9/17/68

Memorandum 68-95

Subject: New Topic - Counterclaims and Cross-Complaints

Two law professors responded to our request for new topics by suggesting the same topic: Whether the distinction between a cross-complaint and a counterclaim should be eliminated and provisions modeled after Federal Rules 13 and 14 adopted. The two were Professor John Bauman (U.C.L.A. Law School) and Professor Stephen A. Weiner (Boalt Hall) whose letter forwarded an extract from an article (attached as Exhibit II).

Attached as Exhibit I is a statement that could be included in our Annual Report to request authority to study this matter.

Respectfully submitted,

John H. DeMoully
Executive Secretary

Memorandum 68-95 EXHIBIT I

A study to determine whether the law relating to counterclaims and cross-complaints should be revised.

When a party wishes to assert a claim against one who has sued him, he is confronted in California by the bewildering distinction between a cross-complaint and a counterclaim. By a cross-complaint, under Code of Civil Procedure Section 442, a litigant seeks affirmative relief, against any person, relating to the transaction upon which the action is brought. By a counterclaim, under Code of Civil Procedure Section 438, a litigant asserts a claim which "must tend to diminish or defeat the plaintiff's recovery"; the claim "must exist in favor of a defendant and against a plaintiff between whom a several judgment might be had in the action." [1] Where a claim tending to diminish or defeat a plaintiff's recovery also "arises from the transaction set forth in the complaint," and in no other case, the claim will be deemed a compulsory counterclaim and the litigant barred from maintaining a subsequent action thereon. [2]

Carey v Cusack, [3] a recent case in the district court of appeal, illustrates the problems posed by this method of classification. Cusack entered an agreement for improvement and sale of land with Carey, a real estate broker; the latter retained an engineer to assist in the project, but after substantial work by Carey and the engineer Cusack sold the land through another broker.

The engineer sued Cusack for services rendered and Cusack filed a cross-complaint against Carey, the first cause of action being a declaratory judgment that Carey was liable for the engineer's services and the second a "subrogation" against Carey should Cusack be required to pay the engineer. The court held Cusack liable and Carey not liable to the engineer. Two months after entry of judgment, Carey sued Cusack for services rendered. Cusack argued that Carey should have pleaded this as a counterclaim in his answer to the prior cross-complaint and was now barred from asserting it. The court of appeal rejected Cusack's argument on grounds that (1) Carey's claim was not a "counterclaim" within Section 438,[4] and (2) even assuming the claim could be brought within Section 438, it would not be compulsory because it did not arise from the same transaction involved in Cusack's cross-complaint.[5]

The decision indicates a need for statutory revision in this area of California procedural law. Since Carey's claim is neither a "counterclaim" nor a "cross-complaint" within the Code, he would not (under the court's reasoning) be <u>permitted</u> to assert his claim against Cusack in a prior action. Even if assertion should not have been required, <u>compelling</u> a separate action on this claim seems unsound. Had Cusack not filed a cross-complaint against Carey but brought a separate action against him after Cusack had paid a judgment for the engineer, Carey clearly could have counterclaimed. It is difficult to see why Carey should be disadvantaged simply because he happens to be brought

into an action originally commenced by a third party.

There are also strong arguments why assertion of Carey's claim in the prior action should have been mandatory. The claims of Carey and the engineer, as well as the dispute between Carey and Cusack, related to the same business deal. Duplication and the consequent waste of public and private resources would be avoided by a single trial. Moreover, the amount of Carey's recovery was potentially intertwined with disposition of the engineer's claim. In light of these factors, an unduly narrow interpretation seems to have been attached to the term "transaction."

A more reasonable approach is found in the Federal Rules of Civil Procedure. In federal court, a pleading may state as a counterclaim any claim against any opposing party.[6] The counterclaim is normally compulsory "if it arises out of the transaction or occurrence that is the subject matter of the opposing party's claim. . ."[7] There is in the Federal Rules no such concept as a cross-complaint. A party in the position of Carey - ie, one impleaded to enforce defendant's claim for indemnification if held liable to plaintiff - is expressly authorized to assert counterclaims against the one bringing him into the action.[8] The federal scheme thus avoids the restrictions embedded in the California Code, relying upon the power to grant separate trials to counteract any difficulties caused by unlimited permissive assertion. Moreover, whether a counterclaim arises out of the transaction that is the subject matter of the opposing party's claim, and

is therefore compulsory, hinges upon duplication in the presentation of evidence which would result from separate trials.[9]

The foregoing discussion indicates the need for a study to determine whether the California law relating to counterclaims and cross-complaints should be revised.

## Footnotes

1. Cal. Code Civ. Pro. # 438. See also ## 422, 437.

2. Cal. Code Civ. Pro. #439.

3. 245 Cal. App. 2d 57, 54 Cal. Rptr. 244 (1966), hearing denied, 1st Cir. 22687, Div. 2, 65 A.C. Minutes 2 (Nov. 25, 1966).

4. Id. at 64, 67; 54 Cal. Rptr. at 249, 250-51.

5. Id. at 66; 54 Cal. Rptr. at 250.

6. Fed. Rules Civ. Pro. ## 13(b), (c).

7. Id. # 13(a). For the situation in which a counterclaim is not compulsory, see 3 Moore, Federal Practice para. 13.19 (1) (2d. ed. 1967).

8. Fed. Rules Civ. Pro. # 14(a). When the court believes that a claim and a counterclaim cannot be conveniently tried together, it may order separate trials. Fed. Rules Civ. Pro. ## 42(b), 13(i). A California court presently has this power under Cal. Code Civ. Pro. # 438.

9. At least the federal courts have so interpreted the provision. See, e.g., Great Lakes Rubber Corp. v Herbert Cooper Co., where the court stated: "(A) counterclaim is compulsory if it bears a 'logical relationship' to an opposing party's claim," that is, "where separate trials on each of their respective claims would involve a substantial duplication of effort and time by the parties and the courts." 286 F. 2d 631, 634 (3d. Cir. 1960).

Cross-complaints and Counterclaims

When a party wishes to assert a claim against one who has sued him, he is confronted by the bewildering distinction, to which California has tenaciously clung, between a cross-complaint and a counterclaim. By a cross-complaint, a litigant seeks affirmative relief against any person, whether or not a party to the original action, relating to the transaction upon which the action is brought.[39] By a counterclaim, a litigant asserts a claim which "must tend to diminish or defeat the plaintiff's recovery";[40] that is, he seeks a money recovery in an action in which a money recovery is sought of him.[41] A counterclaim "must exist in favor of a defendant and against a plaintiff between whom a several judgment might be had in the action."[42]

A claim for affirmative relief will frequently qualify as both a cross-complaint and a counterclaim, in that a claim tending to diminish or defeat a plaintiff's recovery will arise "out of the transaction set forth in the complaint." Under these circumstances -- and no other -- the claim will be deemed a compulsory counterclaim, and the litigant will be barred from maintaining a subsequent action thereon.[43]

In Carey v. Cusack, 44/ the court of appeal wrestled with some problems posed by the foregoing modes of classification. The Cusacks had entered into an agreement with Carey and Kennan, real estate brokers, for the subdivision into lots, improvement and sale to the public of a parcel of land which the Cusacks owned. The brokers retained an engineer to assist in the project, but after substantial work had been completed by both the brokers and the engineer, the property was sold intact by the Cusacks, through another broker, to a college. The engineer sued the Cusacks to recover for services rendered. The Cusacks in turn filed a cross-complaint against the brokers, in which the first cause of action sought a declaratory judgment that the brokers were liable for the engineer's services, and the second cause of action sought "subrogation"against the brokers in the event the Cusacks were required to pay the engineer. The court held the Cusacks liable to the engineer, and ruled that the brokers were not liable.

About two months after the entry of judgment in this action, the brokers sued the Cusacks to recover for services rendered. The Cusacks argued that the brokers should have pleaded this claim as a counter-claim in their answer to the former cross-complaint, and that they were now barred from asserting it.

The court of appeal rejected the argument on three different grounds. It first suggested that, in view of the statutory definition, a "counterclaim" could be asserted only "against a plaintiff. . . and may not be used to bring in third parties or seek relief against a codefendant."[45] The court was unsympathetic to the argument that the words "plaintiff," "defendant" and "complaint" in the statutes pertaining to counterclaims should be read to include "cross-complainant," "cross-defendant" and "cross-complaint" respectively. Accordingly, even assuming the brokers could have asserted a "cross-complaint" to the Cusacks' cross-complaint, they would not be prohibited from bringing a separate action, since a claim must qualify as both a "counterclaim" and a "cross-complaint" to be compulsory.

The court gave another reason why the brokers' claim could not have been asserted as a "counterclaim" to the cross-complaint:

> It does not tend to defeat or diminish the recovery sought by the Cusacks against the brokers.... [T]here were no monetary claims made by the Cusacks against the brokers. In one cause of action, the Cusacks' cross-complaint merely asked for a declaratory judgment holding ... the brokers liable for Nolte's [the engineer's] services. In their other causes of action based on the right of subrogation, the Cusacks could have made no direct monetary recovery from the brokers unless and until they first paid Nolte the amount owed.... They were not demanding a monetary damage award but were, in effect, simply asking the court to declare that someone else was liable for Nolte's services. 46/

Even assuming the brokers' claim could be brought within the statutory definition of a counterclaim, the court held that it would still not be compulsory, because it did not arise out of the transaction set forth in the cross-complaint. The court noted that "the term 'transaction' is not limited to a single, isolated act or occurrence, but may embrace a series of acts or occurrences logically interrelated."47/ However, it held that the dealings between the brokers and the engineer, which led to the latter's employment, and the agreement between the Cusacks and the brokers "were based on two separate and distinct transactions, and are devoid of any logical interrelation."48/

The decision vividly illustrates the urgent need for statutory revision in this area of California procedural law. The first point to be noted is that, under the court's reasoning, the brokers would not have been permitted to assert their claim against the Cusacks in the prior action, even had they so desired. Their claim would not qualify as a "counterclaim." Nor would it qualify as a "cross-complaint," since held to be based on a different transaction than the complaint and the Cusacks' cross-complaint, and "devoid of any logical interrelation" with such claims of other parties.

Even assuming that assertion of the brokers' claim should not have been required, prohibiting its assertion, and compelling a separate action, is clearly unsound. Faced with the Cusacks' claim that the obligation to pay the engineer was on them, surely the brokers should have been allowed to counterattack in the same action, by seeking payment from the Cusacks for services performed on the very business deal for which the engineer was retained. Since the brokers sought a recovery in quantum meruit,[49] they could have argued, had

they alone been held liable for paying the engineer, that reimbursement of this cost should be one of the elements in fixing the amount of their own recovery. Even if the brokers were held obligated to indemnify the Cusacks for the latters' payment to the engineer, were they entitled to a larger payment from the Cusacks for their own services, the court would have entered judgment for the excess in favor of the brokers.[10] The brokers should not be compelled to assume the risk of a net loss by virtue of the Cusacks' bankruptcy following a judgment requiring the brokers to indemnify the Cusacks.

Moreover, if the Cusacks had not filed a cross-complaint against the brokers, but had brought a separate action against them seeking reimbursement after the Cusacks had paid a judgment for the engineer, the brokers clearly would have been permitted to counterclaim. It is difficult to see why they should be placed at a disadvantage simply because they happen to be brought into an action originally commenced by a third party.

There are also strong policy arguments why the assertion of the brokers' claim in the prior action should have been mandatory. The claim for services of both the engineer and the broker related to the

same general business deal. So did the dispute between the Cusacks and the brokers over responsibility to the engineer. It is reasonable to assume that resolution of the controversies about the engineer's fee would entail introduction of much of the same evidence as would be presented in connection with the brokers' claim. Background information, the relationship among the parties, the negotiations held -- these and other matters were common to all the points at issue. Thus duplication, and the consequent waste of public and private resources, would be avoided by a single trial. Moreover, as already noted, the amount of the brokers' recovery was potentially intertwined with the disposition of the engineer's claim. In view of these factors, the court seems to have given an unduly narrow interpretation to the term "transaction."

The California scheme for categorizing claims against an opposing party is nonsensical in the modern world,[5/1] and should be replaced by the relevant provisions of the Federal Rules of Civil Procedure. In federal court, a pleading may state as a counterclaim any claim against any opposing party, whether ot not it diminishes or defeats the recovery

sought by such party, and even if it claims relief exceeding in amount, or different in kind, from that sought in the pleading of the opposing party.[52] The counterclaim is normally compulsory "if it arises out of the transaction or occurrence that is the subject matter of the opposing party's claim. . . ."[53] There is no such concept as a cross-complaint, all claims against an opposing party being labeled counterclaims. A party in the position of the brokers, who has been impleaded to enforce defendant's claim for indemnification if held liable to plaintiff, is expressly authorized to assert counterclaims against the one bringing him into the action.[54] When the court believes that a claim and a counterclaim cannot be conveniently tried together, it may order separate trials.[55]

Thus, the federal scheme avoids the artificial restrictions on the maintenance of claims against opposing parties which are embedded in the California statutes, relying upon the power to grant separate trials to counteract any difficulties caused by unlimited permissive assertion. Moreover, whether a counterclaim arises out of the transaction that is the subject matter of the opposing party's claim, and is thus

compulsory, hinges upon the duplication in the presentation of evidence which would result from separate trials.[56]

FOOTNOTES

39. Cal. Code Civ. Pro. § 442.

40. Id. § 438.

41. See 2 B. Witkin, California Procedure, Pleading § 580 (1954).

42. Cal. Code Civ. Pro. § 438. An answer is required to a cross-complaint, which is deemed a separate pleading, but not to a counterclaim, which is considered part of the answer. See id. §§ 422, 437.

43. Id. § 439.

44. 245 Cal. App. 2d 57, 54 Cal. Rptr. 244 (1966), hearing denied, 1st Cir. 22687, Div. 2, 65 A.C. Minutes 2 (Nov. 25, 1966).

45. Id. at 64, 54 Cal. Rptr. at 249.

46. Id. at 67, 54 Cal. Rptr. at 250-51.

47. Id. at 66, 54 Cal. Rptr. at 250.

48. Id.

49. While they had a contract with the Cusacks, it did not state what compensation, if any, would be due to the brokers if the transaction did not proceed to the sale of improved subdivided lots.

50. Cal. Code Civ. Pro. § 666.

51. The distinctions presently embraced by California have hoary historical origins. See, e.g., F. James, Civil Procedure 472-79 (1965). 20½

52. Fed. R. Civ. P. 13(b), (c).

53. Id. 13(a). If a counterclaim is not compulsory, it must be supported by an independent basis of federal jurisdiction to entitle the counter-claimant to affirmative relief. 3 J. Moore, Federal Practice ¶13.19[1] (2d ed. 1967). It can be used defensively as a set-off without such jurisdictional grounds. Id.

54. Fed. R. Civ. P. 14(a).

55. Id. 42(b); see also id. 13(i). A California court presently has this power. Cal. Code Civ. Pro. § 438.

56. "[A] counterclaim is compulsory if it bears a 'logical relationship' to an opposing party's claim," that is, "where separate trials on each of their respective claims would involve a substantial duplication of effort and time by the parties and the courts." Great Lakes Rubber Corp. v. Herbert Cooper Co., 286 F.2d 631, 634 (3d Cir. 1960).