BUSINESS LAW TODAY

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- **Proposition 65 and food**
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- *WARNING: This area contains a chemical known to the State of California to cause cancer and birth defects or other reproductive harm.*
- **75 years after Prohibition**
  It's a typical day. A venture capitalist wants to buy a farm, grow some grapes, and maybe sell some wine. A local chef wants to increase profits by buying and selling private label wines. A winery is fighting with one of its distributors and wants to dump them.
- **The next wave**
  The Credit Default Swap (CDS), an arcane and relatively novel instrument of institutional finance, recently gained notoriety as the apparent cause of the near collapse of American International Group, Inc. (AIG).
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Departments:

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- Keeping Current: **Standards of Review; Officer Fiduciary Duties; and Shareholder Ratification**
  The Delaware Supreme Court recently clarified issues of Delaware law in its unanimous en banc opinion in Gantler v. Stephens, No. 132, 2008 (Del. Jan. 27, 2009). Specifically, the Delaware Supreme Court held that . . .
- Speaking Volumes: **An update to a landmark treatise**
  Lawyers who give, and those who advise clients on receiving, third-party closing opinions should be delighted at the recent publication of the Third Edition of Glazer and FitzGibbon on Legal Opinions.

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Le Menu: The UCC and Food

The UCC and Food

By Steven O. Weise

To a foodie, food is something special, artistic, aesthetic, and to be savored. To a UCC lawyer, food is just a source of energy and another kind of property subject to commercial laws. When most of us buy or eat food, we don't think much about the UCC, but food is an important type of property that pops up all over the place in the UCC. The UCC affects or facilitates the food distribution change from soup to nuts, or from the farm to the plate. Indeed, without the UCC much of the food that we eat would not make its way to our kitchen tables or would cost a whole bunch more. A lawyer working on a deal involving food should consider how the UCC might affect the deal.

Amuse Bouche

Although we generally think of the UCC as applying to widgets and the like, there are plenty of provisions that often apply to food.

Hors D'Oeuvres

Article 1.

Entrées

Article 2 often applies to food. A seller of food, whether a grocery store or a restaurant, can breach the article 2 warranties if the food is defective. Recall the decision where a customer in a grocery store picked up a bunch of bananas? It turns out that there was a tarantula living among the bananas. It did not like to be disturbed and bit the customer on the way to the check-out stand. The court held that the grocery had not yet made a warranty about the bananas because the customer had not yet bought them. So, the customer could sue only for negligence. CeBuzz, Inc. v. Sniderman, 466 P.2d 457 (Colo. 1970). In the restaurant context, the question that arises is whether the food meets the reasonable expectations of the restaurant customer—i.e., there

should not be any bones in the burger.

Letters of credit frequently are used to pay for shipments of food. A supplier of food may sell it to a buyer in another country. The seller wants assurance that the buyer will pay and does not want to take the risk of going after a buyer in another country. Sometimes there is a requirement for a certificate that the shipped food is in good shape. If the food is spoiled, the buyer does not want the seller to be able to draw on the letter of credit. Without article 5's rules on letters of credit, food distributors might not be able to get food from other countries. That's particularly important when buying food not in season in the United States, requiring that it be sent from the other side of the equator, where the seasons are the opposite. No UCC would mean no blueberries in the winter.

Owners of food, such as wheat, store the sheaves of wheat in warehouses. This allows for the accumulation of the wheat from many growers and the efficient disposition of the wheat (or other foodstuffs) through the distribution system. The warehouse issues a warehouse receipt for the wheat. The receipt can be used to transfer ownership of the wheat from producers to distributors to retailers—all without moving the wheat. Enormous costs can be saved and the system has great transparency and certainty. So, once again, the UCC keeps the granola in our breakfast bowls at a reasonable price.

Les Desserts

And then there's the final course of the UCC—article 9.

Article 9 applies to all sorts of personal property and there's nothing more personal than food. But how personal? Consider the apple tree and the gross of apples on it. The apples are crops (while on the tree or still with the farmer before any processing) and the tree may well be a fixture (see state real property law). Crops in turn are farm products. Crops, farm products, and fixtures are personal property, but these categories mean that special rules may apply to perfection and priority.

Article 9 now covers agricultural liens, which are statutory liens on farm products (including crops) arising in favor of someone who provides goods or services to a farmer. The where-to-file rules for perfecting an agricultural lien differ from those for perfecting a security interest, but an agricultural lien might have priority over a security interest. A lawyer working on a secured loan to a farmer should check out these rules.

And then comes foreclosure. As we all know when we examine the nether reaches of our refrigerators and pantries, food can spoil. Article 9 is well aware of this. The notice and timing provisions of article 9's foreclosure rules often provide exceptions if the collateral is food that will spoil if the regular rules are followed. Without those clever exceptions, there would not be anyone at the foreclosure sale and the spoiled food would be wasted.

Les Fromage

So where would we be without the UCC? Hungry!

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A Trip Around the Food Law World

Introducing New Food Products in the Global Marketplace

By Christine M. Castellano

As challenging as it may be to introduce a new food product in the United States, it is even more challenging when your target market is not just the United States, but the world. In today's global marketplace, introduction of new food and beverage products is rarely confined to a single country. This means that everything that goes into a successful food product launch—from demographic and market research to product design, regulatory approval, and market introduction—must be navigated in each country of interest.

This article is designed to provide a perspective on international food regulation challenges faced by the first timer—a company that has not recently engaged in substantive new product introduction and that, as a result, does not have internal resources dedicated to this function.

Rationale for Food Regulation

Our journey begins with an understanding that not all countries regulate food products in the same manner. In establishing food registration and approval requirements, each country seeks to protect its citizens against dangerous or unsuitable products. Generally, this goal is achieved by requiring some form of registration of the new food, ingredient, or additive, frequently supported by safety testing or certifications. This can be a challenging process in any single country. It is even more complex when a company wants to launch a product in multiple countries with multiple—and often contradictory—regulations. For example, expensive and detailed animal or human food safety studies that suffice in one country might be deemed insufficient in the next—a regulator might want assurance that the product's safety has been proven for citizens of their particular country.

On the List?

In some cases, your journey might be easy because your product is already recognized by the

regulators as approved. This recognition may take two forms. Some countries regulate by means of positive lists—anything expressly listed is acceptable. No further testing or proof of wholesomeness is required. Your product, however, must match the specifications of the listed product.

Others rely on negative lists—listed ingredients are prohibited. If your product is not included on a negative list, it is presumed safe. Generally, there are only minor regulatory hurdles (e.g., manufacturer registrations) to clear. Again, safety testing is not required.

Not all countries have a list system, however. Further, a truly novel product might not be included in either a positive or a negative list, or might not meet the specifications for a listed product. In this case, specific approval from the regulatory body must be sought. The approvals required may depend on whether the product is considered an ingredient, an additive, or a food; and these definitions can vary by country. Safety testing, which frequently involves human or animal testing, is generally required.

Whether your product already has been generally recognized as safe (GRAS) in the United States or approved by the Codex Alimentarius Commission (in the EU) may be informative, but it is not binding on other countries. As a result, you may be able to use the scientific studies underlying U.S. or EU approvals to support your regulatory approval in another country, but you also will have to satisfy the local regulators. In some cases, this may involve additional testing or certification.

Health Claims and Labeling

Each country also will likely have specific laws regarding product labeling and health claims (e.g., "promotes digestive health"). Unfortunately, definitions differ from country to country. For example, if you wish to know whether your product can be marketed as a fiber or as natural, you need to understand how the terms "fiber" and "natural" are defined in each relevant country. At times, these definitions might be contradictory, making a consistent global marketing approach difficult. At other times, the definitions and requirements may be unclear or inconsistent, or may be guided at least in part by public sentiment (as is discussed in the example of genetically modified organisms below).

Timing Is Everything

The timing needed for approvals also can vary greatly, from months to years—another challenge to a global commercial rollout. In companies without internal resources, food regulatory issues must be balanced against the need to control spending on outside legal counsel and consultants. This calls for a global strategy, with key regulatory personnel as integral members of the product launch team, and a detailed commercial marketing plan that allows prioritization of efforts based on market attractiveness and planned launch dates.

Across the Pond—European Markets

Many U.S. companies view the European market as a priority. Consumers share similar preferences in food and beverage products. As we begin our international food regulatory journey, the first stamp in our passport therefore requires that we understand the different players in the European food regulatory arena.

The Codex Alimentarius Commission was formed in 1963 and is a joint commission of the United Nations Food and Agriculture Organization and the World Health Organization. Codex is responsible for the development of international food standards, with scientific expertise provided by the Joint FAO/WHO Expert Committee on Food Additives (JECFA).

These international standards do not replace or create national rules. Each EU member state establishes its own food regulatory regime. The European Food Safety Authority (EFSA) cooperates with similar bodies in each member state to provide scientific analysis. EFSA operates independently of JECFA and Codex and does its own scientific research.

Once a product is approved in an EU member state, there are protocols for reciprocal recognition. Strategic decisions must be made, however, as to where safety testing should be conducted (remembering that some regulators have a bias toward testing conducted in their own jurisdiction) and in which EU member state to initiate testing—in those with the most rigorous standards (raising the specter of failing to obtain approval, or of additional costly testing), with the least rigorous standards (suggesting that it might be more difficult to obtain reciprocal admission without, again, additional costly testing), or where language concerns are limited (e.g., for U.S. companies, the UK).

Other Markets

A truly global launch will not be limited to the United States and the EU, so more passport stamps are required for our journey. Here, newcomers find significant complexity. For example, in Argentina, standards are set in the Codigo Alimentario Argentino according to specifications issued by the MERCOSUR countries (Argentina, Brazil, Uruguay, and Paraguay). Brazil also has specific national standards. In Australia and New Zealand, national standards are compiled by Food Standards Australia/New Zealand. In each country, products not listed must be specifically authorized.

In Asia, Malaysia uses a negative list system, creating a presumption that all foods not listed are permitted. South Korea, by contrast, uses a positive list, so any foods not listed are prohibited.

Culture also influences food regulation. In Pakistan, for example, there are prohibitions against products containing pork and alcohol. As in many countries, the Pakistani food ordinance also prohibits products considered unwholesome, injurious to health, or unfit for human consumption.

Local regulatory approval may be easier if a product previously has been approved in the United States or EU. Both Argentina and Brazil will look to Codex for guidance. In some cases, the failure of a product to obtain GRAS or Codex approval might be seen as probative on local regulatory approval, or as evidence of a violation of general prohibitions against unwholesome or unfit foods. Great care must be taken if a product has a negative history in the United States, EU, or countries such as Japan. Frequently, testing must be conducted to directly rebut the negative perception.

Case Study—GMOs

The use of genetically modified organisms (GMOs) in food illustrates the challenges surrounding international food marketing. The science of inserting specific genes into different organisms, allowing the organism to produce proteins not previously produced and, consequently, new traits, has been around since the 1960s. Genetic modification was seen as a way to improve crop yields; create resistance to insects (thereby reducing the need for chemical pesticides) and disease; and increase tolerance to climatic conditions such as drought or flood. Genetic modifications also were seen as providing potential health benefits (e.g., "golden" rice was genetically altered to combat vitamin A deficiency, which leads to blindness and lowered immune response).

For the most part, the U.S. agricultural complex enthusiastically accepted GMOs. In 1994, the Flavr Savr tomato, produced by California company Calgene LLC, was genetically modified to be resistant to rotting. It was sold commercially in the United States with FDA approval. By 2006, the U.S. Department of Agriculture estimated that 90 percent of the soybeans, 90 percent of the cotton, and 73 percent of the corn grown in the United States were genetically modified. GMO crops are now grown in Argentina, Brazil, Canada, China, India, and South Africa.

Public Outcry. GMOs have detractors as well, and here, as in many areas of food regulatory law, public perception played a role in the creation of local regulatory regimes. For example, in 1999, protestors in the United States dressed in monarch butterfly costumes in order to dramatize what they viewed as negative environmental consequences. GMOs were portrayed as "Frankenstein foods." Organizations such as Greenpeace took a strong stance against GMOs:

> The introduction of genetically modified (GM) food and crops has been a disaster. The science of taking genes from one species and inserting them into another was supposed to be a giant leap forward, but instead they pose a serious threat to biodiversity and our own health. In addition, the real reason for their development has not been to end world hunger but to increase the stranglehold multinational biotech companies already have on food production.
>
> Web site—Greenpeace UK: www.greenpeace.org.uk/gm

Consumer groups also challenged the introduction of what they viewed as science with unknown consequences:

> The current generation of genetically modified (GM) crops unnecessarily risks the health of the population and the environment. Present knowledge is not sufficient to safely and predictably modify the plant genome, and the risks of serious side-effects far outweigh the benefits. We urge you to stop feeding the products of this infant science to our population and ban the release of these crops into the environment where they can never be recalled.
>
> Web site—Organic Consumers Association: www.organicconsumers.org/gelink.cfm

Lists and Labels. Countries around the world began regulating GMOs. Those regulations generally came in one of two forms, although in some cases both types of regulation co-exist. The first form of regulation, used in the United States and the EU, is the designation of approved and unapproved varieties of GMO. Only approved varieties are acceptable for human food.

Labeling is the second key form of regulation. Countries in the EU and Japan, for example, mandate that products containing GMOs be specifically labeled. Many countries' labeling laws, however, contain exceptions. For example, in South Korea, only food ingredients that might contain residual proteins must be labeled. Many countries' regulations also contain exceptions for adventitious, or accidental, contamination, provided that it does not reach certain thresholds, which vary by jurisdiction.

Accordingly, a product might require labeling in one country, but not in another, a real problem if a company has export sales or sells ingredients that are incorporated into consumer products. Proponents of labeling argue that consumers have a right to know and to choose between GMO and non-GMO products. Opponents, however, maintain that there are no known health risks and that labeling increases costs to the industry and, ultimately, to consumers.

*Practical Concerns***.** Critical practical concerns quickly arose. A short visit to Brazil provides insight.

In 1999, the commercial growing of GMOs in Brazil was banned. As a result, by 2001, corn grown in Brazil demanded a $6-7 premium per ton, this record high resulting from the country's strict non-GMO policy. Between 2002 and 2005, and notwithstanding the government's ongoing prohibition, genetically modified corn and soy were repeatedly found in southern Brazil. Speculation resulted as to its origin. Was it the result of black market seeds or of smuggling from neighboring countries, many of which allowed the planting of GMO crops? Between 2003 and 2005, the government began relaxing its restrictions on soy, and by 2007, GMO corn was allowed.

Even in other countries, practical issues exist. The food industry infrastructure in many countries generally does not support separation of GMO and non-GMO varieties. Crops are frequently commingled after harvest—in transport or in grain elevators. A 2007 American Corn Growers Foundation survey found that only 26 percent of U.S. grain elevators were segregating GMO and non-GMO corn, making it difficult to source non-GMO varieties with any degree of certainty. Even if a crop is delivered direct from farm to factory, the food company relies on certifications provided by the farmer. While it may be possible to obtain written certifications from large corporate growers, when small family farms or individuals are involved, as in many foreign countries, certifications are difficult to obtain and even harder to enforce. Further, cross-pollination makes it hard to guarantee GMO status based on the boundaries of a particular farmer's land.

*Flaws in the System***.** Although opinions as to the desirability of GMOs may differ, it is clear that the food regulatory regime in the United States has not always functioned in an ideal manner. In 2002, the StarLink variety of genetically modified corn, which was not approved for use in human food, was found in taco shells for sale in retail establishments. That same year, Zambia refused U.S. corn aid during a famine due to concerns about genetically modified varieties, and later was joined by Angola, Malawi, Mozambique, and Zimbabwe. In 2005, it was discovered that an unapproved Bt 10 corn variety had been sold for several years under the mistaken belief that it was the approved variety Bt 11. These problems heightened the public concern, leading to calls for greater regulation, more testing (even though scientific testing was itself evolving), and product labeling (or, in extreme cases, a desire to remove from store shelves all products that were not certified non-GMO).

Science and Regulation. The science surrounding GMO crops continues to evolve—although not as quickly as the public opinion surrounding it. New GMO crops or new strains might arise at any time, and companies must stay up-to-date on the current status of their raw materials.

Similarly, companies struggled with the ability of scientific testing to keep pace with the law. A type of testing known as PCR (polymerase chain reaction) testing looks for novel DNA introduced into raw materials, such as corn. Unfortunately, with highly refined products, various manufacturing processes can either degrade the DNA or physically remove it. Without DNA, the test cannot determine whether the original raw material was genetically modified.

Further, testing cannot distinguish between "stacked" strains, where more than one GMO might be present (e.g., is a feed pellet produced from corn variety AB, or from a mixture of corn variety A and corn variety B).

Identity Presentation. One way in which companies try to mitigate against these risks, and comply with the myriad of labeling laws, is by establishing identity preservation programs. These programs demonstrate diligence in the procurement and manufacturing of product from non-GMO raw materials. They involve a variety of good manufacturing practices and controls, as well as testing of both raw materials and finished product.

The identity preservation approach, as with other food regulatory issues, requires companies to balance risks and rewards. First, the company must determine to what standards it seeks to be held—those of its home country, its major export markets, the EU, or the markets of its customers. It must then determine how far it can go to demonstrate compliance with those standards. For example, many customers are not willing to pay increased ingredient prices that would result from PCR testing of every ingredient batch produced. This is especially true in today's economy, with rising commodity and food prices of global concern.

A Successful Global Launch

The global GMO regulatory patchwork—with elements of science, public opinion, and practical considerations—illustrates the challenges faced by first timers in the international food regulatory arena. How can a company get its new food product to market without spending all of its anticipated potential profits on outside legal counsel or consultants? To some degree, the challenges faced depend on the nature of the product. Thus, an internal review of the existing science and public opinion, if any, is essential. This review should be ongoing through the product launch, so that the company is prepared for any regulatory hurdles that might arise. A well-developed marketing plan, with input from in-country professionals and a prioritization of markets, also is key. The regulatory budget should be linked to this plan. This allows for the prioritization of regulatory approval processes. When costs are incurred, they support planned product launches in markets and countries viewed as desirable from a business perspective (an approach that also can be taken with regard to trademark registrations and patents).

It also helps to have local personnel, even if not experts in the regulatory arena, do initial fieldwork on governmental requirements and timing by reviewing Web sites, speaking with relevant agencies, and reviewing written resources made available by the local regulatory body. Local personnel can monitor any public sentiment relating to the proposed product. Marketing or scientific testing can be designed to address any concerns. When this is not possible, or if dealing with a particularly unique product or one regarding which regulatory hurdles are anticipated, it might make sense to partner with a local agent who can assist with the regulatory process (ensuring that proper due diligence is conducted so as to shield your company from risks inherent in such a relationship, including those under the Foreign Corrupt Practices Act).

Through strategic planning and careful prioritization, it is possible for a successful regulatory trip around the world.

Food Regulatory Bodies Around the World

Codex Alimentarius Commission
www.codexalimentarius.net

Joint FAO/WHO Committee on Food Additives
www.who.int/ipcs/food/jecfa/en/index.html

European Food Safety Authority
www.efsa.europa.eu

Food and Agriculture Organization of the United Nations
www.fao.org

Argentina—Instituto Nacional de Alimentos, a part of the Administración Nacional de Medicamentos, Alimentos y Tecnología Médica (Web site in Spanish)
www.anmat.gov.ar

Australia/New Zealand—Food Standards Australia/New Zealand
www.foodstandards.gov.au

Brazil—Agência Nacional de Vigilância Sanit#225;ria (Web site in Portuguese, Spanish, and English)
www.anvisa.gov.br

Canada—Health Canada
www.hc-sc.gc.ca/index-eng.php

China—Ministry of Health
www.moh.gov.cnenglish.gov.cn/2005-10/09/content_75326.htm (English)

India—Ministry of Food Processing Industries (English)

mofpi.nic.in/food&health/

Japan—Japan External Trade Organization (English)
www.jetro.go.jp/en/reports/regulations/

Mexico—Comisión Federal para la Protección contra Riesgos Sanitarios (English language version)
www.cofepris.gob.mx/wb/cfp/ingles

South Korea—Korea Food & Drug Administration (Web site in Korean; limited items such as Food Additives Code available in English)
kfda.go.kr/index3.html

Thailand—Food & Drug Administration (English language version)
www.fda.moph.go.th/eng/index.stm

Resources on GMOs

American Medical Association
www.ama-assn.org/ama/pub/category/13595.html

Canada: Biotechnology: Agricultural Biotechnology Report 2006
www.fas.usda.gov/gainfiles/200609/146208866.doc

Pew Initiative on Food and Biotechnology (reports, fact sheets, etc.)
www.pewtrusts.org

U.S. Department of Agriculture (Agriculture, Research and Science, Agricultural Biotechnology)
www.usda.gov

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The Sparkling Wine War

Pitting Trademark Rights Against Geographic Indications

By Carol Robertson

"Masquerading as Champagne might be legal, but it isn't fair," reads a recent ad sponsored by the Office of Champagne, USA, a trade group dedicated to the promotion of the interests of French champagne producers. What is their complaint?—that certain U.S. winemakers are legally entitled to produce sparkling wine in this country and label it "champagne."

The Historic Mystique of Champagne

Champagne (in French "le champagne") is a beverage produced in La Champagne. This region of Northeastern France is known for its chalky soil, which contributes to the unique flavor of a sparkling wine that has long been a favorite celebration beverage—at marriages, births, and, of course, the New Year. Since the early nineteenth century, American vintners have attempted to produce a sparkling wine that would rival champagne. In 1842, Louis Longworth of Cincinnati (known as the father of the American wine industry) produced a bubbly wine from the native Catawba grape that was compared favorably to the French product. In 1876, a *New York Times* correspondent encountered a sparkling wine called "Eclipse" at Buena Vista Winery in California. By the end of the nineteenth century, a number of U.S. producers were making sparkling wine and were not hesitant to call their products "champagne." Among these were the Korbel brothers, who began producing a sparkling wine called "champagne" in California in 1882.

The misuse of place names to sell wine is as old as the American wine industry. Borrowing the name of a well-regarded wine was a shorthand way for new winemakers to impart some of the cachet of a better-known beverage to a new American product. Ironically, Prohibition facilitated the willingness of the American consumer to substitute an inferior locally produced sparkling wine for the higher-quality French product that only remained accessible to the wealthy. The weekly "Talk of the Town" feature in the *New Yorker* from the late 1920s had numerous items about these connoisseurs. For example, bon voyage gifts of legal champagne were presented to

travelers heading abroad once the ships were safely out of the United States' territorial waters. The less well-off contented themselves with less than authentic "champagne" more likely produced in a nearby warehouse from cheap grapes or with so-called medicinal champagne that could still legally be sold under the Volstead Act. And when Repeal enabled Americans to once again legally toast their special events, their inexperienced palates could not appreciate the difference between French champagne and an American sparkling wine bearing the same name.

To them, the word "champagne" had become synonymous with any sparkling wine. This was the situation during much of the twentieth century. Sparkling wine was inexpensive to make, particularly if the producer selected a method of production that was less costly and time intensive than the *m&éthode champenoise* used in Champagne, such as by injecting finished wines with carbon dioxide or inducing secondary fermentation in large tanks of still white wine made from inexpensive grapes. If anything, the word "champagne" usually connoted a higher-quality wine and thus was a desirable addition to a sparkling wine label. For example, when Jack and Jamie Davies acquired the old Schramsberg winery in 1965, they produced a well-regarded sparkling wine using the *méthode champenoise* that was first served at state dinners at the White House during the Nixon administration. They called it "Schramsberg Sparkling Champagne." (The word "champagne" has since been dropped from the Schramsberg label.)

Place Name Versus Trademark

There is a conflict between European wine producers and American wine producers over whether greater importance should be placed on the name of a place where a wine is produced or the brand under which it is sold. In America, historically, the trademark has been the most important feature, not the provenance of the wine. But European producers have long recognized the importance of "terroir"—that wine made from grapes grown in a particular location will have a unique taste. The word "terroir" has no English translation. It means place, certainly, but also it implies soil characteristics, climate, and altitude, for example. It represents also the learnings about wine production passed on from an earlier generation of winemakers to their followers, that is, the craft of the winemaker. France's first laws designed to protect geographic areas were enacted in the nineteenth century, as a means to deter fraudulent indication of origin. In 1919, the French created the Appellation D'Origine Contrôl&ée (AOC), which required that the true geographic origin of a wine be accurately represented and which remains in effect to this day. Starting in 1989, the European Union (EU) passed a number of regulations governing wine products with a goal of preventing descriptions that were incorrect or were likely to cause confusion or to mislead consumers. These regulations were intended to apply not only to wines produced in Europe but also to wines originating in other countries. They specifically prohibit the use of the name of a given region in the EU to describe an imported wine.

American View: Primacy of Trademark

As noted, American law has given primacy to protection of trademarks over geographic location; it is a brand-driven economy. Since the early days of wine production in the United States, wineries have gone to great lengths to protect their trademarks. As early as 1910, Italian Swiss Colony sued another wine producer in an attempt to protect its trademark for its Chianti-style wine. As the wine economy has become more global over the past 20 years, producers have grown more and more conscious of the importance of their brands and have gone to greater and greater lengths to protect them. The goodwill associated with a well-known wine label can translate into a premium price and substantial profits.

Europe's Stance: Geography Controls

For comparable reasons, Europeans wish to protect their place names. The French have long railed against the common practice of U.S. winemakers to indiscriminately borrow French place names—such as Champagne, Burgundy, or Chablis—to label wines that do not come from these specific regions and that do not even closely resemble them. Lawsuits against this practice in the United States date back to the early days of wine production and establish that these European place names have become, at least in part, generic or semi-generic terms for wine types on American wines. The Europeans want to reclaim these semi-generic names for use only on wines grown and produced in the original appellations. What the Americans perceive as long-established trademarks related to generic names, the French view as deceptive. While American law, accordingly, has established a wine labeling system that seeks to protect these trademarks, countries forming the EU have developed a regulatory framework separate and apart from trademark designations, designed to identify and protect the geographic regions historically recognizable as sources of well-established and well-regarded products—such as champagne (so-called geographic indications).

A Case for Geographic Indications

It is only recently that geographic areas, such as the Napa Valley, evoke any particular qualities in an American's mind. With respect to the identification of geographic origin, the Bureau of Alcohol,

Tobacco, Firearms and Explosives, the federal agency responsible for wine regulation (the ATF), first established a formal appellation program for wine in the United States in 1978. Current regulations separate place names into three different classes: generic, semi-generic, and nongeneric. A geographic indication is deemed generic if the name, while "originally having geographical significance," now merely designates a "class or type of wine." (An example of a generic name is vermouth.) Nongeneric names are those that can only be used "to designate wines of the origin indicated by such name," such as Californian or French, or that become "distinctive designations" when they are "known to the consumer and to the trade as the designation of a specific wine of a particular place or region, distinguishable from all other wines." These include Bordeaux Rouge and Médoc. Semi-generic names are those that currently have "geographical significance" but also designate "a class or type of wine." If a semi-generic name is used for a wine that is from a region other than that indicated by the name—such as a sparkling wine produced in California—the label must designate the wine's true place of origin, and the wine itself must reflect the qualities typically associated with the semi-generic name. Under these regulations, a California wine producer, if using a semi-generic name such as "champagne," would also have to identify California as the place of origin—thus "California Champagne."

Because geographic indications can—much as trademarks—create value, and also because they are a means for European winemakers to continue their historic dominance in an industry that has become increasingly globalized, a conflict has developed between those who seek to protect their established brands, such as Korbel (which has called its California sparkling wine "champagne" since the late 1800s), and those who want to protect the image of traditional place names against interloping products that weaken their prestige. The regulations of the EU would bar from the market a California sparkling wine that bears the word "champagne" in its label on the grounds that this label would mislead the customer. According to this view, "champagne" describes not any sparkling white wine, but only sparkling white wine produced in the traditional manner in the Champagne region of France from grapes grown there.

International Protection of IP

This conflict came to the forefront in negotiations in December 1993 for the International Agreement of Trade-Related Aspects of Intellectual Property Rights (or TRIPS). Recognizing wine appellations as valuable intellectual property rights, article 23 of this agreement provides an enhanced level of protection for geographic indications for wines and spirits. The principal aim of this section is to prevent geographic indications identifying wines from becoming generic terms. Under provisions that took effect in 1996, all signatory countries, which include the United States and member countries of the EU, agreed to protect under their laws geographic indications. The major thrust of TRIPS is to ensure that consumers are not deceived by misdescriptive geographic references on wine labels. Accordingly, TRIPS absolutely prohibits the registration of any trademark containing a false geographic indication as a source of wine. However, article 24 of TRIPS built in certain exceptions, and those exceptions protect the continued use of geographic indications that were in trademarks in actual use before TRIPS became effective—such as Korbel's "California Champagne."

2006 Agreement on Trade in Wine

Because of these exceptions to TRIPS, European producers have not believed that the United States is serious about protecting geographic indications, despite the fact that bilateral discussions between the United States and the EU to establish mutually acceptable guidelines to protect the rights of European wine producers—but also to protect U.S. trademark owners—continued over the decade following the signing of TRIPS. Finally, on March 10, 2006, the United States and the European Union entered into an agreement intended to resolve this "wine war" (Agreement on Trade in Wine). This agreement attempts to settle differences concerning winemaking practices and the labeling of a wine's place of origin. The first substantive portion of the agreement prevents either party from blocking the importation of wine on the basis of the other's winemaking practices. This section is viewed as benefiting American wine producers who may export wine produced by techniques that are banned in Europe, such as adding wood chips to give the product an enhanced oak flavor. In addition, however, the United States pledged to seek a change in legal status for a set of 17 semi-generic terms to restrict their use solely to wines originating in the applicable EU member state and to ensure that these terms are only used on wines produced in the EU. These terms are Burgundy, Claret, Chablis, Champagne, Chianti, Malaga, Marsala, Madeira, Moselle, Port, Retsina, Rhine Wine, Hock, Sauterne, Haut Sauterne, Sherry, and Tokay.Nonconforming wine labels are to be blocked from the market.

However, there are certain exceptions in the agreement, most notably a grandfather clause to protect winemakers who used an otherwise prohibited semi-generic term if the use occurred only on labels for wine bearing the brand name for which the applicable Certificate of Label Approval (COLA) was issued by the secretary of the treasury before the date of signing of the agreement. Congress codified these provisions as part of the Tax Relief and Health Care Act of 2006. In

return, the EU promised reciprocal treatment for "names of viticultural significance" in the United States, such as "Napa," and in May 2007 Napa became the first U.S. wine region to receive geographic indication status within the European Union.

Not surprisingly, European wine producers reacted with outrage to the terms of this agreement. In their view, the EU made a bad deal in accepting American production practices and agreeing to a grandfather clause that sanctions the continued use of semi-generic terms by the larger American wine producers. By some accounts, as much as 50 percent of bottles of sparkling wine sold in the United States carry the word "champagne" on their labels. The legal position taken by American producers is that this term has become generic for a quality sparkling wine and that they have long-established valuable trademark rights to those names that they should be allowed to keep. As the wine economy becomes more global and grows more competitive, however, there is a real risk that the names of popular U.S. wine-producing regions such as Napa will be increasingly used on bottles of wine produced outside of the United States. Therefore, at least a few U.S. winemakers have joined in a call to protect geographic indications.

And the Controversy Continues

While they continue to work out their legal differences in continued trade negotiations, French champagne producers are escalating their public relations campaign—called "Unmask the Truth." Besides placing high-profile advertising in national publications, the Office of Champagne, USA, has issued press releases and has engaged consumers in a high-profile movement, including sponsoring an online petition, to put pressure on U.S. lawmakers in support of a law prohibiting misleading labels. They have learned that pressing their message solely through trade negotiations has not been effective and that other methods, such as developing allies among U.S. winemakers, implementing consumer advocacy, and high-profile media messaging, may be a more effective way to achieve their goal of limiting the use of the term "champagne" to the sparkling wine produced in La Champagne.

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Advertising Food Products

Understanding the Regulatory Mix

By Timothy S. Ernst

Advertising has become an increasingly important tool for food manufacturers to sell their products. No longer is it sufficient for a food product to be wholesome, good tasting, and available on store shelves. With the proliferation of new food products responding to increasingly diverse consumer demands and an expanding diversity in channels of distribution, advertising has become critical to the success of new products and the survival of old favorites. Consumers need to know about the existence of a product, understand how it meets their needs, and know where to obtain it. Launching a new product without a well-designed and executed advertising program may condemn an otherwise excellent product to an early trip to the remainder aisle. Importantly, not only must an advertising program be effective, it must be legally sound in order to avoid a potentially serious detour to the courthouse or regulatory agency.

Advertising is any direct or indirect communication of information by a company about itself or its products. Magazine ads, Web pages, and television commercials are obvious forms of advertising. Less obvious forms of advertising include the sponsorship of a cooking school, paying actors to use certain products in television shows or movies, and press information kits distributed to food editors of local newspapers. Advertising also includes written materials designed for use by distributors, retailers, or brokers (so-called sell sheets); statements made by servers offering samples at the local club store; and, of course, claims made on product labels.

Although advertising is a constitutionally protected form of commercial speech, it is subject to extensive regulation. Food products, in light of health and safety concerns associated with them, are subject to more regulatory oversight than other types of consumer products. Advertising that is false or deceptive is not constitutionally protected and may be illegal. Furthermore, even advertising that is literally truthful may be restricted by the government—and even banned in some contexts—if it is misleading due to its context or if the government has determined that the

public well-being requires that certain types of claims be limited.

This article will provide a brief overview of legal issues related to the advertising of food products. It is intended to give the general practitioner a brief introduction to this area of the law. As with any specialized area, there are a number of detailed regulations, interpretations, and practices that may impact a particular area or inquiry.

Regulation by the FTC and FDA

The Federal Trade Commission Act (the FTC Act) and associated regulations are the federal government's primary weapon against false, deceptive, or unfair advertising. Section 5 of the FTC Act prohibits "unfair or deceptive acts or practices in or affecting commerce." Section 12 of the FTC Act deals specifically with the false advertising of "food, drugs, devices or cosmetics," and prohibits the dissemination of any false advertisement for the purpose of inducing, or which is likely to induce, directly or indirectly, any purchase of such items. "False advertisement" is defined as any advertisement, other than labeling, that is misleading in a material respect. In determining whether an advertisement is misleading, the Federal Trade Commission (FTC) will take into account not only representations made or suggested by statement, word, design, device, sound, or any combination thereof, but also the extent to which the advertisement fails to reveal material facts about the product or its performance.

As noted above, the FTC's authority over advertising does not cover labeling. The Food and Drug Administration (FDA) regulates claims made on labels of food products while the Department of Agriculture regulates claims made on labels of meat and poultry products. Section 201(m) of the Food, Drug, and Cosmetic Act (the FD&C Act) defines labeling as "all labels and other written, printed or graphic matter upon any article or any of its containers or wrappers or accompanying such article." Under this formulation, labeling includes not only actual product labels, but also point-of-sale materials (such as display-ready units, "shelf-talkers," and retail handouts) that accompany food products. And in a controversial reach for expanded jurisdiction, the FDA recently took the position that if a product label refers consumers to a Web site, then FDA's regulatory authority over labeling extends to claims made on that Web site (*see* FDA Warning Letter to Ocean Spray Cranberries, Inc., Jan. 19, 2001).

Under section 403 of the FD&C Act, food labeling that is false or misleading in any particular causes the product to be misbranded in violation of section 301 of the FD&C Act. Note that this is a much more rigorous standard than under the FTC Act, which prohibits only advertising claims that are misleading "in a material respect." While this distinction had some significance in the past (one court said that unlike the standard used by the FTC, FDA's regulatory authority was intended to protect "the ignorant, the unthinking and the credulous"), since December 2002 FDA has followed the FTC's "reasonable consumer standard" in determining whether a claim on a conventional food is misleading.

FDA has issued detailed regulations governing claims on product labeling. *See*, e.g., 21 C.F.R. Part 101. For example, and of particular recent interest, FDA has adopted a comprehensive regulatory framework governing nutrition and health claims made on food products. FDA both restricts the number and type of nutrition and health claims that can be made on product labels and has issued detailed definitions and guidelines that must be met with respect to those claims that are allowed. FDA has adopted a highly technical structure characterizing different types of claims:

- Health Claims—As defined by regulation, a health claim is anyclaim that expressly or by implication characterizes the relationship of any substance to a disease or health-related condition (for example, a claim that links the consumption of soluble fiber to a reduced risk of heart disease is considered by FDA to be a health claim). Heath claims can only be made on food labels if supported by the "totality of publicly available scientific evidence" and there must be "significant scientific agreement" among qualified experts that the claim is supported by such evidence. FDA has authorized only a limited number of health claims. *See* 21 C.F.R. §§ 101.70-101.83.
- Qualified Health Claims—Qualified health claims are claims that describe substance/disease relationships based on "competent and reliable scientific evidence" but that must be accompanied by explicit qualifying language informing consumers that the evidence supporting the claim is not conclusive.
- Structure/Function Claims—Structure/function claims describe the effect of a particular food or nutrient on the structure or function of the body (for example, the claim that a particular food or nutrient helps maintain joint health and flexibility).
- Dietary Guidance Statements—A dietary guidance statement addresses the role that general categories of food play in the diet. For example, "Diets rich in fruits and vegetables may reduce the risk of some types of cancer and other chronic diseases."

The requirements associated with each of the above types of claims are beyond the scope of this paper, but practitioners should understand that any type of health claim made on a food product should receive a high degree of scrutiny and should be reviewed by a lawyer who is an expert in the field. This is particularly important where label claims are involved since once a label is printed and attached to a product, it becomes extremely difficult and expensive to modify or remove the claim.

Self-regulation

Self-regulatory bodies play an increasingly active role in the regulation of food-related advertising. Most important of these self-regulatory bodies is the National Advertising Division of the Better Business Bureau (NAD) and its sister organization, the Children's Advertising Review Unit (CARU). With respect to food-related advertising, the NAD has stated that it will harmonize its self-regulatory efforts with the regulatory schemes of the FDA and FTC. However, the NAD rarely will refuse to adjudicate a matter based solely on the argument that the subject area is preempted by FDA.

Despite the voluntary nature of participation in NAD proceedings, the NAD has become the de facto regulatory authority over advertising that either is national in scope or is distributed within several regions of the country. Refusal to participate in the NAD process may result in a referral to a governmental agency (and personnel at such governmental agencies have indicated that referrals from NAD land at the top of the enforcement list). Although challenges from competitors constitute the principal source of NAD cases, the NAD and CARU also monitor television, radio, and print advertising and respond to complaints from individual consumers, consumer groups, and local Better Business Bureaus. CARU monitors advertising directed to children (generally persons under the age of 12) and has published comprehensive Guidelines for Children's Advertising.

If the NAD or CARU determines that an advertisement is false or misleading or that a claim is not adequately substantiated, it will ask the advertiser to discontinue or modify the advertisement. While the NAD/CARU cannot force an advertiser to take certain action, if an advertiser refuses to cooperate with the NAD or CARU, the matter may be referred to the appropriate governmental regulatory agency. NAD, CARU, and NARB (National Advertising Review Board) decisions are available in online reports. Each published report identifies the advertiser and product, includes the positions of the advertiser and challenger, and concludes with the adjudicating body's decision and a statement of the advertiser (in most cases accepting the decision). The reports published by NAD/CARU/NARB are thorough, well-reasoned, and the best available source for the latest legal thinking with respect to advertising claims.

Analyzing the Advertiser's Claim

What Claim Is Being Made? In determining whether an advertisement is truthful, on the one hand, or deceptive (i.e., false or misleading), on the other, the first thing that must be determined is what claims are being made. An advertiser is responsible for both express and implied claims made by its advertisement. The overall impact of the advertisement is determinative—what a reasonable consumer would take away from an advertisement—not the literal meaning of individual words or phrases. Thus, even if an advertisement may be literally or technically correct, if the overall message of the advertisement is deceptive or misleading, the advertisement is subject to challenge. Advertisers must substantiate any implied claim that can reasonably be derived from the literal language of an advertisement.

In reviewing proposed advertising with marketing personnel, this concept of the primacy of the consumer takeaway (rather than the literal claim) can be difficult to communicate. Often marketing personnel are quite pleased with some of the implied messages associated with creative efforts, which may communicate more than the literal facts may allow. This is sometimes referred to as the halo effect of a claim. Marketing personnel are further reluctant to allow a lawyer to dictate what the consumer takeaway from a creative piece may be, and are resistant to the idea that a claim can be misleading even if factually correct. A great teaching tool for this issue, I have found, is an NAD case involving Duncan Hines chocolate chip muffin mix.

In this case, General Mills challenged Aurora Foods' claim that Aurora Foods' Duncan Hines chocolate chip muffin mix contained "50 percent more chocolate chips" than General Mills' comparably sized Betty Crocker muffin mix. General Mills conceded that the Duncan Hines claim was literally true—the Duncan Hines mix really did contain 50 percent more chocolate chips. However, the NAD agreed with General Mills that the consumer takeaway from the claim was that the Duncan Hines mix contained more chocolate than the Betty Crocker mix. In fact, however, because the Betty Crocker mix contained larger chocolate chips, there was actually more chocolate in the Betty Crocker mix, rendering the Aurora Foods' claim misleading in the eyes of the NAD. The NAD recommended that Aurora Foods discontinue the claim, and Aurora Foods agreed to do so. NAD Case Report No. 3623 (Feb. 1, 2000). This case provides an excellent illustration of the

importance of the implied claim and how a claim can be misleading even if literally true.

An implied claim also may be made by the omission of certain information, the inclusion of which is necessary to prevent an affirmative representation from being misleading. Claims therefore must be not only accurate but also complete. Similarly, when the overall impression of an advertisement is misleading, it will not be cured by a tiny footnote placed at the bottom or back of a label. Disclaimers, footnotes, and information boxes are appropriate only to explain language that may be susceptible to more than one meaning or to provide additional information, not to contradict messages that are primarily conveyed by the advertisement.

An Advertiser Is Responsible Only for Claims That Are Material. An advertiser will only be responsible for deceptive claims that are material. A claim is "material" if it is one that is "likely to affect a consumer's choice or use of a product or service." FTC Policy Statement on Deception (1983). Thus, even though a particular claim or statement may be found to be incorrect, if it is immaterial—would not affect a reasonable consumer's purchase decision—the claim itself will not be actionable. Express claims, intentional implied claims, and claims involving health or safety are presumptively considered material.

*Some Claims Do Not Require Substantiation; These Are Called Puffing.*Puffing is a statement of exaggeration or hyperbole that is (1) obviously a statement of subjective opinion; (2) a statement of broad generality, impossible to verify; or (3) so extreme or outrageous that reasonable consumers would not rely upon the statement in making their purchase decision. Puffing claims do not require substantiation.

The line between puffing and a claim that requires substantiation can sometimes be a fine one, and the line is constantly evolving and may be drawn differently by different persons. Although no hard and fast rule can identify precisely where the boundary between puffery and a representation of fact may lie, the following characteristics of a particular advertisement could influence the review of a regulator or judge:

- General claims are more likely to be considered puffing than specific claims.
- The more obvious the exaggeration, the safer the claim will likely be.
- Statements relating to health, safety, or nutrition, no matter how soft or generalized, are generally more vulnerable to challenge as objective claims.
- The content of an advertisement can influence the interpretation of a claim. A humorous setting can soften specific claims, while a serious authoritative figure can make general statements seem more like objective claims.

Visual Depiction of Food

Advertisers of food products wish to present their products in the most appealing light: they want hamburgers to appear fat and juicy, vegetables to appear crisp and green, and soups to appear robust and chunky. So-called food stylists are commonly employed during commercial filming or photo shoots to ensure that food products look their best for the photographers. However, the law requires that photographs, pictures, or models used in an advertisement accurately reflect the product being represented. Colors should not be enhanced, product consistency should not be modified, and quantity or concentration of ingredients should not be adjusted so as to make the product appear more attractive in the advertisement. So, while it is appropriate to use care and effort to ensure that a product presents its best face to cameras, the product should not be manipulated to misrepresent its actual appearance. One major food manufacturer got into trouble by placing clear marbles in the bottom of a bowl of soup used in an advertisement in order to make the soup appear more chunky. In addition to the legal problems this created, the advertiser suffered a lot of bad publicity.

One exception to this general rule is when a product is modified for purposes unrelated to product appearance or performance. For example, mashed potatoes could be substituted for ice cream in a television advertisement showing the joys of eating ice cream (real ice cream would melt under the hot camera lights). On the other hand, mashed potatoes could not be used in an advertisement emphasizing the creamy texture of a particular brand of ice cream.

Just How Fresh Is "Fresh"?

"Fresh" is a word that food marketers love to use. In fact, "fresh" may be the favorite of all words available to the food brand manager. As a result of the abuse of the term, FDA has established rules relating to use of the word "fresh" and the NAD frequently issues decisions involving improper use of the word. In its "fresh" regulations (found at 21 C.F.R. § 101.95), FDA states that the word "fresh" cannot be used on food product labels in a manner that suggests or implies that

the food referred to is unprocessed or unpreserved unless the food referred to is in its raw state and has not been frozen or subjected to any form of thermal processing or any other form of preservation. An advertiser generally cannot use the word "fresh" to describe a food that has been thermally processed or subject to preservation (unless such usage does not suggest or imply that the food is unprocessed (e.g., "fresh bread")). It is acceptable to claim that a thermally processed product is "made from" fresh ingredients if factually correct. Marketers will sometimes rely on statements such as "fresh idea" and "fresh taste" to convey the concept of "freshness" with respect to a processed product, but the permissibility of such efforts will depend on the context.

Conclusion

As noted above, the regulation of food advertising is a complex area with multiple pitfalls. Unlike other forms of advertising, where an unsubstantiated claim may mean a withdrawn advertisement, guessing wrong on a claim that appears on a product label can be a very costly mistake. Therefore, it is important that all claims be carefully evaluated for both the express and implied claim being communicated and that applicable regulations be consulted to ensure that claims that may in other contexts be permissible are not restricted under FDA's unique regulatory authority.

For More Information:

The FDA obtains its regulatory authority over false labeling by virtue of section 301 of the Food, Drug, and Cosmetic Act (21 U.S.C. § 331), which prohibits the misbranding of any food in interstate commerce. Section 403 of the FD&C Act (21 U.S.C. § 343) defines "misbranding" as labeling that is "false or misleading in any particular." Regulations issued under the Nutrition Labeling and Education Act contain FDA's rules on nutrition and health claims, and can be found at 21 C.F.R. Part 101.

Section 5 of the FTC Act (15 U.S.C. § 45) proscribes "unfair or deceptive acts or practices in or affecting commerce." Section 12 of the Act (15 U.S.C. § 52) addresses the marketing of food products, and declares that the dissemination of any false advertisement in or affecting commerce that is likely to induce the purchase of food constitutes a prohibited unfair or deceptive act or practice.

The FTC has published a number of guides and policy statements that are very useful. See, particularly, the FTC's *Policy Statement on Comparative Advertising, Policy Statement on Deception, Advertising Substantiation Policy, and Guides Concerning Use of Endorsements and Testimonials in Advertising* (which are currently in the process of being revised). All are available on the FTC's Web site at www.ftc.gov.

The best resource for advertising law issues are the *Case Reports* published by the NAD and CARU. These thoughtful and reasoned decisions are available online (with membership) at nadreview.org.

The Washington, D.C., law firm of Keller & Heckman presents annually an excellent seminar on Food Labeling, Advertising, and Promotion. *See* www.khlaw.com.

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Seeing Red over "Green"

The Fight over "Organic," "Natural," and "Sustainable"

By Ricardo Carvajal and Riëtte van Laack

Spurred on by rewards in the form of higher prices and increased market share, more and more food companies have begun using "green" labeling claims. Some companies seek to capitalize on consumer demand for products perceived as being healthier and better for the environment by shifting to the use of organic ingredients and marketing their products as "organic." Other companies seek to achieve the same ends through the use of more nebulous claims, such as "natural," and other claims that suggest that the food was produced with the use of ingredients and processes that would be familiar to a home cook or in a manner that has low environmental impact. Differences of opinion as to whether particular foods should be permitted to bear these claims, as well as apparent abuses on the part of some companies, have led to the filing of trade complaints by competitors, lawsuits by public interest groups and consumers, and regulatory action by federal agencies. This is a primer on the current status of voluntary "green" labeling claims in foods, including an update on recent legal and regulatory actions and what they portend for the future.

Don't Panic—It's Organic

Perhaps the most tightly regulated of all "green" marketing claims is "organic." Any food labeled and marketed as "organic" must meet standards set by the U.S. Department of Agriculture (USDA) through the National Organic Program (NOP). The NOP was established by the Organic Foods Production Act of 1990 (OFPA). The OFPA came about largely as the result of pressure from industry and consumer groups, who grew disenchanted with the increasingly unmanageable patchwork of state standards that had sprung up in the absence of a federal standard. Thus, the OFPA was intended by Congress to create national organic marketing standards, assure consumers that organic foods meet a consistent standard, and facilitate interstate commerce in organic foods.

The OFPA applies to agricultural products only, and focuses on the production of raw materials,

although it also addresses finished food products. The NOP standards specify the methods, practices, and substances that can be used in production and handling of organic foods, and requires certification of both producers and handlers. A "producer" is any person engaged in the business of growing or producing food or feed. A "handler" is any person engaged in the business of selling, processing, or packaging agricultural products, not including final retailers. The NOP standards require that organic production and handling operations be certified to be in compliance by a USDA-accredited inspector. The NOP has established accreditation standards for inspectors.

Under the OFPA and the NOP regulations, the use of a "nonagricultural substance" or a "synthetic" substance in a food product labeled as organic is prohibited, unless that substance is on the National List of Allowed and Prohibited Substances. Although the terms "nonagricultural substance" and "synthetic" are defined by regulation, the definitions themselves have proven difficult to interpret and apply. To complicate matters further, the NOP has recently classified numerous seemingly nonagricultural substances, such as color extracts, as agricultural. The NOP took this action because nonagricultural substances cannot qualify as organic, and producers of nonagricultural substances thus have no incentive to use organically produced raw materials as sources for those substances. Once a substance is classified as an agricultural substance, then the nonorganic version of that agricultural substance can be used only if an organic version of the substance is not available. Because of this restriction, the NOP's action creates an incentive for the use of organic raw materials in the manufacture of color extracts, and can be expected to provide manufacturers who use organic raw materials with a competitive advantage.

In addition to prohibiting the use of certain substances, the NOP prohibits certain practices and requires others. For example, operations certified as organic cannot use ionizing radiation or other excluded methods, such as genetic engineering. As for the production and handling requirements that might apply to a given operation, these include land requirements for crop production, practices to maintain soil fertility, health care practices and living conditions for livestock, and those that address prevention of commingling.

As a grocery shopper, you may have noticed that the claim "organic" is used in different ways on different products. This is because the composition of a given product will determine how the claim "organic" can be used. Under the OFPA, a product that is comprised of 100 percent organic ingredients can display the claim "100 percent organic," can use the term "organic" to modify the product's name on its label, and can display the USDA organic seal. A product that is comprised of 95 to 100 percent organic ingredients can use the term "organic" to modify the product's name and can display the USDA organic seal. A product comprised of greater than 70 percent organic ingredients can display the claim "made with organic X, Y, and Z" (where the letters correspond to the names of the ingredients) but cannot display the USDA organic seal. Finally, a product comprised of less than 70 percent organic ingredients can display the claim "X percent organic ingredients" if it also identifies those ingredients, but it cannot display the USDA organic seal.

Given the premium paid by consumers and the emotional commitment that many consumers make to the organic sector, it is not surprising that producers that are alleged to misuse the organic label can incur significant liability. As an example, last year the USDA threatened a large dairy producer with revocation of its certification due to alleged noncompliance with NOP standards. Although the dairy worked out a settlement with USDA and denied any wrongdoing, it was promptly sued by a consumer group. The lawsuit charged the dairy with defrauding consumers, and demanded as partial relief the repayment to consumers of the difference in price between organic milk and conventional milk for all milk sold during the period in question. Shortly thereafter, the litigation expanded to include other deep-pocketed defendants in the chain of distribution. It is thus critically important for producers and handlers to have a good understanding of what requirements apply to their products, to implement robust compliance programs, and to assiduously maintain required records.

Let's Be Natural

Unlike the term "organic," use of the term "natural" is not governed by a comprehensive set of requirements. Nonetheless, surveys suggest that consumers express a preference for products labeled as "natural" over those labeled as "organic." The ambiguity of the "natural" claim, coupled with its value to consumers, has resulted in great controversy over its use.

The Food and Drug Administration (FDA) and USDA, the two agencies with primary jurisdiction over food, have different policies on the use of "natural." Under FDA's policy, a claim of "natural" is permitted if the food does not contain an added color, synthetic substance, or flavor, or anything artificial or synthetic that would not normally be expected in the food. Thus, FDA places emphasis on the nature of the substance at issue, and on consumer expectation. Notably, FDA has no preapproval authority over labeling. Thus, if FDA objects to a given use of the term "natural," its only recourse would be to take enforcement action against the offending product to get it off

the market.

Different segments of industry have attempted to convince FDA to engage in rulemaking to define "natural," thus far to no avail. Powerful interests have lined up in opposing camps on particular ingredients. For example, the sugar industry and some consumer groups take the view that high fructose corn syrup is not "natural," whereas corn syrup manufacturers maintain that it is. Use of the term "natural" on products containing high fructose corn syrup has been the subject of litigation, which has prompted manufacturers of beverages such as Capri Sun and 7UP to abandon use of the term in product labeling. Earlier this year, FDA caused a small sensation when it stated in response to a question from a trade publication that FDA does not consider a food that contains high fructose corn syrup to be eligible for use of the term "natural." However, after meeting with industry and learning more about the manufacture of high fructose corn syrup, FDA partially reversed course and advised that products containing high fructose corn syrup may be eligible for use of "natural" depending on how the syrup is made.

The use of "natural" on USDA-regulated products, including meat, poultry, and egg products, has been no less controversial. Under USDA's policy, a claim of "natural" is permitted in labeling if no artificial flavor, color, chemical preservative, or any other artificial or synthetic ingredient is added, and if the product and its ingredients are not more than minimally processed. USDA's policy differs from FDA's in that it emphasizes the degree of processing of the product and its ingredients, and doesn't explicitly concern itself with consumer expectation. Unlike FDA, USDA does have premarket authority over labeling. This has forced USDA to grapple with the ambiguity of the term more directly, and to limit the term's misuse.

As with FDA-regulated industries, USDA-regulated industries have pressured USDA to include or exclude certain substances from products eligible to be marketed as "natural." As an example, in 2005, USDA modified its policy to allow use of sodium lactate in products labeled as "natural." Shortly thereafter, USDA was petitioned to define "natural" by regulation, and to exclude the use of sodium lactate from products labeled as natural. In response, USDA rescinded the policy modification to permit use of sodium lactate in products labeled as "natural," and announced its intention to define "natural" by regulation. Those decisions became the subject of litigation that remains unresolved. As an additional example, USDA has been criticized by some producers, consumer groups, and congressional representatives for allowing poultry injected with certain solutions to be labeled as "natural."

Given the ambiguity of the term "natural" and the absence of clear standards governing its use, companies should make decisions about whether use of the term on a particular product is appropriate on a case-by-case basis. Typically, that decision will require the input of personnel with expertise in the methods and substances used to manufacture the food in question. For USDA-regulated products, the fact that labeling is preapproved by USDA provides some margin of comfort, notwithstanding USDA's occasional reversals. For FDA-regulated products, challenges are more likely to come from competitors and consumer groups than from FDA.

Sustainability: Coming of Age?

The concept of sustainability has special resonance in food production and marketing. After all, if our systems for producing and distributing food cannot be sustained into the future without damaging the resource base on which they depend, then our future looks decidedly bleak. The importance of the concept has been recognized by Congress, which defined "sustainable agriculture" in the 1990 Farm Bill to mean

> an integrated system of plant and animal production practices having a site-specific application that will, over the long term (1) satisfy human food and fiber needs, (2) enhance environmental quality and the natural resource base upon which the agricultural economy depends, (3) make the most efficient use of nonrenewable resources and on-farm resources and integrate, where appropriate, natural biological cycles and controls, (4) sustain the economic viability of farm operations, and (5) enhance the quality of life for farmers and society as a whole.

Neither FDA nor USDA has offered definitions for terms such as "sustainably produced" for use in the marketing of food. There is a nongovernmental standard-setting effort under way under the auspices of the Leonardo Academy, a nonprofit organization that is accredited as an American National Standards Institute (ANSI) standards developer. That effort has resulted in publication of a Draft Sustainable Agriculture Practice Standard (Draft Standard). If finalized, the resulting standard would be a voluntary ANSI standard that could be used by producers to help support claims of sustainability. Even though use of the standard would be voluntary, the effort to develop the standard may prove to be at least as controversial as FDA's and USDA's attempts to elaborate on the use of "natural." Early on, substantive and procedural concerns about the development of the Draft Standard prompted a number of prominent food and agriculture sector companies and

trade associations to write letters expressing their displeasure to the Leonardo Academy and to numerous high-level government officials. The dispute escalated to the point that USDA then asked ANSI to revoke the Leonardo Academy's standing as an ANSI-accredited standards developer, a request ANSI recently denied.

Because the Draft Standard is regarded only as a reference document, the content of the standard is likely to evolve as the process of standard development moves forward. Nonetheless, it is worth pausing to list some of the major elements of the Draft Standard to convey a sense of its ambitious scope. The elements include (1) sustainable crop production, (2) ecosystem management and protection, (3) resource conservation and energy efficiency, (4) integrated waste management, (5) fair labor practices, (6) community benefits, (7) product quality, and (8) product safety and purity. The inclusion of energy efficiency and community benefits as elements is particularly notable, given increasing consumer interest in locally produced foods. The Draft Standard also includes annexes that address specific sectors, such as biofuels and cut flowers.

Pending development of an ANSI standard, general guidance on the use of sustainability claims can be found in the Federal Trade Commission (FTC) Environmental Marketing Guides (also known as the Green Guides). Although these were last revised in 1988, they continue to provide a useful point of reference. As a point of departure, all claims made in advertising must have a reasonable basis, or what FTC refers to as substantiation, in the form of competent and reliable evidence. Beyond that, the Green Guides discuss both general principles and specific categories of claims (e.g., biodegradable, compostable, recyclable).

In keeping with the goal of avoiding deception, all qualifications and disclosures in an advertisement should be clear, prominent, and understandable. Also, it should be clear whether an environmental attribute or benefit claimed in an advertisement refers to the product or to the packaging. Broad claims can be especially problematic, as these tend to overstate environmental attributes or benefits, and often are not supported by a life cycle analysis. Comparative claims can also be problematic if the basis for the comparison is unclear, or if the claimed comparative advantages are not substantiated.

For the moment, it appears unlikely that use of sustainability claims will be the subject of regulatory challenges. They may, however, become the subject of more frequent challenges by competitors and consumers, particularly if the efforts to establish an ANSI Sustainable Agriculture Practice Standard are successful. Thus, businesses with an interest in making sustainability claims would be well advised to participate in the standard-setting efforts that are underway. In addition, as scrutiny of sustainability claims increases, it would be advisable to line up scientific and legal support for any sustainability claims prior to the launch of a marketing campaign based on those claims.

Beyond Marketing

Just as consumer interest in "organic" and "natural" foods has increased dramatically in the past decade, so has consumer awareness of environmental issues more generally. This trend can be expected to continue as the effects of global climate change and other threats to the environment become more apparent. As we finished writing this article, the U.S. Climate Change Science Program issued a draft report concluding that climate change already has begun, and containing a number of disturbing observations about the potential impacts of climate change on agricultural productivity. It remains to be seen whether "green" marketing claims (and the production practices that they ostensibly reflect) will play a significant role in ameliorating environmental degradation, or will serve primarily as a means to differentiate products in a competitive marketplace.

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Proposition 65 and Food

You Have Now Been Warned

By Jennifer Yu Sacro

Perhaps you've seen it posted in a California hotel lobby or gas station during a recent business trip:

> WARNING: This area contains a chemical known to the State of California to cause cancer and birth defects or other reproductive harm.

You think about the message for a couple of seconds and assume that the chemical referenced is secondhand smoke, petroleum, or some other compound that you already expected to be present in that area. Having seen warnings like this more than once, and in a variety of places, you probably also don't give the warning too much thought.

But what if you represent a company that sells products in California and your client receives a letter from a California private attorney general notifying it that its products contain a chemical known to the state to cause cancer or reproductive harm and that, under California's Proposition 65, the company is required to warn California consumers that its products contain such a chemical. Even worse, what if the products your client sold were food items? In the last 10 years, the issue of Proposition 65 warnings with respect to foods has become an increasingly hot topic of debate and litigation. This article provides a brief overview of Proposition 65 and summarizes key Proposition 65 litigation involving food products.

What Is Proposition 65?

More formally known as the Safe Drinking Water and Toxic Enforcement Act of 1986, Proposition 65 is a California ballot initiative approved by voters that requires businesses to notify California consumers about the presence of certain chemicals in their products and prohibits California businesses from knowingly discharging certain chemicals into sources of drinking water.

The chemicals at issue are those "known to the state to cause cancer or reproductive toxicity" and are identified in a list that is updated and republished by the governor on a regular basis. A chemical is listed through one of several ways: (1) one of the state's two committees of scientists and health professionals—i.e., the Carcinogen Identification Committee (CIC) and the Developmental and Reproductive Toxicant Identification Committee (DARTIC)—finds that the chemical clearly has been shown to cause cancer or reproductive harm; (2) an organization deemed authoritative by either CIC or DARTIC finds that the chemical causes cancer or reproductive harm; or (3) a state or federal agency requires that the chemical be labeled as causing cancer or reproductive harm. Substances identified by reference in California Labor Code § 6382(b)(1) and (d) also are required to be included in the Proposition 65 chemical list, though it is unclear whether the requirement applied only to the initial Proposition 65 chemical list or whether it applies on an ongoing basis to every Proposition 65 chemical list that may be published.

Businesses selling products that expose consumers to a listed chemical must provide a "clear and reasonable" warning to California consumers that the products contain a chemical known to the state to cause cancer or reproductive harm or they must be able to demonstrate one of three things: (1) the existence of a federal law that governs warnings applicable to the exposure in a manner that preempts state authority; (2) that the exposure took place less than 12 months after the chemical in question was added to the Proposition 65 chemical list; or (3) that the exposure is "not significant." If a warning is necessary, it may be issued in various forms—e.g., a label on the product, a sign at the workplace, or a notice in a newspaper—subject to specific requirements listed in the regulations. Businesses that do not provide the requisite warning may be subject to a civil lawsuit by the California attorney general or any individual acting in the public interest and face stiff penalties as high as $2,500 per violation. The state agency charged with implementing Proposition 65 is the Office of Environmental Health Hazard Assessment (OEHHA).

Key Cases Involving Food

Improvements in chemical testing and scientific research on cooking have led more and more enforcement groups to set their sights on the food industry. Indeed, some of the Proposition 65 cases in recent years involve foods that are staples of the American diet—meat, potatoes, fish, and dairy products.

One of the first food items to be implicated in a Proposition 65 enforcement action was cheese. In 1997, the Working Group on Carcinogenic and Immune Suppressing Chemicals (Working Group) issued a Proposition 65 60-day notice of violation against cheese manufacturers and retailers including Altadena Dairy, Kraft Foods, and Sargento Cheese Co. The Working Group alleged that these companies failed to warn consumers that their cheese products contained diethylhexyl phthalate (DEHP). DEHP is a plasticizer commonly used in building products, medical devices, and food packaging such as plastic cling wraps, adhesives, food container seals, and inks. The Working Group alleged that DEHP in plastic wrappers on packaging materials leached into the cheeses that the defendant companies sold to Californians. Although no lawsuit or warning resulted from the notice, the resulting media attention raised public concern regarding the presence of Proposition 65 chemicals in foods.

Bottled water also has come under Proposition 65 scrutiny. In 1999, the Environmental Law Foundation sued water bottlers such as Crystal Geyser, McKesson Water Products, and Vittel because their bottled water allegedly contained some Proposition 65 chemicals, including arsenic. One Proposition 65 enforcement group has theorized that such chemicals got into water supplies from industrial pollution. The notice led to litigation, which ultimately was settled in 2000.

Another food item that has become a focus of Proposition 65 litigation is fish. In 2001, the Public Media Center brought a Proposition 65 suit against tuna canning companies like Tri-Union Sea Foods, Bumble Bee Sea Foods, and Del Monte because their products allegedly contained unacceptable levels of methyl mercury. Methyl mercury, which is a chemical found in the ocean, bioaccumulated in tuna over time. Following a bench trial, the court issued a decision comprised of three key rulings in favor of the tuna canning companies. First, the court found that Proposition 65's warning requirement with respect to methyl mercury in canned tuna conflicted with the Food and Drug Administration's (FDA) "carefully considered" policy of advising consumers about both the benefits and risks of eating fish and recommendations concerning the frequency with which tuna products may safely be consumed by women of childbearing age and pregnant women. By contrast, a Proposition 65 warning would communicate only the risks associated with consumption of tuna and, thereby, frustrate the FDA's more balanced approach to this issue. Because of this conflict, the court held that federal policy preempted Proposition 65's warning requirement. Second, the court found that the tuna canning companies sufficiently demonstrated that the exposure of the average woman of childbearing age and/or pregnant woman to methyl mercury in canned tuna was at levels lower than the maximum allowable dose level for methyl mercury under

Proposition 65. Finally, methyl mercury in canned tuna was naturally occurring, i.e., the chemical was not present in the food as a result of human activities and was found in the food at the lowest level currently feasible. For these reasons, the tuna canning companies were not required to warn consumers about methyl mercury in their products and had no liability under Proposition 65. This decision presently is under review by the court of appeal. Meanwhile, another Proposition 65 lawsuit had been filed against large grocery stores and restaurant chains that served tuna, swordfish, mackerel, and other sport fish that contained methyl mercury. This suit, however, has been stayed pending the court of appeal's decision in the tuna canning case.

Then came the candy and vinegar cases. In 2002, the American Environmental Safety Institute (AESI) filed a lawsuit against several chocolate manufacturers including Mars, Hershey's, Nestle, and See's Candies because their chocolate products contained lead. AESI initiated litigation despite a letter from the California attorney general's office in 2001 stating that they have investigated the matter and concluded that no warning under Proposition 65 was required because the lead present in chocolate products was naturally occurring. After over a year of litigation, AESI settled with the chocolate manufacturers.

In 2004, the Environmental Law Foundation, the Center for Environmental Health, and the Environmental Health Coalition filed Proposition 65 lawsuits against manufacturers and distributors of Mexican candies and vinegar. Apparently, various Proposition 65 enforcement groups had commissioned tests that showed that lead also was present in these food items. After a couple years of litigation, those cases settled as well.

Potato products also have become a focus of Proposition 65 litigation. In 2002, Swedish scientists discovered that many foods when cooked formed acrylamide—a chemical compound used in making plastics, grouts, water treatment products, and cosmetics. Acrylamide is found in virtually every item on the breakfast menu—breads, cereals, coffee, fried potatoes, and prune juice—as well as grilled asparagus, cookies, crackers, and canned black olives. A week after the Swedish data were announced, the Council for Education and Research in Toxics (CERT) sent a notice of intent to sue, and eventually sued McDonald's and Burger King for failing to warn consumers that their french fries contained acrylamide. In 2005, the California attorney general filed a separate lawsuit against the two companies as well as additional restaurant chains and potato chip manufacturing companies. CERT and the California attorney general ultimately settled those cases.

More recently, enforcement groups have targeted grilled meats. In 2006, veteran Proposition 65 plaintiff Whitney Leeman and the Physicians Committee for Responsible Medicine filed lawsuits against numerous restaurant chains for failing to warn Californians that their flame-broiled and grilled meat products contained polycyclic aromatic hydrocarbons (PAHs) and PhIP (i.e., 2-Amino-1-Methyl-6-Phenylimidazol[4,5-B]Pyridine). PAHs are chemical compounds formed during the burning of coal, oil, gas, wood, and other organic substances and are used to make dyes, plastics, pesticides, and asphalt. In meats, PAHs are formed when the fat drips onto a hot surface and the resulting smoke, which contains PAH, is deposited back into the food. PhIP, on the other hand, is formed directly in the meat as a result of grilling and broiling. While some of those Proposition 65 cases have settled, other suits remain in active litigation.

Conclusion

The application of Proposition 65 to food items raises concerns for the industry for several obvious reasons. First, no manufacturer, restaurant, or grocer wants to tell its customers that its food products contain ingredients that the state of California believes are cancerous or cause reproductive harm. Second, while most Proposition 65 enforcement actions ultimately settle, resolving such actions—whether through litigation or a settlement—costs both money and time.

Unfortunately, food probably will continue to be a focus of future Proposition 65 litigation. For one thing, the Proposition 65 chemical list is steadily growing. The list, which in 1987 contained approximately 85 chemicals, now has expanded to include roughly 700 compounds. Beginning in 2000, the list has grown at an approximate net rate of eight chemicals per year with approximately 76 chemical compounds being added and only seven chemicals being delisted. Additionally, the technology used to detect different chemical compounds at lower and lower levels has been rapidly improving. Advances in analytical methodologies have made it cheaper, simpler, and faster to analyze a greater variety of chemical compounds in foods at nanogram and picogram levels for larger amounts of samples. Given the increasing number of Proposition 65 chemicals and the technology available to detect compounds at trace levels, there is a good chance that even more Proposition 65 chemicals will be discovered in food items.

What can members of the food industry do to address Proposition 65

concerns?

1. Don't be caught by surprise. Monitor the Proposition 65 list and participate in the regulatory process. Businesses that take a proactive approach to Proposition 65 and take advantage of opportunities to participate in the regulatory process ultimately may be more successful in addressing Proposition 65 issues than businesses that pay little or no attention to Proposition 65 issues until they receive a notice letter from an enforcement group. Proactive businesses, for instance, will be better informed about the current state of food and health science relevant to their products as well as OEHHA's current and anticipated regulatory activities. Greater knowledge in these areas will provide companies with more options in addressing Proposition 65 concerns and a longer time frame within which to consider different business and legal solutions.

With respect to chemicals relevant to their products, companies should consider participating directly or through trade associations in the comment process concerning contemplated listings. Even if CIC or DARTIC ultimately decides to recommend a chemical for listing, it still may be useful for companies to participate in the public hearings in order to develop an administrative record that may later help establish defenses to a Proposition 65 enforcement action.

Companies also should participate in OEHHA's ongoing process of evaluating Proposition 65's continued application to food. In April 2008, OEHHA announced that it was forming a working group comprised of stakeholders to assist it in drafting possible regulatory language to address warnings for exposures to listed chemicals in foods. In December 2008, following conferences with the working group, OEHHA announced that it will begin drafting such regulatory language this year. Companies that have not taken part in the workshops still have an opportunity to participate in the regulatory process by providing input during the notice and comment period.

2. Know the rules. Understand the limitations of Proposition 65, particularly as they apply to food. The warning requirements have some key limitations. For instance, no warning is required for certain chemical exposures caused by "naturally occurring" chemicals in the food. Chemical contaminants that occur naturally are only exempt from the warning requirement if they are found in amounts that are "at the lowest level currently feasible," and much litigation has arisen over the meaning of this phrase. As mentioned above, authorities have applied the "naturally occurring" provision to exempt tuna canning companies and chocolate manufacturers from having to warn consumers of methyl mercury and lead in their products.

Additionally, the regulatory definition of the "no significant risk" level is more flexible in cases where the chemical at issue is produced by cooking necessary to render the food palatable or to avoid microbiological contamination. This alternative standard would apply, for instance, to the carcinogen exposure issues in the grilled meat cases.

Further, a warning is not required when the chemical exists at or below the "no significant risk" level. This level basically is one of two numbers—the "safe harbor" established by the State of California as a default or the level of exposure the company can demonstrate presents no significant risk of cancer or reproductive toxicity. Companies that seek to establish this alternative level, however, must do so using a quantitative risk assessment that meets certain regulatory criteria.

3. Stay ahead of enforcement groups. Know your product. It is prudent for businesses to stay abreast of relevant scientific developments and periodically reevaluate previous conclusions they may have reached regarding their product's contents. Products that contain known Proposition 65 chemicals normally should undergo some type of Proposition 65 compliance assessment.

4. Stay in touch with the FDA. If a company believes that a Proposition 65 warning would be misleading as it relates to a particular food product, it should consider discussing its concerns with the FDA or another federal agency with appropriate expertise. The FDA obviously has expertise over food and health issues that likely will be given some deference by OEHHA and California courts. In connection with the canned tuna case, for instance, the then-FDA Commissioner, Lester Crawford, wrote to the California attorney general to convey the FDA's view that there is no scientific basis for requiring warning labels on tuna products and that the lawsuits could have "adverse public health consequences." The letter ultimately helped secure a trial victory for the tuna canning companies.

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75 Years After Prohibition

The Regulatory Hangover Remains

By Susan Cagann and Rick Van Duzer

It's a typical day. A venture capitalist wants to buy a farm, grow some grapes, and maybe sell some wine. A local chef wants to increase profits by buying and selling private label wines. A winery is fighting with one of its distributors and wants to dump them. A private equity firm is investing in a company that owns hotels, restaurants, and grocery chains. The manager of a sports arena has just received a lucrative sponsorship offer from a beer company, but regulators are threatening enforcement proceedings. A spirits brand owner is launching a national marketing program including sweepstakes and sales incentive programs. A café owner decides she can improve her bottom line by serving homemade lemoncello to her afternoon customers.

Easy enough. You rely on your years of business judgment and legal expertise to help craft a plan to accomplish your clients' objectives, right? Not so fast. The state and federal regulators are not cooperating either with you or with each other, an archaic web of "tied house" laws complicate what should be relatively straightforward solutions, trade practice regulations handcuff your creativity, and the franchise laws of five different states need to be researched, considered, and satisfied before you can do anything. Welcome to the world of wine, beer, and spirits law.

The regulatory and legal maze impacting the manufacture, distribution, and sale of alcohol products had its genesis in pre-Prohibition America. In the days when Carrie Nation took an axe to barrels in Kansas saloons, alcohol was blamed by the burgeoning temperance movement as the source of virtually all societal ills, particularly the destruction of the family. The tied house was the villain of the temperance movement. Tied houses were bars or public houses that served the products of a single manufacturer. The manufacturer typically owned the house and controlled all aspects of its operation. Some public houses, legend has it, went as far as to serve heavily salted sandwiches to encourage their patrons to drink----go figure. The only way to stop this debauchery, according to the temperance movement, was to prohibit the sale and consumption of

alcohol altogether.

But Prohibition proved not to be the answer. When it was repealed in 1933, extraordinary power to regulate commerce in alcohol was conveyed to the states. States chose widely divergent paths in wielding their newfound power. The resulting system was designed to address the evils of demon rum and its destructive powers. All evil influence was presumed to flow down from powerful manufacturers to wholesalers and from wholesalers to local retailers. Lawmakers created new rules to govern the entire system of production, marketing, sales, and distribution. The policy goals behind the new rules were orderly market conditions, limits or prohibitions on vertical integration, avoiding dominance by suppliers over retailers through bribery or predatory marketing practices, product integrity, temperance, and taxation. In the wake of Repeal, federal and state legislatures also promulgated laws designed to avoid the evils of Prohibition where alcohol trafficking fell under control of bootleggers and organized crime. While market forces have changed dramatically since 1933, the maze of state regulations has not kept pace. The result is a legal minefield.

Permitting and Licensing Systems

Federal, state, and local governments have developed programs to keep tabs on persons trafficking in alcoholic beverages. These programs—while simple at first blush—can throw wrenches into mergers, stall acquisitions, dampen profit projections, and hinder operating efficiencies. Thorough assessments of the regulatory impact on business transactions enable clients to work around or through these regulatory roadblocks.

The federal permit system applies to manufacturers of wine and spirits, importers, and wholesalers of distilled spirits, wine, or malt beverages. The permitting process is designed to keep permits out of the hands of persons with criminal convictions or with financially unstable businesses. Permits are obtained from the Department of Treasury Alcohol and Tobacco Tax and Trade Bureau (TTB). The applicant must disclose direct and indirect owners and establish that it has sufficient financial resources to conduct its business. Applicants are investigated thoroughly. These same rules are invoked in mergers and acquisitions of beverage alcohol companies. Within 30 days of any direct or indirect change in control or ownership, the change must be reported to the TTB. The new owners, officers, and directors must be vetted and approved by TTB. Any owner of greater than 10 percent indirect interest in a business must be disclosed even if the interest is held in a remote parent entity. Some exceptions are made for government pension funds and publicly traded companies.

State permission also is required. At the state level, owners, officers, and directors must be fingerprinted for each state in which a state license is required. There is no federal clearinghouse for determining eligibility to participate in these businesses. If your client acquires a retail chain operating 1,800 stores in 28 states, its shareholders, officers, and directors must follow unique qualification processes in each jurisdiction.

State systems will vary. States grappled with the issue of whether to adopt private licensing systems or state-controlled systems, where sale and distribution would be performed by the state. Eighteen states opted to control the sale of distilled spirits at the wholesale level. Twelve states control retail off-premise sale through government-operated package stores or designated outlets. "Control states" include Alabama, Idaho, Iowa, Maine, Michigan, Mississippi, Montana, New Hampshire, North Carolina, Ohio, Oregon, Pennsylvania, Utah, Vermont, Virginia, Washington, West Virginia, and Wyoming.

Other states permit private industry to manufacture, import, wholesale, and retail alcoholic beverages. Many, however, prohibit or constrict vertical integration in the industry. "License states," as they have come to be known, issue licenses and sharply defined privileges to each tier of the distribution system—supply, wholesale, and retail. Most of these states prohibit a supplier from owning an interest in a retailer or a wholesaler.

The licensing structure permits states to empower their agencies to evaluate the character, fitness, and financial responsibility of each license applicant. States also enacted laws to prohibit a person convicted of a felony or crime involving liquor laws, gambling, prostitution, or other crimes against morality from holding direct or indirect interests in a license. Several states prohibit a retailer from employing anyone with a felony conviction. State licensing authorities may take into account proposed locations of premises and may limit the concentration of licenses. Some states limit the number of licenses that can be held by any particular company and create barriers to chain retailers holding more than one license. A handful of states have concurrent licensing processes with local governments where both the local government and the state government issue licenses.

In the context of mergers and acquisitions, state licensing can create deal quagmires. A fund or private equity company may be prohibited from holding significant interests in a winery and in a hotel or retail chain. Some states prohibit members of boards of directors of an entity with operations in one tier from owning interests in another tier. During acquisitions, officers, directors, and any other person with greater than a 10 percent ownership interest in the acquiring company should be vetted to ensure they do not hold any personal investments or other interests that could disqualify the person from holding an interest in the assets that are purchased. Spouses of significant shareholders also must be eligible. In California, for example, a spouse cannot be a peace officer or district attorney or hold management responsibilities in another tier.

While prohibitions on vertical integration are the rule, exceptions do exist. Some states with powerful constituents in a particular sector have passed laws with expansive privileges. In the winery context, California, Colorado, New York, Pennsylvania, Oregon, Virginia, and Washington have granted wineries great flexibility in their ability to market and sell wine. The expanded privileges can include the right to serve as their own distributors, sell direct to consumers at retail on-site and through the Internet, and the right to own off- and on-premise businesses.

Formula and Label Approvals

In addition to licensing requirements, distilled spirits, beer, and wine must be bottled, packaged, and labeled in strict conformity with federal labeling regulations. A supplier must obtain prior approval of labels. Advertising must meet regulatory standards for labeling and may not contain any statement inconsistent with the product labels. The responsible advertiser must be identified. A supplier cannot stop though at federal compliance. Thirty states require a supplier to register its labels.

Federal and state laws have many content restrictions on labeling and advertising products. For example, Santa Claus and God may not be used on a wine or distilled spirits label in a particular jurisdiction. Words such as "powerful" or "strong" may not be used to describe the product itself. Interpretations wax and wane based upon agency policy. Wine labels depicting artful reclining nudes were approved by the federal government for several years only to be rejected by a new administration. Cooperative advertising bearing the brand name of a product and a retailer is prohibited in most jurisdictions. Many states do not allow advertising the proof of an alcoholic beverage while others require it.

Trade Practice

In addition to literally prohibiting vertical integration, many rules were promulgated to prohibit cross-tier influence. Federal law provides the platform from which state trade practice laws follow. The laws constrain relations between the three tiers—suppliers, wholesalers, and retailers. Federal law identifies acts by supply-tier members that are means to induce retail-tier members to buy alcohol products and mandates that they are unlawful if they have an exclusionary effect on trade. The prohibited acts include exclusive outlets, tied houses, commercial bribery, and consignment sales.

Unlawful inducements under the federal tied house prohibitions include holding a direct interest in a retail licensee or the property of a licensee, furnishing things of value to a licensee, paying a retailer for display space or advertising, guaranteeing loans, extending credit, or requiring quota sales. Federal regulations then enumerate exceptions to the unlawful means to induce. Suppliers, for example, may offer product displays of less than $300 per brand; point-of-sale advertising materials; equipment if sold at cost; a specified number of samples; combination packaging; educational seminars; consumer tastings; consumer promotions such as coupons, prizes, and refunds; stocking and rotation services; and outside signs not exceeding $400 in cost. In order to establish a tied house violation at the federal level, the government must establish that there has been an unlawful inducement and the inducement resulted in the exclusion of a competitor's product.

Each state has adopted its own trade practice rules. Unlike the federal prohibitions, which require an exclusionary impact, state laws tend to establish prohibited practices as a strict liability crime. Each state prohibits a manufacturer or wholesaler from providing an item of value to a retailer. Suppliers are prohibited from paying retailers for advertising or display space. The regulations then are followed by numerous exceptions to these general prohibitions. For example, California's Alcoholic Beverage Control Act defines its tied house restrictions as prohibiting a discrete ownership interest in on- and off-sale licensees and providing items of value directly or indirectly to such licensees. These prohibitions are followed by 40 statutory exemptions to the rule.

In practical terms, a supplier cannot run a national marketing campaign without customizing certain elements to address vagaries in state law. Sweepstakes offer a good example. Sweepstakes are a popular promotional vehicle. Most states permit sweepstakes in beverage

alcohol marketing campaigns. Some states require prior approval with significant lead time. Others prohibit alcoholic beverages as prizes and all require the winner to be of legal drinking age. Yet the prize in a California sweepstakes sponsored by a wine supplier cannot exceed one dollar in value. Couponing presents another challenge. Rules differ state by state as to whether mail-in coupons, instant redeemable coupons, or coupons with purchase of alcohol are allowed. California permits all three forms with no dollar value limit. Texas prohibits all three forms of coupons.

Distribution

What could possibly be next for these consumer products? Once you have a federal permit, a state license, approved labels, and compliant advertising programs, you need a distribution network. This means working with distributors as most states will not allow a winery, brewer, or distiller to sell its products direct to retailers.

Practices that would be considered anticompetitive restraints on commerce for any other consumer product pervade beverage alcohol regulation. Many states require retailers to purchase all beverage alcohol products from the state itself (control states), or from licensed wholesalers. Many states create protection for the wholesaler tier. These include exclusivity mandates, minimum price margins, constraints on termination rights, and privilege exclusivity. Many states prohibit discrimination by a trade member toward members in another tier even with legitimate business justification. Others compel transparency with respect to the distribution relationship by compelling disclosure and posting of pricing and discounts, and appointment of wholesalers and filing of private contracts between suppliers and their wholesalers.

The stakeholders in the three-tier systems have changed in form and power since Repeal of Prohibition. Initially, wholesalers were local businesses highly effective at influencing the passage of legislation to protect their investment in contributing to the success of a brand. Many states have passed some form of legislation known as "franchise regulation" governing formation and conclusion of the relations between suppliers and wholesalers. The purpose underlying these protections ostensibly was to check the power of suppliers over the other tiers. Absent such regulations, the supplier-wholesaler relationship is established by the parties and may or may not be evidenced by a written contract. If a dispute arises, the parties resolve the dispute in court or arbitration under generally applicable contract laws. Franchise laws create additional protections.

Generally franchise laws require the formal appointment of a wholesaler, notification to the state of such appointment and permission of the state to terminate the relationship. In many franchise states, a supplier cannot "dual," that is, appoint two or more wholesalers in a specific geographic area. Twenty-one states have adopted some form of franchise laws that benefit beverage alcohol distributors. Many of these states require that the franchise fee be paid if a supplier terminates a wholesaler without good cause. Most franchise laws cannot be waived in contracts between suppliers and distributors.

In the consolidating world of suppliers and distributors, these and other state laws respectively constrain and protect the parties' expectations in mergers and acquisitions. Many state laws do not include a change in control in the supplier or distributor as good cause to terminate. Larger companies may find themselves required to deal with several distributors in a given geographic area. As distributors consolidate, many brand owners find themselves captive in distribution houses where a competitive brand has more influence or attention. In a franchise state, the brand owner generally cannot change distributors without litigating the issue of good cause or paying a fee to leave.

While distributors are consolidating, the number of small wineries and craft breweries has grown considerably. Many smaller suppliers cannot command the attention of large distribution houses and chain retailers. Many of these small suppliers have turned to direct-to-consumer sales as an alternative trade channel in order to build or maintain their brands.

Sales to Consumers

Wineries have embraced the Internet and mail-order businesses as a high margin trade channel. Small wineries without distributors have gravitated to the direct-to-consumer channel as the only viable means by which to market their goods. In the last 10 years, many states have permitted interstate wine shipments to local consumers. Several states permitted in-state wineries to ship to consumers but did not confer such privileges on out-of-state wineries. Challenges were brought against the laws of two of those states—Michigan and New York. Michigan permitted in-state wineries the privilege to ship to in-state consumers. New York permitted in-state wineries and out-of-state wineries with "a branch, factory, office or storeroom" within New York to ship directly to New York consumers. The cases were consolidated and presented to the Supreme Court. In 2005, the Court declared such differential treatment between in-state and out-of-state wineries explicit discrimination against interstate commerce and found the regulations unconstitutional

under the Commerce Clause in *Granholm v. Heald*, 544 U.S. 460 (2005).

Since *Granholm*, the fight has shifted to state legislatures. There, states are faced with leveling up and allowing both in- and out-of-state wineries to sell direct to consumers or leveling down and prohibiting all direct-to-consumer sales. The collateral consequences of these legislative efforts are hurting Internet retail businesses. Typically these businesses were riding the wave of liberalized direct shipping laws. The post-*Granholm* legislative efforts often have resulted in the restriction of direct shipping privileges to wineries only. Internet retailers now are litigating these restrictions with mixed results.

Conclusion

Consolidation has produced economically powerful retail and wholesale tiers that need little or no protection from the influence of suppliers. Nevertheless, wholesalers—squeezed on both ends—have reacted to their powerful customers and suppliers by seeking additional protections in the form of state franchise laws and mounting opposition to the liberalization of direct shipping. Craft brewers, wineries, and distillers are beginning to flex their collective muscle to bring much-needed changes to state licensing and trade regulations. Yet, to date, no nationwide attempt to streamline the regulation of the sale and distribution of alcoholic beverage businesses has taken hold. Until that happens, there will always be a place in the industry for knowledgeable, creative lawyers capable of finding their way through legal and regulatory obstacles to effective real-life business solutions.

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The Next Wave: Developments in Credit Default Swap Litigation

Developments in Credit Default Swap Litigation

By Alan H. Scheiner

The Credit Default Swap (CDS), an arcane and relatively novel instrument of institutional finance, recently gained notoriety as the apparent cause of the near collapse of American International Group, Inc. (AIG). AIG's downfall and bailout, involving up to $170 billion in federal funds, testifies to the importance of these credit derivatives.

The CDS market, which arose only in the 1990s, is shockingly large. A survey of members conducted by the International Swaps & Derivatives Association, Inc. (ISDA) reported that the CDS market had a notional value, meaning the face value amount of all potential payouts, of $54.6 trillion as of mid-2008. For comparison, the gross domestic product of the United States in 2008 has been estimated by the Bureau of Economic Analysis at $14.28 trillion. The immense size of the CDS market—combined with a continuing environment of financial distress—seems destined to produce a wave of CDS litigation over the next several years.

A CDS is a promise by the seller of the CDS to pay a fixed amount to the buyer of the CDS upon the occurrence of a "Credit Event," a term defined by each particular swap agreement. Although some states are proposing to regulate CDSs as insurance, one feature that distinguishes the CDS from bond insurance is that the buyer of credit protection need not—and often does not—own the underlying obligation that is the subject of the CDS. And the Credit Event payment may be keyed to a change in the financial condition of a debtor, such as a lowered credit rating or bankruptcy filing, rather than a default on a specific debt.

This article examines some of the recent legal developments in CDS litigation, for hints of what the future holds. CDS litigation has so far been rare. But the handful of reported CDS decisions show that CDS litigation will be as complex and varied as the instruments themselves. Some cautionary signposts already appear on the road ahead.

- First, CDS participants must take care that they do not unintentionally waive their rights. For example, a CDS seller may wish to temporarily accommodate, because of other business relationships with a counterparty, what it believes are unreasonable demands for collateral. But a recent decision holds that payment of a CDS collateral call could waive any objections to the amount paid.
- Second, CDS buyers must take all actions necessary to establish that a Credit Event occurred before the termination date of the CDS. A delay of just one day could mean the difference between collecting the full value of a CDS contract, or zero.
- Third, CDS buyers should anticipate and meet all the procedural deadlines controlling settlement of the CDS. Failure to do so can result in complete forfeiture of the buyer's bought-and-paid-for rights to credit protection.

General Structure of CDS Agreements

CDS contracts can be difficult to interpret because they are written using a terminology peculiar to credit derivatives, and are subject to innumerable variations in the particulars of their crucial terms. Easing that difficulty (somewhat), all CDS contracts share a common structure based upon the standard master agreement and definitions published by the ISDA. Note, however, that CDS contracts continue to evolve, including the recent opening of a central counterparty clearinghouse.

Typically, the parties to a CDS enter into a master agreement that governs all their individual CDSs. For each swap, a confirmation, which can modify the terms of the master agreement, is issued setting forth the basic terms of the swap. Each confirmation will typically define a "reference entity" (the debtor that is the subject of the swap), a "reference obligation" (an instrument or security that is the subject of the swap), a termination date, the types of Credit Event that will trigger payment, the payments to be made by the buyer to the seller in exchange for the CDS (which may be fixed or variable), the payment to be made by the seller if there is a Credit Event, notice requirements, and settlement procedures.

The reference entity, a particular debtor, may be a corporation, other business entity, or a sovereign government or agency. The reference obligation could be of any sort, but is often a collateralized debt obligation (CDO), mortgage-backed security, bond, or other direct or indirect loan obligation.

Of central importance is any requirement of collateral, or margin, that must be posted by the seller of the CDS, and that may vary during the life of a CDS depending on credit rating changes (of the counterparty or reference entity), securities prices, and other market events. Thus, the cost to the seller of meeting its CDS obligations can increase over time, well before the CDS is required to be paid, and even if it is never required to be paid. When a CDS requires collateral (termed "credit support" by ISDA), that requirement is governed by the ISDA Credit Support Annex, the variables of which are modified by the parties in paragraph 13 of the Credit Support Annex. CDS collateral calls were pivotal in the troubles of AIG.

The trigger to the payout on a CDS—the Credit Event—is an adverse event concerning the reference entity or the reference obligation. Regarding the entity, it may be a bankruptcy filing, significant default, and/or a credit rating downgrade. Regarding the obligation, it may be a failure to pay, any event of default, a write-down, or a credit rating downgrade. The definitions of a Credit Event are limited only by the ingenuity of the CDS counterparties. The CDS will have a termination date before which the Credit Event must occur in order to trigger the payout. Occurrence of the Credit Event before termination will result in a payout and termination of the CDS contract.

CDS settlement procedures are standardized, for either "physical settlement" or "cash settlement." All require a "Credit Event Notice," which is followed by a "Notice of Intended Physical Settlement" if "physical settlement" is required. In that case, the buyer must deliver to the seller a specified security or class of securities (often the reference obligation or an equivalent). If cash settlement is permitted, the payout will be made according to a formula based on the difference between the face value and market value (if any) of the reference obligation.

Developing Issues in CDS Litigation

The few reported judicial decisions give guidance for the future, and indicate caution to CDS participants. One repeated theme is the failure to follow procedures set out in CDS documentation, leading to the complete forfeiture of rights under the CDS. With respect to margin disputes, a failure to follow the margin dispute resolution procedures set forth in the ISDA Credit Support Annex can lead to waiver of any objections to margin call amounts. A failure to make all appropriate demands can lead to a failure to establish a Credit Event requiring payment under the CDS. Counterparties must timely follow settlement procedures, or may forfeit their rights to

collect under the CDS. Each of these developments is discussed in detail below.

Waiver of Margin Disputes

In a pair of recent lawsuits in the federal court in the Southern District of New York, VCG Special Opportunities Master Fund, Ltd. (VCG), a hedge fund of approximately $50 million in assets and a CDS seller, sued Citibank, N.A. and Wachovia Bank, N.A., CDS buyers, raising similar claims against each bank. VCG alleged that both banks had bought CDS contracts from VCG, each covering a different CDO for the amount of $10 million, and that each had made unwarranted and bad faith demands for additional credit support, i.e., margin calls.

Although the two claims involve distinct transactions, the substance of the two suits is identical: VCG claimed that no margin calls were permitted under its CDS contracts, and therefore all the margin calls were unwarranted. In the Citibank case, VCG alleged that Citibank demanded nearly the face value of the CDS of $10 million as collateral. In the Wachovia case, VCG claimed that at one point the bank demanded more than the face value of the CDS as collateral, requiring $10.4 million against a CDS covering a $10 million mortgage-backed CDO.

On November 5, 2008, the claim against Citibank was dismissed by District Judge Barbara Jones in the Southern District of New York; the Wachovia case remains pending. The decision in *VCG v. Citibank, N.A.*, 08-CV-01563 (BSJ), 2008 WL 4809078 (S.D.N.Y. Nov. 5, 2008), currently on appeal, provides insight into the types of disputes to be expected regarding CDS contracts and some of the pitfalls facing litigants. The decision applied New York law.

VCG alleged that Citibank made a series of margin calls in 2007 that ultimately required VCG to post a total of $9.96 million in collateral against a contingent payment of $10 million. VCG claimed that the margin calls were without contractual basis because the original $2 million in collateral posted on the contract—referred to as the "independent amount"—was the only collateral that was required. The CDS provided for "floating payments"—interim payments by VCG upon certain credit events less significant than a total default on the reference obligation—but VCG said those were the only interim payments permitted under the CDS and no variable margin payments could be required. Citibank, on the other hand, read the CDS to allow for margin calls based on variations in the market value of the CDO reference obligation.

The court held against VCG regarding the margin calls on two grounds. First, the court found that the parties' Credit Support Annex to the master agreement allowed Citibank to request additional collateral based on its "exposure," as measured by the gain or loss it would incur at any given time in replacing the CDS with an equivalent transaction. The court found nothing in the CDS confirmation to contradict that provision of the Credit Support Annex.

Unlike VCG, most parties to CDS contracts generally agree with their counterparties about whether their contracts permit margin calls at all, and are far more likely to disagree about the amount of the calls. For those participants, the second part of the court's holding on margin calls is far more significant.

In that holding, the court found that VCG had *waived* any dispute regarding the margin calls on two grounds: (1) by paying the calls and continuing to accept payments from Citibank under the CDS and (2) by failing to invoke the dispute resolution procedure in the contract. VCG claimed that it paid Citibank's unreasonable demands because it feared that Citibank would declare a default and seize the collateral. The court held that that was an insufficient excuse. The court applied the basic rule that "where a party to an agreement has actual knowledge of another party's breach and continues to perform under and accepts the benefits of the contract, such continuing performance constitutes a waiver of the breach." Because VCG paid the margin calls while continuing to accept Citibank's payments under the CDS (over a period from August to November 2007), the court found that VCG waived its objection to the margin calls.

In addition, the court held that the dispute resolution procedure contained in the parties' Credit Support Annex to their master agreement was a mandatory prerequisite to suit. In other words, VCG waived its objection because it did not invoke the dispute resolution provisions pertaining to disputed margin calls. The court found that New York public policy favored strict enforcement of alternative dispute resolution agreements, and therefore "VCG cannot now challenge Citibank's requests for additional collateral without having first vetted the claim in the manner agreed upon in the CDS contract." Thus, *VCG v. Citibank* is a strong caution to CDS parties to scrupulously follow dispute resolution procedures if they wish to preserve a margin call objection.

Definitions and Timing

The *VCG v. Citibank* decision also addressed a question of whether a "Floating Amount Event"—requiring an interim payment on the CDS—had occurred. Citibank had declared a Floating Amount

Event on the basis of an "implied write-down" (as defined by the CDS documents) of the reference obligation, requiring an interim payment from VCG that VCG refused to make. As a result, Citibank terminated the CDS, foreclosed on the collateral, and sought to collect the remainder of the unpaid Floating Amount Payment.

All parties agreed that an implied write-down constituted a Floating Amount Event, but they disagreed about whether an implied write-down occurred. Under the standard terms supplement incorporated by the CDS confirmation, there could be no implied write-down if the reference obligation itself expressly provided for write-downs. In fact, the reference CDO did permit write-downs on the collateral that secured the CDO, namely, mortgages. Citibank argued, however, and the court agreed, that the relevant write-down was not of the collateral securing the CDO, but of the CDO itself. Because the CDO did not provide for a write-down of the CDO itself, Citibank was free to find an implied write-down and demand a floating amount payment.

Not only the definition of payment triggers, but also the question of when they occur, can be crucial in the outcome of CDS litigation. The decision of the Second Circuit in February 2007, in *Aon Financial Products, Inc. v. Societe Generale*, 476 F.3d 90 (2d Cir. 2007), concerned whether the failure of an agency of the government of the Philippines to pay on certain bonds constituted a Credit Event under the CDS. A different court had already ruled that a different CDS, between Aon and a third party, made Aon liable for the face value of the defaulted bond. The question was whether Societe Generale (SG) was in turn liable to Aon for that amount, which Aon claimed it had covered by its CDS with SG.

In the court's view, Aon was mistaken in believing that it had fully hedged its exposure to Philippine agency bonds. The decision turned on the definition of the reference entity, which was defined as the "Republic of the Philippines." The court found that the Republic of the Philippines did not include the agency, hardly an intuitive result. Therefore, the default by the agency was not a default by the Republic of the Philippines, as required to constitute a Credit Event.

Ironically, the Republic of the Philippines did default on its statutory obligation to guarantee the debt of its agency, but unfortunately Aon failed to take action that would have established that Credit Event before the expiration of the CDS. For a period of almost one month, Aon could have demanded payment from the Republic, which would have been refused, resulting in a Credit Event before the expiration of the CDS, but Aon did not make the demand in time. Thus, *Aon v. SG* is a caution to understand every event that might constitute a Credit Event, and to make all potentially relevant demands for payment or establish any other preconditions, before the expiration of the CDS.

Requirements for Settlement

Court decisions also indicate that notice provisions and procedural requirements for settlement of a CDS will be strictly enforced. In *Aon v. SG*, the Second Circuit noted that Aon had failed to provide the notice of a Credit Event and demand for payment as required by the CDS. Aon argued that a letter it issued to SG explaining its position on the CDS constituted a Credit Event Notice. However, the Second Circuit carefully parsed the letter, noting that it did not contain the term "Credit Event Notice," and that the letter allowed for circumstances where payment would not be required. Therefore, the court held, it was not a Credit Event Notice, and none had ever been issued.

In a decision of the U.S. District Court of the Southern District of New York in 2006, Judge Denise Cote held, after a bench trial, that requirements for the timing of physical settlement would be strictly enforced. In *Deutsche Bank AG v. Ambac Credit Products, LLC*, 04 Civ. 5594 (DLC), 2006 WL 1867497 (S.D.N.Y. July 6, 2006), the CDS—which was a portfolio CDS covering numerous different obligations—required the following standard procedure for payment upon a Credit Event: (1) delivery of a Credit Event Notice; (2) within 30 days from the Credit Event Notice, delivery of a Notice of Intended Physical Settlement (NIPS); and (3) delivery of a qualified security (specified in the NIPS) by the number of days after the NIPS set by the original CDS confirmation, or, if the CDS confirmation is silent, based on the "current market practice" for settlement of the sale of a particular security. Failure by the buyer to meet any of these deadlines results in the forfeiture of any payment by the seller under the CDS.

Unfortunately, Deutsche Bank issued a timely Credit Event Notice and NIPS but it did not complete delivery of the securities for settlement until a month after the deadline the bank itself had set. Deutsche Bank argued, among other things, that because the CDS was a portfolio CDS (which did not automatically terminate upon the Credit Event for a single reference obligation), the bank was entitled to settle any particular obligation at any time before the overall termination date. The court found, however, that the parties intended the physical settlement dates on particular obligations to be different from the overall termination date on the entire portfolio. This decision is

an example of how even basic questions concerning the operation of a CDS can be unclear, even to sophisticated market participants.

Conclusion

Given the volume of CDS contracts outstanding and the variety of their possible permutations, CDS litigation is likely to occupy litigants, lawyers, and judges for some time to come. Parties can minimize difficulties in CDS litigation by solidifying their understanding of key contract terms before litigation, and by strict adherence to dispute resolution, notice, and procedural requirements embedded in the CDS to avoid the unintended forfeiture of crucial rights.

Additional Information

- ISDA forms and definitions: www.isdadocs.org
- CDS market information, CLE courses: www.isda.org
- Related ABA committees: Committee on Derivatives and Futures Law of the Business Law Section, and ABA Committee on Regulation of Futures and Derivatives: www.abanet.org
- A CLE primer: "An Introduction to Over-the-Counter Derivatives," March 16, 2007, Business Law Spring Meeting.

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Planning for Life after the Closing

The Impact of Information Technology and Outsourcing

By Christopher C. Cain and Karl A. Hochkammer

In the sale of a business, the buyer, seller, and their respective counsel often pay too little attention to the impact of information technology (IT) and outsourcing on the business pre-closing and post-closing. That is unfortunate because IT and outsourcing drive many financial and operational functions of the modern business.

Understanding and addressing these functions will have a significant operational and financial impact on the ability of the parties to realize the synergies expected from the deal. In this regard, there are two critical IT and outsourcing components of any business sale that should be considered: (1) planning the post-closing transition of the business from the seller's IT infrastructure and business processes to the buyer's IT infrastructure and business processes and (2) documenting that plan in a comprehensive transition services agreement.

The benefits of addressing these components are significant for all parties—for the seller, a better understanding of the cost to it of the transition, both from a financial and a human/capital requirements perspective, and a definitive timeline to be "done" with the business; for the buyer, the same understanding of the cost of the transition but also a clearer integration strategy and path to realizing the expected synergies that drove it to do the deal in the first place. Attorneys knowledgeable about these IT and outsourcing issues can help their clients plan for and document the parties' post-closing needs and goals.

Focus on the "Backbone"

In the sale of a business, each party typically has some idea of its operational goals after the closing, but spends little to no time in due diligence fully examining the operational "backbone" of the business. The backbone of a business typically includes a patchwork of contracts for IT systems, software licenses, hardware and software maintenance and support, and a host of

outsourcing service contracts for critical business functions and operations.

Focusing on this backbone early in the transaction process helps identify opportunities, potential pitfalls, and issues that will arise after the deal closes so they can be addressed before the closing. The perspectives of the buyer and seller are different, but areas of overlap exist. The seller wants a clean break with the divested business, both financially and operationally. The buyer also wants a clean break from the seller so it can get on with running the new business. Neither side can achieve its goals without working through and documenting how they need to help each other get there.

This is where a transition services agreement should come into play, right at the start of due diligence, but it is often an afterthought addressed in the waning moments before the closing. The result of this last-minute cursory attention is often a vague, poorly drafted, and incompletely thought-out transition services agreement. Even worse, the transition services agreement is often drafted entirely by the businesspeople, with little or no oversight or review by counsel. This can be a mistake because a thorough transition services agreement dictates the basic approach to the eventual integration of the acquired business into the buyer's operations and defines how and when the seller will support and then eventually cease supporting the divested business.

The authors have witnessed firsthand the perils of not paying early enough and sufficient attention to the backbone and, by extension, the transition services agreement. In one case, where we represented the buyer, the seller had agreed early on to support the computers of the divested business for a period of years, only to later discover that its licenses for the software did not permit it do so. This discovery forced the seller, at the last minute, to have to renegotiate with its existing vendors when time was running out and it had little negotiating leverage. Similarly, we have seen deals where the buyer finds out too late (because of inaccurate or incomplete information from the seller) that certain services it was counting on receiving from the seller were more expensive than planned because of licensing restrictions or other contractual restrictions. Each of those situations resulted in last-minute disagreements, hasty negotiations with each other and third parties, and unanticipated delays and costs.

Plan for Post-Closing

Proper planning for post-closing transition and integration of IT and outsourcing involves at least three steps: (1) due diligence planning and analysis, (2) understanding what services seller can offer buyer and how they are impacted by the seller's agreements with third parties who may need to provide some of the services, and (3) considering how the buyer will eventually move from the transition services and proceed toward post-transition integration, which integration often requires the buyer to leverage its existing outsourcing relationships or create new ones.

Plan in Due Diligence. Many necessary questions are not asked or addressed until it is too late for counsel to be proactive in helping clients identify and head off issues—putting the parties into a reactive position. Reactive actions cost more then proactive ones, resulting in increased transaction costs, unexpected resource requirements and sometimes situations where the seller has to pay for services or goods it no longer receives.

Instead, start examining these issues in the early stages of a business sale. Both parties should conduct an internal due diligence program to understand their respective existing operations so that they can assess the impact of the transaction on their respective third-party relationships and understand the scope of a transition services agreement. In other words, the seller needs to know what services it can provide and how much it will cost to do so. The buyer also should use the due diligence process as the first step in developing its integration strategy and identifying opportunities to achieve operational efficiencies and cost savings (including implementing new, or leveraging existing, outsourcing relationships) as it weans itself from the seller-provided transition services.

Seller's Transition Abilities. The seller is often faced with the difficult task of carving the business being sold out of its existing operations. The seller often discovers that its underlying contracts with third parties do not provide for the required degree of flexibility or fail to address the issues that arise when the seller is required to support the divested business for a period of time after the deal closes.

Examples of issues that frequently arise include the following:

- Can the seller use its existing software systems to support a third party without the need to obtain consent from the licensor?
- What consents are required, how much are the consent fees, and who is going to pay them?

- How should the seller address issues of confidentiality when its employees may be providing certain critical functions for the divested business after closing (i.e., purchasing activities, legal support, finance and accounting services, and human resource administration services)?
- Where services are subject to service levels, should the same service levels be applied to the services received by the divested entity?
- After the business is sold, will there be an impact to the price of the services or goods (e.g., will the volume of services fall below a minimum revenue commitment)?
- How will the parties address changes to items provided by the seller that the buyer required to meet changing needs?

The specific process and functions to be provided under transition services agreements will be provided either by the seller itself or by one or more third-party service providers, or both. For those shared IT and business process services that are provided by the seller internally, counsel and the client should work together to ensure that existing business processes are thoroughly mapped to the business users and to develop transition services requirements, including appropriate service level agreements and providing for continuity of business operations after the sale. Where those services are provided by third parties, negotiations may be necessary to modify, assign, terminate, or exit those agreements.

As part of the standard due diligence process, the seller identifies material third-party contracts relating to the business to be sold. However, in many instances, the seller does not think to inquire about third-party services provided to the seller's business operations as a whole. Examples of these types of agreements include enterprise software license agreements and the related support and maintenance and information technology and business processing outsourcing agreements.

Technology agreements may permit the divested business to receive the benefits of the services to be provided but if so, usually only for some limited period of time, often for no more than 12 months. These same agreements often impose requirements and restrictions on the ability of the divested business to enjoy the benefit of these services, each of which should be addressed in a transition services agreement. In addition, software license agreements often require the licensor's consent to the divested business continuing to use the software and such consents often cost a significant amount of money. The seller needs to identify and understand these items so that it can develop a proposal for the buyer and the buyer needs to understand the nature of the services that are available and the associated costs.

A good understanding of the contractual limitations on the seller's ability to support the divested business is critical to deciding what services can be offered, the terms that are applicable to those services, and how long the services are to be provided. This concern directly relates to the duration of the transition services and whether the acquired business can be easily folded into the buyer's existing IT infrastructure.

Buyer's Integration Needs. The issues the buyer faces and the questions it needs to ask typically are mirror images of the questions and considerations discussed previously for the seller. However, from the buyer's point of view, those questions and considerations may have a slightly different focus, such as the following:

- What, if any, transition services are needed from the seller after the deal closes to ensure that the acquired business continues to operate in the ordinary course until the new operations are integrated into the buyer's existing operations, how much will they cost, and how long will they last?
- Does it make sense to include the acquired business within the scope of the buyer's existing outsourcing and third-party technology agreements, if at all possible?
- Are there opportunities for the buyer to use new outsourcing contracts or third-party technology agreements to realize cost saving opportunities and synergies as part of the overall integration plan?

As part of the buyer's due diligence activities, it is important that it ask the seller to identify all of the functions that the business will no longer receive from the seller after the closing. Such questions should include the following:

- What services and functions does the seller itself provide to the divested business?
- What services and functions does the seller provide to the divested business through third parties?
- How much do these third-party services cost and how are the contractual relationships structured?
- What third-party consents are required to provide the services, who obtains them, and who pays for

them?

- How will the parties address intellectual property issues?
- What obligations and liabilities associated with the post-closing support of the divested business need to be transferred or shared?
- How will the parties address additional or new capital investments that may be required in the seller's systems and operations to support the divested business?
- How will the economics be structured for the transition services?
- How do the parties plan to address requests for new services?
- How will the parties structure their contractual governance processes?

By way of illustration, if a buyer only needs transition services for a few months, or the buyer can easily add volume or new sites to its existing agreements, or if the required services are not critical to the day-to-day operation of the acquired business, then the seller's ability or inability to provide some or all of the required services is less material. However, if the buyer requires transition services for a significant period of time or cannot easily add the acquired business to its existing agreements, then the buyer needs to understand all of the limitations on the seller's ability to provide the services. For example, the seller's IT outsourcing agreements may limit the seller's ability to provide help desk services to a divested business to a period of no more than six months. The buyer needs to be aware of this limitation so that it can start to put an alternative solution in place as soon as possible, either by working with the seller to modify the outsourcing agreement or by finding a new service provider itself.

Understanding both parties' respective obligations and needs related to moving the divested business away from the seller's transition service offering and into the buyer's organization is therefore critical. Where these types of issues are identified and planned for early on in the transaction process, the parties will be prepared to address them and can allocate the appropriate resources to the issues. This attention in turn makes it easier to ensure that the transition services agreement will meet the needs of the acquired business and will be consistent with what the seller is permitted to do under its existing agreements.

Conclusion

It can be difficult to achieve all of the post-closing expectations of the parties in the sale of a business. However, with careful attention to the IT and outsourcing needs and anticipated requirements of both parties, each party will be in a better position to achieve its goals. Transition services agreements should not be an afterthought, but rather should be the seller's last operational interaction with the divested business and the buyer's initial stepping stone toward successfully integrating the business into its existing operations.

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ABA BUSINESS LAW SECTION
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Snap Judgments

By Molly Thomas

Recession Chic

What was old (fashioned) is new again in terms of office attire. The *Wall Street Journal* reports that the power suit is reappearing as layoffs loom large in the legal world. Gretchen Neels, a Boston communications consultant, says, "In our economic times, you really want to have your game on. You can't be too formal." After more than a decade of business casual, which in some cases disintegrated into simply casual, even the youngest former proponents of "comfortable" office wear are suiting up in the face of uncertainty. No longer can a sense of entitlement dominate dress code attitudes, as Ms. Neels says, "If they want you to dress up like Big Bird every day, for $160,000 a year, just do it!" Firm Bickel & Brewer, with offices in Dallas and New York City, never acquiesced to a business casual way of doing things, and even the mail clerks there wear suits and ties. Formality fits, and at menswear retailer Paul Fredrick, the recent big sellers have been white-collared dress shirts and the yellow power tie, both favored 1980s trademarks.

A Friendly Game of Chutes and Lawyers

Lawyers are no strangers to competition, and so it only seems natural that firms would begin holding contests to see who could drum up the most new business. The *National Law Journal* reports that Boston-based boutique litigation firm Hanify & King called their networking contest "Passing the Bar," and awarded prizes based on points accumulated for collecting business cards, attending seminars, and, the biggest potential point maker, setting up one-on-one meetings with potential clients. Executive director Bob Perry said, "I wanted the associates to participate in this as something that will help their professional careers. It's difficult to get out of the office and meet people and go to events." First prize in the Hanify & King contest, in which all 12 Boston associates participated, was a weekend getaway to Cape Cod. Winner Chris Morrison, business

litigation associate, said, "Mostly it was about good habit creation. In a firm of our size, it's important for attorneys to be active in the community . . . It's a pretty important part of what we do [and] how we develop professionally."

Pay Problems

Wage and hour litigation is seeing an increase in the deteriorating economy and crumbling job market, and no business or industry seems to be exempt. Reports *New York Law Journal*, wage and hour class action suits have been filed against employers in various large industries, such as insurance, health care, and publishing, as well as small businesses like restaurants and grocery stores. Allegations include failure to compensate for hours worked off the clock, impermissible deductions, and withheld gratuities, among others.

BusinessWeek reports that as jobs disappear across every industry, more employees laid off without severance are turning to class action suits seeking compensation under WARN, the federal Worker Adjustment and Retraining Notification Act. A surprising number of companies are skimping on severance as they trim their bottom line and attempt to stay afloat. Says Gerald T. Hathaway of the New York office ofemployment law firm Littler Mendelson, "Companies used to throw up their hands and say, 'Just pay it.'" But these days they are "looking for more certainty that they really have to [pay out], because it's not cheap." Although there are no national figures kept on WARN activity, employment lawyers report a major spike in complaints.

The *Wall Street Journal* reports that age complaints in particular are on the rise, as claims of age discrimination are at their highest levels. Researchers point out that it may be more difficult for older workers to find new comparative employment than those newer to the workforce, and that older workers could be more heavily targeted because "the senior staffers are generally the highest paid and have the most lucrative benefits," says David Grinberg, Equal Employment Opportunity Commission spokesperson.

Boost in Revenue for Regional Firms

If anyone can be considered a winner in the current economy, mid-sized regional firms might fit the bill, reports the *American Lawyer*. Those that are able to offer quality work at a lower price may stand to profit from cost-cutting at large companies, where general counsel are looking for less expensive firms. Enter the mid-sized regional firm, particularly those that have already been contracted for smaller projects in the past. Robert Feit, general counsel at Paoli, Pennsylvania-based electronics manufacturer Ametek, has started contracting more work with mid-Atlantic firm Saul Ewing because, he says, "we do a lot of transactions, and we use the larger New York firms. But that is very expensive. So we decided, 'Let's try someone in our backyard that has all the capabilities we need.'" Feit's strategy seems to typify the trend, which still steers high-end deals to the top firms but deems mid-sized firms, with typically 100-300 lawyers, "more than capable" for bread and butter work. This doesn't mean that the mid-sized firms aren't suffering due to the economy, as layoffs seem to be a reality across the board—Saul Ewing cut 12 administrative employees in January. Will the mid-sized firms retain their coup when the economy regains strength? Only time will tell whether the relationships established in the tough times will be strong enough to make it.

Data Breaches Break the Bank

Paying the price for data breaches goes beyond the nickel and dime, involving deeper issues such as loss of customer trust, reports *washingtonpost.com*. According to a new study by Tucson-based research firm Ponemon Institute, an average of $6.6 million was spent by firms that had experienced data breaches in order to "rebuild their brand image and retain customers." Costs averaged $202 per compromised customer record, and included hiring forensic experts, costs associated with notifying customers such as setting up telephone hotlines, and discounts applicable to future services and products. Indirect but equally significant are costs that are less tangible—customer turnover due to loss of trust. Says Gerhard Watzinger, of computer security firm McAfee, "We're seeing a shift in attitude about these preventative technologies from one of a cost center to being a potential revenue generator. With all of these well-publicized data breaches, companies are finding out how expensive it is to repair things after the fact because the pain organizations suffer from a data breach now is pretty high."

Classroom Wait-Out

Looks like business is booming . . . in the classroom? The *Wall Street Journal* reports that despite the woes in the legal job market, law schools are experiencing an upward surge in applications. Applications to Washington and Lee University in Virginia rose 29 percent from last

year, while the University of Texas School of Law and Yale Law School both have seen an 8 percent increase in applications. Across the nation, total applications are up by over 2 percent from last year. Educators surmise that college grads are seeking safe harbor from the economy in higher education, anticipating that the job market will improve while they wait it out. Richard Geiger, associate dean of enrollment at Cornell University Law School, which has seen applications rise 8 percent, says "there are a lot of people who have decided they will not test the job market as a graduating senior from college." School administrators point out that a law degree is a solid investment and that lawyers will play a central role in a variety of fields affecting the economy for years to come. University of North Carolina in Chapel Hill senior Claire Arnett put her plans to move to New York City after graduation on hold and, instead, applied to law school, reasoning that a law degree is useful in a variety of fields, not just the law. Says Ms. Arnett, "Whether I end up practicing, I feel like it's a good degree to have."

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Business Law Today
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Keeping Current: Securities

By Julian W. Poon and Joshua I. Wilkenfeld

Tenth Circuit Clarifies Loss Causation Burden

On February 18, 2009, the U.S. Court of Appeals for the Tenth Circuit issued a significant decision in *In re: Williams Securities Litigation—WCG Subclass* (Docket Number 07-5119), that clarified the contours of a plaintiff's "loss causation" burden under federal securities laws. Although the loss causation requirement always requires evidence that a loss was causedby fraud, the Tenth Circuit's decision suggests that in certain cases, the loss causation burden also requires affirmative evidence that a loss *was not* caused by other negative market, industry, or company-specific information unrelated to the specific allegations of fraud.

Facts and Procedural History

Williams arose out of the collapse in share value of Williams Communications Group (WCG), a telecommunications company and a former subsidiary of The Williams Companies (Williams). The months following WCG's spin-off from Williams proved rocky for WCG and the telecommunications company. The market as a whole suffered in the wake of the September 11 terrorist attacks and the Enron bankruptcy, and the telecommunications industry in particular suffered industrywide price declines of approximately 83 percent. WCG stock suffered declines that paralleled the declines of other telecommunications companies: WCG's stock price, which had peaked at over $60 during the boom days of the telecommunications market, declined from around $28.00 per share on July 21, 2000, to $1.63 by January 29, 2002. WCG filed for bankruptcy on April 22, 2002.

The first of several federal securities lawsuits were filed against WCG and Williams on January 29, 2002. Plaintiffs claimed that various defendants had intentionally misrepresented the financial well-being of WCG, and thereby inflated the price of WCG shares.

During the course of the litigation, the Supreme Court decided *Dura Pharmaceuticals, Inc. v. Broudo*, 544 U.S. 336 (2005), which made clear that federal securities plaintiffs cannot recover simply by proving that they purchased at an inflated price, but must instead demonstrate "loss causation"—i.e., that plaintiffs' losses were caused by fraud. In an attempt to satisfy this burden, plaintiffs submitted the testimony of a proposed loss causation expert. Defendants moved to exclude the proposed expert testimony under *Daubert v. Merrell Dow Pharmaceuticals, Inc.*, 509 U.S. 579 (1993), and argued that the proposed evidence failed to reliably isolate losses caused by the revelation of fraud. The district court agreed and excluded the testimony. After the district court granted summary judgment in favor of the defendants, the reliability of the proposed loss causation testimony became the primary issue on appeal.

The Tenth Circuit's Decision

In its first decision to apply *Dura*,the Tenth Circuit affirmed the exclusion of the proposed loss causation testimony as unreliable evidence of loss causation.

The court held that, under *Dura*, a plaintiff is required to "show that it was [a] revelation that caused the loss and not one of the 'tangle of factors' that affect price." Both aspects of this requirement—that the loss (1) "was [caused by] a revelation" and (2) was not caused by "one of the tangle of factors that affect price"—proved significant in *Williams*.

First, the Tenth Circuit held that one of the plaintiffs' loss causation theories failed to properly establish a "revelation." Plaintiffs claimed that the alleged "truth" about WCG "leaked" out over time, thus obviating the need to identify any particular disclosure of the alleged misrepresentations. The court rejected this approach, however, because the plaintiffs failed to pre-sent evidence of specific revelations of fraud: "The inability to point to a single corrective disclosure does not relieve the plaintiff of showing how the truth was revealed."

Second, the court rejected the plaintiffs' alternative loss causation theory for failure to sufficiently account for the possibility that the plaintiffs' losses were caused by "one of the tangle of factors that affect price" such as market, industry, or company-specific factors. For example, the plaintiffs attempted to satisfy loss causation by coupling the stock price decline of January 29, 2002, with the delay in WCG earnings that was announced on that same day. But the court rejected that effort because of plaintiffs' failure to account for the possibility that other pieces of news from the same day were responsible for the plaintiffs' loss—including the filing of the plaintiffs' own class action. The court held that the plaintiffs could not show loss causation with evidence that "ma[kes] no attempt to show why . . . losses were entirely attributable to the revelation of fraud and nothing else."

More generally, the court rejected the plaintiffs' effort to define the alleged frauds so broadly as to render the loss causation element meaningless. In *Williams*, the plaintiffs' expert "beg[an] with the assumption that WCG was virtually valueless" and labeled "any negative information about WCG a corrective disclosure" so as to support the argument that any negative information about WCG "drained the fraud premium." But the Tenth Circuit held that *Dura* requires proof of a more precise relationship between a misrepresentation and a later decline in price: "We must again be careful not to connect each and every bit of negative information about a company to an initial misrepresentation that overstated a company's chances for success."

Implications of *In re: Williams*

Williams may wellhave important implications for securities class actions and other defendants—not just in the Tenth Circuit, but also across the country.

First, the case strongly supports the proposition that a plaintiff's loss causation burden requires affirmative evidence that a loss was not caused by plausible nonfraud factors, especially where the stock prices of others in the industry suffer comparable declines.

Second, *Williams* makes clear that in all securities fraud cases, a plaintiff must identify specific pieces of information or disclosures that revealed past misstatements.

Third, *Williams* rejects efforts to define a misrepresentation so broadly as to render the loss causation requirement meaningless. Although the *Williams* plaintiffs claimed that the entire financial picture of WCG was fraudulent, the Tenth Circuit opinion demanded a much more precise connection between a particular fraud and a particular revelation.

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Keeping Current: Corporate Governance

By Julie Kaufer and Justin Radell

Standards of Review; Officer Fiduciary Duties; and Shareholder Ratification

The Delaware Supreme Court recently clarified issues of Delaware law in its unanimous *en banc* opinion in *Gantler v. Stephens*, No. 132, 2008 (Del. Jan. 27, 2009). Specifically, the Delaware Supreme Court held that

- a board's rejection of an acquisition offer, without more, is not a defensive action that triggers the *Unocal* enhanced scrutiny standard of review;
- officers owe the same fiduciary duties of loyalty and care as directors; and
- shareholder ratification is limited to circumstances where fully informed shareholders specifically approve director action that does not legally require shareholder approval to become effective.

In *Gantler*, the board of directors of First Niles Financial, Inc., a small bank holding company, decided to put First Niles up for sale and engaged financial and legal advisors to assist in the sale process. The board received three separate bid letters, all of which were in the suggested range, according to First Niles' financial advisor. With respect to the three bids:

- one offer, in which the bidder stated it had no plans to retain the board, was not pursued at all by the board;
- another offer was withdrawn after defendants failed to comply in a timely manner with the bidder's due diligence requests; and
- a third offer was rejected by the board without any discussion or deliberation.

The board ultimately decided to go forward with a plan to privatize First Niles through a share

reclassification rather than sell the company. The share reclassification became effective after a majority of the shareholders voted in favor of it.

In the complaint, plaintiffs challenge the board's decision to reject the third offer and to go forward instead with the share reclassification. Plaintiffs' allegations include that defendants breached their duties of loyalty and care as directors and officers of First Niles by abandoning the sale process, and defendants breached their duty of loyalty by effecting the reclassification. The chancery court granted a motion to dismiss each of plaintiff's claims. The supreme court reversed with respect to all claims and reinstated the suit.

Standard of Review
The supreme court determined that the *Unocal* enhanced scrutiny standard did not apply to the board's decision to abandon the sale process because that decision was not a defensive action by the board as is required under *Unocal*. The supreme court also determined that the board's decision not to pursue the merger opportunity should not have received the benefit of the business judgment rule. For the business judgment rule to apply, directors must show that they reached their decision in the good faith pursuit of a legitimate corporate interest *and* must have done so advisedly. If plaintiffs assert facts that support director self-interest, the business judgment presumption can be rebutted, and the entire fairness review may be applied. Here, the supreme court held that the entire fairness standard should apply because the plaintiffs alleged sufficient facts to conclude that a majority of the board acted disloyally and did not reach its decision in good faith.

The plaintiffs' allegations included that the defendants rejected the bid to retain their positions and maintain corporate control, certain officers failed to respond timely to diligence requests or to inform the board of their failure to do so in an effort to sabotage the sale process, and there existed conflicts with certain directors who did business with the bank and would potentially lose a significant client if the bank were sold. The supreme court emphasized that facts related to a director's disloyalty must go beyond a mere assertion that the director desired to retain corporate control—as is the case here.

Care and Loyalty Owed by Officers
The supreme court also found sufficient factual allegations of wrongdoing to support the plaintiffs' claim that officer defendants breached their duty of loyalty. Although the Delaware Supreme Court alluded to it in the past, the supreme court explicitly held for the first time that corporate officers owe the same fiduciary duties of care and loyalty as directors of Delaware corporations.

Shareholder Ratification Doctrine
The chancery court held that claims that defendants breached their duty of loyalty were extinguished because a disinterested majority of shareholders ratified the share reclassification by voting in favor of it. The supreme court disagreed, concluding that the shareholder ratification doctrine is limited to circumstances approving director action that does not legally require shareholder approval to become effective. What's more, shareholder ratification is limited to those director actions or conduct that shareholders are specifically asked to approve and does not include all related actions taken by directors. Further, shareholder ratification does not extinguish claims relating to the director action that was ratified but merely subjects the director action to the business judgment rule.

Observations from the *Gantler* Decision
Evaluate Potential Director Conflicts. When considering transactions, boards must carefully evaluate any situations where a director could be considered to have a conflict of interest, including any business or other interests that arguably could differentiate the director's interests from the interests of other shareholders. If not properly addressed, those conflicts could subject the board's actions to the entire fairness standard of review.

Inform Officers of Duties. Legal counsel typically advises directors of a corporation of their fiduciary duties at the commencement of any sales process. The corporation should ensure that its officers also are informed of and understand their fiduciary duties.

Officers' Liability Exposure. While the court made clear that the fiduciary duties of officers are the same as those of directors, their respective liability exposure is different. Delaware law permits the inclusion of provisions in charter documents that eliminate directors' liability for damages arising from a breach of the duty of care; these provisions do not extend to corporate officers.

Limits to Shareholder Ratification. This decision narrowed the application of the shareholder

ratification doctrine and made it clear that shareholder ratification does not "cleanse" all aspects of a board's decision, as many had thought, but rather subjects the challenged action to the business judgment rule.

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Speaking volumes

Reviewed by Stanley Keller

An update to a landmark treatise

Glazer and FitzGibbon on Legal Opinions, Third Edition
By Donald W. Glazer, Scott T. FitzGibbon, and Steven O. Weise
Aspen Publishers
2008, 1,500 pages, $285.00
ISBN 9780735560659

Lawyers who give, and those who advise clients on receiving, third-party closing opinions should be delighted at the recent publication of the Third Edition of *Glazer and FitzGibbon on Legal Opinions*. This landmark treatise holds a special place among legal treatises for its usefulness to practitioners through its combination of both in-depth analysis and focused practical advice. As such, it is a valuable resource and essential deskbook both to legal opinion experts and to everyday transactional lawyers who find themselves occasionally giving or reviewing a legal opinion.

The Third Edition of this leading work in the opinion field comes at a welcome time because of the significant changes that have taken place in legal opinion practice since publication of the Second Edition in 2002 and the increased exposure of lawyers to liability during that period. To cite a few examples of developments reflected in the new edition:

- Trend Toward National Opinion Practice. Although earlier editions reflected the concern that there was a proliferation of state bar group reports that impeded development of a national consensus on opinion practice, the trend since the 2002 publication of the Second Edition has been toward development of a national consensus based upon acceptance of the ABA and TriBar reports as valuable sources of guidance on customary practice. We have seen during this period widening recognition of customary practice as the basis on which opinions are given and received. Except for

publication of an annotated streamlined form of opinion through the Boston Bar Association, no state or similar bar group that previously had not issued a report has done so, and the Boston form, co-authored by Don Glazer and me, in fact was an effort to reflect in practice in a streamlined form the guidance of the ABA and TriBar reports. Reports issued by state bar groups that previously issued reports were in large part revisions to align them with the ABA and TriBar reports. This developing national consensus based on customary practice is thoroughly explored and documented in the Third Edition.

- Focus on Risk Mitigation. With the expansion of lawyer exposure to liability, as evidenced by a greater number of suits against lawyers (although still relatively few in number, but in some cases involving huge dollar exposure), increased attention has been given to liability exposure and ways of mitigating risk. This attention has been taking place on a national level through programs run by a group organized under the auspices of the ABA representing various constituencies in the opinion process. One product of this attention has been the reexamination of factual confirmations requested of lawyers, such as no litigation confirmations, negative assurance, and, most recently imported from the EU, diligence memos. The Boston streamlined form attempted to address the first of these by narrowing the form of no litigation confirmation. The Third Edition addresses throughout these liability and risk mitigation issues.

- New Opinion Reports. Several important reports have been issued by TriBar and the ABA that expand the understanding of the meaning of opinions. These reports include the TriBar reports on the remedies opinion, the most common opinions involving LLCs, and the meaning of the opinion that preferred stock is "duly authorized." They also include the ABA report on negative assurance to underwriters, which recently has been updated to reflect the changes arising from the SEC's securities offering reform initiative. In addition, California issued an important report that analyzed when, applying cost-benefit considerations, opinions were justified. These recent reports are reflected in the Third Edition. For example, Chapter Nine on The Enforceability Opinion has been extensively revised to reflect the TriBar Remedies Report and Chapter Eighteen on Negative Assurance has been added to pick up the learning of the ABA report on that subject.

- Increased Use of Noncorporate Entities. With the expanded use of LLCs, opinions on LLCs have become increasingly important since the Second Edition. The Third Edition has a new chapter on LLC opinions. It includes helpful advice on the knotty problem non-Delaware lawyers face in giving opinions on Delaware LLCs arising from the significance of state contract law to LLCs in contrast to the statutory law governing corporations.

The Third Edition carries forward the book's tradition of including appendices with the most important and up-to-date reports of state and other bar groups so that these are readily available, both in print and electronically with the CD-ROM included with the book. Many of these reports are cited throughout the text and thus having them so readily available is especially helpful.

Don Glazer, the lead author, is a recognized dean of the legal opinion bar who has been instrumental in shaping legal opinion practice and is frequently called upon for his expertise in the area. Through his efforts, the treatise addresses the most important practical issues in a highly accessible style. He has been effectively supported by co-authors Professor Scott FitzGibbon, who brought an academic perspective to the original treatise, and by Steve Weise, a practicing lawyer, well-known for, among other things, his expertise in the Uniform Commercial Code and other commercial law subjects. Both Don and Steve are former chairs of the ABA Legal Opinions Committee and Don currently serves as co-chair of TriBar. The quality and authoritativeness of the views expressed by the authors have been enhanced by their practice of reaching out to a group of legal opinion experts to test those views. I have been fortunate to have been included among them.

The bottom line is that if you do not already own the treatise, rush out and purchase the Third Edition; if you already own a prior edition, you will want the new edition covering in depth the many developments that have taken place in this rapidly evolving area.

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