainage Dist.* (1915) 239 U.S. 254, 264 ["the power of taxation should not be confused with the power of eminent domain"].)

(CDTFA at n. 31, p.50, emphasis added.)

The CDTFA's argument has a glaring omission. The CDTFA does not even attempt to establish that excess sales tax reimbursement remitted by retailers under Tax Code §6901.5 is a "tax." In fact, the opening phrase of Tax Code §6901.5 says the opposite:

> When an amount represented by a person to a customer as constituting reimbursement for taxes due under this part is computed upon an amount that is not taxable or is in excess of the taxable amount and is actually paid by the customer . . .

(Tax Code §6901.5, emphasis added.)

How can a payment that is "computed upon an amount that is not taxable or is in excess of the taxable amount" possibly be a "tax"? The CDTFA's brief does not offer even a clue as to how that might be possible.

Additionally, under §6901.5 the excess sales tax reimbursement must be either "returned by the person [i.e. the retailer] to the customer" or "remitted by that person to this state." If Tax Code §6901.5 were designed to raise tax revenue, there would be no reason to provide retailers with the option of returning the excess sales tax reimbursement to customers, since that would defeat the goal of raising tax revenue. Indeed, CDTFA admits §6901.5 is designed to prevent unjust enrichment of retailers (an escheat function), rather to raise tax revenues:

> [S]ection 6901.5 ensures as a matter of equity that retailers do not in any circumstance retain and profit from monies collected from consumers as sales tax reimbursement with the representation and understanding that they would be paid over to the State.

(CDTFA at 45, emphasis added.)

It is well settled that permanent escheats are subject to the Takings Clause. (*See, e.g., Hodel v. Irving,* (1987) 481 U.S. 704, 706, 717 ("*Hodel*") ["The question presented is whether the original version of the 'escheat' provision of the Indian Land Consolidation Act of 1983 [citation omitted] effected a 'taking' of appellees' decedents' property without just compensation . . . . Since the escheatable interests are not, as the United States argues, necessarily *de minimis*. . . a total abrogation of these rights cannot be upheld."]; *Webb's Fabulous Pharms. v. Beckwith*, 449 U.S. 155 (U.S. 1980) ("Webb's") [Florida statute providing that interest accruing on interpleader monies deposited with the clerk shall be deemed income of the clerk's office violates the Takings Clause]; *Cerajeski v. Zoeller* (2013) 735

F.3d 577 (7th Cir. , Posner J.) ("*Cerajeski*") [Indiana's escheat of interest on a small bank savings account violates the Takings Clause].)

The CDTFA argues, however, that the "tax system will still operate to the public benefit" by "reading *Javor* narrowly" so as to "foreclose[] consumer class action refund suits challenging retailers' routine, day-to-day decisions about the application of conditional sales tax exemptions." (CDTFA at 29.) Indeed, "foreclose[ing] . . . refund suits" has been the State Agencies' strategy for decades.

Although the CDTFA admits that "information from customers could cause the Department to conduct an audit . . . [a]nd it can require a retailer to return already collected excess sales tax reimbursement to those consumers who paid it" (*id.* at 41), the State Agencies never do so. For example, for decades the State Agencies did not voluntarily conduct an audit and rule on the taxability issues in *Javor*, *Loeffler,* the instant case, nor — to the best of Petitioners' knowledge – on any other customer claim for refund of excess sales tax reimbursement.

Instead, the State Agencies wait for retailers to file tax refund claims, which retailers never do owing to an "incentive problem" — a phrase which the CDTFA coined and acknowledges to exist. (*See* CDTFA at 14 and 33 ["The Court in *Javor* stepped in only to correct an "incentive" problem; some percentage of retailers had failed to submit claims to the Department for refunds clearly due, because they would not be entitled to retain the benefits of their efforts."]

This case is a perfect example of the State Agencies' refusal to address overcharges of sales tax reimbursement on legally tax exempt transactions. The SBE was brought into this case in February 2006 on Cross-Complaints filed by the Retailers on order of the Superior Court. (Retailers at 29.) It is now twelve years later, and the CDTFA admits that (1) neither the Paliani letter nor its restrictive conditions for tax exemption

have ever been considered by the Board, nor has the Board ever disagreed with Petitioners' claim that all pharmacy sales of test strips and lancets are exempt from the sales tax. (OBOM at 18-19.) Yet the State Agencies have never initiated an audit to examine the legality of Paliani conditions, instead preferring to expend enormous resources to defend Petitioners' *Javor* claim (which seeks to compel the State Agencies to perform their job and make a taxability determination).

The CDTFA's brief attempts to excuse the State Agencies' misfeasance by stating that they favor means for securing the "public benefit" other than refunds of excess sales tax reimbursement, such as by "operating a competitive marketplace" so that consumers can "exercise[e] their purchasing power." (CDTFA at 29.) Apparently the CDFTA is unaware that the State Agencies' admitted practice of "reading *Javor* narrowly" so as to "foreclose[] consumer class-action refund suits" is a *per se* violation of the Takings Clause. The "taking" of excess sales tax reimbursement under R&TC §6901.5 operates as a "physical taking" because the State ends up with physical possession of the money (rather than a "regulatory taking" such as enacting a land use regulation). Under *Brown v. Legal Foundation* (2003) 538 U.S. 216, 233-234 ("*Brown*"), physical takings amount to a *per se* taking for which victims are entitled to just compensation without "complex factual assessments of the purposes and economic effects of government actions." (Emphasis added.)

In other words, as to physical takings, there is no balancing of the "public benefit" of the State paying "just compensation" versus other approaches such as the State Agencies "operating a competitive marketplace." Rather, the express language of the Takings Clause — "nor shall private property be taken for public use, without just compensation" — is strictly enforced with respect physical takings. *See Koontz v. St. Johns River Water Management Dist.* (2013) __ U.S. __, 133 S.Ct. 2586 at

2600 ["We are not here concerned with whether it would be 'arbitrary or unfair' for respondent to order a landowner to make improvements to public lands that are nearby. . . . Whatever the wisdom of such a policy, it would . . . amount to a *per se* taking similar to the taking of an easement or a lien."].

Here, however, the CDTFA admits that the State Agencies' strategy has been to "foreclose [] consumer class-action refund suits" in favor of other methods to secure the "public benefit." (CDFTA at29.) That is a *per se* violation of the Takings Clause that can only be cured by this Court reversing the Court of Appeal and adopting a robust interpretation of the *Javor* remedy. To be constitutional, such interpretation must enable Petitioners to obtain a determination of the legality and enforceability of the Paliani conditions, first from the CDTFA and, if necessary, from the courts under Tax Code §§6933-6934.

2. Reply to the Retailers' Arguments Regarding the Takings Clause.

The Retailers attempt to rebut applicability of the Takings Clause on the ground that that there is "no state action." (Retailers at 55-57.) Tellingly, the State itself does not argue that there has been "no state action."

The Retailers cite three cases in support of their "state action" argument. (Retailers at 56.) Those cases, at most, hold that a Takings Clause claim requires "state action" and cannot be asserted against private parties. But here, Petitioners only argue that the State would be liable under the Takings Clause, and there is abundant proof of "state action" by the State Agencies.

The mere fact that the State has escheated the funds and is unjustly enriched thereby is sufficient "state action", as shown by all of the escheat cases cited in Petitioners' Opening Brief on the Merits. Moreover, there is

abundant evidence of other forms of "state action" here. The State enacted an escheat statute — Tax Code §6091.5 — without providing a statutory procedure by which customers who are charged excess sales tax reimbursement can make a claim for return their property. Through issuance of the Paliani letter in contravention of the Administrative Procedure Act ("APA") and without authority from the Board, the SBE staff commanded 13,000 retailers to employ pointless and burdensome new conditions to the tax exemption for test strips and lancets. Since the SBE never articulated any public policy reason for applying new conditions to test strips and lancets (but not to insulin and insulin syringes) , it appears that the new conditions were mandated for the sole purpose of discouraging retailers from honoring the tax exemption. And for fifteen years thereafter and counting, the State Agencies have accepted sales tax reimbursement without notifying California pharmacies and diabetics that the conditions for tax exemption stated in Paliani letter were unauthorized by the Board and void for lack of compliance with the APA. As a result, the State has been unjustly enriched by tens of millions of dollars per year. It is difficult to imagine a deprivation of property without due process of law and a taking without just compensation that has more "state actions" than is present here.

3. Reply to Respondents' Arguments Regarding The Due Process Clause.

As previously discussed, the CDTFA argues that Tax Code §6901.5 imposes a "tax" rather than an escheat, and that the Takings Clause does not apply to taxes. (*See* pp.4-5, *supra.*) Even if the CDTFA were correct that Tax Code §6901.5 imposes a "tax" rather than an escheat, that would not help the CDTFA here. Tax Code §6901.5 would still be unconstitutional under the Due Process clause because the State does not

afford "meaningful backward looking relief to rectify an unconstitutional deprivation." (*See* OBOM at 33-35 and cases cited therein).

The CDTFA responds:

> Plaintiffs state that they too must be provided with "'meaningful backward-looking relief'" . . . . even though the Legislature (in section 6901.5) did not provide for this remedy. (OBM at pp. 33-35.) Due process does not require this result.

(CDFTA at 45, emphasis added.)

The CDTFA fails to recognize that the State Legislature does not determine the confines of Fifth Amendment Due Process, the Constitution does. The Due Process Clause ("No person shall... be deprived of life, liberty, or property, without due process of law") is not limited to "taxpayers" but runs to "persons" with respect to their "property:" Here, no one contends that customers are not "persons" or that excess sales tax reimbursement does not belong to them. (*See Loeffler* at 1115 quoting *Javor* at 802 ["We observed that the Board 'is very likely to become enriched at the expense of the customer to whom the amount of the excessive tax actually belongs.'"] (Emphasis added).)

The CDTFA next argues that as "nontaxpayers" under the Tax Code, Petitioners would have no standing to assert a Due Process challenge to Tax Code §6901.5. (CDFTA at 46.) Of course, it is Respondents who wants to characterize excess sales tax reimbursement as a "tax" rather than an escheat. But even if that characterization were true, Petitioners would have standing to bring a Due Process challenge to §6901.5 for failing to afford them any "meaningful backward looking relief." That is because §6901.5 itself expressly recognizes that customers have an ownership interest in excess sales tax reimbursement:

> When an amount represented by a person to a customer as constituting reimbursement for taxes due

> under this part is computed upon an amount that is not taxable or is in excess of the taxable amount and is actually paid by the customer to the person, the amount so paid shall be returned by the person to the customer upon notification by the Board of Equalization or by the customer that such excess has been ascertained.

(Tax Code §6901.5, emphasis added.)

Indeed, out of the three categories of involved parties (customers, retailers, and the State) it is only retailers who are forbidden by §6901.5 from retaining any excess sales tax reimbursement. (CDFTA at 45 ["[S]ection 6901.5 ensures as a matter of equity that retailers do not in any circumstance retain and profit from monies collected from consumers sales tax reimbursement."].) As the only real-parties-in-interest, customers therefore have standing to assert a Due Process challenge to Tax Code §6901.5.

The CDTFA also argues that there is no Due Process violation because Tax Code §6905.1 does not create or recognize "a vested property interest held by consumers." (CDTFA at 44-45.) That argument is contrary to the CDTFA own admission. (CDTFA at 45 ["Of course, once it has been conclusively ascertained through the processes established in the tax code that a retailer has paid excess sales tax . .[t]he Department will ensure that refunded tax payments are in turn passed back to the consumers who paid sales tax reimbursement."].) It is also contrary to the Retailers acknowledgment that the excess tales tax reimbursement "rightfully belongs" to customers. (Retailers at 22 ["this Court allowed the [Javor] suit to proceed—as it was unwilling to leave the Board with the excess revenue that rightfully belonged to the purchasers."].)

The CDFTA apparently wants to draw a distinction between that which "rightfully belongs" to customers and that in which they have "a

vested property interest." But in doing so, the CDTFA merely assumes its own conclusion: that it can keep excess sales tax reimbursement without providing due process to customers to whom it rightfully belongs. Not surprisingly, the CDTFA cites no authority that supports such a circular argument.

The Retailers' argument is equally circular. They argue that:

> [R]etailers, as the taxpayers, are afforded the opportunity to file refund claims with the Board and, thus, are clearly afforded the constitutionally-mandated procedural due process. (*Loeffler, supra*, 58 Cal.4th at pp. 1107-1108 [retailers are permitted to file refund claims with the Board].) Therefore, Plaintiffs do not derive any right to be heard from a statutory scheme that does not directly affect them. (*Doyle v. Oklahoma Bar Ass'n* (10th Cir. 1993) 998 F.2d 1559, 1567 [parties do not have due process interest merely because government's taking of another's substantive right may have a derivative impact on them].)

(Retailers at 52, emphasis added.)

The Retailers' argument assumes that only retailers are "afforded the constitutionally-mandated procedural due process" with respect to their "substantive right" to file a tax refund claim, so customers have no "due process interest" in rights which "merely... may have a derivative impact on them." That is the same argument as made by the CDTFA, just substituting the term "substantive right" for "vested right." It assumes its own conclusion that customers have no "substantive right" to either due process or the excess sales tax reimbursement of which they were deprived.

If, by contrast, one accepts that the rightful owners of escheated property have a "substantive right" to due process (as was held by this Court in *State v. Savings Union Bank & Trust Co.* (1921) 186 Cal.294 ("*State v. Savings*")) and "just compensation" under the Takings Clause (as was held in cases such as *Hodel*, *Webb's*, and *Cerajeski*), then the

Retailers' circular argument unwinds. Because the rightful owners of escheated property have a Constitutional "substantive right" to procedures for the recovery of such property, the impact of a "statutory scheme" [Tax Code §6901.5] that confiscate such property does have a direct "impact on them" (rather than a "derivative impact on them" as the Retailers contend).

The Retailers also argue that "Plaintiffs voluntarily paid sales tax reimbursement to the Retailers as a matter of implied contract, which does not implicate due process." That is a straw man argument. Petitioners do not claim that their payment of sales tax reimbursement to the retailers gives rise to any claim other than their First Cause of Action against the Retailers for breach of the contract specified in Civil Code §1656.1, including breach of the duty of good faith and fair dealing.

Petitioners' constitutional arguments, by contrast, arise from the State escheating under Tax Code §6901.5 the excess sales tax reimbursement from the Retailers' custody and retaining such amounts without providing any procedures by which the rightful owners — the customers – can reclaim the property belonging to them. (*See, e.g. State v, Savings, Hodel, Webb's*, and *Cerajeski.*)

In the category of "no harm, no foul," the Retailers argue that "(e)ven if retailers opted not to collect sales tax reimbursement, but merely chose to increase the cost of the products to account for the sales tax paid, the economic effect would be the same on the consumer." (Retailers at 51, emphasis added.) That argument is true if the Retailers "assumed" the "sales tax paid" and raised their prices by a corresponding amount. But here the sales of test strips and lancets were legally tax exempt, so there was no need for the Retailers to pay sales tax, and therefore no need to raise prices. Indeed, the Retailers' argument demonstrates how diabetics have been damaged by the Retailers collecting sales tax reimbursement on tax-exempt sales of test strips and lancets.

II. PETITIONERS FIRST CAUSE OF ACTION ALLEGES AN ACTIONABLE CLAIM AGAINST THE RETAILERS FOR BREACH OF THE CONTRACT SPECIFIED IN CIVIL CODE §1656.1.

The Retailers' brief addresses Petitioners' First Cause of Action by paraphrasing at p. 46 three arguments from the Court of Appeal's opinion: *i.e.* that the First Cause of Action (1) is "premised on the claimed existence of an unwaivable exemption" (*See* Op. at 701), (2) would "have a court make taxability determinations in the first instance" (*See* Op. at 701) and (3) is "based upon unstated intent" of customers. (*See* Op. at 705).

The substance of each of those arguments is rebutted in the sections below. More generally, the consequence of Respondents' position would be that the Board could defeat any suit seeking to utilize Javor by adopting a contrived position that manufactured a dispute as to "taxability," or by stating that it has not considered the issue. And that is what the Board is, in fact, trying to do here. Specifically, despite convincing the trial court that the issue of taxability was "hotly disputed" by the Board, the Board later admitted in its Respondent's Brief before the appellate court that this was not true at all; that despite knowing about this issue at least since 2005, meaning for over 12 years, it still has not decided it:

> Appellants interpret Regulation 1591.1 to mean that all sales of glucose test strips or skin puncture lancets are exempt from sales tax. However, there has been no binding determination by the Board that Appellants' interpretation is correct. The Board could well come to a different conclusion, ruling that sales of skin puncture lancets and glucose test strips are nontaxable only if the products are furnished by an individual registered pharmacist (and not picked up off the shelf or dispensed by an employee who is not a registered pharmacist) and only if the customer presents documentation to show that the products are purchased pursuant to the instructions of a physician to control diabetes (such as a prescription or a copy of the written

> instructions). Because the taxability issue in this case has not been decided by the Board, the Superior Court properly dismissed the lawsuit."

(SBE's Respondent's Brief Before Appellate Court, p. 34)

Respondents now argue before this Court that they can continue to collect millions of dollars in unauthorized sales tax "reimbursement" from diabetic consumers, and that there is nothing consumers or the courts can do about it, so long as the Board never decides "taxability in the first instance." This cannot be the law.

A. Reply to the Retailers' Argument That Petitioners' Breach of Contract Cause of Action "Is Premised on the Claimed Existence of an Unwaivable Exemption."

The Retailers and the Court of Appeal contend that "plaintiffs' breach of contract cause of action is premised on the claimed existence of an unwaivable exemption." (Retailers at 46, Op. at 701.) On the contrary, Petitioners acknowledge that retailers can waive the tax exemption, but that does not mean that retailers can both waive the tax exemption and charge customers excess sales tax reimbursement. As pointed out by this Court in *Loeffler,* the Legislature in adopting 1978 Senate Bill 472

> added Civil Code section 1656.1 ..., permitting but not requiring the addition of reimbursement charges, designating the charges as a matter for a contractual agreement between seller and buyer, and permitting the retailer to absorb the tax.

(*Loeffler* at 1117, emphasis added.)

Thus, whether purchasers can be saddled with the cost of such a waiver is "a matter for a contractual agreement between seller and buyer." Absent an agreement from the buyer, the retailer must "absorb the tax."

Indeed, the SBE's Respondent's Brief in the Court of Appeal admits (1) that the presumed agreement for customer reimbursement of the sales

tax under Civil Code §1656.1 applies only to sales tax "that the retailer must pay to the Board" (i.e. not to excess sales tax reimbursement) and (2) that a retailers' choice to waive the tax exemption means that the retailer must "absorb the cost of the sales tax itself":

> The law does allow the retailer and the consumer to agree that the consumer will reimburse the retailer for sales tax that the retailer must pay to the Board. (Civ. Code, § 1656.1, subd. (a).) However, the law does not require that the consumer and retailer enter into such an agreement, and the retailer may choose not to collect any sales tax reimbursement from the consumer and absorb the cost of the sales tax itself. (*Ibid.; Loeffler, supra*, 58 Cal.4th at p. 1117.)

(SBE RB at 20, emphasis added.)

Thus, the consequence of the retailer waiving the exemption is that the retailer must "absorb the cost of the sales tax itself." Petitioners' First Cause of Action, however, only deals with situations where the retailer has not "absorb[ed] the cost of the sales tax itself," but rather has charged diabetics excess sales tax reimbursement. That cause of action is not premised upon the exemption being "unwaivable," but rather upon the Retailers waving the exemption without fulfilling their obligation to "absorb the cost of the sales tax itself."

B. Reply To The Retailers' Argument That Petitioners Seek To Have A Court "Make Taxability Determinations In The First Instance."

The Retailers next contend with respect to Petitioners' First Cause of Action that "the crux of this claim is to have a court make taxability determinations in the first instance." (Retailers at 46, Op. at 701.)

In *Loeffler*, this Court held that the consumers' action against the retailer, Target, failed because "the taxability of a transaction must be resolved in the first instance by the Board." (*Loeffler* at 1134.) But there is

a critical difference between this case and *Loeffler*. In this case the State Agencies are defendants in Petitioners' Fifth Cause of Action for an equitable remedy under *Javor*, whereas the *Loeffler* plaintiff's declined the trial court's invitation to join the SBE as a party. (*See Loeffler* at 1096 ["The court . . . .formally granted plaintiffs' motion for leave to add the Board as a defendant. . . . Plaintiffs filed a second amended complaint, but this complaint did not add the Board as a defendant." (emphasis added.)].)

Thus, without the Board being named as a defendant in *Loeffler* on a *Javor* claim, there was no procedure by which the *Loeffler* plaintiffs could present the taxability issue to the Board for determination "in the first instance." This Court therefore held in *Loeffler* that the action against the retailer could not be maintained. (*Loeffler* at 1134.)

Here, by contrast, Petitioners accepted *Javor's* invitation to join the Board as a party. (*See Javor* at 802 ["allowing the Board to be joined as a party for these purposes in the customer's action against the retailer is an appropriate remedy entirely consonant with the statutory procedures providing for a customer's recovery of erroneously overpaid sales tax" (emphasis added)].) By properly sequencing the *Javor*-compelled taxability decision by the CDTFA to occur before a decision on Petitioners' claims regarding taxability, the Superior Court can easily guarantee that the CDTFA will "make taxability determinations in the first instance."

C. Reply To The Retailers' Argument That Customers "Cannot Establish A Breach of Contract Claim Based Upon Unstated Intent."

The Retailers next contend customers "cannot establish a breach of contract claim based upon unstated intent" (Retailers at 46, Op. at 705); that "the terms of the contract are determinable by an external, not an internal standard" (*id.* at 48); that "uncommunicated subjective intent is irrelevant" (*id.*at 49); and that "mutual consent is gathered from the

reasonable meaning of the words and acts of the parties, and not from their unexpressed intentions or understanding (*id.* at 49). In the very next sentence the Retailers' brief skips to its conclusion — "[t]herefore, beyond the prohibitions in *Loeffler*, Plaintiffs failed to state a claim" (*id.*).

However, the Retailers omit an all-important step from their analysis. Contrary to their own authorities, the Retailers reach their conclusion *without ever discussing "the reasonable meaning of the words and acts of the parties."* As anyone who has ever made a taxable retail purchase in California knows, the contractual "words of the parties" are shown on the sales check in the form of a dollar amount identified as "sales tax." By that singular express term of the sales agreement, the seller represents that the amount collected as sales tax reimbursement is actually owed as "sales tax." Thus, the statement quoted by the Retailers from Petitioners' Opening Brief on the Merits (OBOM at 36 quoted in Retailers at 47.), while being an accurate statement of Petitioners' intent, refers not to an "unstated intent," but rather to an intent which is "stated" in every sales check.

Indeed, it is the Retailers — not Petitioners — who are attempting to avoid the express terms of the sales checks by relying upon their "unstated intent" to collect "reimbursement" for amounts that they voluntarily remit to the State, not as compulsory tax under the Tax Code and regulations, but as gifts to the State in response to the Paliani letter (which discovery will show to have been known by the Retailers to be unauthorized by the Board and issued in contravention of the APA).

Moreover, the authorities cited by the Retailers for the ineffectiveness of "unstated intent" all concern situations where only one party is asserting an intent at variance with the "words of the parties." In the circumstance where both parties admit (or are found by a court) to have the same peculiar understanding of the contractual "words of the parties,"

obviously that mutual meeting of the minds governs, regardless of whether it varies from the usual literal meaning of the words used by the parties. (*See. e.g. Hotchkiss v. National City Bank* (S.D.N.Y. 1911) 200 F. 287, 293 (Learned Hand opinion) ["if it appear by other words, or acts, of the parties, that they attribute a peculiar meaning to such words as they use in the contract, that meaning will prevail, but only by virtue of the other words, and not because of their unexpressed intent."]; *Pacific Gas & E. Co. v. G. W. Thomas Drayage etc. Co.* (1968) 69 Cal.2d 33, 37 ["A rule that would limit the determination of the meaning of a written instrument to its four-corners merely because it seems to the court to be clear and unambiguous, would either deny the relevance of the intention of the parties or presuppose a degree of verbal precision and stability our language has not attained."].)

Here, the Retailers *admit* that "[p]laintiffs voluntarily paid sales tax reimbursement to the Retailers as a matter of implied contract." (Retailers at 53, emphasis added.) The Retailers also *admit* to having understood that the contractual agreements were based on the "expectation" and "presumpti[on]" that any sales tax reimbursement charged to the customer would be of sums owed on the transaction by the retailer to the State as "sales tax." (*See* Retailers at 55 ["Plaintiffs entered a contractual agreement to pay such monies for purposes of sales tax reimbursement. . . And consistent with expectations, the Retailers eventually paid those sums as presumptively owed sales tax to the Board." (emphasis added.)].)

Indeed, the SBE's Respondent's Brief in the Court of Appeal admits that the presumed agreement for customer reimbursement of the sales tax under Civil Code §1656.1 applies only to sales tax "that the retailer must pay to the Board" (*i.e.* not to excess sales tax reimbursement). (*See* p. 15, *supra.*) That coincides with this Court's earliest decision on sales tax reimbursement, *National* Ice, which held that retailers could constitutionally "pass on" the tax to purchasers with their consent.

(*National Ice* at 292 ["such declaration of the law is not intended to indicate the illegality of authority which may be lodged in a retailer to 'pass on' the tax to a purchaser with the latter's consent thereto, either expressly or impliedly given.].) Excess sales tax reimbursement, by contrast, cannot in any sense be characterized as the "pass-on" of a "tax" that wasn't owed.

Moreover, there is nothing in the legislative history of Civil Code §1656.1 to suggest that the rebuttable presumption was intended to restrict this Court's decision in *Javor,* which had been issued four years earlier. Of all the potential reasons listed by the *Javor* Court for its holding, the "terms of the agreement of sale" are not mentioned. That is because no one doubted that an implied term of every retail sale was that "sales tax reimbursement," as its name implies, would only cover "reimbursement" of amounts actually owed by the retailer as "sales tax."

Enactment of Civil Code §1656.1 did nothing to change that understanding. On the contrary, by encouraging the use of sales checks, agreements of sale, or posted signage documenting the addition of "sales tax" to the price, §1656.1 assures that an express written agreement for the customer to reimburse "sales tax" virtually always exists to augment the implied term to the same effect that the courts, retailers and customers have always assumed and expected. And in the extremely rare circumstance where no such writing exists, there is also no presumption under §1656.1 that "the parties agreed to the addition of sales tax reimbursement."

D. Reply To The Retailers' Argument That The Implied Covenant Cannot Be Used To Create Independent Rights Or Causes Of Action In Conflict With Controlling Law

The Retailers next argue that "the implied covenant, however, is relied on, at best, to enforce obligations created by a contract. It cannot be used to create independent rights or implement private causes of action in conflict with controlling law." (Retailers at n.8 p. 49 [*citing Carma*

Developers (Cal.), Inc. v. Marathon Development California, Inc. (1992) 2 Cal.4th 342, 373-376].) *Carma Developers* does not, however, actually say that. For example, the phrases "independent rights" and "private causes of action" do not appear anywhere in *Carma Developers.* And rather than saying that the implied covenant is used to "enforce obligations created by contract," *Carma Developers* says the opposite:

> To begin with, breach of a specific provision of the contract is not a necessary prerequisite. (citation omitted) Were it otherwise, the covenant would have no practical meaning, for any breach thereof would necessarily involve breach of some other term of the contract.

Instead, the "implied covenant of good faith is read into contracts 'in order to protect the express covenants or promises of the contract,'" not to enforce them. (*Carma Developers* at 373, emphasis added.)

What *Carma Developers* does say is the following:

- The covenant of good faith finds particular application in situations where one party is invested with a discretionary power affecting the rights of another. Such power must be exercised in good faith. . . .
- A party violates the covenant if it subjectively lacks belief in the validity of its act or if its conduct is objectively unreasonable.
- breach of a specific provision of the contract is not a necessary prerequisite.
- the covenant of good faith can be breached for objectively unreasonable conduct, regardless of the actor's motive.
- the scope of conduct prohibited by the covenant of good faith is circumscribed by the purposes and express terms of the contract, and
- as a general matter, implied terms should never be read to vary express terms.

(*Carma Developers* at 372-374.)

Thus, the questions posed by *Carma Developers* are whether the implied covenant of good faith and fair dealing would (1) "protect the express covenants or promises of the contract," or (2) "vary the express terms" and, if the former, whether the Retailers (3) are "invested with a discretionary power affecting the rights of another", (4) have failed to exercise that power in good faith, and/or (5) have engaged in conduct that is "objectively unreasonable."

As previously discussed, the "express covenants or promises of the contract " is shown on each sales check as a dollar amount identified as "sales tax." (*See* p.18-18, *supra.*) By that singular term the retailer represents that the amount collected as sales tax reimbursement is actually owed as "sales tax." However, such representation is not true with respect to *excess* sales tax reimbursement collected on tax-exempt sales. Yet once the retailer remits the excess sales tax reimbursement to the State Agencies, there is no procedure for the customer to recover it without the retailer filing a tax refund claim. Therefore the "implied covenant of good faith is read into contracts 'in order to protect the express covenants or promises of the contract'" and the retailer "is invested with a discretionary power affecting the rights of another." Under *Carma Developers* "[s]uch power must be exercised in good faith," but the Retailers have not done so, and instead have engaged in objectively unreasonable conduct including that set forth in Petitioners' Opening Brief on the Merits at p. 38.

III. PETITIONERS FIFTH CAUSE OF ACTION ALLEGES AN ACTIONABLE CLAIM UNDER *JAVOR* TO REMEDY THE STATE'S UNJUST ENRICHMENT.

A. Respondents Have Abandoned The First Ground Upon Which The Court Of Appeal Based Its Decision

The Court Of Appeal held that there are "three prerequisites" for utilizing the *Javor* remedy. However, these prerequisites can never exist in any case regardless of its facts, and even did not exist in *Javor* itself. In other words, under the *McClain* Court's *Javor* prerequisites, the *Javor* case itself could not have gone forward. If left to stand, *McClain* will have *de facto* "overruled" this higher Court's opinions in *Javor* and *Loeffler* by making it definitionally impossible for any consumer to ever pursue a *Javor* remedy regardless of the facts of the case.

Neither Respondent denies this. In fact, the Board of Equalization ("Board") not only no longer denies this, but the Board now actually appears as if it might be joining with Petitioners in agreeing that McClain violates Loeffler's and Javor's holdings and must, at least to some extent, be reversed:

> And while plaintiffs complain that the decision below "effectively abolish[ed]" such a claim by imposing impossible prerequisites (OBM 28-32), the Department is not requesting that this Court disapprove Javor or impose any preconditions to asserting *Javor*-type relief beyond what are set out in that case and discussed in Loeffler and in the previous sections of this brief."

(CDTFA at 45, emphasis added.)

The first "prerequisite" was that: "the person seeking the new tax refund remedy has no statutory tax refund remedy available to it." (*McClain v.* Sav-*On Drugs* (2017) 9 Cal. App. 5th 684, 690 ("*McClain*"). Petitioners' Opening Brief on the Merits pointed out that the supposed statutory remedies (1) were of no benefit to customers, and/or (2) were applicable to every excess sales tax reimbursement, so *McClain* would block every *Javor* claim, including that of the *Javor* plaintiffs themselves.

(OBOM at 25-27.) In light of the CDTFA's concession, it appears that the Court of Appeal's first basis for its decision is abandoned by Respondents.

B. Reply to the Retailers' Argument That Application of the *Javor* Remedy Violates The "Safe Harbor."

The Retailers argue that they are protected from liability on the Fifth Cause of Action by the "safe harbor" that this court recognized in *Loeffler.* (Retailers at 34-36; *Loeffler* at 1125-1126 quoting *Cel-Tech Communications, Inc. v. Los Angeles Cellular Telephone Co.* (1999) 20 Cal.4th 163 at 182-183. ["When specific legislation provides a "safe harbor," plaintiffs may not use the general unfair competition law to assault that harbor. . . . Acts that the Legislature has determined to be lawful may not form the basis for an action under the unfair competition law . . ."].)

The Retailers do not, however, make their "safe harbor" argument as to Petitioners' First Cause of Action for breach of the contract specified in Civil Code §1656.1. (Retailers at 46-50.) That is because Petitioners' Opening Brief on the Merits raised a compelling counter-argument: *i.e.* that utilizing the "safe harbor" to bar a cause of action for breach of a contract mandated by the Legislature in Civil Code §1656.1 "operates not to protect a statute enacted by the Legislature but to nullify it. That is a misuse of the 'safe harbor' and directly contrary to this court's decision in *Cel-Tech* . . .and also directly contrary to this court's decisions in *Loeffler*." (OBOM at 41-42, emphasis added.)-The Retailers have no answer to Petitioners' counter-argument, failing to even cite to *Cel Tech.* Instead, the Retailers concede the point by not asserting the "safe harbor" as to Petitioners' breach of contract cause of action. (*See* Retailers at 46-50.)

As to the Fifth Cause of Action, however, the Retailers do, argue that "[a]llowing a consumer to force a retailer to litigate taxability by pursuing a refund claim plainly is inconsistent with the 'safe harbor.'" (Retailers at 35.) There is not the slightest hint in *Loeffler* that the "safe

harbor" protects retailers from their minimal obligations as nominal parties under the *Javor* remedy, and *Javor* would be effectively overruled if the "safe harbor" did apply. Respondents' argument is therefore contrary to both *Javor* and *Loeffler* (to the extent it approves of the *Javor* remedy), and must be rejected.

By effectively overruling *Javor*, the Retailers argument would also make Tax Code §6901.5 unconstitutional under the Due Process clause. (OBOM at pp. 28-35.)

C. Reply to the Retailers' Argument That Application of the *Javor* Remedy Requires Them To Pursue Refund Claims In Conflict With The Tax Code.".

The Retailers argue that "[c]ompelling retailers to pursue a refund action in this case also would directly conflict with the code provision allowing them to elect not to do so" by "force[ing] retailers to incur the costs and expense of establishing the exemption and distributing the refunds—exactly what the tax code allows them to avoid." (Retailers at 37-38.)

That is a straw man argument. No one, least of all Petitioners, is suggesting that retailers must "pursue a refund claim" or "incur the cost and expense of establishing exemption and distributing the refunds." But nor should retailers serve as roadblocks to legitimate taxability questions reaching the State Agencies for decision merely because retailers have no financial incentive to lift a finger on behalf of their customers.

The first step in the *Javor* remedy is for the Superior Court to compel the retailer to file a tax refund claim with the State Agencies under Tax Code §6904 ("Every claim shall be in writing and shall state the specific grounds upon which the claim is founded."). That is a simple and inexpensive process for which the customers who file a *Javor* action would doubtless accept responsibility. Thereafter, it makes sense that prosecution

of the refund claim — including, if necessary, bringing a Superior Court action under Tax Code §§6933 and 6934 —shifts to the customers who brought the *Javor* action. The retailers become "nominal parties," just like the corporation is a nominal party in a shareholder derivative action.

The "incentive problem" which the CDTFA acknowledges to exist with respect to retailers who charge excess sales tax reimbursement (CDTFA at 14 and 33) is akin to that which caused courts of equity to create shareholder derivative standing as a "remedy born of stockholder helplessness:"

> Equity came to the relief of the stockholder, who had no standing to bring civil action at law against faithless directors and managers. Equity, however, allowed him to step into the corporation's shoes and to seek in its right the restitution he could not demand in his own. It required him first to demand that the corporation vindicate its own rights but when, as was usual, those who perpetrated the wrongs also were able to obstruct any remedy, equity would hear and adjudge the corporation's cause through its stockholder with the corporation as a defendant, albeit a rather nominal one. This remedy born of stockholder helplessness was long the chief regulator of corporate management and has afforded no small incentive to avoid at least grosser forms of betrayal of stockholders' interests. It is argued, and not without reason, that without it there would be little practical check on such abuses.

(*Cohen v. Beneficial Indus. Loan Corp.* (1949) 337 U.S. 541, 548.)

In California, this Court recognized derivative standing for corporate shareholders by 1909, following precedents from other states and England. (*Turner v. Markham* (1909) 155 Cal. 562, 569-570.) The California Legislature did not codify the corporate derivative action or its procedural requirements until 1949. (*Hogan v. Ingold* (1952) 38 Cal.2d 802, 805.) Thus, for at least 40 years, this Court had sole responsibility for defining the parameters of the derivative action for California corporations. More

recently, the Court of Appeal recognized a limited partner's common law and equitable standing to sue derivatively on the limited partnership's claims. (*Wallner v. Parry Professional Bldg., Ltd.* (1994) 22 Cal.App.4th 1446 at 1450, n.4 ["[T]he courts have concluded that a limited partner's derivative action arises from both equitable as well as statutory grounds.].)

Because the *Javor* remedy is necessary in order for Tax Code §6901.5 to satisfy due process (OBOM at 28-35), the *Javor* remedy must itself be administered in a manner that comports with due process. Petitioners spelled out the procedures, including derivative standing, that they believe are required by the *Javor* remedy and due process in their Appellants' Opening Brief in the Court Of Appeal as follows:

> Indeed, there appears to be no dispute as to the procedures under *Javor*. Defendant retailers would be required to file a claim with the SBE for a refund of the total amount of sales tax paid on sales of test strips and lancets since March 10, 2000. The SBE then makes a determination. If the SBE's ruling allows a claim, the SBE interpleads the refund into the court for distribution to the class members.
>
> If the SBE disallows the claim, then an action against the SBE is brought in accordance with R&TC §§6933 and 6934 "for the recovery of the whole or any part of the amount with respect to which the claim has been disallowed." The court would then resolve the claim.
>
> However, as the Supreme Court has twice noted, retailers have no financial interest in obtaining a tax refund that must be passed-through to their customers. (*Javor* at 795; *Loeffler* at 1115, 1122.) In such situations, where the party holding legal title to a claim has no interest in pursuing the claim, California common law recognizes the right of real-parties-in-interest to bring a derivative claim in the right of the title owner, who is relegated to the role of a nominal defendant. (*Wallner v. Parry Professional Bldg., Ltd.* (1994) 22 Cal.App.4th 1446.)

> Here, *Javor* has already adopted the first step in the derivative process by holding that consumers can compel the filing of tax refund claims by the holders of the legal title to those claims, the retailers. This Court should provide guidance that defendant retailers would be nominal defendants with respect to prosecuting the *Javor*-compelled refund claims before the Board and, if disallowed, before the Superior Court under R&TC §6933. Control over the prosecution should instead vest in plaintiffs.
>
> Indeed, the California Supreme Court has twice instructed that "[i]t is still left to the courts to adopt appropriate remedies when excessive reimbursements have been collected by mistake and paid to the state." (*Decorative Carpets, supra*, 58 Cal.2d at 256 and *Javor* at 799.)

(AOB at 47-48, emphasis added.)

Derivative standing is also consistent with the Retailers' argument that they "have no dog in that fight" and should be left "out of Plaintiffs' taxability dispute with the Board." (Retailers at 13.)[2] However, to the extent the Retailers argue that being compelled to perform the minimal tasks of a nominal party conflicts with the Tax Code, the Retailers are rebuking this Court's decision in *Javor* and *Loeffler* and threatening the constitutionality of Tax Code §6901.5. Such argument should therefore be rejected.

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[2] Of course, here there is an independent basis for the Retailers' liability on Petitioners' First Cause of Action for breach of the contract specified in Civil Code §1656.1, including breach of the duty of good faith and fair dealing.

D. Reply To Respondents' Argument That Application of the Javor Remedy s "Presents Serious Constitutional Concerns."

The Retailers argue that *Javor* "requiring retailers to pursue refund claims on the demand of consumers . . . presents serious constitutional concerns" under Article XIII, Section 32 "by "expanding the methods for seeking tax refunds expressly provided by the legislature." (Retailers at 38-42.) The CDTFA argues that "[t]he Legislature has subjected [taxability] questions to an administrative exhaustion requirement" that would be overridden by application of the *Javor* remedy "presenting separation of powers concerns." (CDTFA at 36 and n.17.) In truth, Respondents' arguments are an unvarnished direct constitutional attack on this Court's decision in *Javor* (and *Loeffler* to the extent that *Loeffler* approves of the *Javor* remedy. *See Loeffler* at 1133, quoted at p. **Error! Bookmark not defined.**-25 *supra.*)

As the Attorney General of the State of California, now its Governor, wrote to this Court on April 1, 2010, as an amicus in support of the consumers' position in Loeffler:

> Contrary to the reasoning put forth by Target Corporation (Target) and adopted by the Court of Appeal, the strictures of article XIII, section 32 of the state Constitution (article XIII, section 32) and Revenue and Taxation Code section 6931 (section 6931) do not apply to the claims at issue. Plaintiffs in this case are not attempting to impede, directly or indirectly, the state's collection of taxes; they are challenging Target's alleged unlawful and fraudulent practice of imposing a charge in the guise of a tax. Nothing in the language of article XIII, section 32 or the Revenue and Taxation Code suggests a prohibition on suits by private litigants alleging that a retailer is collecting money from consumers in a deceptive manner by passing off charges as government mandates when they are not…[H]aving been given a

> "get-out of liability-free" card, it is easy to imagine that some unethical retailers will impose bogus charges under the facade of charging a sales tax."

(AG Amicus Brief in Loeffler, at AA 374.)

The CDTFA makes no attempt to identify the source of the "administrative exhaustion requirement" to which it refers. Presumably the CDTFA is referring to the statutory sequence of filing a tax refund claim (Tax Code §§6904 and 6932), obtaining a Board "determination" regarding that claim (§6901), and bringing a Superior Court action for "recovery of the whole or any part of the amount with respect to which the claim has been disallowed (§6933). Nor does the CDTFA explain how application of the *Javor* remedy would "override" that "administrative exhaustion requirement." Presumably the CDFTA is just reiterating Respondents' unfounded, but oft-repeated, claim that Petitioners seek to have a court "make taxability determinations in the first instance." But there is no merit whatsoever to that contention. (*See* pp. 16-17, *supra.*)

Similarly, the Retailers' accuse *Javor* of "expanding the methods for seeking sales tax refunds" but never identify the supposed "expanded methods." In fact, the methods for seeking sales tax refunds is exactly the same under *Javor*. (*See Javor* at 802 ["We think that allowing the Board to be joined as a party for these purposes in the customer's action against the retailer is an appropriate remedy entirely consonant with the statutory procedures providing for a customer's recovery of erroneously overpaid sales tax." (emphasis added)].) The only difference is that under *Javor* the minimal actions required of the statutory "taxpayer" are performed as a nominal party at the direction of the court.

The Retailers' brief suggests that *Javor* may have somehow been overruled by *Woosley v. SBE* (1992) 3 Cal.4th 758. (Retailers at 39, n.7.) However, the SBE's brief disagrees. (CDTFA at 45 ["the CDTFA is not

requesting that this Court disapprove *Javor* or impose any preconditions to asserting Javor-type relief beyond what are set out in that case and discussed in *Loeffler* and in the previous sections of this brief."].)

Moreover, the Retailers seriously misread *Woosley,* which actually approved of this Court's decision in *Javor.* (*See Woosley* at 788 ["This court has held that a class action may be employed to seek refunds of sales and use taxes" citing *Javor.*].) Rather it was a follow-on Court of Appeal opinion in the *Javor* case — *Javor v. SBE* (1977) 73 Cal. App. 3d 939 — for which *Woosley* indicated *possible* disapproval ("to the extent they express views to the contrary") on a ground not here relevant.

Finally, by effectively overruling *Javor*, Respondents' affirmative constitutional arguments would make Tax Code §6901.5 unconstitutional under the Due Process clause. (*See* OBOM at pp. 28-35.)

E. Reply to the CDTFA Argument That The *Javor* Remedy May Not Be Applied Unless The State Agency Has Previously Determined That Such Sales Are Tax Exempt.

The holding of *Javor* is contained at the end of the opinion as follows:

> We hold that under the unique circumstances of this case a customer, who has erroneously paid an excessive sales tax reimbursement to his retailer who has in turn paid this money to the Board, may join the Board as a party to his suit for recovery against the retailer.

(*Javor* at 802, emphasis added.)

Petitioners and Respondents have engaged in a long-running debate about which circumstances of the *Javor* case were considered by the Court to be indispensable "unique circumstances" for application of the *Javor* remedy. Petitioners contend that the phrase "unique circumstances" was a cross-reference to the only other place in the *Javor* opinion in which the

word "unique" was used: *i.e.*, in the Court's description of the *Javor* plaintiffs' winning contention:

> Plaintiffs contend that since the monies representing the sales tax overage rightfully belong to them, since the Revenue and Taxation Code provides no procedure by which they can claim the refund themselves, and since the retailers are neither mandated by statute nor prompted by financial interest to claim any refunds, the situation is a unique one for which the courts should fashion a remedy based on the broad principles of restitution.

(*Javor* at 797, emphasis added.)

Thus, Petitioners contend that claims for refund of *excess sales tax reimbursement collected from customers*, unlike claims for other type of sales tax refunds (such as refunds of overpayments due to a retailer's miscalculation of its sales tax liability), were deemed "unique" because (1) the retailers are neither statutorily nor financially motivated to seek a refund, and (2) the customers —who are the real parties in interest —have no standing under the Tax Code to file a tax refund claim. It was those "unique circumstances" that made an equitable remedy necessary to "protect the integrity of the sales tax by ensuring" (1) "that customers receive their refunds", (2) "that the retailers not be unjustly enriched," and (3) "also that the state not be similarly unjustly enriched." (*Javor* at 802.)

Respondents contend, by contrast, argue that one of the necessary "unique circumstances" referred to by the *Javor* court was that "[t]he Board has admitted that it must pay these refunds to retailers." (*Javor* at 802.)But State Agencies must frequently refund to retailers sales taxes that they overpaid as a result of miscalculating their sales tax obligation. The State Agency "admit[ting] that it must pay these refunds to retailers," is hardly "unique."

Over the course of briefing the demurrers and the appeal, Respondents vacillated somewhat in their description of what a customer must show in order to qualify for the *Javor* remedy. Compare SBE's Reply Memo of P&A in Support of Demurrer, AA 533 ("[A] *Javor*-remedy does not violate the Code and *Loeffler* only where there is clear authority — a statute, published appellate decision or regulation — which definitively decides the issue of taxability.") with Respondent's Brief of the California State Board of Equalization, 7/13/2016 at 34-35 ("[T]here has been no binding determination by the Board that Appellants' interpretation is correct. . . . Because the taxability issue in this case has not been decided by the Board, the Superior Court properly dismissed the lawsuit.")

The Court of Appeal's ruling, however, was more extreme than any position of Respondents

> We conclude that a court may create a new tax refund remedy-and, accordingly, that the requisite "unique circumstances" exist- only if . . . . the Board has already determined that the person seeking the new tax refund remedy is entitled to a refund, such that the refusal to create that remedy will unjustly enrich either the taxpayer/retailer or the Board.

(*McClain* at 690, emphasis added.)

Thus, the Court of Appeal held that the *Javor* remedy depends not merely upon "taxability" having been decided by "clear authority - a statute, published appellate decision or regulation," but rather the Board must have "already determined that the person seeking the new tax refund remedy is entitled to a refund."

There are three points that Petitioners wish to make about the court of Appeal's ruling. First, it borders on being a *non sequitur*. It suggests that the refusal to create the *Javor* remedy will result in unjust enrichment only where "the Board has already determined that the person seeking the

new tax refund remedy is entitled to a refund," but that clearly is not true. The Board is unjustly enriched whenever a retailer collects excess sales tax reimbursement and remits it to the Board, regardless of whether or not "the Board has already determined that the person seeking the new tax refund remedy is entitled to a refund."

Second, while acknowledging that it was "unjust enrichment that offended the Board's 'vital interest in the integrity of the sales tax' and warranted judicial intervention," *McClain* held that the *Javor* Court was only concerned about unjust enrichment if it was a "*certainty*" (*McClain* at 698, italics in original.) The *Javor* Court, however, held no such thing, stating that "the Board is very likely to become enriched." (*Javor* at 802.) The *Loeffler* Court was even more emphatic, expressing concern about the mere "possibility" or "probability" of unjust enrichment. (*Loffler* at 1133-34 ["The integrity of the tax system and avoidance of unjust enrichment, possibly of the retailer, but more probably of the state, in certain circumstances may support a *Javor*-type remedy for consumers." (emphasis added).]

Given this Court's concern to avoid unjust enrichment of the State that would "likely," "possibly," "or "more probably" occur, what sense would it have made to condition the *Javor* remedy on the SBE having "already determined" that "the person seeking the new tax refund remedy is entitled to a refund"? Obviously, that would make no sense, because it would provide the SBE with a made-to-order method of evading the *Javor* remedy, thereby evading judicial review under Tax Code §6933, and perpetuating the State's unjust enrichment, by the SBE simply failing to consider the customers' entitlement to a refund (as the SBE admitted the Board has done here). (See OBOM at 18-19; 23-24.) The Court of Appeal, however, misinterpreted *Javor* as requiring a "certainty" of unjust

enrichment, and thereby adopted an interpretation of *Javor* that would perpetuate just such misfeasance by the State Agencies.

The Board attempts to take the phrase "unique circumstances" out-of-context and argue it means that the Board has already decided the issue in favor of the consumers. But the "unique circumstances" to which the Court refers are in the paragraph immediately above this holding, and state the following:

> We think that to require this minimal action from the Board is clearly mandated by the Board's duty to protect the integrity of the sales tax by ensuring that the customers receive their refunds. The integrity of the sales tax requires not only that the retailers not be unjustly enriched (*Decorative Carpets, Inc. v. State Board of Equalization, supra*, 58 Cal.2d 252), but also that the state not be similarly unjustly enriched.

(*Javor* at 802.)

In other words, the policies underlying *Javor* are "protecting the integrity of the sales tax by ensuring that the customers receive their refunds," "that the retailers not be unjustly enriched," and "that the state not be similarly unjustly enriched." (Id.) But Respondents skip over that paragraph which is immediately above the words "unique circumstances," and instead jump to a sentence in a paragraph further away to try to argue that the "unique circumstances" in *Javor* were that the Board already had determined it must pay these refunds to retailers, *.i.e*, a Board admission of liability. However, as demonstrated above, that is not an honest reading of Javor.

There is also another reason why Respondents' argument on this is wrong; it is the two words "if any" which are found in that same paragraph in Javor:

> All that plaintiffs seek in this action is to compel defendant retailers to make refund applications to the

> Board and in turn to require the Board to respond to these applications by paying into court all sums, if any, due defendant retailers."

(Javor at 802) (emphasis added)

The words "if any" cannot be squared with Respondents' proffered interpretation of "unique circumstances." Under Respondents' interpretation, the Javor style proceeding could only be initiated if the Board had already determined that a refund was due. But if that were so, then there could never be an occasion when the SBE would not refund something (i.e. the refund that the Board had already determined was due). A refund of zero could not occur, but a refund of zero is precisely the circumstance that the phrase "if any" is designed to cover.

Finally, and most obviously, the Court of Appeal's interpretation of *Javor* is unconstitutional under the Due Process Clause. (*See* OBOM at 28-35 and pp.9-13, *supra*.) Just imagine how this Court would react if a Superior Court dismissed a new case (indeed, all new cases) on the ground that it only accepts cases in which it had "already determined that the person seeking [recovery] is entitled to [recovery]." The due process violation is so obvious that it is difficult to believe that Respondents are still pressing this argument in the California Supreme Court.

The Court of Appeal responded to Petitioners' due process challenge to the Superior Court's ruling by stating that it was following this Court's decision in *Loeffler*:

> Further, our Supreme Court in *Loeffler* — although silent on this point — noted no constitutional impediment to its ruling that left consumers with no direct remedy for a refund and instead relegated them to urging Board inquiry and to filing claims or actions under the Administrative Procedure Act. (*Loeffler, supra*, 58 Cal.4th 1081.) Were we to come to a contrary conclusion, we would effectively overrule *Loeffler*. . . .

However, this Court's decision in *Loeffler* was that Target's customers had no independent claim against the retailers under the UCL and CLRA because of the "safe harbor" and the lack of any means to obtain a taxability determination from the SBE "in the first instance." Here, by contrast, neither of Petitioners' causes of action are subject to the "safe harbor"(*see* pp. 24-25, *supra*) and their *Javor* claim provides a means for Petitioners to obtain a taxability determination from the State Agencies "in the first instance." (*See* pp. 16-17, *supra.*) There is a world of difference between *Loeffler* holding that the SBE gets to make a taxability determination "in the first instance" (which the CDFTA characterizes as an" exhaustion of administrative remedies" requirement, *see* pp. 29-30, *supra*) and *McClain's* holding (and Respondents' arguments) that the SBE need never decide a Javor claim unless "the Board has already determined that the person seeking the new tax refund remedy is entitled to a refund." (*McClain* at 690.)

In sum, the Court of Appeal misunderstood *Javor* to require as a condition for its remedy a "certainty" that unjust enrichment of the State would otherwise occur, when in fact both *Javor* and *Loeffler* held the opposite: that unjust enrichment which "likely," "possibly," "or "more probably" would occur was sufficient. As a result, the Court of Appeal came to an erroneous conclusion that the test for application of the *Javor* remedy is whether the SBE had "already determined" that "the person seeking the new tax refund remedy is entitled to a refund." That test, however, undercuts the very purpose of *Javor* because it provides the State Agency with a made-to-order method of evading remedy by simply failing to ever consider the "taxability question" or the customers' entitlement to a refund. Moreover, that test also blatantly violates Due Process and results in an unconstitutional taking of private property for public use without just

compensation in violation of the Takings Clause. The Court Of Appeal's ruling on the Fifth Cause of Action should therefore be reversed.

F. Reply to Respondents' Arguments That Customers Have Viable Alternatives By Which To Raise Taxability Disputes.

The CDTFA no longer contends that the existence of various statutes, regulations and procedures identified by the Court of Appeal bar the Javor remedy. (*See* pp.**Error! Bookmark not defined.-Error! Bookmark not defined.**, *supra.*) However, Respondents continue to rely upon some of those statutes, regulations and procedures as supposedly "viable alternatives" by which customers can raise taxability disputes, claiming that the alternatives are sufficient to satisfy Due Process. (Retailers at 53-54.). In fact none of those supposed alternatives is of any benefit to customers.

The Retailers argue that "to the extent that Plaintiffs believe the Board's interpretation of regulation 1591.1 is incorrect, they have the ability under Government Code section 11340.6 to petition the Board to amend the regulation." (Retailers at 44.) The Retailers also argue that "Plaintiffs could file a declaratory relief action under Government Code section 11350 to have the regulation declared invalid." (*id.*) But Petitioners do not claim that Reg. 1591.1 is incorrect or invalid. On the contrary, Petitioners rely upon Reg. 1591.1 as the source of the tax exemption for test strips and lancets.. Amending or repealing Reg. 1591.1(b)(5) is not Petitioners' strategy.

The Retailers argue that Plaintiffs could raise their taxability challenge in the context of litigation with the Board over transactions subject to use tax. (Retailers at 45.) However, litigation over the transactions subject to use tax could be easily thwarted by the CDTFA. Any test cases brought by a few customers for refund of the use tax could

be thwarted by the State Agency simply allowing a default judgment to be taken against it, the only cost of which would be refunding the use tax that the test plaintiffs had paid. A class action could not be brought for refund of the use tax because Tax Code §6904 provides that "a claim filed for or on behalf of a class of taxpayers shall... be signed by each taxpayer or the taxpayer's authorized representative." As a practical matter that would doom any class-action seeking refund of a use tax.[3]

The retailers argue that" Consumers can, and often do, lodge complaints with the Board, which can lead to audits of the retailer." No doubt the State Agencies do audit many retailers when there is a complaint or suspicion that the retailer is underpaying the sales tax. The issue, however, however, is whether the State Agencies ever audit a retailer based on a complaint or suspicion that it has overpaid sales tax by collecting from customers and remitting *excess* sales tax reimbursement. Petitioners suspect that the State Agencies do not audit retailers in those circumstances, but rather encourage such conduct (or direct it as the SBE did with the Paliani letter.) Moreover, even the Court of Appeal characterized lodging complaints with the Board as "the practical equivalent of allowing them to tug (albeit persistently) at the Board's sleeve." (*McClain* at 706.)

IV. PETITIONER'S ARGUMENTS WOULD NOT "OPEN THE FLOODGATES OF LITIGATION" BUT RATHER WOULD "PROMOTE THE ORDERLY ADMINISTRATION OF THE TAX LAWS."

Without a shred of evidence, the Retailers state that "Plaintiffs' contract claim under section 1656.1 would disrupt, not promote, the orderly

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[3] A *Javor* action by contrast, is not "a claim filed "for or on behalf of a class of taxpayers " but rather is a claim filed on behalf of a class of consumers to compel each individual retailer to make an claim for a sales tax refund, covering all the sales tax the retailer itself paid to the State Agency for the subject transactions.

tax collection process in California" (Retailers at 50) and "would open the floodgates of litigation by allowing any consumer to challenge the taxability of any transaction." (Retailers at 43.) Likewise the CDTFA claims that "if these types of claims are allowed, we can expect similar, wide-ranging litigation . . . . Such a result should be rejected as 'undermining the 'orderly administration of the tax laws.'" (CDFTC at 37.) In fact, the opposite is true.

For 85 years it has been the law in California that, for the price of a postage stamp, any retailer may file a claim with the SBE for refund of excess sales tax reimbursement (Retail Sales Tax Act of 1933, §23; Tax Code §6904). Nevertheless, almost no such claims have ever been filed by retailers.

Petitioners' acknowledge this Court's concern in *Loeffler* that "independent consumer claims against retailers for restitution of reimbursement charges on nontaxable sales could form a huge volume of litigation over all the fine points of tax law as applied to millions of daily commercial transactions in this state." (*Loeffler* at 1130, emphasis added.) But *Loeffler* was speaking of a situation that might arise absent its ruling that "the propriety of a reimbursement charge that turns on the taxability of a transaction must be resolved in the first instance by the Board" (*Loeffler* at 1134.) After that ruling, a customer's suit against a retailer must in most circumstances be coupled with a *Javor* claim against the State Agency in order to provide a mechanism for securing the State Agency's determination of taxability "in the first instance."

The *Javo*r remedy has been available to customers in this state for 44 years, yet during that time only a handful of cases have been brought seeking the Javor remedy. A Lexis search of California cases containing "sales tax," "reimbursement," and "Javor" yields only five cases where the customer actually sought a Javor remedy (including the instant case and

Javor itself). Only five reported decisions in 44 years strongly suggests that this Court need not fear that *Javor* coupled claims against retailers "would open the floodgates of litigation by allowing any consumer to challenge the taxability of any transaction." (Retailers at 43.)

Similarly unfounded is Respondents' contention that Petitioners' claims would "disrupt... the orderly tax collection process in California." (Retailers at 50 and CDTFA at 37.) Nothing could be less orderly than State Agencies that consistently refuse to determine taxability questions with respect to excess sales tax reimbursement so as to avoid both making a refund and being subjected to judicial review under Tax Code §6933. Even less orderly is a State Agency staff that issues an unpublished directive to 13,000 retailers without Board authority and in contravention of the Administrative Procedure Act, for the apparent purpose of generating excess sales tax reimbursement to unjustly enrich the State. Moreover, it is well known that the Board's tax determinations are often determined to be wrong by the courts, but of course, customer claims for refund of excess sales tax reimbursement never get that far. Numerous courts have rejected SBE interpretations that ignored the legislative history, intent and purpose of a statute. (*See, e.g., Preston v. SBE* (2001) 25 Cal.4th 197, 215 [inconsistent with legislative history]; *Agnew v. SBE* (1999) 21 Cal.4th 310, 314-15 [not supported by the legislative history]; *Helene Curtis, Inc. v. Assessment Appeals Bd.* (1999) 76 Cal.App.4th 124, 132 [misconstrued the legislative history]; *Alpha Therapeutic v. Franchise Tax Bd.* (2000) 84 Cal.App.4th 1, 10-11 ["evidences no consideration of the legislative history"].)

Conversely, allowing Petitioners' claims to proceed does not change important laws that protect the collection of taxes in California. For example, it will still be the law that the imposition of a tax can be challenged only after first paying the tax and then seeking a refund. And

Loeffler will still be the law with its assurance that State Agencies will determine taxability in the "first instance."

By allowing Petitioners' claims, the *Javor* remedy will be preserved in a robust form so as perform its intended purpose of protecting the integrity of the sales tax by ensuring that neither retailers nor the State are unjustly enriched. A robust *Javor* remedy will also restore due process and judicial review to the State's escheat of excess sales tax reimbursement, thereby preserving the constitutionality of a sales tax system in which the tax incidence is placed on retailers rather than customers (who are the real parties in interest).

DATED: March 2, 2018

Respectfully submitted,

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Certificate Of Word Count

The undersigned certifies, pursuant to California Rules of Court, Rule 14(c)(1), that this brief contains 12,566 words, including footnotes, as counted by Microsoft Word 2010, the word processing program used to prepare the brief.

DATED: March 2, 2018

By: /s/Bruce R. MacLeod

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PROOF OF SERVICE

I declare as follows:

I am a citizen of the United States and employed in San Mateo County, California. I am over the age of eighteen years and not a party to the within action. My business address is 255 Shoreline Drive, Suite 510 Redwood Shores, CA 94065. On **March 2, 2018**, I caused to be served the foregoing documents described as **PETITIONERS' REPLY BRIEF ON THE MERITS in Case No. S2411471** on the interested parties in this action by placing the documents listed above in a sealed envelope with postage thereon fully prepaid, in the United States mail at Redwood Shores, California addressed as set forth below, as well as by email addressed as set forth below

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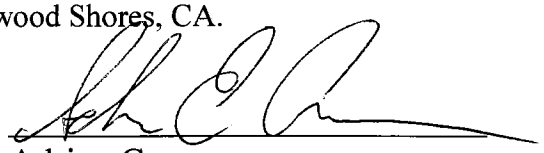
I declare under penalty of perjury under the laws of the State of California that the above is true and correct.

Executed on **March 2, 2018**, at Redwood Shores, CA.



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