BUSINESS LAW TODAY

September/October 2009

Departments:

ABA BUSINESS LAW SECTION
KNOWLEDGE | COMMUNITY | EXPERIENCE

Business Law Today

Volume 19, Number 1 September/October 2009

Delaware LLCs

The Wave of the Future and Advising Your Clients About What to Expect

By Peter J. Walsh, Jr. and Dominick T. Gattuso

In less than two decades, Delaware limited liability companies (LLC) have gone from nouveau "alternative" entity to the "go-to" entity. Since 2001, new LLC formations have outpaced all other business entity formations in Delaware, including corporations. The rapid deployment of LLCs by the business community has naturally led to an uptick in LLC litigation. That litigation has resulted in steady development of the case law surrounding and construing the Delaware Limited Liability Company Act (the DLLCA or the Act). Previously, Delaware courts frequently looked to the well-developed body of corporate jurisprudence for guidance in resolving LLC disputes. As a result, Delaware's LLC law has paralleled the state's corporate law in many key respects. That dynamic appears to be changing, however.

Over the last few years, the common law and statutory law relating to LLCs have experienced fairly dramatic changes. For example, as discussed more fully herein, members can eliminate traditional fiduciary duties, provide broad exculpatory rights, waive the right to judicial dissolution, and waive the right to have a receiver appointed. Additionally, though members may structure their relationship through an oral or implied operating agreement, they need to consider the applicability of the statute of frauds. These, and other, changes in the statutory and common law of LLCs in Delaware reflect an acknowledgment of the inherent differences between unincorporated entities and corporations. As Delaware's LLC law continues to mature, we likely will see greater divergence between the state's LLC law and its corporate law.

This is not to say that Delaware courts will not look to Delaware's well-developed body of corporate law for guidance on occasion. Indeed, they will, and they should. However, the Delaware LLC is an animal of a different stripe, given its contractual lineage. Many of the recent judicial decisions, some of which are discussed below, acknowledge this fact and reflect a concerted effort by Delaware's courts, legislators, and practitioners to develop a body of law for

LLCs with the depth, breadth, and stability that are hallmarks of the state's corporate law.

Operating Agreements

As business law practitioners know, limited liability companies are creatures of contract. Delaware's statutory scheme affords members virtually unlimited discretion to define the terms of their relationship in the operating agreement. Indeed, the Act contains a host of fundamental provisions that are subject to modification by the members. Such unfettered contractual freedom can be problematic, however. As the Delaware experience would suggest, all too often operating agreements contain contradictory, inconsistent, ambiguous, and, sometimes, just plain indecipherable language. When a dispute arises over the meaning of a provision in the operating agreement, Delaware courts employ an objective theory of contract interpretation. Extrinsic evidence is excluded when the meaning of the disputed term is obvious from a plain reading of the contract. The challenge, then, is to draft with precision because unambiguous operating agreements are enforced as written in Delaware.

Indeed, it was on this basis that the court of chancery recently ordered judicial dissolution of an LLC despite one member's claim that the operating agreement failed to reflect the intent of the parties. In *Spellman v. Katz*, C.A. No. 1838 (Del. Ch. Feb. 6, 2009), the operating agreement required dissolution upon the occurrence of a series of events set forth in the agreement. The enumerated events occurred, but neither member moved to dissolve the company for several years. The respondent argued that the dissolution provision was unknown to the members at the time they signed the operating agreement and asserted that the members' true—but unwritten—intent was to operate the company until certain tax and mortgage-related benefits expired, as evidenced by their course of conduct. The court declined to consider the parol evidence, finding the language of the operating agreement unambiguous.

Less than two months later, the court granted dissolution in another LLC action, concluding that the relevant terms of the operating agreement were only susceptible to one reasonable interpretation. In *In re Nextmedia Investors, LLC*, C.A. No. 4067-VCS (Del. Ch. May 6, 2009), the operating agreement specified a date for dissolution and required that all members adversely affected by the amendment approve any extension of the dissolution date. The managers amended the dissolution date even though they were unable to obtain the requisite consent. On a motion for summary judgment, the defendant company argued that the relevant provisions were susceptible to different interpretations and, thus, were ambiguous. The court found that the interpretation asserted by the company conflicted with the plain language of the operating agreement and refused to engage in a tortured reading of the agreement to create an ambiguity. As the foregoing decisions demonstrate, precise drafting ensures that the operating agreement accurately reflects the members' business intentions; clear drafting also enables courts to resolve interpretational disputes early in litigation, thereby reducing litigation costs.

Oral Operating Agreements

Oral and implied operating agreements present a much thornier issue for courts. In Delaware, members may structure their business relationship through a written, implied, or oral operating agreement. The flexibility afforded by section 18-101(7) of the DLLCA is not without risk, however. When members, whether by design, inadvertence, or simple neglect, do not execute a written operating agreement, they face substantial uncertainty if their relationship deteriorates to the point of litigation because oral contracts must be proven by clear and convincing evidence in Delaware. If that evidentiary burden is not satisfied, the court of chancery may look to the DLLCA to supply the terms of the members' operating agreement. Thus, the very real possibility exists that the court-imposed operating agreement will differ dramatically from the oral agreement originally envisioned by the members.

The uncertainty associated with oral operating agreements took on a new twist with the court of chancery's decision in *Olson v. Halvorsen*, C.A. No. 1884-VCL (Del. Ch. Oct. 22, 2008). There, the court considered whether the statute of frauds applied to an oral operating agreement. Generally speaking, the statute of frauds requires that certain types of contracts (e.g., for the sale of land, for the sale of goods in excess of $500, and those that cannot be performed in one year) must be in writing and signed by the party against whom performance is sought for the contract to be enforceable in a court of law.

Prior to *Olson*, no Delaware court had been asked to consider whether the statute of frauds applied to an oral operating agreement. To many, the question seemed something of an academic one. Indeed, if asked, many Delaware practitioners would have answered the question in the negative. A leading Delaware treatise on limited liability company law expressed that very opinion. The authors reasoned that the application of the statute of frauds would run counter to the policy of the Act, i.e., to give maximum effect to the enforceability of operating agreements.

To the chagrin of some, the court of chancery in *Olson* arrived at the opposite conclusion. Though noting the split of scholarly opinion on the applicability of the statute of frauds to an oral operating agreement, the court applied the doctrine to the agreement and held that those provisions that cannot possibly be performed within one year, i.e., a multiyear earn-out provision and other substantive obligations and restrictions extending beyond one year, were unenforceable. The court explained that its decision was "in line with the policy for the enactment of the statute of frauds—to protect defendants against unfounded or fraudulent claims that would require performance over an extended period of time." The court acknowledged the policy of the DLLCA "to give maximum effect . . . to the enforceability of limited liability companies" but reasoned that the narrow application of the statute of frauds did not run counter to that policy. *Olson* adds yet another layer of uncertainty to oral operating agreements. Thus, practitioners should advise their clients of the risks involved with oral and implied operating agreements and encourage them to reduce their agreement to a clear, precise writing.

Fiduciary Duties and Liabilities

By now, it is well understood that, as a result of the amendments to section 18-1101 of the DLLCA in 2004, members may limit or eliminate both traditional fiduciary duties and liabilities arising out of a breach of those duties. Caution is in order, however. Delaware courts typically imply the existence of traditional fiduciary duties as a default mechanism in the absence of an express, unambiguous provision in the operating agreement eliminating those duties. Thus, precise drafting is paramount, as the recent decision in *Bay Center Apartments Owner, LLC v. Emery Bay PKI, LLC*, C.A. No. 3658 (Del. Ch. Apr. 20, 2009), illustrates.

In *Bay Center*, the plaintiff (Bay Center Apartments Owner, LLC) sued the managing member (Emery Bay PKI, LLC) of a Delaware LLC (Emery Bay Member, LLC) and the individual owner of PKI (Alfred Nevis) over a failed condominium development project. Plaintiff asserted claims of breach of fiduciary duty against PKI and Nevis (defendants), which they moved to dismiss. Unfortunately for defendants, the operating agreement contained arguably conflicting provisions concerning fiduciary duties. Defendants pointed to a provision of the agreement stating, "[e]xcept for any duties imposed by this Agreement . . . each Member shall owe no duty of any kind towards the Company or the other members in performing its duties and exercising its rights hereunder or otherwise." But plaintiff pointed to an immediately preceding section of the agreement that stated, "[t]he Members shall have the same duties and obligations to each other that members of a limited liability company formed under the Delaware Act have to each other." That meant, in the Court's view, the members of Emery Bay owe each other default fiduciary duties. Given the conflicting provisions, the court of chancery had no choice but to deny the motion to dismiss. Had the drafters of the Emery Bay agreement made clear their intention with respect to fiduciary duties, this unhappy circumstance (at least for defendants) could have been avoided.

The good news is that when parties make clear that fiduciary duties are eliminated, Delaware courts will readily honor their intent. For example, in *Fisk Ventures, LLC v. Segal*, C.A. No. 3017-CC (Del. Ch. May 7, 2008), the court of chancery held that, "by flatly stating that members have no duties other than those expressly articulated in the Agreement," the parties had eliminated fiduciary duties because the agreement did not otherwise articulate any such duties. Delaware courts similarly will honor the parties' efforts to limit liability for a breach of duty where their intent is unambiguously expressed in the operating agreement. In *Wood v. Baum*, 953 A.2d 136 (Del. 2008), the operating agreement exculpated managers from liability except for claims based on fraudulent, illegal, or bad faith conduct. The Delaware Supreme Court affirmed the court of chancery's dismissal of the action because the plaintiff failed to plead "particularized facts [in the complaint] that demonstrate that the [managers] acted with scienter, i.e., that the [managers] had actual or constructive knowledge that their conduct was legally improper." Thus, whether it is eliminating fiduciary duties or expanding exculpatory rights, practitioners would do well to state the parties' intentions in clear, unambiguous terms.

A further note of caution is in order. Though section 18-1101(c) of the Act prohibits elimination of the implied covenant of good faith and fair dealing, as a practical matter, claims asserting breach of the implied covenant are difficult to sustain in Delaware because the doctrine is construed narrowly. Thus, practitioners should consider advising clients to incorporate some standard of liability in the operating agreement. It is perfectly acceptable, for example, to eliminate manager liability except in cases of fraudulent or illegal conduct, as was the case in *Wood v. Baum*. One can go even further and attempt to define the precise circumstances in which liability may be imposed.

Judicial Dissolution

The story is an all-too-familiar one. A once successful business falters for any number of reasons and one or more of the members seek to exit the business. Though perhaps not thought of as such, the statutory right of judicial dissolution embodied in section 18-802 of the DLLCA is a valuable right because it can provide members with an exit mechanism in certain instances. To obtain judicial dissolution, a member must establish that "it is not reasonably practicable to carry on" the company's business in conformity with its operating agreement. The decision to grant judicial dissolution rests with the sound discretion of the court of chancery, but section 18-802 does not identify the factors the court should consider. As such, the task of developing an appropriate test has fallen to the Delaware courts.

Recently, in *Fisk Ventures, LLC v. Segal*, C.A. No. 3017-CC (Del. Ch. Jan. 13, 2009), the court of chancery identified three factual circumstances that the court should consider in evaluating the reasonably practicable standard: (i) the existence of a board deadlock; (ii) the absence of a mechanism in the operating agreement to circumvent the deadlock; and (iii) the inability of the company to operate, given its financial condition. The court granted dissolution in *Fisk*, finding that all of the factors had been satisfied. There is, however, no requirement that all of these factors be met to obtain a decree of judicial dissolution. Nor are the factors individually dispositive.

Arguably, a fourth factor should be added to the *Fisk* factors: whether the company is operating within the scope of the business purpose clause in its operating agreement. It was on this basis that the court of chancery declined to grant judicial dissolution in *In re Seneca Investments LLC*, 970 A.2d 259 (Del. Ch. 2008). Though Seneca Investments LLC had dramatically reduced its operations, it continued to act as a passive investment vehicle and was pursuing legal claims against one of the members. These activities were within the company's broad business purpose clause, which permitted it to "engage in any lawful act or activity for which corporations may be organized." The court relied on the absence of a board deadlock and the company's compliance with its business purpose to deny dissolution.

More recently, the petitioner in *In re Arrow Investment Advisors, LLC*, C.A. No. 4091-VCS (Del. Ch. Apr. 23, 2009), made a novel, though ultimately unavailing, argument, perhaps in an effort to circumvent the holding in *Seneca*. Arrow Investment Advisors, LLC had a business plan setting forth financial projections for the company's first few years. The economic downturn left the company unable to meet those projections. The managers chose to pursue other strategies not set forth in the business plan, but that were within the scope of the broad business purpose clause in the operating agreement. The petitioner argued that it was no longer reasonably practicable to carry on the business of the company because the company could not meet the projections in the business plan and was pursuing strategies outside the plan. The court found the petitioner's argument unpersuasive, reasoning that the business purpose clause in the agreement, not the business plan, was controlling.

As the foregoing cases demonstrate, Delaware courts are chary about granting judicial dissolution except in the most extreme circumstances. Accordingly, practitioners should advise their clients concerning the potential consequences of board deadlocks, broad (or narrow) business purpose clauses, and the failure to include reasonable buy-out provisions for disgruntled members. Following the decision in *R&R Capital, LLC v. Buck & Doe Run Valley Farms, LLC*, C.A. No. 3803-CC (Del. Ch. Aug. 19, 2008), practitioners also should address the advisability of waiving the statutory right of judicial dissolution.

R&R Capital, LLC presents one of the more controversial court of chancery decisions concerning alternative entities in 2008. In that case, the court held that members could waive their statutory right to judicial dissolution, appointment of a receiver, and winding up. Generally speaking, the decision has two key parts. The court first addressed an "apparent tension" between two provisions in the operating agreement. Section 10.1 of the operating agreement recited that entry of a decree of judicial dissolution pursuant to section 18-802 of the DLLCA would result in dissolution. By contrast, in section 13.1, titled *Waiver of Dissolution Rights*, the members agreed that "irreparable damage would occur if any member should bring an action for judicial dissolution," and waived their "right to seek a court decree of dissolution or to seek the appointment by a court of a liquidator for the Company." Relying on the language of section 18-802, which states that a "decree of judicial dissolution" may be entered upon an "application *by or for* a member or manager," the court reasoned that a member could waive his or her right to seek judicial dissolution, but could not waive another's right to seek judicial dissolution on behalf of the member. This portion of the *Fisk* decision leaves two interesting questions unanswered: first, who would have the power and authority to act "for" a member—a trustee or a guardian, perhaps? Second, if the member knowingly waives a statutory right, how does a trustee or guardian stepping into the shoes of the member, so to speak, succeed to rights greater than those possessed by the member?

The court next addressed waiver of the statutory rights embodied in sections 18-802, 18-803, and

18-805. The court concluded that these statutory rights are permissive, not mandatory, and thus could be waived. This conclusion was premised on three points. First, these sections do not expressly prohibit waiver, whereas other sections of the DLLCA, such as 18-1101(c) and (e), contain express language prohibiting waiver. Second, the court cited the use of permissive, rather than mandatory, language (i.e., "may") in sections 18-802 and 18-805 as evidence that the drafters of the DLLCA intended that these sections could be modified by the members in their agreement. Finally, the court reasoned that these statutory rights were not intended to protect third parties and, therefore, waiver of these rights would not harm the interests of third parties. The court also cited public policy reasons to further buttress its conclusion that these statutory rights could be waived.

Prior to *R&R Capital*, many, if not most, Delaware practitioners were of the opinion that the statutory right to judicial dissolution was mandatory, like its corporate counterpart, and thus could not be waived. Some practitioners remain of the opinion that the right should not be waivable because it affords members an exit mechanism in the face of oppression or other business-related misconduct. Though the court in *R&R Capital* stated that the implied covenant of good faith and fair dealing would provide sufficient protection to members, that doctrine is applied narrowly in Delaware and, therefore, a question remains whether the doctrine truly can provide adequate protection. That said, *R&R Capital* is the law in Delaware presently. Therefore, practitioners would be wise to consider whether this statutory right should be among the panoply of rights and protections incorporated into the members' operating agreement.

Document Inspection Rights

Finally, practitioners should understand and be prepared to define member inspection rights carefully. In the corporate world, stockholders possess a qualified right to inspect the books and records of a corporation in which they have invested, and Delaware courts have been careful to protect and encourage the use of that inspection right. By contrast, section 18-305 of the DLLCA affords members a right of access only to those documents and other information enumerated in that section, subject to such "reasonable standards" as may be set forth in the operating agreement. This right of access is statutorily qualified by the requirement that the demand for access be "for any purpose reasonably related to the member's interest as a member of the limited liability company."

Inspection rights are yet another example of where the law of limited liability companies departs from corporate law in Delaware. Member inspection rights may be broadened or narrowly restricted in the operating agreement. Since inspection rights may serve as an important check on management, care should be taken in drafting these provisions. Practitioners representing nonmanagement members may wish to broaden and fortify a member's right of access in the operating agreement, while those representing member-managers may wish to impose significant but reasonable limitations. As is often the case in much of the law, circumstances drive the decision. However, circumstances change over time, which is why practitioners should advise their clients to be even-handed, careful, and forward-looking when deciding on the terms of the operating agreement.

The Delaware Limited Liability Company Act

The Delaware Limited Liability Company Act (the Act) is reviewed annually and amended periodically to keep it current and to maintain its preeminence. Effective August 1, 2009, the Act was amended to

- Clarify that the court of chancery has subject matter jurisdiction to interpret, apply, or enforce any provision of the Act or any instrument, document, agreement or certificate contemplated by any provision of the Act (Del. Code tit. 6, § 18-111);
- Provide that a certificate of merger or consolidation filed by a surviving or resulting or other business entity must be executed by any person authorized to execute such certificate of such other business entity (Del. Code tit. 6, § 18-204);
- Allow a change of the registered agent or registered office to be included in a certificate of merger that is filed by a surviving domestic limited liability company (Del. Code tit. 6, § 18-209(c)(4));
- Confirm that a limited liability company may amend, or adopt anew, a limited liability company agreement in conjunction with a merger or consolidation under Del. Code tit. 6, § 18-209, unless the agreement expressly prohibits such amendment or adoption of a new agreement in connection with a merger or consolidation (Del. Code tit. 6, §§ 18-209(f) and 18-302(e)). As a result of this amendment, the amendment or adoption of a new limited liability agreement in connection with a merger or consolidation can be accomplished, notwithstanding a provision in the existing limited liability company agreement placing limitations or restrictions on

amendments, e.g., special voting or consent requirements such as supermajority approval; and

- Codify that the doctrine of independent legal significance may apply with respect to actions taken under provisions of the Act (Del. Code tit. 6, § 18-1101). The doctrine of independent legal significance provides that an action taken pursuant to one provision of the Act is legally independent and will not be deemed invalid solely because it is identical to or similar in substance to an action that could have been taken pursuant to another provision of the Act, but fails to satisfy the requirements of that other provision. In other words, each action has independent legal significance.

Walsh is a partner with Potter Anderson & Corroon LLP in Wilmington, Delaware. Gattuso is special counsel with Proctor Heyman LLP in Wilmington, Delaware. Walsh and Gattuso practice in the areas of corporate, alternative entity, and commercial litigation. Their respective e-mails are pwalsh@potteranderson.com and dgattuso@proctorheyman.com. The views expressed herein do not necessarily represent the views of Potter Anderson & Corroon LLP or Proctor Heyman LLP, or the firms' clients.

Back to Top

ABA BUSINESS LAW SECTION

KNOWLEDGE | COMMUNITY | EXPERIENCE

Business Law Today

Volume 19, Number 1 September/October 2009

Delaware Corporate Decisions

Key Cases from Early 2009

By Kevin F. Brady and Francis G. X. Pileggi

The Delaware Supreme Court and the Delaware Court of Chancery have issued collectively over 100 opinions during the first half of 2009. From those decisions, we selected a number of key cases that we thought would be of the most wide-ranging interest and that could be highlighted in this short article. We recognize that many notable Delaware corporate decisions from early 2009 have already been the subject of extensive scholarly commentary, and thus this short article does not attempt to address those decisions in great detail. Copies of the complete decisions cited in this article are available at www.delawarelitigation.com.

Liability of Directors

Inthe opinion styled *In re Citigroup Shareholder Derivative Litigation*, 964 A.2d 106 (Del. Ch.2009), the court found that *Caremark*-type duties were not designed to impose oversight liability for business risk. This opinion was the first detailed analysis of potential liability of directors under Delaware law for claims relating to a company suffering major losses resulting from substantial exposure to subprime debt. (For a discussion of this case's executive compensation claim—the only claim that survived a motion to dismiss in this decision—see the article by Michael J. Biles and Kimberly G. Davis in this issue, titled "Delaware Court Allows Claims Based on Executive Compensation to Go Forward.")

This action was brought by shareholder plaintiffs against current and former directors (i) alleging breach of fiduciary duties for failing to properly monitor and manage the risks that Citigroup faced concerning problems in the subprime lending market and (ii) for failing to properly disclose the company's exposure with respect to its subprime assets. Plaintiffs claimed that there were extensive "red flags" starting in May 2005 that should have put defendants on notice about problems "that were brewing in the real estate and credit markets." Defendants allegedly ignored the warnings and sacrificed the long-term viability of Citigroup for short-term profits. The court noted that "to establish oversight liability a plaintiff must show that the directors *knew* that they were not discharging their fiduciary obligations or that the directors demonstrated a *conscious* disregard for their responsibilities such as by failing to act in the face of a known duty to act." In addition, in order for the plaintiffs to succeed, "a showing of bad faith is a *necessary condition* to director oversight liability."

The court stated: "[a]lthough these claims are framed by plaintiffs as *Caremark* claims, plaintiffs' theory essentially amounts to a claim that the director defendants should be personally liable to the Company because they failed to fully recognize the risk posed by subprime securities." The burden was on the plaintiffs not only to show gross negligence but to rebut the presumption that the directors acted in good faith, on an informed basis, and in the honest belief that the action was taken in the best interests of the company. In light of the "extremely high burden" placed on plaintiffs, the court concluded that plaintiffs' conclusory allegations (and thus their failure to plead particularized facts) were insufficient to state a *Caremark* claim, thereby excusing demand. To the contrary, Citigroup had procedures and controls in place that were designed to monitor risk and the plaintiffs did not contest these standards. And even if there were warning signs, they are not evidence that the directors *consciously* disregarded their duties or otherwise acted in bad faith but may only be evidence that the directors made bad business decisions.

The court then went on to distinguish another 2009 court of chancery decision that *did* allow a *Caremark* "failure to monitor" claim to survive a motion to dismiss. That case was *American International Group, Inc. Consolidated Derivative Litigation*,2009 WL 366613 (Del. Ch. Feb. 10, 2009) (AIG case). The AIG case was distinguishable from this Citigroup case, the court observed, in part because unlike the allegations against Citigroup, the defendant directors in the AIG case "allegedly failed to exercise reasonable oversight over pervasive *fraudulent* and *criminal* conduct" (emphasis in original). Indeed, the court in AIG even stated that the complaint there supported the assertion that top AIG officials were leading a "criminal organization" and that the "diversity, pervasiveness, and materiality of the alleged financial wrongdoing at AIG is extraordinary." Finally, the court in *Citigroup* stated that **"**[o]versight duties under Delaware law are not designed to subject directors, even expert directors, to *personal liability* for failure to predict the future and to properly evaluate business risk" (emphasis in original).

Revlon **Duties of Directors Clarified**

The Delaware Supreme Court reversed the court of chancery's decision denying summary judgment for the directors of Lyondell Chemical Company (Lyondell) as to the "*Revlon*" and "deal protection" claims and whether the directors of Lyondell acted in good faith in conducting the $13 billion sale of Lyondell, in *Lyondell Chemical Company, et al. v. Ryan*, 970 A.2d 235 (Del. 2009).

The class action complaint alleged that the Lyondell directors breached their fiduciary duties of care, loyalty, and candor and put their personal interests ahead of the interests of the Lyondell shareholders. The court of chancery rejected all of the plaintiffs' claims except those directed at the process by which the directors sold the company and the deal protection provisions in the merger agreement, in particular, whether under *Revlon v. MacAndrews & Forbes Holdings, Inc.*, 506 A.2d 173, 182 (Del. 1986), the directors failed to obtain the best available price in selling the company.

The supreme court noted that the court of chancery improperly (i) "imposed *Revlon* duties on the directors before they either decided to sell, or before the sale had become inevitable"; (ii) "read *Revlon* and its progeny as creating a set of requirements that must be satisfied during the sale process"; and (iii) "equated an arguably imperfect attempt to carry out *Revlon* duties with a knowing disregard of one's duties that constitutes bad faith."

The supreme court made clear that *Revlon* duties arise not because a company is "in play" (such as in this case where there was a Schedule 13D filing), but rather when the company "embarks on a transaction—on its own initiative or in response to an unsolicited offer—that will result in a change of control." The supreme court further noted that "there are no legally prescribed steps that directors must follow to satisfy their *Revlon* duties" and that the Lyondell directors' failure to take any specific steps during the sale process could not have demonstrated a "conscious disregard of their duties."The supreme court reasoned that instead of questioning whether disinterested, independent directors did everything that they (arguably) should have done to obtain the best sale price, "the inquiry should have been whether those directors utterly failed to attempt to obtain the best sale price."

Director and Officer Fiduciary Duties

In *Gantler v. Stephens*,965 A.2d 695 (Del. 2009), the Delaware Supreme Court for the first time confirmed and clarified that officers of Delaware corporations have the same fiduciary duties as directors of Delaware corporations. The board of directors of First Niles Financial decided to sell the company, but then the board failed to take seriously the three offers that it received, and instead appeared to favor a privatization or a reclassification plan.

The Delaware Supreme Court for the first time explicitly held what has been implicitly stated previously, and has been also acknowledged by the Delaware Court of Chancery, and that is: "*officers of Delaware corporations, like directors, owe fiduciary duties of care and loyalty, and that the fiduciary duties of officers are the same of directors."* The court made that determination while acknowledging that Delaware General Corporation Law § 102(b)(7) does not exculpate officers from liability for breaches of their duty of care in the current statutory provision. In addition, the supreme court determined that the proxy disclosures concerning the deliberations of the board about the offer that was rejected were materially misleading. The court reviewed the materiality standard and reached a different conclusion than the trial court, thus allowing that claim to proceed.

Advancement of Director Legal Fees
In *Underbrink v. Warrior Energy Services Corp*., 2009 WL 536904 (Del. Ch. Feb. 24, 2009), the court of chancery addressed the application of its prior decision awarding advancement of fees to a dispute about what specific fees incurred in a Texas proceeding were covered by the prior advancement decision. It is well-settled law in Delaware that one who is entitled to advancement is also entitled to "fees on fees" for the cost of vindicating one's right to advancement. The specific amount of the claim for fees and expenses was the central issue that this letter decision addressed.

Although this letter decision analyzes in detail the dispute about the exact amount of fees and expenses covered by the advancement right, the court noted in its prior decision in this case that "the function of a Section 145(k) advancement case is not to inject this Court as a monthly monitor of the precision and integrity of advancement requests. . . . [A] balance of fairness and efficiency concerns would seem to counsel deferring fights about details until a final indemnification proceeding." *Underbrink*, 2008 WL 2262316, at *16 (Del. Ch. 2008). Also of interest on this issue is the case of *LaPoint v. AmeriSourceBergen Corp*., 970 A.2d 185 (Del. 2009) (Delaware Supreme Court addressed separate but related issue of indemnification for purposes of avoiding the waiver of an indemnification claim based on *res judicata* to the extent that there was a missed opportunity to address indemnification in a prior proceeding). The court in this case established the procedure for use of a "Special Master" to which the parties were directed to submit future disputes about the specific amount of fees that would be covered under the advancement right previously established by the court. In this letter decision, the court ordered as interim relief that a percentage of the amounts requested must be paid promptly, subject to modification at a later date in the contemplated, detailed proceedings before the Special Master.

Part of the challenge for the parties and the court was to attempt to separate time and expenses, incurred in Texas litigation on behalf of the two former directors entitled to advancement, from other fees for other parts of the litigation not subject to advancement.

The court did note for the edification of the parties that "neither advancement nor indemnification is appropriate for expenses that cannot be appropriately proven." Moreover, the court observed that a request that included $19,000 for "first class airline tickets [is] an expense generally considered unreasonable." This decision is helpful for the general rule that the court does not want to become entangled in the minutiae of fee disputes in connection with advancement rights, but in appropriate circumstances will address those issues when necessary. A related decision on this topic is *Lillis v. AT&T*, 2009 WL 663946 (Del. Ch. Feb. 25, 2009) (court of chancery reviewed the disputed amounts of fees to be awarded in advancement case involving unusual procedural posture).

Previous Advancement Modified
In *Duthie v. CorSolutions Medical, Inc., et al*., 2009 WL 1743650 (Del. Ch. June 16, 2009), the court of chancery revisited a prior decision awarding advancement due to changed circumstances that differed from those on which the initial award was based.

The important nugget from this relatively short letter decision is that the advancement can be modified based on changes in factual circumstances that occur after an order granting advancement rights is entered. Specifically, in this case, the court had ordered advancement to be provided in order for the plaintiff to pursue affirmative claims that the court determined were defensive in nature and were for purposes of responding to and offsetting claims that were pending against the plaintiff in a separate forum. The prior case is *Duthie v. CorSolutions Medical, Inc.*,2008 WL 4173950 (Del. Ch. Sept. 10, 2008). More specifically, the court held that the right to advancement included fees incurred in connection with a defamation action that was filed by an accused director.

In this most recent ruling in this case, the court of chancery relied on the new representation to the court that the defendants did not intend to bring any other actions against the ex-director. It was those suits against the ex-director that had been the genesis of the affirmative claims for which the court ordered advancement. Based on the fact that the justification for the advancement of fees and expenses incurred in pursuing the affirmative claims no longer existed, the court agreed to modify its prior award and amend the prior decision granting advancement.

The court reasoned that the threat here was over; thus, the court emphasized that there could be no right to advancement of fees and expenses for affirmative claims that were designed to defeat a threat that no longer existed**.** The court referred to the following cases for that point: *Donahue v. Corning*,949 A.2d 574, 579 (Del. Ch. 2008); Z*aman v. Amedeo Holdings, Inc*., 2008 WL 2168397, at *37 (Del. Ch. May 23, 2008).

Stockholder Books/Records Demands

In *Beiser v. PMC-Sierra, Inc*., 2009 WL 483321 (Del. Ch. Feb. 26, 2009), the Delaware Court of Chancery addressed the request of a stockholder plaintiff for books and records under section 220 of the Delaware General Corporation Law. The plaintiff was also the lead plaintiff in a related federal lawsuit in which discovery had been stayed pursuant to the Private Securities Litigation Reform Act of 1995 (PSLRA). The court explained why this particular plaintiff did not plead a "proper purpose," which is a prerequisite for a demand for books and records under section 220. The court explained that when "the only end use for the requested documents that may be inferred is to assist in the prosecution of a federal action where discovery is stayed under the PSLRA," the court will not grant a request for books and records under section 220.

The court recognized existing rulings from both Delaware courts and federal courts to the effect that neither the PSLRA nor the Securities Litigation Uniform Standards Act of 1998 pre-empts section 220 actions, especially where safeguards are present, such as not using the records obtained in the related federal cases that are pending. In the instant Delaware case, however, the court determined that the only purpose to the section 220 demand was to use any data obtained for the pending federal securities case, which was not a "proper purpose" under section 220.

The statutory definition of a proper purpose is "a purpose reasonably related to [one's] interest as a stockholder." Although Delaware courts have held that investigating the possible wrongdoing by officers and directors is a proper purpose under section 220, at the pleading stage, the plaintiff must do more than merely state in a conclusory manner a generally accepted proper purpose. Rather, one must "state a reason for the purpose, i.e., what it will do with the information, or an end to which that investigation may lead." The Delaware courts also have consistently encouraged plaintiffs to utilize section 220 before filing a derivative action.

In this case, unfortunately for the plaintiff, the only inference the court could make was that the purpose would be to aid the plaintiff in the pending federal securities action in which discovery had been stayed. Thus, finding no proper purpose, the court dismissed the case with prejudice.

Demand for Books/Records Denied

In *Norfolk County Retirement System v. Jos. A. Bank Clothiers, Inc*., 2009 WL 353746 (Del. Ch. Feb. 12, 2009), the court of chancery also denied a demand for books and records under section 220. As in the *Beiser* case, this case involved a related federal securities lawsuit, and also the request for books and records was not made until several months after the federal securities suit had been filed.

This case was presented on the procedural basis of two cross motions for summary judgment. Although the court acknowledged that an investigation of a potential corporate wrongdoing is generally a proper purpose under section 220, in order to prevail, one also must present "some evidence to suggest a credible basis from which a court can infer mismanagement, waste or wrongdoing may have occurred." Such a standard does not require that a stockholder making a section 220 demand have actual proof of mismanagement, but rather the stockholder must make a "credible showing through documents, logic, testimony or otherwise, that there are legitimate issues of wrongdoing."

Moreover, documents available to a stockholder under section 220 are limited even when the requirements of section 220 are met. Specifically, a plaintiff is not entitled to inspect all the documents that he or she believes are relevant, or that would lead to information related to the proper purpose. Rather, the courts in Delaware have repeatedly held that "[t]he scope of inspection should be circumscribed with precision and limited to those documents that are necessary, essential and sufficient to the stockholder's purpose." In this case, Norfolk was seeking documents related to circumstances surrounding the allegedly false and misleading statements also at issue in the pending securities class action and a separate derivative action. The company had previously provided a copy of the report of its Special Litigation Committee (SLC) and all exhibits thereto, and the minutes of the meetings of the SLC, as well as the minutes of the meeting of the company's board approving the creation of the SLC. The court reasoned that Norfolk did not establish a need for additional documents beyond what the company had already provided.

Additional Resources

For more reading on a similar topic, you can retrieve the following articles on the *Business Law Today* website at www.abanet.org/buslaw/blt.

All issues since 1998 may be accessed under the "Past Issues" heading at the bottom of the web page.

Keeping Current: Fiduciary Duties
Delaware courts set high bar for directors' breach of duty of loyalty
By Julie Kaufer and Justin Radell
Business Law Today
July/August 2009
Volume 18, Number 6

Keeping Current: Corporate Governance
Standards of review; officer fiduciary duties; and shareholder ratification
By Julie Kaufer and Justin Radell
Business Law Today
May/June 2009
Volume 18, Number 5

Brady is cochair of the Business Law Group of Connolly Bove Lodge & Hutz LLP in Wilmington, Delaware. Pileggi is the founding partner of the Wilmington, Delaware, office of Fox Rothschild LLP. He started a blog at www.delawarelitigation.com in 2005 that includes summaries of all the key decisions on corporate and commercial law from the Delaware Court of Chancery and Delaware Supreme Court. Their respective e-mails are kbrady@cblh.com and fpileggi@foxrothschild.com.

Back to Top

ABA BUSINESS LAW SECTION
KNOWLEDGE | COMMUNITY | EXPERIENCE

AMERICAN BAR ASSOCIATION
Business Law Section

Business Law Today

Volume 19, Number 1 September/October 2009

Know When to Hold 'Em

Don't Be a Gambler with Litigation Holds

By David A. Chaumette and Robert Witte

The scene plays out every day across the country: an injured worker, a demand letter comes in, a subsequent lawsuit. What are the company's responsibilities when it comes to preserving documents? In days past, the question was simpler due to the smaller volumes and fewer document types. Today, almost all business communication occurs electronically from word processing programs to internal and external e-mail accounts. University of California at Berkeley researchers announced that 93 percent of all information created during 1999 was generated in digital form, on computers of some sort. Only 7 percent came from other media, like paper, phonograph records, clay tablets, or smoke signals. And that was 1999.

This change in landscape has complicated the discovery process and increased costs across the board. However, an effective and reasonable document preservation program can serve as an active and early tool in preparing for and responding to broad electronic discovery demands. Such a program should respond to the organization's business, regulatory, and tax needs, including the need to maximize electronic storage space on the entity's server.

At a high level, a company's document retention policy should retain only e-mails with business record significance, to avoid the dangers associated with disclosing damaging information that might appear in personal communications. Such a system should include "litigation holds" to prevent destruction of documents related to ongoing or anticipated litigation. That general pronouncement is often of little use in real-world cases, as litigants in recent cases have discovered. In fact, the dangers in this area have proven quite significant. One of the more notable decisions of 2009, *Phillip Adams v. Dell*, 2009 WL 910801 (D. Utah Mar. 30, 2009) focused on one such hot spot—the issue of when the duty to preserve begins.

Background

Before turning to *Phillip Adams*, some background might help. The challenge to determine the proper scope of litigation holds is hardly new, although it has changed over time. For years, companies have understood that failing to implement and monitor document retention programs effectively can result in severe consequences, even without intentional wrongdoing. For example, in *In re Prudential Sales Practices Litigation*, 169 F.R.D. 598 (D.N.J. 1997), the court imposed a $1 million sanction upon Prudential after finding management had implemented a "haphazard and uncoordinated" policy of notifying employees about their responsibilities to preserve electronic documents. A few years later, one court ordered Phillip Morris to pay a $2.75 million monetary sanction for destroying relevant e-mails. *United States v. Phillip Morris USA Inc.*, 327 F. Supp. 2d 21 (D.D.C. July 21, 2004). The court further ordered that 11 key witnesses could not testify at trial because they collectively failed to comply with the document retention policies.

Having no hold policy in place can be worse. In *Keithley v. The HomeStore.com, Inc.*, 2008 WL 3833384 (N.D. Cal. 2008), the court sanctioned the defendant, HomeStore.com, more than $1.4 million, and entered multiple adverse inferences due to its "lackadaisical attitude with respect to discovery." In *Keithley*, the defendant conceded that no litigation hold policy existed during the relevant time periods underlying the claims.

When Does the Duty Begin?

Knowing when a litigation threat is "real" is subjective—and much easier in retrospect. This decision often requires analyzing overall claim risk, the scope of claim knowledge within your company, and the risk of data destruction absent a legal hold. No single (or easy) answer exists. The economic situation facing most companies, as well as the expense associated with establishing and maintaining a litigation hold, creates significant pressure to respond only when the litigation threat is absolutely concrete.

Yet, all is not lost. Courts are generally sympathetic to these challenges as companies attempt to determine when the preservation obligation arises. For example, in a non-e-discovery case, the Texas Supreme Court held that a producing party does not abuse the discovery process (by failing to produce) unless the opposing party proves that the nonproducing party had a duty to preserve the evidence at issue. *Wal-Mart Stores, Inc. v. Johnson*, 106 S.W.3d 718 (Tex. 2003). In *Johnson*, a Wal-Mart employee stocking merchandise accidentally knocked a decorative reindeer onto Johnson's head and arm. The court held that nothing in the investigation surrounding the accident gave Wal-Mart notice of Johnson's intent to sue or that there was a substantial chance that Johnson would sue. Thus, Wal-Mart had no duty to preserve the reindeer because Wal-Mart did not anticipate litigation.

In the e-discovery context, in *Cache La Poudre Feeds, LLC v. Land O'Lakes, Inc.*, 244 FRD 614 (D. Colo. 2007), the court held that the duty to preserve was not triggered by "back and forth equivocal letters about a dispute," noting the "less than adamant tone" of plaintiff's letters. Absent a clear litigation threat, Land O'Lakes did not need to presume litigation, and, therefore, there was no duty to implement the legal hold until Cache La Poudre Foods filed the lawsuit. Similarly, Judge Lee Rosenthal held that e-mail destruction automatic deletion was not sanctionable, absent demonstrated bad faith when good faith was evident in preserving the other potentially relevant data. *Escobar v. City of Houston*, 2007 WL 2900581 (S.D. Tex. Sept. 29, 2007).

With this backdrop, the District of Utah decided *Phillip Adams v. Dell*. In that patent case, the plaintiff challenged one of the defendants' efforts and timing preserving electronic information. The underlying claims addressed whether that defendant reverse engineered plaintiff's patented programs for solving a defect in floppy disk controllers. When the plaintiff compared the defendant's produced documents with documents produced in other related cases (involving other defendants), it found the production lacking. Simply, the defendant did not produce enough documents relevant to the dispute. The defendant responded, saying that its servers were "not designed for archival purposes" and it had instructed employees to preserve only e-mail "of long term value" locally. Therefore, only a limited number of documents were available for production. Further, the defendant said that it preserved documents only when it was clear that the company would be sued, and not when the first of these related cases appeared at the courthouse.

The court disagreed and held that the defendant had not established good faith in handling data given the threat of potential litigation. The court specifically noted that the company's ability to preserve financial data demonstrated that the company knew how to preserve important electronic information. Therefore, the safe harbor of FED. R. CIV. P. 37(e)—which prevents judicial sanctions when electronically stored information is destroyed during the good faith routine use of a computer system—did not protect the defendant's years of data destruction.

Remarkably, even though this particular defendant received a demand letter in 2005 and was not sued until 2007, the court held that component manufacturers like the defendant "were sensitized" to the floppy disk controller errors by class action lawsuits filed in 1999-2000, and the defendant should have preserved documents and other information related to those errors since that time. Further, as with Prudential years ago, the court held that the defendant's "lack of a retention policy and irresponsible data retention practices are responsible for the loss of significant data."

The judge's criticism on the defendant's retention policies informs other companies about the importance of getting ahead of the problem. The defendant's retention policies allowed individual employees to decide which e-mails to save. This unfettered discretion—combined with a perceived absence of relevant documents—led the court to find the retention policy unreasonable and sanctions appropriate.

The *Phillip Adams* story is not at an end. The magistrate judge's decision is on appeal. That said, the opinion presents a significant cautionary tale on what might trigger the duty to preserve information and when that duty is triggered.

What to Preserve and What to Discard?

Generally, electronic information falls into three categories: active, backup, and residual. Active data files contain information readily available and accessible from personal computers. Active data can include e-mail, word processing documents, spreadsheets, databases, and calendars and is relatively easy to view and obtain. "Easy" means "inexpensive," such that, unless special circumstances exist, companies should limit their production (but not necessarily their collection and preservation) efforts to active data.

E-mail is particularly problematic, because of its sheer volume, and the lack of logical filing methods for most e-mail systems. As a result, business e-mails are mixed with personal e-mails, ranging from love letters to chain-forwarded jokes. Accordingly, retrieving and screening of e-mail messages for relevance and privilege can prove difficult, costly, and time-consuming. Further, while requests for e-mail are common, valuable responsive discoverable documents exist in numerous other formats as well.

Backup data include files created automatically by various applications. These documents were never saved, and the user is probably not aware that they exist. Nevertheless, they may still be retrievable, and therefore discovered. Automatically backing up a file creates a file clone stored on the user's hard drive, but usually not on the network server. These backups continue to reside on the user's hard drive even after the document or file is deleted from the network server. These documents are rarely well organized, at least not from a human's point of view.

Over the years, backup tapes have generated great consternation and concern. While restoring backup tapes was once expensive, it is more economical now. The infamous *Morgan Stanley* case turned on backup tape production. Morgan Stanley could not restore its tapes in a timely fashion, resulting in an adverse inference instruction against it. Prepared future litigants know that if backup tapes are only used for disaster recovery, it will be much less likely that the company will need to restore those tapes.

Courts are increasingly less sympathetic to parties forced to expend significant resources in recovering data from inaccessible sources such as backup tapes when the party failed to preserve the equivalent accessible data. For example, in *AAB Joint Venture v. United States*, 75 Fed. Cl. 432 (Fed. Cl. 2007), the government did not produce any e-mail, and then argued that relevant e-mails were inaccessible because they only existed on backup tapes. The court rejected this argument, noting that a party is not excused from the obligation to produce relevant evidence simply because its preservation system is costly or inefficient. Importantly, the court held that if the government instituted a legal hold when it first became aware of a credible litigation threat, it might have preserved active e-mail, without having to rely on more costly backup tapes. This mistake sank the government's arguments.

In sum, companies must make a measured, considered response to potential litigation threats. Ignoring the issue is a recipe for disaster; courts are more understanding if the company has taken documented steps to evaluate the issues related to the potential dispute, even if the company determines that it does not yet have any duty to preserve.

How to Handle a Hold

The basics of a litigation hold include issuing a hold notice, identifying the right custodians (or key players), coordinating data identification and preservation, monitoring the implementation of the hold, and then releasing the hold.

Issuing a legal hold is the critical first step in satisfying the preservation obligation. However, even before any hold is needed, all employees should understand the company's legal hold policy and how to respond to any hold notice they receive. Representatives from legal, IT, and records management (if applicable) must have a thorough working knowledge of the policy and their various responsibilities under that policy.

Once a lawsuit is filed or hold notice issued, the company must suspend its document retention policies to prevent discarding data, and must notify employees to refrain from deleting e-mails or other computer documents.

This process becomes inefficient and ultimately unproductive if a lawyer does not know who to ask or how to ask for the information sought. It is often useful to interview individual data custodians so that the lawyer can best understand how the data are organized and what they contain. Such an interview would identify what resources the custodian uses and address more substantive issues as well. Topics also should include passwords, e-mail accounts used, and any idiosyncratic shorthand used at the company or in the industry.

With this information in hand, a lawyer can conduct a more focused, reasonable, and cost-effective search that will help undermine objections that discovery demands for electronic evidence are overbroad, unduly burdensome, or cumulative. Time spent analyzing personnel and corporate structure could prove valuable in locating the right employee for deposition or to shape the initial discovery requests.

Once counsel has identified all regular or automatic deletion or alteration operations affecting the company's data, users must understand the need to preserve data and work closely with IT personnel. The company should clearly document how this information is sent to the users. Documenting the process can provide protection against future sanctions and provide assurance that the proper steps are being taken. Importantly, documenting also can, hopefully, avoid problems. Such documentation may include detailing the origin of computer evidence, which computer contains what data, hard drive contents, the computer's location, the computer's custodian, who was authorized to use the computer, and how the drive was imaged. Continuously documenting electronic data collection efforts assists in collecting less nonrelevant data and ensures that data that should be collected are not overlooked.

The case of *Treppel v. Biovail Corp.*, 2008 WL 866594 (S.D.N.Y. Apr. 2, 2008), illustrates some of the pitfalls of failing to send litigation holds and failing to follow up with the custodians. When discussing Biovail's efforts in implementing its litigation hold, the court found the corporation was slow to start its preservation program and that, although the general counsel claimed to have instructed two custodians to preserve electronically stored information, it was unclear when they actually began preserving evidence or what materials they preserved. In the end, Biovail's failings led to significant distractions within the underlying litigation.

Parties face another challenge in determining how to remove litigation holds once put into place. Since the Federal Rules of Civil Procedure were amended in 2006, companies understand the need to implement effective document preservation in order to avoid spoliation claims or other sanctions. However, those same companies typically do not have a process for releasing those holds after the litigation concludes. Automatically retaining data from concluded cases could cause problems because those databases might become sources of evidence in future matters. If counsel and parties are not careful, the company may incur the fixed costs of searching these databases without any real benefit (and potential detriment) in future litigation.

Conclusion

Electronic discovery can result in substantial costs to the parties, even when those parties do everything right. However, the situation becomes worse when those parties do not adequately prepare for litigation, creating the potential for sanctions and other distractions. Courts have been reluctant to sanction companies that have (and follow) well-developed (and documented) processes that can be demonstrated at a later date, but judges are quite willing to sanction companies whose policies are haphazard, poorly implemented, or poorly documented. *Phillip Adams* presents an important shot across the bow, another warning of the dangers of ignoring the e-discovery obligations facing companies today. The lesson is clear: you can't benefit from the safe harbor if you don't know when to get out of the water. In other words, if you don't know when to hold 'em, you might find yourself holding a losing hand.

Additional Resources

For more reading on a similar topic, you can retrieve the following articles on the *Business Law Today* website at www.abanet.org/buslaw/blt. All issues since 1998 may be accessed under the "Past Issues" heading at the bottom of the web page.

E-Discovery and Electronic Evidence in the Courtroom
A Primer for Business Lawyers
By Timothy J. Chorvat
Business Law Today
September/October 2007
Volume 17, Number 1

Avoiding the Preservation Predicament
Preparing for E-Discovery Obligations Before Disputes Arise
By Kevin F. Brady and Chad Breckinridge
Business Law Today
September/October 2007
Volume 17, Number 1

Responding to the "E-Discovery Alarm"
Planning Your Response to a Litigation Hold
By Arthur L. Smith
Business Law Today
September/October 2007
Volume 17, Number 1

Chaumette practices law with De la Rosa & Chaumette in Houston. Witte is a partner at Strasburger & Price, LLP in Dallas. Their respective e-mails are dchaumette@delchaum.com and robert.witte@strasburger.com.

Back to Top

ABA BUSINESS LAW SECTION
KNOWLEDGE | COMMUNITY | EXPERIENCE

Business Law Today

Volume 19, Number 1 September/October 2009

Honest Services Fraud

You May Already Be Guilty!

By Neil Abbott and K. B. Battaglini

All criminal acts contain a component of dishonesty. But do all dishonest acts contain a component of criminality? A brief digression if you please.

A university student schemed with his professor to turn in plagiarized work. He should have been kicked out of school, but instead found himself with a criminal conviction.

A New York lawyer traded side payments to insurance adjusters in exchange for the accelerated processing of his clients' awaiting claims. He made a visit to the state penitentiary when he should have been disbarred.

A prominent Mississippi trial lawyer legally donated money to the state's Democratic Party and then appeared as a lawyer before the judicial candidates who received his donations. All he got for his hard-earned money was a damp prison cell.

You must be wondering: What law did these random private individuals violate? Drum roll please: they were all convicted of violating 18 U.S.C. § 1346—commonly referred to as "honest services fraud." The honest services provision is 28 open-ended words that have created a buzz in the legal community:

> For the purposes of this chapter, the term "scheme or artifice to defraud" includes a scheme or artifice to deprive another of the intangible right of honest services.

The situations discussed above are just some recent examples of the harmless acts of dishonesty that have branded a growing number of unfortunate people forevermore as criminals. It might seem hard to imagine, but similar dishonest conduct could land you in handcuffs.

Sound a little crazy? Well, it certainly is! Prosecutors across America are using honest services fraud to combat a wide array of dishonest acts. But is it really their job to get in the sandbox and play mom? Should ordinary people be held criminally responsible for everyday acts of dishonesty —especially when they are not violating any other law?

Scalia's Scrutiny

Supreme Court Justice Antonin Scalia does not seem to think so. In his recent scathing dissent from the majority opinion in *Sorich v. United States*, 129 U.S. 1308 (2009), he called for a review of honest services fraud. He cited various examples to show the unfairness and utter preposterousness of the honest services provision and stated that "[i]t is simply not fair to prosecute someone for a crime that has not been defined until the judicial decision that sends him to jail."

Justice Scalia listed numerous examples to illustrate why the provision is just too broad. He argued that a state senator who voted for a bill only to appease a small minority essential to her reelection, a mayor who used the prestige of his office to obtain a table at a restaurant, a public employee who recommended an incompetent friend for a public contract, and a self-dealing corporate officer would all be in violation of this criminal law. What Justice Scalia is attempting to demonstrate is how easily an individual can unknowingly fall within the scope of the honest services provision.

Running a quick Google search reveals why the blogosphere has been buzzing for months. Every commentator and his dog have weighed in on the issue and breadth of honest services fraud. Some applaud the law's ability to criminalize a wide range of unethical behavior, while others share Justice Scalia's perspective and view the law as overreaching. However, most are deeply troubled by the politically motivated uses of the honest services provision. The controversy surrounds the use of the law to punish a wide range of seemingly immoral and unethical behavior.

The problem with the honest services provision is that the outer boundary of the law is unclear. It is impossible for individuals, like the increasing number of private citizens convicted under the statute, to know when dishonest acts become criminal. The fine line between criminality and dishonesty is ultimately determined not by the wording of the law, but by the discretion of individual prosecutors.

Justice Scalia recognized this dilemma in *Sorich* and called for an immediate review of the law. Although his colleagues disagreed with him at that time, the Supreme Court has the opportunity once more to review honest services fraud in the appeal, which was recently granted certiorari from the Seventh Circuit, of Canadian media tycoon Conrad Black.

The Supreme Court should take this opportunity to restrict the use of honest services fraud to its original purpose: prohibiting dishonest acts by public officials. Given the range of civil remedies available in the United States, there is no need to use honest services fraud to prosecute private actors.

History of Honest Services Fraud

The provisions for both wire and telephone fraud require a "scheme or artifice to defraud." Up until 1987, courts were expanding the fraud provisions to prohibit any conduct by a public official that deprived citizens of their intangible rights to honest services and impartial government. The Supreme Court rejected this interpretation of the provisions in *McNally v. United States*, 483 U.S. 350 (1987). The court held that this form of official corruption and misconduct did not constitute fraud under the wording of the provisions. *McNally* overturned a line of appellate court decisions, as the Supreme Court clearly said: "If Congress desires to go further, it must speak more clearly."

One year later, in an attempt to reverse the Supreme Court's decision, Congress enacted the honest services provision. Congress failed in its attempt to restore the law to its pre-*McNally* state, and these 28 words have wreaked havoc ever since. For two decades, courts struggled to define the intangible right of honest services and to determine to whom the right is owed. Prosecutors artfully seized the opportunity created by this uncertainty and have used the provision to police an assortment of private conduct.

The "terse amendment," as Justice Scalia states, created broader prosecutorial freedom than under the pre-*McNally* law. Although the amendment's original use was to prosecute people in the public realm, the stories above

Other examples of the uses of the honest services provision

In Los Angeles, federal prosecutors are

demonstrate how its use has expanded over the past 21 years. Prosecutors now use it as a powerful tool when policing the private realm. What was intended to be a criminal offense applicable only to public officials has evolved into a device to criminalize otherwise legal activities.

investigating whether the largest Roman Catholic archdiocese in the United States violated the law when its top officials allegedly covered up sexual abuse of minors by the church's priests.

At Baylor University in Texas, three basketball coaches violated the law when the prosecutor successfully argued that the coaches deprived the school of its right to honest service by violating NCAA recruitment rules.

In the private sector, the appellate courts are split on the requirements for honest services fraud. Some courts recognized the need to restrain the law's scope, while others have allowed prosecutors to run wild. As Justice Scalia stated in *Sorich*, "without some coherent limiting principle to define what 'the intangible right of honest services' is, when it derives, and how it is violated, this expansive phrase invites abuse by headline-grabbing prosecutors in pursuit of local officials, state legislators, and corporate CEOs who engage in any manner of unappealing or ethically questionable conduct."

Some courts have narrowed the law's scope by requiring a breach of a fiduciary duty or the violation of a state law. Other limitations, like intent requirements or proof of actual economic harm, have been used to narrow the scope of the honest services provision. Although these additional requirements are not apparent on the face of the provision, they are effective at reducing the provision's utility as a prosecutorial tool.

It is other courts, which have adopted fewer requirements, that have produced the examples discussed above. These courts need only a dishonest act, whether lawful or unlawful, to obtain a conviction. These courts are concerned only with dishonest conduct, and have convicted without the presence of economic harm or on the basis of a reasonable foreseeability of the economic harm.

These divergences in the law can be handled with ease. Conrad Black's appeal provides the Supreme Court with the ideal opportunity to restore honest services fraud to its original purpose: punishing public officials for acts of dishonesty. Given the range of civil remedies available to the remainder of the populace, honest services fraud is not needed in the private realm.

A Canadian Clarifying American Law?

Even if you have not heard of honest services fraud, you are certainly familiar with it. It was used in several high-profile cases including the prosecution of Enron's Jeffrey Skilling, former Washington lobbyist Jack Abramoff, and impeached Illinois Governor Rob Blagojevich. The law is so far-reaching that even Conrad Black, one of Canada's most well-known corporate criminals, could not escape its grasp.

Ironically, 20 years of uncertainty in American law will be clarified by the appeal of a former Canadian who was never criminally charged in Canada. Conrad Black was a household name north of the border long before the controversy surrounding his company (Hollinger International, Inc.) came south into the U.S. courts. He was an aristocrat who, after a public argument with then Prime Minister Jean Chretien, denounced his Canadian citizenship to become a member of the British House of Lords.

Lord Black, as he is now known, built Hollinger into a world-class organization with market capitalization in excess of $1 billion. It owned and operated several large newspapers, including the *Jerusalem Post*, the *Chicago Sun Times*, the London *Daily Telegraph*, and the *National Post* in Canada.

Lord Black's run-in with the law stemmed from Hollinger's divestment of several smaller newspapers. As part of the sale, Lord Black received noncompetition payments directly from the acquiring parties. The prosecutors proved these payments to be bogus and showed the money rightfully belonged to Hollinger. The court convicted Lord Black under honest services fraud because he denied Hollinger of its right to honest services by accepting the noncompetition payments.

The Supreme Court decided to hear Lord Black's appeal on the basis that his conviction may have been unwarranted. Many hope that the Court will finally clarify the vague and ambiguous language of the 1988 honest services amendment.

Public Law: The Uninvited Guest

The use of honest services fraud to prosecute elected public officials is less offensive than the application of the law in the private sphere. For many, the idea of public office is a noble one, with historic roots and a deep-seeded obligation to fulfill the ultimate unselfish act: public service. This underlying rationale does not support the use of honest services fraud to prosecute private behavior.

The private sector relationship between shareholders and officers of a corporation is generally financial in nature. When conflicts arise, the harms complained of are often financial, and it follows that the remedy sought should be defined in monetary terms and not in years of a prison sentence. Importing the noble idea underlying public service into an economic relationship is inappropriate, as private disputes are properly resolved in civil courts. Numerous remedies are available in tort, contract, and corporate law to individuals wronged in the private realm.

Let's not kid ourselves; the role of corporate officer does not carry the weight, historic significance, or integrity that flows from public service. At its core, the disputes between these private parties are not about the deprivation of honest services. They are about money. The courts that require proof of economic harm to make out a charge of honest services fraud seem to agree.

While easier to justify, it should be noted that public sector honest services fraud is not without its complications. For instance, whatever happened to the idea that politicians should be held accountable by political means? In the absence of honest services fraud, unscrupulous politicians would be held accountable by the same means by which they were empowered: the people.

Journalists would play the role of prosecutors by uncovering the less-than-honest behavior and exposing it to the public. A trial would take place, not in a courtroom, but in the media circus. Each voter would get to participate in the jury, a verdict would be delivered, and the ultimate punishment would be doled out to the tune of public disgrace and no reelection. Given recent incidents involving public officials, the political remedies lack the teeth necessary to protect the integrity of public office. Nevertheless, the current uses of honest services fraud must be reigned in and returned to its original public purpose.

Overzealous criminalization of borderline political dishonesty, while well intended, has been hijacked into kitchen-sink, grab-bag-style prosecutions against nonpolitical officials. The indeterminacy of the statute combined with prosecutorial discretion results in an environment of uncertainty with the potential to criminalize business-as-usual. Recent corporate scandals, coupled with an economic environment that cannot sustain them, scream for increased accountability of corporate officials. But there remains significant debate regarding the best means to achieve this end.

Chaos Finally Controlled?

The honest services provision is a legitimate provision designed to combat legitimate corruption. In the absence of clearly defined limits, the broad wording of the statute invites abuse by prosecutors. The examples above illustrate the danger inherent in a broadly worded criminal statute. Critics and supporters of honest services fraud agree that when liberty is at stake, the outer limits of criminalized behavior must be more clearly defined. Over the past 20 years, defining this outer limit has been a challenge for the courts. This challenge will be resolved if the Supreme Court restricts honest services fraud to its original use of policing public officials.

The remedies for behavior currently captured by private sector honest services fraud can and should remain a matter for the civil courts. It is appropriate to seek a financial remedy for a financial harm that results from a purely financial relationship. Prior to honest services fraud, this type of corporate behavior was held accountable in the civil courts. The corporate behavior captured by private sector honest services fraud is adequately addressed by the existing corporate law concept of breach of fiduciary duty and the judicial award of civil remedies.

Corporate corruption is a problem we all agree merits judicial intervention. The question regarding private sector honest services fraud remains: Is the remedy worse than the disease? The stigma of a criminal record most certainly outweighs the harm that individuals cause others by depriving them of their right to honest services. The law has simply gone too far. The vague requirements of honest services fraud are too broad to allow those who aspire to be law-abiding citizens to actually follow the law.

The proper role of honest services fraud as it relates to adjudicating private sector disputes remains to be defined. Commentators north and south of the border will certainly be following Lord Black's appeal with interest and trepidation. Hopefully the Supreme Court will do its part and finally take up Justice Scalia on his offer to define the law. After all, his dissent in *Sorich* perfectly hones in on the issue: "Indeed, it seems . . . quite irresponsible to let the current chaos prevail."

Additional Resources

For more reading on a similar topic, you can retrieve the following article on the *Business Law Today* website at www.abanet.org/buslaw/blt. All issues since 1998 may be accessed under the "Past Issues" heading at the bottom of the web page.

> **Prosecution of Private Corporate Conduct**
> *The Uncertainty Surrounding Honest Services Fraud*
> By Frank C. Razzano and Kristin H. Jones
> *Business Law Today*
> January/February 2009
> Volume 18, Number 3

Abbott is a partner at the Toronto office of Gowling Lafleur Henderson LLP, and Battaglini is a partner at the Houston office of Greenberg Traurig LLP. Their respective emails are neil.abbott@gowlings.com and battaglinik@gtlaw.com. The opinions expressed in this article are those of the authors and do not reflect a position or endorsement by Gowling Lafleur Henderson LLP or Greenberg Traurig LLP, or any other partner or associate of either firm. *The writers gratefully acknowledge the assistance of law students David Campbell, Michelle McBride, and Nohayia Javed in the preparation of this article.*

ABA BUSINESS LAW SECTION
KNOWLEDGE | COMMUNITY | EXPERIENCE

Business Law Today

Volume 19, Number 1 September/October 2009

The CPSIA

Congressional Response to the "Year of the Recall"

By A. Marvin Quattlebaum, Jr. and Dowse B. "Brad" Rustin IV

In 1972, Congress passed sweeping legislation creating the Consumer Products Safety Commission (CPSC), which was established in 1973. The CPSC, an independent federal agency, was charged with protecting the public from unreasonable risks of serious injury or death associated with consumer products. Since that time, the role of the CPSC has gradually evolved. However, in the wake of a number of high-profile recalls and product scares, Congress passed the most dramatic regulatory regime for consumer products since 1972. With the Consumer Products Safety Improvement Act of 2008 (CPSIA or the Act), Congress has again introduced sweeping reform targeted at manufacturers, distributors, and retailers of consumer products

What Is Affected?

The CPSC defines "consumer products" as "any article or component part thereof produced or distributed (i) for the sale to a consumer for use in or around a permanent or temporary household or residence, a school, in recreation or otherwise, or (ii) for the personal use, consumption or enjoyment of a consumer in or around a permanent or temporary household or residence, a school, in recreation, or otherwise." The CPSC's jurisdiction covers thousands of consumer products that are produced or sold by manufacturers, distributors, and retailers. Despite its expansive regulatory territory—covering over 15,000 types of consumer products—CPSC has been limited in its enforcement ability by its small agency of only 400 to 500 employees, small budget, and disjointed enforcement. To fill these gaps in regulation, a number of states have gone so far as to promulgate their own safety standards, regulations, and testing protocols. These differing standards have been particularly onerous on businesses operating in multiple jurisdictions. These companies must comply not only with federal regulations and testing, but also with the relevant state regulation and testing regime. As would be seen in a number of high-profile recalls, this two-layer process left a number of gaps.

The "Year of the Recall"

The year of 2007 will be remembered as the "Year of the Recall." During this one year alone, there were 20 million toys recalled in the United States, most of which were manufactured in China and recalled due to the use of lead paint. Some of the more high-profile recalls involved the RC2 Corporation, which recalled over 1.5 million Thomas & Friends wooden railway toys, and Mattel, which recalled over 1.5 million Fisher-Price toys followed by an additional recall of 9 million more toys. All of these toys had been manufactured in China. As the number of recalls continued to rise, consumers and politicians began seriously questioning manufacturers' reliance on the overseas manufacture of U.S.-destined consumer goods.

While the Year of the Recall may have motivated sweeping legislation, the legal response has been slower. Immediately in the wake of these recalls, there was significant class action litigation. Somewhat surprisingly, to date there have been no earth-shattering rulings or large awards of punitive damages. This largely can be attributed to problems establishing causation and injury to a particular plaintiff. Instead, the most significant outcome of the Year of the Recall was the passage of CPSIA. The CPSIA has largely been Congress's attempt to avoid a recurrence by enacting stricter rules and stiffer penalties for those companies that fail to comply with CPSC standards. In addition, it increases consumer protection legislation, particularly in the area of children's products.

The CPSIA of 2008

The CPSIA is the strongest single piece of consumer protection legislation since the creation of the CPSC in 1972. It significantly increases CPSC's staff, funding, laboratory facilities, and the number of commissioners. The Act imposes new, stricter limits on consumer products containing lead, specifically children's products containing lead or phthalates (substances that are added to plastics to increase their flexibility, and recently linked to health issues such as autism). Affecting businesses more than any other piece of the legislation, the CPSIA bolsters CPSC enforcement procedures and powers through significant increases in civil fines, criminal penalties, and ease of conviction. Now, a director, officer, or agent of a manufacturer, distributor, or retailer can be convicted of violations of CPSC standards even if he or she has no knowledge of noncompliance with the CPSIA from the commission. It establishes whistle-blower protections and an online CPSC database of reported product hazards and increases state attorneys general enforcement power. Information on violations will be shared by CPSC with other federal, state, local, or foreign governmental agencies. These new requirements and penalties significantly increase the CPSC's power, and as the CPSC continues to implement regulations, the cost and complexity of doing business for sellers of consumer products will continue to increase.

Perhaps the greatest focus in CPSIA pertains to children's products. Though the Act goes into greater detail, a children's product is any consumer product designed or intended primarily for children 12 years of age or younger. In determining whether a product will be classified as a "children's product," the CPSC will examine (1) a manufacturer's statement of intended use of the product, including the label; (2) whether the product is represented as being appropriate for use by children, including its packaging, display, promotion, and advertising; (3) whether consumers commonly recognize the product as being intended for use by children; and (4) whether the product is covered by the Age Determination Guidelines issued by the commission in September 2002. When the product is a "children's product," the CPSIA requires that the product be tested and certified by an approved third-party laboratory. The testing must strictly comply with CPSIA testing protocols, including full destruction lead content testing (the entire product must be tested as one). More importantly, children's products (including clothing, shoes, and toys) must now contain permanent tracking labels to identify the manufacturer, date of manufacture, source of the product, and a batch or run number.

All children's products must now be tested. The CPSC (or a designee) will accredit third-party testing laboratories. In the event a manufacturer uses a proprietary laboratory, the laboratory must be inspected and certified by the CPSC. The third-party testing certification requirements are based on a rolling implementation program.

Certificates to Accompany Products

A certification is applicable to a finished product. Unlike most European testing regimes that allow the certification of individual components, components cannot be manufactured, certified, and incorporated into a number of different products. The certificate must state which CPSC regulations apply to the product. The importer or domestic manufacturer must certify the product. The certificate must identify the location of testing records, as well as the testing date and testing laboratory. This certificate must accompany every import shipment or domestic manufacturer's shipment. The CPSC has promulgated regulations that allow for the use of electronic certificates. It must be supplied to all distributors and retailers of the product. The certificate does not have to be filed with the government, but must be available upon demand.

Testing Requirements

Each regulated or banned substance has individual testing protocols promulgated by the CPSC. Given the reaction by business groups to the testing requirements, the CPSC has somewhat relaxed its testing requirements. Testing, however, still requires that the "sample" in the test be representative of the entire finished product. For example, if a producer manufactures a rocking horse, the entire horse must be mill ground and blended into a homogenous mixture; then a representative sample of the entire horse would need to be tested. The testing procedures for lead paint, for example, have been somewhat relaxed. Paints may now be tested in groups (e.g., mix blue, red, and yellow together in the test sample) if the final test can conclusively determine that no individual paint could exceed the parts per million (ppm) limits under CPSIA. These testing regimes, however, are still quite involved for most manufacturers and may not be familiar to small producers of children's products.

Temporary Stay of Enforcement

The temporary stay provides limited relief from the testing and certification requirements that went into effect on February 10, 2009, for new total lead content limits (600 ppm), phthalates limits (1,000 ppm), and mandatory toy standards. The testing and certification requirements were stayed until February 10, 2009, pending a follow-up vote by the commission as to the possible extension of the stay. Even though manufacturers and importers will not need to test or certify to these new requirements, they must still meet the lead and phthalates limits, mandatory toy standards, and other requirements as set forth in the CPSIA.

Home-Based Business Challenges

The new CPSIA regulations affect not only large manufacturers of products but also apply across the board to small and home-based businesses. Regardless of the size of the manufacturer (a multinational company or an individual), the new requirements will apply. The limitations apply to resellers of children's products as well, though the regulations are slightly relaxed. A reseller of products may not sell products that he or she has reason to believe may contain a prohibited material. Otherwise, the requirements, including all third-party testing requirements, are required of every product.

This has provoked a strong reaction by small business advocacy groups. There are few CPSIA certified labs, and those currently certified tend to be in Asia. The "total destruction" testing is particularly expensive and can be cost prohibitive if the producer makes a few, large children's products. Though the CPSC attempted to relax some of the more onerous testing requirements, the overall effect has been a particular burden placed on small businesses. As the *Washington Post* pointed out in a December 21, 2008, article, manufacturers are reporting that testing of a single product can run as much as $24,000. A number of small manufacturers have already pulled out of the domestic toy market given the costs of compliance. These responses from small business groups represent the ongoing tension created by CPSIA between consumer advocates and manufacturers of small, historically safe products.

Retroactive Effect

The most controversial portion of CPSIA may not be contained within the Act, but within an interpretation letter issued by CPSC's general counsel. By letter dated September 12, 2008, CPSC's general counsel issued an interpretation stating that the limits and bans under the CPSIA apply not only to the manufacture of goods, but also apply to all products currently in the supply chain or on retailers' shelves. The retroactive effect of the CPSIA has been upheld by courts, including the Southern District of New York. This interpretation has been particularly difficult on some retailers, as they have no ability to pass the costs of compliance back to manufacturers or distributors. Rather, the costs of compliance must be absorbed or passed on to the consumers.

Conclusion

The CPSIA of 2008 represents one of the most comprehensive pieces of legislation since the creation of the Consumer Product Safety Commission. Only through careful attention to the new regulations and bans can a manufacturer (whether a multinational company or home-based, handmade producer) meet the various obligations imposed by the Act. Manufacturers should determine immediately whether any of these new provisions apply to their products. While the testing and certification requirements currently are stayed, manufacturers would be well advised to begin their third-party testing programs for the creation of the mandatory shipment certificates. Though the debate continues over the implementation and regulation of the CPSIA, the CPSC has shown a willingness to impose strict and immediate guidelines following the high-profile recalls of 2007.

More information regarding the CPSC can be obtained from its website, www.cpsc.gov.

A Brief Overview of CPSIA's Impact

Areas of increased and/or new regulation
· Children's products containing lead
· Standards regarding lead paint
· Standards and consumer registration of nursery products
· Labeling requirements for advertising toys and games
· Toy safety standards (choking, small parts, etc.)
· Products containing certain phthalates
· All-terrain vehicles (ATVs)
· Use of proprietary laboratories
· Information identifying supply chains

Enhanced oversight
· Mandatory third-party testing of children's products
· Required use of tracking labels for children's products
· Enhanced recall authority and corrective action plans
· Heightened penalties
· Increased enforcement powers by state attorneys general
· Whistle-blower protections
· Interagency cooperation
· Preemption of other state and local regulations

	CPSC Publishes Accreditation Procedure	Third-Party Testing Required
Lead paint (600 ppm)	September 2008	December 2008
Cribs and pacifiers	October 2008	January 2009
Small parts	November 2008	February 2009
Metal jewelry (600 ppm lead)	December 2008	March 2009
Baby bouncers, walkers, and jumpers	March 2009	June 2009

Quattlebaum is a managing partner and Rustin is an associate at Nelson Mullins Riley & Scarborough LLP in Greenville, South Carolina. Their respective e-mails are marvin.quattlebaum@nelsonmullins.com and brad.rustin@nelsonmullins.com.

ABA BUSINESS LAW SECTION
KNOWLEDGE | COMMUNITY | EXPERIENCE

Business Law Today

Volume 19, Number 1 September/October 2009

Supreme Court Update

Decisions from 2009

By Kendyl Hanks, Kate David, and Stacy Nathanson

While business cases perhaps do not typify the popular culture war du jour, they are no less significant. As one commentator noted in a 2008 analysis of the Court's recent opinions,

> Business cases at the Supreme Court typically receive less attention than cases concerning issues like affirmative action, abortion or the death penalty. The disputes tend to be harder to follow: the legal arguments are more technical, the underlying stories less emotional. But these cases—which include shareholder suits, antitrust challenges to corporate mergers, patent disputes and efforts to reduce punitive-damage awards and prevent product-liability suits—are no less important. They involve billions of dollars, have huge consequences for the economy and can have a greater effect on people's daily lives than the often symbolic battles of the culture wars.
>
> --Jeffrey Rose, *Supreme Court Inc.*, N.Y. Times Mag. (Mar. 16, 2008).

A few recent and select culture-war cases aside, the Roberts Court has been widely heralded as business-friendly. *See, e.g.*, Tony Mauro, *Supreme Court Continues Pro-Business Stance*, Legal Times (Feb. 21, 2008); Greg Stohr, *Alito Champions Business Causes in First Full High-Court Term*, Bloomberg (June 26, 2007) (referring to the 2006-07 Supreme Court term as "what may have been the most pro-business U.S. Supreme Court term in decades"); Robert Barnes & Carrie Johnson, *Pro-Business Decision Hews to Pattern of Roberts Court*, Wash. Post (June 22, 2007) (describing a case as another "victory for business in what has been a resoundingly successful year before the nation's highest court"). Observers have noted, for example, the U.S. Chamber of Commerce's impressive success at the Court in recent years through direct litigation and amicus filings. *See, e.g.*, David L. Franklin, *What Kind of Business-Friendly Court? Explaining the Chamber of Commerce's Success at the Roberts Court*, 49 Santa Clara L. Rev. 1019 (2009) (arguing that the

Court's recent decisions are less about "pro-business" or "pro-defendant" jurisprudence, and more about "a broadly shared skepticism among the justices about litigation as a mode of regulation).

With a few important exceptions—most notably preemption—the Court's most recent term (which wrapped up in June) confirmed this view with a series of pro-business decisions in the areas of antitrust, pleading standards, arbitration, and discrimination.

Restricting Private Antitrust Claims
The business community has witnessed a dramatic increase in antitrust suits filed in the United States in recent years. *See, e.g*, David Emanuelson, Parker Norman & Joseph Ostoyich, *More of the Same: Growth in Private Antitrust Litigation and Cutbacks by the US Supreme Court*, Global Competition Review: The Antitrust Review of the Americas 2009 (noting that "the number of federal court antitrust cases filed each year not only continues to grow, but is poised to reach levels not seen since the 1970s"). As a judicial counterbalance—intentional or not—the high court has issued a number of significant opinions that, together, indicate a trend toward restricting antitrust suits brought by private individuals. *See Leegin Creative Leather Products v. PSKS Inc*., 551 U.S. 877 (2007) (reversing an almost century-old rule that treated vertical resale price maintenance as *per se* illegal, and holding that vertical agreements are subject to the "rule of reason"); *Credit Suisse Securities (USA) L.L.C. v. Billing*, 551 U.S. 264 (2007) (holding that immunity can be implied when application of the antitrust laws might create a conflict with a competing federal regulatory regime); *Bell Atlantic Corp. v. Twombly*, 550 U.S. 544 (2007) (holding that in order to survive a Rule 12(b)(6) motion to dismiss a Sherman Act § 1 horizontal conspiracy claim, the plaintiff must plead facts that show it has a "plausible" claim; allegations that the defendants engaged in parallel conduct, coupled with "mere labels and conclusions" that the conduct resulted from "a conspiracy," is insufficient) (*see also supra*); *Weyerhauser Co. v. Ross-Simmons Hardwood Lumber Co. Inc.*, 549 U.S. 312 (2007) (holding that in order to prove predatory bidding—the practice of bidding up input costs to drive rivals out of business—the plaintiff must satisfy the *Brooke Group* standard, which requires a plaintiff prove that the alleged predatory bidding led to below-cost pricing of the predator's outputs) (citing *Brooke Group Ltd. v. Brown & Williamson Tobacco Corp*., 509 U.S. 209 (1993) (holding that in a single-product predatory pricing case, a plaintiff must prove that (1) its rival's low prices were below an appropriate measure of its rival's costs and (2) its rival "had a reasonable prospect, or, under § 2 of the Sherman Act, a dangerous probability, of recouping its investment in below-cost prices")).

This term was no exception. In *Pacific Bell Telephone Co. v. Linkline Communications, Inc.*, 129 S. Ct. 1109 (Feb. 25, 2009), the Court dealt a blow to plaintiffs asserting antitrust claims under a "price squeeze" theory. In *Linkline*, Internet service providers (ISPs) sued Pacific Bell, claiming that the company was charging them excessively high wholesale prices for digital subscriber line (DSL) access in comparison to the unreasonably low price it charged Pacific Bell's retail customers. The ISPs alleged that the scheme constituted "price squeezing" in violation of § 2 of the Sherman Act. A price squeeze occurs when a company holding a monopoly on the production of certain goods sets its wholesale prices higher than its retail prices, effectively preventing the wholesale customers from competing with it at the retail level. The district court denied Pacific Bell's motion to dismiss the case for failure to state a claim under Rule 12(b)(6) but granted its motion for an interlocutory appeal. Lower courts had previously found antitrust violations exist where wholesale prices are "too high" in relation to retail prices to allow firms purchasing from the integrated producer at wholesale to earn a "fair profit" through retail sales. Based on these authorities, the Ninth Circuit determined that the ISPs had stated a legitimate price squeezing claim.

Reversing in an opinion by Chief Justice Roberts, the Supreme Court held that vertically integrated producers are not subject to antitrust liability for so-called price squeezes unless they (1) have an "antitrust duty to deal" with their competitors at the wholesale level and (2) engaged in "predatory pricing" at the retail level of competition. The Court held that a "price squeezing" claim cannot be brought under § 2 of the Sherman Act when the defendant is under no duty to sell inputs to the plaintiff in the first place. Relying on its decision in *Verizon Communications Inc. v. Law Offices of Curtis V. Trinko*, the Court held Pacific Bell only owed the ordinary antitrust duty not to engage in predatory pricing. *See Verizon Communications Inc. v. Law Offices of Curtis V. Trinko, LLP*, 540 U.S. 398 (2004) (holding that a firm with no antitrust duty to deal with its competitors has no obligation to provide those competitors with a "sufficient" level of service). The Court then remanded, noting that the ISPs had already been allowed to file an amended complaint alleging an ordinary predatory pricing claim but that this claim "may not survive a motion to dismiss" because "if [Pacific Bell] can bankrupt plaintiffs by refusing to deal altogether, plaintiffs must demonstrate why the law prevents Pacific Bell from putting them out of business by pricing them out of the market."

As a practical matter, the Supreme Court's new standard in *Linkline* effectively forecloses price-squeeze antitrust claims except in the most extreme circumstances. But in the context of the larger trend of restricting private litigants' ability to bring antitrust claims, it exhibits the increasing difficulty antitrust claimants face at the courthouse. What remains to be seen is whether this judicial trend will have the effect of reducing the number of antitrust claims actually filed.

Favoring Arbitration (Mostly)

Mediation and arbitration have become increasingly popular vehicles for resolving disputes and avoiding costly litigation, a common objective for businesses. The issue of substantive and procedural enforceability of arbitration clauses has been winding through federal courts in recent years, which have witnessed increasing judicial acceptance—and enforcement—of arbitration as an alternative to litigation. These cases have generally announced a strong federal policy favoring arbitration. In this most recent term, the Court decided three significant arbitration cases of note to the business community—one of which calls into question this trend.

The most recent of these arbitration cases, *Vaden v. Discover Bank*, 129 S. Ct. 1262 (Mar. 9, 2009), was a case of strange bedfellows and, at least in the view of the dissenting chief justice, may restrict courts' ability to enforce arbitration agreements. Justice Ginsburg drafted the majority opinion, in which Justices Scalia, Souter, Kennedy, and Thomas joined. In *Vaden*,the Court more clearly defined the limits of federal jurisdiction under § 4 of the Federal Arbitration Act (FAA). *Vaden* was originally filed by Discover in Maryland state court to recover past-due charges from one of its credit cardholders. The cardholder counterclaimed alleging that Discover's finance charges, interest, and late fees violated state law. Although Discover's complaint and Vaden's pleading both invoked only state law, Discover urged that Vaden's state law counterclaims were preempted by federal law. Discover separately filed a petition in the U.S. District Court for the District of Maryland to compel arbitration of Vaden's counterclaims under § 4 of the Federal Arbitration Act based on an arbitration clause included in its cardholder agreement with Vaden. Although the FAA does not itself provide a basis for federal jurisdiction, Discover urged that its preemption defense to the cardholder's counterclaim was sufficient to invoke the district court's jurisdiction.

In a two-part holding, the Court first unanimously held in *Vaden* that a federal court may "look through" an FAA petition to compel arbitration to determine whether it is predicated on an action that "arises under" federal law. The second part of the Court's opinion, however, was decided 5-4, with Chief Justice Roberts filing an opinion in which Justices Stevens, Breyer, and Alito joined. The majority opined that federal-question jurisdiction depends on the contents of a well-pleaded complaint, and may not be predicated on actual or anticipated counterclaims, even when compulsory. Thus, a state law *claim* that is completely preempted by federal law may form the basis of federal court jurisdiction because it is recast as a federal question, but a state law *counterclaim* asserted by a defendant will not, even if the doctrine of complete preemption applies to the counterclaim. In dissent, Chief Justice Roberts complained that the majority's analysis "sharply restricts the ability of federal courts to enforce agreements to arbitrate."

In the second of the three arbitration opinions, the Court reaffirmed the strong federal policy favoring arbitration along a more predictable 5-4 split. In *14 Penn Plaza LLC v. Pyett*, 129 S. Ct. 1456 (Apr. 1, 2009),the Court held that a collective bargaining agreement (CBA) that clearly and unmistakably requires union members to arbitrate claims is enforceable as a matter of federal law. Respondents were members of a union that had engaged in industry-wide collective bargaining with the Realty Advisory Board on Labor Relations, Inc. (the RAB), a multiemployer bargaining association for the New York City real estate industry. The resulting CBA required union members to submit all employment discrimination claims to arbitration. Petitioner 14 Penn Plaza LLC was a member of the RAB that owns and operates the New York City office building where respondents worked. After 14 Penn Plaza, with the union's consent, engaged Spartan Security to provide licensed security guards to the lobby and entrances of the building, respondents were reassigned to jobs as porters and cleaners.

Respondents filed suit in federal district court alleging that their reassignment constituted age discrimination violating the Age Discrimination in Employment Act of 1967 (ADEA). Petitioners filed a motion to compel arbitration pursuant to §§ 3 and 4 of the FAA. The district court denied the motion, and the court of appeals affirmed, relying on *Alexander v. Gardner-Denver Co.*, 415 U.S. 36 (1974), for the proposition that CBAs requiring arbitration of ADEA claims, which reflect rights created by Congress, are prohibited.

Reversing in a decision by Justice Thomas, the Court held that the parties collectively bargained in good faith and agreed that employment-related discrimination claims, including those brought under the ADEA, would be resolved in arbitration. The Court reasoned that this freely negotiated term easily qualified as a "conditio[n] of employment" subject to mandatory bargaining under the NLRA and held that the CBA's arbitration provision must be honored unless the ADEA itself removes this particular class of grievances from the NLRA's broad sweep, which it does not. The Court held that the *Gardner-Denver* line of cases did not control where the CBA's arbitration provision expressly covers both statutory and contractual discrimination claims. Unconvinced by the majority's efforts to distinguish *Gardner-Denver*,Justice Stevens and Justice Souter (joined by Justices Stevens, Ginsburg, and Breyer) dissented in separate opinions and argued that the prior cases required the conclusion that "a CBA cannot waive employees' rights to a judicial forum to enforce antidiscrimination statutes."

The last of the three arbitration cases further solidifies the Court's favor for arbitration provisions. In *Arthur Andersen LLP v. Carlisle*, 129 S. Ct. 1896 (May 4, 2009), the Court held in a 6-3 opinion by Justice Scalia that a nonparty to a written arbitration agreement may seek to stay the proceedings under § 3 of the FAA if state law allows that nonparty to enforce the agreement. In *Carlisle*,plaintiffs sought tax advice from Arthur Andersen regarding the sale of their company. Arthur Andersen in turn introduced plaintiffs to Bricolage Capital, who referred them to a law firm for legal advice. These advisers recommended a particular tax shelter, which the IRS subsequently determined was illegal. Although the IRS offered amnesty to taxpayers who use such arrangements, the plaintiffs alleged that their advisers failed to inform them of that option and ultimately entered into a settlement program paying the IRS all taxes, penalties, and interest owed.

Plaintiffs filed suit in federal district court against Bricolage and Arthur Andersen, alleging a variety of tort and malpractice claims. Defendants moved to stay the action under § 3 of the FAA, demanding plaintiffs arbitrate their claims under their investment agreements with Bricolage. The district court denied the motions and defendants filed an interlocutory appeal, which the Sixth Circuit dismissed for lack of jurisdiction.

Reversing, the Court first held that § 16 of the FAA permits an appeal from an order denying a motion for stay pending arbitration regardless of whether the litigant is in fact eligible for a stay, and that because the defendants asked for a stay pursuant to § 3, the appellate court had jurisdiction to review. The Court then rejected the Sixth Circuit's determination that nonparties to a written arbitration agreement are categorically ineligible for relief under the FAA. Rather, § 3 provides that stays are available if the claims are "referable to arbitration under an agreement in writing." The Court concluded that if "a written arbitration provision is made enforceable against (or for the benefit of) a third party under state contract law, the statute's terms are fulfilled."

Pleading Standards

While standards governing a civil litigant's pleadings may be less than stimulating reading for most, cases altering those standards often have the broadest impact on tort lawsuits affecting businesses. The Court's most notable decision on pleading standards this term was *Ashcroft v. Iqbal*, 129 S. Ct. 1937 (May 18, 2009), a 5-4 opinion written by Justice Kennedy elaborating on the oft-analyzed *Twombly* interpretation of Federal Rule of Civil Procedure 8(a)(2)'s requirement that a pleading contain a "short and plain statement of the claim showing that the pleader is entitled to relief." *Bell Atlantic Corp. v. Twombly*, 550 U.S. 544 (2007). In *Iqbal*, the Court resolved any doubt about the scope of *Twombly* (an antitrust case) and held that the newly articulated standardapplies to all federal civil cases and all elements of the plaintiff's claims, including intent.

Under *Twombly*, while a plaintiff is not required to make "detailed factual allegations," he must do more than offer "labels and conclusions" or "a formulaic recitation of the elements of a cause of action." The Court further held that in order to satisfy Rule 8(a)(2)'s requirement to "state a claim to relief that is plausible on its face," a claim must be accompanied by facts that "allow[] the court to draw the reasonable inference that the defendant is liable for the misconduct alleged." This "facial plausibility" cannot be supported by "mere conclusory statements," and a reviewing court is required to "draw on its experience and common sense" in its determination of plausibility.

As applied in *Iqbal*, the existence of "more likely explanations" for the defendants' conduct (i.e., valid policy reasons) left the Supreme Court to conclude that the discriminatory allegations did "not plausibly establish this [discriminatory] purpose." The Court also addressed the plaintiff's complaint that he had insufficient opportunity to conduct discovery prior to dismissal, and held that Rule 8's liberal notice pleading standard "does not however unlock the doors of discovery for a plaintiff armed with nothing more than conclusions." Therefore, "the question presented by a motion to dismiss a complaint for insufficient pleadings does not turn on the controls placed upon the discovery process."

Iqbal and *Twombly* together have the potential to dramatically impair civil plaintiffs' ability to survive a motion to dismiss in all substantive areas. Legislators have taken note—Senator Arlen

Specter (D-Pa.) filed legislation on July 22, 2009, designed to return the civil pleading standard to its pre-*Twombly* status. In support of his legislation, Senator Specter complained on the floor of the Senate that "[t]he effect of the Court's actions will no doubt be to deny many plaintiffs with meritorious claims access to the federal courts and, with it, any legal redress for their injuries." Specter expressed the belief that private litigants' access to the courts is crucial where "the litigating resources of our executive-branch and administrative agencies [are] stretched thin, [and] the enforcement of federal antitrust, consumer protection, civil rights and other laws that benefit the public will fall increasingly to private litigants." Absent the passage of such legislation, however, these newly articulated pleading standards will remain an obstacle to asserting civil claims in federal court.

Reverse Discrimination

In probably the most significant discrimination case issued by the high court in decades, *Ricci v. DeStefano*, 129 S. Ct. 2658 (June 29, 2009), a sharply divided Court held that reverse discrimination is illegal under Title VII. The case arises in the context of testing employees for promotions. The city of New Haven, Connecticut, based future promotions of firefighters primarily on a written test that was administered by a consultant. A total of 59 out of 118 applicants passed, with only the top scorers eligible for promotion—including 17 whites, two Hispanics, and no African Americans. In an attempt to avoid a *disparate impact* claim, New Haven froze the promotions process to assess whether there was a test that appropriately evaluated candidates for promotions without the adverse impact on minorities. The white firefighters sued, alleging reverse discrimination (*disparate treatment*) and violations of the equal protection clause, and demanded the test scores be reinstated, with the promotions to follow. The city relied on the threat of the disparate impact claim as a defense to the disparate treatment claim. The district court granted summary judgment in the city's favor, and the Second Circuit affirmed. (Notably, Supreme Court appointee Sonya Sotomayor was on the panel of judges affirming the district court.)

Reversing, the Court avoided the equal protection issue and focused on the reverse discrimination claim. The Court held that (1) the decision to not honor the test results because the higher-scoring candidates were white violated Title VII and (2) the city's stated defense of a "good faith" belief that it would face disparate impact liability against the minority candidates did not excuse what otherwise would be prohibited disparate treatment discrimination. The Court required the defendant to show a "strong basis in evidence" to believe it would be subject to disparate impact liability "if it fails to take the race-conscious, discriminatory action," and held that the city's race-based rejection of the test results could not satisfy that standard. The Court held that applying "the strong-basis-in-evidence standard to Title VII gives effect to both the disparate-treatment and disparate impact provisions, allowing violations of one in the name of compliance with the other only in certain, narrow circumstances." The Court did, however, suggest that it will allow for affirmative action plans and noted that the employer's "voluntary compliance efforts" are essential to the success of Title VII.

Justice Ginsberg, joined by Justices Souter, Breyer, and Stevens, issued a strongly worded dissent, arguing that the Court should have considered the historically pervasive race discrimination in fire departments and Title VII's approval of employer-driven remedial measures. She concluded with her belief that "[t]he Court's order and opinion, I anticipate, will not have staying power." In the meantime, the new standards announced in *Ricci* will make it more difficult for employers to disregard exam results once they are administered, even if they have a disproportionately negative impact on members of a given racial group. It also may provide some succor for employers who elect not to take action to reverse negative impact on racial minorities and avoid a discrimination suit, where that action would negatively impact other racial (and nonminority) groups.

In another discrimination case concerning disparate treatment, *Gross v. FBL Financial Services, Inc.*, 129 S. Ct. 2343 (June 18, 2009), the Supreme Court held, in a 5-4 decision by Justice Thomas, that a plaintiff bringing an ADEA disparate treatment claim "must prove, by a preponderance of the evidence, that age was the 'but-for' cause of the challenged adverse employment action" and that "[t]he burden of persuasion does not shift to the employer to show that it would have taken the action regardless of age, even when a plaintiff has produced some evidence that age was one motivating factor in that decision." This holding essentially means that so-called mixed-motives claims (claims in which the evidence indicates that the employer was motivated by both unlawful and lawful reasons when taking an adverse employment action) are not permitted under the ADEA because a lawful reason for the employment decision would preclude a "but-for" causation finding as to the unlawful reason. The Court's decision creates a distinction between disparate treatment claims brought under Title VII (a federal statute that prohibits discrimination based on, among other things, race, religion, and gender) in which mixed-motives claims are permitted and the ADEA, in which they are not.

In other discrimination cases of note this term, the Court held that (1) the "opposition clause" of Title VII's antiretaliation provision is broad enough to protect an employee who speaks out about discrimination when answering questions during an employer's internal investigation, even though the employee did not initiate the complaint (*Crawford v. Metropolitan Government of Nashville and Davidson County*, 129 S. Ct. 846 (Jan. 26, 2009)) and (2) an employer does not necessarily violate the Pregnancy Discrimination Act (PDA) when it pays pension benefits calculated in part under an accrual rule—applied prior to the PDA's enactment—that gives less retirement credit for pregnancy than for medical leave generally (*AT&T Corp. v. Hulteen*, 129 S. Ct. 1962 (May 18, 2009)).

Due Process and Contributions

A modern cost of doing business is lobbying. Major industries often secure the services of government affair specialists who lobby state and federal legislatures on behalf of business interests. These lobbying efforts often spill over into judicial campaigns, where financial contributions are focused on candidates who are perceived as receptive to a particular position or judicial philosophy espoused by an industry or trade group. Such contributions may, however, do more harm to a litigant's interests, as illustrated by perhaps the most anticipated case of this term, *Caperton v. A. T. Massey Coal Co.*, 129 S. Ct. 2252 (June 8, 2009).

In *Caperton* the Court held that due process required disqualification of a judge where one party to the litigation had given substantial campaign contributions to the judge while the party's case was pending. In *Caperton*, a coal company and its affiliates (Massey) were held liable for a variety of torts and were ordered to pay petitioners (Caperton) $50 million in damages. Massey's CEO supported Judge Benjamin in his bid to be elected to the West Virginia Supreme Court, contributing $3 million—an amount that exceeded the total amount spent by all other supporters. Benjamin won by fewer than 50,000 votes. Citing these contributions, Caperton moved to disqualify Justice Benjamin under the Due Process Clause and the West Virginia Code of Judicial Conduct. The West Virginia court then reversed the $50 million verdict. During the rehearing process, Justice Benjamin refused twice more to recuse himself, and the court once again reversed the jury verdict. Four months later, Justice Benjamin filed a concurring opinion, defending the court's opinion and his recusal decision.

In a 5-4 opinion authored by Justice Kennedy, the Court held that the Due Process Clause required the judge's recusal, emphasizing that a "fair trial in a fair tribunal is a basic requirement of due process." The Court noted that normally judicial recusal does not rise to a constitutional level but that "there is a serious risk of actual bias—based on objective and reasonable perceptions—when a person with a personal stake in a particular case had a significant and disproportionate influence in placing the judge on the case by raising funds or directing the judge's election campaign when the case was pending or imminent." The Court's inquiry focused on "the contribution's relative size in comparison to the total amount of money contributed to the campaign, the total amount spent in the election, and the apparent effect such contribution had on the outcome of the election." Applying that standard to the facts of this case, the Court held that Justice Benjamin should have recused himself.

Backing Away from Preemption

This term the Court revisited a subject that seemed to dominate the 2006-07 term: preemption. The doctrine is important to the business community because the unsettled issue of whether federal or state law will govern certain kinds of claims—such as products liability and consumer claims—creates substantial uncertainty and potential risks for businesses. The Court's pro-business reputation has not, however, been vindicated by its recent preemption decisions.

The Court issued several significant preemption opinions this term. Disappointing pro-business observers, in *Altria Group, Inc. v. Good*, 129 S. Ct. 538 (Dec. 15, 2008), the Court concluded that a state law prohibiting deceptive tobacco advertising is not preempted by federal law regulating cigarette advertising. The Court held that, while smokers' lawsuits are preempted by the Federal Cigarette Labeling and Advertising Act (Labeling Act) if they claim that the tobacco companies did not warn them in their marketing about how unhealthy cigarette smoking is, claims based on a broader legal obligation detached from claims about smoking and health—for example, a claim that the cigarette company's marketing was an attempt to deceive by misrepresenting or leaving out key facts about their products (fraud)—may proceed. Justice Thomas, joined by Chief Justice Roberts and Justices Scalia and Alito, dissented, arguing that the Court should adopt a clear test that expressly preempts any state law claim that imposes an obligation because of the effect of smoking upon health.

Then, in the much-anticipated *Wyeth v. Levine*, 129 S. Ct. 1187 (March 4, 2009), the Court held that federal approval of labels giving warnings about effects of drugs does not bar lawsuits under state law claiming inadequate warnings of a health risk. In an opinion by Justice Stevens, the

Court first rejected the drug manufacturer's argument that by unilaterally changing its labeling of its drug to describe possible injuries that could occur from the negligent injection of the drug, it would have violated federal labeling regulations, and asserted that the manufacturer bears ultimate responsibility for the content of its labels at all times. The Court then rejected the drug manufacturer's argument that requiring it to comply with the state-law duty to provide a stronger warning would interfere with Congress's purpose of entrusting the FDA with drug labeling decisions. Rather, the Court reasoned that Congress did not intend to preempt state-law failure-to-warn actions when it created the FDA.

Finally, in *Cuomo v. Clearing House Ass'n, L.L.C.*, 129 S. Ct. 2710 (June 29, 2009), the Court held that claims under state fair lending laws are not preempted by the National Banking Act and that a state attorney general may bring a judicial enforcement action to enforce state law against a national bank. In an opinion by Justice Scalia, the Court held that the Office of the Comptroller of the Currency's (OCC) regulation purporting to preempt state law enforcement is not a reasonable interpretation of the NBA, which provides that "[n]o national bank shall be subject to any visitorial powers except as authorized by Federal law, vested in the courts . . . or . . . directed by Congress." The Court argued that the term "visitorial powers" is limited "to a sovereign's supervisory powers over corporations," or "administrative oversight." The Court emphasized the distinction between supervisory powers, where the OCC has a monopoly and the NBA preempts state action, and law enforcement (such as bringing suit to enforce state law against a national bank), where federal agencies *and* the states have jurisdiction over national banks.

Hanks and Nathanson are associates in the New York City office of Haynes and Boone, LLP, and David is an associate at Haynes and Boone, LLP in Houston. Their respective e-mails are kendyl.hanks@haynes boone.com, kate.david@haynesboone.com, and stacy.nathanson@haynesboone.com.

Back to Top

ABA BUSINESS LAW SECTION
KNOWLEDGE | COMMUNITY | EXPERIENCE

Business Law Today

Volume 19, Number 1 September/October 2009

Corporate Miranda

Clarifying Lawyers' Loyalty During an Internal Investigation

By Ashish S. Joshi

Internal investigation into suspected wrongdoing in a company is a veritable minefield for all involved. The afflicted company's officers are in a tricky situation to be sure, as they worry over possible outcomes and consequences of an investigation, but this article aims to help the company's attorneys avoid adding to the muddle. One way to achieve this is to clarify the attorney's loyalty to each involved employee. Explicitly warning employees that an attorney conducting the investigation is not representing their best interests may have its disadvantages, but as cases explored below show, this clarification, known as a "Corporate Miranda," is necessary.

Corporate Miranda or *Upjohn* warnings, in essence, place every employee that company counsel interviews during an investigation under a cloud of suspicion. The warning is generally provided to an employee being interviewed at the outset of an interview conducted by the company's lawyers during an internal investigation. At a bare minimum, the warning admonishes the employee that

1. Counsel represents the corporation and not the employee;

2. Communications between the employee and counsel will be privileged;

3. However, this privilege belongs to the corporation and the corporation alone can decide to exercise it or waive it.

At its core, Corporate Miranda attempts to clarify the loyalty of the lawyer conducting the investigation: I, the lawyer, owe my duty of loyalty to the company and not to you, an employee. In theory, a lawyer may, at least at the initial stage of the investigation, represent both the company and its employees—provided the company and individual clients are fully informed of potential conflicts and consent to multiple representations. The immediate advantages of such dual or multiple representation are enticing, especially from the company's perspective: avoid duplication of effort, enhance employee cooperation, permit a unified defense, and, last but not least, provide a considerable saving in cost and attorney fees. The downside of dual representation is that it may undermine the integrity and credibility of the investigation, risk a waiver of any applicable privilege, and/or land a lawyer in an ethical quandary or, worse, facing a charge of obstruction of justice.

The importance of delivering a clear Corporate Miranda was highlighted in the court filings of two recent criminal prosecutions, each initiated after the company retained outside counsel to conduct an internal investigation or to represent the company in an ongoing governmental investigation.

The Broadcom Case

A Conflicted Relationship from the Outset. William J. Ruehle is a former chief financial officer of Broadcom Corporation. In the spring of 2006 there were a series of news articles alleging improper practices of stock option granting at Broadcom and other corporations. Following this, in May 2006, Broadcom retained the law firm Irell & Manella (Irell) to conduct an internal investigation into its stock option practices. At this time, both Broadcom and Ruehle had long-standing relationships with Irell. In 2002, Irell represented both Broadcom and Ruehle personally in several securities-related actions that concluded at the end of 2005. Shortly after Irell was retained to conduct an internal investigation by Broadcom, on May 25, 2006, a group of shareholders filed a derivative action against Ruehle and other officers of the company. Also, on May 26, 2006, in another action, Ruehle was named as a defendant. Both actions focused on the stock option practices at Broadcom. Irell accepted individual representation of Ruehle in both actions in addition to its representation of Broadcom in connection with the internal investigation.

Failure to Clarify Duty of Loyalty. In May of 2006, Ruehle received several e-mails from the Irell lawyers regarding their representation of him in the civil actions. The e-mails updated Ruehle on the lawyers' progress in the civil actions. Then, on June 1, 2006, Irell lawyers met with Ruehle and interviewed him regarding their investigation of Broadcom's stock option granting practices. At this time, the Irell lawyers did not clarify to Ruehle that they were not his lawyers but were acting solely in the best interest of Broadcom. Nor did the lawyers suggest to Ruehle that he might want to consult with another lawyer before speaking with them.

On June 13, 2006, the SEC commenced its investigation of the stock option granting practices at Broadcom. During this time, Ruehle continued to receive legal advice from Irell regarding their defense of him and other officers of Broadcom in the ongoing civil actions. In August of 2006, at Broadcom's direction, Irell disclosed the substance of Ruehle's interviews to outside auditors and then to the SEC and the U.S. Attorney's Office. Irell's disclosures were summarized by the government in FBI 302 memorandums. Irell neither sought nor did Ruehle consent to any of these disclosures. Ruehle first learned about Irell's disclosures and the government's intended use of them against him when the FBI 302 memorandums were produced in December 2008 in connection with the government's criminal case against Ruehle. Ruehle promptly moved to suppress this evidence and asserted that his conversations with Irell were privileged communications. Judge Cormac Carney of the U.S. District Court for the Central District of California, after holding a three-day evidentiary hearing, agreed with Ruehle.

The court held that given the circumstances that Ruehle had a long-standing relationship with Irell and that Irell represented Ruehle in the ongoing civil actions during the time that Irell conducted internal investigations at Broadcom's directive, Ruehle was reasonable in believing that he was communicating with his attorneys. Ruehle reasonably believed that when he was "interviewed" by the Irell lawyers, the interviews were being conducted to gather information in preparation for his defense in the ongoing civil actions. Had Ruehle understood that the Irell lawyers might disclose his statements to third parties, he would have stopped the interviews, would have asked "some very serious questions at that time," and would never have agreed to provide information that Irell could then turn over to the government.

Corporate Miranda, Even If Delivered, Would Have Been Inadequate. As to the *Upjohn* warning, or Corporate Miranda, the court expressed serious doubts whether any was given to Ruehle. Ruehle did not remember being given any warning, no warning was referenced in the Irell lawyer's notes from the interview, and no written record of the warning existed in this case. But even if an *Upjohn* warning had been given to Ruehle, the court held that it would be woefully inadequate in light of the undisputed attorney-client relationship between Irell and Ruehle. In such circumstances, the court held that an *Upjohn* warning is "nonsensical at best and unethical at worst."

Lawyers' Omissions Violated Their Duty of Loyalty. Judge Carney then made a finding that Irell committed "at least three clear violations of its duty of loyalty to Mr. Ruehle." First, Irell had a duty to disclose to Ruehle the potential conflict of interest created by the dual representation and obtain Ruehle's written consent to that conflict; Irell violated this duty. Second, Irell breached its duty of loyalty to Ruehle by interrogating him for the benefit of another client, Broadcom. Third, Irell disclosed Ruehle's privileged communications to third parties without his consent. The court found Irell's ethical breaches to be "very troubling" and referred the firm to the State Bar of California for appropriate discipline.

The Broadcom case makes it clear that before accepting an internal investigation assignment, the company's lawyers must thoroughly undertake a conflict of interest check. Past representation of a company employee or the lawyers' past or current relationship with an employee must be carefully analyzed and taken into consideration. After all, as this case demonstrates, in some situations, even delivering a clear Corporate Miranda may not absolve the lawyers for committing an ethical violation.

The Stanford Case

Lawyer Retained to Represent the Company. Laura Pendergest-Holt is a former chief investment officer of the Stanford Financial Group (SFG). Since June of 2008, the SEC had been conducting an investigation into allegations that SFG and its executives had defrauded investors of more than $8 billion in deposits. During the same time period, other governmental agencies also were conducting a criminal investigation into these same allegations. SFG retained an attorney of the law firm Proskauer Rose (Proskauer) to "represent the companies in regulatory matters." In January 2009, the SEC issued subpoenas to SFG and its related entities and to its executives, including Pendergest-Holt. On January 21, 2009, Pendergest-Holt participated in a meeting with other top SFG executives and the attorney from Proskauer. The group agreed that the Proskauer lawyer would notify the SEC that Pendergest-Holt, along with another executive, would testify before the SEC.

Keeping 'em Inside the Tent: Let's "Pray Together." On January 22, 2009, the SEC attorneys met with the Proskauer attorney to discuss the issues regarding the SEC subpoenas. The SEC informed the Proskauer attorney that they wanted to depose individuals with the knowledge of the "entire investment portfolio." Proskauer informed the SEC that Pendergest-Holt (along with another executive) could provide information regarding SFG's entire investment portfolio. In an e-mail dated January 24, 2009, to a SFG executive (that was forwarded to Pendergest-Holt), the Proskauer attorney noted that "one problem [he] foresee[s] is that [Pendergest-Holt] knows about tier 1 and tier 2, but little about tier 3. [Pendergest-Holt] will have to get up to speed on tier 3 before the SEC investigation." Proskauer's lawyer also noted that he would like to make sure that "[Pendergest-Holt] [has] ample time to prepare and practice the week before the SEC meeting."

On January 27, 2009, the Proskauer lawyer sent an e-mail to Pendergest-Holt advising her that she would need to address all three investment tiers and not just Tier I and Tier II. On or around February 3, 4, and 5, 2009, Pendergest-Holt met with other SFG executives and the Proskauer lawyer at the SFG office in Miami. Pendergest-Holt and other SFG executives made presentations to the group concerning the value of the investments within Tiers I, II, or III. Some of the members of the group were surprised and unnerved by Pendergest-Holt's "revelations." One witness later described to the SEC that after watching Pendergest-Holt's presentation, he felt as if he "had been kicked." One senior executive voiced his concerns about the true nature of the Tier III investments and declared that he would not testify before the SEC "as the information he obtained at the meeting was not the information he disclosed to investors or [foreign] regulators." Other executives stated that they wanted to report the information learned at these meetings to the SEC. The Proskauer attorney was present during all of these meetings. On February 6, 2009, the group again met at the SFG Miami office. At this meeting, one of the group members broke down crying because of the revelations made during the previous meetings. This executive told the group (including the Proskauer attorney): "If you are going to go through more information I didn't know, I don't want to be there, and I'm going to the authorities." At this the Proskauer attorney walked over to the executive and "suggested they begin to pray together."

Who Did the Lawyer Represent? On February 10, 2009, Pendergest-Holt appeared in the company of the Proskauer attorney at the SEC's Texas regional office to give her testimony, which was taken under oath. At the outset, Pendergest-Holt was asked by an SEC lawyer whether she was represented by counsel, to which she answered: "I am"—obviously referring to the Proskauer attorney. The SEC lawyer then asked the Proskauer lawyer to make an appearance for the record. The Proskauer lawyer responded by stating his name, the firm's name, and that he represented *the company.* When the SEC lawyer asked point blank:

> Just so we're clear. As I understand your statement, you do not, as far as you're concerned, represent [Pendergest-Holt] today?

The Proskauer lawyer responded:

> I represent her insofar as she is an officer or director of one of the Stanford affiliated

companies.

Upon hearing this, the SEC lawyer asked Pendergest-Holt whether she would "like to have personal representation of counsel before proceeding?" Pendergest-Holt declined. At several times during the testimony, the SEC lawyers questioned Pendergest-Holt about her conversations with Proskauer while admonishing her to answer the questions without disclosing the substance of these conversations. At times, the Proskauer lawyer intervened, objected, and advised Pendergest-Holt to not answer a question that could lead to a disclosure of privileged information. Also, during her testimony, Pendergest-Holt conferred with the Proskauer attorney.

Later during a break in questioning, the Proskauer lawyer called his secretary to "pull the engagement letter to be clear who [he] represent[s]." The lawyer then clarified on the record that he was engaged by SFG and all of its affiliated companies.

Lawyer's Noisy Withdrawal. Shortly after Pendergest-Holt's testimony, the Proskauer attorney wrote to the SEC and made a "noisy withdrawal," disavowing anything he had ever told the agency about the SFG investigation. On February 25, 2009, the government filed a criminal complaint in the U.S. District Court for the Northern District of Texas against Pendergest-Holt, alleging that Pendergest-Holt obstructed the SEC investigation by failing to reveal the truth and by making false statements to the SEC agents.

A $20 Million Legal Malpractice Lawsuit. A month later Pendergest-Holt filed a civil malpractice lawsuit against the Proskauer attorney seeking damages in excess of $20 million. Pendergest-Holt alleged that Proskauer's legal malpractice resulted in Pendergest-Holt being arrested and ultimately charged in a felony complaint with obstruction of a proceeding before the SEC. Pendergest-Holt also alleged that she met with the Proskauer attorney on several different occasions to prepare for her testimony and that the attorney accompanied her to her sworn testimony before the SEC. Based upon the representations that the attorney made to her, Pendergest-Holt alleged that she believed that Proskauer was "assisting her as her lawyer[], [was] representing her interests, and [was] protecting her interests as her attorney[] in her individual capacity." Pendergest-Holt alleged that Proskauer caused her (a nonlawyer) to reasonably believe that since they represented her interests prior to and during the testimony before the SEC, the communications by and between her and Proskauer were privileged. Instead, Pendergest-Holt alleged, Proskauer acted in the best interest of SFG and its sole shareholder, Allen Stanford. Pendergest-Holt also alleged that unbeknownst to her, the night before the Proskauer attorney met with her to prepare her for her testimony before the SEC, the attorney "had solicited a multi-million dollar retainer from Stanford to represent Stanford personally." Pendergest-Holt also alleged that when Proskauer learned—during the ongoing testimony before the SEC—that it was not authorized to represent Pendergest-Holt in her individual capacity and could not adequately do so, it took no action to protect her interests even though the attorney-client relationship with her in her individual capacity was already established. Pendergest-Holt alleges that Proskauer should have stopped the testimony, formally withdrawn from representing her, advised her of the necessity of the retention of another attorney, and allowed her the ability to do so. Instead, she argued, Proskauer "hung her out to dry" and "a false criminal complaint resulted." At the time of writing this article, it appears that Pendergest-Holt has dismissed her lawsuit against Proskauer without prejudice to refiling.

As these cases demonstrate, the role of company counsel in conducting an internal investigation is inherently complex. An additional layer of complexity is added at the time company counsel interviews and interacts with company employees during the course of an investigation. While there are no easy black-and-white rules, some guideposts do emerge from a study of the above cases. *See* sidebar to this article. Company counsel would do well to take them into consideration. Of course, these suggestions are by no means exhaustive. Practitioners may have a different take on these suggestions; some may find these to overly err on the side of caution, while some may believe that the suggestions do not include some pointers that they may routinely follow in their practice. Conducting an internal investigation is not an easy task. At the end of the day, nothing can replace the requisite expertise and experience of counsel required to navigate the turbulent and perilous waters involved in conducting an internal investigation.

Ten Tips Concerning Corporate Miranda Warnings

1. Undertake a thorough conflicts check before accepting the internal investigation assignment from a corporate client. Determine whether investigation may touch upon matters on which counsel has previously advised the company or its officers. If so, this may materially interfere with counsel's independent professional judgment. Further, if counsel represents any officer or employee of the company in another action, counsel must advise his clients—both the company and the officer—about a potential conflict of interest and obtain a written waiver concerning the conflict

from both before accepting the assignment.

2. Avoid dual representation at all costs. Counsel should avoid making a statement that he also could represent an employee "as long as no conflict arose." Apart from creating unnecessary and unwarranted complexities regarding the role and duty of the counsel, dual representation also could jeopardize the company's raison d'être for conducting an investigation, which often is to cooperate with authorities and waive the attorney-client privilege to avoid a criminal indictment. Also, care should be taken to avoid creating a dual relationship from the outset—any Corporate Miranda warnings given after an attorney-client relationship is created are irrelevant.

3. Before interviewing the employees, inform them about the purpose of the interviews. Depending upon the facts of the case, advise each interviewee of the following: (a) the fact that the government is conducting an investigation, (b) the subject matter of the investigation, (c) that counsel has been retained to provide advice to the company in this matter, and (d) that the interview is necessary for the counsel to obtain the information necessary to provide appropriate advice to the company.

4. Before commencing the interview, deliver a Corporate Miranda warning to an employee being interviewed. Advise the interviewee that (a) counsel represents the company, not the employee, and is conducting the interview as counsel to the company; (b) while the interviews are subject to the attorney-client privilege, the privilege is the company's, and not the employee's, and the company alone can assert or waive it; and (c) the employee has no role in making a decision whether or not to waive the privilege and provide the information to third parties, including the government.

5. Prepare a form summarizing the Corporate Miranda and have it ready at the time of the interviews. After orally delivering the warning to an employee, give this form to the employee and ask the employee to sign this form, thereby affirming that he has received and understood the warning. If the employee is reinterviewed in the future or the interview is continued on another day, redeliver the warning. This may appear as overkill. However, if an employee later claims that he was under an impression that he was talking to "his" attorney and attempts to assert privilege concerning his interview, this signed form may be crucial in determining that the employee could not have had reasonable expectation that he was talking to his, and not the company's, lawyer.

6. Advise the employee that the substance of the interview may be disclosed to third parties, including the government. Although this may cause the employee to be less forthcoming, this may be necessary where the matter under investigation is not yet known to the government and where the company has a statutory obligation to disclose the matter.

7. Ask the employee whether he has any questions and clarify any issues that may be subject to misinterpretation. If an employee does seek clarification, document these questions and your answers to the employee. This may go a long way to demonstrate that the employee was not misled, nor could he have any illusion that he was talking to his lawyer and not the company's lawyer.

8. If at any point an employee asks whether she needs her own attorney, tread with caution. The better practice is to have independent lawyers available to represent the employee. However, in a real-world scenario this often depends upon the nature of the investigation, the size of the company, and the circumstances surrounding the investigation.

9. Whether or not the company makes independent lawyers available to an employee, under no circumstances should company counsel provide legal advice to the employee. Doing so may risk a later finding of dual representation.

10. After the interview, memorialize the substance of the interview with each witness. The memorandum should not resemble a transcript but should document counsel's standard introduction, delivery of Corporate Miranda, any questions from a witness and clarification provided by the counsel, and closing remarks to the witness along with counsel's mental impressions with respect to the witness. Mark this memorandum as being subject to attorney-client privilege and the work product doctrine.

Joshi is a shareholder attorney with Lorandos & Associates in Ann Arbor, Michigan. His practice focuses on complex commercial litigation, international litigation, and white-collar criminal defense. Mr. Joshi can be reached at a.joshi@lorandoslaw.com.

Back to Top

ABA BUSINESS LAW SECTION
KNOWLEDGE | COMMUNITY | EXPERIENCE

Business Law Today

Volume 19, Number 1 September/October 2009

Responding to the Call for ADR

Teaching an Old Law Firm New Tricks

By Norman Solovay

The mandate that issued from the last Board meeting could not have been clearer—litigation costs must be brought under control. The belt-tightening that is the stuff of global headlines has just hit your desk. As general counsel, you need to focus on new ways to handle the numerous disputes, large and small, that are brought to you every day. You realize that you need to add an alternative dispute resolution specialist to your outside counsel team, and now! How will you find the right person?

The partners' meeting just broke up and panic is setting in. Law firms across the country are laying off associates, and even partners have reason to worry about job security. In recent years clients have become increasingly unwilling, and now in many cases have become unable, to pay the skyrocketing costs of full-blown litigation. You realize that you need to develop and market alternative dispute resolution skills as a core offering of your firm if you want not only to survive the current economic downturn, but be a real player in what many believe to be the wave of the future for legal disputes. How do you go about building such an expertise?

Both the in-house counsel and the law firm face the same dilemma. Legal needs are changing dramatically. Corporate clients are no longer willing or able to underwrite the costs of litigation. In-house counsel are looking for cost-effective alternatives, and law firms will have to provide them in order to survive. But how does a law firm break out of the traditional mold to offer such alternatives? How will the litigation department react? How will the other practice groups incorporate the idea of alternative dispute resolution into their client services?

ADR: A Separate Discipline?

Alternative dispute resolution, or ADR, is an umbrella term for a panoply of techniques, some well established, others emerging and evolving, that can be used to resolve conflict without resort to litigation, and without exposure to the increasingly insupportable costs in time, money, and emotional stress that almost always accompany a protracted court battle. In the three decades or so since ADR became part of the industry lexicon, it has been seen primarily as a "cross-practice" that can be used incidentally by one or more practice groups within a firm should a circumstance arise where it seems appropriate or necessary to explore the possibility of peaceful resolution of an existing or potential dispute. Others may look upon ADR as another tool in the litigation department's arsenal—where it is likely to get sparing use. In many cases, it has been relegated to sole practitioners, who go out on their own to practice ADR, perhaps due to a lack of support within the law firm structure.

The fact is that ADR, through its many diverse components, is indeed a separate discipline and should be recognized and treated as such. If it is left to other firm departments to utilize ADR on an ad hoc basis, the firm will develop neither a specialty nor a reputation for seeking alternative, cost-effective resolutions for its clients. If it is left to the litigators, it is likely to be used only when mandated by the court or by a contract dispute resolution clause. Indeed, if law firms don't support both their lawyers who have an ADR sensibility and are drawn to this work and its clients whose voices continue to be raised in opposition to existing law firm practices, then they will watch those lawyers peel off from their firms and take with them what could be a substantial source of business and client goodwill. Establishing a full-service, separate ADR department within the law firm, staffed with lawyers who possess this specialized knowledge and training, will prevent such defections and respond to the growing call for more affordable and less taxing dispute resolution.

Filling the Void

The legal profession has always been quick to step into a void and provide needed services in newly developing areas. Just look at the proliferation of environmental lawyers in the last 10 years, or the burgeoning bankruptcy practices responding to today's economic realities. Yet with ADR, there's always been a bit of a pushback against the use of techniques that, to a bottom-line-oriented management committee, can appear to be a direct hit against litigation revenues. So why should a firm commit to an alternative dispute resolution practice? How can it overcome the practical objections of its own partners? What promise does it hold, both to clients and law firms, in the new economic environment in which we find ourselves?

The first and most obvious answer is that without alternatives to litigation, clients will begin to drift to any lawyer or law firm that is willing to look at the bigger picture and sacrifice substantial litigation revenues for an approach that might better serve the client. It may sound harsh, but anyone who has worked in litigation knows that a protracted battle, extensive discovery and motion practice, and drawn-out, position-based settlement attempts are all great revenue builders. Every lawyer also knows the well-publicized statistic that more than 98 percent of all cases filed are resolved before trial—but many of them only after long, grueling machinations that exact a tremendous price on the client both financially and emotionally.

It is just this type of practice to which corporate counsel must find alternatives. Their ability to carry out one of their primary job responsibilities, resolving both internal and external disputes, is experiencing a financial constraint like never before. In-house counsel need to know that their lawyers are trained, experienced, and committed to alternative techniques that are likely to resolve their issues with significant savings. Yet it is the rare law firm website that actively suggests an exploration of ADR possibilities wherever and whenever feasible.

It is helpful to position a new ADR practice as an enhancement of existing firm services. Not only will clients appreciate being given more options, but lawyers in other practice areas should find it a tremendous asset to be able to offer more options to clients who find themselves facing a legal dispute. This is particularly true of corporate lawyers, whose clients almost always have a vested interest in preserving and enhancing their business relationships. ADR is particularly well-suited to resolving disputes where the parties desire a continued relationship. Traditional litigation can be so divisive and emotionally charged as the parties dig into their respective positions and hunker down for the long fight that business realities, and ongoing relationships between the parties, are often sacrificed. ADR also can be helpful in getting through a tough spot in a negotiation. Mediation has been successful in resolving issues that otherwise might have caused transaction negotiations to break down. Issues may arise in the course of a corporate transaction that could be resolved by mediation. The same will be true in other areas of the firm. All the firm's lawyers will benefit from being able to offer their clients a choice of exploring options with the ADR department, instead of going directly to litigation or shutting down negotiations. There will almost always be an ADR technique that can be tried before committing to litigation or giving up on a deal.

What's So "Specialized" About ADR?

Sometimes the members of a firm's litigation department in particular will balk at the idea of a separate and discrete "alternative dispute resolution" practice within their firm. Whereas transactions belong to the corporate department, wills and trusts to T&E, and bankruptcy filings to their own discrete practice area, disputes have always been the exclusive domain of the litigators. Moreover, since the vast majority of cases do eventually settle, it is not surprising to hear litigators say that they engage in settlement discussions all the time, and query why they need to involve someone else—and give away their own business—to do something that is already an integral part of their practice.

This oversimplification misunderstands the entire purpose and process of alternative dispute resolution. Yes, it is true that "settlement," as opposed to "war," is a goal of all ADR techniques. But the specialized expertise of an ADR practitioner is found in the process used to achieve the clients' goals, which are viewed more broadly to include not only a settlement of the dispute before them, but a resolution that seeks to preserve ongoing relationships and foster cooperation for the long term. These are things that are not easily achieved by the standard, position-based settlement negotiations that typically occur at various stages of a litigated dispute. Furthermore, settlement talks engaged in by litigators are of a different nature and quality than those engaged in by a lawyer committed only to finding a peaceful resolution to the dispute. Asking a lawyer to engage simultaneously in litigation strategy and settlement discussion creates a dissonance, and some would say even a conflict of interest, that is not easily overcome. A separate ADR practitioner, operating without such distractions, has a much clearer path to resolution.

In a recent widely acclaimed book by Canadian law professor Julie Macfarlane titled *The New Lawyer: How Settlement Is Transforming the Practice of Law*, the reality of the resistance of corporate and personal clients alike to spending large amounts of time and money on litigation is shown to be resulting in the increasing use of negotiation, mediation, and collaboration in resolving lawsuits. Professor Macfarlane makes the following observation, which should be the watchword for law firms looking to respond to the changing market:

> [A]s settlement processes become more mainstream and accepted, the expectation of skillful [ADR] performance, and its market value, rises. Firms . . . begin to market themselves as mediation or alternative dispute resolution "specialists" as this expertise becomes a valuable commodity.

Practical objections require practical solutions. Developing a valuable commodity that can enhance existing client relationships and bring in new ones is an obvious first line of defense against lawyers who cry foul at the thought of having disputes that could carry on in litigation for years diverted to an ADR department designed to resolve them far more quickly and efficiently. The value lies in the client relationship. While there will always be those clients who want the aggressive pit bull litigator duking it out on their behalf, far more often our clients want resolution, not war, and smaller legal bills, not larger. Our ability to deliver is rewarded in client loyalty. Our inability to do so, particularly in the current economy, is likely to result in client disaffection and alienation.

Do the Right Thing

There is one more reason to consider doing things the easier, softer way. Cooperative resolution not only eases the burdens of our clients, it is rewarding for us as lawyers in its own right. Mohandas Ghandi, speaking about his experience encouraging a settlement by a client of a commercial dispute, said:

> My joy was boundless. I had learnt the true practice of law. I had learnt to find out the better side of human nature and to enter men's hearts. I realized the true function of a lawyer was to unite parties riven asunder. The lesson was so indelibly burnt into me that a large part of my time during the twenty years of my practice as a lawyer was occupied in bringing about private compromises of hundreds of cases. I lost nothing thereby—not even money, certainly not my soul.

Some consider the newer forms of ADR to signal a spiritual renaissance of the legal profession. Perhaps that is because, in many cases, it is simply the right thing to do.

Building a Successful ADR Practice

Good negotiating skills are a great starting point for an ADR practitioner, but they are just that—a starting point. And if a lawyer is accustomed to position-based negotiation, even those basic skills will require adaptation. ADR finds its foundation in interest-based negotiation. Identified and described in the seminal work on the subject, *Getting to Yes*, by Roger Fisher and William L. Ury, interest-based negotiation looks underneath the entrenched positions of the parties to better understand their needs, motives, and objectives, and uses that information to creatively generate options that are responsive to those needs. It requires a completely different skill set than positional bargaining, and may not fit comfortably with a career litigator's developed tactics for getting the best deal for his or her client.

It is precisely for this reason that ADR deserves a separate place within the law firm structure. The lawyers who are drawn to ADR are likely to have a temperament, possess skills, and have relationships with their adversaries of a sharply different nature than their litigation counterparts. To assume that the firm's litigators can simply step into the role of an ADR practitioner is a mistake. Rather, a firm should seek out the type of lawyer for whom this work is attractive, not just something they need to try before getting out the next set of motion papers.

The lawyers in the ADR department, in turn, need to take advantage of the many training opportunities that exist in various forms of ADR. CLE courses abound in the areas of mediation and arbitration, both for those who wish to advocate for their clients in a mediation or arbitration setting, as well as those who wish to act as the neutral in such proceedings. Becoming a neutral requires a higher level of training, and commitment to that training says a great deal to a potential client about the lawyer's, and the firm's, commitment to the ADR process. Perhaps even more specialized is collaborative law, once confined to the practice of family law but now finding its footing in the civil arena as well. As more law firms get on board with ADR departments, we can expect to see a concurrent growth in cases that can and will be handled through collaborative or cooperative processes.

Hiring an ADR Firm

In searching for a law firm that will address the goal of litigation cost containment through the use of alternative dispute resolution techniques, in-house counsel should, first and foremost, find a firm that has made a commitment to a discrete ADR department. This speaks volumes about the firm's honest desire to be part of the solution to the crushing costs of litigation in today's world. Then, ask about the extent of services offered in the ADR department, look for a depth of understanding about various techniques and processes, and inquire about the level of training and experience of the lawyers practicing in the department. Is the lawyer taking care to explain everything carefully and patiently? Is he or she involving you in the process and decisions from the very start? The client's involvement and understanding are key, and the relationship between client and lawyer will provide a window into how that lawyer will work cooperatively in an ADR setting to resolve conflict with another party.

Be sure you understand your options. It is almost always appropriate to try some sort of alternative dispute resolution technique before heading to court. Don't give up too quickly. Many an ADR practitioner will tell you that seemingly impenetrable impasses can dissolve with the passage of time. And work with your ADR lawyer to find a process that works. One pioneering ADR firm, the Boston Law Collaborative, has successfully experimented with cooling-off periods before ADR is abandoned in favor of litigation. Some cases will, however, end up there, despite the best efforts of their ADR lawyer. It is not appropriate for an ADR lawyer to stay engaged in alternative techniques past the point where they are of use to the client, even if it is out of a strong sense of commitment to peaceful resolution.

Finally, make ADR a protocol of your in-house practice. If it is company policy to always explore ADR options before litigating, then adversarial parties are less inclined to believe that an offer of ADR is in any way a sign of weakness. Many Fortune 500 companies and others have made commitments to a peaceful approach to corporate disputes. Membership in organizations such as the CPR Institute, the International Institute for Conflict Prevention and Resolution, makes a strong statement about corporate standard practice, and will serve to deflect criticism or negative assumptions that might otherwise arise in those unfamiliar with the promise of ADR.

Conclusion

The marketplace is demanding the services that can be offered by alternative dispute resolution professionals. Law firms, slow to embrace a new way of looking at conflict as well as their own business model, have remained behind the curve in offering the specialized services that are needed. Discrete ADR departments within a firm can provide a greater choice of services for clients, work cooperatively with other departments, and over time develop a firm reputation for constructive and cooperative dispute resolution.

No less a figure than Abraham Lincoln has seen the promise in such a practice. He said:

> Discourage litigation. Persuade your neighbors to compromise whenever you can. Point out to them how the nominal winner is often a real loser—in fees, expenses and waste of time. As a peacemaker, the lawyer has a superior opportunity of being a good man. There will still be business enough.

Alternative Dispute Resolution Techniques

Mediation
A process in which a neutral third party helps disputing parties explore their dispute and reach resolution. The mediator is not a decision maker, and the parties may or may not be represented by counsel. While final resolution is not guaranteed, the goal is always to bring the parties to a new level of understanding of one another's positions.

Arbitration
The arbitrator or arbitral panel acts as decision maker, but is ordinarily free from the constraints of the rules of evidence and is not strictly required to rule in accordance with the law. Arbitration seeks a just and fair result in a process designed to be far more expeditious than court proceedings.

Settlement Counsel
Before a complaint is filed, or often in the course of a litigated matter, the parties wish to take a step back and see if they can settle their differences. Very often, the person least well suited to handle those settlement discussions is their litigation counsel. Settlement counsel is hired, either from within the same law firm or without, to focus on settlement negotiations, without detracting from the forward movement of the litigation strategy.

Collaborative Law
Collaborative law, in its pure form, has both sides represented by collaborative law counsel, and all four (the clients and their lawyers) agree to work cooperatively and in good faith to resolve their differences. If they are unable to do so and the matter must be litigated, the collaborative lawyers must drop out, which provides a strong incentive for continued efforts at settlement.

Cooperative Process
Similar to collaborative law, but without the drop-out provision, which has proven to be an obstacle for some practitioners outside of the family law setting.

Med-Arb
One of many variations and combinations of mediation and arbitration, med-arb begins as a mediation and, in the event that resolution cannot be reached on one or more issues, the mediator changes hats and becomes an arbitrator, thereby guaranteeing that there will be a final determination at the end of the process. In practice, the possibility that the case may become an arbitration strongly motivates agreement at the mediation phase. And while few cases actually proceed to arbitration, those that do end far more quickly and economically than regular arbitrations.

Solovay is the chair of the Alternative Dispute Resolution department at McLaughlin and Stern, LLP in New York and is a proponent of using collaborative, cooperative, and other ADR processes to promote peaceful dispute resolution. His e-mail is nsolovay@mclaughlinstern.com. *The author wants to acknowledge the invaluable assistance of Lisa Brogan in connection with this article.*

Back to Top

ABA BUSINESS LAW SECTION

KNOWLEDGE | COMMUNITY | EXPERIENCE

Business Law Today

Volume 19, Number 1 September/October 2009

Snap Judgments

By Molly Thomas

No Cursing While Working

Small business owners are drawing the line on increasingly casual workplace environments, and the buck stops at cursing. Reuters reports that a survey by SurePayroll revealed that 75 percent of small business owners find swearing in the workplace "offensive and unprofessional," despite the fact that 40 percent admitted to letting unsavory language escape from their own lips from time to time. SurePayroll's president, Michael Alter, says of four-letter words at work, "While pop culture is saying it's more acceptable, small business owners say it's not." In particular, small business owners tend to see their work as a continuation of their family, and when competing against larger companies, find it even more crucial to put forth the most professional face possible, a face that does not include cursing. Suggestions by the online payroll service of ways to deter workplace profanity include vulgarity replacement phrases such as "What the French toast?" or "Oh shift." The old classic, dollar-in-a-jar motivator may be effective as well, and a good way to raise money for a certain charity or after-hours outing. And once off company property, your language is up to you.

Uncle Sam Wants You

The *National Law Journal* reported recently that, according to recruiters and military attorneys, applications from attorneys for the JAG Corps are set to reach record levels this year. They speculate that while the military cannot offer as large a salary as the big firms, the stability and wide range of locations can be a strong pull for lawyers seeking work in the current stalled economy. Laid-off lawyers as well as recent law school graduates are competing in an ever larger and more experienced pool of applicants, and the real winners in the situation are the recruiters, who can be more selective than ever. The Navy received twice as many applications in the 2009 recruiting season than in the 2008 period. "People are looking for stability right now," said chief judge advocate for the Army's recruiting, Lt. Col. Paulette Burton. "As the economy continues to go in this downward spiral, [judge advocates] can count on their salaries and their benefits. We don't lay people off."

Pushed Out of Public Service?

One way law firms are deferring incoming first-year associates is by putting them in temporary public interest jobs with healthy stipends. But, reports the *National Law Journal*, does this kindness actually hurt those who have prepared themselves for just this type of work, which already can be competitive to break into? Some recent law school graduates who have intended to go into public service all along feel pushed aside by the wider legal community, interpreting this move by big firms as an undeserved pat on the back to students who haven't completed internships for nonprofits or law school clinics, but are entering into public service as a last-ditch employment effort. Jane Fox, a June graduate of Brooklyn Law School, said, "Deferred associates are getting congratulated for going to public-interest organizations in the final hour and being so generous, while the people who were planning on working at these organizations throughout law school and have demonstrated a commitment are again forgotten by the legal establishment." Allison Standard, a recent graduate of the University of North Carolina School of Law, sees both sides of the issue, saying, "The hard part is that there is no easy solution to all of this. You can't blame the organizations for taking the free labor. But people who intended on public-interest careers have been working throughout law school to build a path to these jobs, and they might get passed over."

Law on Wheels

The *National Law Journal* reports on a rather unique law school clinic that's taking its act on the road. University of Detroit Mercy School of Law pulled up roots and is touring the country in a Winnebago, helping veterans obtain pension and disability benefits. General Motors donated the vehicle last year and outfitted it to be an office on wheels—complete with filing cabinets and a wheelchair lift. The official name of the venture is Project Salute, and so far it has visited 11 states where more than 2,000 veterans have been helped. Across the country, more than 740 pro bono lawyers are participants. The project's director, law professor Tammy Kudialsi, said, "We pack up the show and take it on the road. One of the most shocking things that we see is that many of [the veterans] don't even know that they're entitled to benefits. Most of the mobile contingent of participants are second- and third-year law school students, who gain invaluable hands-on experience when meeting with veterans, reviewing their histories, and deciding whether or not their claim has merit, in which case they are passed on to the pro bono lawyers participating in Project Salute, many of whom are former veterans themselves. Jeff Dillon, a second-year law student involved in the program, believes the program has prepared him to be a superior lawyer. "It's amazing to me some of the hoops that [the veterans] have to jump through. I was unaware of the level of work they had to do to obtain their benefits." Project Salute recently celebrated its one-year anniversary.

Game On!

Video game popularity continues to increase, perhaps as a result of more Americans trying to find cheaper, at-home ways to entertain themselves, according to the *American Lawyer*. A recent report found that nearly two in three respondents reported playing a video game in the last six months, in contrast to only about 50 percent of respondents reporting having gone to see a movie in the same time period. And video game industry lawyers aren't unaware of the optimistic gaming market and its benefits. Says Mark Skaist, a 17-year veteran of the business, who represents video game publishers and developers, "Games remain very popular and video game companies are relatively bullish." He also reported that while other clients are asking for reduced rates, no such appeals are originating from his video game clients. The demand for lawyers is partially driven by the fact that the business model for video game development and publication is still flexible and evolving. As gaming transitions to multiplayer games like Sony's Everquest, and more games are hosted on social networking sites and devices such as the Apple iPhone, the traditional business model is undermined, making the work of lawyers such as Skaist even more in demand.

Meeting in the Middle

In Chicago, companies experiencing commercial disputes and looking to minimize litigation fees because of the down economy are turning to mediation firms, reports *Crain's Chicago Business*. Whereas before, mediation used to be associated primarily with personal injury, property damage, and product liability, a growing number of mediation firms are seeing business rise dramatically, and topics of mediation diverge from the former classics. Stuart Nudelman left the

Cook County Circuit Court three years ago, and since then has seen his share of commercial cases in mediation increase to 40 percent of his caseload, where it used to be 20 percent of his work. "I would guess by the end of the year it would be 50-50," Nudelman said. Business is being boosted by contracts with specific mediation clauses in them, in industries such as employment and construction. There's evidence, also, that judges are nudging cases toward mediation, since a 2001 Illinois Supreme Court ruling allowed "court-annexed" mediation programs.

Back to Top

ABA BUSINESS LAW SECTION
KNOWLEDGE | COMMUNITY | EXPERIENCE

Business Law Today

Volume 19, Number 1 September/October 2009

Keeping Current: Corporate Compensation

By Michael J. Biles and Kimberly G. Davis

Delaware Court Allows Claims Based on Executive Compensation to go Forward

Directors and officers, take notice. In the current economic climate, in which most Americans have seen their 401(k) accounts shrink dramatically, there is a growing impatience with executives who receive enormous compensation packages despite less-than-stellar performance.

Courts are not immune to the political zeitgeist. Recently, a Delaware chancery court upheld a claim brought derivatively for waste, where Citigroup awarded its outgoing CEO with a retirement package worth $68 million. This is an unusual move from the traditionally pro-business Delaware courts.

In *In re Citigroup Inc. Shareholder Derivative Litigation*, 964 A.2d 106 (Del. Ch. 2009), decided February 24, 2009, plaintiffs brought myriad claims against the board of directors for breach of fiduciary duty and waste relating to Citibank's alleged $55 billion loss due to subprime lending. Usually, Delaware courts recognize a "business judgment rule" that defers to the decisions of directors, even if those decisions turn out to be bad for the company and its investors. And the *Citigroup* court, unwilling to "hold director defendants personally liable for making business decisions that, in hindsight, turned out poorly for the company," dismissed all but one of the claims against the directors. (For a discussion of the dismissed claims, see the article by Kevin F. Brady and Francis G.X. Pileggi in this issue, titled "Delaware Corporate Decisions: Key Cases from Early 2009.") The only one to survive was a corporate waste claim regarding the CEO's compensation.

The surviving claim alleged that Citigroup paid the multimillion-dollar compensation package to a departing CEO whose failures were allegedly responsible, in part, for billions of dollars of losses at Citigroup. The court ruled that this allegation of corporate waste demonstrated that the director defendants authorized "an exchange that is so one sided that no business person of ordinary, sound judgment could conclude that the corporation has received adequate consideration." The claim is currently going forward in the Delaware court.

What is remarkable about this decision is that waste claims are traditionally considered difficult to plead in Delaware. Its courts routinely dismiss waste claims because the test is considered "stringent," particularly in the context of executive compensation. As the Delaware Supreme Court said in 2000, "[A] board's decision on executive compensation is entitled to great deference. It is the essence of business judgment for a board to determine if a particular individual warrant[s] large amounts of money, whether in the form of current salary or severance provisions." *Brehm v. Eisner*, 746 A.2d 244, 263 (Del. 2000). Rarely has a plaintiff been able to plead that a compensation decision is "so one sided that no business person of ordinary, sound judgment could conclude that the corporation has received adequate consideration." The *Citigroup* decision may mark the beginning of a new era in Delaware business jurisprudence.

Despite this initial victory, however, the plaintiff-shareholders still have a difficult road ahead. In 2005, shareholders similarly sued directors at the Walt Disney Company over the $130 million exit package Michael Ovitz received after just 14 months of work. After a 37-day trial before the chancery court, plaintiffs in that case lost. Despite alleging waste and breach of fiduciary duty claims against the directors, the shareholders lost that suit because they could not rebut the presumption of the business judgment rule. The Delaware Supreme Court affirmed the decision. *In re Walt Disney Co. Derivative Litigation*, 907 A.2d 693 (Del. Ch. 2005); *aff'd*, 906 A.2d 27 (Del. 2006).

Another avenue shareholders may pursue to effect change in a company's executive compensation structure is to file a "books and records" request. Such a request is a function of state corporations law, and permits shareholders to inspect a company's books and records under certain circumstances. For example, under Delaware General Corporations Law, Del. Code tit. 8, § 220, a stockholder of a Delaware corporation has a statutory right to inspect the books and records of the corporation. The stockholder must satisfy form and manner requirements for requesting books and records and have a proper purpose for the inspection. The statute defines "proper purpose" as any purpose "reasonably related to such person's interest as a stockholder." Where the demand is for inspection of books and records rather than for a stock list, the stockholder bears the burden of proving a proper purpose.

Shareholders may use a books and records request to investigate executive compensation decisions. For example, as reported this year in the *New York Times*, a shareholder at Chesapeake Energy, whose directors awarded a $75 million bonus to its chief executive even as the company's stock plummeted, initiated a books and records demand in a state court in Oklahoma, where Chesapeake is incorporated. If the court allows the proceeding, shareholders can examine corporate documents to see if the board's approval of the CEO's bonus was proper.

Don't be surprised if many more companies face similar challenges to executive compensation decisions in the near future. These challenges may come in a variety of forms; for example:

1. Shareholders may bring derivative lawsuits, like the suit brought in *Citigroup*;
2. Shareholders may make a demand on the board of directors, outlining perceived problems with the executive compensation structure and requesting that the company bring suit;
3. Shareholders may file a "books and records request," allowing them to examine corporate documents to see the reasoning behind compensation decisions; or
4. Shareholders may wage proxy contests, seeking a seat on the board of directors.

What Companies Should Do Now

An in-depth analysis of strategies for dealing with these issues is beyond the scope of this analysis. But there are a few key themes directors should keep in mind in the current economic climate. Now more than ever, boards and compensation committees should have a reasonable, written process for making compensation decisions, and that process should be faithfully followed. All compensation decisions should be well documented and should consider the actual value the executive has brought to the company. If compensation is tied to some measure of performance, then that measure should focus on the long-term health of the company more so than on any short-term financial metrics (i.e., quarterly earnings). Finally, a board's compensation decisions must be consistent with the methodologies explained to shareholders in the annual proxy statement.

Additional Resources

For more reading on a similar topic, you can retrieve the following articles on the *Business Law Today* website at www.abanet.org/buslaw/blt. All issues since 1998 may be accessed under the "Past Issues" heading at the bottom of the web page.

Disney directors survive attack on Magic Kingdom
Learning from the trial court's opinion
By Mark R. High
Business Law Today
January/February 2006 Volume 15, Number 3

In re The Walt Disney Company Derivative Litigation
A New Standard for Corporate Minutes
By Cullen M. "Mike" Godfrey
Business Law Today
July/August 2008
Volume 17, Number 6

and in this issue...

Speaking Volumes
A review of *Executive Compensation for Emerging Growth Companies*, Third Edition
By Michael J. Hussey
Business Law Today
September/October 2009
Volume 19, Number 1

Biles is a shareholder and Davis is an associate in Greenberg Traurig's Securities Litigation practice. Their respective e-mails are bilesm@gtlaw.com and daviskg@gtlaw.com.

Back to Top

Business Law Today

Volume 19, Number 1 September/October 2009

Keeping Current: Patents

By Catherine Toppin

Federal Circuit Places USPTO Final Rules on Hold

On March 20, 2009, the U.S. Court of Appeals for the Federal Circuit (Federal Circuit) issued a significant ruling in *Tafas v. Doll* that addressed the ability of the U.S. Patent and Trademark Office (USPTO) to implement several of its Final Rules changing patent prosecution practice.

The Final Rules affected continued examination filings, patent applications containing patentably indistinct claims, and requests for continued examination (RCEs) of claims in patent applications. A continuation application is a patent application filed by an applicant who wants to pursue additional claims to an invention disclosed in an earlier parent application of the applicant that has not yet been issued or abandoned. The continuation uses the same specification as the pending parent application, claims the filing date priority of the parent, and must name at least one of the same inventors as in the parent. This type of application can be useful when a patent examiner has allowed some but rejected other claims in an application, or where an applicant may not have exhausted all useful ways of claiming different embodiments of the invention. An RCE is a request from an applicant to continue to try to get a patent after the patent office has issued a final rejection. It allows an applicant to pay an additional fee and continue to argue his or her case with the patent examiner.

The Final Rules at issue were the result of its efforts since January 2006 to address the large and growing backlog of applications, according to the USPTO. Under § 2(b)(2) of the Patent Act, the USPTO has the power to establish rules governing the conduct of proceedings in the Office. The Administrative Procedure Act gives a court the authority to set aside the actions of the USPTO, as a federal agency, if their actions are found to exceed statutory authority.

The case came before Federal Circuit Judges Rader, Bryson, and Poston on appeal from the April

1, 2008, decision by the U.S. District Court for the Eastern District Court of Virginia brought by Triantafyllos Tafas, SmithKline Beecham Corporation, and Glaxo Group Limited (collectively appellees) against the USPTO and John Doll in his role as the Acting Under Secretary of Commerce for Intellectual Property and Acting Director of the USPTO. The district court proceedings preliminarily enjoined the USPTO from implementing the Final Rules. Summary judgment was subsequently entered by the district court in favor of plaintiffs' motion to strike down four of the USPTO's recently promulgated rules on the basis that the rules exceeded the scope of the USPTO's rule-making authority.

The Final Rules at issue before the Federal Circuit were as follows:

- Final Rule 75, requiring applications with either more than five independent claims or more than 25 total claims to provide the USPTO with a detailed examination support document;
- Final Rule 78, allowing an applicant to file two continuations or continuation-in-part applications as a matter of right; additional continuations require an applicant to make a showing that the amendment, argument, or evidence could not have been submitted during the prosecution of the prior-filed application;
- Final Rule 114, requiring a showing that the amendment, argument, or evidence could not have been submitted during the prosecution of the prior-filed application for more than one RCE per application; and
- Final Rule 265, outlining the following requirements for an examination support document: it must (1) include the results of a prior art search, (2) list the most relevant prior art references, (3) identify which limitations are disclosed by each reference, (4) explain how each independent claim is patentable over the references, and (5) show where the limitation is disclosed in the specification.

The USPTO set forth two lines of reasoning in its appeal. First, the USPTO argued that the district court failed to give the USPTO proper deference under its rule-making authority, alleging that the issue is whether the USPTO's Final Rules abide by a reasonable interpretation of the Patent Act. Essential to this issue is the USPTO's argument that the district court improperly grafted a distinction between substantive and procedural rules where there is no such plain language in § 2(b)(2). Second, the USPTO alleged alternatively that notwithstanding the first inquiry, the USPTO's Final Rules were clearly procedural. The appellees maintained that the district court correctly decided that the USPTO cannot make substantive rules and that the USPTO acted outside of its statutory authority.

The Federal Circuit rejected the argument that the USPTO's interpretation of its own rule-making authority should be given deference; maintained the district court's procedural versus substantive distinction; and determined that the district court was not vested with any general substantive rule-making power. Based on these determinations, the Federal Circuit analyzed Final Rules 75, 78, 114, and 265 based on whether they were procedural versus substantive. The Federal Circuit affirmed the district court's grant of summary judgment that the USPTO's proposed limits on the filing of continuation applications in Rule 78 were an impermissible substantive rule that altered an applicant's rights and obligations under the Patent Act. Summary judgment was vacated with respect to Final Rules 75, 114, and 265 and remanded to the district court for further proceedings.

The Federal Circuit also expressly summarized that the following questions remain open: namely, whether any of the Final Rules are arbitrary and capricious; whether any of the Final Rules conflict with the Patent Act in ways not specifically addressed in the opinion; whether all USPTO rule making is subject to notice and comment under 5 U.S.C. § 553; whether any of the Final Rules are impermissibly vague; and whether the Final Rules are impermissibly retroactive. To that end, some of these issues may once again be subject to appellate review and could potentially make their way to the Supreme Court.

As a practical matter, the injunction against the USPTO's implementation of the rules remains intact, and, as a result, the Final Rules have not yet impacted patent practice as it currently exists. In addition, because the USPTO is still transitioning its administrative leadership, it remains to be seen whether the USPTO will maintain its position with respect to the Final Rules.

Toppin is an associate at Edwards Angell Palmer & Dodge LLP in Boston. She can be reached at ctoppin@eapdlaw.com.

Back to Top

Business Law Today

Volume 19, Number 1 September/October 2009

Speaking volumes

Reviewed by Michael J. Hussey

Guidance on a topic that spans practice areas and professions

***Executive Compensation for Emerging Growth Companies,* Third Edition**
By P. Garth Gartrell with Contributing Author Steven P. Lapidus
West
2008, Looseleaf, $395.00

As the stock market crumbled in fall 2008, executive compensation was placed squarely in the public eye by angry shareholders and members of Congress. As shareholders saw their portfolio values decline, many began to wonder what value they were receiving from the executives leading the companies who were now in need of a government bailout merely to stay afloat. By December 2008, the chief executive officers of the Big Three automobile manufacturers had come to Washington, D.C., hat in hand, asking for a bailout. After some grandstanding about the propriety of flying private jets to Washington, executive compensation was again an issue.

Both the bailout passed by Congress in October and the loan extended by former President Bush to the automakers contain limitations on the deductibility of executive compensation. While these high-profile bailouts have focused primarily on publicly traded corporations, the changes to the executive compensation landscape since the second edition of *Executive Compensation* was published in 2000 have impacted closely held corporations, too.

The changes have been broad—affecting everything from accounting rules to federal income tax law to SEC rules and regulations. This edition also includes changes following the enactment of Sarbanes-Oxley, the rewrite of item 402 of SEC Reg. S-K, Rule 144, and the Form 4 filing requirements. In *Executive Compensation*, Gartrell and Lapidus provide a thorough explanation of all of these changes and the impact of each change on executive compensation.

In the tax area, I.R.C. § 409A was enacted in October 2004 as part of the American Jobs Creation Act. It dramatically changed the executive compensation landscape. Section 409A addresses nonqualified deferred compensation as traditionally understood but also casts a wide net on many agreements not traditionally thought of as deferred compensation. On December 31, 2008, the transitional relief for compliance with § 409A and its regulations expired. Gartrell and Lapidus provide a straightforward and step-by-step walk through § 409A. In the second paragraph of their § 409A materials, they show their grasp of the complexity of § 409A with an appreciation for the practical side of having to work through it. They write:

> § 409A represents a significant trap for the wary and unwary alike: it is complex, applicable to innumerable common and arcane transactions, and exposes appropriate and necessary transactions to devastating potential consequences if its strict rules are not observed. Nonetheless, the IRS guidance to date has been fairly clear and detailed and reflects a fairly balanced approach for dealing with many common and reasonable business practices.

Gartrell and Lapidus provide clear and simple examples to explain the rules of § 409A and its many exceptions. For example, they do a very good job of explaining § 409A's expansive reach to any agreement that provides compensation for one taxable year be paid in a subsequent taxable year. There are several exceptions and even exceptions to those exceptions. One exception to coming within § 409A's burdensome confines is the short-term deferral exception. Gartrell and Lapidus clearly explain the possible alternate ending dates for the two-and-a-half-month short-term deferral by giving a clear example with sample dates that can easily be substituted for your particular situation. From here, the authors go right into an exception to the short-term deferral exception. They further explain that a payment made outside of the two-and-a-half-month short-term deferral window still qualifies for the safe harbor of the short-term deferral if it was administratively impracticable to make the payment in the two-and-a-half-month window, such impracticability was unforeseeable, and such payment is made as soon as practicable. In this same section, Gartrell and Lapidus also discuss two other exceptions to the general short-term deferral exception rules. The authors' step-by-step approach of walking through § 409A is helpful to understanding the broad reach of § 409A. At the end of Chapter 2, the authors provide a useful and plainly written question-and-answer section on IRC § 409A. The Q&A is especially helpful because it identifies and addresses many traps for the unwary, particularly as to transactions that were common before § 409A was enacted.

Likewise, in Chapter 6, Gartrell and Lapidus address the accounting issues associated with executive compensation, particularly using stock to compensate executives. Chapter 6 begins with an overview of revised Financial Accounting Statement 123 (FAS 123R). FAS 123R made significant changes to the proper accounting treatment of compensatory equity awards. The authors begin with a clear statement of FAS 123R's applicability and what compensation is excluded from its scope. As with I.R.C. § 409A in Chapter 4, Gartrell and Lapidus take a step-by-step approach to explaining FAS 123R, including its applicability to employees, nonemployees, leased employees, and nonemployee directors. The material on FAS 123R then turns to providing an overview on fair value recognition and the mechanics of valuing equity-based compensation. The book gives a detailed explanation of using either the Black-Scholes method or a lattice model to value the compensation, noting that FAS 123R prefers a lattice model over Black-Scholes but finds the Black-Scholes model acceptable.

Executive Compensation also contains numerous sample forms that are provided in Rich Text Format on an enclosed CD. The forms include stock purchase agreements, stock option agreements, employment agreements, option plans, prospectuses for stock option plans, board resolutions, and a § 409A plan. The forms note which sections are often modified; which sections give rise to additional issues, e.g., § 409A issues, if modified beyond what is suggested; and which sections are required by California law. Gartrell and Lapidus provide forms both for the "quick-and-dirty" times when you need something in writing and for the more involved negotiations. For example, an Employee Offer Letter is included. It provides the basic terms of the employment relationships, e.g., title, compensation, benefits, stock options, severance, and protection of proprietary information. A more detailed Employment Agreement also is included and covers additional topics such as signing bonuses, relocation expenses, more detailed termination provisions, and nonsolicitation or noncompete provisions, depending upon your jurisdiction. *Executive Compensation* is a great handbook for either those lawyers new to executive compensation or lawyers who need a straightforward guide through the many recent changes.

Hussey is an associate professor of law at the Harrisburg, Pennsylvania, campus of Widener Law.

Professor Hussey can be reached at mhussey@widener.edu.

Back to Top

