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BUSINESS LAW TODAY

Seeking Law Abiding Drones: What to Tell Clients that Want to Use Drones in Their Business

By Hank Perritt and Eliot O. Sprague

The proliferation of microdrones priced around $1,000 confronts many businesses with difficult legal choices. These little aircraft have phenomenal aerial photography capabilities and obviously can be useful in supporting photojournalism, aerial photography for real estate sales promotion, aerial surveying, pipeline and powerline patrol, law-enforcement, and other public safety activities. They cannot carry much more than a good camera or laser or infrared sensor – delivery of Amazon packages or pizzas will come later. (The price escalates rapidly for professional grade aircraft, cameras, gimbals, and high quality video streaming.)

The term "drone" and its politically correct alternative "unmanned aircraft system" (sUAS) span a wide range of air vehicles, from rotary-wing toys that fit in the palm of one's hand, priced at less than $100 and intended to be flown inside, to fixed-wing configurations the size of a Cessna 172 or a fighter jet derived from battlefield weapons. (We call these "machodrones.") The most interesting ones in the context of this article are ones between these extremes, such as the DJI Phantom 2, often seen in news reports and on web pages. It costs about $1,000, has endurance of about a half-hour, and can carry a GoPro camera.

The law right now is confused. Congress obligated the FAA to integrate drones into the National Airspace System, beginning with microdrones, which were supposed to be operable under an FAA regulation to be in place in 2014. Such a regulation is not in place, and a notice of proposed rulemaking has not even been issued, although the FAA promises one before the end of the year. For now, operation of one of these microdrones is illegal unless one does it purely for fun. The same vehicle's bona fides depend on whether it is flown for hobbyist or recreational purposes (legal and unregulated) or whether it is flown for commercial purposes (illegal).

The FAA is losing more enforcement cases than it is winning. An administrative law judge at the NTSB, in the *Pirker* case, held that the FAA cannot impose penalties for violating rules that do not exist. There is no rule that prohibits commercial microdrone flight, only an FAA *position*. A Texas organization flying drones for search and rescue support challenged a cease-and-desist letter received from the FAA. The D.C. Circuit dismissed the challenge on subject matter jurisdiction grounds, holding that it was not final agency action eligible for judicial review because the FAA had followed no procedures allowing notice and an opportunity to be heard before issuing it. The journalism community raised First Amendment arguments in an amicus brief filed with the NTSB, arguing that the FAA's prohibition of news collection by drones is unconstitutional. Virtually every significant aviation industry trade association signed an April 2014 letter to the FAA Administrator urging him to expedite regulatory accommodation of microdrones.

Exceptions to the prohibition are available through three procedures. First, a would-be commercial operator can petition for an exemption from specific FARs – like the one requiring display of a registration certificate in the aircraft. There is no one aboard a microdrone to see the certificate. Second, a private sector operator can obtain a Special Airworthiness Certificate/ Experimental (SACE), which allows it to fly a drone for research, demonstration, and training purposes only in a defined geographic area approved by the FAA.

Application for a SACE requires submission of 20 pages of details about drone design, flight characteristics, and the behavior of its electronic systems. The application process obviously was designed for manned homebuilt and experimental aircraft. Relatively few SACEs have been granted, mostly limited to collaborators in six test sites that the FAA selected in early 2014 to conduct research into various aspects of drone integration. A handful of others allow larger fixed-wing drones derived from military designs to be flown in conjunction with oil and gas exploration in Alaska.

The third route to obtain permission is to apply for a Certificate of Waiver and Authorization (COWA), a process still formally available only to governmental entities like the armed services and state and local law-enforcement agencies. Several hundred COWAs have been granted, predominantly to the Armed Forces, but also to some law-enforcement agencies.

The FAA apparently is willing to relax some of the specific requirements on a case-by-case basis, but its formal position is that drones may be operated only under an exemption, under a SACE or COWA, that they only may be operated by persons holding pilot licenses, that drones must be certificated and registered as aircraft, and that they must comply with the operating rules contained in part 91 of the FARs. Compliance with all of these requirements is ill-suited to the nature of microdrones like the Phantom and entirely disproportionate to the risks they present. It is as though the national Highway Traffic Safety Administration extended rules designed for over-the-road trucks to bicycles.

Even if one meets all these requirements, there is no clear pathway to get approval for the full range of commercial drone activities.

Apparently the FAA wants to relieve some of the dammed up pressure for action in a case-by-case exemption process. The exemption process is more flexible than the SACE or COWA processes. It just approved eight Hollywood petitions to allow microdrone support of movie shooting at defined locations in California. Still, what Hollywood proposes to do hardly can be said to involve integration of drones into the National Airspace System. It's more like enforced segregation.

The FAA has some 40 other petitions for exemption under consideration, including one filed by co-author Perritt on behalf of Colin Hinkle, a Chicago news photographer.

We've argued in other articles and in a petition for rulemaking filed with the FAA that the agency is thinking about the problem in the wrong way. Microdrones cannot be regulated as manned aircraft have traditionally been regulated, by trying to specify the details of drone operation and operator qualifications; they must be regulated like the consumer products they are – like lawnmowers – by prohibiting their sale unless they have built in safety features that cannot be overridden by the DRone OPerator (DROP). This may help reduce the chance for midair collisions by reducing temptation to go higher and further.

The FAA should embrace drones' ability to hold themselves accountable – to make them law abiding right out of the box. The FAA should require them to have built-in systems to prevent them from violating fewer than a half-dozen key safety principles. These principles, widely agreed on as best practices for model aircraft flight:

- restrict flights to the airspace at or below 400 feet above ground level;
- allow flight only within line of sight;
- exclude the drone from those classes of airspace already defined as controlled and congested; and
- require the drone automatically to return to the launching point if something goes wrong, such as a control-link failure or operator incapacitation or inattentiveness.

Autonomously implementing these limitations is well within the capability of even the lowest cost microdrones. Most of them already have these features, but their activation is optional with the operator. Additional government regulation is not popular, but government intervention is the only means to keep air traffic safely separated. Our proposed approach is far less intrusive than detailed DROP licensing requirements, aircraft certification, and prescribing and enforcing flight profiles. It is quite clear that the status quo is not sustainable. The FAA will never have sufficient enforcement resources to detect even a fraction of the violations of its outright ban, let alone to prove those flights that it detects were for commercial purposes. The thousands of people who think that flying a Phantom right out-of-the-box from Amazon would be fun or would be an asset to their business activities are not going to wait around for the FAA to navigate its way out of its regulatory jungle. Unlike traditional manned aircraft pilots and operators, they have no particular ties to the FAA, have not been trained in a culture that has the Federal Aviation Regulations at its core, and the FAA lacks the leverage over them that it has over pilots commercial aircraft operators, who must have and maintain some kind of FAA license or certificate to keep their jobs and businesses.

The result is that the FAA pretends that commercial drone flight is illegal while thousands of people do it anyway, presenting mushrooming hazards to manned aircraft and to persons or property on the ground because the operators have not thought through what the risks are and how to avoid them.

The regulatory climate is in a state of flux – to understate the obvious. It will change week-by-week and month-by-month, and it will surely open up the possibilities for much useful commercial drone activity. Exactly how it will change and what kinds of trade-off among vehicle design, operator qualification, and detailed flight rules will result is difficult to predict.

But many of your clients want to want to fly them now. Other clients wish drones could be exterminated.

What do you do?

First, explain to your client the current distinction between hobbyist and recreational flight on the one hand, and commercial flight on the other. Your client can do almost anything that qualifies as hobbyist and recreational and, without special permission, can do almost nothing that involves commercial flight.

Second, make sure your client understands that even small drones can be dangerous. They can collide with manned aircraft, especially if they are flown above 400 feet. (Most manned airplanes and helicopters stay above 500 feet, most of the time, except when they are landing or taking off.) They can injure persons or property on the ground if they fly or crash into them. It is relatively easy for an operator to lose control of them, especially if they fly too far away from him or her. The client must understand, moreover, that it is liable for damage caused by its drone operations. The general rule is that standards for common-law negligence must be based only on FAA regulations. While state law may provide remedies for violating the standards; it may not substitute or supplement the federal standard of care. But if the FAA has not promulgated regulations for drone operations, the likelihood of federal preemption is much less.

Third, help your client work through the risks and rewards of alternative courses of action. Some clients do not want to be pioneers, testing legal limits. Others are eager to act, less concerned about legal consequences. The following alternative approaches can be useful to discuss with clients.

A. *Become a test case.* Imagine a construction contractor who controls a construction site, secured from public access. The contractor himself, or through a drone subcontractor, buys a Phantom microdrone to obtain overhead photography useful for surveying the site and monitoring activities to improve it. It sets the parameters on the Phantom so that it cannot fly higher than 400 feet above the ground, so that it cannot fly outside the boundaries of the construction site, and so that it returns to home if the control link is lost. This hypothetical client seeks no advance approval from FAA; it simply flies its drone to meet its needs, making sure that all of its employees and contractors comply with the limitations described.

   A similar approach might be suitable for powerline and pipeline patrol operators and real estate agents who fly only over property they have legal access to and a measure of control over.

   Bold television stations also can take advantage of the current legal cloudiness. They have available to them a variety of legal theories that support what they want to do to distinguish them from other stations in their markets. They would go ahead and fly microdrones for newsgathering, or at least buy newsworthy imagery already collected by somebody else.

   This is not as stark a defiance of law as it might seem. Substantial uncertainty exists about the validity of the FAA's prohibition on commercial drone flight. The *Pirker* decision has not been reversed by the NTSB, and it plainly holds the FAA ban on commercial flight invalid. The *Equusearch* decision makes clear that the FAA must follow due process in drone enforcement proceedings. And, of course, a client cited for violating a rule can defend on the grounds that the rule is ultra vires or arbitrary and capricious. The client's drone activities may go undetected by the FAA, and, even if they are detected, the FAA may not devote the resources to an enforcement action.

   This is not a risk-free approach, but it can be useful in crystallizing the legal framework, if a client is willing to make itself available as a test case. If the FAA commences an enforcement action, its position will be weak, and that of the client strong.

B. *File a petition for exemption*. A more cautious client can file a petition for an exemption, following in the footsteps of the Hollywood success and Hinkle's effort. They might propose limitations similar to those proposed in the *Hinkle* petition or they might come up with their own.

C. *Get ready*. In any event, clients should get ready to fly their first microdrones on the first day that FAA rules allowing commercial use become effective. There *will* be a reasonably comprehensive framework for legal microdrone ENG flight within the next few years. The pressure to establish a coherent regulatory framework is simply too strong, and the mushrooming noncompliance with the FAA's ban is changing the political dynamics and adding the voices of drone opponents to those of drone proponents urging the FAA to act soon. Change almost certainly will be in the direction of permitting commercial drone use; the statute commands that, and it also clearly envisions that restrictions will be relaxed for microdrones before the entire integration problem is solved. As the regulations are being finalized, it also is not unreasonable to expect that there will be a relaxation for certain kinds of experimental or demonstration activities in a commercial context through streamlined special approval mechanisms.

   Equipment selection, decisions about whether to contract for microdrone support or do it in-house, strategies for deployment and use, development of downlinks for aerial imagery, training of field reporters and ENG photographers, development of legal theories all can be done now. In fact, Modovolate Aviation, LLC ("Movo Aviation") will begin offering packages of ENG microdrones to local TV stations in early 2015, so that they can begin preparing.

D. *Don't get caught up in the frenzy over privacy*. It is important to keep the privacy issues in perspective. Lots of privacy law is on the books already, and privacy advocates are sophisticated and influential. The FAA knows very little about privacy; it is a safety agency. Moreover, it is not clear that the FAA has statutory authority to promulgate limitations on flight solely to deal with privacy concerns.

   Privacy law already provides basic protection. If a drone operator causes a microdrone to look through a bedroom window and capture imagery of the people inside, it constitutes common-law invasion of privacy under the intrusion-upon-seclusion variant. If he or she puts the resulting video up on YouTube, the operator is liable under the giving-publicity-to-private facts variant. Little case law exists to support these propositions, because microdrones having this capability are too new, and it would take an extremely reckless helicopter pilot to commit the tort on the hypothetical facts.

   Similarly, tort law also provides protection against aircraft, including drones, flying so low as to constitute a common-law trespass or nuisance.

As frequently happens with new technologies, both the benefits and the dangers of microdrones probably are exaggerated. As more people buy them and fly them for commercial purposes, many will discover that their limited range and endurance and the fact that they must be transported to the site by another vehicle blunt their apparent economic advantages over manned helicopters. Their limitations mean that they will, at most, supplement manned helicopters, not supplant them.

The dangers also are exaggerated. Few of them will crash and hurt people or damage property. Only a few nuts will use them to peer into bedroom windows, and if the occupants of the bedroom care enough, they will have a lawsuit strong enough to attract contingency-fee lawyers.

Meanwhile, the bar should help its clients navigate the regulatory uncertainty, encouraging the bolder ones to galvanize some test cases. More important, clients and the bar alike should help the FAA figure out a viable approach to this new aeronautical opportunity, recognizing the limits of legal compulsion when the law is too far out of step with technological reality, and recognizing that new technologies can make rules self-enforcing.

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Citations

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docket no. FAA-2014-0473,
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***Texas Equusearch Mounted Search and Recovery Team v. Federal Aviation Administration*, No. 14-1061**
(D.C. Cir. *per curiam* order filed July 18, 2014).

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Additional Materials

The co-authors have written a number of articles published in trade magazines and law reviews and are under contract to write a book about the implications of inexpensive microdrones. See Henry H. Perritt, Jr. & Eliot O. Sprague, *Is there a drone in your future?* HELIWEB, May, 2014 p. 14 (with Henry H. Perritt, Jr. & Eliot O. Sprague); Henry H. Perritt, Jr. & Eliot O. Sprague, *Drone Dread,* ROTOR & WING MAGAZINE, June, 2014, p.34; Henry H. Perritt, Jr. & Eliot O. Sprague, *But Who's Going to Fly Them?* PROFESSIONAL PILOT, June, 2014, p.94; Henry H. Perritt, Jr. & Eliot O. Sprague, *Leashing Drones*, ROTORCRAFT PRO, Aug., 2014; Henry H. Perritt, Jr. & Eliot O. Sprague, *Law and Order in the Skies,* THE TECH (MIT student newspaper), 13 June 2014; Henry H. Perritt, Jr. & Eliot O. Sprague, *Drones*, ___ VANDERBILT J. ENT. & TECH. L. ___ (forthcoming 2014); Henry H. Perritt, Jr. & Eliot O. Sprague, *Ready for the Microdrone Races*?, RADIO AND TELEVISION DIGITAL NEWS ASSOCIATION NEWSLETTER (forthcoming, Oct. 2014); Henry H. Perritt, Jr. & Eliot O. Sprague, DOMESTICATING DRONES: THE TECHNOLOGY, ECONOMICS, AND LAW OF UNMANNED AIRCRAFT (Ashgate, forthcoming 2015).

BUSINESS LAW TODAY

What Banks Should Know About the Eighth Circuit's Decision in *Choice Escrow & Land Title, LLC v. Bancorpsouth Bank*

By Lori A. Desjardins and Katie Hawkins

On June 11, 2014, the Eighth Circuit Court of Appeals (Court) issued a decision regarding cyber security and who should bear the loss for unauthorized funds transfers. In *Choice Escrow & Land Title v. BancorpSouth Bank*, 2014 U.S. App. LEXIS 10817, the court of appeals affirmed the U.S. District Court for the District of Missouri's grant of summary judgment in favor of BancorpSouth Bank, concluding that under Article 4A of the Uniform Commercial Code, BancorpSouth Bank complied with commercially reasonable security measures and was not responsible for Choice Escrow & Land Title's loss resulting from a fraudulent payment. Additionally, the court of appeals reversed the district court's dismissal of a counterclaim for attorney's fees filed by BancorpSouth Bank. The Eighth Circuit's decision in this case was markedly more favorable to financial institutions than the First Circuit's decision in *Patco Construction Co. v. People's United Bank,* 2012 U.S. App. LEXIS 13617. This case is informative for all banks as the issue of loss allocation for fraudulent payment orders continues to evolve.

Review of the Case

Background on the Parties and the Litigation

Choice Escrow & Land Title (the "Customer") is a Missouri company that provides real estate escrow services. Choice opened a trust account at BancorpSouth Bank (the "Bank") that was used to hold funds entrusted to Choice by a buyer of real estate until those funds were wired to the seller at closing.

On March 17, 2010, after an employee of Choice fell victim to a phishing scam, an unknown third party accessed Choice's online account at BancorpSouth and issued a payment order instructing BancorpSouth to wire $440,000 from Choice's account to a bank account in the Republic of Cypress. BancorpSouth accepted and executed the payment order.

Choice sued BancorpSouth for the lost funds in the district court. BancorpSouth filed a counterclaim for attorney's fees based on an indemnification agreement that it had executed with Choice. The district court granted summary judgment in favor of BancorpSouth after concluding that under the provisions of Article 4A of the Uniform Commercial Code, the risk of loss from the fraudulent payment order was allocated to Choice. Further, the district court dismissed BancorpSouth's counterclaim after concluding that the indemnification agreement was unenforceable because it conflicted with Article 4A. Choice appealed the decision of the district court.

Security Measures Offered to Choice by the Bank

BancorpSouth offered four security measures designed to ensure that access to its customers' accounts was available only to each customer's employees or authorized users. The four security measures included:

- A unique user ID and password
- Device authentication
- Daily dollar limits on the volume of wire transfer activity from a customer's account
- Dual control requiring a second authorized user to separately approve a pending payment order

Choice declined two of the four security measures. Specifically, (1) Choice did not place daily transfer limits on its account; and (2) Choice declined the use of dual control and signed the requisite waiver of that security feature. In fact, Choice twice declined dual control. In November 2009, an employee of Choice received an e-mail from one of Choice's underwriters describing a phishing scam that led to transfers of money to overseas banks. The Choice employee forwarded that e-mail to a BancorpSouth employee and asked whether the Bank could stop all foreign wire transfers. In the response to the e-mail, a BancorpSouth employee indicated that the Bank was unable to stop just foreign wires but reiterated the Bank's recommendation of dual control. Choice again declined dual control.

Choice's Use of Wire Transfers

In order to initiate a wire transfer, Choice's employees used an online banking platform called InView. Choice authorized two of its employees to use InView, and each of those employees was issued a unique user ID and password. One of those employees would log into InView (through BancorpSouth's website) using her unique user ID and password. A commonly used device authentication software known as PassMark would then authenticate the device the employee used to access InView by checking the IP address and other specifications of the device. If PassMark did not recognize the device, the employee would be prompted to answer challenge questions. Once the device was recognized or the challenge questions were answered correctly, the employee would gain access to InView and could issue payment orders to BancorpSouth. If Choice had sufficient funds, the payment order would be sent to one of BancorpSouth's six employees responsible for routing payment orders from Choice, and the payment order would be executed. BancorpSouth would debit the funds from Choice's account and confirm the transaction by sending a fax to Choice.

Applicable Law and Guidance

Article 4A of the UCC

The rights, duties and liabilities of banks and their *commercial* customers with respect to electronic funds transfers are governed by Article 4A of the UCC. *See* Miss. Code Ann. § 75-4A-108. (Consistent with *Choice Escrow*, reference is made to Mississippi's codification of Article 4A.) In general, the parties may not vary by agreement any rights and obligations arising under Article 4A.

Under Article 4A, the general rule is that a bank receiving a payment order bears the risk of loss of unauthorized funds transfers. Miss. Code Ann. § 75-4A-204. The bank may, in turn, shift the risk of loss to the customer in one of two ways:

- The bank may show that the payment order was the authorized order of the person identified as the sender if that person indeed authorized the order or is otherwise bound by it under the law of agency, Miss. Code Ann. § 75-4A-202(a), or
- If the bank and its customer have agreed that payment orders will be verified pursuant to a security procedure, the payment order is effective, whether or not authorized if:
  - the security procedure is commercially reasonable; and
  - the bank proves that it accepted the payment in order in good faith and in compliance with the security procedure and any written agreement. Miss. Code Ann. § 75-4A-202(b).

A "security procedure" is established via the agreement of the bank and customer primarily in order to "verify that the payment order or communication amending or cancelling a payment order is that of the customer." Miss. Code Ann. § 75-4A-201.

A bank can demonstrate that a security procedure is "commercially reasonable" in one of two ways. First, the standard is not whether the security procedure is the best available, but rather whether "the procedure is *reasonable for the particular customer and the particular bank*." Miss. Code Ann. § 75-4A-203, cmt. 4 (emphasis added). Second, a security procedure is deemed to be commercially reasonable if:

- the security procedure was chosen by the customer after the bank offered and the customer refused a security procedure that was commercially reasonable; and
- the customer expressly agreed in writing to be bound by any payment order, whether or not authorized, issued in its name and accepted by the bank in compliance with the security procedure. Miss. Code Ann. §75-4A-202(c).

In the event that the bank proves that the security procedure was commercially reasonable and that it accepted the payment order in good faith and in compliance with the security procedure, the payment order is effective as an authorized order of the customer. Miss. Code Ann. § 75-4A-202(b)(ii), §75-4A-203(a)(1). If the bank is unable to prove that its security procedures were commercially reasonable, the risk of loss remains with the bank. *See* Miss. Code Ann. §75-4A-202(b)(1).

Even if the bank demonstrates commercial reasonableness, however, the customer may still shift the risk of loss back to the bank if the customer proves that the order did not result from either an insider fraud (e.g., a current or former employee) or a breach of its physical or electronic security. Miss. Code Ann. §75-4A-203(a)(2). In the event that the court determines that the bank bears the risk of loss, the bank must refund the payment order and must pay interest on the refundable amount." Miss. Code Ann. §75-4A-204(a).

FFIEC Guidance

In August of 2001, the agencies of the Federal Financial Institutions Examination Council (FFIEC), first issued guidance titled "Authentication in an Internet Banking Environment." Available at http://www.ffiec.gov/pdf/pr080801.pdf. That guidance was updated on October 12, 2005. The 2005 Guidance in particular requires that banks should "periodically . . . [a]djust their information security programs in light of relevant changes in technology, the sensitivity of its customer information, and internal or external threats." Additionally, the 2005 Guidance describes existing authentication methodologies as involving the following factors: (1) something the user knows (e.g., password, PIN), (2) something the user has (e.g., ATM card), and (3) something the user is (e.g., fingerprint). Use of more than one of these methodologies is called "multi-factor authentication," which presents a more reliable and stronger fraud deterrent than single-factor methods. Accordingly, the 2005 Guidance states:

> The agencies consider single-factor authentication, as the only control mechanism, to be inadequate for high-risk transactions involving access to customer information or the movement of funds to other parties. . . . Account fraud and identity theft are frequently the result of single-factor (e.g., ID/password) authentication exploitation. Where risk assessments indicate that the use of single-factor authentication is inadequate, financial institutions should implement multifactor authentication, layered security, or other controls reasonably calculated to mitigate those risks.

Analysis

Choice and BancorpSouth agreed that BancorpSouth complied with its security procedures in accepting the payment order that resulted in a loss for Choice; however, disputes existed as to whether (1) BancorpSouth's security procedures were commercially reasonable; (2) BancorpSouth accepted the payment order in good faith; and (3) BancorpSouth accepted the payment order in compliance with the customer's written instructions.

The Bank's Security Procedures Were Commercially Reasonable

A threshold question was addressed as to whether the Bank's use of device authentication was a security procedure. Choice argued that it was not, because under Article 4A, a security procedure must be "established by agreement," and Choice asserted that the Bank did not mention device authentication in any written contract or make any formal offer to use PassMark.

The court, however, concluded that all four security measures were security procedures because there was ample evidence that the parties agreed to implement PassMark, including:

- all BancorpSouth customers were *required* to sign up for PassMark when they signed up for InView; and
- an Addendum to Business Services Agreement between the parties states that Choice "assumes full responsibility and risk of loss for all transactions made by BancorpSouth . . . in accordance with . . . the procedures set forth in the InView User Manual(s) and Help screens" and the bank posted a digital manual titled "PassMark Login Security" on the InView portal.

Next, the Court turned to the question of whether the security procedures were commercially reasonable. Choice argued that a commercially reasonable security procedure must include manual review by a human being of every payment order. The Court rejected Choice's argument calling it a "rigid, foreign standard" that is "essentially at odds with" Article 4A. Like the Court in *Patco*, the Court here analyzed FFIEC Guidance (described above in Section II) to determine whether BancorpSouth's security procedures were commercially reasonable. In doing so, the Court determined that BancorpSouth's security procedures complied with the FFIEC guidance by requiring multifactor authentication – including *something that the user knows* (correct password) and *something that the user has* (a recognized computer). The Court took note that BancorpSouth additionally offered dual control, which it characterized as an additional security procedure that addresses the increased security threats since the FFIEC guidance was issued in 2005.

Further, Choice contended that a bank must use a different security procedure for each of its customers in order for the security procedure to be suitable for the customer based on its wishes expressed to the bank and the circumstances of the customer known to the bank. The Court was dismissive of Choice's argument and noted that if a bank were to develop a "single effective and versatile procedure," it would not be commercially unreasonable for the bank to apply that procedure to all or substantially all of its customers, making changes to the procedure only when necessary.

Thus, the Court concluded that BancorpSouth's security procedures were commercially reasonable and characterized this as a case where "an informed customer refuses a security procedure that is commercially reasonable and suitable for that customer and insists on using a higher-risk procedure because it is more convenient or cheaper," and Choice "voluntarily assumed the risk of failure of the procedure and cannot shift the loss to" BancorpSouth.

The Bank Accepted the Payment Order in Good Faith

To establish that it acted in good faith, BancorpSouth needed to demonstrate that its employees accepted and executed Choice's payment order in a way that comported with Choice's reasonable expectations as established by reasonable commercial standards of fair dealing. The Court concluded that BancorpSouth accepted the March 17 payment order in good faith based, in part, on testimony that it was "normal banking practice" for a bank's employees to route payment orders that are submitted in compliance with security procedures without conducting any further review to determine whether that payment order might be suspicious. Additionally, the Court noted that Choice was well aware that:

- BancorpSouth employees saw a payment order only after it cleared the Bank's security procedures; and
- the role of BancorpSouth employees was not to check for any irregularities in payment orders, but rather to route payment orders to the correct beneficiaries.

Further, the Court concluded that even if the March 17 payment order had been pulled for further review, it was not so unusual that it would have caused alarm because:

- the Bank provided evidence that it was not the largest payment order ever submitted by the Customer; and
- the Customer's payment orders varied in size from a few thousand dollars to a few hundred thousand dollars.

Choice argued that a notation on the memo line, which was inconsistent with Choice's business and past practice, should have been a red flag for BancorpSouth. The Court disagreed, however, that two words on the memo line of the payment order were enough to make the transaction so suspicious that BancorpSouth's failure to notice it amounts to bad faith. In fact, the Court said, "if BancorpSouth's employees had to remember the business of each of BancorpSouth's 400,00 clients to ensure the memo line of each payment order made sense, BancorpSouth would not be in business long."

The Bank Accepted the Payment Order in Compliance with Customer's Written Instructions

The only evidence of an instruction to the Bank by the Customer was the November 11, 2009 e-mail from a representative of the Customer asking if it would be possible to stop foreign wire transfers. This e-mail resulted from the Customer's employee learning of phishing scams from one of the Customer's underwriter. The Court did not find that this exchange constituted an instruction (rather, it was an inquiry); therefore, the Bank did not violate any instruction made by the Customer.

Attorney's Fees

The district court dismissed a counterclaim filed by BancorpSouth, in which it sought attorney's fees based on an indemnification provision in its contract with Choice. The district court concluded that the indemnification clause, in which Choice agreed to indemnify and hold harmless BancorpSouth for, among other things, all "damages, losses [and] liabilities," frustrated Article 4A's attempts to balance the risk of fraudulent payment orders between a bank and its customer. The Eighth Circuit disagreed with the district court's analysis, finding that the provision focused on by the district court is not at issue in the Bank's counterclaim. Rather, the Bank sought attorney's fees, not damages, stemming from the fraudulent payment order, and no provision in Article 4A allocates attorney's fees between a bank and its customer in the event of litigation.

Some Takeaways for Banks

The outcome of this case does not change the First Circuit's decision in *Patco,* and the lessons learned from *Patco* remain relevant for all banks. The Eighth Circuit's decision in *Choice Escrow* does, however, provide some useful take-away points for banks to think about and be aware of as the issue of loss allocation for fraudulent payment orders continues to evolve:

- Banks should continue to require and/or offer various security procedure options, such as dual control or authorizations for some or all customer actions, out-of-band verifications of transactions (e.g., call-backs), account limitations that are customer-specific, etc. However, it is important that those communications are documented and preserved – *particularly any election by the customer to refuse, waive or otherwise opt out of any such options* – so that they can be used as evidence to show what options were made available to but not implemented by a customer.
- The bank's agreements with its commercial customers should invoke and carefully track the requirements of Article 4A of the UCC in order to shift liability to the customer for fraudulent transactions.
- Banks and their commercial customers need to be thoroughly versed in and trained on the importance of security systems and procedures. Both sides need to fully understand how Article 4A of the UCC allocates liability for fraudulent transactions in order to make informed decisions about what steps should be taken when processing high-risk payment orders. If a customer understands that refusing an out-of-band verification option or call-back procedure – *or dual control* – just because it is inconvenient could result in liability for unauthorized transfers, they may choose otherwise – or they can certainly accept the risk but do so only after being fully informed of the ramifications. The element of surprise has no place in this high-risk space.

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BUSINESS LAW TODAY

Section 10(b) Litigation: The Current Landscape

By Jay B. Kasner and Mollie M. Kornreich

Shareholder lawsuits for violations of Section 10(b) of the Securities Exchange Act of 1934 (Exchange Act) are a common source of liability for public companies. These cases are often triggered by nothing more than a drop in stock price, after which shareholder plaintiffs allege that the change in price reflects newly public information that the company previously and improperly concealed.

Pleading Requirements

Section 10(b) makes it unlawful to "use or employ, in connection with the purchase or sale of any security" a "manipulative or deceptive device or contrivance in contravention of such rules and regulations as the [SEC] may prescribe." 15 U.S.C. § 78j(b). "Security" is defined broadly to include, among other things, stocks, bonds, debentures, a variety of other instruments, or, "in general, any instrument commonly known as a 'security.'" 15 U.S.C. § 78c(a)(10).

The SEC's implementing regulation, Rule 10b-5, further defines the scope of the statutory language. The rule renders it unlawful, in connection with the purchase or sale of any security, to:

- Employ any device, scheme, or artifice to defraud;
- Make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made not misleading; or
- Engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person.

See 17 C.F.R. § 240.10b-5 (2014).

Although the statute does not provide for an express private right of action to enforce Section 10(b) and Rule 10b-5, one has been implied since the mid-1940s. The Supreme Court has declined, however, to imply a private cause of action for aiding and abetting liability under the statute. *See Cent. Bank of Denver v. First Interstate Bank of Denver*, 511 U.S. 164, 176–77, 179–80, 191 (1994). Notably, the SEC is not bound by this limitation. *See* 15 U.S.C. § 78t(e); *SEC v. U.S. Envtl.*, Inc., 155 F.3d 107, 113 (2d Cir. 1998).

To establish liability under Section 10(b), a plaintiff must show that:

- The defendant made a material misstatement or omission;
- The misstatement or omission was made with an intent to deceive, manipulate or defraud (that is, with scienter);
- There is a connection between the misrepresentation or omission and the plaintiff's purchase or sale of a security;
- The plaintiff relied on the misstatement or omission;
- The plaintiff suffered economic loss; and
- There is a causal connection between the material misrepresentation or omission and the plaintiff's loss.

See Dura Pharms., Inc. v. Broudo, 544 U.S. 336, 341–42 (2005).

Each of these elements has been the subject of numerous opinions and ample scholarship as the scope of liability under the statute continues to evolve.

Misstatement or Omission

Section 10(b) requires a defendant to have made a misstatement or omission. An omission may only give rise to liability if it was necessary to render another statement not misleading, or if the defendant had a duty to disclose.

Recently, in *Janus Capital Group, Inc. v. First Derivative Traders*, the Supreme Court addressed what it means to "make" an untrue statement under Section 10(b). It found that a mutual fund investment advisor could not be held liable for false statements in its clients' prospectuses, as it did not "make" the statements at issue. Rejecting the argument that liability could extend to the person who provided the false information, the Supreme Court held that "the maker of a statement is the person or entity with ultimate authority over the statement, including its content and whether and how to communicate it." 131 S. Ct. 2296, 2300–02 (2011).

Materiality

Only a material misstatement or omission can give rise to liability under Section 10(b) and Rule 10b-5. 17 C.F.R. § 240.10b-5. A fact is material if "there is a substantial likelihood that a reasonable shareholder would consider it important" in making his investment decision. In determining materiality, the misstatement or omission is not viewed in a vacuum. Rather, the question is whether disclosure would have "significantly altered the 'total mix'" of available information.

Materiality is generally a mixed question of law and fact, and is decided as a matter of law only when "reasonable minds could not differ on" the statement's importance. *See, e.g., Litwin v. Blackstone Grp*., *L.P.*, 634 F.3d 706, 717 (2d Cir. 2011) (internal quotation marks omitted). However, there are cases where this standard is met and alleged misstatements or omissions are deemed immaterial as a matter of law. For example, certain statements may be considered mere "puffery" when they are too general to induce a reasonable investor's reliance on them. *See, e.g., City of Pontiac Policemen's & Firemen's Ret. Sys. v. UBS AG*, 752 F.3d 173, 183 (2d Cir. 2014).

The Supreme Court recently addressed materiality in *Matrixx Initiatives, Inc. v. Siracusan*o, 131 S.Ct. 1309 (2011). There, it considered whether a pharmaceutical company's failure to disclose adverse event reports associated with one of its products was material, where the reports did not disclose a "significant number of adverse events." The Court held that the plaintiffs had adequately pled materiality given the quality of the reports, the commencement of related product liability lawsuits, previous studies which lent credibility to the reports and the fact that the product in question allegedly accounted for 70% of the defendant's sales. Because these facts suggested "a significant risk to the commercial viability of [the defendant's] leading product," it was "substantially likely that a reasonable investor would have viewed this information as having significantly altered the total mix of information." (Internal quotation marks omitted.)

"In Connection with" a Purchase or Sale

It is well-settled that a private action under Section 10(b) can be brought only by a purchaser or seller of the security. 15 U.S.C. § 78j(b). *Blue Chip Stamps v. Manor Drug Stores*, 421 U.S. 723, 730–31 (1975). Therefore, a potential buyer who was dissuaded from purchasing as a result of a fraudulent misstatement, or an investor who held a security and, in reliance on the alleged misstatement, did not sell it cannot bring suit. *See Merrill Lynch, Pierce, Fenner & Smith Inc. v. Dabit*, 547 U.S. 71, 79–80 (2006).

Recently, courts have focused on the "in connection with" requirement in determining the scope of the Securities Litigation Uniform Standards Act (SLUSA), which precludes certain state law class actions that allege a misrepresentation or omission of a material fact in connection with the purchase or sale of a "covered security." *See Chadbourne & Parke LLP v. Troice*, 134 S. Ct. 1058, 1064 (2014); *Dabit*, 547 U.S. at 84.

Scienter

A plaintiff pursuing a Section 10(b) claim must demonstrate that the defendant acted with scienter, or the intent to deceive, manipulate or defraud. Although negligent conduct is insufficient to create liability, reckless conduct may satisfy this requirement, and the necessary degree of recklessness varies by Circuit. *Tellabs, Inc. v. Makor Issues & Rights, Ltd.*, 551 U.S. 308, 319 & n.3 (2007).

Under the Private Securities Litigation Reform Act (PSLRA), a plaintiff must also state with particularity facts giving rise to a strong inference that the defendant acted with the required state of mind. When evaluating whether a plaintiff has met this standard, a court "must consider plausible, nonculpable explanations for the defendant's conduct, as well as inferences favoring the plaintiff." A complaint will survive only where a reasonable person would deem the inference of scienter "cogent and at least as compelling as any opposing inference" that could be drawn from the facts alleged.

The formulation of the scienter standard adopted by the U.S. Court of Appeals for the Second Circuit is illustrative. Under that standard, a plaintiff may sufficiently plead scienter by alleging facts showing either that the defendant had both motive and opportunity to commit fraud, or strong circumstantial evidence of conscious misbehavior or recklessness. *See Novak v. Kasaks*, 216 F.3d 300, 307 (2d Cir. 2000). Only an "extreme departure from the standards of ordinary care . . . to the extent that the danger was either known to the defendant or so obvious that the defendant must have been aware of it" may constitute recklessness severe enough to give rise to liability. Quotation marks omitted.)

Courts have found scienter to be insufficiently pled where, for example:

- The plaintiffs alleged that the defendant attempted to inflate its stock price to reduce the cost of acquiring another financial institution, among other things, and that the individual defendants were motivated to increase their compensation and bonuses. See *ECA & Local 134 IBEW Joint Pension Trust of Chicago v. JP Morgan Chase Co.*, 553 F.3d 187, 200–01 (2d Cir. 2009).
- The plaintiffs' confidential witness allegations asserted that various managers at a subsidiary had knowledge of undisclosed customs violations, and that high-level officers of the defendant would meet with subsidiary management. *See Rahman v. Kid Brands, Inc.*, 736 F.3d 237, 243–44 (3d Cir. 2013).

Reliance

Reliance, sometimes called transaction causation, provides the requisite causal connection between an alleged misstatement or omission and the plaintiff's injury.

In cases involving affirmative misstatements, the most direct way to demonstrate reliance is to show that the plaintiff was aware of a company's statement and engaged in the relevant transaction based on that specific misrepresentation. *Erica P. John Fund, Inc. v. Halliburton Co.*, 131 S. Ct. 2179, 2185 (2011).

Where omissions are at issue, reliance may be presumed under certain circumstances. In *Affiliated Ute Citizens v. United States*, 406 U.S. 128 (1972), the Supreme Court held that where a plaintiff alleged that the defendant breached an affirmative duty to disclose certain information, the plaintiff did not need to show proof of reliance on the purported omission. Rather, it was enough to show that the withheld facts were material, or important to a reasonable investor. Under the *Ute* presumption, lack of reliance remains a viable defense in omission cases, effectively shifting the burden to the defendant to demonstrate that the plaintiff did not rely on the omission.

Another reliance presumption available to plaintiffs is based on the fairly controversial fraud on the market theory. Under this theory, plaintiffs are afforded a presumption that the prices of shares traded in an efficient market reflect any material misrepresentations. Therefore, the typical investor who buys or sells stock at the market price does so in reliance on the belief that the price reflects all public, material information. *See Halliburton v. Erica P. John Fund, Inc.*, 134 S. Ct. 2408, 2398 (2014). This commonly used presumption permits class action plaintiffs to avoid individualized issues of reliance when moving to certify a class.

To invoke the presumption, the plaintiffs must show that:

- The misrepresentations were public;
- The misrepresentations were material;
- The securities traded in an efficient market; and
- The plaintiffs traded between when the misstatements were made and when the truth was disclosed.

Recently, in *Halliburton Co. v. Erica P. John Fund, Inc.*, the Supreme Court clarified that defendants must be given the opportunity before class certification to defeat this presumption through evidence that an alleged misrepresentation did not actually affect the market price of the stock. If it did not, the prerequisites for establishing the presumption cannot be established. 134 S. Ct. at 2414.

Loss Causation

Under Section 10(b), a plaintiff must demonstrate loss causation, or a link between a misstatement or omission and the damages sought. Put differently, the misrepresented or concealed information must have negatively affected the stock price. *See Dura Pharms.*, 544 U.S. at 346.

A plaintiff often makes this showing by pointing to a subsequent disclosure that seeks to correct the alleged misstatement or omission and triggers a negative response from the market, commonly known as a corrective disclosure. *See, e.g., In re Omnicom Grp., Inc. Sec. Litig*., 597 F.3d 501, 511 (2d Cir. 2010).

Defending Section 10(b) Claims

Among other defenses to a Section 10(b) action, a defendant may assert that the plaintiff's claim does not involve securities listed on a U.S. exchange or a domestic transaction, or that the claim was not brought within the applicable statutory period.

Extraterritoriality

The Supreme Court has interpreted Section 10(b) to apply only to securities listed on domestic exchanges or domestic transactions in other securities. *See Morrison v. Nat'l Austl. Bank Ltd.*, 561 U.S. 247, 273 (2010). Therefore, private claims under Section 10(b) are not actionable if the relevant securities were not listed on a US exchange and the purchase or sale did not occur within the US.

In considering whether a transaction involving securities that are not listed on a US exchange may be deemed domestic under *Morrison*, the Second Circuit has articulated a test that looks to whether "irrevocable liability is incurred or title passes within the United States." *Absolute Activist Value Master Fund Ltd. v. Ficeto*, 677 F.3d 60, 67 (2d Cir. 2012).

Recently, the Second Circuit clarified that "while a domestic transaction or listing is *necessary* to state a claim under § 10(b)," it may not be *sufficient*. *Parkcentral Global Hub Ltd. v. Porsche Auto. Holdings SE*, 11-397-CV L, 2014 WL 3973877 at *15 (2d Cir. Aug. 15, 2014). Thus, on the facts of that case, the Circuit found that a claim against foreign defendants based on "largely foreign conduct, for losses incurred by the plaintiffs . . . based on the price movements of foreign securities would constitute an impermissibly extraterritorial extension of the statute."

Timeliness

A plaintiff's ability to bring claims under Section 10(b) faces two temporal limitations, both of which must be satisfied: claims must be brought within two years of "discovery of the facts constituting the violation," and not more than five years after the alleged violation. 28 U.S.C. § 1658(b).

The two-year limitations period is triggered once the plaintiff discovers, or with reasonable diligence should have discovered, the facts constituting the violation, whichever comes first. *See Merck & Co. v. Reynolds*, 559 U.S. 633, 653 (2010). In other words, where the plaintiff never actually learned of the alleged fraud, the limitations period commences when "a reasonable investor conducting . . . a timely investigation would have uncovered the facts constituting a violation." *City of Pontiac Gen. Employees' Ret. Sys. v. MBIA, Inc*., 637 F.3d 169, 174 (2d Cir. 2011). A fact is sufficiently discovered in this context when "a reasonably diligent plaintiff would have sufficient information about that fact to adequately plead it in a complaint."

The PSLRA and SLUSA

In 1995, Congress passed the PSLRA, which contained a number of procedural reforms applicable to Section 10(b) class actions, including, among other things:

- A heightened pleading standard that requires plaintiffs to identify each allegedly fraudulent statement; explain why each statement purportedly is fraudulent; state with particularity facts giving rise to a "strong inference" that the defendant acted with scienter; and plead and prove that the alleged misconduct caused the purported loss. 15 U.S.C. §§ 78u-4(b)(1)-(2), (4).
- A safe harbor for forward-looking statements that were accompanied by mean-

ingful cautionary language or were not knowingly false when made. 15 U.S.C. § 78u-5(c)(1); *see also Slayton v. Am. Express Co.*, 604 F.3d 758, 765–66 (2d Cir. 2010).

- An automatic stay of discovery during the pendency of a motion to dismiss, absent a finding "that particularized discovery is necessary to preserve evidence or to prevent undue prejudice to [either] party." 15 U.S.C. § 78u-4(b)(3)(B).
- A cap on damages that is limited to the difference between the price a plaintiff paid for a security and that security's mean trading price over the 90 days after corrective information was released to the market. 15 U.S.C. § 78u-4(e)(1).
- New procedures relating to appointment of class action plaintiffs and counsel, meant to ensure that the lead plaintiff has a significant stake in the litigation. 15 U.S.C. § 78u-4(a)(3).

Because of the new restrictions on who may be the lead plaintiff in a securities class action, lead plaintiffs are now usually institutional investors, who tend to have a larger financial stake in the company than individual shareholders.

To prevent plaintiffs from circumventing the PSLRA's requirements by filing state securities class actions, Congress passed SLUSA in 1998. SLUSA provides that no "covered class action" may be brought under state law by a private party alleging, among other things, "a misrepresentation or omission of a material fact in connection with the purchase or sale of a covered security." 15 U.S.C. § 78bb(f)(1)(A). If a class action that meets the statutory requirements is brought in state court, it may be removed to federal court and dismissed on preemption grounds. 15 U.S.C. §§ 78bb(f)(1)-(2).

The statute defines "covered class action" as any lawsuit or group of lawsuits, not including derivative suits, involving common questions of law or fact in which "damages are sought on behalf of more than 50 persons or prospective class members." 15 U.S.C. § 78bb(f)(5). The causes of action that are expressly excluded from SLUSA's reach and may be brought in state court include:

- State law claims arising in the proxy solicitation or tender offer context relating to an equity holder's decision on how to vote, or in exercising dissenters' rights or appraisal rights, commonly known as the Delaware carve-out. 15 U.S.C. § 78bb(f)(3)(A)(ii);
- Securities suits brought by a state, political subdivision of a state or state pension plan. 15 U.S.C. § 78bb(f)(3)(B); and
- Actions under contractual agreements between issuers and indenture trustees to enforce conditions of the indenture. 15 U.S.C. § 78bb(f)(3)(C).

The Supreme Court has addressed the scope of SLUSA preemption twice since the statute's enactment.

In *Dabit*, the Supreme Court held that SLUSA's preemption of state securities suits encompassed claims by plaintiffs who alleged to have held (rather than sold) securities in reliance on a misrepresentation. The Supreme Court reached this conclusion despite the fact that these "holder" plaintiffs also cannot bring a Section 10(b) action, resulting in complete preclusion of these class actions in either forum. The Court reasoned that the PSLRA and SLUSA were motivated by many of the same policy considerations regarding vexatious litigation that anchored the decision in *Blue Chip Stamps* to limit 10(b) claims to purchasers and sellers, and a narrow reading of the statutes would undercut that purpose. Further, use of Section 10(b)'s "in connection with the purchase or sale" requirement in SLUSA suggested congressional intent to give the language its settled judicial interpretation.

The Supreme Court recently interpreted SLUSA preemption again in *Chadbourne & Parke LLP*, 134 S. Ct. at 1065–66. Addressing the "in connection with the purchase or sale" language, it held that SLUSA did not preempt state law fraud claims involving the purchase of certificates of deposit, which were not covered securities. Because SLUSA's primary focus is on transactions in covered securities, the Supreme Court reasoned, SLUSA preemption applies only to matters "where the misrepresentation makes a significant difference to someone's decision to purchase or sell a covered security."

* * *

Eighty years after the Exchange Act was enacted, the scope of liability under Section 10(b) continues to evolve. While shareholder class actions may threaten companies with potentially large exposure, the PSLRA, SLUSA and several recent Supreme Court decisions have given defendants tools that may be effectively employed to halt meritless cases at the pleading or class certification stages.

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BUSINESS LAW TODAY

Keeping Current:

SEC Charges Broker-Dealer for Failure to Protect Against Insider Trading by Employees

By Daniel A. Nathan and Tiffany A. Rowe

The Securities and Exchange Commission for the first time brought charges against a broker-dealer for failure to adequately protect against insider trading by its employees. The charges stem from a broker's use of a customer's confidential information to purchase shares in a company being acquired by a private equity firm. (The SEC previously charged the broker with insider trading in a separate action.) The broker-dealer that employed the broker settled charges of violations of the securities laws for failing to adequately establish, maintain, and enforce policies and procedures reasonably designed to prevent insider trading by employees with access to confidential client information.

Since 1988, the federal securities laws have required broker-dealers to establish, maintain, and enforce written policies and procedures, consistent with the nature of their business, to prevent the misuse of material nonpublic information. The policies and procedures must be tailored to the specific circumstances of the business, and broker-dealers (and investment advisers) must not only adopt such procedures but also vigilantly review, update, and enforce them.

As the SEC's settlement order points out, broker-dealers obtain material nonpublic information (MNPI) in various ways, including through their investment banking business and research operations, or from their customers. These various channels of obtaining MNPI and the risks of potential misuse make monitoring of trading by the firm, its registered representatives, and its customers critical to complying with the supervision requirements.

Procedural Deficiencies

In its settlement order, the SEC found that the broker-dealer, failed to establish, maintain, and enforce policies and procedures reasonably designed to prevent the misuse of MNPI, specifically, any MNPI obtained from its customers and advisory clients. In 2010, the risk became reality when a registered representative of the firm used information from one of his customers before the information was publicly announced. The representative traded on the basis of that information and also tipped others, including several customers of the broker-dealer.

The SEC found that the principal failure of the firm's procedures occurred when the compliance group reviewed the representative's trading after the public disclosure of the acquisition but did not share information about the trading with other compliance groups in the firm or with senior management.

The SEC faulted the firm's insider trading procedure that required a "look-back" review of trading in employee accounts and in customer and client accounts after announcements that significantly affect the market. Specifically, the firm's written guidance regarding the look-back review procedures was insufficient. Among other things, the firm did not provide appropriate guidance on actions to be taken by employees with respect to:

- Parameters to be considered by the firm's control group regarding the daily identification of market-moving news stories to identify securities warranting a trading review, and the documentation of work performed on those trading reviews;
- Additional review to be conducted by the control group when it found "red flags" such as profits or losses avoided greater than $5,000, trading by an "insider," or trades in any accounts in the same branch as an insider;
- The procedure for performing personnel interviews upon identification of "red flags" and for escalating reviews of suspect trading to the control group manager when there was not a "sufficient explanation for the basis of the trade" provided during the review;
- The documentation of the look-back review performed on trading reviews, which made it nearly impossible for firm management to determine whether the firm's policies and procedures were followed when conducting the reviews.

The SEC also found that the firm's policies and procedures failed to address how to consider options trading as part of the look-back reviews.

Failures to Implement the Policies and Procedures

The firm also failed to implement the policies and procedures in several ways, according to the Order.

- For a period of 10 months, the compliance department failed to perform reviews in a timely manner of at least 40 instances of suspected insider trading flagged for review;
- The procedures requiring the reviewer to print news stories for the review file was not consistently met and doing so was not an adequate means of ensuring enforcement;
- The requirement that the reviewer contact the branch if any red flags were found was not enforced.

Because the policies and procedures implemented by the broker-dealer did not assign responsibility to particular units and did not address coordination, in the instance of insider trading underlying this action, each of the units failed to:

- Recognize the significance of the indications of insider trading;
- Properly consider those indications; and
- Elevate those indications within their own group or communicate with other groups responsible for surveillance of trading activity.

Failure to Detect This Insider Trading

The SEC found that the compliance officer responsible for the look-back procedure incorrectly concluded, in reviewing the particular trading at issue, that several suspicious factors were not red flags. These included the fact that the broker and his customers had purchased the subject securities within 10 days before the announcement of the acquisition, and that their purchases were the top four positions in those securities across the entire firm. Accordingly, the compliance officer failed to escalate the matter or contact the branch, and closed the review with no findings. Because of that disposition, her supervisors were unaware that the review had been conducted and failed to coordinate with other departments in the firm, including the anti-money laundering group, and the central unit that reviewed trade data, which also had received indications suggesting the misuses of MNPI by the representative in the particular security.

Takeaways from This SEC Action

Notably, the SEC did not take issue with the firm's general strategy for preventing the misuse of MNPI. However, the SEC found that the firm's resources and policies and procedures for executing the strategy were deficient, and the implementation of those policies and procedures was lacking. Broker-dealers and investment advisers should review their policies and procedures with the SEC's cautionary findings in mind; as the SEC and FINRA have told the industry repeatedly, review of firms' procedures for preventing insider trading is a top priority.

The potential procedural gaps that firms should look for include:

- The failure to devote sufficient personnel to regular review of trading prior to material public announcements;
- Insufficient communication, cooperation, and assignment of responsibility among groups or units with overlapping responsibility regarding insider trading policies and procedures;
- Inconsistencies in application of policies and procedures; and
- Insufficient guidance to compliance personnel responsible for those policies and procedures. The guidance should be as specific as possible, and those carrying out the policies should be closely supervised.

Firms should carefully address these gaps at all personnel levels and ensure a "tone at the top" that encourages proper protection of MNPI in possession of the broker-dealer and its registered representative and other personnel. Means of doing so include:

- Robust employee education on insider trading laws and standards pertaining to the identification and protection of MNPI and frequent updates and refreshers on these issues;
- Implementing policies and procedures that provide significant guidance on indications of possible insider trading, including examples of varying types of indicators that may present themselves in different ways;
- Specific and consistent documentation of investigations and reviews that are conducted, including a discussion of the methods of review used; and
- Testing the effectiveness of the procedures, including adopting a schedule of "surprise" compliance reviews to ensure that the policies and procedures are being followed and are in fact identifying the risk of trading on MNPI.

Conclusion

As stated, regulators have emphasized this area, and if past trends are any indication, they will seek to build on this case by looking for other control systems failures. Indeed, any instance of insider trading by a registered representative is likely to prompt an investigation of any gaps that might have failed to detect it. Firms risk getting swept up in the vortex surrounding prosecution of insider trading. To avoid it, they should ensure that their policies and procedures reflect all of the applicable guidance, and that those policies and procedures are being implemented appropriately.

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BUSINESS LAW TODAY

Keeping Current:

The New York State Supreme Court Commercial Division: Past, Present, and Future

By Hon. Timothy S. Driscoll

In 1995, under the leadership of then-Chief Judge Judith Kaye, New York State established the Commercial Division of the Supreme Court. Upon its creation, the Commercial Division was one of the first state court trial divisions devoted entirely to business cases.

Fast forward almost 20 years later. The success of the Commercial Division can be measured by the depth and breadth of the cases over which its judges preside, the active and innovative management techniques employed by individual judges to manage cases of ever-increasing complexity, and the desire of nearly all counsel who are litigating a business case to have their matter heard in the Commercial Division. The four judges from New York County (Manhattan) who originally comprised the Commercial Division have grown to over 25 judges throughout New York City, its suburbs, and the remainder of the state. The Commercial Division has its own procedural rules, found at 22 NYCRR § 202.70, which are designed to ensure the expeditious resolution of cases assigned to the division.

Responding to calls from the business community and the bar to ensure that the Commercial Division reflected the stature of New York State as a commercial center of the nation and indeed the world, Chief Judge Jonathan Lippman convened a Task Force co-chaired by now-former Chief Judge Kaye and commercial practitioner Martin Lipton of Wachtell, Lipton, Rosen & Katz to recommend ways in which the Commercial Division could retain its quality, reliability, and visibility. That Task Force, which included judges and attorneys from private practice, government, corporations, and academia, issued a report in June 2012. The report recognized that the Commercial Division "provides a benefit to the economy and society of New York and an incentive to businesses to locate in New York." Nevertheless, the Task Force recommended various areas of focus to "ensur[e] that the Commercial Division continues to earn that approbation." Those recommendations were divided into six categories: (1) revising the docket of the Commercial Division, (2) providing additional support for the Commercial Division judges, (3) reforming the procedures by which cases are assigned to and managed by the Commercial Division, (4) facilitating early resolution of Commercial Division cases, (5) supporting international arbitration of commercial cases, and (6) addressing long-term strategic goals for the Commercial Division.

Acting upon the suggestion in the last category, in March 2013 Chief Judge Lippman appointed a statewide Advisory Council on the Commercial Division. The Advisory Council, chaired by Robert Haig of Kelley Drye & Warren, consists of over 40 judges and attorneys from throughout the state. The Council has already formulated proposals to implement a significant number of the Task Force's recommendations, which have in turn been adopted by Chief Administrative Judge A. Gail Prudenti upon the advice and consent of the Administrative Board of the New York State Courts. Among the highlights of the Advisory Council's proposals that have been adopted thus far are:

1. Increased Monetary Thresholds for Commercial Division Cases

The monetary threshold for assignment of a case to the Commercial Division had ranged from $25,000 to $150,000, depending on the geographic area of the state. Initially focusing on New York County, which has a plurality of the Division's judges and cases, the Task Force recommended, and the Administrative Board adopted, a threshold of $500,000 for new cases filed there, and a doubling of the threshold in nearly every other geographic area.

2. More Robust and Timely Expert Disclosure

New York State's Civil Practice Law & Rules (CPLR) differs markedly from the federal rules regarding expert disclosure. The federal rules, of course, require fulsome disclosure of the expert's opinions, including the opportunity to depose the expert. Not so the CPLR. It requires only the disclosure in "reasonable detail" of the subject matter of the expert's testimony and the expert's opinions, as well as the qualifications of the expert, and does not expressly permit a deposition. Moreover, the CPLR does not contain any specific time requirement by which an expert must be disclosed.

The Task Force expressed concern that this led to a lack of predictability and efficiency in Commercial Division cases, and thus the Commercial Division rules were amended to require expert disclosure that largely mirrors the practice in federal court.

Under the new rule, the parties are to confer on a schedule for expert disclosure no later than thirty days prior to the completion of fact discovery, and shall complete expert disclosure no later than four months after the completion of fact discovery. Expert disclosure is to be accompanied by a written report, and the expert is subject to a deposition. Finally, expert disclosure that is not timely provided can result in preclusion of that expert from testifying at trial.

3. Limitations on Privilege Logs

Privilege logs are often described as the bane of any commercial litigator's existence, surpassing only slightly the desire of judges to review those logs. Privilege logs often spawn satellite litigation that is costly and delays resolution of the case. The ubiquity of electronic discovery has increased these difficulties almost logarithmically. The Advisory Council thus recommended, in recognition of the successful protocol in place in the Delaware Court of Chancery, that the parties meet and confer throughout the case to discuss the scope of privilege review, and use categorized designations for privileged documents rather than individual listings in a privilege log. The parties are further required to designate an attorney to supervise the privilege review process. In the event that a party requesting documents refuses to permit a categorical approach, and instead insists on a document-by-document listing, the producing party may apply to the court for allocation of costs incurred in producing such a document-by-document log.

4. Limitations on Interrogatories

Mirroring the local rule in the United States District Court for the Southern District of New York, the Commercial Division rules now limit to 25 the number of interrogatories that a party may serve, and restricts their scope to (1) names of witnesses who have information "material and necessary" to the subject matter in the action, (2) the computed amount of alleged damages, and (3) the location and description of any "material and necessary" documents and other physical evidence. Parties may consent to the waiver of these limitations, or the court may permit deviation from the limitations upon a showing of good cause.

5. Establishment of a Pilot Program for Mandatory Mediation

As anyone who has participated in a complex commercial dispute knows, business cases are extremely expensive to litigate. Both the Task Force and the Advisory Council quickly learned that the business community clamored for mandatory mediation at the outset of a case. Judges, however, had individual practices and predilections that might not be as hospitable to mediation. A pilot program for New York County was thus established in which one of every five new cases in that county is designated for mandatory mediation upon assignment to a judge. The parties can either jointly select a mediator or request appointment of a mediator by the court. The parties are then to advise the court as to the success of the mediation within seven months of the date on which the case was initially assigned to the judge. The program does have flexibility, as the parties can either stipulate that they wish to opt out of mediation or can request that, upon a showing of good cause, the assigned judge exempt the matter from the program. This program was launched as a pilot on July 28, and will be in place for 18 months.

6. The Opportunity for Accelerated Adjudication of Commercial Disputes

Imagine a commercial case being ready for trial in nine months! That is the reality, upon the parties' consent – including such consent in a contract signed in the course of the parties' business dealings. The Commercial Division's new accelerated adjudication procedure will render a case trial ready in nine months. This procedure requires the parties to (1) agree to waive any defenses based on lack of personal jurisdiction or *forum non conveniens*, and also waive heir rights to trial by jury, punitive damages, and any existing right to an interlocutory appeal, and (2) significantly narrow their discovery requests, including no more than seven interrogatories, five notices to admit, and seven discovery depositions of no more than seven hours each.

The Advisory Council looks forward to continuing to work to ensure that businesses, as well as the lawyers who represent them, can rely on the Commercial Division of the New York State Supreme Court for the efficient and expert resolution of business disputes.

Hon. Timothy S. Driscoll is a Justice of the Supreme Court of the State of New York, Nassau County Commercial Division.

BUSINESS LAW TODAY

Keeping Current:

Delaware Appraisal: Practical Considerations

By Steven Epstein, Philip Richter, Robert C. Schwenkel, and Gail Weinstein

As has now been widely noted, the number of post-merger appraisal petitions in Delaware has increased significantly in recent years. Through 2010, the number of appraisal petitions filed in Delaware roughly paralleled overall merger activity, with appraisal rights being asserted in about 5 percent of the transactions for which they were available. In 2011, the rate of petitions doubled to 10 percent. In 2013, 28 petitions were filed in Delaware, representing 17 percent of appraisal-eligible transactions. The amounts at stake have increased as well, with the value of dissenting shares seeking appraisal in 2013 ($1.5 billion) being 10 times the value of dissenting shares in 2004, and more than five times the value of dissenting shares at their highest point in the last five years. In 2014, 20 appraisal claims have been filed in Delaware through August.

Most of this increased activity is due primarily to the rise of appraisal arbitrage as a weapon of shareholder activists seeking alternative methods of influence and value creation in the M&A sphere. "Appraisal arbitrage" refers to the acquisition of target shares by hedge funds and activist investors after announcement of a merger, with the purpose of seeking appraisal rights (often accompanied by a call to other stockholders not to vote for the merger and to join in seeking appraisal rights for their shares). As shareholder activists acquire large equity stakes in companies in anticipation, or after announcement, of a bid for a company, appraisal rights offer a route to increased profit if a board negotiates a lower than expected price. Moreover, appraisal offers an alternative route to profit – without the challenge of having to prove any wrongdoing in connection with the transaction – if a breach of fiduciary duties action against a board is not successful.

The basic arbitrage opportunity presented by appraisal rights stems from the Court of Chancery's 2007 *Transkaryotic* decision, where the court, against expectations, held that investors that buy target company shares *after* the record date for the vote on a merger can still assert appraisal rights. This decision provided the foundation for activists and hedge funds to emerge as "appraisal investors," delaying until the date of the stockholders meeting a decision on whether to buy target company stock for the purpose of pursuing an appraisal action. With this timing advantage, investors can review information in the company's proxy statement relating to its sale process and fairness of the price, can assess any pre-closing shareholder litigation that has been commenced, and can evaluate market, industry, and target company conditions at a time much closer to the merger closing date (as of which time the court will determine fair value in an appraisal proceeding), as compared to the time when the deal price was negotiated and then voted on.

A number of funds have been established that are devoted exclusively to appraisal actions as independent investment opportunities. Merion Capital, which has filed more than 10 Delaware appraisal actions, in late 2013 reportedly raised $1 billion for a fund dedicated to appraisal claims. Major mutual funds and insurance companies – institutions that have not been significantly involved in standard stockholder litigation – also have recently filed appraisal petitions. Appraisal arbitrage now commonly affects the public dynamics surrounding challenges to deals and can have a significant effect on the certainty and ultimate price paid in deals.

Even the threat of appraisal actions now commonly affects deal dynamics. Activists publicly and aggressively encourage other stockholders to join in an appraisal proceeding, increasing the threat of the proceeding to the target board – and thus, as a result, the activist's leverage in negotiating a settlement. Companies face significant risks that an appraisal proceeding may lead to a large appraisal award (even more problematic if financing arranged for the transaction will not be sufficient), or may lead to the transaction not being approved by the requisite stockholder vote (even more problematic if the required vote is a majority of all outstanding minority shares, since stockholders who want to seek appraisal cannot vote in favor of the merger). These risks prompt many companies to reach settlements (which often are large) with shareholders seeking appraisal rights. In the Dell going private transaction, for example, the threat by Carl Icahn and others to seek appraisal of the shares they had amassed after announcement of the deal effectively blocked the required shareholder vote (a majority of the minority shares outstanding) and led to a $400 million increase in the merger price paid to shareholders (as recently discussed publicly by legal counsel to the Dell special committee).

Why Appraisal Actions Were Rare In the Past

Appraisal litigation historically has been considered to be risky and costly. The wide discretion the court has under the statute to determine fair value makes the outcome of appraisal proceedings unpredictable. Fair value for these purposes is the going concern value of the company assuming the transaction giving rise to appraisal rights had not occurred (that is, excluding the value of merger synergies and a control premium). The appraisal proceeding usually involves a "battle of the experts" on both sides, with the burden ultimately on the court itself to make the determination of fair value, based on any methodology generally considered acceptable in the financial community. The methodology most often used by the court to determine going concern value is a discounted cash flow analysis, which is based in large part on assumptions and projections that themselves can be highly uncertain, including the company's internally generated projections and speculative data about how the company would have performed if the merger had not occurred.

Also, there are strict procedural requirements mandated by the statute and the process is typically quite lengthy and expensive. A key limiting factor to the attraction of appraisal actions has been the long period of time that a dissenting shareholder has its investment tied up while the proceeding is pending. The process usually lasts at least two years and involves a multi-day trial on the merits with extensive testimony from financial experts on both sides, as well as post-trial briefing and arguments. Importantly, unlike other litigation challenging a deal, stockholders are unable to proceed as a class and shift attorneys' fees to stockholders as a whole or to the defendants.

Why Appraisal Actions Have Increased

In addition to the phenomenon of appraisal arbitrage, discussed above, the well above market statutory interest payable on appraisal awards – 5 percent above the Fed discount rate, compounded quarterly and accruing from the closing date of the transaction to the date the appraisal award is actually paid – has encouraged the filing of appraisal petitions. Other factors include the increased stockholder challenges of all types to deals generally; an increase in the number of going private, management-led buyout and controller transactions, where conflicts of interest create skepticism about the deal price; and the willingness of the Delaware courts to consider a wide variety of arguments as to why fair value in a given case should be more than the merger price, often leading to appraisal awards higher than the merger price.

Results of the Delaware Appraisal Cases

An analysis of the post-trial appraisal decisions issued in Delaware since 2010 (summarized in the chart below) indicates that the court's appraisal determinations have exceeded the merger price in all but two cases – with the appraisal determinations representing premiums over the merger price ranging from 8.5 percent to 149 percent (with an average of 61 percent). The statutory interest paid on the appraisal awards represented an additional premium over the merger price of 11.7 percent to 214 percent (accrued over the period of the appraisal proceedings, which ranged from 2 years to 12.4 years, averaging 3.6 years). In the five cases that the court viewed as "interested" transactions (that is, mergers involving a controlling stockholder, parent-subsidiary, or management buyout), the appraisal amount was higher than the merger price in every case, with premiums over the merger price (not including the statutory interest) ranging from 19.5 percent to 149 percent. Notably, the sale process in each of these cases had not included a market check. The highest premium was awarded in a case in which an arbitration panel had already determined that the only reason for the merger was to eliminate the petitioner as the sole remaining minority stockholder – "without notice and without legal justification"; and that the court found involved "strong-arm tactics" by the controlling stockholder and a process that was "anything but fair."

By contrast, in the four transactions viewed by the court as "disinterested" (i.e., third party arm's length transactions), the fair value determination was higher than the merger price in two of them, but with premiums above the merger price (8.5 percent and 15.6 percent, respectively) that were below those in the interested transactions. In one of the disinterested transactions, the appraisal amount was equal to the merger price; and in one the appraisal amount was below the merger price (representing a 14.4 percent discount to the merger price).

Practical Considerations

The Overall Risk of Appraisal Arbitrage Has Been Overstated

Notwithstanding the notable increase in appraisal activity, it is 17 percent of appraisal-eligible transactions that attract appraisal petitions – while almost *all* strategic transactions now attract fiduciary duty litigation. Moreover, while the only consideration in an appraisal determination is the determination of going concern value just prior to the merger (and wrongdoing by the target board or flaws in the sale process have be held by the court to be legally irrelevant for these purposes), the transactions that attract appraisal petitions, and that result in appraisal awards with the highest premiums over the merger price, are transactions that involve some basis for a belief that the deal price significantly undervalued the company (i.e., interested transactions).

Need to Consider the Likelihood of Appraisal Petitions and the Possible Effect on the Transaction

In general, acquirors must evaluate the possibility of an appraisal proceeding being a component of the process in mergers and acquisitions transactions. If an arm's length transaction has been subject to an aggressive competitive process, the pursuit of appraisal then would seem more unlikely. At the other extreme, a transaction with a company controller or a private equity deal with major management participation would be a probable suspect for the assertion of appraisal rights, particularly if the sale process appears to raise questions. Other transactions between these extremes will require a careful evaluation of the facts and circumstances to determine the likelihood of appraisal rights being sought and, if so, the possible effect on the transaction.

The obvious advice is that buyers need to build into their financial models the possibility of an appraisal award after the transaction closes. The advice is problematic, however, given both the effect on the bid's competitiveness and the potentially significant amount of the appraisal award (plus the above market interest). The anticipated internal rate of return for a transaction can be significantly adversely affected by an unanticipated post-closing cost (whether due to a court determination or settlement of an appraisal claim or of fiduciary litigation), and it is very difficult to model for such an outcome. Of note, appraisal settlements have become increasingly difficult to reach as investors focus on the benefits of the above market interest rate that accrues until payment of the appraisal award.

Increased Risk and Uncertainty for Transactions

The increased strategic use and threat of appraisal actions can increase uncertainty and risk both for buyers and sellers. Closing uncertainty for both sides increases with inclusion of an appraisal rights condition (discussed below). Without an appraisal rights condition, buyers are faced with the uncertainty that a significant payment may become payable to dissenting shareholders post-closing; that arranged financing may not cover the full required payment to shareholders (because the amount payable to dissenting shareholders will be uncertain even after closing); and that a shareholder vote requiring a percentage of all outstanding disinterested shares may not be obtainable (because dissenting shares cannot vote). Moreover, investors can threaten appraisal without later following through – providing a no-cost route to exerting the pressure that results from actually bringing an appraisal action.

Importantly, the company's sale process, as well as the range of fairness established by the target company's bankers, is unknown to the buy-side party until the company's proxy statement is furnished to shareholders. A buyer – for example, a private equity firm in a management-led buyout (where the court can be expected to be skeptical of the transaction) – may want to try to avoid attracting appraisal petitions by offering a price at the high end of the fairness range and by acquiescing in (or even encouraging) a robust sale process by the seller. Critically, however, even in this case, the buyer has no certainty as to whether the seller may have improperly prepared the company projections, conducted the market check or dealt with any conflicts, or otherwise may have acted in ways that could render the process unreliable – and thus invite appraisal demands. Buyers, particularly those in transactions that will be most at risk for attracting appraisal petitions, may begin to seek ways to obtain some protection in this area, such as, possibly, including representations as to the process in the merger agreement or requiring information about the process before signing the merger agreement.

In addition, there is uncertainty about how the court will determine fair value in any given case. As discussed above, it is reasonably predictable that an arm's length transaction that included a meaningful market check will not result in an appraisal determination significantly above the merger price, and that an interested transaction without a meaningful market check may well result in an appraisal determination significantly above the merger price. It is not necessarily predictable, however, what the result will be in any given case that falls between these extremes – i.e., where in an arm's length transaction there has been a less than perfect market check or in an interested transaction there has been a meaningful market check. Certainly, a court, when it evaluates the extent to which a deal price is a relevant factor in determining fair value, will be more likely to give deference to the deal price if it was reached after an arm's length negotiation in a pristine sale process that included an effective market check.

Consideration of an Appraisal Condition to a Merger

Acquirors may again consider use of appraisal rights conditions, which used to be common – i.e., a condition to the merger that not more than a specified percentage, often 10 percent, of the outstanding target shares seek appraisal rights. Of course, sellers will resist this condition as it effectively reallocates the risk associated with appraisal rights to the seller. Buyers in a competitive process will be wary to include this condition as it would be likely to significantly diminish the competitiveness of the bid as compared to bids not imposing the condition. An appraisal rights condition may be most attractive to (or even necessary for) a financial buyer or a buyer with significant financing needs for the transaction.

Importantly, it is difficult to predict the effect of an appraisal rights condition on a transaction. On the one hand, the condition helps to provide more certainty to the acquiror by limiting the potential exposure to appraisal rights. On the other hand, the condition may provide more leverage to last-minute opportunistic investors who can threaten to derail the deal by triggering the condition, thus causing more uncertainty for both the buyer and the seller. At the same time, though, it may be that activists and hedge funds will ensure that the condition is *not* triggered, as their least preferred alternative will be a deal that does not close (in which case they would receive neither the merger price nor appraisal rights).

Conclusion

Despite the significant increase in the filing of appraisal petitions in recent years, and the not insignificant uncertainty associated with appraisal cases, appraisal petitions still are not filed in a large majority of transactions (with about 17 percent of appraisal-eligible transactions attracting petitions in 2013, as compared to almost all strategic transactions now attracting fiduciary duty litigation); appraisal cases are largely self-selecting for transactions in which the apparent facts provide a basis for believing that the merger price significantly undervalues the company; and, when an appraisal case is brought, it is unlikely that the appraisal determination will significantly exceed the merger price in a non-interested transaction that included a meaningful market check.

Accordingly, parties to transactions, when considering merger price and sale process issues, will want to factor into that calculus the risk associated with appraisal. Target company stockholders, when deciding whether or not to seek appraisal, will want to consider the nature of the transaction and the reasonableness of the price and process—including the nature and extent of the market check in the sale process, the presence of any other features lending credibility to the merger price (such as a majority-of-the-minority stockholder vote requirement for the merger), the range of fairness determined by the target company's investment bankers in connection with their fairness opinion, the investment bankers' underlying financial analyses supporting their range of fairness, and the general reaction of the market and analysts.

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Additional Materials

For a discussion of "appraisal arbitrage," please see "The Rise of Appraisal Arbitrage," published in Insights Corporate & Securities Law Advisor (July 2014); "Perspective on Appraisal Arbitrage – and a Look at Delaware's Most Recent Appraisal Cases," Fried Frank M&A Quarterly (2nd Quarter 2014); and "New Activist Weapon – A Look at Appraisal Arbitrage Cases," published in Law360 (August 7, 2014).

Delaware Appraisal Decisions:2010 through August 2014

(in descending order by size of premium of appraised fair value over merger price)

Date	Case	Merger Price	Court's Fair Value Appraisal/ Valuation Method	Premium Over Merger Price [Additional premium represented by statutory interest]	Respondent's Fair Value/ Petitioner's Fair Value	Type of Transaction	Market Check
INTERESTED TRANSATIONS							
2/15/10	*In re Sunbelt Beverage*	45.83	114.04 DCF	148.8% [213.8%]	36.30 114.04	Controlling stockholder squeeze-out merger	No
7/18/12	*In re Orchard Enterprises*	2.05	4.67 DCF	127.8% [36.1%]	1.53 5.42	Controlling stockholder squeeze-out merger	Weak – Go-shop; no proposal received (Appraisal amount was largely based on court's determination that preferred stock liquidation payment was not triggered by merger)
6/25/14	*Laidler v. Hesco*	207.50	387.24 DCCF	86.6% [24.7%]	250.30 515	90% short-form merger	No
6/28/13	*Towerview v. Cox Radio*	4.80	5.75 DCF	19.8% [26.9%]	4.28 2.12	90% short-form merger after tender offer (6 of 8 directors affiliated with acquisition)	No
4/23/10	*Global v Golden Telecom*	105	125.49 DCF	19.5% [14.7%]	88 139	2 largest stockholders of acquiror (44% and 34%) were also 2 largest stockholders of target (25% and 18%). (Majority of acquiror's board and large portion of target's board had been appointed by these stockholders)	No – Court determined that post-signing "passive market check" (that produced no proposal) was irrelevant without guarantees by the 2 stockholders that they would support a higher bid if made
DISINTERESTED TRANSACTIONS							
3/18/13	*IQ v. Am. Commcl. Lines*	33	38.16 DCF	15.6% [13.7%]	-- --	3rd party merger	Weak – Go-shop; no proposal received
7/8/13	*Merion v. 3M Cogent*	10.50	10.8% DCF	8.5% [14.3%]	10.12 16.26	3rd party merger	Yes – but, as neither party relied on merger price, court deemed it "irrelevant"
11/1/13	*Huff v. CKx*	5.50	5.50 merger price	0%	4.41 11.02	3rd party merger	Yes – full competitive auction
4/30/12	*Gearrald v. Just Care*	40M (whole company)	34.24M DCF	(-14.4%) [11.7%]	33.6M 55.2M	3rd party merger	No – but 1 unsolicited proposal was received

BUSINESS LAW TODAY

Delaware Insider:

Private Company Financings: Delaware Court Provides Guidance for Boards and Venture Funds

By Jeffrey R. Wolters

A common fact pattern for venture-backed companies is the emergency "inside round": the company is running out of cash, new investors have not been found, and therefore the current backers – that is, the venture funds that likely control a majority of the company's stock and a majority of its board seats – agree to invest additional capital. This used to be a fact pattern that was well known in the market, but had rarely been seen in the Delaware courts. That has changed in recent years, as the Delaware courts have by now decided several notable cases concerning inside rounds – and in particular the fiduciary duties of boards in approving them.

The recent decision of the Delaware Court of Chancery in *In re Nine Systems Corporation Shareholders Litigation*, Consol. C.A. No. 3940-VCN (Del. Ch. Sept. 4, 2014), is especially instructive for private company directors, investors, and the lawyers who advise them. The case was highly critical of the process followed by directors and their VC affiliates in connection with an inside round. However, by pointing out in detail the defects in the process, the court also created a road map for running a better process and protecting directors and VCs in the future. The court also showed once again that Delaware courts are sophisticated in their analysis of valuation questions and willing to recognize that an inside round, particularly for a struggling company, may have been priced fairly even though the directors and VCs faced conflicts.

The *Nine Systems* Case

The case involved a two-year-old startup company that needed additional financing to continue operations and make acquisitions. Three venture funds designated a majority of the company's board and held a majority of its outstanding stock and debt. Two of these three agreed to invest – by buying new preferred stock and converting prior debt into stock – and the third was given the opportunity to invest. The investment was based on a $4 million valuation of the company. One consequence of the investment was that the percentage of stock owned by the company's minority stockholders decreased from 26 percent to 2 percent. Another consequence was that, eventually at least, the company turned around. It made the two acquisitions and, four years later, was acquired in a merger for $175 million.

After receiving the proxy statement for the merger, which disclosed the impact of the prior financing, the company's founder and certain other minority stockholders brought suit. They did not attack the merger, but rather the financing. They argued that because the opportunity to buy preferred stock in the financing was offered only to the venture firms that designated a majority of the board, the financing was a conflict transaction and therefore subject to the rigorous "entire fairness" test under Delaware law. Under that test, if a majority of the board has a conflict of interest in approving a transaction, or if the transaction is with a controlling stockholder or control group (which the plaintiffs also argued), then the defendants must prove that the transaction was entirely fair to the minority, both in terms of the procedure leading up to the transaction and the ultimate substance (i.e., price and terms) of the transaction. If the defendants cannot satisfy this test, then they are deemed to have breached their fiduciary duty of loyalty and may owe personal damages. It was on this basis that the case went to trial, resulting in a 146-page ruling in September.

The Court's Ruling, and a Road Map for Better Process

The court's ruling focused on a detailed application of the entire fairness test – both procedurally ("fair dealing") and substantively ("fair price"). The court ultimately found that the challenged financing was fair in terms of price, but that because the process leading up to the transaction was so "grossly unfair," the directors had breached their fiduciary duties and did not satisfy the entire fairness test.

Fair Dealing

The court's conclusion concerning the lack of procedural fairness was based on several factors. In pointing out what went wrong, the court implicitly offered a road map for getting it right.

Participation by the Independent Director

Although three of the company's five directors were conflicted, it did have one clearly independent director who was affiliated with the minority shareholder group. However, this director did not play a significant role in considering the transaction. Indeed, the court concluded that the rest of the board, rather than ensuring that this director was fully informed and involved, actually took steps to exclude him from the process (such as by holding meetings at times when they knew he could not attend and generally not keeping him informed). Further, at one point the director said he would approve the transaction subject to certain changes being made to benefit the minority; the board accepted his "yes" vote but did not follow through with the changes.

One comment by the court suggests a better path: "Biderman was independent, but there was no effort to condition the [transaction] on his approval or that of disinterested stockholders." Taking this one step further, the board also could have appointed the independent director as an independent committee. The use of independent committees is less common for private companies than for public companies, partly due to the perceived delay and expense of a committee process. But *Nine Systems* repeatedly emphasized the importance of a "contextual" approach to assessing whether a given process was fair. This suggests that a court would appreciate the contextual exigencies of a private company liquidity crisis – and would give credit for running a credible independent committee process even if it lacked all the trappings of a public company process. Such a process (i.e., one that was as good as practicable in the context) should, at a minimum, be strong evidence of fairness, even if it might not always have the full doctrinal effect of triggering the business judgment rule. One recent case did find that the business judgment rule applied to protect a private company transaction with its majority stockholder, where a committee process was coupled with a minority stockholder vote. *Swomley v. Schlecht*, C.A. No. 9355-VCL (Del. Ch. Aug. 27, 2014) (Transcript).

Finally, the court also found that the board misunderstood its fiduciary duties. The board apparently believed that the independent director was the one charged with looking out for the minority stockholders. All directors owe duties to all stockholders, the court corrected, while noting that the board's misunderstanding of its duties was itself evidence of an unfair process. Presumably this problem can be avoided in most deals in the future so long as counsel takes care to inform the directors of their duties.

Valuation

The court next found that an unfair process was shown by the fact that the board did not have explained to it or understand the valuation that drove the pricing of the challenged financing. The valuation was not prepared by the board, management, or an outside financial advisor, but rather by a principal of one of the venture investors. The court implicitly suggested two fixes. First, the valuation could have been explained to the board, with minutes summarizing the discussion and demonstrating the board's contemporaneous understanding and adoption of the valuation. Second, an outside financial advisor could have been consulted. The court noted that this was not required by Delaware law, but would often be strong evidence that the board was adequately informed concerning valuation. A middle course seems clear as well: obtain a written valuation analysis from management and build a record that the board fully understood it and concluded it was the best available valuation.

Rights Offering

The court next considered that the right to participate in the financing was offered only to the funds affiliated with the board majority, and was not effectively disclosed or offered to other stockholders. Prior Delaware cases have found that if a financing opportunity is offered pro rata to all stockholders, that generally will cleanse the conflict posed by an otherwise "inside" round. The court in *Nine Systems* reiterated this view, stating that a director "who approves a stock issuance *not offered to all stockholders* may, if he or she is in a fiduciary relationship with a recipient of the new stock, faces an inherent conflict of interest." Thus, in future transactions, use of a rights offering should be considered as a way to eliminate a conflict of interest, or, at the least, stand as strong evidence of fair process.

Disclosure

The court also found "powerful evidence of unfair dealing" in the board's failure to inform stockholders concerning the financing, particularly in a notice that was sent at the time. That notice informed stockholders that the financing had occurred, but did not disclose who participated and on what terms. The solution to this problem next time is clear: full and fair disclosure.

Changed Terms

Finally, the court also found evidence of unfair dealing in the fact that certain terms of the financing were changed, to benefit the investors, following the board's approval of the financing. Putting aside whether the final terms of the financing were even duly authorized, the fix next time is apparent: obtain board approval of the final terms.

Unitary Analysis and Fair Price

Based on the factors discussed above, the court found a "grossly unfair process." But it came out differently on the important second prong of the entire fairness test, "fair price." As with its analysis of the process, the court took a highly "contextual" approach. First, it recognized that fair price was not a single number, but instead a range. Second, and crucially, it recognized that while price issues would often be assessed based on valuation methods that relied on a company's projections (such as the discounted cash flow method), those methods were not persuasive if a company's projections were not reliable. That was the case in *Nine Systems*, where the company had only one year of forward projections, and had consistently and widely missed its projections in the past. The court thus agreed with the defendants' expert witness that the best way to value the company was not based on its forecast, but rather based on last 12 months revenue multiples for comparable companies. The court also found that it was appropriate to apply a "private company discount" to those multiples. The court ultimately concluded that the pricing of the challenged financing was fair because, based on the best valuation evidence before the court, the company's stock had no value at the time of the financing.

The Upshot

Because the price was fair, no damages were awarded, even though the process was unfair. This is the same result as the much-noted *Trados* decision last year. *In re Trados Inc. Shareholder Litigation*, 73 A.3d 17 (Del. Ch. 2013). Importantly, however, the court in *Nine Systems* also noted that a particularly bad process could "infect" a court's consideration of price fairness. Thus, while fairness of price may still be the preponderant consideration in such cases – and the main factor in assessing whether damages are awardable – the process can, at a minimum, influence the price analysis. Moreover, because they had shown such an unfair process, the plaintiffs in *Nine Systems* were invited to apply for attorneys' fees.

In the future, boards and their venture backers should be able to mitigate lawsuit risk by establishing a record, up front, of the type of valuation considerations credited by the court in *Nine Systems* and by addressing the procedural elements that undermined the board's ability to demonstrate fair dealing.

Jeffrey R. Wolters is a partner at Morris, Nichols, Arsht & Tunnell LLP in Wilmington, Delaware.

ADDITIONAL RESOURCES
For other materials related to this topic, please refer to the following.

Business Law Today

Side-Stepping Fiduciary Issues in Negotiating Exit Strategies for Preferred Stock Investments after Trados
By Lisa R. Stark
September 2013

BUSINESS LAW TODAY

Member Spotlight:

An Interview with Professor Sharon K. Sandeen

Sharon K. Sandeen is a Professor at Hamline University School of Law in St. Paul, Minnesota, and a recognized expert on trade secret law, having co-written the first casebook on trade secret law in the United States, Cases and Materials in Trade Secret Law. *She's also the co-author of* Trade Secret Law in a Nutshell.

Prior to beginning her teaching career, she practiced law for 15 years in Sacramento, California, specializing in intellectual property litigation.

Professor Sandeen received a Bachelor of Arts degree from UC Berkeley, her Juris Doctorate from the University of Pacific, McGeorge School of Law, and an LL.M. from UC Berkeley School of Law (Boalt Hall). She is the immediate past Chair of the IP Committee and the incoming Chair of the Publications Board of the Business Law Section of the American Bar Association.

* * *

Welcome Professor Sharon Sandeen. I read that your first ambition was to be a jockey. So, what happened to that dream and how did you decide to become a lawyer?

When I was little, I loved horses, so I thought I'll be a jockey. But reality set in as I got older and bigger. Also, I didn't have the means to get into horseback riding as much as I wanted. My next dream was to become a forest ranger. I liked the outdoors – hiking and backpacking. During my last year in high school, I went to a career day and I learned about becoming a lawyer and politics. After that, I got involved in local politics and that led me to become a lawyer.

What did you do in politics?

My first exposure to politics was in 1976 when I was still in high school. My local assemblyman was one of the first legislators to endorse Jimmy Carter, so my first experience in politics was to work on a Jimmy Carter for President event before the California primary. After graduating from high school, I started working in my local assemblyman's office as a legislative assistant, helping with constituent phone calls.

You're a first generation college graduate and lawyer, and you worked your way through college and law school. How did you balance it all? What were the different jobs that you did?

The first two years of college, I went to Cal State Hayward, which is now Cal State East Bay. That saved money on tuition and I could live at home. Then I transferred to Berkeley and also commuted from home. I had a lot of odd jobs during college: bookkeeper, gardening, unloading and loading trucks for UPS. I also worked at my dad's plumbing company and on several political campaigns. Following my graduation from college, I went to work for the California Legislature in Sacramento and I attended law school at night while working full-time during the day. The last year of law school, I got a job clerking with several law firms.

After reading Twenty Years at Hull-House and The Grapes of Wrath, you realized that each book told the story of one side of your family. Can you elaborate?

It's kind of embarrassing to admit that I didn't make that connection until years after I read those books. As an adult I started asking my family, how did we end up in California since both my mother and father were born in the Midwest?

With respect to one side of the family, in the early '30s, my grandfather was a farmer in northeastern South Dakota. It was essentially the *Grapes of Wrath* story where the barn burned down, there was a drought, they couldn't grow anything, they didn't have a livelihood. So, my grandparents took off for the West Coast with their five children and settled in Oakland where my grandfather became a carpenter. Fortunately, they were better off than the families depicted in the *Grapes of Wrath* because they were able to keep the farm.

With regard to the other side, the only reason I figured this out is my grandmother, who is Italian, used to talk about growing up in Chicago on Bunker Street. One day I went to the Hull House and I looked at one of their old maps and saw Bunker Street. It was then that I realized that my Italian immigrant side of the family came to United

States in the late 1800s, which is what the Addams book is about.

You're an internationally recognized expert on trade secret law. What initially drew you to this area of law?

When I was in law school, I didn't take one intellectual property law course. After graduating, I went to work at the largest law firm in Sacramento and did general business litigation. Soon after joining the firm, my brother, who is very entrepreneurial and an inventor, had one of his products knocked-off by another company. We had to sue, and I got very interested in intellectual property law. This was the late '80s and IP was not as big as it is today, but I told my firm that I wanted to develop a specialty in that area.

Because I'm not a scientist, I couldn't focus on patent law. So I focused on copyright, trademarks, and trade secrets. When I decided to leave practice and become a law professor, I went back to school at Berkeley to get my LL.M. and I decided to focus on trade secret law because there wasn't a lot of scholarship in the area.

What do you see as the most pressing issues in trade secret law today?

As I delved into trade secret law, I thought a lot of the cases were wrongly decided. My theory was that there wasn't a lot written about the theory, purpose, and evolution of trade secret law. A central concern of mine is that a lot of people do not understand that, as with patent and copyright, there are very important limits on the scope of trade secret protection. I'm trying to educate people about those limits.

Have you seen progress?

There's definitely been progress, because there's been a lot more scholarship in the area. There is a group of scholars, we call ourselves Trade Secret Scholars, who regularly meet. As a result, I think the understanding of trade secret law has improved over the past 12 years, but there are still misunderstandings, particularly among businesspeople who tend to have an expansive view of trade secret protection.

You recently wrote about storing information in the cloud and its relationship to trade secret law. Can you briefly tell us what you discovered?

There is a very well established principle under trade secret law that I call the "third-party doctrine of trade secrecy." The central point is this: if you have information that constitutes your trade secret and you give it to another person, you waive trade secret protection unless there's a confidentiality agreement between the trade secret owner and the person who's receiving the information.

So, if you upload trade secret information to the cloud are you waiving your trade secret protection? I think there are risks associated with that activity. Generally speaking, cloud service providers are not willing to promise confidentiality or privacy with respect to stuff uploaded to the cloud.

I want to move onto copyright law. There's a movement to change U.S. copyright laws which some say make it hard to access and share work online. Can you comment?

I think you're probably referring to Professor Pamela Samuelson's work and the recent formation of the Authors' Alliance, which I belong to. The way I like to describe what's going on – and it doesn't just apply to copyright, but also to trade secrets – is that now that we live in the Information Age, everyone is beginning to realize the value of information. If you can collect information, there may be an opportunity to resell it or tie advertising to it to make money.

So, there's a land grab of information going on. The concern is that we need to have balance. We have to make sure that information isn't tied up too much. In that regard, much of the history of the United States, dating back to the formation of the country, has been about increasing the diffusion of knowledge. We've seen it in the funding of public schools, public universities, and public libraries. All these efforts are designed to increase the knowledge of the citizenry on the theory that if we have an educated populace, they will be more productive and more entrepreneurial, leading to greater economic development. If we tie up information too much, we risk economic and personal development.

Whether the law needs to be changed is another question. A lot of people would say we have existing principles of law that are designed to protect these ideals. They just need to be applied better and recognized more frequently by the court and by litigants.

I'm going to switch gears. You've been teaching since 1996 and currently teach at Hamline University School of Law. What do you enjoy most about teaching?

Helping students to learn the law and legal processes. My goal is to make sure that by the time my students graduate, they have the knowledge and skills to be successful lawyers.

Do you have a favorite class to teach?

I like all the classes I teach. Mostly I teach intellectual property courses, which are taken by second and third-year law students. But I have also taught the first-year Torts course. What I love about teaching Torts is that I get to help build a foundation of knowledge for future learning.

How has law school changed over the time period since you've been teaching?

In my opinion, it hasn't changed enough, but I think it is starting to change more. One way it has changed, since I went to law school in the '80s, is that the demographics are different. There are more women and people of color. Also, there are more students with a variety of undergraduate degrees. I think this has ramifications for legal education and it ties into what you were asking me earlier about my background.

You take somebody like me, first generation college graduate and first lawyer in her family. I didn't have a lot of people in my world who could serve as role models about what it means to be a lawyer, or even what the legal system is. In the past, a lot of people who went to law school had some exposure to the law either through family members or some other way. They may have had a degree in legal studies or political science. We have students who don't have any of that.

The legal profession is changing, too. That requires law schools to change their methods of education. The big movement now is for experiential learning: trying to get students ready to practice on the theory that when they graduate, they're not going to have a mentor. For instance, at Hamline we have practicums where we put students into internships with different lawyers in different types of legal settings in order for them to get exposure to the practice of law.

The other thing we're doing at Hamline, and I think it's unique, is what I call a structured experiential learning class or lab where the student doesn't necessarily have to go offsite or represent clients, but we walk the students through a particular business negotiation or a particular litigation practice. In this way, they don't just learn the law, but they learn the steps to use to solve the problems presented by their clients.

I've read that in your first history class, that you took as an undergraduate at UC Berkeley – a class on the Reconstruction Era – no mention was ever made of women. Have you made it a point to emphasize the role of women in law?

I do try to emphasize the role of women in law. When we're reading a case or I'm talking about a case and a pioneering woman or female judge is involved, I always point that out.

You recently served as the Chair of the IP Committee of this Business Law Section of the ABA. What has been the value of your involvement with this Section?

A lot of intellectual property lawyers join the IP Section of the ABA. I chose to join the Business Law Section and that was very conscious on my part. The members of the Business Law Section look at IP issues from all different directions. I get to learn about IP issues as they are emerging in business, rather than waiting to see them hit the press. I've also found the members accessible and friendly.

You currently serve as the Vice Chair of the Publications Board of the Business Law Section of the ABA. What's been the value of this experience?

I will be the Chair in September. For those people who aren't familiar with the Publications Board of the Business Law Section, we're responsible for all the books that the Business Law Section publishes. The value of the experience is that the Publication Board has the opportunity to publish books that enable lawyers to do their jobs better and more efficiently. For instance, I was editor for *The IP Desk Book for Business Lawyers*. The book is a guide to the various IP issues that arise in different business transactions. So if you're an attorney doing Wills and Trusts, or a real estate deal, or a franchising deal, you can pick up the book and quickly figure out what IP issues might arise.

Would you encourage younger lawyers to get involved in that section?

Getting involved in the ABA or any other bar group is very, very important for young lawyers, not only for the networking benefits but for the educational benefits.

What are your interests outside of the law?

My general interest is I like to learn and discover new things. I travel, hike, go to art exhibits and theater, and so forth. The Twin Cities is amazing. It's an interesting combination between the small town feel of Sacramento where I lived and worked for 20 years and a vibrant urban environment like the Bay Area where I grew up.

What are you currently working on? Is there something we should watch for?

Elizabeth Rowe and I are writing a book on international trade secret protection to be published by Edward Elgar. We're not just talking about the law of other countries. We are also developing a guideline or approach that attorneys should take in trying to understand the trade secret laws of other countries.

I'm also working on an article about recent changes to patent law and its intersection with trade secret law. I have a working theory that one of the purposes behind the recent changes to the patent law was to increase the ability of companies to protect patentable inventions through trade secret law. What I predict, depending on how that new law is interpreted, is that many more companies will start protecting their information as trade secrets instead of patenting it. If they're successful, then there is going to be more information tied-up because the disclosure goals of patent law will not apply.

Thank you so much for your time.

BUSINESS LAW TODAY

Selected Program Materials and Audio from the Business Law Section Annual Meeting

The Business Law Section Annual Meeting, held at the Hyatt Regency Chicago on September 10–13, 2014, included 69 CLE programs. The program materials and the audio recording of those programs can be accessed here.

Highlights include the following programs.

"AVOIDING DISCOVERY AND TRIAL PRACTICE DISASTERS – TALES FROM THE BENCH AND TRENCHES" was presented by the Business and Corporate Litigation Committee. This program illuminated and discussed, in an interactive format, mistakes made in discovery and at trial from the bench's point of view. It addressed civility and ethical issues confronted during trial and best practices for avoiding disasters in the courtroom. The program was chaired by Daniel R. Formeller, Chicago, IL, and moderated by Paul Masinter, New Orleans, LA. Speakers included Honorable Audrey J.S. Carrion, Baltimore, MD, William D. Johnston, Wilmington, DE, Honorable Clifton Newman, Kingstree, SC, and Arnold A. Pinkston, Irvine, CA. Program materials can be found here, and audio for the program can be found here.

"CASES DO MATTER: JUDICIAL FORCES SHAPING M&A DEAL TERMS" was presented by the Mergers and Acquisitions Committee, and co-sponsored by the Knowledge Strategy Interest Group of the ABA Law Practice Division This program discussed (1) recent judicial decisions affecting M&A deal terms, such as those interpreting merger agreements or state law applicable to constituent entities, successor liability, or fiduciary duty, (2) some market trends from the 2013 Deal Points Studies, and (3) how law firms can effectively share this kind of information among its lawyers to better serve clients. The program was chaired by Craig Menden, Palo Alto, CA, and speakers included Jack Bostelman, San Francisco, CA, Melissa DiVincenzo, Wilmington, DE, Michael O'Bryan, San Francisco, CA, and Scott Whittaker, New Orleans, LA. Program materials can be found here, and audio for the program can be found here.

A consortium of committees presented a symposium on alternative dispute resolution in finance transactions.

"COMMERCIAL DISPUTE SYMPOSIUM PART 1 – TAKE THE FIGHT OUTSIDE! DISPUTE RESOLUTION IN COMMERCIAL FINANCE: PROTECTING THE VALUE OF THE DEAL," was presented by the Commercial Finance Committee, and co-sponsored by the Business Bankruptcy Committee, the Dispute Resolution Committee, and the Project Finance and Development Committee. What dispute resolution mechanism is best for achieving a resolution of disputes with business deals? What role can the business lawyer continue to play to restore the economics of the deal? This panel addressed the different alternatives and included an in-house lender, borrower's counsel, and neutral dispute resolution expert. This portion of the symposium was chaired and moderated by Jeremy Friedberg, Baltimore, MD, and speakers included Pamela Corrie, Norwalk, CT, Judith Greenstone Miller, Southfield, MI, and Stuart M. Widman, Chicago, IL. Program materials for this portion can be found here, and audio can be found here.

"COMMERCIAL DISPUTE SYMPOSIUM PART 2 – THE POWER OF DISPUTE REVIEW BOARDS: DRAFTING AND NEGOTIATING PROVISIONS TO USE DISPUTE REVIEW BOARDS & OTHER DISPUTE AVOIDANCE AND RESOLUTION TECHNIQUES," was presented by the Project Finance and Development Committee, and co-sponsored by the Commercial Finance Committee and the Dispute Resolution Committee. Dispute review boards (DRBs), a dispute resolution process that is part of project administration, are finding increasing favor in the United States as a lower cost, less adversarial manner to manage disputes. DRBs are a creature of contract, and issue, generally, non-binding recommendations. This panel discussed different DRB and other dispute avoidance and resolution techniques, different DRB provisions and alternatives, pros and cons of different alternatives, and provided samples of DRB provisions that have been used with great success nationally and internationally. This portion of the symposium was chaired and moderated by Sarah B. Biser, New York, NY, and speakers included Deborah Bovarnick Mastin, Miami, FL, and Thomas J. Welsh, Meriden, CT. Program materials for this portion of the program can be found here, and the audio for this portion can be found here.

"COMMERCIAL DISPUTE SYMPOSIUM PART 3 – DISPUTE RESOLUTION AND FINANCE: DID YOU EVEN SEE THE ETHICS ISSUES?" was presented by the Commercial Finance Committee, and co-sponsored by the Dispute Resolution Committee and the Project Finance and Development Committee. Mediation and arbitration can be trickier processes than they may first appear. Various professional and state-based bodies have promulgated rules, statutes, guidelines, canons, and other ethical pronouncements whose application in ADR processes may not always be apparent. This panel posed hypothetical examples of situations that may appear benign on their face, but pose hidden risks for professional error for clients, representatives, and neutrals. This portion of the symposium was chaired and moderated by F. Peter Phillips, Montclair, NJ, and speakers included Sandra C. McCallion, New York, NY, and Stanley Sklar, Northbrook, IL. Program materials for this portion of the symposium can be found here, and the audio for this portion can be found here.

"DRAFTING A STRONGER PREFERRED STOCK: RESPONSES TO RECENT CASE LAW DEVELOPMENTS" was presented by the Private Equity and Venture Capital Committee and co-sponsored by the Corporate Documents and Process Committee. In recent years, preferred stockholders have found that rights they believed they had secured are ineffective or unenforceable, largely as a result of gaps in drafting. The panel discussed recent cases addressing the rights of preferred stockholders as a backdrop for exploring best practices in drafting preferred stock instruments. The program was chaired an moderated by John Mark Zeberkiewicz, Wilmington, DE, and speakers included David Gammell Boston, MA, James D. Honaker, Wilmington, DE, and Megan W. Shaner, Norman, OK. Program materials for the program can be found here, and the audio can be found here.

"ETHICS – THE RESPONSIBILITIES AND LIABILITIES OF THE LAWYER IN INTERNATIONAL TRANSACTIONS" was presented by the International Business Law Committee, and co-sponsored by the Mergers and Acquisitions Committee, the Professional Responsibility Committee, the Project Finance and Development Committee, and the White-Collar Crime Committee. This program included an examination of the ethical challenges in understanding and executing instructions when there are practice, political, cultural, and legal differences among jurisdictions (ABA Model Rules 1.1), and addressed considerations in dealing with conflicts and whistle blowing in jurisdictions which may not have been familiar to the audience (ABA Model Rules 1.7 to 1.11). The program was chaired by Alison R. Manzer, Toronto, ON, and the speakers included Franziska Ruf, Montreal, QC, Brian T. Sumner, New York, NY, Roland Trope, New York, NY, and Amy Walsh, New York, NY. Materials for this program can be found here, and the audio here.

Upcoming *In The Know* Programs

In the Know programs are remote CLE programs presented by the Business Law Section and presented free of charge to Section members. Registration for two up-coming programs is available now.

On October 29, 2014; 1:00–2:30 p.m. Eastern (12:00–1:30 p.m. Central), the LLCs, Partnerships, and Unincorporated Entities Committee will present "Drafting of LLC Operating and LP Agreements." In many transactions, the prospective members and partners have differing negotiation power and conflicting and different business and economic interests which are the nuts and bolts of the deal and not the tax-driven provisions. In this webinar, experienced practitioners will outline the principal business issues and how they affect clients, including governance, control, exit strategies, and dispute resolution. The presenters will discuss how and why they address the issues in their practice from various viewpoints and in various business situations, and will provide sample provisions. Panelists will include Edward L. Wender (Moderator), Baltimore, MD, Frank Ciatto, Washington, DC, Joseph W. Boucher, Madison, WI, and Carmen Fonda, Baltimore, MD. You can register for this program here.

On November 5, 2014; 1:00–2:30 p.m. Eastern (12:00–1:30 p.m. Central) the Corporate Governance Committee will present "Hot Corporate Governance Issues Facing General Counsel." General counsel are being called upon to advise their management on matters far beyond the traditional suite of issues. This CLE program will provide an overview of the current landscape of corporate governance issues facing general counsel, including shareholder activism, cybersecurity, executive compensation, the impact of proxy advisory firms, director tenure and qualifications, exclusive forum by-laws, enterprise-wide risk management, compliance, and government enforcement and investigations. We will discuss these issues and the key role general counsel play in developing and implementing strategies to address them. Panelists include Randall Ebner (Moderator), Irving, TX, Robert Bostrom, New Albany, OH, Ellen Grady, Wayne, PA, and Ning Chiu, New York, NY. Registration for this program is available here.

BUSINESS LAW TODAY

Nominations Sought for Section Leadership Positions

Do you know anyone who has what it takes to be a good Section leader? The Nominating Committee of the Section needs your recommendations for leadership positions for the 2015-2016 association year. Nominees will be selected for: Chair-elect (who automatically assumes the position of chair the following year); Secretary (who automatically assumes the position of vice chair the following year); Budget Officer; one Section Delegate to the ABA House of Delegates; and five additional Council members for a four-year term expiring in 2019. The Nominating Committee will take into account the following principles in making its selections. It will: select nominees who have been substantial and active contributors to the Section; seek geographic diversity in the leadership of the Section; strive for representation from a broad cross-section of the areas of law represented in the Section; and seek to draw leaders from a broad cross-section of the various sectors of practice, including corporate law departments, government, academia and private law firms; and actively recruit nominees that reflect the diversity of the Section. Please send your nominations by email to susan.tobias@americanbar.org no later than November 14.

Business Law Today Board Members 2014–2015