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Inside Business Law

Should lawyers be using a streamlined form of legal opinion that strips out much of the boilerplate, including assumptions regarding the genuineness of signatures and the authenticity of the documents? A recent appellate court decision suggests this may not be the right approach. This article in the recent edition of the Legal Opinion Newsletter analyzes whether to streamline legal opinions.

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The ABA Business Law Section's Online Resource

Shifting Tides for SEC Settlements: A Sea Change in the Making?

By Eric Rieder, Paul Huey-Burns, and Nikki A. Ott

For years, the Securities and Exchange Commission (SEC) has gone about settling civil enforcement actions in a manner widely accepted by the SEC bar and courts.

Now, in just the past few months, a combination of judicial decisions, internal policy changes, and public commentary has raised uncertainty about whether this practice will continue.

The SEC has traditionally permitted all defendants in civil enforcement proceedings to enter into consent orders without admitting or denying the allegations in the civil complaint. However, beginning with U.S. District Judge Jed Rakoff's November 28, 2011 decision rejecting a proposed settlement in *Securities and Exchange Commission v. Citigroup Global Markets, Inc.* (the *Citigroup* action), this longstanding policy has come under criticism in the courts, the press and Congress. In addition, the SEC itself has modified its procedures for settling charges with litigants who are also the subject of parallel criminal proceedings. In early March, a federal judge in Washington rejected another proposed settlement, albeit on different grounds than Judge Rakoff, reflecting the heightened scrutiny of SEC settlements.

Then, just last week, the pendulum swung again. A three-judge panel of the U.S. Court of Appeals for the Second Circuit issued a preliminary stay of Judge Rakoff's ruling. It concluded, based on a preliminary review, that the SEC and Citigroup had shown that it was likely the court would reverse Judge Rakoff's rejection of their settlement and that they would be seriously harmed absent a stay. The panel's decision is not binding on the Second Circuit judges who will hear the appeal, however, and was delivered without the benefit of any counsel arguing on behalf of the district court's position. The court plans to appoint counsel to argue Judge Rakoff's position on the appeal.

While the panel's decision was quite critical of Judge Rakoff's reasoning, it does not definitively resolve the issue. Thus, the result of the controversy remains uncertain, both for the SEC as well as for parties facing SEC investigations. It is still to be seen whether the ultimate effect will be a dramatic change in how the SEC settles cases, more modest adjustments of its procedures, or, as now seems more likely in the wake of the Second Circuit's stay order, little or no change beyond that the SEC has already made on its own.

History of the Citigroup Decision

On October 19, 2011, the SEC Enforcement Division concluded a four-year investigation of Citigroup Global Markets, Inc. (Citigroup) and its conduct in structuring and marketing a collateralized debt option (CDO) called Class V Funding by filing separate civil actions against Citigroup and one of its executives, Brian Stoker. In essence, the SEC alleged that Citigroup benefitted from a decline in the housing market by structuring and selling a CDO that was designed to include poor-quality Citigroup assets from prior CDOs, then taking a short position on those very assets. Despite what the SEC alleged to be an inherent conflict of interest, Citigroup failed to disclose its role in asset selection or its short position to investors.

The SEC's complaint included allegations one would expect to see in suits alleging scienter-based fraud. For example, the SEC referred to the action as one for "securities fraud." The SEC also stated that Citigroup "knew or should have known that [marketing materials], by failing to disclose Citigroup's role in the selection of the investment portfolio, was inaccurate and misleading," and that Citigroup deliberately structured the Class V transaction as a "prop trade" in which Citigroup knew that it would short assets for its own account, but that Citigroup "did nothing to ensure that the marketing documents accurately disclosed Citigroup's actual interest in the collateral." Despite these fraud-like allegations, the SEC charged Citigroup with violations of sections 17(a)(2) and (a)(3) of the Securities Act of 1933, which only require that the SEC show negligence. Securities fraud allegations under section 10(b) of the Securities Exchange Act of 1934 and Rule 10b-5 thereunder (as well as section 17(a)(1) of the 1933 act) require proof of scienter.

As is typical where the Enforcement Division staff negotiates a settlement prior to filing an enforcement action, Citigroup

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and the SEC announced they had settled the charges simultaneously with filing the complaint in the Southern District of New York. Under the terms of the proposed settlement, which required approval from the U.S. district court, Citigroup would (1) neither admit nor deny the SEC's allegations; (2) be permanently enjoined from future violations of sections 17(a)(2) and (a)(3) of the Securities Act; and (3) overhaul its procedures for reviewing and approving CDO transactions for three years. In addition, Citigroup agreed to a $285 million payment, comprised of $160 million in disgorged profits, $30 million in prejudgment interest, and a $95 million civil penalty.

Judge Rakoff's Decision

Judge Rakoff challenged the proposed settlement. He ordered both parties to explain why the proposed settlement was "fair, reasonable, adequate, and in the public interest." His order questioned, among other things, why he should approve a settlement in a case alleging serious securities fraud when the defendant neither admitted nor denied wrongdoing, how the SEC monitors compliance with and enforces injunctions against future violations of the securities laws, and how a securities fraud of such magnitude could be the result of negligence rather than intentional misconduct.

Both the SEC and Citigroup responded to Judge Rakoff's queries in briefs and at a hearing. The SEC's responses focused heavily on the permissible scope of Judge Rakoff's review, the practicalities underlying the SEC's policy permitting no admit/deny settlements, and the possible harm to the SEC's ability to efficiently prosecute enforcement actions and resulting harm to the public that would result if the SEC were no longer able to enter into no admit/deny settlements.

Judge Rakoff issued his decision on November 28, 2011. He rejected the proposed settlement in its entirety, holding that it was "neither fair, nor reasonable, nor adequate, nor in the public interest." Judge Rakoff sharply criticized the mismatch between the SEC's allegations of fraud and its decision to only charge Citigroup with negligent misconduct. He emphasized that the SEC's complaint in the *Stoker* action accused Citigroup of knowing misconduct in structuring and selling the Class V transaction—an allegation that was not included in the *Citigroup* complaint. Judge Rakoff further rejected the SEC's arguments that he should not consider the public interest in deciding whether to approve the settlement, noting that evaluation of the public interest in a necessary element of any reward of injunctive relief.

The proposed penalties imposed on Citigroup also came under fire. Judge Rakoff characterized the proposed $285 million payment as "very modest," "pocket change," and "just a cost of doing business" for a company the size of Citigroup. Finally, Judge Rakoff gave little weight to the value of obtaining the proposed injunctive relief, noting that the SEC rarely, if ever, seeks to hold recidivist defendants in contempt for violating prior injunctions.

In the most controversial part of the decision, Judge Rakoff challenged the validity of no admit/deny settlements. Specifically, he refused to issue an injunction, enforced by the court's contempt power, in the absence of any admitted or proven facts. Judge Rakoff criticized the SEC policy permitting such settlements as "hallowed by history, but not by reason," and stated that, absent facts on which to base a decision, "the court becomes a mere handmaiden to a settlement privately negotiated on the basis of unknown facts, while the public is deprived of ever knowing the truth in a matter of obvious public importance." Judge Rakoff further decried the fact that private litigants cannot use the allegations in a no admit/deny complaint and settlement for collateral estoppel purposes in private actions, a problem compounded in this case because investors cannot pursue private securities fraud claims based on negligence.

The Aftermath

The *Citigroup* decision provoked a strong reaction. The SEC's director of enforcement, Robert Khuzami, promptly issued a public statement criticizing the decision. Mr. Khuzami referenced statutory provisions that appear to limit penalties on a "per violation" basis (although defense lawyers have in some cases argued that the SEC has sometimes calculated instances of violations in a way that results in penalties that exceed "ill-gotten gains"). Mr. Khuzami also stated that the *Citigroup* decision "disregards the fact that obtaining disgorgement, monetary penalties, and mandatory business reforms may significantly outweigh the absence of an admission when that relief is obtained without the risks, delay, and resources required at trial."

The SEC and Citigroup both appealed the decision to the Second Circuit. The SEC also filed a petition for mandamus, an alternative route to obtain appellate review. Mr. Khuzami expressed the SEC's belief that Judge Rakoff "committed legal error by announcing a new and unprecedented standard that inadvertently harms investors." The SEC and Citigroup also sought a stay of Judge Rakoff's order pending the resolution of the appeals and mandamus petition.

Initially, the Second Circuit granted a temporary stay. Then, on March 15, the Second Circuit issued a per curiam decision turning that temporary relief into a full stay pending its decision on the appeal and mandamus petition.

The Second Circuit's decision did not decide the appeal, which will be done after further briefing by a separate "merits panel"; it simply assessed the "likelihood of success on the merits" in deciding whether the criteria for a stay were met. In its analysis of likelihood of success, however, the stay panel rejected the key points in Judge Rakoff's analysis. Signficantly, the panel held that the district court had not given appropriate deference to the SEC's policy judgment that the settlement was in the public interest, including in regard to the allocation of government resources. The court also questioned whether it was proper for the district court to question Citigroup's judgment that the settlement was in its interest; it expressed its doubts about an approach that would allow for second-guessing the decisions of such a "private, sophisticated, counseled litigant."

The court seemed particularly skeptical of Judge Rakoff's focus on the lack of a

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binding admission of liability by Citigroup under the settlement, and suggested that requiring such an admission would often make settlement practically impossible. It stated: "Finally, we question the district court's apparent view that the public interest is disserved by an agency settlement that does not require the defendant's admission of liability. Requiring such an admission would in most cases undermine any chance for compromise."

Recognizing that both the SEC and Citigroup sought to overturn Judge Rakoff's decision, the panel noted that its "ruling is made without benefit of briefing in support of the district court's position. . . ." It directed that counsel be appointed to argue in support of the district court's position.

Before the Second Circuit issued its stay, at least two other federal judges echoed Judge Rakoff's concerns regarding no-admit/deny settlements between the SEC and private parties. On December 20, 2011, Judge Rudolph T. Randa of the United States District Court for the Eastern District of Wisconsin initially refused to approve a settlement between the SEC and Koss Corporation and its CEO, Michael Koss. Citing the *Citigroup* decision, he directed the SEC to submit "a written factual predicate for why it believes the Court should find that the proposed final judgments are fair, reasonable, and in the public interest." The SEC defended the settlement in a brief filed on January 24, 2012. In a footnote, the SEC further argued that Judge Rakoff erred in holding that a reviewing court must find that a settlement is in the public interest, and that it only need find that a settlement is fair, reasonable, and adequate.

Unlike Judge Rakoff, however, Judge Randa ultimately approved the SEC's settlement with Koss Corporation. He stated that the SEC's response "largely satisfie[d] the Court's concerns," provided that the SEC agreed to revise the proposed judgments to provide greater specificity. The court entered final judgments on February 23, 2012.

In addition, Judge Renée Marie Bumb of the United States District Court for the District of New Jersey, issued an order on February 22, 2012, in *Federal Trade Commission v. Circa Direct, et al.*, Case No. 11-civ-2172 (D.N.J.), challenging a no admit/deny settlement of charges of violations of the Federal Trade Commission Act. Judge Bumb has ordered the parties to submit briefs responding to four questions which center on whether the standard that Judge Rakoff applied in *Citigroup* applies in the case before her and whether, given the lack of any admission of wrongdoing, the settlement is fair, adequate, and in the public interest. The parties' responses were due March 14, 2012.

The issue has also been posed to Judge William H. Pauley III in the antitrust context. On March 6, 2012, the Department of Justice filed in *United States v. Morgan Stanley, Inc.*, Case No. 11-civ-6875 (S.D.N.Y.), copies of public comments and its responses concerning a proposed settlement of charges of civil antitrust violations against Morgan Stanley. The AARP and the Public Service Commission of the state of New York both urged Judge Pauley to reject the settlement, in part based on the fact that Morgan Stanley neither admits nor denies any wrongdoing. Both commenters cited the *Citigroup* decision in their comments.

Further, Judge Richard A. Jones of the United States District Court for the Western District of Washington earlier this month rejected a proposed settlement between the SEC and three defendants in a case involving an alleged $300 million Ponzi scheme. Judge Jones took issue with the fact that the SEC requested that the court enter judgments on injunctive relief now as part of approving the settlement, but reserve decisions on monetary relief for the future. While Judge Jones' decision did not discuss the same concerns raised by Judges Rakoff and Randa, this latest rejection reflects the heightened scrutiny of SEC settlements.

Congress, too, has taken an interest in the SEC's use of no admit/deny settlements. On December 16, 2011, the House Financial Services Committee announced that it would hold a hearing to examine the SEC's settlement policy, citing to the concerns Judge Rakoff expressed in the *Citigroup* decision. The committee has not yet scheduled the hearing.

Changes to the SEC's Settlement Policies

In addition to the possible changes that may stem from the *Citigroup* decision, the SEC has made its own changes. On January 6, 2012, the SEC announced a new policy under which any defendant who has been found guilty of or who has admitted to engaging in criminal conduct, either by conviction or by entering into a nonprosecution or deferred prosecution agreement (NPA or DPA, respectively) that contains admissions or acknowledgments of criminal conduct, will be prohibited from settling parallel SEC charges without admitting the SEC's allegations.

The new policy also permits the SEC staff to include in settlement documents the fact and nature of the criminal conviction or NPA or DPA, and, importantly, any relevant facts that the defendant may have admitted during a plea allocution or in the NPA or DPA. As in the past, defendants will be prohibited from denying the SEC's allegations or suggesting that they are not based in fact.

The SEC's new policy will not affect the majority of SEC enforcement proceedings. Rather, it applies only to enforcement proceedings in which (1) a defendant is also subject to parallel criminal proceedings and (2) the defendant has admitted or acknowledged criminal conduct. It is unclear, however, whether the policy will evolve and affect other situations, such as civil actions involving multiple defendants or separate cases involving related conduct. For example, it remains to be seen whether the SEC will begin to insist that a settling corporate defendant admit facts admitted by an officer or director in a related criminal proceeding (or in an administrative proceeding in which the SEC has made "findings" of misconduct).

Future Impact

The fate of no admit/deny settlements with the SEC (or other federal agencies, for that matter) is undetermined. Should the Second Circuit uphold the *Citigroup* decision (which now must be considered unlikely following the panel's stay decision), the SEC will be forced to reexamine and perhaps overhaul its

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settlement procedures. In this scenario, the SEC will only be able to seek injunctive relief, including mandatory prophylactic measures, if the defendant provides some sort of admission or proof of wrongdoing. Judge Rakoff appears to have telegraphed his preference for this procedure in footnote seven of the *Citigroup* decision, in which he compared the *Citigroup* settlement with the SEC's 2010 settlement of similar charges against Goldman Sachs. The Goldman Sachs settlement involved not only a much larger financial penalty and evidence of extensive cooperation with the SEC, but also Goldman Sachs' admission that the marketing materials at issue "contained incomplete information," that Goldman Sachs made a mistake in issuing such incomplete information, and that "Goldman regrets that the marketing materials did not contain that disclosures."

The SEC's recent changes to its policy for settling with civil litigants subject to parallel criminal investigations may, in fact, be the first step along this road, despite the fact that the SEC expressly denied that the *Citigroup* decision, which did not involve parallel criminal proceedings, spurred the policy change. Although the new policy only affects a limited subset of SEC enforcement actions, settlements that meet the new SEC standard are more likely to satisfy the standard set forth in the district court's *Citigroup* decision.

Alternatively, the SEC may settle cases in a manner that does not require court approval of injunctive relief. For instance, the SEC may increase its use of administrative proceedings, opting for cease-and-desist orders rather than injunctive relief. This may be an attractive solution, particularly in light of the fact that the SEC invariably seeks permanent injunctions prohibiting future violations of the securities laws, but rarely enforces those injunctions, even against defendants with long histories of settled violations. As the SEC admitted in the *Citigroup* action, it has not pursued civil contempt proceedings against a large financial institution in at least 10 years, and it has no statutory authority to seek criminal contempt. Instead, when faced with a recidivist defendant, it brings a new enforcement action (although it may take prior actions into account in deciding what penalities to seek).

As suggested by the Second Circuit, Judge Rakoff's reasoning represents a significant departure from current standards for approving settlements with the federal government. Indeed, the SEC's practicality arguments, which SEC Chairwoman Mary Schapiro recently reiterated while staunchly defending its policy of permitting no admit/deny settlements at a news media breakfast on February 22, 2012, clearly resonated with the Second Circuit panel deciding the stay request. So too did the separation of powers concerns presented by a district judge rejecting an agency's judgment about when and how to settle a case. If the Second Circuit merits panel applies the reasoning of the stay panel, the SEC may not need to change its approach to settlement at all. Yet even if it prevails, the SEC may seek to foreclose public or legislative criticism by making some changes, as it chose to with respect to settlements in cases involving parallel criminal actions. The answers to the questions raised by the *Citigroup* decision may not emerge until after the Second Circuit, Congress, and the SEC itself have contributed to the current debate. Until that time, the future of the SEC's settlement procedures and policies will remain unsettled.

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Privacy Considerations Limit Geolocation Technologies

By Ted Claypoole and Richard C. Balough

American courts are beginning to place limits on the previously unrestricted use of location-tracking technology. In both law enforcement cases and consumer litigation, litigants and judges are drawing lines that define the degree to which Americans may be tracked, followed, and surveilled using cost-effective location-reporting devices.

This trend toward greater restrictions is important as the cost of constant location reporting plummets so that parents, employers, jealous lovers, and law enforcement officials can simply follow every step taken and mile driven by a targeted individual, and as each of us brings the implements of pervasive location tracking––especially new cars and smartphones––with us wherever we travel. In addition, better awareness of tracking technology has led to new applications like Foursquare, Facebook Maps, and Google Latitudes, which broadcast people's present spot on the globe. Law enforcement has also become more sophisticated in using both stationary cameras and location-monitoring systems like EZPASS, as well as the many ways that cell phones can pinpoint a person's location.

This article examines the United States' judicially recognized privacy rights, including those dealt with in the recent *Jones v. United States* case addressing location privacy in January 2012 by the U.S. Supreme Court, and discusses recent trends in legal claims demanding better mobile privacy of personal location. The narrowly decided *Jones* case is likely to be an early shot in the war for geolocation privacy and is far from the final battle. The various *Jones* opinions and recently filed cases support this conclusion. Business lawyers will best serve their clients by carefully watching this rapidly changing technology field and the legal restrictions placed on the use of geolocation technology.

Location Tracking Devices are Part of Today's Society

Many people are concerned about the insidious creep of location-tracking technology into our lives. For example, the latest iPhone software includes your location to answer your questions with a voice response. Your reminder to stop for a loaf of bread when you leave your office is triggered when you actually leave the office. In other words, it knows the exact location of your office and the time you leave it. On Foursquare, friends can share their locations with each other and check in at certain sites, where you can earn points or merely meet up with other users. Facebook and LinkedIn users frequently notify their friends of their location or when they leave on trips.

As a society, we have evolved from colonial times when a person could simply walk away in the dark or step outside of town for a completely private moment. At that time, entire armies disappeared for days, and a ship leaving port may not have been heard from for months or years, if ever. With today's geolocation tracking, someone knows where we are at all times. Over a hundred years ago, Justices Samuel D. Warren and Louis D. Brandeis observed:

> The intensity and complexity of life, attendant upon advancing civilizations, have rendered necessary some retreat from the world, and man, under the refining influence of culture, has become more sensitive to publicity, so that solitude and privacy have become more essential to the individual; but modern enterprise and invention have, through invasions upon his privacy, subjected him to mental pain and distress, far greater than could be inflicted by mere bodily injury.

4 Harv. L. Rev. 193, 196 (1890).

At the time, the authors worried about "instantaneous photographs" and mechanical devices that threatened "to make good the prediction that 'what is whispered in the closet shall be proclaimed from the housetops.'" These concerns caused them to conclude that there should be a right to privacy for individuals under certain circumstances.

There is no specific provision in the U.S. Constitution granting a "right of privacy" in those words. However, the Supreme Court has crafted a right to protect private matters from certain governmental intrusion, through the Fourth Amendment search-and-seizure provisions and the Fourteenth Amendment due process provisions. In *Griswold v. Connecticut,* 381 U.S. 479, 485

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(1965), the Supreme Court stated:

> The present case, then, concerns a relationship lying within the zone of privacy created by several fundamental constitutional guarantees. . . . Would we allow the police to search the sacred precincts of marital bedrooms for telltale signs of the use of contraceptives? The very idea is repulsive to the notions of privacy surrounding the marriage relationship.
>
> We deal with a right of privacy older than the Bill of Rights—older than our political parties, older than our school system.

This right of privacy is the basis for many other court decisions, including cases relating to the privacy of personal conversations. In *Katz v. United States*, 389 U.S. 347 (1967), the Supreme Court held that wiretapping a telephone booth violated the reasonable expectation of privacy that a person had in his conversation over that phone line and that, because the Fourth Amendment protects people, and not places, a government "trespass" on private space was not necessary to prove the government violated a person's Fourth Amendment rights. The court held that Fourth Amendment protections do not rely on the presence of a physical intrusion by the government.

Technology Has Made Practical Obscurity Obsolete

In 1989 the United States Supreme Court similarly found that the disclosure of a private citizen's "rap sheet" to third parties constituted an unwarranted invasion of privacy, holding that an invasion of privacy is unwarranted if the "practical obscurity" of certain information outweighs the public interest in publicizing the information. *United States Department of Justice v. Reporters Committee for Freedom of the Press,* 489 U.S. 749, 780 (1989). With the Internet, public records not only are not in practical obscurity, but rather are only a Google search away.

The U.S. Supreme Court recently addressed the intrusion on practical obscurity of an individual's location in *Jones v. United States*, ___ U.S. ___ (2012), analyzing whether a drug-dealing conviction could hinge on 28 days of location monitoring from a tracking device placed on a suspect's car without a warrant, when the device reported the suspect's location every 10 seconds for the entire period. While the police had originally obtained a warrant to track the suspect's car, that warrant had expired by the time the tracking device was placed.

The appellate court had thrown out the conviction, finding that use of the GPS tracking device for such a lengthy period of time required a warrant. *United States v. Maynard*, 615 F.3d 544 (D.C. Cir. 2010). The lower court found that, while a person has no expectation of privacy while on a public thoroughfare, a "reasonable person does not expect anyone to monitor and retain a record of every time he drives his car, including his origin, route, destination, and each place he stops and how long he stays there; rather, he expects each of these movements to remain disconnected and anonymous." Reflecting the reasoning in *Reporters Committee*, the *Maynard* court stated that "[a] person who knows all of another's travels can deduce whether he is a weekly church goer, a heavy drinker, a regular at the gym, an unfaithful husband, an outpatient receiving medical treatment, an associate of particular individuals or political groups—and not just one such fact about a person, but all such facts."

The holding in *Maynard* was directly contrary to other geolocation tracking decisions, including *United States v. Cuevas-Perez*, 640 F.3d 272 (7th Cir. 2011). Cuevas-Perez's car was tracked for 60 hours during a road trip through New Mexico, Texas, Oklahoma, Missouri, and finally Illinois, where the GPS battery gave out, requiring the Immigration and Customs Enforcement agents to ask that the Illinois police follow his car and pull him over for any type of violation, which they did. The divided *Cuevas-Perez* court said *Maynard* "is wrongly decided."

Warrant Required for Tracking Device on Car

This conflict was tangentially addressed by the Supreme Court in *Jones*, which unanimously agreed that surreptitiously placing a tracking device on a suspect's car and electronically tracking the car everywhere for a number of days could not be conducted without a judicial warrant. The five-member Court majority held that deciding this case did not demand a review of whether the police's actions intruded on the suspect's reasonable expectation of privacy as described in the *Katz* case above. Instead, it held that the police trespassed on the suspect's car when placing the tracking device there. The Fourth Amendment protects the "right of the people to be secure in their persons, houses, papers and effects, against unreasonable searches and seizures," and the suspect's car was an "effect" protected against unwarranted trespass by the government. This majority opinion stated that the *Katz* "reasonable expectation of privacy" test for Fourth Amendment cases added to the prior case law based on trespass to property, and since the placement of tracking devices was a "search," then it must be a reasonable search under the law.

However, another important aspect of the *Jones* case can be found in the various concurring opinions to the majority's holding, where four members of the court accuse the majority of shirking its responsibility to address the true "vexing problems" of the *Jones* case, including whether the simple act of electronically monitoring a suspect for 28 days without a warrant is allowed under the Fourth Amendment. The primary concurrence accuses the majority of relying on "18th Century Tort Law" to avoid deciding the important issues of personal privacy in this age of technological surveillance. It is clear from a reading of *Jones* that the entire Supreme Court believes it is likely that the *Jones* majority opinion is not the final word on the government's obligations when using location-tracking equipment. Even Justice Scalia, in his majority opinion, states, "We may have to grapple with these 'vexing problems' in some future case where a classic trespassory search is not involved and resort must be had to *Katz* analysis; but there is no reason for rushing forward to resolve them here."

Justice Alito, writing for a four-judge minority of the Court, felt that the *Jones*

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case should be decided against the government because the tracked suspect had a reasonable expectation that his movements would not be electronically monitored every 10 seconds for four straight weeks. Justice Sotomayor, who joined the majority opinion, also wrote a concurrence in which she credited Justice Alito's arguments, but found that the facts of the *Jones* case could be decided more effectively by addressing the government's physical trespass on the suspect's vehicle. So we may easily believe that there is at least a majority of Justices who agree with Justice Alito's broader argument, although Justice Sotomayor did not choose to apply this argument to the specific fact pattern before the Court in *Jones*.

Justice Alito notes that purely electronic surveillance, such as activating a stolen-car tracking system or monitoring phone movement through cell tower triangulation would have created the same effect on the suspect without a trespass that the majority opinion relied upon for its decision. Justice Alito and his concurring coalition find both tracking methods––physical and electronic––equally objectionable without a warrant. While Justice Alito invited legislative action to clarify law enforcement's obligations in regard to long-term electronic location tracking, he found that, with or without a physical trespass, four weeks of warrantless surveillance was clearly out of bounds, and the government's actions violated the suspect's reasonable expectation of privacy.

Using Triangulation Raises Constitutional Concerns

In other geolocation tracking cases, courts have questioned the extent of a person's privacy expectation where the government seeks records that identify and triangulate the base station towers for cell phones. With this information, the government can determine a person's exact location when placing calls, e-mailing, or texting. But is such electronic tracking a search under the Fourth Amendment? Pursuant to the Stored Communications Act, 18 U.S.C. §2703, the government may demand disclosure of records pertaining to a subscriber only with a court order, which "shall issue only if the government entity offers specific and articulable facts showing that there are reasonable grounds to believe" that the communication is relevant to an ongoing criminal investigation. This showing is lower than probable cause required for a warrant.

In the Matter of an Application of the United States of America for an Order Authorizing the Release of Historical Cell-Site Information, a district court in New York denied the government's request for cell tower information. The court noted that the use of "cell-site location records present even greater constitutional concerns than the tracking at issue in *Maynard*." The court found that cell-site location records enable the tracking of the vast majority of Americans: "Thus, the collection of cell-site location records effectively enables 'mass' or 'wholesale' electronic surveillance, and raises greater Fourth Amendment concerns than a single electronically surveilled car trip." 2011 U.S. Dist. Lexis 93494 *17–18. The court rejected the argument that a cell-phone user voluntarily discloses his or her location by turning on a phone and making and receiving calls and text messages.

Embedded Software Tracking: Private Cause of Action

The issue of the use of cell phones to determine a person's location also has arisen outside the criminal courts, as several recent plaintiffs have sought class-action certification in location privacy cases. For example, in *Cousineau v. Microsoft Corp.,* W.D. Washington No. 2:11CV0438, the plaintiff seeks class action status in a complaint against Microsoft. The case involves whether the Microsoft Windows Phone 7 application surreptitiously forces users into its non-stop geo-tracking program. The plaintiff alleges that, even when a user turned off the tracking feature, the information was still sent to Microsoft. In response, Microsoft said there was a software error in the code. Microsoft has filed a motion to dismiss the case.

Another approach of addressing the unanticipated loss of privacy due to intrusive use of mobile device data is to sue the manufacturers for breaching promises or for violation of consumer protection laws. One of the first cases to claim that intrusive and unprotected software is a consumer defect under the consumer protection laws is the recent filing of *Goodman v. HTC America* (the *AccuWeather* case), Case Number 2:2011cv01793, filed October 23, 2011, in the United States District Court, Western District of Washington. The plaintiffs alleged that a mobile phone manufacturer and application developer installed the AccuWeather application on their phones ostensibly to provide convenient weather reports, but subsequently used the application to transmit plaintiffs' locations for other purposes (including "fine" geographic location date, which identifies the latitude and longitude of a particular device's location within several feet at a given data and time). Plaintiffs also claimed that defendants failed to meet accepted baseline information security standards by transmitting the information in an unencrypted manner. The plaintiffs claim class representation and the complaint alleges violations of specific consumer laws in several states.

The AccuWeather application apparently cannot be uninstalled or easily disabled, allowing the plaintiffs to claim that defendants had intentionally planted a Trojan horse application on their phones masked as a weather guide. Ultimately, this case may serve as the basis for consumers to classify overly intrusive software and hardware as violating federal and various state consumer protections laws, and to forum shop for the laws most likely to support their favored conclusions.

Apple also received a class action complaint related to its collection of customer location information on iPhones. In *Vikram Ajjampur v. Apple, Inc.*, Case 8:11-cv-00895-RAL-TBM, filed April 22, 2011, in the United States District Court, Middle District of Florida, the plaintiffs allege that Apple iPhones and 3G iPads are secretly recording and storing details of all their owners' movements, and

> the location data is hidden from users but unencrypted, making it easy for Apple or third parties to later access. . . . Collection of this information is "clearly intentional." Users of Apple products

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> have to no way to prevent Apple from collecting this information because even if users disable the iPhone and iPad GPS components, Apple's tracking system remains fully functional.

This lawsuit charges Apple with violations of the law for taking this information and for not protecting it at rest or in transit. The plaintiffs cited an alleged violation of the consumer protection laws of all 50 states, based on allegations that the data is unencrypted (on both the mobile devices and on users' computers which synch with those devices) and publicly accessible, which puts plaintiffs at serious risk of privacy violations (including stalking), that Apple's terms of service do not disclose tracking of users, and that ordinary consumers would not understand Apple's privacy policy to include the location tracking and synching.

In response to public concern over the collection of location data, Apple released a software update for mobile devices, available through iTunes. The update will limit the storage of location data to one week, stop the transfer of location data when the device is synched, and erase all location data from a device if a user turns off "Location Services." Location data stored on the device will also now be encrypted.

Conclusion

As location technology becomes cheaper and more pervasive, individuals are finding that their movements can be tracked by governments and by the organizations and people in their lives. Never before has such extensive location surveillance been available. Both criminal and civil courts are preparing to set the rules for electronically tracking people, but U.S. law is a long way from settled on these matters. The business lawyer should alert clients to the practical applications of the new technology, but should warn clients that the constitutional limitations of using this technology are not clear, and that class action lawsuits may soon place limits on how the technology and the information it yields may be used by business.

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BUSINESS LAW TODAY
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The Durbin Derby: Are There Any Winners?

By Laura Hobson Brown and Robert W. Savoie

The Dodd-Frank Wall Street Reform and Consumer Protection Act (the Act) impacted to some degree almost every aspect of the financial services industry, from securities transactions to mortgage origination and servicing to deposit accounts. For many Americans, the changes brought about by the Act have seemed distant and theoretical until now. But the recent implementation of one of the Act's provisions has resulted in changes in banking relationships that have made that Act more of a reality for many individuals. Among its many provisions, the Act included an amendment to the Electronic Fund Transfer Act (EFTA). That amendment added EFTA section 920, which limits the fees that banks can charge retailers for their customers' use of debit cards and establishes other restrictions for debit card transactions. This provision, which was a last-minute addition to the Act, has been dubbed "the Durbin Amendment" (or Amendment), named after its author, Senator Richard Durbin.

The Durbin Amendment

EFTA section 920(a)(2) limits the amount of the interchange transaction fee that a debit card issuer may receive or charge with respect to an electronic debit transaction to an amount that is "reasonable and proportional" to the issuer's cost with respect to the transaction. Section 920(a)(3) requires the board of governors of the Federal Reserve System (the Board) to establish a regulation to implement this requirement. The Board responded by adopting a final implementing rule, Regulation II, 12 C.F.R. § 235, which generally became effective on October 1, 2011.

An "interchange transaction fee," the focus of the Durbin Amendment and Regulation II, is any fee established, charged or received by a payment card network to compensate a debit card issuer for its involvement in an electronic debit transaction. The amount of this "swipe fee" must be reasonable and proportional to the cost incurred by the debit card issuer with respect to the transaction. The Board has established a maximum interchange fee of $0.21 per debit card transaction, plus five basis points of the transaction's value (as an ad valorem component), plus a fraud-prevention adjustment of up to $.01 per transaction for qualifying issuers. The $0.21 cap, as implemented by Regulation II, effectively creates a "safe harbor"; a debit card transaction interchange fee that complies with the cap is deemed to be conclusively reasonable and proportional. Regulation II also creates certain exemptions from these rules and prohibits specific actions, discussed below.

Overview of Debit Card Industry

The typical debit card transaction consists of the interaction of the cardholder, the bank that issued the debit card to the cardholder, the network operator, the merchant's bank, and the merchant itself, with the network operator in the center of the transaction. On one side of the network operator is the consumer utilizing his or her debit card and the bank that issued the debit card to the consumer (the issuer). The merchant and its bank (the acquirer) are on the other side of the network operator. The merchant traditionally contracts with its bank in order to gain access to the network operator and to compensate the bank for its services. In a pre-Durbin Amendment $100 debit card transaction, the funds might have been distributed as follows: the merchant received roughly $97.20; the issuing bank kept approximately $1.70 and remitted about $.50 to the merchant bank for the network operator.

Debit card transactions are typically processed over networks utilizing a personal identification number, or "PIN," or the cardholder's signature. A PIN debit network uses a single-message system that carries authorization and clearing information in one message. A signature-based network uses a dual-message system, carrying the transaction authorization and clearing information in separate messages. The vast majority of debit cards support both PIN- and signature-based transaction methods.

The Durbin Rule's interchange fee standards apply to the four-party system. The four-party system, the most commonly used processing system, involves the cardholder, the issuer, the merchant, and the acquirer. In a typical four-party

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system, the cardholder provides his or her card to a merchant to initiate a purchase, and, in a PIN debit, enters a PIN. The merchant sends an electronic authorization request for a specific dollar amount, along with the cardholder's account information, to the acquirer and to the network, which sends the request to the issuer. The issuer verifies that the cardholder's account balance is sufficient to cover the transaction amount and that the card is valid. A message approving or declining the transaction is returned to the merchant by the reverse path, usually within seconds of the authorization request. The network calculates and communicates to the issuer and acquirer its net debit or credit position for settlement.

Each debit card transaction involves various fees. Typically, the merchant pays an interchange fee to the issuer through the network operator, which sets the amount of the fee. The network also charges the acquirer and issuer a "switch fee" as compensation for its role in processing the transaction. In each transaction, the acquirer charges the merchant a merchant discount, which includes the interchange fee, the network switch fee, any other acquirer costs, and a markup applied by the acquirer. Over the past 10 years, the levels of nearly all components of the interchange fee assessed by PIN-based networks have risen, and caps on overall fees have been increased or eliminated entirely. Signature-based transaction fees followed the same pattern but have risen more slowly.

In addition to assessing fees, each card network establishes operating rules with which merchants and processors must comply in order to utilize the network. These rules govern conduct such as merchant card acceptance, technological specifications for cards and terminals, risk management and determination of how a transaction will be routed when multiple networks are available.

Regulation II (12 C.F.R. part 235)

Definitions

For purposes of the Durbin Amendment's implementing Regulation II, "debit card" is defined broadly as a card, payment card, or device issued through a payment card network to debit an "account," which is a transaction, savings or asset account established for any purpose and located in the United States. "Debit cards" do not include checks, drafts, or similar paper instruments or electronic representations of those instruments or the use of an account number to initiate ACH transactions.

An "electronic debit transaction" is the use of a debit card as a form of payment to initiate a debit to an account. It includes the use of a debit card to purchase goods or services, to satisfy an obligation (e.g., taxes) or for other purposes. It also includes a transaction in which a cardholder uses a debit card to make a purchase and to withdraw cash at the point of sale (a "cash-back transaction"). Transactions conducted at ATMs, including cash withdrawals and balance transfers, are not "electronic debit transactions."

Fee Restrictions

The October 1, 2011, deadline has passed and, for the most part, the requirements established by the Durbin Amendment, implemented by the Board's adoption of Regulation II, have become effective. An issuer is prohibited from receiving or charging a debit card interchange transaction fee in excess of a base component of \$0.21, which does not vary with a transaction's value, plus an ad valorem component equal to five basis points of the transaction's value. The interchange fee amount does not differ between PIN and signature transactions. The base component includes certain allowable costs related to authorization, clearance, and settlement of a debit transaction, consisting of network connectivity; software, hardware, equipment, and associated labor; network processing fees; and transaction monitoring. The ad valorem component is based on the median per-transaction fraud losses that issuers reported to the Board. A fraud-prevention adjustment of \$0.01 per transaction is also available if the issuer meets certain standards established by the Board.

The fee restrictions and the other limitations of Regulation II apply to both business and consumer accounts, as well as general-use prepaid cards, unless they are subject to the prepaid exemption to the interchange fee limitation, discussed below. Decoupled debit cards (where the issuer does not hold the debit account), deferred debit cards (where the issuer agrees not to post transactions until a later date), and payment codes or devices (even if not issued in card form, like a mobile phone or sticker containing a contactless chip) are all subject to the regulation's restrictions.

Interchange Fee Exemptions

A small issuer that, with its affiliates, has assets of less than \$10 billion is exempt from the interchange fee restrictions. The Board will publish an annual list of all institutions, identifying those with assets below the \$10 billion exemption amount. Exempt issuers are permitted to receive a higher interchange rate than the Regulation otherwise permits for non-exempt issuers. The Board's staff has been instructed to monitor how well the exemption works for small issuers and to report to the Board over time regarding the exemption's impact on small issuers.

Debit cards issued pursuant to government-administered programs and certain reloadable general-use prepaid cards are also exempt from the fee restrictions. However, these exemptions will expire on July 21, 2012, if the issuer charges an overdraft fee in connection with the card or a fee for the first withdrawal each month from an ATM that is part of the issuer's designated ATM network.

Network Exclusivity and Routing Restrictions

The Durbin Amendment also required the Board to prescribe regulations that prohibit an issuer or network from restricting the number of networks over which a merchant may process an electronic debit transaction to fewer than two unaffiliated networks (the "network exclusivity restrictions"). In addition, the Board was required to issue regulations prohibiting an issuer or network from preventing a merchant that accepts debit cards from routing a debit transaction through any network that will process the transaction (the "merchant routing restric-

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tions”). These exclusivity restrictions are implemented by section 235.7(a)(1) of Regulation II. An issuer complies with these requirements if it allows an electronic debit transaction to be processed on at least two unaffiliated payment card networks, each of which does not restrict network operation to a limited geographic area, specific merchant, or transaction and each of which has taken steps to enable the network to process the debit transaction that it reasonably expects to be routed to it, based on transaction volume. For example, it would be sufficient for an issuer to issue a debit card that operates on one signature-based card network and one PIN-based card network, as long as the two networks are not affiliated. Alternatively, an issuer could issue a debit card that operates on two unaffiliated signature-based card networks, but is not enabled for PIN debit transactions, or vice versa.

In order to avoid a prohibited exclusivity arrangement, a network may not restrict or limit an issuer’s ability to contract with any other payment card network that may process debit card transactions involving the issuer’s debit cards. Similarly, a network may not set rules or guidelines that allow only that network’s brand, mark, or logo to be displayed on a particular debit card or that prohibit the appearance of logos of other networks on a debit card. However, there is no requirement for a debit card to display the brand, mark, or logo of each network over which a debit card transaction may be processed.

There is no exemption from the routing and exclusivity restrictions for small issuers, cards issued pursuant to government-administered payment programs and certain reloadable prepaid cards.

A network cannot prohibit a merchant from offering a discount to customers who pay by a particular method, including cash, check, debit or credit cards. In addition, a network cannot prevent a merchant from setting a minimum dollar value for accepting credit cards, provided that the minimum amount does not vary amount issuers or payment card networks and the established minimum value does not exceed $10. No such minimum value has been established for debit cards; it could be set at any amount.

The exclusivity rules as they apply to payment card networks were effective on October 1, 2011. Otherwise, the rules are generally effective on April 1, 2012. However, April 1, 2013, is the effective date for these rules as they apply to (1) debit cards that use point-of-sale transaction qualification or substantiation systems to verify the eligibility of purchased goods or services and for general-use prepaid cards. The routing rule was effective on October 1, 2011.

Enforcement

Compliance with Regulation II will be administratively enforced by an entity’s functional regulator under the EFTA. The Consumer Financial Protection Bureau is not authorized to enforce this provision. Furthermore, the criminal and civil liability provisions of the EFTA are not applicable to violations of this provision.

Response to the Durbin Amendment

Debit Card Industry Response

Since the Board’s publication of its rule implementing the Durbin Amendment (or the “Durbin Tax” as it has been referred to lately), many banks have responded by implementing reactionary programs and policy changes.

1. *Additional Fees? Maybe Not*. As one of the primary early responses to the Board’s $0.21 cap on debit card interchange fees, a number of banks either adopted monthly checking account charges or fees for debit card charges for checking accounts that had previously been free of such charges. Comparison site Bankrate reported that not even half of all checking accounts were free in 2011, whereas the majority were free in 2010. In a heavily publicized move, Bank of America was the first to announce that it would impose a $5 monthly debit card fee for checking accounts, beginning in October 2011, in an effort to recoup at least a part of the large sums that the bank expected to lose as a result of the reduction in interchange fees. Most of the other large banks followed suit and announced plans to increase checking account fees and/or begin imposing debt credit fees. The public’s reaction to these new or increased fees was swift and extremely negative. As a result of this reaction, the vast majority of these fees have been canceled or modified to substantially reduce their effect.

2. *Rewards Programs*. Many banks have announced that debit card rewards programs will be limited, if not eliminated entirely, since these rewards programs were largely funded by debit card interchange fee income. At least one bank cited the Durbin Amendment as the basis for its decision to close a significant number of branches, while some analysts asserted that the Amendment should be more properly considered as a factor contributing to, rather than a root cause of, bank closures. However, industry observers roundly admit that the implementation of the Durbin Amendment has triggered cost-cutting decisions by a number of banks.

3. *Where Will the Savings Go?* The reduction in the interchange fees that they have to pay could result in a major boost to merchants’ bottom lines. However, the net savings that merchants will realize is uncertain because the Amendment and Regulation do not restrict how much debit card networks can charge merchants.

Consumer interest groups have announced that they will closely watch merchants to ensure that they pass on interchange fee savings to consumers. Richard Hunt, president of the Consumer Bankers Association, stated that “[r]etailers, their trade associations and Senator Durbin repeatedly stated they would pass along the ten billion dollars in savings to consumers immediately.” Mallory Duncan, chairman of the Merchants Payments Coalition, noted that multiple approaches will be used, and that consumers will likely see a mixed result among retailers; some retailers will not raise prices while others will cut prices as a result of the reduction in interchange fees.

In the wake of the large banks’ reaction to the changes implemented by the Durbin Amendment, smaller banks that qualify for the $10 billion exemption have attempted to attract new customers by publicizing their lack of debit card fees

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and checking account fees.

Public reaction to the fees proposed by major banks encouraged, if not created, a strong consumer backlash against major banks, manifested by "Bank Transfer Day." Depositors at major banks were urged to close their accounts with those major banks on Bank Transfer Day, November 5, 2011, and move those accounts into credit unions and smaller community banks.

While Bank Transfer Day was a grassroots initiative designed to highlight customer dissatisfaction at major banks, it created some lasting momentum. It demonstrates a current trend of depositors moving away from major banks and into banks they view as local and more consumer friendly. Although consumer sentiment regarding big bank fee initiatives is decidedly negative now, analysts expect the long-term impact on banks nationwide to be modest.

Credit Card Industry Response

In the wake of the implementation of the Durbin Amendment, retailers have already begun efforts to obtain similar restrictions on credit card interchange fees. The Retail Industry Leaders Association is already initiating plans to lobby on the same scale for credit card interchange fees as it lobbied for debit card interchange fees. However, financial services industry representatives indicate that, because of lingering political fatigue from the contentious fight over debit card transaction fees, this is not an optimal time for such a debate.

Conclusion

It is still too early in the process to accurately predict whether or how the Durbin Amendment and Regulation II will affect the various parties involved in a debit card transaction. While the small issuer exemption could prove to be valuable, too many unknowns still exist to be able to accurately predict how smaller banks will be ultimately impacted. Consumers may see some savings as a result of the new fee restrictions, but this depends on merchants' willingness to pass along part of the interchange fee reduction. The real winner of the Durbin Derby will only be identified with the passage of time, when the full impact of the Amendment's restrictions and exemptions is more apparent.

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BUSINESS LAW **TODAY**
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Keeping Current:

A New Tort is Born! Ontario Recognizes its First Privacy Tort

By Lisa R. Lifshitz

The Canadian province of Ontario's Court of Appeal recently recognized for the first time the right of a plaintiff to bring a civil action for damages for the invasion of personal privacy, drawing upon U.S. legal concepts in the process.

The case of *Jones v. Tsige*, 2012 ONCA 32 (CanLII) (available at http://www.canlii.org/en/on/onca/doc/2012/2012onca32/2012onca32.html), began in July 2009 when the appellant, Sandra Jones, discovered that the respondent, Winnie Tsige, had been secretly looking at her banking records. The two both worked at the Bank of Montreal in separate branches but for complicated interpersonal reasons (Tsige was involved in a relationship with Jones' ex-husband). Tsige had accessed Jones' banking records at least 147 times over a period of four years. Tsige had reviewed Jones' transactions details, as well as her personal information including date of birth, marital status, and address. Tsige did not publish, distribute, or record the information in any way.

Jones ultimately became suspicious of Tsige and complained to the bank, who found that Tsige had no legitimate reason for viewing the information. The bank determined that she was doing so contrary to the bank's Code of Business Conduct and Ethics and her professional responsibility. Tsige later apologized for her actions, was suspended for one week without pay by the bank, and denied a bonus. Feeling that this was an inadequate remedy given that her privacy interest in her confidential banking information had been "irreversibly destroyed," Jones claimed C$70,000 for invasion of privacy and breach of fiduciary duty and punitive and exemplary damages of C$20,000.

At issue was whether Ontario recognized the existence of a tort of invasion of privacy. Canada presently has a complex patchwork of private sector, public sector, and sector-specific privacy laws. To date, four provinces (British Columbia, Manitoba, Saskatchewan, and Newfoundland) currently have a statutorily created tort of invasion of privacy. All four statutes establish a limited cause of action, whereby liability will only be found if the defendant acts willfully (not a requirement in Manitoba) and without a claim of right. Moreover, the nature and degree of the plaintiff's privacy entitlement is circumscribed by what is "reasonable in the circumstances." The first motion judge found that in Canada, there is no free-standing right to dignity or privacy under the Canadian Charter of Human Rights or at common law. He also added that given the existence of existing privacy legislation protecting certain rights, any expansion of those rights should be dealt with by statute rather than common law. The judge also felt that Jones had pursued the litigation "aggressively" and failed to accept reasonable settlement offers. Jones appealed.

In Canada, the question of whether the common law should recognize a cause of action in tort for invasion of privacy has been debated for the past 120 years. The Ontario Court of Appeal canvassed Canadian, U.S., and English jurisprudence and commentators, including the 1890 *Harvard Law Review* article "The Right to Privacy" by Samuel D. Warren and future U.S. Supreme Court Justice Louis D. Brandeis and William Prosser's 1960 article "Privacy." The court particularly focused on the *Restatement (Second) of Torts* (2010) regarding the tort of "intrusion upon seclusion."

The court found it appropriate to confirm the existence of a right of action for intrusion upon seclusion, which it held to be "consistent with the role of this court to develop the common law in a manner consistent with the changing needs of society." They were also aided by the particular circumstance of this case, with facts "that cry out for a remedy," and characterizing Tsige's actions as "deliberate, prolonged and shocking."

Interestingly, the court explicitly dismissed the idea that it was not open to adapting the common law to deal with the invasion of privacy on the ground that privacy is already the subject of legislation in Ontario and Canada more generally. The court also found that Canada's federal private sector act, the Personal Information Protection and Electronic Documents Act (PIPEDA) which would otherwise apply to organizations subject to federal legislation such as banks, does not speak to the existence of a civil cause of action in the

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province and was therefore unhelpful for Jones. Moreover, the remedies available under PIPEDA do not include damages, and it would be difficult to see how Jones could benefit from lodging a PIPEDA complaint with Canada's federal regulator against her own employer rather than the wrongdoer Tsige.

The Ontario Court of Appeal adopted as elements of the action for intrusion upon seclusion the *U.S. Restatement (Second) of Torts* (2010) formulation as follows:

> One who intentionally intrudes, physically or otherwise, upon the seclusion of another or his private affairs or concerns, is subject to liability to the other for invasion of his privacy, if the invasion would be highly offensive to a reasonable person.

The key features of this cause of action, as found by the court were, (1) that the defendant's conduct must be intentional (including reckless); (2) the defendant must have invaded, without lawful justification, the plaintiff's private affairs or concerns; and (3) that a reasonable person would regard the invasion as highly offensive causing distress, humiliation, or anguish.

The court was very cognizant that it was creating a new tort and went out of its way in its written judgment to reassure the Canadian public that this cause of action will not "open the floodgates" to vast numbers of new claims and that the cause of action will arise only for "deliberate and significant invasions of personal privacy." The court explicitly stated that "claims from individuals who are sensitive or unusually concerned about their privacy" are to be excluded (although it remains to be seen what these will look like). The court then deliberately limited the tort to "intrusions into matters such as one's financial or health records, sexual practices and orientation, employment, diary or private correspondence that, viewed objectively on the reasonable person standard, can be described as highly offensive." The court also cautioned that proof of actual loss is not an element of the cause of action but given the intangible nature of the interests protected, damages for intrusion upon seclusion will ordinarily be measured by a "modest" conventional sum, especially by American litigation standards.

Having established the existence of the new tort, the court then considered the damages that it should award to Jones for her ordeal. The court canvassed damages under Ontario case law, particularly in the related areas such as nuisance and trespass as well as under the four provincial privacy acts, and in typical Canadian fashion, determined that, absent proof of actual pecuniary loss, the awards for such suffering should be "modest." The court found that damages for intrusion upon seclusion in cases where the plaintiff has suffered no pecuniary loss should be "modest but sufficient to make the wrong that has been done" and fixed the range at up to C$20,000.

Leaning to the conservative side once again, the court also commented that it would not "exclude nor encourage awards of aggravated damages" but absent truly exceptional circumstances, the plaintiffs should be held to the above-mentioned C$20,000 range. While Tsige's actions were deliberate and repeated and Jones was upset by the intrusion into her private financial affairs, Jones fundamentally suffered no public embarrassment or harm to her health, welfare, social, business, or financial position and Tsige had apologized for her conduct. Thus, the court placed this case at the mid-point of the identified range and damages were awarded in the amount of C$10,000 with no order as to costs.

While the above damage award to Jones is arguably exceedingly low, especially from an American perspective, the importance of the Jones v. Tsige case is certainly not the financial gain to Jones—it is the fact that this case opens the doors to future plaintiffs to avail themselves of an actual remedy following an "intrusion upon seclusion" event, even with a modest financial payout that recognizes their suffering rather watching their perpetrator merely get a slap on the wrist from the privacy regulator. Despite the attempts of the Ontario Court of Appeal to minimize instances of its application, this new tort is definitely of great interest to Canadians and those who do business in Canada and underscores the growing recognition that Canada's judiciary attaches to the importance of personal privacy and the importance of privacy in Canada more generally.

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BUSINESS LAW **TODAY**
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Delaware Insider:

Running a Proper Independent Committee Process: Practice Tips from Recent Delaware Cases

By Jeffrey R. Wolters

A board of directors faced with a conflict transaction—such as a transaction with a controlling stockholder or, in many cases, an acquisition by a financial buyer where management will be retained and will receive equity in the post-acquisition entity—will usually form an independent committee of directors to consider the transaction. The required attributes of an independent committee process are by now fairly clear under Delaware law. However, recent cases have pointed out a few remaining uncertainties in the Delaware law governing committees, particularly as regards the scope of authority that must be given to a committee and the legal standards that a reviewing court will apply in assessing a committee process. Perhaps more importantly from a practitioner's standpoint, recent cases also highlight certain recurring fact patterns that have undermined committee processes. This article briefly reviews the legal uncertainties, and then turns to these recurring facts patterns and suggests ways that counsel could deal with them.

Settled Law and Remaining Uncertainties

Under Delaware law (as generally outlined in *In re So. Peru Copper Corp. S'holder Derivative Litig.*, 2011 WL 6440761 (Del. Ch. 2011)), a transaction with a controlling stockholder, or a transaction in which a majority of the board otherwise has a conflict, will be reviewed under the entire fairness standard. This means that the defendants will bear the burden of proving that the transaction was entirely fair, both in terms of "fair process" and "fair price." If the defendants cannot satisfy this standard, they may be personally liable for damages.

However, the proper use of an independent committee can provide significant protection for directors by changing how these legal standards are applied, either by changing the standard of review, shifting the burden of proof, or providing evidence of fairness. In a transaction with a controlling stockholder, use of an independent committee can shift the burden of proof under the entire fairness standard back to the plaintiff. In a transaction not involving a controlling stockholder, it can change the standard of review from the entire fairness standard to the business judgment rule. In either case, whether or not there is a change in the standard of review or burden shift, the committee process can itself be important evidence of fairness.

Within this relatively settled framework, recent cases have pointed out three open questions.

Scope of Authority

The first question relates to the scope of authority that must be granted to or exercised by the committee. It is not clear that a committee will result in the benefits discussed above, particularly the benefits relating to burden of proof and standard of review, unless the committee is granted broad authority. This could include not only the standard "power to say no" to any given transaction, and the power to retain independent advisors, but also the power to consider alternative transactions (even in response to an offer from a controlling stockholder who could potentially veto other deals) and to take defensive measures to protect stockholders. *In re CNX Gas Corp. Shareholders Litigation*, 2010 WL 2705147, *10 (Del. Ch. 2010); *In re So. Peru Copper Corp. S'holder Derivative Litig.*, 2011 WL 6440761, *23 (Del. Ch. 2011).

Standard of Review

The second open question relates to standard of review in a transaction with a controlling stockholder. The Chancery Court has suggested that the use of an independent committee, if combined with a "majority of the minority" stockholder vote, should result in the full protection of the business judgment rule, rather than simply a shift in the burden of proof under the entire fairness standard. At the same time, the Chancery Court has laid down stringent requirements for committees in this context, including, generally, that the committee's authority match that of an independent board as much as possible. *In re CNX Gas Corp. Shareholders Litigation*, 2010 WL 2705147 (Del. Ch. 2010). The Delaware Supreme Court has yet to rule whether it will adopt the Chancery

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Court's suggested approach as the law of Delaware.

Shift in Burden of Proof

The third open question relates to when a court will determine whether a committee process has the effect of shifting the burden of proof in a control stockholder transaction. Chancellor Strine recently concluded in *In re Southern Peru Copper Corp. S'holder Derivative Litig.*, 2011 WL 6440761, *23 (Del. Ch. 2011), that the precedents dictate that this cannot be determined until after the trial court has reviewed the factual record to decide whether the committee functioned properly. He also candidly noted that if a court cannot determine who bears the burden of proof until after reviewing all the facts, it calls into question the relevance of a "burden shift" as a practical matter.

Recurring Fact Patterns to Address

Even in the midst of some uncertainty concerning the legal rules applicable to committees, lawyers who advise committees can help ensure the maximum effectiveness of a committee process by being alert to certain recurring fact patterns that have troubled the courts in recent cases.

Scope of Authority Granted to the Committee

The courts have clearly signaled that because a primary purpose of an independent committee process is to replicate the process that an independent board would go through in a transaction with a third party, the committee should have powers that are generally comparable to the powers of a board in such a situation. The courts have focused recently on whether a committee must be given the power to consider alternatives, including in response to a proposal made by a controlling stockholder. Delaware law is fairly settled that if a controlling stockholder has stated that it will vote its shares against other transactions, then a board generally does not have a duty to pursue the "futile act" of shopping for alternative deals. It might therefore be argued that a committee need not be empowered to consider alternatives if the controlling stockholder has made such a "veto statement." On the other hand, arguably the decision whether or not to believe the veto statement, and what to do in response to it, is a decision that should be left to the committee. A decision "not to shop" may be perfectly defensible if made by the independent committee, but subject to attack if foreordained by the board as a whole. An important role for committee counsel in this context is to make sure the committee understands the scope of the authority granted to it, and to discuss with the committee whether it could be advisable to seek to expand that authority.

Committee Member Conflicts

A court may not respect a committee process if it is not fully convinced that the committee members are in fact independent in relation to any conflicted parties and the transaction in question. Recent cases have focused on the need for liquidity as a potential conflict. In the *Southern Peru* case, for example, a committee was established to consider a transaction proposed by a majority stockholder. One committee member was affiliated with another large stockholder that wanted to liquidate its stake, but could not do so unless its stock was registered—a decision which the court found was controlled by the majority stockholder (through its control of a majority of the board). The court concluded that this "liquidity conflict," although different from a "classic self-dealing interest," nonetheless called into question the independence of the committee member.

Another example of a liquidity conflict arose in the Chancery Court's recent decision in *N.J. Carpenters Pension Fund v. infoGROUP, Inc*., 2011 WL 482588, *10 (Del. Ch. 2011). There it was alleged that the CEO had pushed for a sale of the company because he needed liquidity to fund another venture of his own and to cover certain personal liabilities. The company was being sold to an unrelated third party and therefore the sale itself did not raise conflict issues. However, the court found that the CEO's liquidity needs compromised his independence, and in turn infected the sale process as a whole given his central role in negotiating the deal and leading the board.

An important role for counsel can be to flush out any actual or potential conflicts of interest at the outset of a committee process. This might be done by interviewing the committee members or providing them with a detailed questionnaire. If a conflict or potential conflict is discovered, it is not necessarily disqualifying for the committee member. It may be crucial, however, that the matter be disclosed to and discussed by the committee as a whole, so that the record can reflect the committee's knowledge of the matter and its collective judgment whether to take any action. This point was highlighted in another recent decision of the Delaware Chancery Court, *In re El Paso Corp. S'holder Litig.*, 2012 WL 653845, *8 (Del. Ch. 2012), where both the CEO and the board's investment banker were found to have had conflicts of interest that were not disclosed to the board. The court stated that "[w]hen anyone conceals his self-interest . . . it is far harder to credit that person's assertion that self-interest did not influence his actions." Committee counsel can often play an important role in flushing out such conflicts at the outset, rather than waiting for them to surface in litigation, when they are likely to cause far more damage.

Committee Control of Management

Another recurring "bad fact pattern" is where management rather than the committee appears to be leading the process, but management has a conflict of interest. Such a conflict often arises in connection with a sale of the company to a financial buyer which plans to retain management and provide management with new equity (i.e., a rollover). The Delaware courts have emphasized repeatedly that in this context, it is important for the record to reflect that the committee actively directed the process rather than ceding control to management. In litigation challenging the buyout of J. Crew, for example, (*In re J. Crew Group, Inc. Shareholders Litigation,* C.A. No. 6043 at 66 (Del. Ch. Dec. 14, 2011)), the court commended the committee for implementing management guidelines that

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restricted management's ability to discuss retention or equity participation with bidders, unless authorized by the committee. Damage had already been done, however, because the CEO had brought in the winning bidder, and discussed his own retention and rollover package with that bidder, before the board as a whole was made aware of the potential sale and was able to establish the independent committee. Chancellor Strine criticized boards in general for not having in place policies to prevent CEOs from front-running sale processes in this manner:

> I really don't understand why it is not expected of all public company boards that they have protocols in place to deal with the [not] unusual circumstance of whether the CEO decides that the best strategic option for the company might be a sale. It is, in my view, outrageous for a board to be the last to know when the CEO changes the fundamental strategic direction in his own mind . . .
>
> I believe that there are deals tainted by CEOs messing around early, boards not having policies in place. It's inexcusable for companies to be doing this. I don't get why all boards don't have policies to say, when the CEO changes in his own mind that it's a viable option [to sell the company], the board hears first. The company's advisors belong to the company. You don't talk to employees. You don't share confidential information. You don't make promises to work for anybody else, or anything like that, without talking to us. And there are many defense lawyers and people who advise boards in the room, and it's really not excusable [that they fail to implement such policies].

In re J. Crew Group, Inc. Shareholders Litigation, C.A. No. 6043 at 66, 69–70 (Del. Ch. Dec. 14, 2011) (Transcript).

Committees should expect similar criticism if they do not move forcefully to control management's role in a sale process in which management may have a conflict of interest. This does not mean that it is necessarily required to exclude management from the process, and it will typically be neither feasible nor advisable to do so. But the committee and its counsel should develop a clear record that they actively dealt with the issue and implemented rules to mitigate the potential for any management conflict to affect the process to the detriment of stockholders as a whole.

Financial Advisor Conflicts

An independent board or committee process may also be undermined by conflicts of interest on the part of the directors' financial advisor. The Delaware Chancery Court has repeatedly emphasized the importance of vetting and disclosing "banker conflicts," and the serious risk that such conflicts may pose to a sale process:

> Because of the central role played by investment banks in the evaluation, exploration, selection, and implementation of strategic alternatives, this Court has required full disclosure of investment banker compensation and potential conflicts. This Court has not stopped at disclosure, but rather has examined banker conflicts closely to determine whether they tainted the directors' process.

In re Del Monte Foods Company Shareholders Litigation, 25 A.3d 813, 831–832 (Del. Ch. 2011) (citations omitted).

In addition, as noted in the *El Paso* case, the concealment of such conflicts magnifies the substantive problem. Thus in the *Del Monte* case, the court enjoined a merger primarily because of the undisclosed actions of a conflicted banker, notwithstanding that the board of directors itself was independent and the sale was to a third party. The banker's actions included arranging to provide financing to the buyer before a final deal price was struck.

The conflict created when a target financial advisor also provides buy-side debt financing—so-called stapled financing—was again considered by the court in the *El Paso* case. There, interestingly, Chancellor Strine took care at the hearing to note that such financing was not necessarily a problem if an independent committee controlled the process and could show a benefit to the company, such as luring more bidders or a potentially higher price.

Conclusion

In summary, regardless of where a conflict originates or what course of action is chosen, the key issue in a committee process will often be whether the record reflects that the committee was proactive, in control and made an informed judgment on the matter, or whether the committee instead appeared to be a passive victim of the conflicted party (whether a banker, management, a conflicted committee colleague, the board as a whole, or a controlling stockholder).

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BUSINESS LAW **TODAY**
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Member Spotlight

Jean Allard: Leader, Groundbreaker, Mentor, and Friend

Jean Allard, the first woman elected Chair of the Business Law Section, and the first recipient of the Glass Cutter Award named in her honor, passed away on Sunday, January 29, 2012, after a long illness. She was 87 and is survived by a son, John Allard, a granddaughter, and a niece.

Originally from Trenton, Mo., Allard came to Chicago as a student in the psychology doctoral program at the University of Chicago. Midway through her program, she sought and received permission from the university to take a few classes at the law school. Allard excelled in her studies, transferred to the law school, and went on to serve as the managing editor of the *University of Chicago Law Review.* She also won the ABA's national student moot court competition for best brief and second best oral argument. She finished her degree in 1953, one of only two women in that year's graduating class.

Despite her academic excellence, Allard was unable to find a law firm willing to hire her. Undeterred, she got her professional start as a research associate working for the husband and wife team of Karl Llewellyn and Soia Mentschikoff. (Llewellyn and Mentschikoff are well known legal scholars and two of the original team appointed by the American Law Institute to draft the Uniform Commercial Code. They later married and continued working together professionally.)

Allard's career spanned many diverse areas: as an antitrust lawyer; as general counsel for Maremont Corp., an auto parts manufacturer; as vice president of the University of Chicago; and as the first female partner at the law firm of Sonnenschein Nath & Rosenthal, now known as SNR Denton. She was appointed to and served on the boards of LaSalle Bank, Commonwealth Edison Co., and Marshall Field & Co. In 1987, she was included on the list of Chicago's 10 most powerful women compiled by the *Chicago Tribune*.

When asked about her success, Allard spoke of her penchant for volunteerism. As she told *Today's Chicago Woman*, "I volunteered for work a lot, which I think is one of the ways you become a more important person in any institution."

Corinne Cooper, herself a Glass Cutter Award recipient in 1996, became good friends with Allard during their work together in the Section. Cooper counts herself among those who benefited from Allard's guidance. Cooper says, "She appointed me to Chair my first committee, Arbitration, and then challenged me to grow the committee. If she felt that you were moving too fast, she would tell you that, too. And she wasn't afraid to say, 'Wait your turn!' She didn't mentor men any differently than she mentored women, but she was very aware of the need to include women in the leadership of the Section. She understood the pipeline. Because of Jean, we've had a series of outstanding women leaders in the Section."

Former Section Chair and Glass Cutter Award recipient (1995) Amy Boss recalls being simply in awe of Allard. She was "articulate, outgoing, in command, professional, and yet still retained her femininity. People were drawn to her. You wanted to be like her. She was quick to mentor others and share what she had learned." Boss describes the late 70s and early 80s as a time when it was not unusual for her to walk into a Section committee meeting and be the only woman in the room. But any meeting that included Allard had a "different atmosphere, one where you felt included."

For all of Allard's professional accomplishments, she always retained an innate graciousness and willingness to help others. Cindy Elliott met and was hired by Allard while she (Elliott) was in law school. Allard needed assistance editing *The Business Lawyer* and the print version of *Business Law Today*, and the two worked closely on Section business for several years.

Former Section Chair and 1998 Glass Cutter Award recipient, Barbara Mendel Mayden, recalls how much has changed within the Section over the past 20 years. Mayden describes "a time of closed committee meetings and an intimidating atmosphere," but that Allard was persis-

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tent in making sure there were places for talented people, "especially those who didn't fit the traditional mold." Mayden remembers, "Jean invented mentoring before anyone else really knew what it was. She was always on the lookout for young people who needed an introduction and a seat at the table. Even if you didn't have the gumption to try, she just kept pushing you forward. I feel very fortunate to have been mentored by her personally. Without Jean's influence, I would never have remained so involved with the Section."

Elliott also remembers Allard fondly. "Jean was an amazing person, so engaged in everything she was doing, and with more energy than anyone I've ever met. She was great to work with, very much a listener, but very decisive when she needed to be. She was extremely bright and competent, yet totally confident and relaxed. Jean always said there were two types of women in business, 'the kind who climb the ladder and pull it up after they get to the top, and the kind who climb the ladder and reach down to help those behind her manage the steep climb.' Jean was always helping those around her, always promoting capable people, and giving them opportunities to shine that they would not have had otherwise."

It was at a Section luncheon 25 years ago, at the Spring Meeting in St. Louis, that Elliott serendipitously was seated next to the man whom she would eventually marry, Mitchell Bach. While Allard never claimed credit for introducing the couple, Allard was responsible for finding the federal judge that married the couple in Chicago and was a special guest at their wedding. Bach recalls Allard as "a giant, way ahead of her time."

When Allard's son John was contacted and asked to share some thoughts about his mother, he recalled how happy she was to attend the Business Law Section meetings. She loved being around everyone and catching up with her friends. Thus it seems only fitting to honor Jean Allard at this year's Spring Meeting as the 20th Glass Cutter Award is bestowed on one of the Section's deserving female leaders.

Jean Allard was a beloved member of the Business Law Section. A link to this article will be posted on the Business Law Section's Facebook page, https://www.facebook.com/ABABusinessLaw. We invite you go there and share your thoughts and memories about this remarkable woman.

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Inside Business Law

Highlights of Committee Work Product
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Focus on Legal Opinions

- Should lawyers be using a streamlined form of legal opinion that strips out much of the boilerplate, including assumptions regarding the genuineness of signatures and the authenticity of the documents? A recent appellate court decision suggests this may not be the right approach. This article in the recent edition of the *Legal Opinion Newsletter* analyzes whether to streamline legal opinions.
- The Dodd-Frank Act and its implementing regulations can have broad reach for certain transactions in which legal opinions are given, including those involving derivatives, such as swaps and securities-based swaps, and securitizations. This broad reach and uncertainty of application of certain of the regulations can raise issues for opinion preparers in these transactions. Learn more in this insightful article.
- Under what circumstances does the SEC treat an attorney serving only as counsel to a borrower in a bond transaction as an offeror and a seller of the bonds for purposes of liability under sections 17(a) and 10(b)? Read this article for the answer and an interesting summary of a recent SEC case.
- In a cross-border transaction, recipient's counsel may request an opinion typical in its jurisdiction but is considered unreasonable by the opinion giver in its jurisdiction. A recent report by the City of London Law Society on opinion letters for English law financial transactions addressed this topic. For a brief summary of the report, read this article which explores the reluctance or refusal to give an opinion in a cross-border transaction.
- Recently, a report on third-party legal opinion customary practice in Florida was approved by the Executive Council of various Florida Bar sections. For a summary and access to this report, check out this article.

LLCs and Partnerships

- In a recent decision interpreting and applying the Wisconsin LLC Act, the court suggested that the fiduciary obligations amongst all businesses or organizations not only are, but should, be the same. The author of this article from the *LLC & Partnership Reporter* argues that the court got it wrong.
- If an operating agreement prohibits transfers of membership interests, and a member transfers its interest notwithstanding the operating agreement's prohibition, is the transfer void? Or is the transfer effective, even though the transferor is in breach of the operating agreement and may be subject to a breach of contract claim? Read this article for a summary of the Colorado Supreme Court's decision on this issue. to store them under state or federal law.
- For a summary of the ABA's Revised Prototype Limited Liability Company Act published in November 2011, check out this article.

Business and Corporate Litigation

- Class actions receive special treatment that "get them around" the subject matter jurisdiction diversity of citizenship requirement. The U.S. Court of Appeals for the Second Circuit, however, recently highlighted an exception to this well-known rule. This article in the Spring 2012 issue of the *Business and Corporate Litigation newsletter* summarizes the interesting decision.

Cyberspace Programs of Interest

- The March 2012 issue of the *Cyberspace Law Committee Newsletter* highlights several programs of interest, including programs about domain names, social media, data privacy and other hot topics. If you are interested in information about these programs, the *Cyberspace Law Committee Newsletter* provides dates, times and other registration information.

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