You've Been Served: Defending Against a State Tax Class Action

Are you prepared for this rising threat to your business?

By Dave Dorner and Mike Lurie

An email comes from the general counsel: your company has been sued by a customer who alleges that the company systematically overcharges sales tax.[1] The complaint—the legal document that starts the lawsuit—contains multiple counts for various violations of state statutes and common law doctrines and demands damages, attorney's fees, and costs and, maybe worst of all, requests class certification. The general counsel wants to meet in a few hours to discuss the allegations and next steps.

This article is a primer on what to do when you are served with a consumer class action complaint alleging the collection of excessive state taxes. The article focuses on the nuts and bolts of what a company must consider and act upon over the next few hours, days, and months. Although unique facts and circumstances drive each case, this article provides the foundation for defending against a state tax consumer class action.

State tax class actions are a rising threat to businesses. In 2021 alone, plaintiffs filed more than two dozen new state tax class actions. To date, these class action cases largely involve retail, lodging, telecommunications, and software transactions and generally claim that the defendant incorrectly classified transactions as taxable or applied an incorrect tax rate. However, any business that collects sales or excise taxes from consumers is vulnerable to a state tax consumer class action.

Class action lawyers are known to be aggressive, and they see state tax as a new opportunity to score paydays by targeting large vendors. Additionally, a business has no guarantee it will not wind up receiving a consumer class action complaint just because it taxes every transaction consistently with published guidance, because consumers can challenge the government's interpretation of tax law.[2] Consequently, tax executives should know how to react if their company is served with a state tax consumer class action complaint.

A state tax class action is a lawsuit by a consumer against a retailer in which the consumer alleges that the retailer overcharged state tax to the consumer, and to other similarly situated consumers, in violation of state law. Although state tax class actions can include common law claims (such as unjust enrichment, fraud, or negligence), consumers generally plead a violation of a state's consumer protection statutes. These statutes often provide for remedies not allowed for under common law actions, such as punitive damages, statutory damages, and attorney's fees.

At the outset of a case, a defendant should consider potential defenses to the allegations raised in the complaint. If there is a clear defense, it may be worth raising this defense informally with plaintiffs' counsel.

What Is a Class Action?

A class action allows one or more persons to bring a lawsuit on a representative basis on behalf of a group of similarly situated people. Although class actions can be complex and costly to defend, they do provide a major benefit to defendants: once a class action is resolved, the outcome binds the entire class, and no member of the class can bring a similar claim against the defendant. Due to the binding effect of a class action, the proposed class must receive approval from a court in a process known as "class certification." Class certification ensures the adequate protection of the interests of the entire class. Until a court certifies a class, the case is referred to as a "putative class action."

For the court to certify a class, a plaintiff must establish four characteristics: *numerosity* (that "the class is so numerous that joinder of all members is impracticable"); *commonality* (that "there are questions of law or fact common to the class"); *typicality* (that "the claims or defenses of the representative parties are typical of the claims or defenses of the class"); and *adequacy* (that "the representative parties will fairly and adequately protect the interests of the class").[3] If a plaintiff cannot prove any one of these four elements, then a court likely cannot certify a class. Defeating class certification can be a major win for the defendant, because plaintiffs' lawyers may not want to proceed on a nonclass basis. Accordingly, an important initial consideration when you are served with a class action complaint is whether there is basis for defeating class certification. The typical arguments against class certification are that the facts, claims, or damages of the persons within the proposed class are insufficiently similar.

What Are Consumer Protection Laws?

Consumer protection laws are statutes enacted by states to protect consumers from deceptive and unfair trade practices. All states and the District of Columbia have consumer protection laws. Although these laws can vary by state, there are general commonalities. For instance, the legal thresholds for alleging and proving a violation of a state's consumer protection laws are purposefully low when compared to common law actions such as fraud. Consumer protection statutes also often include financial incentives to file claims, such as statutory damages and the recoupment of attorney's fees.

The Importance of Damages

Understanding damages is key to defending against a state tax class action. Plaintiffs' lawyers favor consumer class actions because they can collect significant fees for securing compensation for the class. To this end, state tax consumer class actions typically include demands for punitive damages (damages awarded to punish the vendor), statutory damages (damages awarded pursuant to a statute and intended to be compensatory), and attorney's fees (ordering the retailer to pay the plaintiffs' counsel's fees and costs). Based on this cocktail of potential damages and fees, even a relatively small claim for damages spread out over a large class of consumers can add up to a substantial amount of money, a percentage of which will likely be paid to the class lawyers.

Initial Steps to Defending Against a State Tax Consumer Class Action

An important initial step if you are served with a state tax class action complaint is to maintain potential evidence. Once a plaintiff files a complaint, the defendant must preserve evidence. Failure to comply with the duty to preserve evidence can result in an adverse inference against the defendant.[4] Your company's tax department is likely to have much of the evidence required for a state tax consumer class action. Accordingly, the tax department should be prepared to explain 1) what data the tax department maintains, 2) where the tax department stores its data, 3) how the tax department's systems interact with other systems (such as point-of-sale and ERP systems), and 4) retention policies. A document retention letter is commonly circulated to all company personnel identified as likely to have documents (including electronically stored information) that may be relevant to the allegations raised in the complaint.

Another important initial step in defending against a state tax class action is choosing outside counsel. Outside counsel should provide the company with the knowledge and expertise it will need to successfully defend against a state tax class action. In addition to interacting with plaintiffs' counsel and the court, outside counsel will also help the company develop a litigation strategy and objectives and work with the company's tax department to identify, gather, and prepare documents relevant to the class action case. Factors you should consider when choosing outside counsel include:

- experience with class action defense in general and state tax class action defense in particular;
- experience with state taxes;
- familiarity with local courts, judges, and opposing counsel;
- proposed litigation strategies and how well those proposed strategies align with the company's objectives; and
- proposed budget.

State Court vs. Federal Court and Removal to Federal Court

The United States legal system has two separate court systems: state courts and federal courts. State courts are typically courts of general jurisdiction, which means they can hear many different kinds of cases, whereas federal courts are courts of limited jurisdiction, which means they can hear only cases authorized by the US Constitution or Congress.[5] Whether a case is heard in state or federal court can significantly affect how quickly and efficiently a state tax consumer class action is resolved. As a general rule of thumb in consumer class actions, defendants generally prefer federal court, whereas plaintiffs generally prefer state court.

The plaintiff chooses the court where the complaint is filed, and plaintiffs often elect to file in state court. However, a procedure known as "removal" may offer a defendant the opportunity to move the case from state court to federal court.[6] To move a case from state court to federal court, the defendant must generally file a notice of removal with the federal court within thirty days of receiving the state court complaint.[7]

Are There Defenses Against a State Tax Consumer Class Action?

At the outset of a case, a defendant should consider potential defenses to the allegations raised in the complaint. If there is a clear defense, it may be worth raising this defense informally with plaintiffs' counsel. Plaintiffs' counsel are sometimes willing to cut their losses early by voluntarily dismissing a complaint if they realize they were misinformed about the facts or the law when the complaint was filed.

Filing a motion to dismiss can also provide a defendant with an early opportunity to present its defenses before incurring the costs of discovery and class certification. Below are a few of the defenses that may be raised in a motion to dismiss a state tax consumer class action:

- *The transaction was taxed correctly.* If the company can prove that tax was correctly charged, then the plaintiffs' complaint should fail as a matter of law. This defense works best when the company can point to clear authority supporting the company's tax treatment of the transaction.
- *Exclusive jurisdiction*. An exclusive jurisdiction defense asserts that the only remedy for a consumer who overpaid tax is to seek a refund directly from the state. The strength of this defense varies by state. For instance, some states categorically bar a claim against the vendor and require consumers instead to file their refund claims directly with the state,[8] whereas other states limit only the circumstances under which the vendor can be sued directly for excessive tax collected.[9]
- *Primary jurisdiction.* Primary jurisdiction (or administrative exhaustion) requires consumers to bring their claim against the state taxing authority first and exhaust all administrative remedies before bringing a claim against the vendor.[10] From the vendor's perspective, primary jurisdiction is less favorable than exclusive jurisdiction, but it can benefit the defendant by having the state taxing authority weigh in regarding the plaintiff's claim.
- *Arbitration.* Federal law requires courts to enforce written arbitration agreements with only limited exceptions.[11] A defendant armed with a well-drafted arbitration clause in its consumer contracts can likely compel arbitration, which should stay the putative class action pending arbitration.[12] A motion to compel arbitration can sometimes be enough to convince plaintiffs' counsel that the claim is not worth pursuing.
- *Voluntary payment doctrine*. The "voluntary payment doctrine embodies the . . . rule that money voluntarily paid under a claim of right to the

payment and with knowledge of the facts by the person making the payment cannot be recovered back on the ground that the claim was illegal."[13] Under this doctrine, a plaintiff's claim could be dismissed if the plaintiff voluntarily paid the tax and had knowledge of the underlying facts.
- *Tax collection is not subject to consumer protection law.* Some state consumer protection statutes apply only to limited types of conduct, and tax collection may not fall within the scope of these statutes. For example, some consumer protection statutes apply only to the "conduct of any trade or commerce,"[14] and tax collection may not be considered trade or commerce in a state.[15]
- "*Safe harbor" for reliance on guidance from taxing authority*. If a retailer collects tax on a transaction based on guidance from a taxing authority, the retailer may be able to point to that guidance as a defense. Some state consumer protection statutes contain a safe harbor provision for "[c]onduct in compliance with the orders or rules of" a "state or local governmental agency."[16] These safe harbor provisions could allow a retailer to raise the defense that it was entitled to rely on guidance from a taxing authority. The strength of this defense may depend on the type of guidance (for example, formal rulemaking or an unpublished letter ruling) and its specificity.

Although the above defenses may be viable once a state tax consumer class action is filed, avoiding lawsuits through regular compliance reviews is the best way to minimize a company's risks and costs. Retailers should regularly review their tax determinations and tax software engine elections and default logic to ensure that they are complying with state law on tax collection. Retailers may benefit from involving outside advisors in this process to help evaluate their risks and possibly to support a defense against a lawsuit alleging income tax collection.

Options for Settling a State Tax Consumer Class Action

It is almost never too early to start thinking about settlement in a state tax consumer class action. A few factors to consider when evaluating whether to settle are the merits of any potential defenses, the scope of potential exposure, and the expected cost of litigation. Even if a company has a strong defense, a settlement could still be cheaper, quicker, and less risky than litigation.

There are two main ways to settle state tax consumer class actions. The first option is to reach a one-off settlement with the class representative named in the complaint. This allows the defendant to avoid the costs and burdens of administering a class, but one-off settlements are not always allowed under state law. Additionally, a one-off settlement does not bind anyone other than the named class representative, which means that other consumers could bring similar suits against the defendant.

The second option is to reach a class settlement. Class settlements bind all class members, but they require court approval, can be expensive to administer, and can result in negative publicity. A variation of a class settlement is for the defendant to file a claim for a tax refund with the state and assign its rights to the refund to the class.[17] Filing and assigning a tax refund reduces the defendant's out-of-pocket costs, shifts a portion of the defendant's risk onto the class, and allows the defendant to receive a definitive answer on taxability that can guide its future conduct. However, this option does have potential downsides, including the need for extensive cooperation between the parties, and the refund process can delay final resolution of the case.

Conclusion

If you have just been served with a state tax class action, there is no need to panic. Although being sued is far from pleasant, you now have the tools at hand to prepare your defense. Take a few deep breaths, start gathering your facts, and get ready to make some important strategic decisions.

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Endnotes

1 While every state has a tax agency charged with administering state tax laws, a number of states allow private litigants to bring lawsuits to enforce the tax laws of the state. Lawsuits brought for the *under*collection of tax, known as *qui tam* lawsuits, are generally filed under the state's false claims act laws. Lawsuits for the collection of excessive tax are generally filed as class actions under the state's consumer protection statutes or common law.

2 Unfortunately, this means that vendors at times must walk the fine line between risking a *qui tam* suit for under-collection and a class action for excessive collection.

3 For example, Federal Rule of Civil Procedure 23(a). The federal rules of civil procedure do not apply in state court,

but most state rules of civil procedure contain a class action provision that is similar to Federal Rule 23.

4 See *Victor Stanley, Inc. v. Creative Pipe, Inc.*, 269 F.R.D. 497, 522 (D. Md. 2010).

5 For instance, federal courts have jurisdiction to hear some putative class actions where the potential damages are more than $5,000,000 and at least one member of the putative plaintiff class is a citizen of a state different from the state where any defendant is a citizen. 28 U.S.C. Section 1332(d)(2). There are a few exceptions to this rule, and plaintiffs' lawyers have become adept at drafting complaints that on their face arguably fit within one of these exceptions. Additionally, some federal courts have found that they cannot (or should not) hear state tax consumer class actions due to the Tax Injunction Act, 28 U.S.C. Section 1341, or the doctrine of tax comity.

6 28 U.S.C. Section 1441.

7 28 U.S.C. Section 1446(b).

8 *Kawa v. Wakerfern Food Corp.*, 24 N.J. Tax 444 (N.J. Sup. Ct. App. Div. 2009).

9 See *McClain v. Sav-On Drugs*, 435 P.3d 424, 428–29 (Cal. 2019) (citing *Javor v. State Board of Equalization*, 527 P.2d 1153 (Cal. 1974)), in that the consumer can bring a claim against a vendor only when there is "a prior legal determination" that has established "entitlement to a refund").

10 See, for example, *Stoloff v. Neiman Marcus Group, Inc.*, 24 A.3d 366 (Pa. Super. Ct. 2011) and *Butcher v. Ameritech Corp.*, 727 N.W. 2d 546 (Wis. Ct. App. 2006).

11 9 U.S.C. Section 2.

12 See, for example, *AT&T Mobility LLC v. Concepcion*, 563 U.S. 333 (2011).

13 *McIntosh v. Walgreens Boots Alliance, Inc.*, 135 N.E. 3d 73 (Ill. 2019) (internal quotations omitted).

14 See, for example, Mass. Gen. L. ch. 93A, Section 2(a).

15 As the Massachusetts Supreme Court has explained, the fact that a retailer must remit "the proceeds from the tax collected" to the government suggests that tax collection should not be considered trade or commerce. *Feeney v. Dell*, 908 N.E.2d 753, 770 (Mass. 2009); see also *McLean v. Big Lots Inc.*, 2021 US Dist. LEXIS 106039 (WD Pa. June 7, 2021).

16 For example, 815 ILCS 510/4.

17 For example, *In re: AT&T Mobility Wireless Data Services Sales Tax Litigation*, Case No. 1:10-cv-02278, Global Class Action Settlement Agreement (ND Ill. 2010).