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Historically, the SEC's enforcement architecture embodied respect for the principle that, holding all else equal, procedures ought to be commensurate with the stakes of the adjudication. After Dodd-Frank, the agency abandoned this principle. The backlash is, at least in part, attributable to and justified by this reversal.

The SEC should have done after Dodd-Frank what it had done after previous expansions of its administrative penalty powers: reestablish the equilibrium between penalties and procedures by revising its rules of practice that govern APs. The SEC's recently proposed amendments to these rules are too little, too late. A bolder approach is required.

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The liability of RBC in last year's *In re Rural/Metro* decision was derivative of several breaches of fiduciary duty by the Rural/Metro directors, including those directors' failing "to provide active and direct oversight of RBC." In discussing that failure, the Court of Chancery stated that a "part of providing active and direct oversight is acting reasonably to learn about actual and potential conflicts faced by directors, management and their advisors." In the year since *Rural/Metro*, there has been an ongoing discussion—in scholarly and trade journals, courtrooms and the marketplace—regarding how, if at all, the process of vetting potential financial advisor conflicts should evolve. In this article, we set out our belief that financial advisor engagement letters are an efficient (although admittedly not the only) tool to vet potential conflicts of a financial advisor. We then discuss four contractual provisions that, we believe, are helpful in providing the active and direct oversight that was found lacking in *Rural/Metro*.

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SEC Administrative Proceedings: Backlash and Reform

*By Alexander I. Platt**

The Securities and Exchange Commission's aggressive prosecution of securities violations inside administrative proceedings (APs) has generated backlash. Key stakeholders are now attacking the agency's enforcement program as illegitimate and a growing number of respondents charged in APs have launched broad constitutional challenges. Though these suits target deeply entrenched features of administrative adjudication, they have already begun to prove successful, and threaten significant transformations to the SEC and beyond.

Historically, the SEC's enforcement architecture embodied respect for the principle that, holding all else equal, procedures ought to be commensurate with the stakes of the adjudication. After Dodd-Frank, the agency abandoned this principle. The backlash is, at least in part, attributable to and justified by this reversal.

The SEC should have done after Dodd-Frank what it had done after previous expansions of its administrative penalty powers: reestablish the equilibrium between penalties and procedures by revising its rules of practice that govern APs. The SEC's recently proposed amendments to these rules are too little, too late. A bolder approach is required.

The Securities and Exchange Commission (SEC or Commission or agency) is under attack. The agency has been confronted with a wave of broad constitutional challenges to its prosecution of securities violations in administrative proceedings (APs).[1] This forum, which lacks many of the fundamental procedural protections offered in federal court, has been in use in some form as long as the agency itself. Dodd-Frank enhanced the agency's penalty authority in these proceedings and the Commission has taken advantage of its new penalty authority, bringing more—as well as more *important*—cases as APs.

In response, key stakeholders have begun challenging the legitimacy of the agency's enforcement regime, and the regulated industry and its attorneys have filed broad constitutional challenges attacking the SEC's AP expansionism. Though these challenges target practices that are ubiquitous across administrative agencies, they have a realistic chance of success—particularly if and when

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[1] *See generally infra* Table 1 (listing cases).

they make it to the U.S. Supreme Court. Two district judges have already found that certain features of APs likely violate the U.S. Constitution,[2] and another described the constitutional challenges as "compelling and meritorious."[3]

Much is at stake in these suits. The challenges invite courts to strike down features of administrative adjudication utilized (in variation) by regulatory agencies across the executive branch. The broad support these challenges have received from courts and commentators reflects a significant blow to the legitimacy of the agency's enforcement program. Even if the agency ultimately escapes constitutional liability, other harms may well follow from this wave of backlash.

This Article examines and interprets the backlash through the lens of recent SEC history. The SEC's enforcement architecture has embodied steady respect for the principle that, holding all else equal, procedures should be commensurate with the stakes of the adjudication. When Congress expanded the SEC's administrative penalty power in the past, the agency responded by recalibrating the procedures governing APs to ensure a continuing equilibrium between penalties and procedures. Dodd-Frank undermined the principle by equalizing penalties across district courts and APs, each with very distinct levels of procedural protection. But the agency made it worse: after receiving these broad new administrative powers, it failed to undertake any reforms to reestablish the equilibrium. The result has been a growing (and justified) sense that the AP system had become fundamentally unfair.

The SEC could have prevented some of the damage to the legitimacy of its enforcement program by doing immediately after Dodd-Frank what it had done previously after receiving new administrative penalty powers: reestablishing the equilibrium between procedures and penalties by comprehensively amending its rules of practice. But it declined to do so, allowing the backlash to mount. Finally, after years of ignoring or rebuffing attacks on the legitimacy of its enforcement regime, in 2015 the agency began showing signs that it recognized it had overreached. In May, the Enforcement Division published a brief statement explaining its approach to forum selection,[4] and in September the SEC announced several proposed reforms to its rules of practice.[5] These changes—particularly the proposals related to expanded discovery rights and liberalized timelines for proceedings—would surely be a step in the right direction if adopted. But

[2] *See* Duka v. SEC, No. 15-cv-357 (S.D.N.Y. Aug. 3, 2015) (Berman, J.) (decision and order), ECF No. 57; Gray Fin. Grp., Inc. v. SEC, No. 15-cv-492 (N.D. Ga. Aug. 4, 2015) (May, J.) (order), ECF No. 56; Timbervest, LLC v. SEC, No. 15-cv-2106 (N.D. Ga. Aug. 4, 2015) (May, J.) (order), ECF No. 25; Hill v. SEC, No. 15-cv-1801, 2015 WL 4307088 (N.D. Ga. June 8, 2015) (May, J.).

[3] Bebo v. SEC, No. 15-cv-3, 2015 WL 905349, at *2 (E.D. Wis. Mar. 3, 2015); *see also* SEC v. Citigroup Global Mkts., Inc., 24 F. Supp. 3d 379, 380 n.8 (S.D.N.Y. 2014) (Rakoff, J.) (stating, regarding the SEC's broad AP authority, "[o]ne might wonder: from where does the constitutional warrant for such unchecked and unbalanced administrative power derive?").

[4] *Division of Enforcement Approach to Forum Selection in Contested Actions*, U.S. Sec. & Exch. Comm'n (May 8, 2015), https://www.sec.gov/divisions/enforce/enforcement-approach-forum-selection-contested-actions.pdf [hereinafter Division of Enforcement Approach].

[5] Securities and Exchange Commission, Proposed Rule, Amendments to the Commission's Rules of Practice, 80 Fed. Reg. 60082 (Oct. 5, 2015); Securities and Exchange Commission, Proposed Rule, Amendments to the Commission's Rules of Practice, 80 Fed. Reg. 60091 (Oct. 5, 2015).

they are too little, too late. Challengers will not be deterred and critics will not be won over unless the SEC undertakes a broader, deeper review and recalibration of its procedural regime.

This Article proceeds as follows. Part I reviews the structure of APs, the expansion of SEC administrative penalty authority by Dodd-Frank, and the agency's increased reliance on APs to prosecute securities violations. Part II analyzes the wave of constitutional lawsuits filed against the SEC and the related criticism that the SEC is unfairly using APs to *make* law. Part III discusses how the agency has used procedural reform to ensure a balance between procedures and penalties, shoring up its legitimacy after past legislative expansions, and criticizes the agency for failing to undertake similar reforms immediately after Dodd-Frank. Part IV reviews and criticizes the agency's recent proposed reforms, and proposes an alternate package of procedural reforms that might go farther to reestablish this balance and shore up the agency's legitimacy.

I. Background

A. The Structure of APs

After an investigation reveals a securities law violation, the SEC can refer a matter to the U.S. Department of Justice (DOJ) for consideration of criminal charges, file a civil lawsuit in federal district court, or commence an AP.[6] APs are governed by the SEC's own rules of practice.[7] An AP is initiated with an Order Instituting Proceedings (OIP), the equivalent of an indictment or complaint, which outlines the charges against the respondent and the factual basis for those charges.[8] Though the SEC's Enforcement Division prosecutes the case, the OIP is issued by the Commission.[9]

Actually, much action takes place before the OIP is issued. The agency typically notifies the target that it is considering filing charges ahead of time and provides an opportunity to contest the contemplated charges in writing.[10] If the target chooses to make such a submission, it will be forwarded along with the recommendation of the Enforcement Division to the Commission, which makes the ultimate decision of whether to initiate a proceeding.[11] The leadership of the Enforcement Division is appointed by and accountable to the Commission.

[6] 17 C.F.R. § 202.5(b) (2015); *see also* 2 Harold S. Bloomenthal & Samuel Wolf, Securities Law Handbook § 26:56 (2014 ed.). For convenience, I use "AP" to encompass various types of administrative hearings conducted under the securities laws, including various types of disciplinary hearings and cease-and-desist proceedings. For a detailed overview of APs, see Stavros Gadinis, *The SEC and the Financial Industry: Evidence from Enforcement Against Broker-Dealers*, 67 Bus. Law. 679 (2012).

[7] 17 C.F.R. §§ 201.100–.1106 (2015).

[8] *Id.* § 201.200.

[9] *E.g.*, *id.* § 201.101(a)(7).

[10] *See id.* § 202.5; *see also* 2 Bloomenthal & Wolf, *supra* note 6, § 26:56.

[11] 2 Bloomenthal & Wolf, *supra* note 6, § 26:56; *see also* 17 C.F.R. § 201.101(a)(7) & (9)(i); *cf.* 2 Bloomenthal & Wolf, *supra* note 6, § 26:57 ("Although the entire structure of the Rules of Practice is built around this assumption, curiously, no Rule explicitly provides for the issuance of such order.").

Settlements are also often negotiated at the pre-OIP stage. A successful negotiation will result in the publication of charges and terms of the settlement in the same document. The Commission must approve any settlement.

Once filed, an AP is assigned by the chief administrative law judge[12] to herself or one of the other four administrative law judges (ALJs).[13] All ALJs are hired by the Commission's Office of Human Resources with input from the chief ALJ and the U.S. Office of Personnel Management, but with no direct role for the Commission itself.[14] Once appointed, the Commission "may remove . . . an administrative law judge only for good cause established and determined by the [Merit Systems Protection Board (MSPB)[15]] on the record and after opportunity for a hearing before the Board."[16] Of the five active ALJs, three have been appointed since 2011.[17]

The chief ALJ also fixes the time and place for the hearing.[18] The Rules of Practice provide for fixed timelines.[19] The most extended timeline (reserved for the most complex actions) requires that the ALJ's filing decision be issued within 300 days after the OIP is filed—with "approximately 4 months from the order instituting the proceeding to the hearing, approximately 2 months for the parties to obtain the transcript and submit briefs, and approximately

[12] Brenda Murray has served as chief ALJ for over twenty years. Recent allegations suggest that Chief Judge Murray has pressured ALJs to rule in favor of the agency. *See infra* Part II.A.3.

[13] 17 C.F.R. §§ 201.110, 200.30-10(a)(2) (2015); *see also* 5 U.S.C. § 3105 (2012) (requiring that ALJs "shall be assigned to cases in rotation so far as practicable").

[14] Affidavit of Jayne L. Seidman, *In re* Timbervest, LLC, SEC Admin. Proceeding No. 3-15519 (June 4, 2015); Notice of Filing by U.S. Sec. & Exch. Comm'n Div. of Enforcement, *In re* Timbervest, LLC, SEC Admin. Proceeding No. 3-15519 (June 4, 2015); *see also* Alison Frankel, *Why the SEC Can't Easily Solve Appointments Clause Problem with ALJs*, REUTERS (June 17, 2015), http://blogs.reuters.com/alison-frankel/2015/06/17/why-the-sec-cant-easily-solve-appointments-clause-problem-with-aljs/ (ALJs are "named through a bureaucratic process and not by the commissioners.").

[15] "The Merit Systems Protection Board is an independent, quasi-judicial agency in the Executive branch that serves as the guardian of Federal merit systems. . . . The mission of the MSPB is to 'Protect the Merit System Principles and promote an effective Federal workforce free of Prohibited Personnel Practices.'" *See About the Merit Systems Protection Board*, MERIT SYS. PROTECTION BOARD, http://www.mspb.gov/About/about.htm (last visited Sept. 27, 2015).

[16] 5 U.S.C. § 7521 (2012); *see also* 5 C.F.R. § 1201 (2015) (procedures for MSPB hearing).

[17] The five ALJs (and years appointed) are: Jason Patil (2014), James Grimes (2014), Cameron Elliot (2011), Carol Fox Foelak (1996), and Chief Brenda Murray (1994). *See* Press Release, U.S. Sec. & Exch. Comm'n, SEC Announces Arrival of New Administrative Law Judge Cameron Elliot (Apr. 25, 2011), https://www.sec.gov/news/press/2011/2011-96.htm; Sarah N. Lynch, *SEC Judge Who Took on the "Big Four" Known for Bold Moves*, REUTERS (Feb. 2, 2014), http://www.reuters.com/article/2014/02/02/us-sec-china-elliot-idUSBREA1107P20140202; Press Release, U.S. Sec. & Exch. Comm'n, SEC Announces New Hires in the Office of Administrative Law Judges (June 30, 2014), http://www.sec.gov/News/PressRelease/Detail/PressRelease/1370542202073#.VRv_TuHlx5Y; Press Release, U.S. Sec. & Exch. Comm'n, SEC Announces Arrival of New Administrative Law Judge (Sept. 22, 2014), http://www.sec.gov/News/PressRelease/Detail/PressRelease/1370543014965; Cara Salvatore, *SEC Announces Arrival of 2nd New ALJ*, LAW360 (Sept. 22, 2014), http://www.law360.com/articles/579842/sec-announces-arrival-of-2nd-new-alj; Sarah N. Lynch, *SEC Judge in Cohen Case No Stranger to High-Profile Cases*, REUTERS (July 24, 2013), http://www.reuters.com/article/2013/07/24/us-sec-cohen-judge-idUSBRE96N1G820130724; Craig Quintana, *FCC to Volusia: Revamp System or Lose All Channels*, ORLANDO SENTINEL (Mar. 4, 1992), http://articles.orlandosentinel.com/1992-03-04/news/9203041087_1_volusia-county-county-officials-bob-vog.

[18] 17 C.F.R. § 200.30-10(a)(1).

[19] *But see infra* Part IV.A (discussing SEC's proposed changes to these timelines).

4 months after briefing for the hearing officer to issue an initial decision."[20] The rules "strongly disfavor[]" variance from these timelines.[21]

Once the action is commenced, the Enforcement Division is required to disclose most of its investigative file.[22] The respondent can request additional documents by subpoena (approved by the ALJ),[23] and can informally interview potential witnesses, but cannot take depositions except to preserve testimony that will be unavailable at trial.[24]

Pre-trial dispositive motions are generally unavailable to respondents.[25] Under the rules, the respondent can file a motion for summary disposition seeking dismissal,[26] but may do so before trial only with leave from the ALJ.[27] In practice, motions for summary disposition filed by respondents are almost never granted.[28] Denials of such leave are not appealable.[29] If the respondent files such a motion after the Enforcement Division has presented its case, the ALJ must consider it, but the trial will ordinarily proceed pursuant to schedule even while such a motion is pending, because stays and extensions are strongly

[20] *Id.* § 201.360(a); *see also* Andrew Ceresney, Dir., U.S. Sec. & Exch. Comm'n Div. of Enforcement, Remarks to the ABA Business Law Section Fall Meeting (Nov. 21, 2014) [hereinafter Ceresney, ABA Speech] ("An ALJ normally has 300 days from when a matter is instituted to issue an initial decision. . . . For cases we file in district court, we can often go 300 days and still be just at the motion to dismiss stage or part of the way through discovery, with any trial still far down the road.").

[21] *See* 17 C.F.R. § 201.161(b); *see also* Rules of Practice, 68 Fed. Reg. 35787 (June 17, 2003) (adopting mandatory timelines).

[22] 17 C.F.R. § 201.230. The investigative files can be quite large, and so can be overwhelming for respondents' attorneys to work through in the short time allotted between disclosure and trial. *E.g.*, Plaintiff's Motion for Preliminary Injunction at 2, Chau v. SEC, No. 14-cv-1903 (S.D.N.Y. June 5, 2014), ECF No. 20 (complaining about the short time allotted to review twenty-two million documents disclosed in the agency's investigative file); Plaintiff's Motion for Preliminary Injunction at 4, Bebo v. SEC, No. 15-cv-3 (E.D. Wis. Jan. 23, 2015), ECF No. 14 (complaining about the short time allotted to review "millions of documents" disclosed in the agency's investigative file).

[23] 17 C.F.R. § 201.232.

[24] *Id.* § 201.233.

[25] *See* Luke T. Cadigan, *Litigating an SEC Administrative Proceeding*, BOSTON BAR J. (Jan. 7, 2014), http://bostonbarjournal.com/2014/01/07/litigating-an-sec-administrative-proceeding/ ("As a practical matter, there are also no dispositive motions prior to the hearing."); William F. Johnson & Amelia R. Medina, *SEC's Administrative Enforcement Intensifies Fairness Debate*, 252 N.Y. L.J. (Nov. 6, 2014), http://www.newyorklawjournal.com/id=1202675574765/SECs-Administrative-Enforcement-Intensifies-Fairness-Debate?slreturn=20150826104029 ("no dispositive motion practice prior to the hearing, with rare exceptions"); *see also* Complaint at para. 29, Gray Fin. Grp., Inc. v. SEC, No. 15-cv-492 (N.D. Ga. Feb. 19, 2015); Complaint at para. 23, Duka v. SEC, No. 15-cv-357 (S.D.N.Y. Jan. 16, 2015); Complaint at para. 37, Peixoto v. SEC, No. 14-cv-8364 (S.D.N.Y. Oct. 20, 2014).

[26] 17 C.F.R. § 201.250.

[27] *Id.* In a 2011 order denying leave, Chief Administrative Law Judge Brenda Murray wrote: "I know of no guidance, and the parties have not cited any, as to what factors should be considered in granting leave to file a motion for summary disposition beyond that specified in the Comments to Rule 250 when adopted in 1995: 'Such leave shall be granted only for good cause shown, and if consideration of the motion will not delay the scheduled start of the hearing.'" *In re* Flannery, SEC Admin. Proceeding No. 3-14081 (Jan. 10, 2011).

[28] *See* Alexander I. Platt, Unstacking the Deck: Administrative Summary Judgment and Political Control (working draft, on file with author) (reporting the results of an empirical study of every use of summary disposition in SEC APs from 1996 to 2014). In contrast, the Enforcement Division often wins summary disposition. *See id.*

[29] 17 C.F.R. § 201.250(b).

discouraged. Interlocutory appeal of denials of motions for summary disposition is "disfavored" and only available in "extraordinary circumstances."[30]

At trial, the Enforcement Division must prove its case only by a preponderance of the evidence, far lower than the beyond a reasonable doubt standard required in criminal prosecutions (but the same as required in district court civil proceedings).[31] The rules of evidence do not apply, and the ALJ will consider any evidence that is not "irrelevant, immaterial or unduly repetitious."[32] A respondent may appeal a post-trial decision by the ALJ to the Commission.[33] But the same Commission signed off on the initiation of proceedings at the outset.[34]

A respondent may appeal a Commission decision to the U.S. Court of Appeals,[35] which will review the agency's factual determinations under the substantial evidence standard and legal determinations under the applicable level of deference.

B. The Utility of APs

APs have provided the SEC with an alternative forum to district court civil actions and criminal referrals for as long as the SEC has existed.[36] From the perspective of the agency, this forum offers several advantages, including the streamlined procedures surveyed above, the use of specialized factfinders,[37] and the speed with which each case is resolved either by litigation or settlement.[38]

[30] *Id.* § 201.400.

[31] Steadman v. SEC, 450 U.S. 91 (1981).

[32] 17 C.F.R. § 201.320; *see also* Ceresney, ABA Speech, *supra* note 20 ("In practice, what this means is that ALJs are guided by, but not obligated to strictly apply, the Federal Rules of Evidence").

[33] 17 C.F.R. § 201.411.

[34] *E.g.*, Complaint at para. 41, Peixoto v. SEC, No. 14-cv-8364 (S.D.N.Y. Oct. 20, 2014) ("Any appeal from the SEC ALJ's decision goes to the SEC itself: the very body which, prior to the AP, determined that an enforcement action was necessary."); Complaint at para. 37, Gray Fin. Grp., Inc. v. SEC, No. 15-cv-492 (N.D. Ga. Feb. 19, 2015) (same); Complaint at para. 40, Stilwell v. SEC, No. 14-cv-7931 (S.D.N.Y. Oct. 1, 2014) (same); Plaintiff's Motion For Preliminary Injunction at 1, Bebo v. SEC, No. 15-cv-3 (E.D. Wis. Jan. 23, 2015), ECF No. 14 (similar).

[35] *See* Securities Act § 9(a), 15 U.S.C. § 77i (2012); Exchange Act § 25(a)(1), 15 U.S.C. § 78(y) (2012); Investment Advisers Act § 213(a), 15 U.S.C. § 80b-13(a) (2012); Investment Company Act § 43(a), 15 U.S.C. § 80a-42 (2012).

[36] *See, e.g.*, Securities Exchange Act of 1934, Pub. L. No. 73-290, § 4, 48 Stat. 881, 885 (creating U.S. Securities and Exchange Commission); *id.* §§ 19(a), 22, 48 Stat. at 898, 901 (authorizing the Commission to deny, suspend, or withdraw registrations "[a]fter appropriate notice and opportunity for hearing"); *see also* Ceresney, ABA Speech, *supra* note 20 ("[W]e have been using administrative proceedings throughout the 42-year history of the Division of Enforcement, and the Commission used them even before its enforcement activities were consolidated in one division.").

[37] Ceresney, ABA Speech, *supra* note 20 (noting that ALJs "develop expert knowledge of the securities laws, and the types of entities, instruments, and practices that frequently appear in our cases").

[38] *Id.* (noting that "administrative actions produce prompt decisions" and "from the standpoint of deterrence and investor protection, I think we can all agree that it is better to have rulings earlier rather than later"). From the agency's perspective, another benefit is the ability to streamline these proceedings even further by filing for summary disposition—a technique the Enforcement Division has made increasing use of in the past decade. *See* Platt, *supra* note 28.

This forum also offers advantages to the regulated industry at least in some cases. The flexibility, uniformity, and speed offered by the forum—for litigation and settlement—provide a meaningful advantage over district court actions to some respondents charged with relatively minor and clear violations. APs offer such respondents an opportunity to quickly settle or litigate the case and move on without undergoing the same litigation costs that might be incurred in a federal court action.[39]

Of course, the exercise of adjudicatory power by executive officers also extends far beyond the SEC. Apparently this function dates to the very first Congress,[40] and it is today utilized (with tremendous variation) across the federal bureaucracy in the administration of many federal benefit and regulatory programs.

C. Dodd-Frank: Increasing Administrative Penalty Powers

Dodd-Frank expanded the SEC's penalty authority in APs in several ways. First, it gave the SEC authority to impose civil penalties against persons associated with unregistered entities.[41] (Under prior law, the SEC had authority to impose civil monetary penalties in APs only against persons associated with entities directly regulated by the Commission;[42] to reach persons associated with unregistered entities, the SEC had to go to district court.)

Second, Dodd-Frank gave the SEC authority to impose so-called "collateral bars"—i.e., bans on associating across the entire securities industry.[43] This form of penalty is extremely severe, and it has been described by some courts as "the securities industry equivalent of capital punishment."[44] (Under prior law, the agency had authority to bar a respondent from associating with the securities industry sector he had previously associated with and which led to the charged misconduct—i.e., an investment adviser could be barred from associating with other investment advisers, but not with brokers, dealers, etc.[45]).[46]

[39] *Cf.* Ceresney, ABA Speech, *supra* note 20 (respondents "can benefit when witnessess' recollections are fresher" and "the relaxed rules of evidence may likewise give [respondents] more flexibility in offering evidence").

[40] Jerry L. Mashaw, Richard A. Merrill & Peter M. Shane, Administrative Law: The American Public Law System 310 (2003) (citing Richard H. Fallon, *Of Legislative Courts, Administrative Agencies, and Article III*, 101 Harv. L. Rev. 915, 919 (1988)).

[41] Dodd-Frank § 929P, 15 U.S.C. §§ 77h-1, 78u-2(a), 80a-9(d)(1), 80b-3(i)(1) (2012). However, certain calculation methods remained exclusively in the district court.

[42] This authority, itself, was created in the Securities Enforcement Remedies and Penny Stock Reform Act of 1990, Pub. L. No. 101-429, 104 Stat. 931. *See infra* Part III.A.

[43] Dodd-Frank § 925, 15 U.S.C. §§ 78o, 78o-4, 78q-1, 80b-3 (2012); *see also* Chad Howell, *Back to the Future: Applying the Collateral Bars of Section 925 of the Dodd-Frank Act to Previous Bad Acts*, 7 J. Bus. & Tech. L. 285, 288 (2012) ("Essentially, the Commission is now authorized to put an individual completely out of the regulated securities business, even out of areas that had nothing to do with the violation of the securities law for which the individual was charged.").

[44] *See, e.g.,* PAZ Sec., Inc. v. SEC, 494 F.3d 1059, 1065 (D.C. Cir. 2007).

[45] *See generally* Teicher v. SEC, 177 F.3d 1016 (D.C. Cir. 1999).

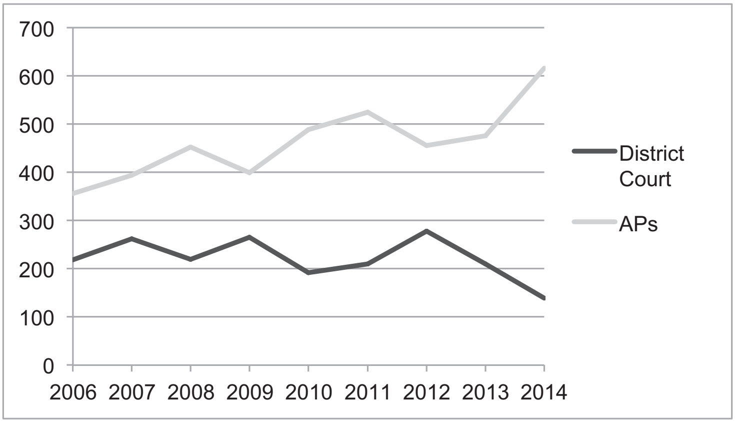
[46] Earlier legislation gave the SEC the authority to use an AP to bar a respondent from serving as an officer or director of a public company. Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, § 1105, 116 Stat. 745, 809 (codified as amended at 15 U.S.C. §§ 78u-3, 77h-1 (2012)).

D. The Rise of APs

Commentators suggested that Dodd-Frank would alter the agency's incentives regarding its choice of forum going forward and predicted a shift towards APs.[47] Indeed, the data seems to confirm that the SEC has increased its relative use of APs since Dodd-Frank.

Figure 1

SEC Enforcement, Pre- and Post-Dodd-Frank[48]



Senior SEC personnel have acknowledged the post-Dodd-Frank shift.[49] The SEC also recently expanded its ALJ staff to accommodate the increased case-

[47] *E.g.*, *The Dodd-Frank Act Reinforces and Expands SEC Enforcement Powers*, Gibson Dunn (July 21, 2010), http://www.gibsondunn.com/publications/pages/Dodd-FrankActReinforcesAndExpandsSECEnforcementPowers.aspx (suggesting Dodd-Frank "gives the SEC and its Enforcement Division a powerful incentive to bring more cases as administrative actions"); Joseph De Simone, Hector Gonzalez & John J. Tharp, Jr., *The Dodd-Frank Act's Impact on Securities Litigation and Enforcement*, Mayer Brown (Oct. 2010), https://www.mayerbrown.com/public_docs/doddfrank5907.pdf (suggesting that the changes created "more incentive for the SEC to bring cases as Administrative Actions"); *Dodd-Frank Beefs Up SEC and CFTC Enforcement*, Covington & Burling (July 21, 2010), https://goo.gl/dmau5O (suggesting that the changes "could radically affect the rights of companies and individuals outside the securities industry who become subject to SEC enforcement action").

[48] The data in this figure is from SEC annual reports, PACER, and Susan Resley et al., *Dealing with the SEC's Administrative Proceeding Trend*, Law360 (Jan. 13, 2015), http://www.law360.com/articles/610688/dealing-with-the-sec-s-administrative-proceeding-trend. The last few years of data represent calendar year, not fiscal year. *See also* Jean Eaglesham, *SEC Is Steering More Trials to Judges It Appoints*, Wall St. J. (Oct. 21, 2014), http://www.wsj.com/articles/sec-is-steering-more-trials-to-judges-it-appoints-1413849590 [hereinafter Eaglesham, *Steering Trials*] (collecting data).

[49] *See* Sarah N. Lynch, *U.S. SEC to File Some Insider Trading Cases in Its In-House Court*, Reuters (June 11, 2014) http://www.reuters.com/article/2014/06/11/sec-insidertrading-idUSL2N0OS1AT20140611 (quoting Andrew Ceresney: "I do think we will bring more insider-trading cases as administrative proceedings in appropriate cases."); Gretchen Morgenson, *At the SEC, a Question of Home-Court Edge*, N.Y. Times (Oct. 5, 2013), http://www.nytimes.com/2013/10/06/business/at-the-sec-a-question-of-home-court-edge.html?_r=0 (quoting Andrew Ceresney: "Our expectation is that we will be bringing more administrative proceedings given the recent statutory

load.[50] The director of enforcement has acknowledged that the shift toward APs was a response to the new penalty powers: "[W]hat we are doing now is simply making use of the administrative forum in cases where we previously could only obtain penalties in district court."[51]

And, as many have noticed, the post-Dodd-Frank shift seems to be driven in part by a desire to move away from the district court.[52] From September 2013 to September 2014, the SEC won all six of its litigated APs, but only eleven out of the eighteen federal court trials.[53] Moreover, the agency's trial failures included some high-profile actions, such as the case against Mark Cuban. Such salient losses might have caused the agency to shift even further toward APs.[54] At a minimum, the timing of the shift creates an unfavorable impression that the agency is "running away from federal court" toward its home forum.

E. The Rise of APs: A Broader Lens

Commentators have understandably focused on Dodd-Frank's effect on the SEC's enforcement patterns. But Dodd-Frank was not the first time Congress has altered the SEC's enforcement patterns by giving it new penalty authority in APs. A review of the SEC's choice of forum since 1972[55] reveals that the agency's recent increased preference for APs relative to district court actions is not unique to this moment. Rather, the SEC's relative preference for APs seems to have also jumped in the early 1990s, and then again in the early 2000s.

changes."); Eaglesham, *Steering Trials*, *supra* note 48 (quoting Kara Brockmeyer, head of the SEC's FCPA practice: "It's fair to say it's the new normal. Just like the rest of the enforcement division, we're moving towards using administrative proceedings.").

[50] *See supra* note 17.

[51] Ceresney, ABA Speech, *supra* note 20.

[52] *See* William McLucas & Matthew Martens, *How to Rein in the SEC*, Wall St. J. (June 2, 2015), http://www.wsj.com/articles/how-to-rein-in-the-sec-1433285747 ("The timing of the agency's decision in late 2013 to move toward more in-house proceedings couldn't have been worse. . . . One need not be a conspiracy theorist to wonder whether at least part of the SEC's rationale was to avoid the federal courts.").

[53] Eaglesham, *Steering Trials*, *supra* note 48; *see also* Resley et al., *supra* note 48; Keystone Address of Jed S. Rakoff at the PLI Securities Regulation Institute, Is the S.E.C. Becoming a Law Unto Itself? (Nov. 5, 2014) [hereinafter Rakoff, Law Unto Itself]; Morgenson, *supra* note 49; *see also* Complaint at para. 36, Gray Fin. Grp., Inc. v. SEC, No. 15-cv-492 (N.D. Ga. Feb. 19, 2015) ("The SEC's apparently unstoppable series of 'wins' in Administrative Proceedings brings to mind long-ago discredited systems like monarchical Star Chambers and hardline regimes' show trials.").

[54] Rakoff, Law Unto Itself, *supra* note 53 (discussing the agency's "stinging defeats" in district court as a reason the agency shifted towards APs); David A. Wilson, *Coming to an Administrative Law Judge Near You: Insider-Trading Cases*, Westlaw J. Derivatives, Dec. 19, 2014, at 1, 21, No. 2 WJDER 1 (Westlaw) ("Given some recent high-profile failures in federal court cases, and the SEC's near-perfect record before administrative law judges, it is expected that the agency will bring more of those cases before its own ALJs."); Johnson & Medina, *supra* note 25 (suggesting the SEC's "underwhelming" trial results motivated the SEC's "recent practices in forum selection"). *But see* Ceresney, ABA Speech, *supra* note 20 (rejecting the "notion that we are running away from cases in district court").

[55] In 1972, the SEC consolidated all prosecutorial functions in a single enforcement division.

Figure 2
SEC Enforcement 1972–2014[56]

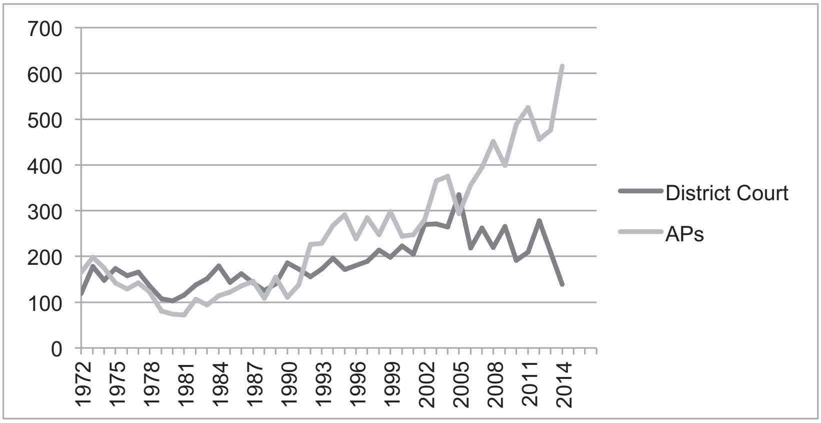
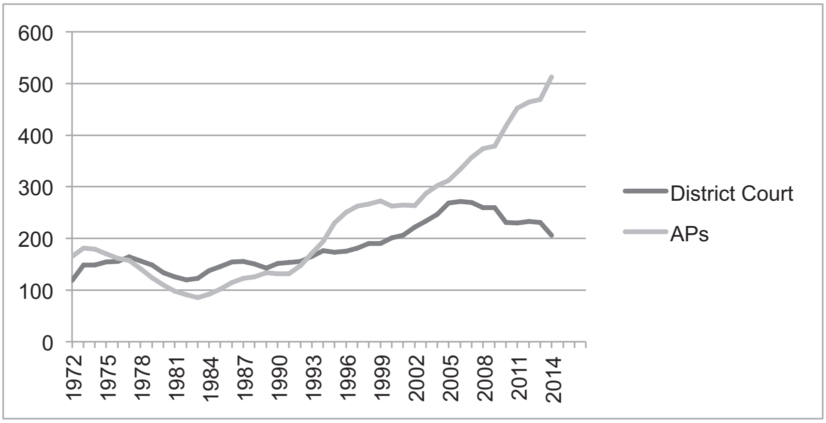


Figure 3
SEC Enforcement 1972–2014 (5-year Rolling Average)



Both of these earlier jumps seem to correspond roughly with earlier legislation that, like Dodd-Frank, boosted the SEC's penalty authority in APs: the 1990 Remedies Act and the 2002 Sarbanes-Oxley Act. Accordingly, this data invites closer scrutiny of those two episodes. How did the industry react to the SEC's expanded authority? What, if anything, did the SEC do to secure its legitimacy

[56] For an explanation of the data, see *supra* note 48.

in those episodes?[57] This Article returns to consider those prior episodes in Part III.

II. Backlash

The post-Dodd-Frank shift toward APs has provoked backlash in the regulated industry and by its attorneys. This backlash has taken two forms. Targets of SEC prosecutions have filed a series of constitutional challenges, attacking procedural features of APs. At the same time, opinion leaders have leveled criticisms about the agency's use of APs as an obstruction to the proper development of the securities laws. Together, they amount to a significant challenge to the legitimacy of the SEC's enforcement regime.

A. Constitutional Challenges

As of this writing, a dozen challenges have been filed across four judicial circuits by individuals facing charges in APs. These suits attack various features of APs under various constitutional provisions and theories.[58] They include broad assaults on familiar features of administrative adjudication like the use of ALJs, the comingling of prosecutorial and adjudicative functions, the availability of monetary penalties and other sanctions, and the use of procedures less protective than the Federal Rules of Civil Procedure. Two district judges have already ruled for the plaintiffs on some of the claims, and others have credited the claims in other ways.

Regardless of whether these claims ultimately prevail, they signal significant opposition among key stakeholders to the agency's enforcement strategy since Dodd-Frank, and a growing sense that this strategy is illegitimate and unfair. This Part reviews the arguments advanced in these constitutional challenges, not to offer a comprehensive analysis or to prognosticate about the prospects for success, but only to show that the SEC is facing a tidal wave of opposition triggered by its recent enforcement efforts and a realistic chance of significant disruption as a result.

[57] There are reasons to be cautious about drawing strong inferences from this data. First, there is much noise contained in the data about APs that has nothing to do with the thesis that the agency is substituting APs for district ourt actions. When the agency settles a case before filing, that case is often registered as an AP. *See* Ceresney, ABA Speech, *supra* note 20 ("For settled matters, we often, but not always, choose to file in an administrative forum, largely because of efficiency. The filing quickly ends the matter on a settled basis, among parties that have agreed to a settlement, and there is no need to have implementation of the parties' agreement subject to the competing demands of busy district court dockets."). Similarly, the agency often brings "follow-on" proceedings, that are also registered as APs. APs also include relatively minor actions, such as delinquent filings. *See, e.g.*, Mark J. Fagel, *What the SEC Enforcement Stats Really Tell Us*, Law360 (Mar. 3, 2015), http://www.law360.com/articles/627323/what-the-sec-enforcement-stats-really-tell-us (arguing that the "SEC's stats are a poor indicator of the division's actual productivity or accomplishments" because, in part, they include cases against issuers for delinquent filings).

[58] *See infra* Table 1 (listing cases).

Table 1

Pl.	**No.**	**D.J.**	**Ct.**	**Filed**	**Status**	**Def.'s Att'ys**	**Claims**
Gupta	11-cv-1900	Rakoff	S.D.N.Y.	Mar. 18, 2011	Voluntarily dismissed.[59]	SEC	Equal Protection
Jarkesy	14-cv-114	Howell	D.D.C.	Jan. 29, 2014	Dismissed for lack of jurisdiction;[60] D.C. Circuit affirmed.[61]	SEC	Due Process (Separation of Functions); Equal Protection; Seventh Amendment; Nondelegation
Chau	14-cv-1903	Kaplan	S.D.N.Y.	Mar. 18, 2014	Dismissed for lack of jurisdiction;[62] Second Circuit appeal fully briefed Sept. 11, 2015.[63]	SEC	Procedural Due Process; Equal Protection
Stilwell	14-cv-7931	Forrest	S.D.N.Y.	Oct. 1, 2014	Voluntarily dismissed.[64]	DOJ	Removal; Nondelegation
Peixoto	14-cv-8364	Pauley	S.D.N.Y.	Oct. 20, 2014	Voluntarily dismissed.[65]	DOJ	Removal; Equal Protection; Seventh Amendment
Bebo	15-cv-3	Randa	E.D. Wis.	Jan. 2, 2015	Dismissed for lack of jurisdiction;[66] Seventh Circuit affirmed.[67]	DOJ	Removal; Equal Protection; Procedural Due Process; Seventh Amendment
Duka	15-cv-357	Berman	S.D.N.Y.	Jan. 16, 2015	Motion to dismiss denied as to appointment;[68] Second Circuit briefing set to be complete Dec. 22, 2015.[69]	DOJ	Removal; Appointment

[59] Joint Stipulation of Dismissal, Gupta v. SEC, No. 11-cv-1900 (S.D.N.Y. Aug. 8, 2011), ECF No. 27.

[60] No. 14-cv-114, 2014 WL 2584403 (D.D.C. June 10, 2014).

[61] No. 14-5196, 2015 WL 5692065 (D.C. Cir. Sept. 29, 2015).

[62] No. 14-cv-1903, 2014 WL 6984236 (S.D.N.Y. Dec. 11, 2014).

[63] *See* Docket, Chau v. SEC, No. 15-461 (2d Cir.).

[64] Notice of Voluntary Dismissal, Stilwell v. SEC, No. 14-cv-7931 (S.D.N.Y. Mar. 16, 2015), ECF No. 35.

[65] Notice of Voluntary Dismissal, Peixoto v. SEC, No. 14-cv-8364 (S.D.N.Y. Jan. 30, 2014), ECF No. 19.

[66] No. 15-cv-3, 2015 WL 905349 (E.D. Wis. Mar. 3, 2015).

[67] 799 F.3d 765 (7th Cir. 2015).

[68] Duka v. SEC, No. 15-cv-357 (S.D.N.Y. Aug. 3, 2015) (decision and order), ECF No. 57; *see also* Duka v. SEC, No. 15-cv-357, 2015 WL 1943245 (S.D.N.Y. Apr. 15, 2015) (denying motion to dismiss as to jurisdiction).

[69] *See* Docket, Duka v. SEC, No. 15-2732 (2d Cir.).

Pl.	**No.**	**D.J.**	**Ct.**	**Filed**	**Status**	**Def.'s Att'ys**	**Claims**
Gray Financial Group	15-cv-492	May	N.D. Ga.	Feb. 19, 2015	Preliminary injunction granted as to appointment;[70] Eleventh Circuit briefing completed Oct. 13, 2015.[71]	DOJ	Appointment; Removal
Tilton	15-cv-2472	Abrams	S.D.N.Y.	Apr. 1, 2015	Dismissed for lack of jurisdiction;[72] Second Circuit appeal argued Sept. 16, 2015.[73]	DOJ	Appointment; Removal
Hill	15-cv-1801	May	N.D. Ga.	May 19, 2015	Preliminary injunction granted;[74] Eleventh Circuit briefing complete Oct. 2, 2015.[75]	DOJ	Nondelegation; Seventh Amendment; Appointment; Removal
Spring Hill Capital Partners	15-cv-4542	Ramos	S.D.N.Y.	June 11, 2015	Dismissed for lack of jurisdiction.[76]	DOJ	Appointment
Timbervest, LLC	15-cv-2106	May	N.D. Ga.	June 12, 2015	Constitutional violation found likely, but preliminary injunction denied.[77]	DOJ	Appointment; Removal

[70] Gray Fin. Grp., Inc. v. SEC, No. 15-cv-492 (N.D. Ga. Aug. 4, 2015) (order), ECF No. 56.

[71] *See* Docket, Gray Fin. Grp., Inc., v. SEC, No. 15-13738 (11th Cir.), *consolidated with* Hill v. SEC, No. 15-12831 (11th Cir.).

[72] Tilton v. SEC, No. 15-cv-2472, 2015 WL 4006165 (S.D.N.Y. June 30, 2015).

[73] *See* Docket, Tilton v. SEC, No. 15-2103 (2d Cir.).

[74] Hill v. SEC, No. 15-cv-1801, 2015 WL 4307088 (N.D. Ga. June 8, 2015).

[75] *See* Docket, Hill v. SEC, No. 15-12831 (11th Cir.).

[76] Spring Hill Capital Partners, LLC v. SEC, No. 15-cv-4542 (S.D.N.Y. June 26, 2015) (order), ECF No. 23; *see also* Transcript of Proceedings at 63–73, Spring Hill Capital Partners, LLC v. SEC, No. 15-cv-4542 (S.D.N.Y. July 8, 2015), ECF No. 26 (providing reasons for decision).

[77] Timbervest, LLC v. SEC, No. 15-cv-2106 (N.D. Ga. Aug. 4, 2015) (order), ECF No. 25.

Table 2

Argument	Targeted Feature	Cases
Removal	ALJs' insulation from presidential control.	*Stilwell, Gray Financial Group, Peixoto, Duka, Bebo, Tilton, Hill, Timbervest*
Appointment	ALJs' appointment by office other than the "head of department."	*Gray Financial Group*, *Tilton*, *Hill*, *Spring Hill*, *Timbervest*, *Duka*
Seventh Amendment	Severe penalties on unregistered persons.	*Jarkesy, Bebo, Peixoto, Hill*
Nondelegation	Choice of forum.	*Jarkesy, Stilwell, Hill*
Due Process/Separation of Functions	Comingling of prosecution and adjudication.	*Jarkesy*
Procedural Due Process	Severe penalties on unregistered persons.	*Chau, Bebo*
Equal Protection	Choice of forum.	*Gupta, Jarkesy, Bebo, Peixoto, Chau*

1. Article II—Appointments and Removal

Two of plaintiffs' strongest challenges arise under Article II of the Constitution. Section 2 of that Article provides that the President "shall appoint . . . all . . . Officers of the United States, whose Appointments are not herein otherwise provided for, and which shall be established by Law," but that "Congress may by Law vest the Appointment of such inferior Officers, as they think proper, in the President alone, in the Courts of Law, or in the Heads of Departments."[78] Plaintiffs argue that SEC ALJs violate this provision because (as the SEC concedes) they are appointed by the SEC's Office of Human Resources, not the "head" of the "department"—i.e., the Commission itself.[79] Plaintiffs also claim that the multiple layers of tenure protection enjoyed by ALJs[80] unconstitutionally impedes the President's control over them under the U.S. Supreme Court's decision in *Free Enterprise Fund v. PCOAB*.[81]

The threshold issue for both claims is whether ALJs are properly classified as "inferior officers" or mere "employees," since only the former trigger the constitutional rules governing appointments and removal.[82] The touchstone is whether they exercise "significant authority"[83]—a standard that requires close

[78] U.S. Const. art. II, § 2.

[79] *See* Free Enter. Fund v. PCOAB, 561 U.S. 477, 511–12 (2010) (finding that SEC commissioners jointly constitute the "head" of the SEC for appointment purposes).

[80] ALJs can only be removed "for cause" by the Commission, who may only be removed by the President for cause. *See Free Enter. Fund*, 561 U.S. at 487. Separately (and in addition), ALJs may only be removed after a hearing before the MSPB who, themselves, may only be removed by the President for cause. *See* 5 U.S.C. § 7512(a) (2012); *id.* § 1202(d).

[81] 561 U.S. 477.

[82] Freytag v. CIR, 501 U.S. 868, 880 (1991) ("'lesser functionaries' need not be selected in compliance with the strict requirements of Article II"); *Free Enter. Fund*, 561 U.S. at 484, 506.

[83] *Freytag*, 501 U.S. at 881 (quoting Buckley v. Valeo, 424 U.S. 1, 126 (1976)).

scrutiny of the precise contours of ALJs' powers and careful comparisons.[84] In *Freytag v. CIR*, the U.S. Supreme Court held that special trial judges of the Tax Court were, indeed, "inferior officers" because (unlike special masters) their positions and roles were fixed by statute, and they exercised "significant discretion" in carrying out their duties and functions, which included "tak[ing] testimony, conduct[ing] trials, rul[ing] on the admissibility of evidence, and . . . enforc[ing] compliance with discovery orders."[85] But, in *Landry v. FDIC*, the D.C. Circuit found that FDIC ALJs were not "inferior officers" because, while their positions and roles were fixed by statute, they lacked authority to make "final" decisions, and instead were limited only to making "recommended" ones.[86]

So far, two district judges have found that SEC ALJs are, indeed, "inferior officers." Judge Leigh Martin May found that "like the STJs in *Freytag*, SEC ALJs exercise 'significant authority'" because they "take testimony, conduct trial, rule on the admissibility of evidence, and can issue sanctions, up to and including excluding people (including attorneys) from hearings and entering default."[87] She conceded that ALJs (like the judges in *Landry*) lacked authority to issue "final orders,"[88] but found that this factor was not dispositive and that the D.C. Circuit's position to the contrary in *Landry* was incorrect.[89] Judge Richard Berman ruled similarly.[90]

If SEC ALJs *are* "inferior officers," the appointments violation follows relatively automatically[91]: the SEC has acknowledged that its ALJs are hired by the Commission's Office of Human Resources with input from the Chief ALJ and the U.S. Office of Personnel Management, but no direct role for the Commission (the "head of the department") itself.[92]

[84] *See, e.g.*, Landry v. FDIC, 204 F.3d 1125, 1132 (D.C. Cir. 2000) (collecting sources) ("The line between 'mere' employees and inferior officers is anything but bright.").

[85] *Freytag*, 501 U.S. at 881; *see also id.* at 892 (Scalia, J., concurring) (finding that ALJs are "officers").

[86] 204 F.3d 1125; *but see id.* at 252 (Randolph, J., concurring in part and concurring in the judgment) ("There are no relevant differences between the ALJ in this case and the special trial judge in *Freytag*.").

[87] Hill v. SEC, No. 15-cv-1801, 2015 WL 4307088, at *17 (N.D. Ga. June 8, 2015).

[88] Judge May explained:

> Plaintiff argues that SEC ALJs can issue final orders because if the respondent does not petition the SEC to review the ALJ's initial order and the SEC does not decide to review the matter on its own, the action of the ALJ will be "deemed the action of the Commission." The SEC argues that the SEC retains plenary authority over ALJs and the regulations make clear that only when the SEC itself issues an order does the decision become final. This Court agrees with the SEC. Because the regulations specify that the SEC itself must issue the final order essentially "confirming the initial order, the Court finds that SEC ALJs do not have final order authority."

Id. at *17 n.10.

[89] *Id.* at *17.

[90] Duka v. SEC, No. 15-cv-357 (S.D.N.Y. Aug. 3, 2015), ECF No. 57.

[91] *See id.*; *Hill*, 2015 WL 4307088, at *19.

[92] Affidavit of Jayne L. Seidman, *In re* Timbervest, LLC, SEC Admin. Proceeding No. 3-15519 (June 4, 2015); Notice of Filing by U.S. Sec. & Exch. Comm'n Div. of Enforcement, *In re* Timbervest, LLC, SEC Admin. Proceeding No. 3-15519 (June 4, 2015); *see also* Frankel, *supra* note 14 (ALJs are "named through a bureaucratic process and not by the commissioners.").

The removal issue is a bit more complicated. In *Free Enterprise Fund v. PCOAB*,[93] the U.S. Supreme Court found that an administrative scheme providing two layers of for-cause removal protection for certain officers constituted an impermissible restriction on the President's removal authority.[94] The case concerned the Public Company Accounting Oversight Board, which Congress created in 2002 to oversee accounting firms involved in the auditing of public companies under the securities laws. Among other things, the Board was empowered to "promulgate[] auditing and ethics standards, perform[] routine inspections of all accounting firms, demand[] documents and testimony, and initiate[] formal investigations and disciplinary proceedings."[95] The Board's members were appointed by the SEC, and they could only be removed by that body "for good cause shown" subject to certain procedures.[96] Members of the SEC, in turn, cannot be removed by the President except for "inefficiency, neglect of duty, or malfeasance in office."[97] The *Free Enterprise Fund* Court held that this two-layered insulation from presidential removal was an unconstitutional hindrance on the President's constitutional duty to oversee his officers.[98]

Plaintiffs read *Free Enterprise Fund* as articulating a formalistic rule: "officers" cannot be insulated from presidential control by more than one layer of for-cause removal. But some courts have read *Free Enterprise Fund* in functionalist terms: what matters is not the number of layers of protection *per se*, but whether those protections interfere with the President's ability to perform his duties.[99]

[93] 561 U.S. 477 (2010).

[94] The U.S. Constitution vests "[t]he executive Power . . . in a President of the United States of America," who must "take Care that the Laws be faithfully executed." Art. II, § 1, cl. 1; *id.* § 3. The Constitution also provides for the appointment of executive "officers" to "'assist the supreme Magistrate in discharging the duties of his trust.'" *Free Enter. Fund*, 561 U.S. at 483 (quoting 30 Writings of George Washington 334 (J. Fitzpatrick ed. 1939)). But "[t]he President cannot 'take Care that the Laws be faithfully executed' if he cannot oversee the faithfulness of the officers who execute them." *Id.* at 484. Thus, the Court has protected the President's authority to remove officers against legislative encroachment. *Id.*; *see also, e.g.*, Myers v. United States, 272 U.S. 52 (1926); Morrison v. Olson, 487 U.S. 654 (1988).

[95] *Free Enter. Fund*, 561 U.S. at 485.

[96] *Id.*

[97] *Id.* at 487.

[98] *E.g.*, *id.* at 497 ("The officers of such an agency—safely encased within a Matryoshka doll of tenure protections—would be immune from Presidential oversight, even as they exercised power in the people's name.").

[99] *E.g.*, Duka v. SEC, No. 15-cv-357, 2015 WL 1943245, at *17 (S.D.N.Y. Apr. 15, 2015) ("*Free Enterprise* clearly did not establish . . . a categorical rule forbidding 'two levels of "good-cause" tenure protection.'"); *id.* ("Supreme Court precedent supports a functional test to determine whether and when statutory limitations on the President's power to remove executive officers violate Article II."); *see also* Hill v. SEC, No. 15-cv-1801, 2015 WL 4307088, at *19 n.12 (N.D. Ga. June 8, 2015) (expressing "serious doubts" that the two-layer tenure protections violate Article II because they "do not interfere with the President's ability to perform his duties").

ALJs are utilized across the federal bureaucracy.[100] A judicial ruling finding them unconstitutional because the wrong person signed off on their appointment, or because they are entitled to job protections under the MSPB, would be potentially transformative.[101] Nonetheless, both Article II challenges have a realistic probability of success before appellate courts and ultimately the U.S. Supreme Court. (It is notable that in cases raising the Article II challenges, the SEC has been represented by DOJ attorneys rather than its own attorneys, suggesting that the government recognizes the strength of this argument.[102])

2. Seventh Amendment

Another strong line of attack is based on the right to jury trial under the Seventh Amendment[103] and the structural limits on Congress's ability to interfere with the "judicial Power of the United States."[104] Any such attack will have to overcome the Court's "public rights" doctrine—the rule that "when Congress creates new statutory 'public rights,' it may assign their adjudication to an administrative agency with which a jury trial would be incompatible'"[105]—which has been used to uphold Article I adjudications since the New Deal.[106] In *Tull v. United States*, the U.S. Supreme Court found that the Seventh Amendment guarantee of a jury trial applied in an action by the government seeking millions of dollars in fines under the Clean Water Act.[107] The Court reasoned that the government's action here was analogous to an "action in debt" at common law, and (further) that the penalties provided by the statute were "intended to punish culpable individuals" not merely "to extract compensation or restore the status quo."[108] Because such punitive remedies were "traditionally available in a court of law," the jury right was applicable.[109]

In addition to trying to analogize the SEC's action and penalty powers to those at issue in *Tull*, plaintiffs may protest that the severe penalties can now be

[100] *E.g.*, Paul R. Verkuil, *Reflections Upon the Federal Administrative Judiciary*, 39 UCLA L. Rev. 1341 (1992).

[101] In the DOJ's words, "the Executive Branch's use of tenure-protected ALJs for nearly seventy years establishes a gloss on the Constitution that supports the current removal framework." Government Opposition at 39, Bebo v. SEC, No. 15-cv-3 (E.D. Wis. Feb. 3, 2015), ECF No. 15; *see also Free Enter. Fund*, 561 U.S. at 537–38 (Breyer, J., dissenting).

[102] *See supra* Table 1; *cf*. U.S. Attorney's Manual § 4-6.100 (1997) (explaining that Main Justice attorneys, rather than Assistant U.S. Attorneys, handle cases which "involve serious or novel constitutional or statutory challenges to federal programs, cases challenging a nationwide program with potentially far-reaching implications, [or] cases in which . . . the client agency . . . has requested assistance").

[103] "In Suits at common law, where the value in controversy shall exceed twenty dollars, the right of trial by jury shall be preserved." U.S. Const. amend. VII.

[104] *See* CFTC v. Schor, 478 U.S. 833 (1986).

[105] Atlas Roofing Co. v. Occupational Safety & Health Review Comm'n, 430 U.S. 442, 455 (1977). For instance, in *Atlas Roofing*, the Court upheld the OSHRC adjudication of civil penalties because it was a "public right." *See also* Crowell v. Benson, 285 U.S. 22 (1932).

[106] *E.g.*, *Atlas Roofing*, 430 U.S. 442.

[107] Tull v. United States, 481 U.S. 412 (1987).

[108] *Id.* at 422.

[109] *Id.* at 422–23; *see also* N. Pipeline Constr. Co. v. Marathon Pipe Line Co., 458 U.S. 50 (1982).

applied to individuals exempt from registration with the Commission. The securities laws require certain individuals and entities to register with the Commission as broker-dealers, investment advisers, stock exchanges, and other SEC-regulated persons. While unregistered securities professionals and firms have always been subject to some regulation,[110] the mine-run of disclosure and other regulatory requirements imposed by the securities laws have been reserved for those required to register. Thus, prior to Dodd-Frank, many hedge fund investment advisers tailored their business model specifically to qualify for the exemption from registration in order to avoid the broader regulatory and disclosure obligations imposed on registered firms.[111] The Court has recognized voluntary submission to agency jurisdiction as an important factor in the constitutionality of non-Article III adjudications.[112] Plaintiffs may argue that unregistered persons have not consented to the agency's jurisdiction, and so it is particularly unfair to subject these individuals and firms to these proceedings.[113]

These arguments may well ultimately be sufficient to distinguish these proceedings from "public rights" adjudications that the Court has upheld in the past.[114] On the other hand, the SEC has consistently insisted that its penalties are remedial in nature—designed to protect the public, not punish the respondent—and so do not trigger any right to a jury trial. And again, similar procedures and penalties are so broadly employed across the administrative state that any ruling for plaintiffs will either have to draw some sort of distinguishing characteristic that makes APs uniquely bad, or risk undermining a vast amount of administrative practice.

3. Due Process/Equal Protection

The other major lines of attack also cannot be ruled out. Some plaintiffs claim that APs violate procedural due process by threatening to deprive them of important liberty and property interests without adequate procedural protections.[115] Others argue that the commingling of prosecutorial and adjudicative functions in the Commission violates the principle of separation of functions embedded

[110] For instance, the antifraud provision of the Investment Advisers Act applies to unregistered advisers. *E.g.*, IAA § 206, 15 U.S.C. § 80b-6 (2012).

[111] *Cf.* Goldstein v. SEC, 451 F.3d 873, 875–77 (D.C. Cir. 2006).

[112] CFTC v. Schor, 478 U.S. 833, 855 (1986) ("Congress gave the CFTC the authority to adjudicate such matters, but the decision to invoke this forum is left entirely to the parties and the power of the federal judiciary to, take jurisdiction of these matters is unaffected.").

[113] *E.g.*, Respondents Opening Brief, In re John Thomas Capital Mgmt. Grp. LLC, Admin. File No. 3-15255 (Jan. 13, 2015) ("Dodd-Frank transformed the SEC administrative enforcement program for ordinary, unregistered persons like Respondents into a penalty-collection program that is indistinguishable from the Water Act penalty program before the Supreme Court in *Tull*.").

[114] Judge May, who ruled for plaintiffs on the Article II Appointment issue, found that they were not. *See* Hill v. SEC, No. 15-cv-1801, 2015 WL 4307088, at *13–15 (N.D. Ga. June 8, 2015); *see also In re Steven Wise*, Admin. Proceeding File No. 3-11247 (Feb. 17, 2005) (order denying motion to dismiss claim for civil monetary penalties) (rejecting Seventh Amendment challenge to civil monetary penalties by unregistered adviser).

[115] *See* Matthews v. Eldridge, 424 U.S. 319 (1976).

in the Due Process Clause.[116] And others argue that the SEC's choice to prosecute them in APs rather than in district court constitutes irrational discrimination under the equal protection principle of the Fifth Amendment.

Each of these arguments faces substantial hurdles. For instance, there seems to be nothing limiting the separation-of-functions attack to the specifics of the SEC APs, rather than to all of the similarly structured agencies which have long been recognized as constitutional. On equal protection, the agency need only provide a "rational" basis for agency action—a low bar.[117]

Like the Seventh Amendment argument, the procedural due process argument appears to call for a balancing of the penalties, procedures, and alternatives. Such case-by-case balancing could, conceivably, allow a court to rule against the SEC without thereby jeopardizing all similarly structured adjudications.

Some plaintiffs have recently bolstered their due process arguments with specific allegations suggesting that ALJs have been subjected to pressure to rule for the agency. In May 2015, the *Wall Street Journal* published a report based on an interview of a former ALJ (Lillian McEwan) who claimed that, while on the bench, Chief ALJ Brenda Murray criticized her for ruling against the agency, questioned her "loyalty to the SEC," and pressured her to rule in favor of the agency more often.[118] Ms. McEwan explained that, while an ALJ, she felt that she was "expected to work on the assumption that 'the burden was on the people who were accused to show that they didn't do what the agency said they did.'"[119] This report led one group of respondents to seek discovery regarding the possible bias of the ALJ hearing their case, Cameron Elliot. The Commission responded with an order "inviting" the ALJ in question to file an affidavit "addressing whether he has had any communications or experienced any pressure similar

[116] Due process requires a judge must recuse himself from hearing a case if he has "a direct, personal, substantial pecuniary interest" in the outcome. Tumey v. State of Ohio, 273 U.S. 510, 523 (1927); *see also* Caperton v. A.T. Massey Coal Co., 556 U.S. 868 (2009). Rather than inquiring into "actual bias," "the Court has asked whether, under a realistic appraisal of psychological tendencies and human weakness, the interest poses such a risk of actual bias or prejudgment that the practice must be forbidden if the guarantee of due process is to be adequately implemented." *Caperton*, 556 U.S. at 883–84 (quotations and citations omitted). Some plaintiffs have claimed that ALJs and commissioners violate this rule by engaging in ex parte conversations with the prosecutors and (in the Commission's case) authorizing the prosecution in the first case. *E.g.*, Jarkesy v. SEC, No. 14-cv-114, 2014 WL 2584403, at *2 (D.D.C. June 10, 2014) ("[The] Commission has conclusively prejudged the case . . . and engaged in impermissible ex parte communications with the [Enforcement] Division staff in connection with the settlement [of a related case.]"). Of course, these circumstances are common to many administrative adjudication schemes and have been long regarded as permissible without crossing any due process lines. *E.g.*, FTC v. Cement Inst., 333 U.S. 683 (1948).

[117] True, this argument is one of the few that has actually made it past jurisdictional hurdles. *See* Gupta v. SEC, 796 F. Supp. 2d 503 (S.D.N.Y. 2011). But that says nothing about its likelihood of prevailing on the merits.

The Division of Enforcement recently released guidelines regarding forum selection which suggest that wherever "similar charges" have been brought against "similarly situated parties" in the "same or closely related matters," "it may be preferable" to "recommend charges" in the same forum. Division of Enforcement Approach, *supra* note 4. Though this generally seems to support the equal protection theory, it is couched in such caveated language that it may not be much help to plaintiffs.

[118] Jean Eaglesham, *SEC Wins with In-House Judges*, Wall St. J. (May 6, 2015), http://www.wsj.com/articles/sec-wins-with-in-house-judges-1430965803.

[119] *Id.*

to that alleged in the . . . *Wall Street Journal* article . . . and whether he is aware of any specific instances in which any other Commission ALJ has had such communications or experienced such pressure."[120] Judge Elliott declined to do so without comment.[121]

These allegations raise serious due process concerns and may provide a subject for discovery for a plaintiff in a district court action. They do serious harm to the legitimacy of the agency's enforcement program, casting doubt on past rulings and raising doubts about the future.

4. Nondelegation

Some cases have developed a nondelegation challenge,[122] and a few others have alluded vaguely to it.[123] The crux of the argument is that, by equalizing penalties across district courts and APs, Congress effectively stripped the "intelligible principle" out from the delegation to the SEC to choose which forum to prosecute its cases in.[124] Before Dodd-Frank, the penalty differential between fora provided an inchoate but still intelligible principle for the SEC's forum selection. As SEC Chairman Breeden explained at the time: "The Commission expects that it would bring civil actions in federal court in those cases in which defendants have received illegal gains substantially in excess of these maximum amounts [permitted in APs.]"[125] After Dodd-Frank, the agency explained that it chooses a forum based on the following:

> In certain cases, we need certain types of discovery that we can only get in district court. For example, where we file our case on an expedited basis to stop an ongoing fraud, a district court might be the only option that allows us to act quickly while still being able to gather evidence. In certain cases, we need emergency relief, such as an asset freeze or receiver, and that requires an order from a district court. We also may believe that we can obtain summary judgment in district court. The bottom line is that we make a case by case determination of which forum is appropriate based on the particular facts of the case.[126]

[120] *In re* Timbervest, LLC, SEC Admin. Proceeding No. 3-15519 (June 4, 2015) (order concerning additional submission and protective order); *see also* Jean Eaglesham, *SEC Judge Declines to Submit Affidavit of No Bias*, Wall St. J. (June 11, 2015), http://blogs.wsj.com/moneybeat/2015/06/11/sec-judge-declines-to-submit-affidavit-of-no-bias/ [Eaglesham, *Declines to Submit Affidavit*] (quoting professor Kent Barnett as describing the request as "unprecedented" and "bizarre").

[121] Eaglesham, *Declines to Submit Affidavit*, *supra* note 120.

[122] *See* Hill v. SEC, No. 15-cv-1801, 2015 WL 4307088, at *10–11 (N.D. Ga. June 8, 2015); Appellant's Brief, Jarkesy v. SEC, No. 14-5196 (D.C. Cir. Dec. 24, 2014).

[123] Complaint at para. 28, Stilwell v. SEC, No. 14-cv-7931 (S.D.N.Y. Oct. 1, 2014) ("The securities laws provide the SEC with discretion—guided by no statute, regulation, or established practice—to bring enforcement action either in federal district court or internal SEC administrative proceedings."); Complaint at para. 24, Gray Fin. Grp., Inc. v. SEC, No. 15-cv-492 (N.D. Ga. Feb. 19, 2015).

[124] When Congress delegates legislative power to agencies, it must "lay down by legislative act an intelligible principle to which the person or body authorized to [act] is directed to conform." Whitman v. Am. Trucking Ass'ns, 531 U.S. 457, 472 (2001).

[125] *Securities Law Enforcement Remedies Act of 1989: Hearings on S. 647 Before the Subcomm. on Securities of the S. Comm. on Banking, Housing, and Urban Affairs*, 101st Cong., 2d Sess. 38–46 (1990) (statement of Richard C. Breeden, Chairman, Securities and Exchange Commission).

[126] Ceresney, ABA Speech, *supra* note 20.

More recently, the Enforcement Division released a four-page document outlining its considerations in choosing a forum. The document explained that there was no "rigid formula," but rather a "number of factors" including "[t]he availability of the desired claims, legal theories, and forms of relief"; "[w]hether any charged party is a registered entity or an individual associated with a registered entity"; "[t]he cost-, resource-, and time-effectiveness of litigation in each forum"; and "[f]air, consistent, and effective resolution of securities law issues and matters."[127] The Court has set the bar for "intelligible principle" so low that this set of considerations may qualify.[128]

More importantly, the target of the claim is the agency's choice of forum which may not be an exercise of undelegable *legislative* authority, but rather an exercise of prosecutorial discretion that is normally exercised by executive agencies.[129] Thus, even if plaintiffs have a good argument that the choice of forum determination now lacks any "intelligible principle," the nondelegation challenge may still not prevail.[130]

Then again, insofar as APs are being used as a forum to develop novel, untested theories of the securities laws (discussed below) as a substitute for rulemaking, plaintiffs may be able to argue that the choice of this forum is itself a quasi-legislative act, requiring an "intelligible principle."[131]

* * *

It should be noted that courts have dismissed several of these claims on jurisdictional grounds, without reaching the merits.[132] But it is clear that these claims will get their day in court—either by courts that reject the agency's arguments about jurisdiction,[133] or by appellate courts hearing claims on appeal from the AP process itself, where jurisdictional hurdles cannot interfere.[134]

It is also true that some of these claims have been voluntarily dismissed after the parties struck settlement bargains with the SEC.[135] But if the SEC is perceived as giving parties who filed suits additional benefits in the settlements in exchange for voluntarily dismissing these suits, this will only lead to more suits being filed.

[127] *Division of Enforcement Approach*, *supra* note 4.

[128] *See generally Whitman*, 531 U.S. 457.

[129] *See* United States v. Batchelder, 442 U.S. 114, 126 (1979) (rejecting a nondelegation challenge where "the power that Congress has delegated to those officials is no broader than the authority they routinely exercise in enforcing the criminal laws").

[130] Judge May rejected the claim on these grounds. *See* Hill v. SEC, No. 15-cv-1801, 2015 WL 4307088, at *10–11 (N.D. Ga. June 8, 2015).

[131] *See infra* Part II.B.

[132] *E.g.*, Tilton v. SEC, No. 15-cv-2472, 2015 WL 4006165 (S.D.N.Y. June 30, 2015); Bebo v. SEC, No. 15-cv-3, 2015 WL 905349 (E.D. Wis. Mar. 3, 2015), *aff'd*, 799 F.3d 765 (7th Cir. 2015); Chau v. SEC, No. 14-cv-1903, 2014 WL 6984236 (S.D.N.Y. Dec. 11, 2014); Jarkesy v. SEC, No. 14-cv-114, 2014 WL 2584403 (D.D.C. June 10, 2014), *aff'd* No. 14-5196, 2015 WL 5692065 (D.C. Cir. Sept. 29, 2015).

[133] Duka v. SEC, No. 15-cv-357, 2015 WL 1943245 (S.D.N.Y. Apr. 15, 2015).

[134] *In re* Timbervest, LLC, SEC Admin. Proceeding No. 3-15519 (Jan. 20, 2015) (ordering briefing on the Article II issue).

[135] *See supra* Table 1.

There is a realistic possibility that one of these challenges will ultimately succeed—perhaps in front of the U.S. Supreme Court. But regardless, they signal a significant breach of faith regarding the agency's enforcement mission among key stakeholders, only a few years after Congress entrusted the agency with broad new powers.

B. The Development of the Securities Laws

Before turning to explanations, this Article first turns to consider a distinct criticism that has been leveled against APs by some opinion leaders—that the SEC is using APs to *make* the law, rather than merely enforce it. Though often repeated,[136] this criticism has yet to be carefully examined.

1. Incentives Fostering Regulation by Prosecution in APs

Individuals charged by the SEC have a right to judicial review. But that right is much costlier to exercise in an AP. In district court, a defendant may attack the agency's legal theories *immediately* by filing a motion to dismiss the suit under the Federal Rules of Civil Procedure. APs afford respondents far more limited rights to raise legal challenges. A respondent may file a motion for summary disposition before the trial only with leave from the ALJ. Denial of leave is unreviewable, and denial of the motion is not appealable to the Commission as of right—respondents must move the ALJ to certify the issue for interlocutory review or appeal directly to the Commission for such review. And such motions have been granted rarely; between 1996 and 2014, only five respondents have persuaded an ALJ to grant summary disposition in their favor—and one of those cases was reversed by the Commission.[137] Meanwhile, the AP is likely to continue to proceed along a fast track to trial, as departures from rigid preferred timelines are "strongly discouraged." Of course, a Commission that has already signed off on the legal theory underlying the prosecution—as well as, in some cases, rejected a respondent's pre-OIP "Wells submission"[138] contesting the theory—is unlikely to reverse its prior determination.

Thus, to raise a legal challenge, a respondent ordinarily must be prepared to submit to trial before an ALJ. Trial can be a risky proposition for white-collar

[136] Rakoff, Law Unto Itself, *supra* note 53; *Is the SEC Stretching Itself Too Thin?*, SEC Enforcement Q. (Sidley Austin, LLP, Chicago, IL), Q3 2012, at 2, 2, *available at* http://www.sidley.com/~/media/files/news/2012/10/sec-enforcement-quarterly-newsletter/files/click-here-to-view-the-newsletter/fileattachment/secenforcementnewsletter_103112.pdf ("[T]he SEC has increasingly relied on charges based on novel or relatively untested legal theories, particularly in complex cases."); Resley et al., *supra* note 48; Complaint at para. 25, Peixoto v. SEC, No. 14-cv-8364 (S.D.N.Y. Oct. 20, 2014).

[137] *See* Platt, *supra* note 28.

[138] The SEC's Rules on Informal and Other Procedures provide that "[p]ersons who become involved in . . . investigations may . . . submit a written statement to the Commission setting forth their interests and position in regard to the subject matter of the investigation." The Enforcement Manual explains that this practice "evolved from recommendations made by an advisory committee chaired by John Wells." U.S. Sec. & Exch. Comm'n Div. of Enforcement, Enforcement Manual § 2.4 (June 4, 2015).

defendants. New facts might emerge which spur further investigation or, even worse, a referral to DOJ for consideration of criminal charges. Principals and other witnesses might be called to testify, which could generate additional unwanted media attention. The uncertainty may lead shareholders, investors, financial counterparties, or other stakeholders to take business elsewhere or charge a risk premium. In addition, the legal costs of trial can be very substantial.

Even if he chooses to endure a trial, a respondent will not get a chance to present his claims in an Article III forum until he receives the ALJ's opinion (as long as 300 days after the OIP), appeals that to the Commission, and then appeals that to a circuit court. That means not only more delay, and extended uncertainty, but also (potentially) multiple rounds of negative publicity.

Thus, faced with a choice between attacking a faulty legal theory after a trial and reaching a settlement, many (or even most) respondents will choose the latter. More importantly, respondents in APs are more likely to make this choice than are defendants in district court actions, who have relatively easy access to legal challenges via a motion to dismiss or for summary judgment prior to trial. The SEC understands this settlement-forcing power of APs and takes advantage. The director of enforcement recently admitted: "there have been a number of cases in recent months where we have threatened administrative proceedings[;] it was something we told the other side we were going to do, and they settled."[139]

The result is that APs present an appealing mechanism for the agency to advance and establish novel theories of liability, relatively immune from timely judicial challenge. Over time, settlements add up into a body of agency "precedent." One chairman of the Commission explained:

> [W]hen the SEC staff comes upon a novel activity that it believes violates the law, it will often attempt to settle the first several cases of that nature, so that it can establish its own set of precedents. . . . The advantage to the Commission . . . is that [it] can issue a lengthy description of the conduct it finds objectionable, and its rationale for finding that conduct violative of the law. . . . After one or two of these relatively lenient settlements, the SEC will then increase the "penalty" for similar violations . . . .[140]

[139] Bryan Mahoney, *SEC Could Bring More Insider Trading Cases In-House*, LAW360 (June 11, 2014, 6:53 PM EST), http://www.law360.com/articles/547183/sec-could-bring-more-insider-trading-cases-in-house (quoting Andrew Ceresney); *see also* Appellant's Brief at 11–12 n.8, Jarkesy v. SEC, No. 14-5196 (D.C. Cir. Dec. 24, 2014).

[140] Harvey L. Pitt & Karen L. Shapiro, *Securities Regulation by Enforcement: A Look at the Next Decade*, 7 YALE J. ON REG. 149, 181–82 n.126 (1990) (collecting cases); *see also* Zachary W. Carter, *The SEC's "Settlement Prudence": "Law" Creation Through a Coercive Settlement Process*, LAW SEMINARS (June 30, 2004, 2:32 PM), http://www.lawseminars.com/materials/07SDAMNY/carter.pdf; Roberta S. Karmel, *Creating Law at the Securities and Exchange Commission: The Lawyer as Prosecutor*, 61 LAW & CONTEMP. PROBS. 33 (1998); ROBERTA KARMEL, REGULATION BY PROSECUTION 219–22 (1982).

Critics have also emphasized another problem: that, even if a respondent refuses to settle and pursues a legal challenge to an appellate court, that court will review the agency's legal determinations with deference accorded by administrative law. *E.g.*, Rakoff, Law Unto Itself, *supra* note 53. I think this criticism is secondary, and I discuss it further in Part IV.

Though this tendency toward regulation by settlement is, to some extent, hardwired into APs, recent developments have intensified the effect. Dodd-Frank's enhancement of the penalties available in APs strengthened the SEC's ability to coerce settlement, by making it even costlier for respondents to refuse to deal. The SEC will threaten a respondent with draconian penalties (lifetime bars from working in the securities industry, very large fines, etc.), unless the respondent accepts the SEC's offer to settle the case.[141] As discussed above, the SEC used to have an incentive to prefer district court actions in some cases—if the agency wanted a severe penalty, it had to go to that forum, even if it meant sacrificing some procedural advantages. Dodd-Frank equalized the penalties across fora and removed the built-in incentive.

In addition, APs may function as a substitute for rulemaking, which has recently become more costly for the agency. As former Commissioner Roberta Karmel put it: "constraints . . . on the regulatory process . . . increase the incentives on agencies like the SEC to develop new standards through enforcement cases rather than through rulemaking proceedings."[142] In 1996, Congress amended the rulemaking provisions of the securities laws to require the agency to "consider . . . whether the action will promote efficiency, competition, and capital formation."[143] Beginning with *Chamber of Commerce v. SEC*,[144] then *American Equity Investment Life Insurance Co. v. SEC*,[145] and most recently *Business Roundtable v. SEC*,[146] the D.C. Circuit has struck down major SEC rules, finding the agency's "consideration" of the 1996 factors was inadequate.[147] Many commentators observed that these cases seemed to abandon the deference to SEC judgment in favor of a much more stringent review.[148] These cases made rulemaking

[141] *Cf.* Appellant's Brief at 11, Jarkesy v. SEC, No. 14-5196 (D.C. Cir. Dec. 24, 2014); Complaint at para. 29, Stilwell v. SEC, No. 14-cv-7931 (S.D.N.Y. Oct. 1, 2014); Complaint at para. 26, Gray Fin. Grp., Inc. v. SEC, No. 15-cv-492 (N.D. Ga. Feb. 19, 2015).

[142] Karmel, *supra* note 140, at 288 ("Because of the prominence of enforcement programs in a deregulatory environment, there remains a possibility that enforcement proceedings will become a substitute for formal regulation.").

[143] National Securities Markets Improvement Act of 1996, Pub. L. No. 104-290, § 106, 110 Stat. 3416, 3424–25 (1996) (codified as amended at 15 U.S.C. § 77b(b) (2012) (Securities Act), 15 U.S.C. § 78c(f) (2012) (Exchange Act), 15 U.S.C. § 80a-2(c) (2012) (Investment Company Act), 15 U.S.C. § 80b-2(c) (2012) (Investment Advisers Act)). For a review of the history of this provision, see James D. Cox & Benjamin J.C. Baucom, *The Emperor Has No Clothes: Confronting the D.C. Circuit's Usurpation of SEC Rulemaking Authority*, 90 Tex. L. Rev. 1811, 1818–24 (2012). The agency had been performing some version of cost-benefit analysis even before this statute. *See* Bruce Kraus & Connor Raso, *Rational Boundaries for SEC Cost-Benefit Analysis*, 30 Yale J. on Reg. 289, 296–300 (2013).

[144] 412 F.3d 133 (D.C. Cir. 2005).

[145] 613 F.3d 166 (D.C. Cir. 2010).

[146] 647 F.3d 1144 (D.C. Cir. 2011).

[147] For critical commentary on this trio, see Kraus & Raso, *supra* note 143; Cox & Baucom, *supra* note 143; Jill E. Fisch, *The Long Road Back:* Business Roundtable *and the Future of SEC Rulemaking*, 36 Seattle U. L. Rev. 695 (2013).

[148] For instance, Raso and Kraus suggest:

> The *Business Roundtable* court appears to have applied a new burden of proof—the opposite of deference—to the SEC's rule. The proxy access rule was vacated on "admittedly (and at best) 'mixed' empirical evidence," evidence that evidently failed to convince the court. If unclear, unconvincing evidence fails the test, perhaps the court meant to require that the SEC present "clear and convincing" evidence—a heavy and unprecedented burden of proof.

more costly for the agency, which subsequently hired many economists and established a new Division of Economic and Risk Analysis to bring stronger economic analysis to rulemaking.[149] Some have also suggested that the SEC's rulemaking machinery has been "clogged" by mandatory rulemaking imposed by recent legislation.[150]

In sum, recent developments have made APs a relatively appealing method for the SEC to establish new theories of liability as compared to both district court actions and rulemaking.

2. Is the SEC Advancing Novel Theories in APs?

Commentators have suggested that the agency is using its new AP authority to advance novel theories of liability.[151]

There is some support for this claim. Indeed, the agency has acknowledged as much. Chairwoman Mary Jo White recently announced that the agency had brought a large number of "first-of-their-kind cases that expanded our enforcement footprint," and she cited several APs as evidence.[152] The director of enforcement has made similar statements.[153] The Division of Enforcement's recently released guidelines on forum selection states that an AP may be preferable to a district court action where a matter "is likely to raise unsettled and complex legal issues under the federal securities laws" because of the Commission's "expertise concerning those matters."[154] Some of the plaintiffs

Raso & Kraus, *supra* note 143, at 316. Similarly, Cox and Baucom suggest:

> Through its single-minded focus on cost-benefit analysis, the ultimate effect of the *Chamber of Commerce* and *Business Roundtable* decisions appears to be nothing less than establishing a new review standard.

Cox & Baucom, *supra* note 143, at 1828. And, "the D.C. Circuit has assumed for itself a role opposed to the one Congress prescribed for courts reviewing SEC rules." *Id.* at 1813.

[149] *See, e.g., Current Guidance on Economic Analysis in SEC Rulemakings*, U.S. SEC. & EXCH. COMM'N (Mar. 16, 2012), https://www.sec.gov/divisions/riskfin/rsfi_guidance_econ_analy_secrulemaking.pdf (implementing the demanding standard of economic analysis articulated by the D.C. Circuit in *Business Roundtable*); *see generally* Raso & Kraus, *supra* note 143, at 325–32.

[150] Raso & Kraus, *supra* note 143, at 319; *see also* DAVIS POLK, SUMMARY OF THE DODD-FRANK WALL STREET REFORM AND CONSUMER PROTECTION ACT, ENACTED INTO LAW ON JULY 21, 2010 ii (2010), *available at* http://www.davispolk.com/sites/default/files/files/Publication/7084f9fe-6580-413b-b870-b7c025ed2ecf/Preview/PublicationAttachment/1d4495c7-0be0-4e9a-ba77-f786fb90464a/070910_Financial_Reform_Summary.pdf (counting 243 rulemakings required by the Act); *see also* Fisch, *supra* note 147, at 696 (Dodd-Frank "tasked the SEC with an unprecedented number of required rulemakings").

[151] *See* sources cited at *supra* note 136 and *infra* notes 176–77.

[152] Mary Jo White, Chairman's Address at SEC Speaks 2015 (Feb. 20, 2015).

[153] Ceresney, ABA Speech, *supra* note 20 (describing several APs filed in 2014 as "first-of-their-kind actions").

[154] Division of Enforcement Approach, *supra* note 4; *see also* Nicholas Bourtin et al., *Sullivan & Cromwell Discusses SEC Guidance on Approach to Forum Selection in Contested Actions*, CLS BLUE SKY BLOG (June 15, 2015), http://clsbluesky.law.columbia.edu/2015/06/15/sullivan-cromwell-discusses-sec-guidance-on-approach-to-forum-selection-in-contested-actions ("[T]he guidance may exacerbate the criticism voiced by Judge Rakoff and others that the SEC should expose novel applications of the securities laws to de novo judicial review rather than handle them through administrative proceedings.").

in the constitutional challenges to SEC AP authority have also raised this allegation.[155]

Consider the agency's string of APs defining the scope of fiduciary duties borne by private equity and hedge fund managers—investment advisers formerly exempt from regulation with the Commission but obligated to register by Dodd-Frank.[156] Last year, the agency brought charges against Lincolnshire Management, a private equity firm, based on actions related to the integration of companies controlled by two separate funds under its management.[157] The firm had properly disclosed the merger but, according to the SEC, breached its fiduciary duties by allowing "one portfolio company (and, indirectly, the fund that owned it) [to]pay[] *more than its share* of certain expenses that benefitted both companies."[158]

Long ago, the U.S. Supreme Court found that the antifraud provision of the Investment Advisers Act "establishe[d] 'federal fiduciary standards' to govern the conduct of investment advisers,"[159] including those exempt from registration with the Commission. But, apart from a general obligation to disclose conflicts, which is now separately required by rule,[160] the precise contours of these federal fiduciary duties for hedge fund and private equity advisers have remained obscure.[161]

Per the Supreme Court, advisers bear a fiduciary duty to "*eliminate, or at least to expose*, all conflicts of interest which might incline an investment adviser—

[155] *See* Complaint at para. 25, Peixoto v. SEC, No. 14-cv-8364 (S.D.N.Y. Oct. 20, 2014) ("This case represents the SEC's attempts to expand the boundaries of insider trading law.").

[156] Private equity advisers and hedge fund advisers had been exempt from registration with the Commission and also from general reporting requirements, until Dodd-Frank. *See generally* Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, tit. IV, 124 Stat. 1376, 1570–80 (2010); *see also* Lyman P.Q. Johnson, *Why Register Hedge Fund Advisers—A Comment*, 70 WASH. & LEE L. REV. 713 (2013) (defending the investor protection rationale for registration and reporting requirements on hedge funds).

[157] *In re* Lincolnshire Mgmt., Inc., SEC Admin. Proceeding No. 3-16139 (Sept. 22, 2014) (order instituting cease-and-desist proceedings).

[158] *Id.* at paras. 10, 37 (emphasis added). These expenses "related to administrative fees associated with payroll and 401(k) benefits; information technology; sales and marketing; and corporate management." *Id.* at para. 26.

[159] Transamerica Mortg. Advisors, Inc. (TAMA) v. Lewis, 444 U.S. 11, 17 (1979) (citing SEC v. Capital Gains Research Bureau, Inc., 375 U.S. 180, 191–92 (1963)). *But see* Arthur B. Laby, SEC v. Capital Gains Research Bureau *and the Investment Advisers Act of 1940*, 91 B.U. L. REV. 1051 (2011) (arguing that the *Capital Gains* Court correctly found only that § 206 recognized the preexisting fiduciary duties of advisers, while the *Transamerica Mortgage* Court misread it as finding that § 206 established new federal duties).

[160] 17 C.F.R. § 275.206(4)-8 (2015).

[161] One treatise explains:

> The precise scope of Section 206 is subject to debate. Some practitioners believe that Section 206 essentially imposes a disclosure requirement on advisers. . . . A second school of thought views Section 206 as imposing substantive regulatory requirements on advisers in addition to disclosure obligations. Under this view, making full disclosure or obtaining client consent may not, by itself, be sufficient to insulate an adviser from liability if the adviser is not acting in the best interests of clients consistent with its fiduciary obligation. There is no definite answer as to which view of Section 206 is correct . . . .

THOMAS P. LEMKE & GERALD T. LINS, REGULATION OF INVESTMENT ADVISERS § 2:30 (2015); *see also* Laby, *supra* note 159, at 1054 (the fiduciary standard is "notoriously imprecise"); *id.* at 1088–98 (documenting sources of ambiguity).

consciously or unconsciously—to render advice which was not disinterested."[162] This formulation leaves open the possibility of duties beyond mere disclosure. Some have suggested that conflicts of interest in hedge funds and private equity funds are "completely pervasive" and "far more common than in ordinary companies."[163] Such ubiquity only exacerbates the vagueness of the duty to avoid them.

The *Lincolnshire* case appears to represent a step toward the elaboration of substantive fiduciary duties for these formerly exempt advisers. An SEC official explained that the case stood for the principle that "[a]dvisers that commingle assets across funds must do so in a manner that satisfies their fiduciary duties to each fund and prevents one fund from benefiting to the detriment of the other."[164] Commentators have read this case as imposing a new substantive obligation on firms regarding the treatment of cross-fund investments and transactions.[165]

The SEC also brought several other significant APs articulating fiduciary obligations under section 206.[166] SEC leaders have indicated that more enforcement

[162] *Capital Gains*, 375 U.S. at 191–92 (emphasis added); *see also* Julie M. Riewe, Co-Chief, Asset Mgmt. Unit, Div. of Enforcement, U.S. Sec. & Exch. Comm'n, Conflicts, Conflicts Everywhere—Remarks to the IA Watch 17th Annual IA Compliance Conference: The Full 360 View (Feb. 26, 2015).

[163] John Morley, *The Separation of Funds and Managers: A Theory of Investment Fund Structure and Regulation*, 123 Yale L.J. 1228, 1262 (2014). Morley lists some of the conflicts that arise where (as is common) multiple funds are under the same management:

> Because managers owe fiduciary duties to each of their funds and because resources are scarce, the allocation of virtually any resource to one fund places the manager in a conflict of interest with its other funds. These conflicts arise in innumerable aspects of management companies' operations, such as the allocation of investment opportunities; the allocation of workers' time; the allocation of administrative resources; the order in which trades are executed; the way shares are voted in portfolio companies when different funds hold conflicting interests in the companies; and the speed and order in which redemptions are processed, as well as myriad other matters.

Id. at 1261. Morley also cites a "boom in academic articles that catalog new sources of inter-fund conflicts for fund managers." *Id.* at 1261 & n.76 (collecting sources).

[164] Press Release, U.S. Sec. & Exch. Comm'n, SEC Charges New York-Based Private Equity Fund Adviser with Misallocation of Portfolio Company Expenses (Sept. 22, 2014), http://www.sec.gov/News/PressRelease/Detail/PressRelease/1370543006673#.VQni9OHlx5Y.

[165] *E.g.*, Veronica E. Rendon et al., *New Developments in the SEC Focus on Private Funds*, Arnold & Porter (Dec. 2014), https://goo.gl/fjgh6t ("The basic lesson from Lincolnshire is that allocations among multiple entities must be equitable."); *cf.* Jason Brown et al., *SEC Brings First Action Against a Private Equity Fund Adviser for Misallocation of Portfolio Company Expenses*, Ropes Gray (Sept. 23, 2014), https://www.ropesgray.com/newsroom/alerts/2014/September/SEC-Brings-First-Action-Against-a-Private-Equity-Fund-Adviser.aspx (explaining that Lincolnshire "confirms that the SEC is pursuing the industry aggressively, providing added support to the conclusion that firms are well advised to ensure that they are reviewing their practices"). The firm's general counsel, for his part, explained the decision not to litigate because the litigation was "very expensive" and "a distraction to our business, and so we are happy to get it behind us and resolve it." Sarah N. Lynch, *Private Equity Adviser Settles SEC Charges over Expense Allocations*, Reuters (Sept. 22, 2014, 12:36 PM EST), www.reuters.com/article/2014/09/22/sec-privateequity-fees-idUSL2N0RN0ZO20140922 (quoting James McLaughlin, managing director and general counsel at Lincolnshire); Eva C. Carman et al., *Takeaways from SEC Action Against Lincolnshire*, Law360 (Sept. 26, 2014, 10:24 AM EST), http://www.law360.com/articles/581223/takeaways-from-sec-action-against-lincolnshire.

[166] In February 2014, the SEC brought an AP charging Clean Energy Capital, a private equity firm, with, *inter alia*, violating its fiduciary duties by engaging in a conflict of interest related to

against private equity and hedge funds for violating fiduciary duties under section 206 is likely.[167]

From the standpoint of "efficiency, competition, and capital formation,"[168] the optimal scope of these firms' substantive fiduciary duties—as defaults or otherwise—is debatable.[169] By elaborating the fiduciary obligations of hedge fund advisers and private equity advisers through APs and settlements, the SEC avoids a more transparent debate over these questions. Because each incremental advance in the scope of the fiduciary duties creates a risk of liability, the firms must respond by reviewing and possibly changing their practices and/or by taking on additional compliance and legal costs.

* * *

There are other examples of the SEC's recent use of APs to advance novel understandings of the law.

For instance, in *Peixoto*, the agency seems to have attempted to use an AP to broaden the definition of "material nonpublic information" in insider trading cases. Traditionally, these cases revolve around secret information that belongs to a public company—e.g., an announcement about a new business plan,

fees and withdrawal of funds without adequate disclosure. *See In re* Clean Energy Capital, LLC, SEC Admin. Proceeding No. 3-15766 (Feb. 25, 2014) (order instituting proceedings). The respondents initially refused to settle, apparently believing to have been within their legal rights having relied on advice from counsel, but reached a settlement on the eve of trial before an ALJ. *In re* Clean Energy Capital, LLC, SEC Admin. Proceeding No. 3-15766 (Oct. 17, 2014) (order making findings and imposing remedial sanctions). Commentators noted that the case was the first of its kind. Rendon et al., *supra* note 165 ("[T]he lesson from Clean Energy is that the SEC is taking the allocation of fees and expenses seriously and is prepared to take action if it discovers infractions in this area."); Sarah N. Lynch, *Private Equity Adviser, CEO Settle with SEC over Fee Allocations*, Reuters (Oct. 17, 2014, 6:49 PM EST), http://www.reuters.com/article/2014/10/17/us-sec-privateequity-fees-idUSKCN0I62GF20141017 (case was "the first one the SEC filed as part of a broader crackdown into private equity fund fees").

And, in June 2014, the SEC filed and settled an AP against Paradigm Capital, a hedge fund, accusing it of proprietary trading without adequate disclosures. *In re* Paradigm Capital Mgmt., Inc., SEC Admin. Proceeding No. 3-15930 (June 16, 2014). As the SEC later explained, while this was not a breach of fiduciary duty case, it "nonetheless involved a conflict we see frequently: principal transactions without the required written disclosure and consent." Riewe, *supra* note 162.

[167] A February 2015 speech announced that advisers' conflicts of interest would be a priority for the agency in 2015. Riewe, *supra* note 162 ("[O]n the hedge fund side, we anticipate cases involving undisclosed fees; all types of undisclosed conflicts, including related-party transactions . . . . On the private equity side . . . we expect to see more undisclosed and misallocated fee and expense cases like the Clean Energy Capital and Lincolnshire Management, Inc. cases we brought in 2014.").

[168] *See supra* note 143 (discussing National Securities Market Improvement Act of 1996).

[169] The traditional argument was that because investors in these funds were more sophisticated than average securities investors, they were less in need of regulatory protection. But, according to some, the financial crisis revealed that unsophisticated investors were exposed to these funds, e.g., through pension funds. But there may be other reasons to question the application of the full retinue of fiduciary duties to hedge fund and private equity advisers. Prohibiting fund managers from all conflicted transactions, managing multiple funds, engaging in proprietary trading, or charging exorbitant fees would deprive investors of ways they might compensate those who manage their money. *See* Houman B. Shadab, *Hedge Fund Governance*, 19 Stan. J.L. Bus. & Fin. 141 (2013). John Morley argues that investors in these funds have strong exit rights, as compared to investors in publicly traded companies, and thus may have less need for the protections offered strong fiduciary duties. *See generally* Morley, *supra* note 163.

lower than expected earnings, a new hire, etc. In *Peixoto,* by contrast, the respondent had secret information belonging to a hedge fund about its plans regarding investments in a public company.[170] The respondent claimed that the case represented an attempt "to expand the boundaries of existing insider trading law" and that the agency had never before "charged an individual with trading in advance of a private hedge fund's disclosure of its investment plan."[171]

And, in *Gray Financial Group*, the SEC threatened an investment adviser with an AP for violations of his fiduciary duties as articulated by a 2012 Georgia state law governing pension investments.[172] The accused has argued that the issue was a "matter of first impression on the unique state statute that is at best unclear,"[173] and a Westlaw search confirms that there have been no reported cases construing this statute.[174]

Using APs to explore new areas of law is not unique to the post Dodd-Frank era. However, the phenomenon may be accelerating. (A closer comparison of APs before and after Dodd-Frank would be necessary to precisely evaluate the claim.)

3. Challenges to the SEC's Legitimacy

Judge Jed Rakoff laments that the SEC's use of APs to advance novel theories of liability "hinders the balanced development of the securities laws."[175] Another commentator worried that SEC enforcement settlements "impose[] hidden costs interrupting the development of the law."[176] Earlier, former Commissioner Roberta Karmel explained that she had "always been troubled by the utilization of

[170] *In re* Peixoto, SEC Admin. Proceeding File No. 3-16184 (Sept. 30, 2014) (order instituting cease-and-desist proceedings at paras. 1–4).

[171] Complaint at para. 25, Peixoto v. SEC, No. 14-cv-8364 (S.D.N.Y. Oct. 20, 2014). The agency subsequently dropped this case after the Second Circuit issued a decision paring back insider trading liability. *See generally* United States v. Newman, 773 F.3d 438 (2d Cir. 2014); *see also* Michelle Celarier, *SEC Drops Herbalife Insider-Trading Case Amid New Standards*, N.Y. Post (Dec. 16, 2014, 4:30 AM EST), http://nypost.com/2014/12/16/sec-drops-herbalife-insider-trading-case-amid-new-standards/; James Sterngold, *Charges Dropped After Insider-Trading Ruling*, Wall St. J. (Dec. 15, 2014, 7:19 PM EST), http://www.wsj.com/articles/charges-dropped-after-insider-trading-ruling-1418689195.

[172] *In re* Gray Fin. Grp., Inc., SEC Admin. Proceeding No. 3-16554, Securities Act Release No. 9789 (May 21, 2015) (order instituting administrative and cease-and-desist proceedings at para. 12).

[173] Complaint at para. 24, Gray Fin. Grp., Inc. v. SEC, No. 15-cv-492 (N.D. Ga. Feb. 19, 2015).

[174] *See also id.* at para. 17 ("There has not been any publicly available formal statutory interpretation of the unique language of the New Georgia Pension Law, either through reported legislative history or reported appellate case law."). *But see* Division of Enforcement Approach, *supra* note 4 ("[W]here application of state law or other specialized areas of federal law is integral to the matter, district court may be appropriate.").

[175] Rakoff, Law Unto Itself, *supra* note 53.

[176] Arthur B. Laby, *Fiduciary Obligations of Broker-Dealers and Investment Advisers*, 55 Vill. L. Rev. 701, 709 (2010); *see also, e.g.*, U.S. Chamber of Commerce, Report on the Current Enforcement Program of the Securities and Exchange Commission 7 (Mar. 2006) ("The Commission should endeavor to avoid interpretation or expansion of regulations through enforcement actions and should seek to clarify its views on standards of conduct and legal standards before initiating enforcement actions for violation of those standards.").

novel theories in . . . SEC civil enforcement cases where the consequences are serious to the individual defendants."[177]

To the extent critics attack the very concept of regulation through case-by-case adjudication as a general matter,[178] such criticism seems overstated. Scholars of law and economics and administrative law have long recognized that regulation through the ex post interpretation of general standards in individual cases possesses efficiency advantages over regulation through ex ante promulgation of rules.[179] For instance, the relative flexibility of the ex post method may allow for a greater ability to incorporate changes on the ground in the industry, a feature that can be especially valuable in the regulation of a fast-developing industry. Of course, what this method gains in flexibility it may lose in predictability, which might generate costly uncertainty in the regulated industry.

The strongest criticism of the current regime of APs is not the sheer fact that it allows for the development of the law through adjudication, but that it does so without adequately providing for input from the regulated industry. In theory, case-by-case adjudication is an effective method of legal development because each party has the incentive to present the strongest possible argument, allowing the adjudicator to make an informed decision. As the previous discussion suggests, APs appear to have evolved away from that ideal. Rather than a forum for an ALJ to develop the securities laws on the crucible of adversarial litigation, APs now serve as a platform for the SEC to unilaterally assert its interpretation of the laws; respondents are under such terrific pressure to settle, and the SEC uses settlements as if they were meaningful precedents. In a sense APs now represent the worst of both worlds: they impose the uncertainty costs on the regulated industry associated with ex post regulation, without the benefit of flexibility and accommodation usually thought to be offered by that method of regulation.

One way to understand Judge Rakoff's concern that APs may disrupt the "*balanced* development of the law" is that APs lack adequate input from the regulated industry and so may tend to skew toward overregulation, unnecessarily chilling desirable market conduct without any commensurate gains in investor protection. For instance, defining substantive fiduciary duties of hedge fund and private equity managers may over-deter beneficial conduct—if it becomes too costly to manage multiple funds, or to take compensation by proprietary

[177] Karmel, *supra* note 140, at 35. Karmel was a persistent critic on this topic. *See id.* at 45 ("The case-by-case development of regulatory law and policy produces many problems, especially when the policy involves law enforcement actions . . . that have serious adverse consequences."); KARMEL, *supra* note 140, at 219–22.

[178] *See* Paul S. Atkins & Bradley J. Bondi, *Evaluating the Mission: A Critical Review of the History and Evolution of the SEC Enforcement Program*, 13 FORDHAM J. CORP. & FIN. L. 367, 411 (2008) ("There should not be institutional encouragement for using discretion to formulate theories of liability that overstep the boundaries of existing law. Law making is reserved for legislative process in Congress and the SEC rulemaking process under the strict requirements of the Administrative Procedure Act; it is not a function of the Enforcement Division.").

[179] *See, e.g.*, Louis Kaplow, *Rules Versus Standards: An Economic Analysis*, 42 DUKE L.J. 557 (1992); *id.* at 557 n.1 (collecting literature).

trading, or to have certain fee arrangements, these practices may be pushed out or limited to those firms that can afford compliance costs.

It might be objected that this *in terrorem* effect does more good than harm at least in some parts of the financial sector, where (some suggest) inadequate caution helped produce the crisis of 2008. It is far from obvious that promoting general caution with regard to possible enforcement would also promote market stability. But ultimately, while the claim that APs are hampering the securities industry and harming investors is speculative, its endorsement by Judge Rakoff and others undermines the agency's legitimacy and indirectly strengthens the hand of plaintiffs who have filed constitutional attacks.

4. Operationalizing the Criticism

While the pending lawsuits have not generally attacked the SEC's use of APs to advance novel interpretations,[180] a future plaintiff might do so by arguing that a novel interpretation advanced in an AP bears the characteristics of a legislative rule, and thus must be promulgated via notice and comment under the Administrative Procedure Act. Though the U.S. Supreme Court has given agencies broad discretion to establish rules by case-by-case adjudication,[181] a plaintiff could argue that the specifics of the penalties now available in APs, the procedures governing the regime, and the SEC's enforcement strategy extend this discretion too far.

Of course, there are serious obstacles for such a challenge. Line drawing between legislative and interpretive rules is famously difficult.[182] And, though the broad discretion accorded to agencies to develop rules via case-by-case adjudication has been criticized,[183] it remains essentially unlimited.[184]

But, as with the constitutional challenges discussed above, even if this criticism does not produce a particular legal claim, it still signals serious doubts of legitimacy for the agency's enforcement program.

[180] *But cf.* Complaint at para. 25, Peixoto v. SEC, No. 14-cv-8364 (S.D.N.Y. Oct. 20, 2014) ("The case represents the SEC's attempt to expand the boundaries of existing insider trading law.").

[181] *See* SEC v. Chenery Corp., 332 U.S. 194 (1947).

[182] *See, e.g.*, David L. Franklin, *Legislative Rules, Nonlegislative Rules, and the Perils of the Short Cut*, 120 Yale L.J. 276, 278 (2010) ("There is perhaps no more vexing conundrum in the field of administrative law than the problem of defining a workable distinction between legislative and nonlegislative rules.").

[183] Perhaps none more eloquent than the dissenting justices in that case, including Justice Frankfurter who was one of the architects of the SEC.

> [T]he administrative process deserves fostering in our system as an expeditious and nontechnical method of applying law in specialized fields. I cannot agree that it be used, and I think its continued effectiveness is endangered when it is used, as a method of dispensing with law in those fields.

Chenery Corp., 332 U.S. at 217–18 (Jackson, J., dissenting).

[184] *E.g.*, Franklin, *supra* note 182 (reviewing the literature).

III. History of SEC Procedural Reform as Justification and Explanation for Present Backlash

Even as they have begun persuading some courts that the SEC's contemporary enforcement architecture is unconstitutional, opponents (litigants as well as commentators and other key stakeholders) have struggled to articulate a core limiting principle for their criticisms of the SEC's use of APs. If APs are unfair now, why have they not always been unfair? If the SEC's use of APs to develop the law is wrong, then why was it not wrong before Dodd-Frank? Why the new scrutiny of long-established features of administrative adjudication? In short: what explains and what justifies the present backlash?

This Part finds an answer suggested by the SEC's own recent history: the SEC's contemporary enforcement architecture turns its back on a core principle of procedural fairness—that, holding all else equal, procedures be commensurate with penalties—which it demonstrated respect for in the past.

A. The Remedies Act of 1990 and Procedural Reform

In the late 1980s, an SEC task force on fraudulent financial reporting issued a report finding that the agency's existing remedial authority was not adequate to combat fraud in the securities industry.[185] The report urged Congress to give the SEC the authority to "tailor enforcement actions more precisely to particular facts . . . [in order to] maximize its enforcement effectiveness."[186] The SEC ultimately submitted a legislative proposal based on the report's recommendations. With a few modifications, the proposal was enacted as the Securities Enforcement Remedies Act of 1990.[187]

This legislation dramatically expanded the SEC's remedial authority in APs. It empowered the agency to impose financial penalties in APs against regulated firms and individuals associated with those firms,[188] to impose cease-and-desist orders,[189] and to order respondents to account for and disgorge ill-gotten gains.[190] Naturally, SEC leaders at that time praised these new powers as "usher[ing] in a new era of Commission enforcement,"[191] by enhancing "flexibility" and increasing "both the efficiency and deterrent effect of the Enforcement program."[192]

[185] Report of the National Commission on Fraudulent Financial Reporting (Oct. 1987), *available at* http://www.coso.org/publications/NCFFR.pdf.

[186] *Id.* at 64.

[187] Securities Enforcement Remedies and Penny Stock Reform Act (Remedies Act), Pub. L. No. 101-429, 104 Stat. 931 (1990).

[188] *See* Remedies Act § 202, 15 U.S.C. § 78u-1 (2012).

[189] *See* Remedies Act § 102, 15 U.S.C. § 78u-3 (2012).

[190] *See* Remedies Act § 102, 15 U.S.C. § 77 (2012).

[191] William R. McLucas et al., *SEC Enforcement: A Look at the Current Program and Some Thoughts About the 1990s*, 46 Bus. Law. 797, 798 (1991). Notably, McLucas has been highly critical of the agency's recent use of APs. *See* McLucas & Martens, *supra* note 52.

[192] McLucas et al., *supra* note 191, at 832.

But these broad new administrative powers also generated substantial criticisms and attacks on the agency's legitimacy. Some predicted that the new penalty authority would cause the Commission to shift away from district court proceedings toward APs;[193] that "the Commission may utilize the administrative forum to extend the reach of the federal securities laws or to advance novel or unique theories";[194] and that the cease-and-desist authority was "so broad that it may be used to circumvent certain requirements of other provisions."[195] Critics also identified constitutional defects, including some of the same theories being advanced in the litigation pending today i.e., violations of due process,[196] nondelegation,[197] and the Seventh Amendment.[198]

Unlike the present backlash, however, the criticisms and anxieties provoked by the 1990 remedies act never escalated into an existential threat to the AP system. No collateral attacks were filed attacking the constitutionality of APs. While some expressed anxieties about the new powers granted by the legislation, there was not the same level of backlash or legitimacy crisis as has been recently directed at the agency's actual implementation of its new powers. One reason: the Commission's expansion of remedial administrative authority was quickly followed by a rulemaking process to undertake a substantial procedural overhaul.[199]

[193] Ralph C. Ferrara et al., *Hardball!: The SEC's New Arsenal of Enforcement Weapons*, 47 Bus. Law. 33, 97–98 (1991); Pitt & Shapiro, *supra* note 140, at 246 (discussing the 1990 proposal) ("[I]t would in almost every case allow the Commission, at its own discretion, to bypass the federal courts altogether, thereby bypassing many of the safeguards currently protective of respondents' rights in the judicial system."). In fact, a 1994 study found that the SEC had brought "far fewer administrative cases than injunctive actions seeking penalties under the Remedies Act." Arthur Laby & W. Hardy Callcott, *Patterns of SEC Enforcement Under the 1990 Remedies Act: Civil Monetary Penalties*, 58 Alb. L. Rev. 5, 46 (1994).

[194] Ferrara et al., *supra* note 193, at 97–98; *see also* Harvey Pitt & Dixie Johnson, *The Securities Law Enforcement Remedies Act of 1990: A New Era in Enforcement*, N.Y. L.J., July 26, 1990, at 5.

[195] Ferrara et al., *supra* note 193, at 97–98; *see also* Pitt & Johnson, *supra* note 194, at 5.

[196] ABA Comm. on Fed. Regulation of Sec., *Report of Task Force on the SEC Administrative Law Judge Process*, 47 Bus. Law. 1731, 1732 n.2 (1992) [hereinafter *ALJ Task Force Report*] ("The Task Force expresses no opinion as to the constitutionality of such proceedings where there exists a viable alternative which is less restrictive of respondents' fundamental due process rights."); Ferrara et al., *supra* note 193, at 64 ("If the ex parte determination [in a temporary cease-and-desist proceeding] is held to constitute prejudgment, it may be possible to challenge the subsequent decision" since "[a] de facto determination on the merits, and the issuance of an ex parte cease-and-desist order by the same individual or individuals who will conduct the subsequent hearing may not comport with the appearance of justice and, therefore, might result in a judge invalidating the order."); *cf.* Pitt & Shapiro, *supra* note 140, at 249 (worrying that the 1990 proposed remedies framework would "permit the imposition of extraordinarily harsh punishment for seemingly trivial misconduct").

[197] *ALJ Task Force Report*, *supra* note 196, at 1732 n.2 (expressing "no opinion" on "the constitutionality of either the [Remedies Act] or current SEC practice whereby the SEC, at its complete discretion and with no articulated standards, can proceed either before an ALJ or in federal court"); *cf.* McLucas et al., *supra* note 191, at 834 ("the Commission is presently confronting new issues concerning when to seek relief in the judicial or administrative forum"); *cf.* Pitt & Shapiro, *supra* note 140, at 249 (questions of "fairness" arise because "the Commission has the choice, at its complete discretion and without any express or implied standards, to proceed in an administrative forum").

[198] Ferrara et al., *supra* note 193, at 54–55; Pitt & Shapiro, *supra* note 140, at 249 (the 1990 proposal).

[199] In fact, the impetus for the 1995 procedural revision discussed below seems to have come from Congress. *See* McLucas et al., *supra* note 191, at 834–35 (suggesting the expanded administra-

The Commission convened a special task force to consider reforms of the procedures governing its implementation of the new powers granted in this legislation.[200] The task force, led by Commissioner (and future Chairwoman) Mary Schapiro, eventually issued a report that recommended "revis[ing] completely the entire Rules of Practice."[201]

After the task force report was issued, the Commission quickly proposed significant changes to the Rules of Practice, including many of the task force's recommendations.[202] After receiving input from stakeholders and outside groups like the Administrative Conference of the United States,[203] the American Bar Association, and commentators from the regulated industry, the SEC promulgated final revised rules in 1995.[204]

The final rules included substantial new protections for individuals charged in APs (and subject to the agency's enhanced penalty authority in that forum). For instance, new Rule 230 imposed broad automatic disclosure requirements for the agency upon commencement of an action.[205] Similarly, new Rule 232 gave respondents authority to request that the ALJ subpoena documents to be delivered "at any designated time or place." This replaced the former subpoena rule, which made these documents deliverable only at the hearing itself.[206]

And new Rule 250 gave respondents the right to file a motion for summary disposition before trial with leave of the hearing officer. This replaced the former rule, which categorically prohibited such motions before the hearing.[207]

However, the Commission declined to adopt a rule authorizing depositions, finding them to be a "source of delay, extensive collateral disputes, and high lit-

tive powers were conditioned on an informal "[c]ongressional mandate to modify the Commission's Rules of Practice . . . within a year").

[200] *See* Fair and Efficient Administrative Proceedings, Report of the Task Force on Administrative Proceedings of the United States Securities and Exchange Commission (Feb. 1993); Press Release, U.S. Sec. & Exch. Comm'n, SEC Releases Schapiro Task Force Report on Fair and Efficient Administrative Proceedings (Mar. 15, 1993).

[201] *See* Rules of Practice, 60 Fed. Reg. 32738, 32738–39 (June 9, 1995). The report also concluded that the "fundamental structure of the Commission's administrative process [wa]s sound." *Id.* at 32739.

[202] Proposed Rules, Securities Act Release No. 33163 (Nov. 5, 1993).

[203] The entire numbering and organization system for the 1995 Rules of Practice is adapted from the ACUS's model rules. *See* 60 Fed. Reg. at 32738, 32739; *see generally* Michael P. Cox, *The Model Adjudication Rules (MARS)*, 11 T.M. Cooley L. Rev. 75 (1994).

[204] 60 Fed. Reg. 32738.

[205] The proposed rule had conditioned disclosure upon a finding of "relevance" by the agency, but the final rule eliminated that condition and made the disclosure automatic "based in part upon comments received that contended that a relevancy determination by the staff was problematic." 60 Fed. Reg. at 32738, 32741; *see also id.* at 32763 ("One commenter suggested that the scope of required production was too narrow and ill defined, thereby providing too much discretion to the Division of Enforcement staff to determine whether a document was relevant. . . . The rule no longer calls upon the Division of Enforcement staff to make relevancy determinations.").

[206] *Id.* at 32741, 32763–65.

[207] *Id.* at 32741; *see also id.* at 32767 ("The possibility that such motions may simplify the proceeding should not be allowed to delay the planned start of the hearing."). The Commission rejected a proposal to make these motions more widely available, reasoning that APs "[t]ypically . . . involve basic disagreement as to material facts" such that "the circumstances when summary disposition prior to hearing could be appropriately sought or granted will be comparatively rare." *Id.* at 32768.

igation costs" in civil litigation. Moreover, the Commission reasoned, there was less need for depositions in the context of an AP, where "there is ordinarily a detailed pre-institution fact finding investigation and a rigorous pre-institution review process," as compared to in civil litigation "where neither party can compel testimony prior to the filing of the complaint."[208]

The Commission also adopted the task force's recommendation of adopting "guidelines for the timely completion of adjudicatory proceedings," but expressly declined to impose such timelines as rules[209]:

> The guidelines do not create a requirement that each portion of a proceeding or the entire proceeding be completed within the periods described. Proceedings at either the hearing stage or on review by the Commission may require additional time because they are unusually complex or because the record is exceptionally long or for other reasons. In addition, fairness to all parties requires that the Commission's deliberative process not be constrained by an inflexible schedule.[210]

Strikingly, the SEC would later reverse course, imposing mandatory timelines.[211]

Thus, after the 1990 legislation dramatically enhanced the SEC's penalty authority, the agency engaged the regulated industry and outside experts in a rulemaking process that culminated in substantial reforms to the procedures that govern in that forum.

This engagement with stakeholders and the procedural reforms that resulted might have helped defuse the potential backlash or challenge to agency legitimacy that seems to be plaguing the agency's enforcement program now. No collateral attacks were filed challenging the constitutionality of APs. The constitutional criticisms faded away and the industry adjusted to the new regime without any major disruption.

B. Sarbanes-Oxley Act of 2002 and Procedural Reform

The pattern repeated itself on a much smaller (and more ambiguous) scale after the Sarbanes-Oxley Act of 2002. Among many other things, that statute gave the SEC authority to seek to bar individuals from serving as directors and officers of public companies in an AP,[212] a sanction that it had formerly had to go to district court to obtain. This penalty enhancement was a very minor portion of the Sarbanes-Oxley Act. And, as Figure 1 above indicates, Sarbanes-Oxley seems to have triggered a burst of activity of APs over district court actions—though this burst likely had much more to do with other provisions of the Act than the director and officer bar provision. This provision prompted some moderate criticism,[213] including speculation that such lifetime bars might be unconstitutional

[208] *Id.* at 32764.

[209] *Id.* at 32742–43.

[210] *Id.*; *see also id.* at 32821.

[211] Rules of Practice, 68 Fed. Reg. 35787 (June 17, 2003).

[212] *See* Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, § 1105, 116 Stat. 745, 809.

[213] *E.g.*, Jayne W. Barnard, *SEC Debarment of Officers and Directors After Sarbanes-Oxley*, 59 Bus. Law. 391, 410–18 (2004).

as applied in an administrative forum.[214] However, the constitutional and legitimacy-based attacks on the agency were contained. Once again, shortly after enactment, the agency enacted a package of amendments and refinements to its rules of practice,[215] including a limited right to take depositions to preserve testimony that would otherwise be unavailable.[216] Though Sarbanes-Oxley generated substantial criticisms, it did not give rise to the constitutional and legitimacy doubts now plaguing the agency's enforcement program.

C. Procedural Reform, Fairness, and Legitimacy

This history provides a useful lens to interpret the current backlash.

1. Justifying the Backlash

Holding all else equal, fairness requires that procedures be commensurate with the stakes of the adjudication. When greater penalties or deprivations are on the line, procedural protections ought to be relatively more robust (again holding all else equal). Thus, the U.S. Supreme Court, in *Mathews v. Eldridge*, held that "the specific dictates of due process generally require[] consideration of . . . the private interest that will be affected by the official action."[217] And criminal defendants (who face incarceration) are generally accorded greater protections than civil litigants (who do not)—and capital defendants accorded greater protections than others.

Before Dodd-Frank, the SEC's enforcement architecture embodied a commitment to this principle in two ways.

First, the SEC adjusted its procedural regime to accommodate new penalty powers created by Congress. As documented above, when the agency received new penalty powers inside its administrative forum, it expanded the procedural protections available to respondents in that forum accordingly. Thus, procedures remained commensurate with penalties *over time*.

Second, before Dodd-Frank, the penalties available in each of the three fora available for securities law violations (criminal, civil, and administrative) were commensurate with the level of procedural guarantees available. That is, criminal trials offered both the greatest procedural protections (e.g., reasonable doubt) *and* penalties (prison), APs offered the weakest procedures (see above) and penalties (e.g., formal censures or orders to "obey the law"), and civil actions were in the middle. In this equilibrium, the Enforcement Division therefore had an incentive to bring more significant cases in district court rather than in APs.[218] In-

[214] *Id.* at 415 ("It is . . . fair to stop and contemplate whether a lifetime bar order is appropriate in a civil proceeding when a comparable order is not available in a criminal proceeding!"); *but see id.* at 417 (noting that the problems are "probably not of constitutional proportions").

[215] Adoption of Amendments to the Rules of Practice and Delegations of Authority of the Commission, 69 Fed. Reg. 13166 (Mar. 19, 2004).

[216] *See id.* at 13170.

[217] 424 U.S. 319, 325 (1976).

[218] Geoffrey F. Aronow, *Back to the Future: The Use of Administrative Proceedings for Enforcement at the CFTC and SEC*, Futures & Derivatives L. Rep., Jan./Feb. 2015, at 1, 3 ("Given the history of limited authority to proceed via administrative procedure in enforcement actions, the SEC Enforcement Di-

deed, in its 1990 expansion of the SEC's remedial authority in APs, Congress seems to have expressly avoided "equalization" of penalties across APs and district court actions because of concerns about such incentive effects.[219] Thus, penalties were commensurate with procedures *across fora*.

After Dodd-Frank, the SEC's enforcement architecture plainly no longer respects this principle—either *over time* or *across fora*. When Congress raised the penalties available inside APs, the agency failed to update procedures to keep pace as it had done in the past. Instead, the agency actually pressed forward with an aggressive new enforcement strategy designed to maximize its new substantive powers to take advantage of its preexisting procedural advantages. This includes the practice of testing out novel theories of liability in APs and forcing respondents into settlements with the threat of harsh penalties.

And after Dodd-Frank the penalties available inside district court and APs are now equal.[220] A House report states the goal as enhancing the flexibility and efficiency of SEC enforcement by making the "SEC's authority in administrative penalty proceedings *coextensive* with its authority to seek penalties in Federal Court."[221] But there is a significant gap between the procedures available in these fora. The agency's choice of forum calculus is no longer set up to preserve the principle; because of the incentive effect on the agency to proceed with difficult cases in a more procedurally advantageous forum, the forum selection calculus is now set up to *subvert* the principle.

This story casts the current backlash into sharper relief. The problem is not (or not *only*) that the SEC has been bringing more (and more important) cases in its home forum, that the procedures in that forum are deficient per se, or that the penalties available in that forum are draconian. Rather, the problem it is that, unlike in the past, under the SEC's current enforcement architecture, procedural protections are not commensurate with penalties.

None of this is to suggest that the agency cannot justly expand its penalty authority without also increasing procedural protections. To the contrary, other factors may well justify such a move. (Thus, the principle is that "*holding all else equal*," fairness requires that procedures be commensurate with the stakes

vision brought most of its cases, and virtually all of its important cases, in federal court. As a result, even as the authority to use the alternative, administrative route expanded over the years, the Division appeared to continue to believe that important cases should have the imprimatur of federal court.").

[219] As one former commissioner explains: "The concern among members of Congress and internally at the SEC was that if the same remedies were available to the SEC under both judicial and administrative proceedings, then the SEC might be perceived to have an incentive to conduct more enforcement actions through its own administrative proceedings, rather than before a federal district court judge." Atkins & Bondi, *supra* note 178, at 393–94.

[220] *See* Rakoff, Law Unto Itself, *supra* note 53 ("The net result of all of this is that the S.E.C. can today obtain through internal administrative proceedings nearly everything it might obtain by going to court."); Plaintiff's Motion for Preliminary Injunction at 2, Bebo v. SEC, No. 15-cv-3 (E.D. Wis. Jan. 23, 2015), ECF No. 14 ("Providing an agency with the ability to obtain the same remedy in federal court or in an AP is a unique (and unconstitutional) enforcement regime previously unheard of in the large and ever-growing administrative state."); *see also id.* at 13–15.

[221] H. Rep. No. 111-687, at 78 (2010) (emphasis added) (Investor Protection Act of 2009); *see also* Plaintiff's Motion for Preliminary Injunction at 15–16, Bebo v. SEC, No. 15-cv-3 (E.D. Wis. Jan. 23, 2015), ECF No. 14; Appellant's Brief at 7, Jarkesy v. SEC, No. 14-5196 (D.C. Cir. Dec. 24, 2014).

of the litigation.) For instance, in addition to the "private interest that will be affected," the *Mathews v. Eldridge* test also takes account of "the probable value, if any, of additional procedural safeguards," and "the Government's interest, including the fiscal and administrative burdens that the additional or substitute procedures would entail."[222]

Neither Congress, nor the SEC, offered any such justification. They did not adequately explain why the increase in penalties inside of APs did not mandate any sort of re-evaluation of the procedures in that forum—to the contrary, senior SEC officials seemed to acknowledge that some procedural reform was necessary.[223] Nor did they adequately explain why the SEC could pursue the same violation with the same penalty under two vastly different procedural regimes. The closest thing to a justification is a recently released set of factors governing the Division of Enforcement's forum selection decisions.[224] But, as discussed above, these factors are malleable, and they fail to resolve the questions of fairness.[225] The SEC's own recent history provides support for the contention that its current enforcement architecture is unfair.

2. Explaining the Backlash

More formal procedures increase the costs of enforcement.[226] Why would the SEC ever voluntarily adopt such procedures?[227]

One possibility is that SEC officials have a genuine commitment to due process of law and other values promoted by more robust procedures. But SEC officials are also committed to effectively enforcing the securities laws. Facing a tradeoff between these two commitments, why choose to sacrifice effective enforcement on the altar of due process?

Another possibility is that the voluntary adoption of more robust procedures reflects agency capture by the regulated industry. That is, the SEC voluntarily undertakes measures that will slow down enforcement as a favor to their friends in the securities industry. Or, perhaps they do so to create more (and more specialized) work for the private securities bar which they plan to reenter.

The story presented above points toward an alternative explanation: the SEC adopts more formal procedures strategically to secure the legitimation of its en-

[222] Matthews v. Eldridge, 424 U.S. 319, 335 (1976).

[223] Daniel Wilson, *SEC Administrative Case Rules Likely Out of Date, GC Says*, LAW360 (June 17, 2014, 5:55 PM EST), http://www.law360.com/articles/548907/sec-administrative-case-rules-likely-out-of-date-gc-says.

[224] Division of Enforcement Approach, *supra* note 4.

[225] *See supra* text accompanying notes 127–29.

[226] *See* MASHAW ET AL., *supra* note 40, at 311 ("Individualized adjudicatory justice, particularly if it entails all the trappings of formal adversary procedure, is wonderfully anti-bureaucratic. . . . The stage is thus set for continuous trench warfare between ideas of managerial competence and individual fairness. . . . These battles are a ubiquitous feature of administrative legal life and are waged on a host of procedural fronts.").

[227] By "voluntarily," I mean to distinguish the question of why Congress or the courts would impose such requirements on agencies. *Cf.* Mathew D. McCubbins, Roger G. Noll & Barry R. Weingast, *Administrative Procedures as Instruments of Political Control*, 3 J.L. ECON. & ORG. 243 (1987); Lisa S. Bressman, *Procedures as Politics in Administrative Law*, 107 COLUM. L. REV. 1749 (2000).

forcement program and prevent a full-scale defection by the regulated industry. The need to secure legitimation (and reduce the risk of backlash) tends to be particularly acute after significant expansions of the SEC's administrative enforcement powers because these expansions disrupt the equilibrium between procedures and penalties. Adopting new, defendant-favorable procedures helps restore the balance, and thereby avoid a rebellion. In these circumstances, procedural *reform* avoids full-blown *revolution*.

After Dodd-Frank, the agency did not engage the regulated industry regarding the procedures that would govern its exercise of the new penalty powers as it had done in the past. Dodd-Frank's equalization of penalties across fora put the agency in a vulnerable position, but the agency's own failure to consider procedural reform left the industry with no alternative but to launch a full-scale assault, bringing along leading commentators and stakeholders.

IV. Procedural Reform

After blazing forward with aggressive implementation of its new administrative powers and ignoring attacks on the legitimacy of its enforcement program for several years, the agency has finally signaled an understanding that it has overreached. In September 2015, the agency proposed several amendments to its rules of practice[228]—seemingly designed to quell the mounting criticism.[229]

These reforms are too little, too late. That is, they come too late to derail the backlash, and they are too minimal to resolve the procedural imbalance or remedy the damage to the agency's reputation.

After briefly reviewing these proposals, this Part advances a bolder package of procedural reforms that would go farther to mitigate some of the concerns that provoked the current wave of backlash.

A. The SEC's Proposed Procedural Reforms

In September 2015, the SEC proposed several amendments to the Rules of Practice, including changes to the rules governing experts, hearsay evidence, appellate rights, and filings. Two of the most significant changes are to timing and deposition rights.

Timing: As discussed above, APs are currently subject to rigid timelines. Even the most complex matters proceed from service of the OIP to trial in four months. The proposed rules retain the rigidity of the current regime, but would double the timeline for the most complex cases from four to eight months

[228] Amendments to the Commission's Rules of Practice, 80 Fed. Reg. 60082 (proposed Oct. 5, 2015); Amendments to the Commission's Rules of Practice, 80 Fed. Reg. 60091 (proposed Oct. 5, 2015).

[229] *E.g.*, Elizabeth P. Gray et al., *SEC Proposes Amended Rules to Govern Administrative Proceedings*, Wilkie Farr & Gallagher LLP (Sept. 28, 2015), http://www.willkie.com/~/media/Files/Publications/2015/09/SEC_Proposes_Amended_Rules_to_Govern_Administrative_Proceedings.pdf (suggesting the rules were proposed "in order to insulate the Commission from recent constitutional challenges to the forum and format of the proceeding").

from when the OIP is served to the hearing.[230] This change would give respondents valuable additional time to review massive investigatory files and develop their case for trial. However, it would not erase the substantial gap between respondents and the Enforcement Division, which often has a great deal more time to prepare its case—enough to be "measured in years rather than months."[231] Critics may not be appeased by anything less than abandoning the rigid structure of mandatory timelines.

Depositions: As also discussed above, under current rules, respondents may only take depositions in order to preserve testimony that would not be available at the hearing. The proposed rules would give both the respondent and the Enforcement Division the right to take up to three depositions in a matter involving a single respondent, and up to five in a matter involving multiple respondents, without any "preservation" requirement.[232] Again, this is a significant reform, but one that may not go far enough. A complex case is likely to involve more than three (or five) critical witnesses. And, again, the Enforcement Division has had the opportunity to interview many more than five individuals in the course of its investigation, such that giving the same number of depositions to both respondent and Division will, in the words of one group of commentators, "leave the playing field tilted in favor of the Division."[233]

* * *

The SEC's proposals suggest that the agency has, at long last, come to the recognition that it has overreached. But, though these reforms constitute substantial advances in the fairness of APs, they are too little, too late. Perhaps if the agency had acted sooner, announcing these reforms *in conjunction with* the newly expanded emphasis on APs after Dodd-Frank, they might have forestalled any backlash. But as it is, the constitutional challenges are unlikely to be affected much by these proposals, nor will the weakened legitimacy of the agency's enforcement program be remedied by them. For that, a bolder set of procedural reform is required.

B. An Alternate Package of Reforms: Conditional Stipulation and Interlocutory Review[234]

1. Conditional Stipulation

The SEC should amend its rules of practice to provide respondents a right to enter a conditional stipulation, similar to the "conditional pleas" that criminal de-

[230] 80 Fed. Reg. at 60092.

[231] Barry R. Goldsmith et al., *SEC Proposed Amendments to Rules for Administrative Proceedings*, Harv. L. Sch. F. on Corp. Governance & Fin. Reg. (Oct. 15, 2015), http://corpgov.law.harvard.edu/2015/10/15/sec-proposes-amendments-to-rules-for-administrative-proceedings/.

[232] 80 Fed. Reg. at 60092.

[233] Peter K.M. Chan et al., *Tweaking the "Home Court" Rules for SEC Administrative Proceedings*, Morgan Lewis (Sept. 28, 2015), www.morganlewis.com/pubs/tweaking-the-home-court-rules-for-sec-administrative-proceedings.

[234] Proposals are written out in Appendix A.

fendants are entitled to enter under Federal Rule of Criminal Procedure 11(a)(2).[235] That rule provides defendants with the right to accept a plea bargain, and thereby waive the right to a jury trial, while retaining the right to challenge some legal basis for the government's prosecution—often a Fourth Amendment suppression argument. If the defendant prevails on his legal challenge—either in the district court or on appeal—he may withdraw the plea.[236] According to a leading treatise, "[m]ost commentators have looked with favor upon [conditional pleas] because they serve to avoid the necessity for trials undertaken for the sole purpose of preserving pretrial objections."[237]

Respondents charged APs should be entitled to enter, with or without the consent of the Enforcement Division, a conditional stipulation, accepting as true all or substantially all[238] of the facts alleged in the OIP, but reserving the right to challenge the SEC's legal theory of liability—before an ALJ, the SEC, and ultimately, the U.S. Court of Appeals. Such a stipulation would entail a unilateral waiver of the right to a trial before an ALJ, in exchange for the right to attack the SEC's legal theory pursuant to existing (or slightly modified) rules governing motions for summary disposition and interlocutory review.

Such a conditional stipulation could be withdrawn if and when the respondent substantially prevails on his legal challenge—whether before an ALJ, on appeal to the Commission, or on appeal to the U.S. Court of Appeals. And, once withdrawn, it would not have any legal effect. For instance, it could not be used as evidence in a private civil suit.

Making the right exercisable unilaterally, without requiring any negotiation with the Enforcement Division, would make this a powerful tool for respondents to wield. Merely creating the right to effective, low-cost review of the SEC's legal theories would likely deter the agency from pursuing borderline cases in APs.

One difficulty of this proposal is determining what proportion of the factual allegations raised in the OIP would have to be included in the stipulation in order to trigger the trial waiver and the right to appeal. Requiring all of the facts seems unnecessary, given that some of the allegations may be irrelevant to the liability determination, and merely there for the penalty phase. The formulation "substantially all" is meant to accommodate this scenario.

If a respondent loses on his legal challenge, the stipulation would become irrevocable, and he would either have to undergo trial for the penalty phase, or reach some settlement with the Commission on that issue.

Taking an appeal from the Commission to a circuit court should not pose any difficulty. Such review is limited to "final" orders of the Commission, and the

[235] "With the consent of the court and the government, a defendant may enter a conditional plea of guilty or nolo contendere, reserving in writing the right to have an appellate court review an adverse determination of a specified pretrial motion. A defendant who prevails on appeal may then withdraw the plea." Fed. R. Crim. P. 11(e).

[236] *Id.*

[237] 5 Wayne R. LaFave et al., Criminal Procedure § 21.6(b) (3d ed. 2014) (collecting sources).

[238] A respondent should take advantage of the conditional plea without admitting to facts included in the OIP that are unnecessary to establish his liability.

U.S. Supreme Court has expressly ruled that "interlocutory" orders do not qualify. However, in this case, the order is "interlocutory" in name only: because of the conditional plea, the Commission's decision upholding the legal theory would be tantamount to a final order. Thus, judicial review would be available. (If necessary, the rules could also provide for a nominal penalty to be imposed on respondents who enter conditional pleas.)

2. Interlocutory Judicial Review

Alternatively, or in addition to the conditional stipulation, the SEC could adopt a package of reforms that would allow a respondent to challenge the SEC's legal theory of prosecution *without* reaching any plea agreement.

The rule governing motion for summary disposition could be changed to allow for such motions to be filed as of right before trial. Currently, the rule authorizes such motions, but only with "leave" of the ALJ—the determination to grant or deny this leave is unreviewable.[239]

Respondents' track record with dispositive motions is laughable: only five have been granted between 1996 and 2014.[240] Moreover, it is not enough to provide a prompt method to challenge the legal theory before the ALJ. The rule governing interlocutory appeals should be amended to allow for immediate appeals of denials of motions for summary disposition contesting the government's underlying legal theory. Currently, the rule makes interlocutory appeals "disfavored" and granted in only "extraordinary circumstances."[241] The rule should be changed to encourage the Commission to hear interlocutory appeals from denials of motions for summary disposition that squarely confront the Commission's legal theory.

The rules governing "stays" or extensions of trial should be amended to allow for delays of trials pending resolution of the plaintiff's challenge to the government's legal theories, including all appeals. Currently the rules establish rigid timelines and strongly discourage departures from these.[242]

As discussed above, the securities statutes authorize judicial review only of "final" orders. A Commission rejection (on the merits) of an interlocutory appeal attacking the Commission's legal theories is "final" in the sense that it adopts a view of the meaning of the securities laws that is binding on the respondent. But it is not "final" in the sense that it still leaves open the possibility that the respondent will escape any agency action by disproving the charges at trial. The agency might try to solve this problem by adopting a rule construing the word "final," as

[239] The current rule on summary disposition itself was amended in 1995—prior to that date, the rule flatly prohibited such motions. *See* 17 C.F.R. § 201.11(e) (1994); *see* 2 Bloomenthal & Wolf, *supra* note 6, § 36.69.

[240] *See* Platt, *supra* note 28.

[241] 17 C.F.R. § 201.400 (2015).

[242] *See id.* § 201.360; *see also supra* text accompanying notes 19–21.

used in the judicial review statutes, as encompassing Commission decisions upholding legal theories. This rule could require the Commission to "certify" such rulings for judicial review, declaring them "final" for purposes of the securities statutes. The weakness in this solution is that courts, which bear the responsibility for construing the judicial review statutes, could look past the Commission's "certification" of an issue as "final."

* * *

These reforms would help re-establish the equilibrium between procedures and penalties inside APs. Both reforms aspire to overcome the practical obstacles that respondents face in attacking the Commission's legal theories. As such, they would also combat the SEC's incentive to assert novel untested legal theories in APs. When Dodd-Frank increased the SEC's penalty powers in APs, the procedural protections afforded to respondents in these proceedings should have similarly expanded. It is now too late to prevent backlash, but these reforms would go a long way toward restoring the agency's respect for the principle that procedures should be commensurate with penalties, and restore some of the enforcement regime's lost legitimacy.

From the agency's perspective, the reforms might also have an additional benefit: they may somewhat reduce some of the risks under the constitutional claims. For instance, they may reduce the risk of an Article II violation by transforming ALJs into merely recommendatory agents, rather than policy-making "officers." The government has argued that ALJs do not qualify as "officers" because, unlike the PCOAB members, "ALJs do not draft regulations" but merely "adjudicate cases."[243] And "[a]djudications by SEC ALJs . . . do not involve the same kind of important policy choices [as decisions by the PCOAB]; they involve the application of the law to a discrete set of facts in individual cases."[244] But, as discussed above, the SEC's use of APs increasingly blurs that distinction. By relying on APs to develop novel theories of the law, the agency makes ALJs into quasi-rulemaking entities. Allowing for expedited appellate review of legal issues would weaken plaintiffs' claims that ALJs effectively wield final rulemaking authority, and thus demonstrate that, unlike PCOAB members, ALJs do not constitute "officers" of the United States.

Adoption of this proposal might also diminish the prospect that the nondelegation argument would prevail. Plaintiffs must convince a court to find the choice of forum amounted to a legislative (or quasi-legislative) act. The only way for a plaintiff to do so would be to convince a court that APs functioned as quasi-legislative proceedings, producing new rules for the regulated industry relatively immune from judicial review. The proposal diminishes the ALJs' control over this "rulemaking" function, by entitling respondents to prompt and rel-

[243] Government's Opposition at 37, Bebo v. SEC, No. 15-cv-3 (E.D. Wis. Feb. 3, 2015), ECF No. 15.

[244] *Id.*

atively low-cost access to judicial review, and thereby mitigates the potential liability for a nondelegation challenge.

3. Counterarguments

Some might object that this solution targets only one facet of the problem with APs—their impact on the development of the law—and leaves other flaws, constitutional and otherwise, unaddressed. For instance, the proposal does not purport to resolve the possible Seventh Amendment and procedural due process problems: unregistered persons would remain subject to APs, where they would be denied various procedural protections (including a jury trial) and potentially subjected to severe penalties.

It is true that by failing to promptly engage in procedural reform following Dodd-Frank, the SEC may have lost its best opportunity to avoid backlash. Now that the litany of constitutional defects with APs have been aired, and the legitimacy of the agency's expanded use of APs called into doubt, it will take a very significant effort to change the momentum. Still, though it is surely not guaranteed to stop the backlash in its tracks, the proposal is worth consideration insofar as it: (1) does possibly mitigate some of the constitutional arguments (Article II and nondelegation); (2) directly mitigates the criticism, articulated by Judge Rakoff, among others, that the agency is unfairly using APs to develop new doctrines; and, therefore, as a result, (3) may restore some lost legitimacy to APs, which could have an effect on these remaining constitutional challenges.

Some might also object that solution does not go far enough in resolving the concerns about the development of the securities laws. Judge Rakoff criticized APs in part because if and when a legal challenge does reach an Article III court, that court will review legal determinations of the agency with the deference required under *Chevron* and related doctrines.[245]

But the SEC's legal theories advanced in APs have always been subject to judicial review under *Chevron*. And even those who are deeply skeptical of deference regimes seem to have accepted that *Chevron* is here to stay.[246] A better view of the problem (as articulated above) is that APs hinder balanced development of the securities laws not because of *Chevron* deference, but because they too often keep respondents out of the process, thereby depriving adjudicators of input from the regulated industry. Case-by-case adjudication is a legitimate method of law development—only where there is adequate input from both sides of the case. The proposal would remedy the current imbalance in APs by ensur-

[245] Rakoff, Law Unto Itself, *supra* note 53 ("[W]hile the decisions of federal district courts on matters of law are subject to de novo review by the appellate courts, the law as determined by an administrative law judge in a formal administrative decision must be given deference by federal courts unless the decision is not within the range of reasonable interpretation.").

[246] *E.g.*, Perez v. Mortg. Bankers Ass'n, 135 S. Ct. 1199, 1212–13 (2015) (Scalia, J., concurring in the judgment) (admitting with apparent reluctance that the "problem" of deference to agency statutory interpretation is "perhaps insoluble if *Chevron* is not to be uprooted," while actively urging the abandonment of deference to agency regulatory interpretation).

ing that litigants have a low-cost opportunity to contest legal theories articulated by the agency.

Moreover, *Chevron* deference may be overrated. An empirical study of every U.S. Supreme Court opinion from 1986 to 2010 involving an agency interpretation concluded that *Chevron* deference has been applied unevenly at best.[247] Courts have not shied away from closely scrutinizing the SEC's constructions of the securities statutes on review of APs even under the *Chevron* standard.[248] Nor have they been unwilling to take a close look at the agency's decisionmaking in the rulemaking context, despite the standards of deference that apply there.[249]

Most important, several recent opinions cast doubt on certain forms of deference.[250] For instance, in *Whitman v. United States*, Justice Scalia (joined by Justice Thomas) suggested that the deference courts accord to agency interpretations cannot properly, under the rule of lenity, apply to statutes that contemplate both civil and criminal enforcement.[251] This would apply to many of the securities laws that form the basis of APs.[252] And, in *Perez v. Mortgage Bankers Ass'n*, Justices Thomas, Scalia, and Alito suggested (with varying degrees of certainty) overturning precedents requiring deference to agency interpretations of their own regulations.[253]

Some might also object that this proposal goes too far—that respondents will overuse this right to seek appeal as a delaying tactic. The effect would be to diminish the timeliness advantage of APs.

This criticism points to the fact that, as a practical and political matter, any procedural reform solution to the present constitutional backlash must preserve the fundamental advantages of APs for the agency, or else it will not be worth the agency's time in taking it up. There may be methods to effectively deter overuse or frivolous uses of this new right. But if none of these prove effective, the SEC

[247] Connor N. Raso & William N. Eskridge, Jr., Chevron *as a Canon, Not a Precedent: An Empirical Study of What Motivates Justices in Agency Deference Cases*, 110 Colum. L. Rev. 1727 (2010).

[248] *E.g.*, Goldstein v. SEC, 451 F.3d 873 (D.C. Cir. 2006).

[249] *See supra* text accompanying notes 143–50 (discussing *Business Roundtable*, etc.).

[250] *See Perez*, 135 S. Ct. at 1210–25 (opinions of Scalia, J., Thomas, J., and Alito, J.).

[251] 135 S. Ct. 352 (2014) (Scalia, J., respecting the denial of certiorari); *see also* Carter v. Welles-Bowen Realty, Inc., 736 F.3d 722, 729 (6th Cir. 2013) (Sutton, J., concurring).

[252] *See* Securities Act § 20(b); Exchange Act § 21(d)(1); Investment Advisers Act § 209(d); Investment Company Act § 42(d).

[253] 135 S. Ct. 1199, 1210–25 (2015). Again, the opinions expressed this view with varying degrees of confidence. *Compare id.* at 1213 (Thomas, J., concurring in the judgment) (rejecting deference to agency interpretations of their own regulations which "effects a transfer of the judicial power to an executive agency," "undermines our obligation to provide a judicial check on the other branches," and "subjects regulated parties to precisely the abuses that the Framers sought to prevent"), *and id.* at 1212–13 (Scalia, J., concurring in the judgment) ("I would therefore restore the balance originally struck by the APA with respect to an agency's interpretation of its own regulations, not by rewriting the Act in order to make up for *Auer*, but by abandoning *Auer* and applying the Act as written. The agency is free to interpret its own regulations with or without notice and comment; but courts will decide—with no deference to the agency—whether that interpretation is correct."), *with id.* at 1210 (Alito, J., concurring in part and concurring in the judgment) ("I await a case in which the validity of *Seminole Rock* may be explored through full briefing and argument.").

should adopt the conditional stipulation method, which does not raise similar concerns.[254]

C. Rival Proposals

Scholars have only just begun to examine the current backlash.[255] But commentators have advanced a number of proposals to modify the system to mitigate some of the concerns about SEC enforcement.

1. Forum Selection Guidelines

Early in 2015, Commissioner Michael Piowar suggested the agency adopt guidelines governing the choice of forum, in order to "avoid the perception that the Commission is taking its tougher cases to its in-house judges, and to ensure that all are treated fairly and equally."[256] In June 2015, the Division of Enforcement released a four-page document outlining the factors it weighs in making forum selection determinations.[257]

This document does not resolve the legitimacy or constitutional concerns raised about APs. It explicitly states that APs are particularly useful for cases involving "unsettled and complex legal issues under the federal securities laws" because of the Commission's "expertise concerning those matters."[258] It does nothing to restore the pre-Dodd-Frank procedural balance. And because the factors listed are so malleable, it does little to assuage the fear that the SEC is using the choice of forum unfairly to obtain a procedural advantage.[259]

[254] Another criticism: The proposal gives respondents the right to challenge new legal theories, but it is not always easy to distinguish between new legal theories and old legal theories applied to new facts. Insofar as my proposal subjects the former, but not the latter, to greater scrutiny, it might simply encourage the agency to disguise some of its legal innovations as factual.

[255] The only full-length scholarly treatment of these issues that I am aware of is a student note. Ryan Jones, Note, *The Fight Over Home Court: An Analysis of the SEC's Increased Use of Administrative Proceedings*, 68 SMU L. Rev. 507 (2015).

[256] Michael S. Piowar, Comm'r, U.S. Sec. & Exch. Comm'n, A Fair, Orderly, and Efficient SEC, Remarks at 2015 SEC Speaks Conference (Feb. 20, 2015).

[257] *See Division of Enforcement Approach*, *supra* note 4; *see also supra* text accompanying notes 126–128.

[258] *Id.*; *see also* Bourtin et al., *supra* note 154 ("[T]he guidance may exacerbate the criticism voiced by Judge Rakoff and others that the SEC should expose novel applications of the securities laws to de novo judicial review rather than handle them through administrative proceedings."); McLucas & Martens, *supra* note 52 (asserting that the guidance on forum selection "did not address the significant objections that critics have raised").

[259] *See* McLucas & Martens, *supra* note 52 (criticizing the four-page memo and urging the SEC to develop truly "objective criteria" to guide the choice of forum). The Chamber of Commerce's 2015 policy report urges the Commission to adopt more rigid forum selection guidelines, which would limit APs to cases "based upon well-established legal principles that have been adopted by Article III courts." U.S. Chamber of Commerce, Examining U.S. Securities and Exchange Commission Enforcement: Recommendations on Current Processes and Practices 3 (July 2015).

2. Right of Removal

In the last round of anti-AP backlash in the early 1990s (after the Remedies Act, discussed above), the American Bar Association suggested that the SEC should grant all respondents charged in APs a right of "removal," akin to that provided by 28 U.S.C. § 1441, such that any respondent charged in an AP could unilaterally force the SEC to proceed in federal court.[260] The U.S. Chamber of Commerce recently revived the proposal,[261] and it has been taken up by a member of Congress, who introduced legislation in October 2015.[262]

This is strong medicine. Respondents would likely opt out of the AP system very widely, if only for the added delays provided in federal court litigation. APs are a valuable mechanism to enforce the securities laws which have been available since the beginning of the Commission itself. If this were the only available solution, the SEC would have no incentive to take action—it may as well let the constitutional challenges proceed and take its chances.

3. Allocate Choice of Forum

The ABA advanced a second proposal in the early 1990s: to allocate the choice of forum outside of the prosecutorial Enforcement Division to the advisory general counsel.[263] The general counsel provides a variety of services to the Commission, including the preparation of Commission opinions, representing the Commission in federal appellate courts, and providing legal advice. Reallocating the choice of forum from the Enforcement Division to the general counsel, the ABA argued, would eliminate the sense that the agency was forum shopping.

This solution is weak. Much of the mistrust of APs arises from the comingling of prosecutorial and adjudicative functions. Assigning the forum selection role to another actor in the same agency hardly mitigates such concerns. And, in any event, it leaves open the possibility that the choice of forum would simply continue on the current trajectory.

Moreover, the proposal is also likely to be resisted by the Enforcement Division that may feel that the attorneys who know the case best should be the ones who determine which forum best suits the case.

4. ALJ Reform

In *Hill*, Judge May suggested that the appointments violation she found "could easily be cured by having the SEC commissioners issue an appointment."[264] This

[260] *ALJ Task Force Report*, *supra* note 196, at 1736.

[261] U.S. Chamber of Commerce, *supra* note 259, at 4 ("The Commission should adopt a policy that any party named in an administrative proceeding that desires a jury trial may file a notice to remove the proceeding to federal district court.").

[262] Jean Eaglesham, *SEC Faces New Attack on In-House Judges*, Wall St. J. (Oct. 21, 2015), http://blogs.wsj.com/moneybeat/2015/10/21/sec-faces-new-attack-on-in-house-judges/.

[263] *ALJ Task Force Report*, *supra* note 196, at 1737.

[264] Hill v. SEC, No. 15-cv-1801, 2015 WL 4307088, at *20 (N.D. Ga. June 8, 2015). Judge May's proposal is parallel to another recent proposal targeting ALJs more generally, which would re-

would resolve the appointment challenge, but would leave unaddressed the remaining constitutional challenges as well as the concern about the proper development of the law. Moreover, the solution would raise a host of issues regarding cases already decided by (illegally appointed) ALJs.[265]

V. Conclusion

The wave of backlash facing the SEC poses risks potentially reaching well beyond the agency. The agency might have been able to preempt this backlash by promptly recalibrating the procedural protections available in APs, just as it did after receiving new AP penalty authority in the past. It is too late to prevent backlash, but it may not be too late for the agency to mitigate the harm that follows. By substantially reforming its rules of practice to afford respondents an effective opportunity to test the SEC's legal theories, the SEC might shore up legitimacy of its AP system.

The agency's recent proposals are a step in the right direction, but are too little, too late. It has been twenty years since the last comprehensive review of the Rules of Practice in 1995. In the interim, Congress has enacted several major overhauls to the securities laws, the financial industry has been transformed by countless innovations, advances in technology have reshaped litigation, and key legal doctrines governing agency action have changed substantially. The Rules of Practice are due for a comprehensive review. Bold reforms are required.

solve the constitutional questions raised by Article II by changing the appointment and removal structure of ALJs. Instead of being appointed by the Commission, Professor Kent Barnett proposes having ALJs appointed (and removed) by the D.C. Circuit. Kent Barnett, *Resolving the ALJ Quandary*, 66 Vand. L. Rev. 797 (2013). Notably, Judge May cites Prof. Barnett's article elsewhere in her opinion. *See Hill*, 2015 WL 4307088, at *16. And Professor Barnett endorsed Judge May's suggestion. *See* Kent Barnett, *The SEC's Inferiority Complex*, Yale J. on Reg. Notice & Comment (June 11, 2015), http://www.yalejreg.com/blog/the-secs-inferiority-complex-by-kent-barnett).

Barnett's D.C. Circuit proposal seems extremely unlikely to move forward. Judges seem likely to resist any such imposition of administrative duties. True, my proposal also requires additional work from the D.C. Circuit by making it more likely that more cases will come up through the system for a legal appeal. But, at least it is the same genre of work that judges are used to performing—i.e., interpreting the law and reviewing the work of administrative agencies—not reviewing resumes.

[265] *E.g.*, Peter J. Henning, *S.E.C. Finds Itself in a Constitutional Conundrum*, N.Y. Times DealB%k (June 15, 2015), http://www.nytimes.com/2015/06/16/business/dealbook/sec-finds-itself-in-a-constitutional-conundrum.html?_r=0; Frankel, *supra* note 14 (quoting SEC critics as suggesting that, if the SEC reappointed its ALJs as Judge May suggests, "Any defendant with a pending case before an SEC in-house judge—and even defendants previously tried in administrative proceedings—will be able to challenge the constitutionality of the regime in which they were tried.").

Appendix A

AGENCY: Securities and Exchange Commission

ACTION: Proposed rules and request for comment.

SUMMARY: The Securities and Exchange Commission is proposing to adopt revisions to the Rules of Practice.

DATES: Comments must be submitted on or before [Insert date 90 days after date of publication in the FEDERAL REGISTER].

Proposed Amendments:

Rule 161. Extensions of time, postponements and adjournments

. . . .

(b) Considerations in determining whether to extend time limits or grant postponements, adjournments and extensions.

(1) In considering all motions or requests pursuant to paragraph (a) or (b) of this section, the Commission or the hearing officer should adhere to a policy of strongly disfavoring such requests, except in circumstances where the requesting party makes a strong showing that the denial of the request or motion would substantially prejudice their case, ***or where the requesting party is pursuing a motion for summary disposition which primarily attacks the legal theory underlying the enforcement action or an interlocutory appeal of such a motion***. In determining whether to grant any requests, the Commission or hearing officer shall consider, in addition to any other relevant factors:

(i) The length of the proceeding to date;

(ii) The number of postponements, adjournments or extensions already granted;

(iii) The stage of the proceedings at the time of the request;

(iv) The impact of the request on the hearing officer's ability to complete the proceeding in the time specified by the Commission; and

(v) Any other such matters as justice may require.

Rule 203. Conditional Stipulation

(a) In lieu of filing an Answer, a respondent may enter a conditional stipulation, with or without the consent of the Enforcement Division, accepting all or substantially all of the factual allegations asserted in the OIP as true, while reserving the right to challenge the enforcement action on legal grounds.

(b) Upon the entry of such a conditional stipulation, the hearing officer shall set a schedule for briefing of a Motion for Summary Disposition.

(c) A respondent who prevails on these legal claims before the hearing officer, the Commission, or on Judicial Review, may withdraw the stipulation.

Rule 250. Motion for Summary Disposition

(a) After a respondent's answer has been filed and, in an enforcement or a disciplinary proceeding, documents have been made available to that respondent for inspection and copying pursuant to § 201.230, the respondent or the interested division may make a motion for summary disposition of any or all allegations of the order instituting proceedings with respect to that respondent. If the interested division has not completed presentation of its case in chief, a motion for summary disposition shall be made only with leave of the hearing officer~~.~~, ***unless the motion is directed primarily to attacking the legal theory underlying the prosecution, in which case a respondent may file such motion before the hearing as of right.*** The facts of the pleadings of the party against whom the motion is made shall be taken as true, except as modified by stipulations or admissions made by that party, by uncontested affidavits, or by facts officially noted pursuant to § 201.323.

Rule 400. Interlocutory Review

(a) Availability. The Commission may, at any time, on its own motion, direct that any matter be submitted to it for review. Petitions by parties for interlocutory review are disfavored, and the Commission ordinarily will grant a petition to review a hearing officer ruling prior to its consideration of an initial decision only in extraordinary circumstances. ***However, petitions for interlocutory review of motions for summary disposition primarily attacking the legal theory underlying the prosecution should be granted.*** The Commission may decline to consider a ruling certified by a hearing officer pursuant to paragraph (c) of this section or the petition of a party who has been denied certification if it determines that interlocutory review is not warranted or appropriate under the circumstances. This section is the exclusive remedy for review of a hearing officer's ruling prior to Commission consideration of the entire proceeding and is the sole mechanism for appeal of actions delegated pursuant to §§ 200.30–.9 and 200.30–.10 of this chapter.

. . . .

(d) Proceedings not stayed. The filing of an application for review or the grant of review shall not stay proceedings before the hearing officer unless he or she, or the Commission, shall so order. ***However, a petition for interlocutory review of a motion for summary disposition attacking***

> ***the underlying legal theory shall stay proceedings.*** The Commission will not consider the motion for a stay unless the motion shall have first been made to the hearing officer.

Rule ____. Certification for Judicial Review

Whenever the Commission denies (on the merits) an interlocutory appeal from a denial of a motion for summary disposition which primarily attacks the legal theory of the OIP, the Commission shall certify this order as "final" for purposes of judicial review, reflecting the fact that it is the Commission's final statement of the law, creating binding obligations on respondent and others similarly situated.

Financial Advisor Engagement Letters: Post-*Rural/Metro* Thoughts and Observations

*By Eric S. Klinger-Wilensky and Nathan P. Emeritz**

The liability of RBC in last year's In re Rural/Metro *decision was derivative of several breaches of fiduciary duty by the Rural/Metro directors, including those directors' failing "to provide active and direct oversight of RBC." In discussing that failure, the Court of Chancery stated that a "part of providing active and direct oversight is acting reasonably to learn about actual and potential conflicts faced by directors, management and their advisors." In the year since* Rural/Metro, *there has been an ongoing discussion—in scholarly and trade journals, courtrooms and the marketplace—regarding how, if at all, the process of vetting potential financial advisor conflicts should evolve. In this article, we set out our belief that financial advisor engagement letters are an efficient (although admittedly not the only) tool to vet potential conflicts of a financial advisor. We then discuss four contractual provisions that, we believe, are helpful in providing the active and direct oversight that was found lacking in* Rural/Metro.

In litigation arising from the acquisition of Rural/Metro Corporation by Warburg Pincus LLC, the Delaware Court of Chancery famously (or infamously, depending on one's point of view) held RBC Capital Markets, LLC liable for aiding and abetting breaches of fiduciary duty by the board of directors of Rural/Metro.[1] Much ink has been spilled discussing the factual and legal underpinnings of the Court of Chancery's opinions in that litigation. This article does not add to that interesting discussion. Instead of debating the merits of the outcome in *Rural/Metro*, this article begins from that outcome and contains our thoughts on the drafting and implementation of financial advisor engagement letters in a post-*Rural/Metro* world.

RBC's liability in *Rural/Metro* was derivative of a finding that the Rural/Metro directors had breached their fiduciary duties in approving the sale of the company to Warburg Pincus. The directors breached their fiduciary duties by,

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[1] *In re* Rural Metro Corp., 88 A.3d 54 (Del. Ch. 2014) [hereinafter *Rural I*]; *In re* Rural/Metro Corp. S'holders Litig., 102 A.3d 205 (Del. Ch. 2014) [hereinafter *Rural II*]. An appeal in the *Rural/Metro* litigation is pending as of the last edit date of this article (November 17, 2015).

among other things, "fail[ing] to provide active and direct oversight of RBC."[2] Addressing that failure, *Rural I* provided the following admonition:

> Because of the central role played by investment banks in the evaluation, exploration, selection, and implementation of strategic alternatives, directors must act reasonably to identify and consider the implications of the investment banker's compensation structure, relationships, and potential conflicts.[3]

The Court went on to state that a "part of providing active and direct oversight is acting reasonably to learn about actual and potential conflicts faced by directors, management, and their advisors."[4] In our experience, deal advisors have heeded this admonition, using financial advisor engagement letters as a key tool to vet potential conflicts of a financial advisor. That said, we understand that other practitioners have responded to *Rural/Metro* by vetting potential financial advisor conflicts through a side "disclosure memorandum" or a slide in a bankers' book.

In this article, we explain our belief that financial advisor engagement letters are an efficient (although admittedly not the only) tool to vet potential conflicts of a financial advisor.[5] We then discuss certain contractual provisions that are helpful in providing the active and direct oversight that was found lacking in *Rural/Metro*.[6]

[2] *Rural II*, 102 A.3d at 218.

[3] *Rural I*, 88 A.3d at 90.

[4] *Id.*

[5] Professors William W. Bratton and Michael L. Wachter have observed that cases such as *Rural/Metro*, as well as *In re Del Monte Foods Co. Shareholders Litigation*, 25 A.3d 813 (Del. Ch. 2011) and *In re El Paso Corp. Shareholder Litigation*, 41 A.3d 432 (Del. Ch. 2012), reflect a shift in judicial focus to whether "banker-client contracting inhibits realization of the best deal." William W. Bratton & Michael L. Wachter, *Bankers and Chancellors*, 93 Tex. L. Rev. 1, 46 (2014) [hereinafter *Bankers and Chancellors*]. The professors suggest that these cases should lead to reinvigorated negotiation between directors and financial advisors on the terms of the financial advisor engagement letter, and thus cause directors to "us[e] contract [i.e., the engagement letter] to facilitate oversight and position the board to take appropriate action" in the event a conflict arises. *Id.* at 61. We agree.

[6] The starting point for many of the form provisions discussed in this article was a document entitled "Form of Engagement Letter, marked to show comments from Company's counsel." That document, reproduced as Exhibit A to this article, was prepared by David I. Albin, a partner at Finn Dixon & Herling LLP in Stamford, Connecticut, in connection with an ABA, Business Law Section Mergers & Acquisitions Committee Forum that Mr. Albin chaired titled Retaining and Managing Your Investment Banker in the Aftermath of *In Re Del Monte Foods Company Shareholder Litigation* and presented in April 2011 following the release of the *Del Monte* opinion. The potential changes to a form of financial advisor engagement letter shown in that document were meant to be used as a teaching tool and discussion aid in connection with the *Del Monte* opinion and were not meant by the author or the other panel members (Michael G. O'Bryan, a partner at Morrison Foerster LLP, San Francisco, California; Kevin Miller, a partner at Alston & Bird LLP, New York, New York; The Honorable Myron T. Steele, then Chief Justice of the Delaware Supreme Court and now a partner at Potter Anderson Corroon LLP, Wilmington, Delaware; and Patricia O. Vella, a partner at Morris, Nichols, Arsht & Tunnell LLP, Wilmington, Delaware) as recommendations of changes that counsel for the party engaging a financial advisor should request. Among other provisions appearing in that document that we do not, in this article, advocate including in financial advisor engagement letters are (i) a prohibition on engaging in discussions with any third person regarding a deal with the company for one year after the engagement is terminated, (ii) an indemnity running from the financial advisor to the company for actions taken by the financial advisor that cause the directors to violate their fiduciary duties to the company, and (iii) an express statement that the financial advisor will perform its services as a fiduciary to the company.

The Use of a Financial Advisor Engagement Letter to Address Potential Conflicts

In our post-*Rural/Metro* experience, financial advisors and their counsel recognize that because, as discussed above, RBC's liability derived from a breach of the directors' duty of care, conflicts-related disclosures that demonstrate care in the retention of a financial advisor will mitigate the possibility that the financial advisor will be liable for aiding and abetting a breach of the directors' duty of care.

Several commentators on an initial draft of this article, however, questioned whether an *engagement letter* is the proper tool for providing the "direct oversight" that was found lacking in *Rural/Metro*. Those commentators observed, and we readily admit, that using engagement letters as a tool for providing oversight contractually adds time and expense to the financial advisor engagement process and that, historically, the board of directors does not even read the financial advisor engagement letter, let alone understand it to be a tool for addressing conflicts. Rather than addressing these issues contractually, the commentators suggest that "direct oversight" can be accomplished via a page in a board book or via a "disclosure memorandum." In our view, although addressing conflicts-related issues through a board book or a disclosure memorandum represents a positive evolution from pre-*Rural/Metro* practice and is, in many instances, sufficient,[7] negotiating for inclusion in the engagement letter of the provisions discussed in this article could be worth the extra time and expense for several reasons.

First, the process of providing contractual representations encourages the representation giver to exercise thorough diligence in a timely fashion, so as to avoid complications arising from belated discovery and disclosure of significant conflicts.[8] Take the following example. Bank A has been providing financial advice throughout a strategic review process. The process began when Party A lobbed a bid over the transom. Bank A indicated it had a few minor prior engagements for Party A at the outset of the engagement, and the board decided those small minor engagements did not result in a disabling conflict. A few alternative bidders are contacted,

[7] *See* Transcript of Telephonic Ruling on Defendants' Motions to Dismiss at 36, *In re* PLX Tech. Inc. S'holders Litig., C.A. No. 9880-VCL (Del. Ch. Sept. 3, 2015) [hereinafter *PLX II* Transcript] ("The directors' toolbox for vetting these things and continuing their oversight includes basic contracting techniques, such as representations, covenants and disclosure schedules. But it also involves just keeping your eyes open, asking questions, and getting straight and complete answers as the process unfolds.").

[8] James C. Freund, Anatomy of a Merger: Strategies and Techniques for Negotiating Corporate Acquisitions § 7.1.1 (1975) [hereinafter Anatomy of a Merger] ("[R]epresentations constitute a systematic smoke-out of the data about the [bank] which the [board] feels is important."); *see also* GRT, Inc. v. Marathon GTF Tech., Ltd., C.A. No. 5571-CS, 2011 WL 2682898, at *13 n.69 (Del. Ch. July 11, 2011) (citing Anatomy of a Merger, *supra*, at 160 ("But in acquiring a public company [where the representations and warranties expressly terminate at closing], your investigative prowess must be exhibited prior to the closing.")); ABA Model Agreement and Plan of Merger § 2 (Jan. 20, 2010) ("In a public company acquisition [where the representations and warranties expressly terminate at closing], the target's representations and warranties . . . are a device for obtaining disclosures about the target before the signing of a definitive agreement and thus play a significant role in the buyer's diligence process."); *cf.* Weinberger v. Bankston, C.A. No. 6336-VCB, 1987 WL 20182, at *2 (Del. Ch. Nov. 19, 1987) (citing Gould v. Am.-Hawaiian Steamship Co., 387 F. Supp. 163, 168 (D. Del. 1974) and noting that in a proxy solicitation "[o]nly a realistic possibility of liability for damages will encourage due diligence by those who solicit proxies and will protect the interests of informed corporate suffrage").

but a broad-based auction is not conducted. At the end of the process, Party A emerges the winner. As the board and its advisors are negotiating the short strokes of the acquisition agreement, the board's counsel receives a call from counsel to Bank A. It goes something like this: "Well, we were updating our conflicts check for purposes of disclosure in our fairness opinion and noted a few more conflicts."

Honest to goodness, this scenario has come up on more than a handful of occasions. Indeed, in a recent ruling declining to dismiss an aiding and abetting claim against Deutsche Bank, the plaintiff alleged a fact pattern substantially similar to this hypothetical.[9] The increased focus on diligence up front will hopefully mitigate (if not eliminate in its entirety) our unfortunate repeat experience of a financial advisor surfacing conflicts only upon a "more focused conflicts search" performed in drafting its fairness opinion letter.[10]

It may well be that, in fact, financial advisors are performing their conflicts-related diligence at an earlier stage in the process, and with more alacrity, than in prior years, and that the results of such diligence are being reflected in board books or disclosure memoranda. But we believe that if such diligence forms the basis for a contractual representation, as opposed to a unilateral disclosure document, the person performing the diligence will have more incentive to do so at a time when it is most useful. Admittedly, it would be an unusual case where a counterparty to a financial advisor engagement letter sues the financial advisor for breach of a conflicts representation.[11] If a transaction fails, it is hard to envision damages; if a transaction succeeds, it is similarly difficult to envision the successor counterparty to the engagement letter (i.e., the acquiror who likely would have benefitted from the conflict) going after the financial advisor for breach of contract.[12] But even if a contractual action against a financial advisor

[9] *PLX II* Transcript, *supra* note 7, at 19 ("It was only now, during the final days before the presentation of its fairness opinion, that Deutsche decided to disclose to the committee various relationships it had with [the buyer]."); *see also In re* Zale S'holders Litig., C.A. No. 9388-VCP, 2015, WL 5853693, at *17 (Del. Ch. Oct. 1, 2015) [hereinafter *Zale I*] (finding that "the Director Defendants did not learn of Merrill Lynch's conflict until after the merger was announced" despite the board's earlier inquiry), *amended on reargument by* 2015 WL 6551418 (Del. Ch. Oct. 29, 2015) [hereinafter *Zale II*].

[10] PLX II Transcript, *supra* note 7, at 40 ("If the committee had gotten in there at the outset and secured representations or disclosure covenants from Deutsche, it might have been different. Instead, the committee only learned the details of Deutsche's relationship with [the buyer] when Deutsche chose to disclose them one day before presenting its fairness analysis.").

[11] *See* Andrew F. Tuch, *Disclaiming Loyalty: M&A Advisors and Their Engagement Letters: In Response to William W. Bratton & Michael L. Wachter, Bankers & Chancellors*, 93 Tex. L. Rev. 211, 227 (2015) [hereinafter *Disclaiming Loyalty*] ("It seems that directors virtually never sue their M&A advisors."); *see also PLX II* Transcript, *supra* note 7, at 40–41 (suggesting that "firing Deutsche Bank, seeking legal remedies and starting all over" would be at the extreme end of the spectrum of potential responses to an allegedly belated conflicts disclosure).

[12] In *In re Freeport-McMoRan Copper & Gold Inc. Derivative Litigation*, the directors of Freeport-McMoRan Copper & Gold Inc. settled a derivative action arising over Freeport's acquisition of McMoran Exploration Co. and Plains Exploration & Production Co. in a way that would have allowed the plaintiffs to pursue derivatively contractual claims of Freeport against the Freeport board's financial advisor, Credit Suisse. The settlement contemplated the settling defendants making "themselves reasonably available as fact witnesses in any action Plaintiffs may pursue on behalf of Freeport against Credit Suisse arising from Credit Suisse's bad faith, gross negligence, willful misconduct or fraud, as those terms are used in the Engagement Letter between Freeport and Credit Suisse dated September 20, 2012, in connection with its engagement to act as lead financial advisor to the Special Committee of

for breach of a conflicts representation is unlikely, even an unlikely threat of damages could serve to elicit the timely conflicts-related diligence discussed above. Moreover, as discussed below, a contractually created remedy of allowing a target board to terminate the engagement with its initial financial advisor and hire a new financial advisor without having to pay a tail fee if a contractual conflicts representation proved incorrect could, in some instances, provide a more feasible remedy than suing the original financial advisor for damages.[13]

In addition, although directors historically may not have read the financial advisor engagement letter, neither have they historically been provided a disclosure memorandum or a bankers' book containing a slide on conflicts. In any case, even if conflicts-related provisions are included in an engagement letter, we do not believe that means a board must read an engagement letter front-to-back. As with most agreements, it will be the advisors working through the details of the engagement letter and addressing any issues that are surfaced either in negotiating the initial representation or through disclosure covenants. The goal is for the advisors to use that contractual exercise to raise issues that need to be brought to the board's attention, and for the board to understand the advisors are using the engagement letter as a tool in doing so.

Finally, even if potential conflicts are vetted at the outset of the engagement, absent a contractual covenant to disclose additional conflicts that may surface, a financial advisor is under no obligation to disclose future potential conflicts.[14] In

the Freeport Board with respect to Freeport's decision to acquire MMR and Plains." Stipulation and Agreement of Settlement, Compromise and Release, *In re* Freeport-McMoRan Copper & Gold Inc. Derivative Litig. C.A. No. 8145-VCN, at para. 12 (Del. Ch. Jan. 15, 2015). Credit Suisse subsequently settled with plaintiffs for a payment of $10 million to Freeport and an agreement to provide Freeport $6.25 million worth of investment-banking advice during a two-year period. Addendum to Stipulation and Agreement of Settlement, Compromise and Release, *In re* Freeport-McMoRan Copper & Gold Inc. Derivative Litig. C.A. No. 8145-VCN, at para. 9 (Del. Ch. Mar. 16, 2015).

A settlement contemplating a plaintiff stockholder bringing an action sounding in contract against a board's financial advisor presumably would be more difficult in a class action claim (which most deal claims are) than a derivative claim. In addition, as reported by the *Wall Street Journal*, Credit Suisse believed it had a consent right over such a settlement. Liz Hoffman, *Freeport-McMoRan Settlement Leaves Credit Suisse in Cross Hairs*, Wall St. J. (Jan. 15, 2015, 5:12 PM EST), http://www.wsj.com/articles/freeport-mcmoran-settles-litigation-over-acquisitions-1421335791 ("Credit Suisse, which advised Freeport's independent directors and wasn't a defendant in the lawsuit, privately argued that Freeport couldn't settle the case without a guarantee the plaintiffs wouldn't later target the bank."). The breadth of financial advisor contractual consent rights over settlements of claims where the financial advisor might seek indemnification from the company is an evolving area (e.g., no consent rights, absolute consent rights, or consent rights not to be unreasonably withheld). Because of those consent rights, and because of the derivative nature of the claims in *Freeport*, settlements along the lines of those negotiated in *Freeport* may be rare.

[13] One commentator to this article observed that "the provisions [we suggest] dealing with consequences for breach are remarkably lenient." In part that is due to, in our view, the practical reality discussed above that it is unlikely a financial advisor would be subject to a damages action arising out of a breach of a conflicts representation. More important, it reflects our belief that the primary function of representations in an engagement letter is to focus diligence, rather than serve as an allocation of risk.

[14] *But see In re* Dole Food Co., Inc. S'holder Litig., C.A. No. 8703-VCL, 2015 WL 5052214, at *49 n.38 (Del. Ch. Aug. 27, 2015) (questioning the extent to which a financial advisor engagement letter may be used to contract out of agency law principles, including fiduciary obligations of a purported agent); *Disclaiming Loyalty*, *supra* note 11, at 217 n.40 (same); *Bankers and Chancellors*, *supra* note 5, at 42 (same). Whether a provision—typical, in our experience, in financial advisor engagement

the hypothetical above, assume that among the few alternative bidders contacted were Party B and Party C. Bank A might have a substantial co-investment with Party B and no relationship with Party C. Absent a contractual covenant that defines when a financial advisor must provide updated conflicts disclosure, the financial advisor has no contractual obligation to respond to a request from the board to disclose potential conflicts between Bank A and Parties B and C. As much as we would like to accept the "trust me to do the right thing" argument, it simply is not an alternative to a contractual covenant that sets out up front the "what" and "when" regarding future conflicts-related disclosure.[15]

For all of these reasons, we believe that a financial advisor engagement letter is an appropriate tool to vet potential conflicts of a financial advisor.[16] With that, we turn to the actual provisions. Although the remainder of this article discusses potential contractual provisions, we believe that some of the issues discussed below are relevant whether it is a contract, a disclosure memorandum, or a slide in a board book that is being negotiated.[17]

Specific Financial Advisor Engagement Letter Provisions

Disclosure of Actual and Potential Conflicts: The Relationships Representation and the Relationships Covenant

The following subsections highlight two provisions that we have seen in financial advisor engagement letters post-*Rural/Metro*. The first is a Relationships Representation, and it is used to discover potential conflicts at the beginning of an engagement. The second is a Relationships Covenant, and it creates an ongoing disclosure obligation of the financial advisor to disclose potential conflicts during the course of an engagement. Before turning to those provisions, we make two observations.

First, we have sometimes experienced strong pushback against requests for conflicts representations and covenants. That pushback typically proceeds along the lines of: "Our bank is so big, how can you expect us to track this?" In this regard, the following observation from Chief Justice Strine bears noting:

letters—disclaiming that the financial advisor is a fiduciary of the corporation is enforceable is outside the scope of this article. For purposes of this article, we assume that a financial advisor engagement letter is negotiated on the premise that the financial advisor is not a fiduciary of the corporation.

[15] *See, e.g.*, *PLX II* Transcript, *supra* note 7, at 40 ("If the committee had gotten in there at the outset and secured representations or disclosure covenants from Deutsche, it might have been different.").

[16] As discussed in *Bankers and Chancellors*, to the extent one may contract out of agency-based fiduciary obligations, a more extensive conflicts disclosure also is necessary for the financial advisor effectively to contract out of agency-based fiduciary duties. *See Bankers and Chancellors*, *supra* note 5, at 36–39; *see also Rural I*, 88 A.3d at 101 ("If RBC thought it was obtaining a waiver in the engagement letter without first disclosing the conflict and its import, then it was committing 'what, in the old days, might have been called constructive fraud.'" (quoting Hollinger Int'l, Inc. v. Black, 844 A.2d 1022, 1068 (Del. Ch. 2004), *aff'd*, 872 A.2d 559 (Del. 2005))).

[17] We have conformed the sample provisions in this article to an engagement between a "Bank" and a "Board" but they could also operate between a committee of directors and its independent financial advisor. In addition, although this article refers generally to engagement letters between a *target* company and a financial advisor, if an acquiror engages a financial advisor (e.g., in the context of a stock-for-stock transaction, where a financial advisor might assist in negotiating, and opine on, the exchange ratio), the issues addressed in this article may similarly be relevant.

> I also am not purporting to say that setting up conflict identification and limitation processes for investment banks will be without complexity. But, there is likely much that investment banks can learn from the more evolved experience of law firms, and by focusing on this important issue, investment banks will do a better job of surfacing conflict issues and of addressing them with their clients forthrightly. This will improve the industry's reputation for integrity and minimize the litigation risk to their clients that banker conflicts sometimes generate.[18]

Second, we do not mean to suggest that, if a conflict or potential conflict is discovered during the process of negotiating the engagement letter and concomitant disclosures, the financial advisor may not be engaged by the board. To the contrary, the provisions discussed below are designed to assist the board in learning of potential conflicts and deciding whether to engage the financial advisor in spite of (or in many cases because of the benefits arising from) the potential conflict. Indeed, as observed in *Bankers and Chancellors*, "[c]onflicted representation can make cost-benefit sense."[19] Nonetheless, at a recent hearing on a motion to dismiss litigation arising from the acquisition of PLX Technology, Inc. by Avago Technologies Ltd., Vice Chancellor Laster commented that certain financial advisor conflicts might be "non-contractable."[20] And in his oral ruling on that motion, the Vice Chancellor observed that there may be some conflicts that are "so pervasively impairing that the directors could not reasonably consent."[21] At both oral

[18] Leo E. Strine, Jr., *Documenting the Deal: How Quality Control and Candor Can Improve Boardroom Decision-Making and Reduce the Litigation Target Zone*, 70 BUS. LAW. 679 (2015) [hereinafter *Documenting the Deal*].

[19] *Bankers and Chancellors*, *supra* note 5, at 26.

[20] Transcript of Oral Argument on Defendants' Motions to Dismiss at 58, *In re* PLX Tech. Inc. S'holders Litig., C.A. No. 9880-VCL (Del. Ch. Apr. 15, 2015); *see also id.* at 69 ("But I would think that people would view it as a non-contractable conflict if Deutsche were working for Avago on the same deal."); *see also Zale I*, 2015 WL 5853693, at *20 (citing *Bankers and Chancellors* in dicta for the statement that "some of a board's financial advisor's conflicts arguably cannot be consented to").

[21] *PLX II* Transcript, *supra* note 7, at 36. With respect to potential Deutsche Bank conflicts in this transaction, the Schedule 14D-9 disclosed:

> During 2011, the DB Group was paid approximately $24.0 million by Parent or its affiliates for services including (i) acting as a lead underwriter for the 2011 secondary securities offering of Parent's ordinary shares, (ii) acting as book runner in a series of block trades of Parent's ordinary shares, and (iii) general corporate banking and securities advice. During 2012, the DB Group was paid approximately $1.2 million by Parent or its affiliates for services including (i) acting as book runner in a series of block trades of Parent's ordinary shares and (ii) general corporate banking and securities advice. During 2013, the DB Group was paid approximately $1.3 million by Parent or its affiliates for services including (i) acting as financial advisor to Parent in connection with Parent's 2014 acquisition of LSI Corporation and (ii) general corporate banking and securities advice. During 2014 for the year to date, the DB Group has been paid approximately $29.7 million by Parent or its affiliates for services including (i) acting as financial advisor to Parent in connection with Parent's 2014 acquisition of LSI Corporation, (ii) acting as joint arranger on a $4.6 billion term loan and a $500 million revolving credit facility in connection with financing Parent's 2014 acquisition of LSI Corporation, as well as acting as sole book runner on a $1 billion investment in Parent by Silver Lake Partners in the form of a 2% convertible notes offering in connection with financing Parent's 2014 acquisition of LSI Corporation, and (iii) general corporate banking and securities advice. In addition, the DB Group currently holds a position in Parent's or its affiliates' revolving credit facility and a fronting position in Parent's or its affiliates' term loan facility.

PLX Tech., Inc., Solicitation/Recommendation Statement (Schedule 14D-9) (July 8, 2014).

argument and in his transcript ruling, the Vice Chancellor pointed to the example of a "sell-side advisor simultaneously . . . represent[ing] the buyer in the price negotiations over the same deal."[22] The scope of both "non-contractable" conflicts and conflicts that are "so pervasively impairing that the directors could not reasonably consent"[23] awaits further developments by the courts.

The Relationships Representation

Although often contained together in one paragraph, for purposes of ease, this article breaks up a sample Relationship Representation into three sections—the Engagement Representation, the Holdings Representation, and the Prior Pitch Representation, and discusses each in turn.[24]

The Engagement Representation

The Engagement Representation addresses the financial advisor's prior engagements with potential bidders. As repeatedly recognized by Delaware courts, this representation may suggest a conflict of interest for a financial advisor, which may want to steer a bid toward a repeat client.[25] (Although similar conflicts also may arise based on the financial advisor's prior relationship with management of the target,[26] this information can typically be provided by the company.[27])

[22] *PLX II* Transcript, *supra* note 7, at 37.

[23] *PLX II* Transcript, *supra* note 7, at 36.

[24] In lieu of the provisions discussed below, one financial advisor questionnaire we saw after *Rural I* asked for the following disclosure:

> Please describe any other direct or indirect relationship between Bank, its affiliates, any Bank Personnel or any person with whom any Bank Personnel has a family relationship, on the one hand, and any Applicable Entities or their respective management, on the other hand (including any commercial, industrial, banking, consulting, legal, accounting, charitable, or familial relationships, among others) that may influence the performance of Bank's obligations under the Engagement Letter.

Although the breadth of this disclosure may be appropriate in certain circumstances (perhaps in connection with a single bidder strategy), we have not seen this extensive solicitation disclosure often accepted by financial advisor counsel as something to be incorporated into an engagement letter.

[25] *E.g.*, *In re* Ness Techs., Inc. S'holders Litig., C.A. No. 6569-VCN, 2011 WL 3444573 (Del. Ch. Aug. 3, 2011); *In re* Del Monte Foods Co. S'holders Litig., 25 A.3d 813 (Del. Ch. 2011). Of course, financial advisors are in the business of growing their slice of the pie as well as retaining it, and could have incentives to steer a bid toward a new client the advisor has been wooing. To date we have not seen a representation addressing a desire to obtain business from a potential counterparty to the transaction.

[26] *E.g.*, Mills Acquisition Co. v. Macmillan, 559 A.2d 1261 (Del. 1989); *In re* Netsmart Techs., Inc. S'holders Litig., 924 A.2d 171, 199 (Del. Ch. 2007); *In re* Tele-Commc'ns, Inc. S'holders Litig., C.A. No. 16470-CC, 2005 WL 3642727, at *10 (Del. Ch. Dec. 21, 2005); Robert M. Bass Grp., Inc. v. Evans, 552 A.2d 1227, 1233–34 (Del. Ch. 1988).

[27] Although the following admonition from Chief Justice Strine is not addressed to the scope of representations in a financial advisor engagement letter, it nonetheless bears noting in the context of those contractual provisions:

> [I]t is important that the independent directors—in a situation when they have not made sure that the company's regular financial advisor owes its retention and tenure to the independent board majority and not management, and when they must therefore hire another financial advisor—seek out the best and not go with a singular recommendation of management.

Documenting the Deal, *supra* note 18, at 16 n.16.

To flesh out whether this form of conflict exists, counsel may seek the Engagement Representation along the lines of the following two sentences[28]:

> Except as set forth on Schedule A, the Bank has not, within the past three years, had investment banking, capital markets or lending engagements with respect to the parties identified thereon (the "*Relevant Parties*"), or to the Bank's knowledge, a portfolio company of a Relevant Party. Schedule A also sets forth the total fees derived from such engagements by the Bank.

There are four key variables to be negotiated in these two sentences: (i) the list of parties who are the Relevant Parties, (ii) the types of engagements captured by the representation, (iii) the length of the look back, and (iv) the breadth of disclosure regarding the engagements.

The breadth of the list of potential bidders captured by the disclosure is context-specific. Obviously, if a sales process is a response to an unsolicited bid, that single bidder, at a minimum, should be included on the list. On the other end of the spectrum, if a board expects to run a broad pre-signing auction process without any clear top-tier potential partners, it may make little sense to include these two sentences of the Relationships Representation at all. Somewhere in the middle is a limited pre-signing auction. Are there top-tier and second-tier potential bidders? How many potential bidders should be included on the list? These are questions we believe are still being explored by negotiators of financial advisor engagement letters (or, if a board deck or disclosure memorandum is used, the preparers of those documents) post-*Rural/Metro*.[29]

Also being explored post-*Rural/Metro* is the type of engagement to be captured by the disclosure. "Investment banking, capital markets or lending engagements" is a baseline trigger that financial advisors may be comfortable providing. A blanket "all engagements" trigger may be more difficult to obtain, although it is hard to imagine a material engagement that would not be captured by "investment banking, capital markets or lending engagements."

The length of the look back is of course subject to negotiation. Since *Rural/Metro*, we have seen financial advisor engagement letters that included look-back periods from one to three years.[30] FINRA Rule 5150, which requires disclosure in fairness

[28] The provisions discussed in the remainder of this article are amalgams of (i) provisions contained in the form markup included in Exhibit A, (ii) provisions we have seen negotiated, or attempted to be negotiated for, in the past, and (iii) our own editing of such provisions in writing this article. They are both generic and aspirational. They also reflect the best efforts of two lawyers who have negotiated with financial advisors, but have not served in-house to a financial institution and so are not intimately familiar with the unique challenges a large financial institution may face in tracking conflicts. As with any negotiation, forms will be conformed to fit a given fact pattern; and, as with any new development in transactional advice, further experience will inform future negotiations. For ease of reference, the provisions discussed in the remainder of this article are collected in Exhibit B.

[29] By way of one example, in the *PLX* litigation, Vice Chancellor Laster appeared critical of the PLX special committee for not asking its financial advisor about potential conflicts vis-à-vis the ultimate acquiror. At the time of the banker's engagement, that entity "was perhaps the most likely bidder for the company" as it "had shown its eagerness by submitting an unsolicited expression of interest" only eight months earlier. *PLX II* Transcript, *supra* note 7, at 11–12.

[30] *Cf. In re* Ness Techs., Inc., C.A. No. 6569-VCN, 2011 WL 3444573, at *3 (Del. Ch. Aug. 3, 2011) (granting expedited discovery where the financial advisor had provided advisory services

opinions of "any material relationships that existed during the past two years or that are mutually understood to be contemplated in which any compensation was received or is intended to be received as a result of the relationship between the member and any party to the transaction that is the subject of the fairness opinion," may provide guidance in this regard.[31] Again, practice is still evolving.

If there are prior engagements to disclose, the actual text of that disclosure is subject to negotiation. Recognizing that the goal of the Engagement Representation and concomitant disclosure is to understand potential conflicts that could affect a financial advisor's advice, an itemized, representation-by-representation disclosure may not be warranted (and, if the financial advisor is subject to confidentiality obligations, may not be possible). In other words, the specifics of each transaction may or may not be material to a board's "identif[ication] and consider[ation] . . . of . . . potential conflicts" of the financial advisor[32] if the financial advisor is already disclosing that it performs substantive investment banking, capital markets, and lending work for a Relevant Party and the aggregate amount it has received for such work.

The Holdings Representation

The next two sentences of the Relationships Representation address potential conflicts of both the financial advisor and its lead individual bankers working on the transaction arising from their holdings of securities of a potential transaction partner. Before discussing the issues associated with the drafting of those sentences, it is important to identify the situations that those issues arise from.

The language in question addresses the form of conflict that arose in *In re El Paso Corp. Shareholder Litigation*.[33] *El Paso* involved the acquisition of El Paso Corporation by Kinder Morgan, Inc.[34] The El Paso board engaged Goldman Sachs as its financial advisor.[35] Goldman owned 19 percent of Kinder Morgan (an investment worth $4 billion) and the lead Goldman banker on the assignment owned approximately $340,000 worth of Kinder Morgan stock.[36] The Goldman-level conflict was disclosed and efforts were taken to mitigate that conflict.[37] (Goldman put up an internal wall between its representatives working for El Paso and those responsible for its Kinder Morgan investment, and El Paso engaged Morgan Stanley as a conflict-cleansing financial advisor.[38])

within the preceding two years, but the proxy statement did not disclose the amount of fees paid for those services); Transcript of Oral Argument at 101, *In re* Art Tech. Grp., Inc. S'holders Litig., C.A. No. 5955-VCL (Del. Ch. Dec. 20, 2010) (granting a motion to preliminarily enjoin the stockholder vote on a sale of the company until ten calendar days after the parties disclosed the aggregate compensation that the buyer had paid to the seller's financial advisor in the prior four years).

[31] FINRA R. 5150(a)(3) (2008).

[32] *Rural I*, 88 A.3d at 90.

[33] 41 A.3d 432 (Del. Ch. 2012).

[34] *Id.* at 433.

[35] *Id.* at 434.

[36] *Id.*

[37] *Id.* at 440.

[38] *Id.*

Then-Chancellor Strine found on a preliminary record, however, that those efforts did not sufficiently address the conflict because the record suggested Goldman might not have honored the internal wall[39] and, as discussed below,[40] the engagement letter for Morgan Stanley might have created poor incentives for that bank. The individual-banker conflict was not disclosed.[41]

In the *El Paso* decision, the Chancellor observed: "Given that Goldman's largest conflict was surfaced fully and addressed, albeit in incomplete and inadequate ways, whether the plaintiffs could ultimately prove Goldman liable for any shortfall is, at best, doubtful, despite [the lead banker's] troubling individual failure of disclosure."[42] In light of the comfort the Chancellor took in the disclosure of the Goldman entity-level interest in Kinder Morgan, and the concern expressed about the failure to disclose the lead banker's interest in Kinder Morgan, companies could seek variations of the following Holdings Representation in financial advisor engagement letters:

> The Bank has previously disclosed to the Board, and hereby represents, that the Bank and its affiliates (including portfolio companies in which the Bank has investments) do not beneficially own any interests in the Company, a Relevant Party, or to the Bank's knowledge, a portfolio company of a Relevant Party. In addition, the Bank has had discussions with the Vice President and Managing Directors that the Bank intends to work on this engagement (comprising _________ (the "Team Members")) and has confirmed that, other than as set forth on Schedule B, no Team Member has any direct holding, as of the date hereof, in the Company, a Relevant Party, or, to the relevant Team Member's knowledge, a portfolio company of a Relevant Party.[43]

In our experience, the entity-level Holdings Representation may be separated from the individual-level Holdings Representation. That is because the entity-level Holdings Representation often is coupled with a general disclosure regarding the financial advisor holding and trading in securities for the benefit of customers of its brokerage and asset management services. In addition, both the entity- and individual-level Holdings Representations often exclude disclosure related to passive, non-controlling interests which may not create the same economic conflicts that might alter the financial advisor's decisions.

With respect to the individual-level Holdings Representation, in late 2014, Bloomberg reported that Goldman Sachs had issued an internal memorandum prohibiting individual bankers from buying individual stocks and bonds.[44] Should other financial advisors follow suit, the individual-level section of the Holdings Representation may become a very easy representation to give or it

[39] *Id.* at 441.

[40] *See infra* note 64.

[41] *El Paso*, 41 A.3d at 442.

[42] *Id.* at 448.

[43] Some forms of this representation capture holdings by a Team Member's spouse and children.

[44] Michael J Moore, *Goldman Sachs Said to Prohibit Bankers from Buying Stocks*, Bloomberg Bus. (Sept. 26, 2014, 11:00 PM CDT), http://www.bloomberg.com/news/articles/2014-09-26/goldman-sachs-said-to-prohibit-bankers-from-buying-stocks ("Employees at the New York-based firm were notified yesterday of the change, which takes effect immediately, said the person, who requested anonymity because the matter isn't public.").

may evolve into a representation that an engaged financial advisor has instituted that policy (either alone or in combination with a broader individual-level section of the Holdings Representation).

The Prior Pitch Representation

The third element of the Relationship Representation that we examine addresses the phenomenon described by Vice Chancellor Laster in *Del Monte*: "To facilitate transactional activity, investment bankers routinely pitch deals to parties they hope might be interested. Coverage officers for investment banks regularly visit past, present, and potential clients to suggest mergers, acquisitions, and other strategic alternatives."[45] These kinds of pitches are not, of themselves, a bad thing. But, in our view, it is helpful for a board engaging a financial advisor for a sell-side engagement to know whether that advisor has recently pitched a sale of the company.[46] We refer to a representation addressing prior pitches as a Prior Pitch Representation.

We understand that many banks do not track prior pitches in a manner that would permit providing a broad Prior Pitch Representation. By way of example, a commentator to an earlier version of this article noted that a large investment bank could meet with a private equity client several times a year with pitch books identifying hundreds of potential investment candidates without logging every single one of those companies into a globally accessible conflicts system. The goal in negotiating for a Prior Pitch Representation, however, is not to capture fleeting references to a potential target company in a large pitch book. To the contrary, the goal is to capture prior substantive discussions that might affect the financial advisor's representation of the target.

For example, in *Zale*, the board of directors of Zale selected Merrill Lynch as its financial advisor in connection with a strategic review process that ultimately led to the sale of Zale to Signet Jewelers.[47] At the time it selected Merrill Lynch, the board was not aware that a team of investment bankers from Merrill Lynch, including a banker who would eventually work on the Merrill Lynch team representing Zale, had previously pitched an acquisition of Zale to Signet management.[48] That prior pitch presented a valuation of Zale between $17 and $21 per share (with $21 per share ultimately being the price Signet would agree to acquire Zale for).[49] In his initial written opinion in the litigation, Vice Chancellor Parsons found it "reasonably conceivable" that the Zale board's failure to learn of Merrill Lynch's conflict prior to signing the merger agreement could constitute a breach of the board's duty of care.[50] In so finding, the court observed that the Zale board "simply [discussed] the possibility that Merrill Lynch would be con-

[45] *In re* Del Monte Foods Co. S'holders Litig., 25 A.3d 813, 819 (Del. Ch. 2011).

[46] To the contrary, in *Del Monte*, "[t]he Board did not learn of [Barclay's] efforts to stir up the initial LBO bid until discovery in th[e] litigation." *Id.* at 820.

[47] *Id.* at *1.

[48] *Zale I*, 2015 WL 5853693, at *3.

[49] *Id.*

[50] *Id.* at *19.

flicted and apparently re[lied] without question on Merrill Lynch's representation that it had 'limited prior relationships [with Signet] and no conflicts.'"[51] The court further wrote as follows:

> In the context of detecting a preexisting conflict when engaging a financial advisor, [the board's] oversight duty could include negotiating for representations and warranties in the engagement letter as well as asking probing questions to determine what sorts of past interactions the advisor has had with known potential buyers, such as Signet here. In this case, it might have included a question as to whether the potential financial advisor had made any presentations regarding Zale to prospective buyers within, e.g., the last six months.[52]

In an opinion on a motion for reargument, the court subsequently found the complaint in *Zale* failed adequately to allege a breach of the duty of care.[53] In doing so, the court stated, "The conduct of Merrill Lynch in this case [was] troubling," and expressly declined to modify the first sentence in the block quote above.[54] A representation designed to flesh out prior pitches of the *Zale* variety (and one we have obtained in the past) is as follows:

> The Bank has not within the past year engaged in any discussions with any third party concerning the possibility of effecting, causing, or participating in a Transaction with the Company.

We recognize the concern that the above representation should not capture "fleeting references" to a target company in a pitch book and we think the use of the term "discussions" addresses the concern. That said, we suspect that, if Prior Pitch Representations become more common, financial advisors might seek additional language to demonstrate that the representation is designed only to pick up substantive discussions regarding the target company (such as discussions providing a value on the target company stock or discussions regarding the financial advisor providing buy-side financing).

[51] Zale, 2015 WL 5853963, at *19 (alterations in original).

[52] *Id.*

[53] The motion for reargument was predicated on the opinion of the Delaware Supreme Court in *Corwin v. KKR Financial Holdings LLC*, No. 629, 2014, 2015 WL 5772262 (Del. Oct. 2, 2015), issued one day after *Zale I* was released. In *KKR*, the Delaware Supreme Court held that the business judgement rule, rather than the *Revlon* standard of review, applies to a change-in-control transaction not otherwise subject to entire fairness review that is "approved by an informed, voluntary vote of disinterested stockholders." *Id.* at *5. The transaction at issue in *Zale* was so approved. *Zale II*, 2015 WL 6551418, at *2. Accordingly, the court in *Zale II* analyzed plaintiff's claims to determine whether plaintiff had rebutted the presumptions of the business judgment rule (as opposed to analyzing those claims in the context of the *Revlon* standard of review, as the court had done in *Zale I*). *Id.* at *5. The court determined that plaintiff had not done so. *Id. But see In re* TIBCO Software Inc. S'holders Litig, C.A. No. 10319-CB, 2015 WL 6155894 (Del. Ch. Oct. 20, 2015) (finding, in a decision issued after *KKR*, that plaintiffs had adequately pleaded a breach of the duty of care in the context of a change-in-control transaction not otherwise subject to entire fairness review that had been approved by a fully informed disinterested stockholder vote by alleging that a board failed adequately to inform itself about the circumstances of an error in share capitalization information provided to a buyer).

[54] *Zale II*, 2015 WL 6551418, at *5.

Other than drafting for a particular context, the key variable open for negotiation in the Prior Pitch Representation is the length of the look back. Because the Prior Pitch Representation relates to discussions, as opposed to a definitive engagement, counsel might be comfortable limiting this look back to as little as one year. Of course, context-specific facts may call for a longer look back and, as with many provisions of a financial advisor engagement letter post-*Rural/Metro*, practice is still developing.

The Relationships Covenant

The Relationships Representation generally speaks only as of the date of the engagement letter (whether explicitly or not). But transaction processes are dynamic and conflicts may be introduced after the engagement letter has been signed. Accordingly, companies may seek a Relationships Covenant to help provide "active" oversight of financial advisor conflicts.[55]

Relationships Covenants we have seen accepted require the financial advisor to update the Relationships Representation as to additional parties upon certain negotiated triggers. A formulation of the Relationships Covenant we have seen is as follows:

> If the Board elects to engage in formal discussions with one or more parties other than the Relevant Parties about a Transaction, the Bank will, upon the request of the Board, disclose to the Board the information described above concerning such party or parties, and such party or parties will be, and will be deemed, a Relevant Party for purposes of this Agreement.[56]

The Relationships Covenant above requires two conditions be satisfied before the obligations contained therein are triggered: (i) the board elects to "engage in formal discussions" with a party other than a Relevant Party about a Transaction and (ii) the board requests conflicts disclosure from the Bank about such party. From the board's perspective, we would prefer a Relationships Covenant without the first condition. In other words, if a board requests additional conflicts information, we would prefer a Relationships Covenant under which it can receive such information without an analysis as to whether "formal discussions" have begun. Financial advisors, however, may not be willing to accept a broad disclosure obligation without a tie to an objective second condition, negotiated upfront, to provide some guidelines on when a financial advisor must engage in a subsequent conflict check. The language we have often seen for this second condition is the board "electing to engage in formal discussions" with other parties. Admittedly,

[55] *See PLX II* Transcript, *supra* note 7, at 35–36 ("This type of continuous and diligent oversight is necessary because issues can arise during the sale process that were not foreseen or could not be fully vetted at the outset. It may be that at the outset you don't know that a particular bidder will emerge as the most likely candidate.").

[56] A commentator on this article has asked whether this covenant is qualified by confidentiality obligations. We have not been faced with such a request (yet), but do have concern that such a qualification could end up swallowing the entire covenant. We hope that most issues arising from confidentiality obligations could be addressed in drafting the actual disclosure to be made.

"formal discussions" is not a completely clear standard. Could it simply involve negotiating a confidentiality agreement with a bidder that has survived the first round of an auction? Does it require active negotiations over definitive transaction documents? This is yet another area that is still being refined post-*Rural/Metro*.

Note that the above Relationships Covenant does not affirmatively require a financial advisor to bring-down information it previously disclosed, either pursuant to the original Relationships Representation or following a trigger of the Relationships Covenant. To address this, we have sometimes seen a form of the following covenant negotiated as part of the Relationships Covenant:

> If, during the term of this letter agreement, the Bank becomes aware that any of the statements set forth in the Relationships Representation (or provided pursuant to the Relationships Covenant) is, or at the time of the execution of this letter agreement or disclosure of such information was, materially inaccurate, the Bank will promptly notify the Board and inform the Board of the manner in which such statement is or was materially inaccurate.

Target-side counsel may experience pushback from counsel to the financial advisor regarding this covenant. It is admittedly broad and imposes on the financial advisor a continuing obligation to update prior disclosures. We believe, however, it is a reasonable ask. The bring-down does not impose a continuing obligation to search for conflicts; to the contrary, it simply imposes a continuing obligation to inform the board if the financial advisor becomes aware that a statement previously made was inaccurate. Moreover, the use of a materiality (or some other form of) qualifier (as in the language above) can help bridge the gap between the board's ask and the financial advisor's position. Time will tell if this kind of obligation becomes more commonplace in financial advisor engagement letters. To the extent it does not, the Restricted Services Covenant, discussed in the next part, may serve to fill to some extent the hole that may exist by failing to obtain the above covenant.[57]

Restricted Services Covenant

Conflicts arising because another potential transaction partner enters the fray may be unavoidable. What may be avoidable (or at least mitigated), however, are

[57] As discussed below (and implied by its name), the Restricted Services Covenant restricts certain, enumerated future engagements by the financial advisor for Relevant Parties that might raise conflicts that otherwise would need to be disclosed in the Relationships Representation. It does not, however, restrict investments by the financial advisor or individual bankers working the assignment. One possible common ground if the financial advisor is reluctant to include the broad bring-down requirement discussed above is to accept the narrower Relationships Covenant coupled with a strong Restricted Services Covenant and the following bring-down requirement, limited only to the Holdings Representation:

> In addition, the Bank will immediately inform the Board upon the occurrence of the Bank's or any of its affiliates' (including portfolio companies in which the Bank has investments), or a Team Member's having any direct holding in a Relevant Party (or, to the knowledge of the Bank or Team Member, as applicable, a portfolio company of a Relevant Party) at any time before the termination of the engagement contemplated by this Letter Agreement.

financial advisor-initiated conflicts with respect to known potential transaction partners. Although, in our experience, Restricted Services Covenants initially focused on providing buy-side financing,[58] over the years we have seen these covenants broadened to address a wider set of activities that may raise conflicts. A sample is as follows:

> Notwithstanding anything herein to the contrary, during the term of this engagement, the Bank shall not provide M&A advisory services, new debt or equity capital markets or new bank financing to any Relevant Party without the prior written consent of the Board.[59]

Although companies may like to have the services listed in the Restricted Services Covenant match the engagements listed in the Relationships Representation, in our experience financial advisors are more willing to include a broader set of services in a disclosure obligation than they are in a negative covenant. Accordingly, companies may negotiate to include in the Restricted Services Covenant a set of activities such as "M&A advisory services, new debt or equity capital markets or new bank financing" (on the theory that a financial advisor will not agree not to provide financing based on existing facilities).[60]

Some commentators to a draft of this article wondered whether the inclusion of a Restricted Services Covenant would result in financial advisors being restricted in a materially greater fashion than lawyers representing the same client as the finan-

[58] The focus on Restricted Services Covenants sharpened after then-Vice Chancellor Strine's opinion in *In re Toys "R" Us, Inc. Shareholder Litigation*, 877 A.2d 975 (Del. Ch. 2005). In *Toys "R" Us*, Vice Chancellor Strine observed that First Boston, financial advisor to the target board, created an "unnecessary issue" by asking to provide buy-side financing while the strategic review process was ongoing. *Id.* at 1005. The Vice Chancellor was careful to note, however, that he was not "making a bright-line statement" as to the propriety of a sell-side advisor providing buy-side financing. *Id.* at 1006 n.46. In a footnote, the Vice Chancellor distinguished between a collective decision among the directors and financial advisors to provide traditional "stapled" financing and a middle-of-the-process request of a financial advisor to provide buy-side financing. *Id.* at 1006 n.46. The difference between traditional "stapled" financing and other buy-side financing is explained in *Bankers and Chancellors*:

> Staples first appeared as part of a larger package deal: the selling corporation puts itself (or a piece of itself) up for auction and offers debt financing to potential purchasers in tandem with the sale—financing to be supplied by the seller's banker-advisor. The financing package is thus "stapled" to the offering memorandum. The impetus for these couplings came from the banks themselves, which held out their lending capacity to lure potential selling companies into accepting their advisory services. Over time, the term "staple" has come to be used more loosely, applying in any case where the seller's banker-advisor participates in financing the buyer's purchase.

Bankers and Chancellors, *supra* note 5, at 18. Professors Bratton and Wachter report that "[s]tapled financing persists, but not in acquisitions likely to trigger *Revlon* scrutiny." *Id.* at 9; *see also id.* at 5 n.18 (citing an article by Liz Hoffman that appeared in LAW360 for the proposition that, after *Del Monte* and *El Paso*, "staples were said to have largely disappeared"). We do not read *Toys "R" Us* to question the use of "stapled financing" in the traditional sense (as described in *Bankers and Chancellors*), especially in a transaction where financing might not otherwise be readily available.

[59] Restricted Services Covenants, such as the example above, often will provide an escape hatch allowing the committee or board to consent to the financial advisor providing otherwise restricted services. Of course, even absent an express escape hatch, the engagement letter always may be amended or the negative covenant may be waived.

[60] If a financial advisor is a party to an existing credit facility of a potential transaction partner, we expect that fact will be disclosed in connection with the Relationships Representation or Relationships Covenant.

cial advisor. Those commentators noted that lawyers often obtain a broad advance waiver in their engagement letters, facially allowing lawyers to take on transactions involving conflicts similar to those that might arise should a financial advisor undertake a representation it would be restricted from taking under the Restricted Services Covenant. To this we note that, notwithstanding any advance waiver, lawyers are governed by professional rules of conduct. For example, Rule 1.7(b) of the Delaware Lawyers' Rules of Professional Conduct prohibits a lawyer from taking on a matter involving a "concurrent conflict of interest," notwithstanding an advance waiver, if, among other things, the lawyer does not reasonably believe she will be able to provide competent and diligent representation to each affected client.[61] To the contrary, most financial advisor engagement letters disclaim any notion that the financial advisor has fiduciary duties to its client.[62]

We acknowledge that, although an attorney with an advance waiver must judge for herself whether the advance waiver permits her firm to take on another assignment that may involve a conflict of interest without running afoul of ethical obligations, a financial advisor subject to a Restricted Services Covenant must seek express approval for taking on such a representation from her client. Professors Bratton and Wachter suggest that a board should "proactively extract[] a quo" for the "quid" of consenting to a representation that otherwise might be prohibited by a Restricted Services Covenant.[63] In theory, that makes a lot of sense. Practically, we believe that if market practice becomes "extract a quo for every quid of releasing a bank from a Restricted Services Covenant," financial advisors will not be willing to sign up to such covenants. In other words, financial advisors might be unwilling to risk having to forego an opportunity, for example, to provide financing on an unrelated transaction to one of five bidders in a months-long auction process if boards of directors felt too constrained in providing consent to a representation otherwise prohibited by a Restricted Services Covenant.[64]

At times, we have seen financial advisors negotiate up front for specific exclusions to the Restricted Services Covenant (thus avoiding, or at least mitigating, the possibility that the target board would feel obligated to extract a "quo" for a consent midstream). These exclusions range from general advisory services and current assignments to financing arrangements not involving an acquisition of the target company or all or substantially all of its business or assets and any

[61] Del. Lawyers' Rules of Prof'l Conduct R. 1.7(b) (2010).

[62] *But see Bankers and Chancellors*, *supra* note 5, at 42 ("Across-the-board provisions that disclaim a fiduciary duty to the client corporation and its board of directors present more of a problem, for they raise a theoretical question as to whether or not the common law of agency imports a mandatory fiduciary duty."); *supra* note 14.

[63] *Bankers and Chancellors*, *supra* note 5, at 53.

[64] In practice, we have represented clients who have provided their consent to a facial conflict pursuant to a Restricted Services Covenant. Such a decision was made only after the board understood the potential conflict, took stock of the stage of its own market check, and obtained assurances as to the creation of information walls by the financial advisor. Other "asks" we could imagine include a credit to the initial financial advisor's fairness opinion fee if a "conflict cleansing" second financial advisor is brought in (discussed in the next part of this article) and perhaps a fall away of a tail fee if the financial advisor does not abide by the information walls it created.

financing arrangements located on another side of an internal informational wall. The willingness of a board to include such up-front exclusions may be dependent upon whether it appears conflicts might arise in the board's review process (e.g., a board may be more willing to negotiate up-front for exclusions to the Restricted Services Covenant if it is engaging a bank to perform a broad pre-signing auction process as opposed to, say, a proposed go-private transaction). Once again, market practice, in our experience, is still developing.

Addressing Identified Conflicts: Substitute Financial Advisor Provisions and Tail Fee Provisions

Substitute Financial Advisor Provisions

As mentioned above, conflicts not identified at the onset of a financial advisor engagement may surface during the course of a transaction process, and on a few occasions we have seen parties to financial advisor engagement letters negotiate at the time of engagement for the possibility of a conflict arising because the financial advisor requests to be released from the Restricted Services Covenant for a particular engagement. Such negotiation often will lead to a provision offering a "credit" to the target for the cost of the financial advisor delivering a fairness opinion, thus allowing the board to obtain a "conflict cleansing" second financial advisor.[65] The following is based on a form we have seen to address this issue, and it could be included following the first sentence of the Restricted Services Covenant:

> The Bank acknowledges and agrees that in the event that Bank provides such services with the prior written consent of the Board ("Other Services"), any Sale Transaction Fee that becomes payable to Bank hereunder shall have deducted from it an amount equal to the Opinion Fee. In addition, Bank shall ensure that employees of the Bank working on this engagement (i) will not simultaneously work on any team providing the Other Services, and (ii) will not share with any team providing the Other Services any confidential information received from the Company or the Board under this Agreement unless the Board has otherwise authorized such information to be shared.

Of course, this language need not be in the initial engagement letter and could be negotiated as a condition to the board giving consent to the financial advisor providing services otherwise prohibited by the Restricted Services Covenant. That said, in some circumstances we have seen this language appear in financial advisor engagement letters *ab initio*.[66]

[65] In *El Paso*, Morgan Stanley was engaged as a "conflict cleansing" financial advisor. However, the court observed that Morgan Stanley would not be paid any transaction fees if the El Paso board chose not to move ahead with the Kinder Morgan merger and instead to move ahead with a spinoff of certain El Paso assets—which would net fees only for Goldman and not for Morgan Stanley. Accordingly, the court found, the "conflict cleansing" bank had a compensation structure that incentivized it to favor the deal it was brought in to evaluate. *In re* El Paso Corp. S'holder Litig., 41 A.3d 432, 442 (Del. Ch. 2012).

[66] In addition, if certain exclusions from a Restricted Services Covenant are negotiated at the time the engagement letter is executed, those exclusions could be tied to some of the affirmative covenants contained in the language above.

It bears mentioning that we have seen financial advisors try to add to this language an acknowledgement by the target that, if the target obtains a second financial advisor to perform "conflict cleansing," the original financial advisor need not deliver a fairness opinion.[67] Counsel should, however, be aware of then-Chancellor Strine's discussion in *In re Transatlantic Holdings, Inc. Shareholders Litigation*.[68] In *Transatlantic*, the Chancellor suggested that the financial advisor running the process should provide a fairness opinion regardless of whether a subsequent financial advisor is brought in to provide a fairness opinion:

> I don't understand the idea of a banker running a process, doing all the cool and important stuff, and not having to back it up with a fairness opinion. It in no way addresses the conflict for the person who plays the operative role to not actually have to put the fairness opinion on the line. In fact, it would seem more vital when someone acts in a conflicted basis to make them render a fairness opinion. So, what, I'm going to pay someone the most, [L]et them do the really important advisory role, let them do the really important stuff, which is testing the market, giving strategic advice, but I'm going to hand off to someone else giving the fairness opinion because the person I'm asking to do the most important stuff is conflicted? That is a very strange cure.[69]

Finally with respect to Substitute Financial Advisor Provisions, it bears noting that we have not yet seen financial advisors willing to forego their fairness opinion fee if a conflict arises through no fault of their own—i.e., where a new potential bidder, with whom the financial advisor has a prior relationship, becomes actively involved in the process, thereby causing significant potential for a disabling conflict. In that situation, it may be wise for the board to hire a conflict-cleansing second financial advisor (and for this reason, we often try to strike any language requiring the board to retain a financial advisor as an exclusive one). But, perhaps because one benefit of hiring larger banks as financial advisors—as opposed to boutiques—is the larger banks' relationships with potential transaction partners (especially financial sponsors), we have not yet seen an agreement that the initial financial advisor will forego its fairness opinion fee in this circumstance, nor do we expect one.

Tail Fee Provisions

Even if a sell-side company is able to negotiate for a Relationships Representation, Relationships Covenant, and Restricted Services Covenant from a financial advisor, addressing a breach of those provisions in the middle of a sale process may be impractical. In fact, depending on conflicts that might arise from such a breach, the most practical action for the target board to take may be to hire a

[67] In *Rural/Metro* itself, "RBC had delayed working on a fairness analysis because the firm still hoped to secure a buy-side financing role and did not want to render a fairness opinion under those circumstances." *Rural I*, 88 A.3d at 76.

[68] Transcript of Status Conference and Motion to Expedite, C.A. Nos. 6574 & 6776 (Del. Ch. Aug. 22, 2011).

[69] *Id.* at 92.

new financial advisor.[70] Most financial advisor engagement letters require the target to pay a tail fee (i.e., a full transaction fee and not just a fairness opinion fee) if the target engages in a transaction for a specific period after termination of the financial advisor's engagement absent a termination for "cause," which is typically a high benchmark such as "willful misconduct or bad faith." This could make remediation of such a mid-process breach expensive for the target.

Accordingly, companies may negotiate for a provision eliminating the tail fee if the financial advisor has "materially breached" (i.e., lower than "willful" or "in bad faith") any of the Relationships Representation, Relationships Covenant, or Restricted Services Covenant. For example:

> If, at any time prior to the expiration of 12 months following the termination of this agreement (other than a unilateral termination by the Bank or termination for Cause (as defined below) by the Company), the Company enters into an agreement that subsequently results in a Transaction or consummates a Transaction, then the Company will pay the Bank the Transaction Fee specified above in cash promptly upon the closing of the Transaction. Termination for "Cause" means termination by the Company prior to entering into a definitive agreement with respect to a Transaction because of a material breach of representation by the Bank with respect to the representation contained in Section __ hereof or a material breach of the covenants contained in Section __ and Section __ hereof, or willful misconduct, bad faith or gross negligence by the Bank in performing this engagement which conduct is not substantially remedied by the Bank after 10 days written notice from the Company stating that the Company believes such conduct constitutes Cause.

Of course, the efficacy of this provision depends on when the breach is identified. Let's return to the hypothetical set out at the beginning of this article. Bank A has been providing financial advice throughout a process. The process began when Party A lobbed a bid over the transom. Bank A indicated it had a few small prior engagements for Party A in its Relationships Representation, and the board decided those small prior engagements did not result in a disabling conflict. A few alternative bidders are contacted, but a broad-based auction is not run. At the end of the process, Party A emerges the winner. As we are negotiating the short strokes of the acquisition agreement, we receive a call from counsel to Bank A that it has noted a few more conflicts while updating its conflicts check for purposes of disclosure in its fairness opinion. At that time, it may not be feasible to hire a new financial advisor and, despite the frustration, the client may have to swallow the risk.[71]

[70] In theory, a board could bring an action for specific performance of a Restricted Services Covenant against its financial advisor. Practically, we suspect that if a board is suing its financial advisor, that financial advisor no longer is the correct one to be assisting the board in its review of strategic alternatives.

[71] In the *PLX* litigation, the plaintiff alleged that Deutsche Bank belatedly disclosed conflicts vis-à-vis the acquiror, but that the special committee failed appropriately to respond to that disclosure. Although some of the following observations from Vice Chancellor Laster pertain to issues arising outside the scope of an engagement letter, they are worthwhile considerations for any attorney who finds herself advising a client in a similar situation:

Conclusion

Delaware corporate law affords directors significant leeway in their substantive decisions so long as those decisions result from a "good" process. *Rural/Metro* tells us that a "good" process requires "active and direct oversight" over financial advisors."[72] A case decided only a month after *Rural I* illustrates how the provisions discussed above, which encourage the surfacing of conflicts, can protect directors and advisors. In *Houseman v. Sagerman*, plaintiffs alleged that a board that had used the company's largest creditor as its financial advisor breached its duty of care and that the financial advisor aided and abetted that breach.[73] Vice Chancellor Glasscock rejected the argument:

> the Plaintiffs do not contend that the Universata Board was unaware of that fact [that the financial advisor was the target's largest creditor]. . . . Without allegations that KeyBanc actively concealed information to which it knew the Board lacked access . . . the Plaintiffs fail to adequately plead knowing participation in a breach of duty: the Plaintiffs have simply not pled that KeyBanc misled the Universata Board or created an "informational vacuum" sufficient for a finding of knowing participation in a breach.[74]

> As discussed, the complaint suggests that the committee considered only whether PLX needed to hire a second banker. What the directors should have considered was the magnitude of Deutsche Bank's conflict, whether it tainted the sale process up to that point, whether it suggested any steering, and the implications of Deutsche Bank's work to date and for the sale process going forward.
>
> There were a wide range of options available to the directors both in terms of the Deutsche Bank relationship and the sale process. The alternatives ranged from doing nothing, which the directors actually chose—that would be one extreme—to firing Deutsche Bank, seeking legal remedies and starting all over. That's the other extreme. Those are both the fat tails of the distribution. The spectrum of intermediate possibilities is limited only by the resourcefulness of the directors and their legal advisors. But one could envision lots of potential fixes that would likely fall within the range of reasonableness even at the pleading stage. They could range from Deutsche paying for the retention of a second bank to review the process and recommend any corrective action and carry it out. They could have ranged, as I suggested, to reaching out again to particular competing bidders, providing them with additional time or releasing them from their standstills. It could have extended to contacting new bidders.
>
> We know from Vice Chancellor Strine, then Vice Chancellor Strine's decision in *Pennaco* as well as the Supreme Court's decision in *C&J* that there is a relationship between what you do pre-agreement and what you can agree to post-agreement. In other words, the degree of pre-agreement exploration and price discovery affects the amount of post-agreement lockup. Once you had Deutsche's taint revealed, the board, in my view, had to rethink that calibration.

PLX II Transcript, *supra* note 7, at 40–41.

[72] *Rural II*, 102 A.3d at 218.

[73] Houseman v. Sagerman, C.A. No. 8897-VCG, 2014 WL 1600724 (Del. Ch. Apr. 16, 2014).

[74] *Id.* at *9. In *Rural II*, Vice Chancellor Laster suggested that "[d]irectors may breach their duties and yet be 'fully protected' under Section 141(e) if they reasonably rely on advisors." *Rural II*, 102 A.3d at 239. Based on that statement, one might surmise a situation where the directors "reasonably relied" on a conflicts disclosure that turned out to be incorrect such that the directors have breached their duty of care and an underlying breach exists for purposes of an aiding and abetting claim. If a board were to negotiate for the type of provisions discussed above and simply receives incorrect information, it may be difficult to prove the board breached its duty of care in learning about actual and potential conflicts faced by its financial advisors. In any event, the text above from *Houseman* provides some comfort that, should the board obtain contractual provisions similar to those discussed above,

In our view, the provisions discussed above will aid in director oversight. There is legitimate debate whether the disclosures contemplated by these provisions are best addressed in an engagement letter or some other form of writing. For the reasons discussed above, engagement letters are an effective route for addressing these issues. Regardless of the medium, should the post-*Rural/Metro* trend toward conflicts disclosures continue, we should see more opinions of the *Houseman* variety and less of the *Rural/Metro* one.

and the financial advisor provides incorrect information based on anything short of actively concealing the conflict, "knowing participation" necessary for an aiding and abetting claim will not be found.

Exhibit A—Form of Engagement Letter, Marked to Show Comments from Company's Counsel

STRICTLY CONFIDENTIAL

[Company and Address]

Attention:

Ladies and Gentlemen:

Pursuant to our recent discussions, we are pleased to confirm the arrangements under which ____________________ (the "Investment Bank") is engaged by the Board of Directors (the "Board") of ____________________ (the "Company") to act as its financial advisor in connection with evaluating strategic and financial alternatives including a possible Transaction (as defined below) between the Company and any other person (any such person, together with its affiliates, a "Purchaser"). For purposes hereof, the term "Transaction" shall mean, whether in one or a series of transactions, (a) any merger, consolidation, joint venture or other business combination pursuant to which the shareholders of the Company immediately prior to the consummation of such Transaction cease to own at least 50 percent of the resulting entity; (b) the acquisition by a Purchaser, directly or indirectly, of more than 50 percent of the capital stock of the Company by way of tender or exchange offer, negotiated purchase or any other means; and/or (c) the acquisition by a Purchaser, directly or indirectly, of all or substantially all of the assets, properties and/or businesses of the Company, by way of a direct or indirect purchase, lease, license, exchange, joint venture or other means.

1. Financial Advisory Services. During the term of this agreement ("Agreement") we will:

   a. familiarize ourselves with the financial condition and business of the Company and, to the extent necessary, any prospective Purchaser, and advise and assist the Board in considering the desirability of effecting a Transaction or other strategic or financial alternatives;

   b. if requested, assist the Board in preparing a memorandum (based entirely on information supplied by the Company) for distribution to potential Purchasers as approved in advance by the Board, describing the Company, its business and financial condition;

   c. assist the Board in identifying and contacting potential Purchasers as approved in advance by the Board, to ascertain their interest in a Transaction or other strategic or financial alternatives; and

   d. advise and assist the Board in its negotiation of the financial aspects of a Transaction or other strategic or financial alternatives.

In addition, at the request of the Board, the Investment Bank will render an opinion (in writing if so requested) to the Board (the "Opinion") as to the fairness, from a financial point of view, of the consideration to be received by the Company or its shareholders in connection with the Transaction, or, in the case of a stock-for-stock merger, the fairness of the exchange ratio. The nature and scope of our investigation as well as the scope, form and substance of the Opinion shall be such as the Investment Bank considers appropriate.

The Board acknowledges that the scope of the Investment Bank's assignment hereunder does not include or constitute an express or implied commitment by the Investment Bank to purchase or place securities, or to provide or be responsible to provide any financing or enter into any other principal transactions, or include any obligation to provide financial advice with respect to any financing or markets transaction to be undertaken by the Company.

The Board, the Company and the Investment Bank agree that the Standard Terms and Conditions attached hereto form an integral part of this Agreement and are hereby incorporated herein by reference in their entirety.

2. Compensation. The fees payable to the Investment Bank for the foregoing services shall be as follows:

   a. a fee of $__________, payable upon delivery by the Investment Bank of an Opinion at the request of the Board, which shall be credited against any Transaction Fee (as defined below); and

   b. a fee (the "Transaction Fee"), payable upon the closing of a Transaction, in an amount equal to $__________.

   The Investment Bank will be entitled to receive the compensation provided for above if the events specified above occur (or in the case of clause (b), an agreement is entered into which subsequently results in a consummated Transaction) during the term of this Agreement or at any time within 12 months after expiration or termination of this Agreement, as the case may be. All fees payable hereunder are nonrefundable.

3. Expenses and Payments. In addition to our fees for professional services, the Company agrees to reimburse us for, and we will separately bill, our reasonable expenses as incurred, including travel costs, document production and other similar expenses, and reasonable fees of counsel and other professional advisors, provided that the aggregate amount of expenses subject to reimbursement hereunder (excluding, for the avoidance of doubt, any expenses contemplated by Section 1 of the Standard Terms and Conditions) shall not exceed $__________ without the consent of the Company (not to be unreasonably withheld). All amounts

payable under this Agreement (including the Standard Terms and Conditions) shall be paid in immediately available funds in U.S. dollars, without setoff and without deduction for any withholding, value-added or other similar taxes, charges, fees or assessments.

4. Term. This Agreement will be effective as of ________________ (the "Effective Date") and will expire on the date twelve months after the Effective Date. Our services hereunder may be earlier terminated with or without cause by the Board or by us at any time and without liability or continuing obligation to the Board or the Company or to us (except for any expenses incurred by us to the date of termination); provided that the provisions of Sections 2 and 3 hereof and Sections 1, 2 and 4 of the Standard Terms and Conditions-, and the last sentence of this Section 4, shall survive any termination or expiration of this Agreement. The Investment Bank agrees that, from the date on which this Agreement terminates, whether by expiration or termination, and continuing through the first anniversary of said date, the Investment Bank shall not engage in discussions with any third person regarding the possibility of engaging in a Transaction with the Company.

5. Representations and Warranties. The Investment Bank represents and warrants to the Company and the Board that, except as set forth on Schedule A annexed hereto and made a part hereof:

   a. Neither the Investment Bank nor IB Parent (as defined in the Standard Terms and Conditions) is, or has, within the past one (1) year, engaged in any discussions with any third party regarding the possibility of effecting, causing or participating in a Transaction regarding the Company; and

   b. Neither the Investment Bank nor IB Parent has, within the past two (2) years, had any relationship[1] with the following third parties that the Company believes may be interested in engaging in a Transaction with the Company: [list].

6. Covenants of Investment Bank. During the term of this Agreement:

   a. The Investment Bank will promptly disclose to the Board any existing relationship it has, and any relationship[1] it has had within the prior two years, with any third person that the Investment Bank, in good faith, determines is a potential participant in a Transaction, or expresses interest to the Investment Bank in participating in a Transaction. The Board and the Company shall keep this information confidential, except to the extent they determine, upon advice of counsel, that they are required to disclose the same in a public filing or otherwise.

[1] We can discuss a materiality qualifier.

b. The Investment Bank will not, without the express written permission of the Board, grant a waiver or consent, on behalf of the Company or the Board, to any third party allowing said third party to take an action, or not take an action, that its agreements with the Company and/or the Board would otherwise prohibit it from taking or require it to take (for example, and without limitation, allowing a bidder that has agreed not to discuss the possibility of a joint bid with any other potential bidder to engage in such discussions, or a bidder that has agreed to maintain the confidentiality of the Company's confidential information from using it for a purpose otherwise prohibited).

c. The Investment Bank shall perform its services under this Agreement as a fiduciary to the Board, the Company and its shareholders.

If the terms of our engagement as set forth in this Agreement (including the attached Standard Terms and Conditions) are satisfactory, kindly sign the enclosed copy of this letter and return it to the undersigned. We look forward to working with the Board on this assignment.

Very truly yours,

Accepted and Agreed As Of
The Date First Written Above:
Board of Directors of ______________________

With respect to the obligations of the Company hereunder:
Company
By: ______________________________
Name:
Title:

Standard Terms and Conditions

The following general terms and conditions shall be incorporated by reference into the engagement letter dated __________ between the Board of Directors of ________________ (the "Board") and the Investment Bank to which these terms are attached (the "Engagement Letter"). Capitalized terms used below without definition shall have the meanings assigned to them in the Engagement Letter and any references herein to the "Agreement" shall mean the Engagement Letter together with these Standard Terms and Conditions.

1. Indemnification and Contribution.

a. The Company agrees (i) to indemnify and hold harmless the Investment Bank and its affiliates, and the respective directors, officers, agents, and employees of the Investment Bank and its affiliates (the Investment Bank and each such entity or person being referred to as an "Indemnified Person") from and against any losses, claims, demands, damages or liabilities of any kind (collectively, "Liabilities") relating to or arising out of activities performed or services furnished pursuant to the Agreement, any Transaction or the Investment Bank's role in connection therewith, and (ii) to reimburse each Indemnified Person for all reasonable expenses (including reasonable fees and disbursements of counsel) incurred by such Indemnified Person in connection with investigating, preparing or defending any investigative, administrative, judicial or regulatory action or proceeding in any jurisdiction related to or arising out of such activities, services, Transaction or role, whether or not in connection with pending or threatened litigation to which any Indemnified Person is a party, in each case as such expenses are incurred or paid. The Company will not, however, be responsible for any such Liabilities or expenses to the extent that they are finally judicially determined to have resulted primarily from the Investment Bank's bad faith, gross negligence or willful misconduct. Each of the Board and the Company also agrees that no Indemnified Person shall have any liability (whether direct or indirect, in contract, tort or otherwise) to the Board (or any member thereof) or to the Company or any of its securityholders or creditors for or in connection with the Agreement, any Transaction or the Investment Bank's role or services in connection therewith, except to the extent that any such Liabilities or expenses incurred by the Board (or any member thereof) or the Company are finally judicially determined to have resulted primarily from the Investment Bank's bad faith, gross negligence or willful misconduct. In no event shall the Company or any Indemnified Person be responsible for any special, indirect or consequential damages incurred by the other; provided that nothing in this sentence shall be deemed to (i) relieve the Company of any obligation it may otherwise have hereunder to indemnify an Indemnified Person for any such damages asserted by an unaffiliated third party or (ii) relieve the Investment Bank of any liability it may otherwise have hereunder to the Company for any such damages which the Company becomes legally obligated to pay to an unaffiliated third party.

b. The Company shall not be liable for any settlement of any litigation or proceeding effected without its written consent. The Company will not, without the Investment Bank's written consent, settle, compromise, consent to the entry of any judgment in or otherwise seek to terminate any claim, action or proceeding in respect of which indemnity may be sought hereunder, whether or not any Indemnified Person is an actual or potential party thereto, unless such settlement, compromise, consent or termination includes an unconditional release of each Indemnified Person from any liabilities arising out of such claim, action or proceeding. If the Company enters into any agreement or arrangement with respect to, or effects, any proposed sale, exchange, dividend or other distribution or liquidation of all or substantially all of its assets in one or a series of transactions, the Company shall use its reasonable efforts to provide for the assumption of its obligations under this Section 1 by the purchaser or transferee of such assets or another party reasonably satisfactory to the Investment Bank.

c. If the foregoing indemnification is unavailable or insufficient to hold an Indemnified Person harmless in respect of any Liabilities (and related expenses) referred to therein then, in lieu of indemnifying such Indemnified Person hereunder, the Company shall contribute to the amount paid or payable by such Indemnified Person as a result of such Liabilities (and related expenses relating thereto) in such proportion as is appropriate to reflect the relative benefits to the Company, on the one hand, and the Investment Bank, on the other hand, of the Transaction (whether or not the Transaction is consummated) and also the relative fault of each of the Company and the Investment Bank, as well as any other relevant equitable considerations; provided, however, that except to the extent that any such Liabilities or expenses are finally judicially determined to have resulted primarily from the Investment Bank's bad faith, gross negligence or willful misconduct, in no event shall the Indemnified Persons be required to contribute an aggregate amount in excess of the aggregate amount of fees actually received by the Investment Bank under the Engagement Letter. For the purposes of this Agreement, the relative benefits to the Company and the Investment Bank of the Transaction shall be deemed to be in the same proportion as (i) the total value paid or contemplated to be paid or received or contemplated to be received by the Company or its securityholders, as the case may be, in connection with the Transaction or Transactions that are the subject of the Engagement Letter, whether or not any such Transaction is consummated, bears to (ii) the fees paid or to be paid to the Investment Bank under the Engagement Letter.

d. The Investment Bank agrees (i) to indemnify and hold harmless the Company and the Board (the Company and the Board each being referred to as a "Company Indemnified Person") from and against any Liabilities relating to or arising out of activities performed or services furnished by the Investment Bank pursuant to the Agreement that are in breach of this Agreement or that otherwise are found by a court of competent jurisdiction to have caused the members of the Board to have violated their fiduciary duties to the Company and/or its shareholders, and (ii) to reimburse each Company Indemnified Person for all reasonable expenses (including reasonable fees and disbursements of counsel) incurred by such Company Indemnified Person in connection with investigating, preparing or defending any investigative, administrative, judicial or regulatory action or proceeding in any jurisdiction related to or arising out of such activities or services. The indemnification provided for in this Section 1(d) shall have priority over any indemnification or contribution required elsewhere in this Section 1, and neither the Investment Bank nor any Indemnified Person shall be entitled to indemnification, contribution or reimbursement pursuant to Sections 1(a) through (c) above for any matter for which indemnification and/or reimbursement is required pursuant to this Section 1(d).

2. Financial Advisory Role, Information, Reliance, Confidentiality, etc.

a. The Board and the Company understand that the Investment Bank is acting solely as a financial advisor to the Board, is acting as an independent contractor and is not undertaking to provide any legal, accounting or tax advice in connection with its engagement under the Agreement and that the Investment Bank's role in any due diligence will be limited solely to performing such review as it shall deem necessary to support its own advice and analysis and shall not be on behalf of the Board or the Company.

b. Each of the Board and the Company agrees to provide to the Investment Bank all information reasonably requested by the Investment Bank for the purpose of its engagement under the Agreement and also to provide access to employees and directors of the Company (including the members of the Board), so long as such access is reasonable given the confidential nature of the contemplated process. The Company also agrees that upon closing of any Transaction, the Company shall notify the Investment Bank, in writing, (i) whether it expects to treat the consummated Transaction as a "reportable transaction" within the meaning of Treasury Regulation Section 1.6011-4(b), and (ii) if so, the applicable category of "reportable transaction." The Investment Bank shall be entitled to rely upon and assume, without any obligation of independent verification, the accuracy and completeness of all information that is publicly available and of all information that has been furnished to it by the Company or any Purchaser or otherwise reviewed by the Investment Bank, and the Investment Bank shall not assume any responsibility or have any liability therefor. The Investment Bank has no obligation to conduct any appraisal of any assets or liabilities or to evaluate the solvency of the Company or any Purchaser under any state or federal laws relating to bankruptcy, insolvency or similar matters. It is specifically agreed that (x) the Company shall be solely responsible for the accuracy and completeness of the memorandum referred to in Section 1(b) of the

Engagement Letter, and (y) other than as contemplated by such Section l(b) of the Engagement Letter, such memorandum may not be disclosed publicly or made available to third parties, except with the Investment Bank's prior written consent.

c. In order to enable the Investment Bank to bring relevant expertise to bear on its engagement under the Agreement from among its global affiliates, the Company agrees that the Investment Bank may share information obtained from the Company hereunder with its affiliates, and may perform the services contemplated hereby in conjunction with its affiliates, and that any of the Investment Bank affiliates performing services hereunder shall be entitled to the benefits (other than the right to receive fees) and subject to the terms of the Agreement. The Board and the Company agree that, following closing of any Transaction, the Investment Bank may, at its option and expense, place an advertisement or announcement in such newspapers and periodicals as it may determine describing the Investment Bank's role as financial advisor to the Board; provided that any such advertisement or announcement shall be in form and substance reasonably acceptable to the Board. Each of the Board and the Company agrees that the Investment Bank shall have the right to review and pre-approve any reference to it or its role as financial advisor under the Agreement in any public statement made by the Board or the Company (such approval not to be unreasonably withheld).

d. The Investment Bank's financial advice is intended solely for the benefit and use of the members of the Board (in their respective capacities as such) in considering a Transaction, is not on behalf of, and shall not confer rights or remedies upon, any shareholder or creditor of the Company or any other person, and may not be used or relied upon for any other purpose. Except as otherwise required by applicable law or governmental or stock exchange regulation, each of the Board and the Company will treat the Investment Bank's advice and the terms of the Agreement as confidential and will not disclose them to any third party (other than, on a confidential basis, to its counsel and other advisors in connection with a Transaction, it being understood that the Company will be responsible for any breach by such counsel or advisors of the provisions of this sentence) in any manner without the Investment Bank's prior written approval; provided, that each of the Board and the Company shall be entitled to utilize the Opinion in connection with its defense of any action, suit or proceeding relating to the Transaction; provided, further, that the Company may reproduce the Opinion in full in any proxy or information statement or Schedule 14D-9 or other filing relating to the Transaction which the Company must, under applicable law, file with any government agency or distribute to its shareholders. In such event, the Company may also include references to the Investment Bank and summarize the Opinion (in each case in such form as the Investment Bank shall provide or pre-approve in writing) in any such document.

e. Notwithstanding any other provision herein, the Board and the Company and each of its employees, representatives or other agents may disclose to any and all persons, without limitation of any kind, the U.S. income and franchise tax treatment and the U.S. income and franchise tax structure of the transactions contemplated hereby and all materials of any kind (including opinions or other tax analyses, if any) that are provided to the Board or the Company relating to such tax treatment and tax structure insofar as such treatment and/ or structure relates to a U.S. income or franchise tax strategy, if any, provided to the Board or the Company by the Investment Bank or its affiliates.

3. Other Business Relationships.

a. Each of the Board and the Company understands that the Investment Bank and its affiliates (collectively, "IB Parent") comprise a full service securities firm and a commercial bank engaged in securities trading and brokerage activities, as well as providing investment banking, asset management, financing, and financial advisory services and other commercial and investment banking products and services to a wide range of corporations and individuals. In the ordinary course of our trading, brokerage, asset management, and financing activities, IB Parent may at any time hold long or short positions, and may trade or otherwise effect transactions, for our own account or the accounts of customers, in debt or equity securities or senior loans of any Purchaser, the Company or any other company that may be involved in a Transaction. IB Parent recognizes its responsibility for compliance with federal securities laws in connection with such activities.

b. In addition, IB Parent may have and may in the future have investment and commercial banking, trust and other relationships with parties other than the Company, which parties may have interests with respect to the Company, a Purchaser or a Transaction. Notwithstanding anything contained herein, during the term of the Agreement, IB Parent shall not (i) act as M&A financial advisor to any party (other than the Board) in connection with a Transaction; or (ii) arrange and/or provide financing to potential Purchasers in respect of a Transaction. In addition, nothing in this Agreement shall be deemed to restrict (~~C~~A) any direct or indirect principal activities undertaken by any fund or portfolio company in which any IB Parent entity has non-controlling investments, (~~D~~B) any ordinary course sales and trading activity undertaken by employees who have not had access to the information received by the Investment Bank under the Agreement or (~~E~~C) any IB Parent entity or business engaged in providing private banking or investment management services. Although IB Parent in the course of its other relationships may acquire information about a Transaction, a Purchaser or such other parties, IB Parent shall have no obligation to disclose such information, or the fact that IB Parent is in possession of such information, to the Board or the Company or to use such information on the Board's behalf. Furthermore IB Parent may have fiduciary or other relationships whereby IB Parent may exercise voting power over securities of various persons, which securities may from time to time include securities of the Company, a Purchaser, or others with interests with respect to a Transaction. Each of the Board and the Company acknowledges that IB Parent may exercise such powers and otherwise perform its functions in connection with such fiduciary or other relationships without regard to its relationship to the Board hereunder.

4. Miscellaneous. The Agreement may not be assigned by the Board, the Company or the Investment Bank without the prior written consent of the others. The Agreement constitutes the entire understanding of the parties with respect to the subject matter thereof, supersedes all prior agreements with respect thereto, may not be amended except in writing signed by all of the parties, has been duly authorized and executed by each of the parties hereto and constitutes the legal, binding obligation of each such party. The Agreement shall be governed by and construed in accordance with the laws of the State of New York without reference to principles of conflicts of law. Each of the Board, the Company and the Investment Bank irrevocably and unconditionally submits to the exclusive jurisdiction and venue of any State or Federal court sitting in New York City over any action, suit or proceeding arising out of or relating to this Agreement. Each of the Board, the Company and the Investment Bank irrevocably and unconditionally waives any objection to the laying of venue of any such action brought in any such court and any claim that any such action has been brought in an inconvenient forum. The Investment Bank, the Board and the Company (on its own behalf and, to the extent permitted by law, on behalf of the shareholders of the Company) each waives any right to trial by jury in any action, claim, suit or proceeding with respect to the Investment Bank's engagement as financial advisor under the Agreement or its role in connection herewith.

EXHIBIT B—COLLECTED PROVISIONS

Engagement Representation

Except as set forth on Schedule A, the Bank has not, within the past three years, had investment banking, capital markets or lending engagements with respect to the parties identified thereon (the "Relevant Parties"), or to the Bank's knowledge, a portfolio company of a Relevant Party. Schedule A also sets forth the total fees derived from such engagements by the Bank.

Holdings Representation

The Bank has previously disclosed to the Board, and hereby represents, that the Bank and its affiliates (including portfolio companies in which the Bank has investments) do not beneficially own any interests in the Company, a Relevant Party, or to the Bank's knowledge, a portfolio company of a Relevant Party. In addition, the Bank has had discussions with the Vice President and Managing Directors that the Bank intends to work on this engagement (comprising __________ (the "Team Members")) and has confirmed that, other than as set forth on Schedule B, no Team Member has any direct holding, as of the date hereof, in the Company, a Relevant Party, or, to the relevant Team Member's knowledge, a portfolio company of a Relevant Party.

Prior Pitch Representation

The Bank has not within the past year engaged in any discussions with any third party concerning the possibility of effecting, causing, or participating in a Transaction with the Company.

Relationships Covenant

If the Board elects to engage in formal discussions with one or more parties other than the Relevant Parties about a Transaction, the Bank will, upon the request of the Board, disclose to the Board the information described above concerning such party or parties, and such party or parties will be, and will be deemed, a Relevant Party for purposes of this Agreement.

Bring-Down of Relationship Representation and Relationships Covenant

Alternative A

If, during the term of this letter agreement, the Bank becomes aware that any of the statements set forth in the Relationships Representation (or provided pursuant to the Relationships Covenant) is, or at the time of the execution of this letter agreement or disclosure of such information was, materially inaccurate, the Bank will promptly notify the Board and inform the Board of the manner in which such statement is or was materially inaccurate.

Alternative B

In addition, the Bank will immediately inform the Board upon the occurrence of the Bank's or any of its affiliates' (including portfolio companies in which the Bank has investments), or a Team Member's having any direct holding in a Relevant Party (or, to the knowledge of the Bank or Team Member, as applicable, a portfolio company of a Relevant Party) at any time before the termination of the engagement contemplated by this Letter Agreement.

Restricted Services Covenants (with Substitute Financial Advisor Provision in Brackets)

Notwithstanding anything herein to the contrary, during the term of this engagement, the Bank shall not provide M&A advisory services, new debt or equity capital markets or new bank financing to any Relevant Party without the prior written consent of the Board. [The Bank acknowledges and agrees that in the event that Bank provides such services with the prior written consent of the Board ("Other Services"), any Sale Transaction Fee that becomes payable to Bank hereunder shall have deducted from it an amount equal to the Opinion Fee. In addition, Bank shall ensure that employees of the Bank working on this engagement (i) will not simultaneously work on any team providing the Other Services, and (ii) will not share with any team providing the Other Services any confidential information received from the Company or the Board under this Agreement unless the Board has otherwise authorized such information to be shared.]

Tail Fee Provision

If, at any time prior to the expiration of 12 months following the termination of this agreement (other than a unilateral termination by the Bank or termination for Cause (as defined below) by the Company), the Company enters into an agreement that subsequently results in a Transaction or consummates a Transaction, then the Company will pay the Bank the Transaction Fee specified above in cash promptly upon the closing of the Transaction. Termination for "Cause" means termination by the Company prior to entering into a definitive agreement with respect to a Transaction because of a material breach of representation by the Bank with respect to the representation contained in Section __ hereof or a material breach of the covenants contained in Section __ and Section __ hereof, or willful misconduct, bad faith or gross negligence by the Bank in performing this engagement which conduct is not substantially remedied by the Bank after 10 days written notice from the Company stating that the Company believes such conduct constitutes Cause.

Changes in the Model Business Corporation Act to Section 8.70

*By the Corporate Laws Committee, ABA Business Law Section**

The Corporate Laws Committee of the ABA Business Law Section from time to time makes changes to the Model Business Corporation Act (Model Act).

By publication after second reading in the May 2014 issue of *The Business Lawyer*, the Committee proposed amendments to sections 2.02 and 8.70 of the Model Act (and related changes to sections 1.43, 8.31, and 8.60) permitting advance action to limit or eliminate duties regarding business opportunities.[1]

As reported by publication after third reading in the Winter 2014–2015 issue of *The Business Lawyer*, at its meeting on September 12, 2014, the Committee approved the amendments to sections 2.02 and 8.70 of the Model Act (and related changes to sections 1.43, 8.31, and 8.60) without change.[2]

At its meeting on April 17, 2015, the Committee approved clarifying amendments to the text of and Official Comment to section 8.70 of the Act, as set forth below. Changes to the existing provisions are marked to show changes from the text as previously approved and published on third reading. New language is indicated by underscoring and deletions are shown by ~~strikeouts~~.

8.70. Business Opportunities

(a) If a director or officer ~~or related person of either~~ pursues or takes advantage~~,~~ ~~directly or indirectly,~~ of a business opportunity, directly, or indirectly through or on behalf of another person, that action may not be the subject of equitable relief, or give rise to an award of damages or other sanctions against the director, officer or ~~related~~ other person, in a proceeding by or in the right of the corporation on the ground that ~~such~~ the opportunity should have first been offered to the corporation, if

(1) before the director, officer or ~~related~~ other person becomes legally obligated respecting the opportunity, the director or officer brings it to the

* Karl John Ege, Chair.

[1] *See* Corporate Laws Comm., *Changes in the Model Business Corporation Act—Proposed Amendments to Sections 2.02 and 8.70 (and Related Changes to Sections 1.43, 8.31 and 8.60) Permitting Advance Action to Limit or Eliminate Duties Regarding Business Opportunity*, 69 Bus. Law. 717 (2014).

[2] *See* Corporate Laws Comm., *Changes in the Model Business Corporation Act*, 70 Bus. Law. 175 (2014–2015).

attention of the corporation and~~: (i)~~ either: (i) action by qualified directors disclaiming the corporation's interest in the opportunity is taken in compliance with the ~~same~~ procedures set forth in section 8.62, or (ii) shareholders' action disclaiming the corporation's interest in the opportunity is taken in compliance with the procedures set forth in section 8.63~~,~~; in either case as if the decision being made concerned a director's conflicting interest transaction~~;~~, except that, rather than making "required disclosure" as defined in section 8.60, ~~in each case~~ the director or officer shall have made prior disclosure to those acting on behalf of the corporation of all material facts concerning the business opportunity ~~that are then~~ known to the director or officer; or

(2) the duty to offer the corporation the ~~particular~~ business opportunity has been limited or eliminated pursuant to a provision of the articles of incorporation adopted (and ~~in the case of officers and their related persons~~ where required, made effective by action of qualified directors) in accordance with section 2.02(b)(6).

(b) In any proceeding seeking equitable relief or other remedies based upon an alleged improper pursuit or taking advantage of a business opportunity by a director or officer, directly, or indirectly through or on behalf of another person, the fact that the director or officer did not employ the procedure described in subsection (a)(1)(i) or (ii) before pursuing or taking advantage of the opportunity shall not create an ~~inference~~ implication that the opportunity should have been first presented to the corporation or alter the burden of proof otherwise applicable to establish that the director or officer breached a duty to the corporation in the circumstances.

~~(c) As used in this section "related person" has the meaning specified in section 8.60(5).~~

* * *

Official Comment

Section 8.70(a)(1) provides a safe harbor for a director or officer weighing possible involvement with a prospective business opportunity that might constitute a "corporate opportunity." The phrase "directly, or indirectly through or on behalf of another person," recognizes the need to cover transactions pursued or effected either directly by the director or officer or indirectly through or on behalf of another person, which might be a related person as defined in section 8.60(5) or a person which is not a related person. By action of the board of directors or shareholders of the corporation under section 8.70(a)(1), the director or officer can ~~receive~~ obtain a disclaimer of the corporation's interest in the matter before proceeding with such involvement. In the alternative, the corporation may, among other things, (i) decline to disclaim its interest, (ii) delay a decision respecting granting a disclaimer pending receipt from the director or officer of additional information (or for any other reason), or (iii) attach conditions to the disclaimer it grants under section 8.70(a)(1). The safe harbor ~~granted to the director or officer pertains only to the~~ provided under section 8.70(a)(1) may be utilized only for a specific business opportunity ~~and does not have broader application, such as to a line of business or a geographic area~~. A broader advance safe harbor for any, or one or more classes or categories of, business opportunities must meet the requirements of section 2.02(b)(6). Section 8.70(a)(2) confirms that if the duty of an officer or director to present an opportunity has been limited or eliminated by a provision in the articles of incorporation under section 2.02(b)(6) (and, in the case of officers ~~and their related persons~~, appropriate action by qualified directors as required by that section), a safe harbor exists ~~for the director or officer (or related person)~~ in connection with the pursuit or taking of the opportunity.

The common law doctrine of "corporate opportunity" has long been recognized as a ~~core~~ part of ~~the~~ a director's duty of loyalty and, under court decisions, extends to officers. The doctrine ~~stands for the proposition~~ recognizes that the corporation has a right prior to that of its ~~director~~ directors or ~~officer~~ officers to act on certain business opportunities that come to the attention of the ~~director~~ directors or ~~officer~~ officers. In such situations, a director or officer who acts on the opportunity for the benefit of the director or officer or another person without having first presented it to the corporation can be held to have "usurped" or "intercepted" a right of the corporation. A defendant director or officer who is found by a court to have violated the duty of loyalty in this regard ~~is~~, as well as related or other persons involved in the transaction, may be subject to damages or ~~an array of~~ possible equitable remedies, including injunction, disgorgement or the imposition of a constructive trust in favor of the corporation. While the doctrine's concept is easily described, whether it will be found to apply in a given case depends on the facts and circumstances of the particular situation and is thus frequently unpredictable.

In recognition that the corporation need not pursue every business opportunity of which it becomes aware, an opportunity coming within the doctrine's criteria that has been properly presented to and declined by the corporation may then be pursued or taken by the presenting director or officer without breach of the duty of loyalty.

The fact-intensive nature of the corporate opportunity doctrine resists statutory definition. Instead, subchapter G employs the broader notion of "business opportunity" that encompasses any opportunity, without regard to whether it would come within the judicial definition of a "corporate opportunity" as it may have been developed by courts in a jurisdiction. When properly employed, ~~it~~ subchapter G provides a safe harbor mechanism enabling a director or officer to pursue an opportunity ~~for his or her own account or for the benefit~~ directly, or indirectly through or on behalf of another person, free of possible challenge claiming conflict with the director's or officer's duty on the ground that the opportunity should first have been offered to the corporation. Section 8.70 is modeled on the safe harbor and approval procedures of subchapter F pertaining to directors' conflicting interest transactions with, however, some modifications necessary to accommodate differences in the two ~~topics~~ matters addressed.

1. Section 8.70(a~~)(1~~)

Subsection (a)(1) describes the safe harbor available to a director or officer who elects to subject a business opportunity, regardless of whether the opportunity would be classified as a "corporate opportunity," to the disclosure and approval procedures set forth therein. The safe harbor provided is as broad as that provided for a director's conflicting interest transaction in section 8.61~~:~~. ~~if~~ If the director or officer makes ~~required~~ the prescribed disclosure of the facts specified and the corporation's interest in the opportunity is disclaimed by director action under subsection (a)(1)(i) or shareholder action under subsection (a)(1)(ii), the director or officer has foreclosed any claimed breach of the duty of loyalty and may not be subject to equitable relief, damages or other sanctions if the director or officer thereafter pursues or takes the opportunity for his or her own account or through or for the benefit of another person. As a general proposition, disclaimer by director action under subsection (a)(1)(i) must meet all of the requirements provided in section 8.62 with respect to a director's conflicting interest transaction and disclaimer by shareholder action under subsection (a)(1)(ii) must likewise ~~comply with~~ meet all of the requirements for shareholder action under section 8.63. Note, however, ~~two~~ several important differences.

First, in contrast to director or shareholder action under sections 8.62 and 8.63, which may be taken at any time, section 8.70(a)(1) requires that the director or officer ~~must~~ present the opportunity and secure director or shareholder action disclaiming it *before* ~~acting on~~ the director or officer or other person involved through or on behalf of the director or officer becomes legally obligated respecting the opportunity. The safe harbor concept contemplates that the corporation's decision maker will have full freedom of action in deciding whether the corporation should take over a proffered opportunity or ~~elect to~~ disclaim the corporation's interest in it. If the director or officer could seek ratification after ~~acting on~~ the legal obligation respecting the opportunity arises, the option of taking over the opportunity would, in most cases, ~~in reality~~ be foreclosed ~~and~~ to the corporation~~'s decision maker would be limited to denying ratification or blessing the director's or officer's past conduct with a disclaimer. In sum, the~~. The safe harbor's benefit is available only when the corporation can entertain the opportunity in a fully objective way.

The second difference ~~also involves procedure~~ relates to the necessary disclosure. Instead of employing section 8.60~~(7)~~'s definition of "required disclosure," ~~that~~ which is incorporated in sections 8.62 and 8.63, ~~section 8.70(a)(1) requires the alternative disclosure to those acting for the corporation of "all material facts concerning the business opportunity that are then known to the director." As a technical matter, section 8.60(7) calls for, in part, disclosure of~~ and includes "the existence and nature of the director's conflicting interest," ~~that information is not~~

~~only nonexistent but irrelevant for purposes of subsection (a). But there is another consideration justifying replacement of the section 8.60(7) definition. In the case of the director's conflicting interest transaction, the director proposing to enter into a transaction with the corporation has presumably completed due diligence and made an informed judgment respecting the matter; accordingly, that interested director is in a position to disclose "all facts known to the director respecting the subject matter of the transaction that a director free of such conflicting interest would reasonably believe to be material in deciding whether to proceed with the transaction." The interested director, placing himself or herself in the independent director's position, should be able to deal comfortably with the objective materiality standard. In contrast, the director or officer proffering a business opportunity will often not have undertaken due diligence and made an informed judgment to pursue the opportunity following a corporate disclaimer. Thus,~~ the disclosure obligation of subsection (a)(1) requires only that the director or officer reveal all material facts concerning the business opportunity ~~that, at the time when disclosure is made, are~~ known to the director or officer. The safe harbor procedure shields the director or officer even if a material fact regarding the business opportunity is not disclosed, so long as the proffering director or officer had no knowledge of that fact ~~such fact. In sum, the disclosure requirement for subsection (a)(1) must be and should be different from that called for by subchapter F's provisions.~~

~~Section 8.70(a)(2) confirms the effect of any applicable provision in the articles of incorporation to limit or eliminate a duty to offer the corporation a particular business opportunity adopted under the authority of section 2.02(b)(6)~~.

2. Section 8.70(b)

Subsection (b) reflects a fundamental difference between the coverage of subchapters F and G. Because subchapter F provides an exclusive definition of "director's conflicting interest transaction," any transaction meeting the definition that is not approved in accordance with the provisions of subchapter F is not entitled to its safe harbor. Unless the interested director can, upon challenge, establish the transaction's fairness, the director's conduct is presumptively actionable and subject to the full range of remedies that might otherwise be awarded by a court. In contrast, the concept of "business opportunity" under section 8.70 is not defined but is intended to be broader than what might be regarded as an actionable "corporate opportunity." This approach ~~recognizes that, given the vagueness~~ reflects the fact-intensive nature of the corporate opportunity doctrine, with the result that a director or officer ~~might~~ may be inclined to seek safe harbor protection under section 8.70~~(a)(1)~~ before pursuing an opportunity that ~~might~~ may or ~~might~~ may not ~~at a later point be subject to challenge as~~ be a "corporate opportunity." ~~By the same token~~Likewise, a director or officer ~~might~~ may conclude that a business opportunity is not a "corporate opportunity" under applicable law and choose to pursue it without seeking a disclaimer by the corporation under section

8.70(a)(1). Accordingly, subsection (b) provides that a decision not to ~~employ~~ seek the ~~procedures of~~ safe harbor offered by section 8.70(a)(1) neither creates a negative ~~inference~~ implication nor alters the burden of proof in any subsequent proceeding seeking damages or equitable relief based upon an alleged improper taking of a "corporate opportunity."

Changes in the Model Business Corporation Act—Proposed Subchapter E of Chapter 1 Permitting Ratification of Defective Corporate Actions

By the Corporate Laws Committee, ABA Business Law Section

The Corporate Laws Committee of the ABA Business Law Section (the "Committee") develops and from time to time proposes changes in the Model Business Corporation Act (the "Act" or "Model Act").

The Committee has approved, on second reading, new subchapter E of chapter 1 of the Act, permitting the ratification of defective corporate actions, and invites comments from interested persons. Comments should be addressed to Karl John Ege, Chair, Corporate Laws Committee, 1201 3d Avenue, Suite 4900, Seattle, Washington 98101, or sent to him by e-mail at kege@perkinscoie.com. Comments should be received by March 1, 2016, in order to be considered by the Committee before adoption of Subchapter E on third reading.

Subchapter E provides a statutory ratification procedure for corporate actions that may not have been properly authorized and shares that may have been improperly issued. Subchapter E also provides for retroactive validity of subsequent actions taken in reliance on the validity of the defective action that is ratified. A common example is where there are issues regarding the valid issuance of some of the corporation's outstanding shares. This may in turn call into question subsequent corporate actions taken in reliance on the valid issuance of such shares, such as the election of directors. The case law in some states may treat the statutory formalities for the issuance of shares as substantive prerequisites to the validity of the shares being issued, with the result that the failure to comply with such formalities renders the shares in question void, and not curable by ratification. In addition, it may be difficult to determine whether defects in share issuances render the shares void, and thus incapable of being validated or ratified, or merely voidable, and thus susceptible to cure by ratification.

Subchapter E provides corporations with two alternative paths to ratify or validate corporate actions, including share issuances that, due to a defect in authorization, might have been void and incapable of ratification. The first path involves remedial action taken by the corporation itself, through action by its board of directors and, if required, its shareholders. The second path involves a court proceeding that can be initiated by the corporation or certain other interested constituencies. The subchapter also provides for judicial review with respect to ratification taken by the corporation alone. The statutory ratification procedure is designed to supplement common law ratification, but is not the exclusive means by which to ratify defective actions. Rather, subchapter E provides a certain path that will result in a corporate action that was taken without proper authorization or improperly issued shares being deemed valid as a matter of law. Corporate actions ratified under this subchapter remain subject to equitable review.

Proposed subchapter E is set forth below.

Subchapter E.
Ratification of Defective Corporate Actions

§ 1.45. Definitions

In this subchapter:

(a) "Corporate action" means any action taken by or on behalf of the corporation, including any action taken by the incorporator, the board of directors, a committee, an officer or agent of the corporation or the shareholders.

(b) "Defective corporate action" means (i) any corporate action purportedly taken that is, and at the time such corporate action was purportedly taken would have been, within the power of the corporation, but is void or voidable due to a failure of authorization, and (ii) an overissue.

(c) "Failure of authorization" means the failure to authorize, approve or otherwise effect a corporate action in compliance with the provisions of this Act, the articles of incorporation or bylaws of the corporation, a corporate resolution or any plan or agreement to which the corporation is a party, if and to the extent such failure would render such corporate action void or voidable.

(d) "Overissue" means the purported issuance of:

(1) shares of a class or series in excess of the number of shares of a class or series the corporation has the power to issue under section 6.01 at the time of such issuance; or

(2) shares of any class or series that is not then authorized for issuance by the articles of incorporation.

(e) "Putative shares" means the shares of any class or series of the corporation (including shares issued upon exercise of rights, options, warrants or other securities convertible into shares of the corporation, or interests with respect thereto) that were created or issued as a result of a defective corporate action, that:

(1) but for any failure of authorization would constitute valid shares; or

(2) cannot be determined by the board of directors to be valid shares.

(f) "Date of the defective corporate action" means the date the defective corporate action was purported to have been taken, or if the exact date is unknown, the approximate date thereof.

(g) "Validation effective time" with respect to any defective corporate action ratified under this subchapter means the later of:

(1) the time at which the ratification of the defective corporate action is approved by the shareholders, or if approval of shareholders is not required, the time at which the notice required by section 1.49 becomes effective in accordance with section 1.41; and

(2) the time at which any articles of validation filed in accordance with section 1.51 become effective.

The validation effective time shall not be affected by the filing or pendency of a judicial proceeding under section 1.52 or otherwise, unless otherwise ordered by the court.

(h) "Valid shares" means the shares of any class or series of the corporation that have been duly authorized and validly issued in accordance with this Act, including as a result of ratification or validation under this subchapter.

Cross-References

Authorized shares, see § 6.01.
Corporate powers, see § 3.02.
Issuance of shares, see § 6.21.
Share options, see § 6.24.
Ultra vires, see § 3.04.

Official Comment

The definitions of "corporate action," "defective corporate action" and "failure of authorization" are intentionally broad in order to permit ratification of any corporate action purportedly taken that would have been within the power granted to a corporation under the Act.

The term "defective corporate action" includes an "overissue" of shares and other defects in share issuances that could cause shares to be treated as void. For purposes of determining which shares are overissued, only those shares issued in excess of the number of shares permitted to be issued under section 6.01 of the Act would be deemed overissued shares. If it cannot be determined from the records of the corporation which shares were issued prior to others, all shares included in an issuance that is or results in an overissue would be overissued shares.

§ 1.46. Defective Corporate Actions

(a) A defective corporate action shall not be void or voidable if ratified in accordance with section 1.47 or validated in accordance with section 1.52.

(b) Ratification under section 1.47 or validation under section 1.52 shall not be deemed to be the exclusive means of ratifying or validating any defective corporate action, and the absence or failure of ratification in accordance with this subchapter shall not, of itself, affect the validity or effectiveness of any corporate action properly ratified under common law or otherwise, nor shall it create a presumption that any such corporate action is or was a defective corporate action or void or voidable.

(c) In the case of an overissue, putative shares shall be valid shares effective as of the date originally issued or purportedly issued upon:

(1) the effectiveness under this subchapter and under chapter 10 of an amendment to the articles of incorporation authorizing, designating or creating such shares; or

(2) the effectiveness of any other corporate action under this subchapter ratifying the authorization, designation or creation of such shares.

Cross-References

Amendment by board of directors and shareholders, see § 10.03.
Authorized shares, see § 6.01.
Correcting filed documents, see § 1.24.

Official Comment

Subchapter E provides a statutory ratification procedure for corporate actions that may not have been properly authorized and shares that may have been improperly issued. The statutory ratification procedure is designed to supplement common law ratification. Corporate actions ratified under this subchapter remain subject to equitable review.

Examples of defective corporate actions subject to ratification include, but are not limited to, the failure of the incorporator to validly appoint an initial board of directors, corporate action taken in the absence of board resolutions authorizing the action, the failure to obtain the requisite shareholder approval of a corporate action, issuance of shares in the absence of evidence that consideration payable to the corporation for shares was received, the failure to comply with appraisal requirements and the issuance of shares without complying with preemptive rights. The ratification procedure is intended to be available only where there is objective evidence that a corporate action was defectively implemented. For example, subchapter E would permit ratification of shares previously issued but subsequently determined to have been issued improperly. It would not permit the corporation to issue shares retroactively as of an earlier date, however, where there is no objective evidence that shares had previously been issued. Objective evidence may include resolutions, issuance of share certificates, subscription or share purchase agreements, entries in a share ledger or other correspondence indicating that shares were issued or intended to have been issued.

Section 1.46(a) does not distinguish between void and voidable actions. Instead it provides that any defective corporate action that is ratified in accordance with section 1.47 or validated under section 1.52 shall not be void or voidable. Section 1.47 is not the exclusive means by which a defective corporate action may be ratified. Thus, the general common law doctrine of ratification, as applied to a board of directors' adoption of actions taken by officers who may not have had the actual authority to take such actions, continues to be an effective mode of ratification. Section 1.46(b) makes clear that the corporation's ratification of a defective corporate action that is voidable but not void using common law methods of ratification rather than under section 1.47 will not, standing alone, affect the validity of the action or create a presumption that the action is not valid. In addition, ratification under subchapter E is distinct from correction of an already filed document under section 1.24.

Section 1.46(c) provides that an overissue can be remedied by the adoption of articles of amendment or other corporate action that has the effect of authorizing, designating or creating shares of a series or class, such that the putative shares that resulted in the overissue are deemed to be validly issued from the date of original issuance. This provision enables a corporation to cure an overissue occurring when shares have been duly authorized but are issued before articles of amendment are filed. It also permits a corporation to remedy an overissue even if it cannot specifically identify the putative shares.

§ 1.47. Ratification of Defective Corporation Actions

(a) To ratify a defective corporate action under this section (other than the ratification of an election of the initial board of directors under subsection (b)), the board of directors shall take action ratifying the action in accordance with section 1.48, stating:

(1) The defective corporate action to be ratified and, if the defective corporate action involved the issuance of putative shares, the number and type of putative shares purportedly issued;

(2) The date of the defective corporate action;

(3) The nature of the failure of authorization with respect to the defective corporate action to be ratified; and

(4) That the board of directors approves the ratification of the defective corporate action.

(b) In the event that a defective corporate action to be ratified relates to the election of the initial board of directors of the corporation under section 2.05(a)(2), a majority of the persons who, at the time of the ratification, are exercising the powers of directors may take an action stating:

(1) The name of the person or persons who first took action in the name of the corporation as the initial board of directors of the corporation;

(2) The earlier of the date on which such persons first took such action or were purported to have been elected as the initial board of directors; and

(3) That the ratification of the election of such person or persons as the initial board of directors is approved.

(c) If any provision of this Act, the articles of incorporation or bylaws, any corporate resolution or any plan or agreement to which the corporation is a party in effect at the time action under subsection (a) is taken requires shareholder approval or would have required shareholder approval at the date of the occurrence of the defective corporate action, the ratification of the defective corporate action approved in the action taken by the directors under subsection (a) shall be submitted to the shareholders for approval in accordance with section 1.48.

(d) Unless otherwise provided in the action taken by the board of directors under subsection (a), after the action by the board of directors has been taken and, if required, approved by the shareholders, the board of directors may abandon the ratification at any time prior to the validation effective time without further action of the shareholders.

Cross-References

Organization of corporation, see § 2.05.
Requirement for and functions of board of directors, see § 8.01.

Official Comment

The information required by section 1.47(a)(1) regarding the listing of putative shares may be satisfied by attaching a table, including a capitalization table, listing the putative shares. Section 1.47(b) permits the ratification of the initial election of the board of directors by the persons who are acting as the current board of directors, recognizing that if the corporation's initial board of directors was defectively appointed, there may be no effective method of ratification because a duly elected board of directors does not exist.

§ 1.48. Action or Ratification

(a) The quorum and voting requirements applicable to a ratifying action by the board of directors under section 1.47(a) shall be the quorum and voting requirements applicable to the corporate action proposed to be ratified at the time such ratifying action is taken.

(b) If the ratification of the defective corporate action requires approval by the shareholders under subsection 1.47(c), and if the approval is to be given at a meeting, the corporation must notify each holder of valid and putative shares, whether or not entitled to vote, as of the record date for notice of the meeting and as of the date of the occurrence of defective corporate action, provided that notice shall not be required to be given to holders of valid or putative shares whose identities or addresses for notice cannot be determined from the records of the corporation. The notice must state that the purpose, or one of the purposes, of the meeting is to consider ratification of a defective corporate action and must be accompanied by (1) a copy of the action taken by the board of directors in accordance with section 1.47(a) or (2) the information required by section 1.47(a)(1) through (a)(4) and a statement that any claim that the ratification of such defective corporate action and any putative shares issued as a result of such defective corporate action should not be effective, or should be effective only on certain conditions, must be brought within 120 days from the applicable validation effective time.

(c) Except as provided in subsection (d) with respect to the voting requirements to ratify the election of a director, the quorum and voting requirements applicable to the approval by the shareholders required by section 1.47(c) shall be the quorum and voting requirements applicable to the corporate action proposed to be ratified at the time of such shareholder approval.

(d) The approval by shareholders to ratify the election of a director requires that the votes cast within the voting group favoring such ratification exceed the votes cast opposing such ratification of the election at a meeting at which a quorum is present.

(e) Putative shares on the record date for determining the shareholders entitled to vote on any matter submitted to shareholders under section 1.47(c) (and without giving effect to any ratification of putative shares that becomes effective as a result of such vote) shall neither be entitled to vote nor counted for quorum purposes in any vote to approve the ratification of any defective corporate action.

(f) If the approval under this section of putative shares would result in an overissue, in addition to the approval required by section 1.47, approval of an amendment to the articles of incorporation under subchapter A of chapter 10 to increase the number of shares of an authorized class or series or to authorize the creation of a class or series of shares so there would be no overissue shall also be required.

Cross-References

Notices and other communications, see § 1.41.
Quorum and voting requirements for the board of directors, see § 8.24.
Quorum and voting requirements for voting groups, see § 7.25.

Official Comment

Notwithstanding the shareholder notice required by section 1.48(b), only valid shares are entitled to vote on the ratification action or counted for quorum purposes. The retroactive effect of a ratification of putative shares does not invalidate the quorum or voting result of the ratification. For matters other than the election of directors, the quorum and voting requirements applicable to shareholder approval of ratification are the quorum and voting requirements applicable to the corporate action being ratified at the time of such approval. For example, if the defective corporate action being ratified is an amendment to the articles of incorporation, whether in connection with an overissue or otherwise, the vote required would be governed by section 10.03. If the defective corporate action involves a merger, the vote required would be the vote required by section 11.04.

§ 1.49. Notice Requirements

(a) Unless shareholder approval is required under section 1.47(c), prompt notice of an action taken under section 1.47 shall be given to each holder of valid and putative shares, whether or not entitled to vote, as of (1) the date of such action by the board of directors and (2) the date of the defective corporate action ratified, provided that notice shall not be required to be given to holders of valid and putative shares whose identities or addresses for notice cannot be determined from the records of the corporation.

(b) The notice shall contain (1) a copy of the action taken by the board of directors in accordance with section 1.47(a) or (b) or (2) the information required by section 1.47(a)(1) through (a)(4) or section 1.47(b)(1) through (b)(3), as applicable, and a statement that any claim that the ratification of the defective corporate action and any putative shares issued as a result of such defective corporate action should not be effective, or should be effective only on certain conditions, must be brought within 120 days from the applicable validation effective time.

(c) No notice under this section is required with respect to any action required to be submitted to shareholders for approval under section 1.47(c) if notice is given in accordance with section 1.48(b).

(d) A notice required by this section may be given in any manner permitted by section 1.41 and, for any corporation subject to the reporting requirements of Section 13 or 15(d) of the Securities Exchange Act of 1934, as amended, may be given by means of a filing or furnishing of such notice with the United States Securities and Exchange Commission.

Cross-References

Corporate records, see § 16.01.
Householding, see § 1.44.
Notices and other communications, see § 1.41.

§ 1.50. Effect of Ratification

From and after the validation effective time, and without regard to the 120-day period during which a claim may be brought under section 1.52:

(a) Each defective corporate action ratified in accordance with section 1.47 shall not be void or voidable as a result of the failure of authorization identified in the action taken under section 1.47(a) or (b) and shall be deemed a valid corporate action effective as of the date of the defective corporate action;

(b) The issuance of each putative share or fraction of a putative share purportedly issued pursuant to a defective corporate action identified in the action taken under section 1.47 shall not be void or voidable, and each such putative share or fraction of a putative share shall be deemed to be an identical share or fraction of a valid share as of the time it was purportedly issued; and

(c) Any corporate action taken subsequent to the defective corporate action ratified in accordance with this subchapter in reliance on such defective corporate action having been validly effected and any subsequent defective corporate action resulting directly or indirectly from such original defective corporate action shall be valid as of the time taken.

Official Comment

Ratification is effective as of the validation effective time and is not dependent on the expiration of the 120-day time period in which an action challenging the ratification must be brought. The ratification of a defective corporate action has the additional effect of ratifying corporate actions that are defective as a result of the original defective corporate action. For example, an overissue which results in subsequent director elections being invalid calls into question all actions by the invalidly elected board members. The ratification of the overissue, however, would cure any such additional defects.

§ 1.51. Filings

(a) If the defective corporate action ratified under this subchapter would have required under any other section of this Act a filing in accordance with this Act, then, whether or not a filing was previously made in respect of such defective corporate action and in lieu of a filing otherwise required by this Act, the corporation shall file articles of validation in accordance with this section, and such articles of validation shall serve to amend or substitute for any other filing with respect to such defective corporate action required by this Act.

(b) The articles of validation shall set forth:

(1) the defective corporate action that is the subject of the articles of validation (including, in the case of any defective corporate action involving the issuance of putative shares, the number and type of putative shares issued and the date or dates upon which such putative shares were purported to have been issued);

(2) the date of the defective corporate action;

(3) the nature of the failure of authorization in respect of the defective corporate action;

(4) a statement that the defective corporate action was ratified in accordance with section 1.47, including the date on which the board of directors ratified such defective corporate action and the date, if any, on which the shareholders approved the ratification of such defective corporate action; and

(5) the information required by subsection (c).

(c) The articles of validation shall also contain the following information:

(1) if a filing was previously made in respect of the defective corporate action and no changes to such filing are required to give effect to the ratification of such defective corporate action in accordance with section 1.47, the articles of validation shall set forth (i) the name, title and filing date of the filing previously made and any articles of correction thereto and (ii) a statement that a copy of the filing previously made, together with any articles of correction thereto, is attached as an exhibit to the articles of validation;

(2) if a filing was previously made in respect of the defective corporate action and such filing requires any change to give effect to the ratification of such defective corporate action in accordance with section 1.47, the articles of validation shall set forth (i) the name, title and filing date of the filing previously made and any articles of correction thereto, (ii) a statement that a filing containing all of the information required to be included under the applicable section or sections of the Act to give effect to such defective corporate action is attached as an exhibit to the articles of validation, and (iii) the date and time that such filing is deemed to have become effective; or

(3) if a filing was not previously made in respect of the defective corporate action and the defective corporate action ratified under section 1.47 would have required a filing under any other section of the Act, the articles of validation shall set forth (i) a statement that a filing containing all of the information required to be included under the applicable section or sections of the Act to give effect to such defective corporate action is attached as an exhibit to the articles of validation, and (ii) the date and time that such filing is deemed to have become effective.

Cross-References

Correcting filed document, see § 1.24.
Effective time and date of filing, see § 1.23.

Official Comment

Section 1.51 requires that in the event any filing is or would have been required under the Act to effect the defective corporate action, such filing (if no filing was previously made), such corrected filing (if correction to a previous filing is required) or such original filing (if no correction to a previous filing is required) be attached as an exhibit to the articles of validation. This is intended to provide a clear public record of the actions relating to the ratification.

§ 1.52. Judicial Proceedings Regarding Validity of Corporate Actions

(a) Upon application by the corporation, any successor entity to the corporation, a director of the corporation, any shareholder, beneficial shareholder or unrestricted voting trust beneficial owner of the corporation, including any such shareholder, beneficial shareholder or unrestricted voting trust beneficial owner as of the date of the defective corporate action ratified under section 1.47, or any other person claiming to be substantially and adversely affected by a ratification under section 1.47, the [name or describe] court may:

(1) determine the validity and effectiveness of any corporate action or defective corporate action;

(2) determine the validity and effectiveness of any ratification under section 1.47;

(3) determine the validity of any putative shares; and

(4) modify or waive any of the procedures specified in section 1.47 or 1.48 to ratify a defective corporate action.

(b) In connection with an action under this section, the court may make such findings or orders, and take into account any factors or considerations, regarding such matters as it deems proper under the circumstances.

(c) Service of process of the application under subsection (a) on the corporation may be made in any manner provided by statute of this state or by rule of the applicable court for service on the corporation, and no other party need be joined in order for the court to adjudicate the matter. In an action filed by the corporation, the court may require notice of the action be provided to other persons specified by the court and permit such other persons to intervene in the action.

(d) Notwithstanding any other provision of this section or otherwise under applicable law, any action asserting that the ratification of any defective corporate action and any putative shares issued as a result of such defective corporate action should not be effective, or should be effective only on certain conditions, must be brought within 120 days of the validation effective time.

Cross-References

"Beneficial shareholder" defined, see § 1.40.
"Shareholder" defined, see § 1.40.
"Unrestricted voting trust beneficial owner" defined, see § 1.40.

Official Comment

Section 1.52 confers plenary jurisdiction on a designated court to hear and determine claims regarding the validity of any corporate action or any shares, rights, options or warrants. The court's jurisdiction is not limited to reviewing corporate actions ratified or purportedly ratified under section 1.47, and includes the ability of a corporation or other permitted person to obtain a declaration regarding the validity of any corporate actions or shares that are potentially defective. In determining the validity of a corporate action or reviewing a corporate action ratified under section 1.47, the court may consider any factors or considerations it deems proper under the circumstances. These might include whether the person originally taking the defective corporate action believed that the action complied with corporate requirements, whether the corporation and board of directors have treated the defective corporate action as a valid action, whether any person has acted in reliance on the public record that such defective corporate action was valid and whether any person will be or was harmed by the ratification of the defective corporate action or will be harmed by the failure to ratify or validate the defective corporate action.

Changes in the Model Business Corporation Act—Proposed Amendments to Section 11.04 and Section 13.02

By the Corporate Laws Committee, ABA Business Law Section

The Corporate Laws Committee of the ABA Business Law Section (the "Committee") develops and from time to time proposes changes in the Model Business Corporation Act (the "Act").

The Committee has approved, on second reading, amendments to section 11.04 and certain provisions in chapter 13 (the "Amendments") of the Act, permitting the merger of corporations without a shareholder vote following a tender offer, if certain conditions are met, and invites comments from interested persons. Comments should be addressed to Karl John Ege, Chair, Corporate Laws Committee, 1201 3d Avenue, Suite 4900, Seattle, Washington 98101, or sent to him by e-mail at kege@perkinscoie.com. Comments should be received by February 28, 2016, in order to be considered by the Committee before adoption of the Amendments.

The Amendments establish a procedure that allows a corporation to consummate a merger without a shareholder vote if the merger follows a tender offer following which the tender offeror owns sufficient shares that it could approve the merger if it were submitted to a vote at a meeting at which all shares entitled to vote on the approval were present and voted. The Amendments allow a corporation to enter into a "two-step" merger agreement, where the first step is a tender offer by the acquiror and the second step is a merger in which the shares not tendered are converted into the same merger consideration offered in the tender offer. Where the tender offeror acquires sufficient shares in the tender offer to approve the agreement at a meeting at which all shares are voted, the holding of such a meeting would be a mere formality but might take a significant amount of time and impose a significant cost that was otherwise unnecessary. Corresponding changes are made to the provisions regarding appraisal to ensure that shareholders who do not tender would have the same rights to seek appraisal that they would in a merger that was approved at a meeting.

The Amendments are set forth below. Changes to the existing provisions are marked with deletions shown by ~~strikeout~~ and additions by double underscoring.

§ 11.04. Action on a Plan of Merger or Share Exchange

In the case of a domestic corporation that is a party to a merger or share exchange, the plan of merger or share exchange shall be adopted in the following manner:

(a) The plan of merger or share exchange must first be adopted by the board of directors.

(b) Except as provided in ~~subsection (g~~subsections (h) and (j) and in section 11.05, ~~after adopting~~ the plan of merger or share exchange must then be approved by the shareholders. In submitting the plan of merger or share exchange to the shareholders for approval, the board of directors must ~~submit the plan to the shareholders for their approval. The board of directors must also transmit to the shareholders a recommendation~~ recommend that the shareholders approve the plan or, in the case of an offer referred to in subsection (j)(1)(B), that the shareholders tender their shares to the offeror in response to the offer, unless (i) the board of directors makes a determination that because of conflicts of interest or other special circumstances it should not make such a recommendation or (ii) section 8.26 applies. If either (i) or (ii) applies, the board must inform ~~transmit to~~ the shareholders of the basis for so proceeding.

(c) The board of directors may condition its submission of the plan of merger or share exchange to the shareholders on any basis.

(d) If the plan of merger or share exchange is required to be approved by the shareholders, and if the approval is to be given at a meeting, the corporation must notify each shareholder, whether or not entitled to vote, of the meeting of shareholders at which the plan is to be submitted for approval. The notice must state that the purpose, or one of the purposes, of the meeting is to consider the plan and must contain or be accompanied by a copy or summary of the plan. If the corporation is to be merged into an existing corporation or other entity, the notice shall also include or be accompanied by a copy or summary of the articles of incorporation or organizational documents of that corporation or other entity. If the corporation is to be merged into a corporation or other entity that is to be created pursuant to the merger, the notice shall include or be accompanied by a copy or a summary of the articles of incorporation or organizational documents of the new corporation or other entity.

(e) Unless the articles of incorporation, or the board of directors acting pursuant to subsection (c), requires a greater vote or a greater number of votes to be present, approval of the plan of merger or share exchange requires the approval of the shareholders at a meeting at which a quorum consisting of at least a majority of the votes entitled to be cast on the plan exists, and, if any class or series of shares is entitled to vote as a separate group on the plan of merger or share exchange, the approval of each such separate voting group at a meeting at which a quorum of the voting group consisting of at least a majority of the votes entitled to be cast on the merger or share exchange by that voting group is present.

(f) Subject to subsection (g), separate voting by voting groups is required:

(1) on a plan of merger, by each class or series of shares that:

(i) are to be converted under the plan of merger into other securities, interests, obligations, rights to acquire shares, other securities or interests, cash, other property, or any combination of the foregoing; or

(ii) are entitled to vote as a separate group on a provision in the plan that constitutes a proposed amendment to articles of incorporation of a surviving corporation, that requires action by separate voting groups under section 10.04;

(2) on a plan of share exchange, by each class or series of shares included in the exchange, with each class or series constituting a separate voting group; and

(3) on a plan of merger or share exchange, if the voting group is entitled under the articles of incorporation to vote as a voting group to approve a plan of merger or share exchange.

(g) The articles of incorporation may expressly limit or eliminate the separate voting rights provided in subsections (f)(1)(i) and (f)(2) as to any class or series of shares, except for a transaction that (A) includes what is or would be, if the corporation were the surviving corporation, an amendment subject to subsection (f)(1)(ii), and (B) will effect no significant change in the assets of the resulting entity, including all parents and subsidiaries on a consolidated basis.

(h) Unless the articles of incorporation otherwise provide, approval by the corporation's shareholders of a plan of merger or share exchange is not required if:

(1) the corporation will survive the merger or is the acquiring corporation in a share exchange;

(2) except for amendments permitted by section 10.05, its articles of incorporation will not be changed;

(3) each shareholder of the corporation whose shares were outstanding immediately before the effective date of the merger or share exchange will hold the same number of shares, with identical preferences, limitations, and relative rights, immediately after the effective date of change; and

(4) the issuance in the merger or share exchange of shares or other securities convertible into or rights exercisable for shares does not require a vote under section 6.21(f).

(i) If as a result of a merger or share exchange one or more shareholders of a domestic corporation would become subject to owner liability for the debts, obligations or liabilities of any other person or entity, approval of the plan of merger or share exchange shall require the execution, by each such shareholder, of a separate written consent to become subject to such owner liability.

(j) (1) Unless the articles of incorporation otherwise provide, approval by the corporation's shareholders of a plan of merger or share exchange is not required if:

(A) the plan of merger or share exchange expressly (A) permits or requires the merger or share exchange to be effected under this subsection and (B) provides that, if the merger or share exchange is to be effected under this subsection, the merger or share exchange will be effected as soon as practicable following the satisfaction of the requirement set forth in subsection (j)(1)(F);

(B) another party to the merger or share exchange, or a parent of another party to the merger or share exchange, makes an offer to purchase, on the terms provided in the plan of merger or share exchange, any and all of the outstanding shares of the corporation that, absent this subsection, would be entitled to vote on the plan of merger or share exchange, except that the offer may exclude shares of the corporation that are owned at the commencement of the offer by the corporation, the offeror, or any parent of the offeror, or by any wholly owned subsidiary of any of the foregoing;

(C) the offer discloses that the plan of merger or share exchange provides that the merger or share exchange will be effected as soon as practicable following the satisfaction of the requirement set forth in subsection (j)(1)(F) and that the shares of the corporation that are not tendered in response to the offer will be treated as set forth in subsection (j)(1)(H);

(D) the offer remains open for at least 10 days;

(E) the offeror purchases all shares properly tendered in response to the offer and not properly withdrawn;

(F) the shares (I) purchased by the offeror in accordance with the offer, (II) otherwise owned by the offeror or by any parent or wholly owned subsidiary of the offeror, or (III) subject to an agreement to be transferred, contributed or delivered to the offeror, any parent of the offeror, or any wholly owned subsidiary of the offeror in exchange for stock or other equity interests in such offeror, parent or subsidiary are collectively entitled to cast at least the minimum number of votes on the merger or share exchange that, absent this subsection, would be required by this chapter and by the articles of incorporation of the corporation for the approval of the merger or share exchange by the shareholders and by any other voting group entitled to vote on the merger or share exchange at a meeting at which all shares entitled to vote on the approval were present and voted;

(G) the offeror or a wholly owned subsidiary of the offeror merges with or into, or effects a share exchange in which it acquires shares of, the corporation; and

(H) each outstanding share of each class or series of shares of the corporation that the offeror is offering to purchase in accordance with the offer, and that is not purchased in accordance with the offer, is to be converted in the merger into, or into the right to receive, or is to be exchanged in the share exchange for, or for the right to receive, the same amount and kind of securities, interests, obligations, rights, cash, or other property to be paid or exchanged in accordance with the offer for each share of that class or series of shares that is tendered in response to the offer, except that shares of the corporation that are owned by the corporation or that are described in clause (II) or (III) of subsection (j)((1)(F) need not be converted into or exchanged for the consideration described in this subsection (j)(1)(H).

(2) As used in this subsection only:

(A) "offer" means the offer referred to in subsection (j)(1)(B);

(B) "offeror" means the person making the offer;

(C) "parent" of an entity means a person that owns, directly or indirectly (through one or more wholly owned subsidiaries), all of the outstanding shares of or interests in that entity;

(D) shares tendered in response to the offer shall be deemed to have been "purchased" in accordance with the offer at the earliest time as of which (i) the offeror has irrevocably accepted those shares for payment and (ii) either (A) in the case of shares represented by certificates, the offeror, or the offeror's designated depository or other agent, has physically received the certificates representing those shares or (B) in the case of shares without certificates, those shares have been transferred into the account of the offeror or its designated depository or other agent, or an agent's message relating to those shares has been received by the offeror or its designated depository or other agent; and

(E) "wholly owned subsidiary" of a person means an entity of or in which that person owns, directly or indirectly (through one or more wholly owned subsidiaries), all of the outstanding shares or interests.

* * *

Official Comment

1. In General

~~Under section 11.04, a plan of merger or share exchange must be adopted by the board. Thereafter, the board must submit the plan to the shareholders for their approval, unless the conditions stated in section 11.04(g) or section 11.05 are satisfied. A~~ Subject to the exceptions set forth in section 11.04(b), a plan of share exchange must always be approved by the shareholders of the class or series that is being acquired in a share exchange~~. Similarly,~~ and a plan of merger must always be approved by the shareholders of a corporation that is merged into another party in a merger~~, unless the corporation is a subsidiary and the merger falls within section 11.05. However, under section 11.04(g)~~. Under section 11.04(h), approval of a plan of merger or share exchange by the shareholders of a surviving corporation in a merger or of an acquiring corporation in a share exchange is not required if the conditions stated in that section~~,~~ ~~including the fundamental rule of section 6.21(f), are satisfied.~~ are satisfied. Under section 11.04(j), shareholder action by selling shares in a tender offer or exchange offer is accepted as an alternative to the traditional consent by voting if the conditions specified in section 11.04(j) are met.

~~Section 11.04(f) provides that a class or series has a right to vote on a plan of merger as a separate voting group if, pursuant to the merger, the class or series would be converted into other securities, interests, obligations, rights to acquire shares, other securities or interests, cash, or other property. A class or series also is entitled to vote as a separate voting group if the class or series would be entitled to vote as a separate group on a provision in the plan that constitutes an amendment to the articles of incorporation that requires approval by that class or series, voting as a separate voting group, under section 10.04.~~

~~Under section 11.04(g) the articles of incorporation may expressly~~ The authorization under section 11.04(g) for the articles of incorporation to limit or eliminate separate voting as a voting group ~~for any class or series of shares in a merger or share exchange. This authorization~~ does not apply if a plan of merger includes amendments requiring a separate vote under section 10.04. It also does not apply if the merger or share exchange involves ~~both (i) what is or would be~~ an amendment to which section 10.04 would apply ~~and (ii)~~ if the corporation were the surviving corporation and the transaction effects no significant change in the assets of the enterprise on a consolidated basis, i.e., the transaction has no substantive business combination effect, such as a reincorporation or recapitalization. For example, suppose a corporation that is a holding company with a single wholly owned operating subsidiary has two classes of stock, preferred and common, and the articles of incorporation expressly eliminate a separate group vote and provide that the preferred stock and common stock vote together as a single voting group on a merger. The corporation proposes to merge itself into its subsidiary in a merger in which each class will get shares of common stock of the subsidiary as the surviving corporation. In such a case, the transaction would be in substance an amendment of the preferred stock (an exchange or reclassification under ~~Section~~ section 10.04(a)(1)) and the preferred stock would have separate voting rights notwithstanding the provision eliminating the separate group vote. On the other hand, if the subsidiary were not wholly owned but was 60% owned and the holders of the 40% minority were being cashed out in the merger, the elimination of the separate group vote would be effective and the preferred stock and common stock would vote together as a single voting group because the merger would have business substance. The requirement that a provision limiting or eliminating group voting rights on a merger or share exchange be "express" is meant to avoid any ambiguity that might arise from a provision that generally denies voting rights.

~~The introduction of section 11.04(g) in 2010 is accompanied by changes to section 13.02 dealing with~~ Section 11.04(g), together with the appraisal rights provisions of chapter 13, is designed to assure that~~, in the broad array of fundamental~~ in transactions or actions that may occur under Chapters 9, 10, 11 and 12, a shareholder has ~~at least one of~~ either a group voting right or an appraisal right~~. In many cases, a shareholder will have both, but in some cases only one. For example, group voting rights are assured for the amendments covered in section 10.02, even if the shares otherwise have no voting rights, but appraisal rights are not available. On the other hand, under section 13.02(c), appraisal rights may be denied to preferred shares in the articles but, as amended in 2010, section 13.02(c) authorizes such a provision to be effective only if the shareholder has a group voting right on the transaction and does not permit it to be effective if the transaction is a nonprofit conversion under subchapter 9C or an entity conversion under subchapter 9E. See the Official Comment to sections 13.01 and 13.02~~ or both.

Under section 10.04(c), and therefore under section 11.04(f)(1)(ii), if a change that requires voting by separate voting groups affects two or more classes or series in the same or a substantially similar way, the relevant classes or series vote together, rather than separately, on the change, unless otherwise provided in the articles of incorporation or required by the board of directors. If separate voting by voting groups is required for a merger or a share exchange under section 11.04(f), it will not be excused by section 11.04(h). For the mechanics of voting where voting by voting groups is required under section 11.04(f), see sections 7.25 and 7.26 and the Official Comments thereto.

If a merger would amend the articles of incorporation in such a way as to affect the voting requirements on future amendments, the transaction must also be approved by the vote required by section 7.27.

Under section 11.08, the board of directors may abandon a merger or share exchange before its effective date even if the plan of merger or share exchange has already been approved by the corporation's shareholders.

2. Submission to the Shareholders

~~Section 11.04(b) requires the board of directors, after having adopted the plan of merger or share exchange, to submit the plan of merger or share exchange to the shareholders for approval, except as provided in subsection (g) and section 11.05. When submitting the plan of merger or share exchange the board must make a recommendation to the shareholders that the plan be approved, unless (i) the board makes a determination that because of conflicts of interest or other special circumstances it should make no recommendation or (ii) section 8.26 applies. The board might make a determination~~ When submitting a plan of merger or share exchange to shareholders, the board of directors must recommend the transaction, subject to two exceptions in section 11.04(b). The board might exercise the exception under clause (i) where the number of directors having a conflicting interest makes it inadvisable for them to recommend the transaction or where the board is evenly divided as to the merits of the transaction but is able to agree that shareholders should be permitted to consider the transaction. ~~This exception is intended to be used sparingly. Generally, shareholders should not be asked to vote on a plan of merger or share exchange in the absence of a recommendation by the board.~~ Clause (ii) is intended to provide for situations in which the board might wish to commit in advance to submit a plan of merger or share exchange to the shareholders but later determines it is inadvisable or withdraws the recommendation for some other reason. ~~If the board proceeds under either clause (i) or (ii), it must communicate the basis for its determination, when so proceeding. Clauses (i) and (ii) are not intended to relieve the board of its duty to consider carefully the proposed transaction and the interests of shareholders.~~

~~Section 11.04(c) permits the board of directors to condition its submission of a plan of merger or share exchange on any basis.~~ Among the conditions that a board might impose under section 11.04(c) are that the plan will not be deemed approved (i) unless it is approved by a specified vote of the shareholders, or by one or more specified classes or series of shares, voting as a separate voting group, or by a specified percentage of disinterested shareholders or (ii) if shareholders holding more than a specified fraction of the outstanding shares assert appraisal rights. ~~The~~ These are examples and the board of directors is not limited to conditions of these types.

Section 11.04(d) ~~provides that if the~~ sets forth the notice requirements if a plan of merger or share exchange is ~~required~~ to be ~~approved~~ considered by the shareholders~~, and if the approval is to be given at a meeting, the corporation must notify each shareholder, whether or not entitled to vote, of the meeting of shareholders at which the plan is to be submitted~~ at a meeting. Requirements concerning the timing and content of a notice of meeting are set out in section 7.05. Section 11.04(d) does not ~~itself require that~~ address the notice to be given to nonvoting shareholders where the merger is approved, without a meeting, by unanimous consent. However, that requirement is imposed by section 7.04(d).

3. Quorum and Voting

Section 11.04(e) ~~provides that approval of~~ sets forth the quorum requirements applicable to a shareholder vote to approve a plan of merger or share exchange ~~requires approval of the shareholders at a meeting at which a quorum consisting of a majority of the votes entitled to be cast on the plan exists and, if any class or series of shares are entitled to vote as a separate group on the plan, the approval of each such separate group at a meeting at which a quorum consisting of at least a majority of the votes entitled to be cast on the plan by that class or series exists~~. See sections 7.25(f) and 10.04(c) for rules governing when separate classes or series vote together as a single voting group. If a quorum is present, ~~then~~ and subject to any greater vote required by the articles of incorporation or the board of directors pursuant to section 11.04(c), under sections 7.25 and 7.26 the plan will be approved if more votes are cast in favor of the plan than against it by the voting group or separate voting groups entitled to vote on the plan. ~~This represents a change from the Act's previous voting rule for mergers and share exchanges, which required approval by a majority of outstanding shares.~~

In lieu of approval at a shareholders' meeting, approval can be given by shareholder consent under procedures set forth in section 7.04.

~~4. Abandonment of Merger or Share Exchange~~

~~Under section 11.08, the board of directors may abandon a merger or share exchange before its effective date even if the plan of merger or share exchange has already been approved by the corporation's shareholders.~~

4. Two-Step Transactions

Section 11.04(j) authorizes a two-step transaction meeting the requirements of that section to proceed without the shareholder vote that would otherwise be required by section 11.04(b). The first step is an offer to the shareholders to tender their shares in response to which enough shareholders tender so that, upon consummation of the offer, the offering party (and any parent or wholly owned subsidiary) owns or has the right to acquire shares with sufficient voting power to satisfy the shareholder approval that would otherwise be required to approve the plan of merger pursuant to section 11.04. The second step is a merger providing the remaining shareholders the same consideration as was offered in the first step. The shareholder action in selling in response to the offer provides the necessary consent for the transaction, in lieu of a shareholder vote, if the other conditions set forth in section 11.04(j) are met. The requirements of section 11.04(j), together with sections 11.04(b), 13.20, 13.21 and 13.22, are intended to ensure that shareholders are not disadvantaged by the absence of a vote, and that they receive the same protection in terms of timing, director duties and appraisal rights that they would in a transaction approved by a shareholder vote. For example, section 11.04(b) requires, subject to limited exceptions, that the board make a recommendation with respect to the offer that shareholders tender their shares. This ensures that there is a corporate action implicated by the offer, and that the same director duties will apply to the recommendation to tender into the offer as to conversion or exchange pursuant to a plan of merger or share exchange.

5. Personal Liability of Shareholders

Section ~~11.04(h~~11.04(i) applies only in situations where a shareholder is becoming subject to "owner liability" as defined in section 1.40~~(15C)~~, for example, where a corporation is merging into a general partnership. Where another entity whose interest holders have owner liability, such as a general partnership, is merging into a corporation, the effect of the transaction on the owner liability of the interest holders in the other entity will be determined by section 11.07(e).

* * *

§ 13.02. Right to Appraisal

(a) A shareholder is entitled to appraisal rights, and to obtain payment of the fair value of that shareholder's shares, in the event of any of the following corporate actions:

(1) consummation of a merger to which the corporation is a party (i) if shareholder approval is required for the merger by section 11.04, or would be required but for the provisions of section 11.04(j), except that appraisal rights shall not be available to any shareholder of the corporation with respect to shares of any class or series that remain outstanding after consummation of the merger, or (ii) if the corporation is a subsidiary and the merger is governed by section 11.05;

(2) consummation of a share exchange to which the corporation is a party as the corporation whose shares will be acquired, except that appraisal rights shall not be available to any shareholder of the corporation with respect to any class or series of shares of the corporation that is not exchanged;

(3) consummation of a disposition of assets pursuant to section 12.02, except that appraisal rights shall not be available to any shareholder of the corporation with respect to shares of any class or series if (i) under the terms of the corporate action approved by the shareholders there is to be distributed to shareholders in cash its net assets, in excess of a reasonable amount reserved to meet claims of the

type described in sections 14.06 and 14.07, (A) within one year after the shareholders' approval of the action and (B) in accordance with their respective interests determined at the time of distribution, and (ii) the disposition of assets is not an interested transaction;

(4) an amendment of the articles of incorporation with respect to a class or series of shares that reduces the number of shares of a class or series owned by the shareholder to a fraction of a share if the corporation has the obligation or right to repurchase the fractional share so created;

(5) any other amendment to the articles of incorporation, merger, share exchange or disposition of assets to the extent provided by the articles of incorporation, bylaws or a resolution of the board of directors;

(6) consummation of a domestication if the shareholder does not receive shares in the foreign corporation resulting from the domestication that have terms as favorable to the shareholder in all material respects, and represent at least the same percentage interest of the total voting rights of the outstanding shares of the corporation, as the shares held by the shareholder before the domestication;

(7) consummation of a conversion of the corporation to nonprofit status pursuant to subchapter 9C; or

(8) consummation of a conversion of the corporation to an unincorporated entity pursuant to subchapter 9E.

(b) Notwithstanding subsection (a), the availability of appraisal rights under subsections (a)(1), (2), (3), (4), (6) and (8) shall be limited in accordance with the following provisions:

(1) Appraisal rights shall not be available for the holders of shares of any class or series of shares which is:

(i) a covered security under section 18(b)(1)(A) or (B) of the Securities Act of 1933, as amended; or

(ii) traded in an organized market and has at least 2,000 shareholders and a market value of at least $20 million (exclusive of the value of such shares held by the corporation's subsidiaries, senior executives, directors and beneficial shareholders owning more than 10% of such shares); or

(iii) issued by an open end management investment company registered with the Securities and Exchange Commission under the Investment Company Act of 1940 and may be redeemed at the option of the holder at net asset value.

(2) The applicability of subsection (b)(1) shall be determined as of:

(i) the record date fixed to determine the shareholders entitled to receive notice of the meeting of shareholders to act upon the corporate action requiring appraisal rights or, in the case of an offer made pursuant to section 11.04(j), the date of such offer; or

(ii) the day before the effective date of such corporate action if there is no meeting of shareholders and no offer made pursuant to section 11.04(j).

(3) Subsection (b)(1) shall not be applicable and appraisal rights shall be available pursuant to subsection (a) for the holders of any class or series of shares (i) who are required by the terms of the corporate action requiring appraisal rights to accept for such shares anything other than cash or shares of any class or any series of shares of any corporation, or any other proprietary interest of any other entity, that satisfies the standards set forth in subsection (b)(1) at the time the corporate action becomes effective or (ii) in the case of the consummation of a disposition of assets pursuant to section 12.02, unless such cash, shares or proprietary interests are, under the terms of the corporate action approved by the shareholders, to be distributed to the shareholders, as part of a distribution to shareholders of the net assets of the corporation in excess of a reasonable amount to meet claims of the type described in sections 14.06 and 14.07, (A) within one year after the shareholders' approval of the action, and (B) in accordance with their respective interests determined at the time of the distribution.

(4) Subsection (b)(1) shall not be applicable and appraisal rights shall be available pursuant to subsection (a) for the holders of any class or series of shares where the corporate action is an interested transaction.

(c) Notwithstanding any other provision of section 13.02, the articles of incorporation as originally filed or any amendment thereto may limit or eliminate appraisal rights for any class or series of preferred shares, except that (i) no such limitation or elimination shall be effective if the class or series does not have the right to vote separately as a voting group (alone or as part of a group) on the action or if the action is a nonprofit conversion under subchapter 9C or a conversion to an unincorporated entity under subchapter 9E, or a merger having a similar effect, and (ii) any such limitation or elimination contained in an amendment to the articles of incorporation that limits or eliminates appraisal rights for any of such shares that are outstanding immediately prior to the effective date of such amendment or that the corporation is or may be required to issue or sell thereafter pursuant to any conversion, exchange or other right existing immediately before the effective date of such amendment shall not apply to any corporate action that becomes effective within one year of that date if such action would otherwise afford appraisal rights.

* * *

Official Comment

1. Transactions Requiring Appraisal Rights

Section 13.02(a) establishes the scope of appraisal rights by identifying those transactions that afford this right. ~~In view of the significant degree of private ordering permitted by section 13.02(a)(5), the scope of statutory appraisal provided is somewhat narrower than that provided in the 1984 Model Act. As discussed in the first section of the Official Comment to section 13.01, statutory~~ Statutory appraisal is made available only for corporate actions that will result in a fundamental change in the shares to be affected by the action and then only when uncertainty concerning the fair value of the affected shares may cause reasonable differences about the fairness of the terms of the corporate action. The transactions that satisfy both of these criteria are~~:~~ set forth in section 13.02(a), subject to the exceptions set forth in section 13.02(b). In a two-step transaction authorized by section 11.04(j), shareholders at the time of the back-end merger could have appraisal rights even though there is no shareholder vote. Shareholders who tender in response to the offer in the front end of such a transaction would not have appraisal rights, with their tendering in response to an offer that meets the other requirements of section 11.04(j) having the same effect on appraisal rights as if they had voted for the transaction.

~~(1) A merger pursuant to section 11.04 or a short-form merger pursuant to section 11.05. Holders of any class or series that is to be exchanged or converted in connection with a merger under section 11.04 are entitled to appraisal under section 13.02(a)(1). Similarly, shareholders of a subsidiary that is a party to a merger under section 11.05 are entitled to appraisal under 13.02(a)(1) because their interests will be extinguished by the merger. Section 13.02(a)(1)(i) denies appraisal rights to any class or series of shares in the surviving corporation if such class or series remains outstanding.~~

~~(2) A share exchange under section 11.03 if the corporation is a party whose shares are being acquired in the exchange. Consistent with the treatment in section 13.02(a)(1) of mergers, subsection (2) provides appraisal only for those shares that will be exchanged.~~

~~(3) A disposition of assets under section 12.02. As a general rule, shareholders of all classes or series of the corporation, whether or not they are entitled to vote under section 12.02, will be entitled to assert appraisal rights. An exception from appraisal rights is also provided, how-~~

~~ever, in addition to the exception provided in section 13.02(b), if liquidation is required to take place within one year of the shareholder vote and shareholders are to receive cash in accordance with their respective interests, so long as the transaction is not an interested transaction. In these circumstances, where shareholders are being treated on a proportionate basis in accordance with the corporation's governing documents in an arm's-length transaction (akin to a distribution in dissolution), there is no need for the added protection of appraisal rights. As provided in section 12.02(g), a disposition of assets by a corporation in the course of dissolution under chapter 14 is governed by that chapter, not chapter 12, and thus does not implicate appraisal rights.~~

~~(4)~~ ~~Amendments to the articles of incorporation that effectuate a reverse stock split which reduces the number of shares that a shareholder owns of a class or series to a fractional share if the corporation has the obligation or right to repurchase the fractional share so created. The~~ Under section 13.02(b)(4), the reasons for granting appraisal rights in ~~this situation~~ a reverse stock split in which shares are cashed out are similar to those for granting such rights in cases of cash-out mergers, as both transactions could compel affected shareholders to accept cash for their investment in an amount established by the corporation. Appraisal is afforded only for those shareholders of a class or series whose interest is so affected. As provided in section 12.02(g), a disposition of assets by a corporation in the course of dissolution under chapter 14 is governed by that chapter, not chapter 12, and thus does not implicate appraisal rights.

~~(5)~~ ~~Any other merger, share exchange, disposition of assets or amendment to the articles to the extent the articles, bylaws, or a resolution of the board of directors grants appraisal rights to a particular class or series of stock. A corporation may voluntarily wish to grant to the holders of one or more of its classes or series of shares appraisal rights in connection with these important transactions whenever the Act does not provide statutory appraisal rights. The grant of appraisal rights may satisfy shareholders who might, in the absence of appraisal rights, seek other remedies. Moreover, in situations where the existence of appraisal rights may otherwise be disputed, the voluntary offer of those rights under this section may avoid litigation. Obviously, an~~ An express grant of voluntary appraisal rights under section 13.02(a)(5) ~~is intended to override~~ overrides any of the exceptions to the availability of appraisal rights in section 13.02(a). Any voluntary grant of appraisal rights by the corporation to the holders of one or more of its classes or series of shares in connection with a corporate action will ~~thereby~~ automatically make all of the provisions of chapter 13 applicable to the corporation and such holders regarding ~~this~~ that corporate action.

~~(6) A domestication in which the shares held by a shareholder are reclassified in a manner that results in the shareholder holding shares either with terms that are not as favorable in all material respects or representing a smaller percentage of the total outstanding voting rights in the corporation as those held before the domestication. Appraisal rights are not provided if the shares of a shareholder are otherwise reclassified so long as the foregoing restrictions are satisfied.~~

~~(7) A conversion to nonprofit status pursuant to subchapter 9C. Such a conversion involves such a fundamental change in the nature of the corporation that appraisal rights are provided to all of the shareholders.~~

~~(8) A conversion of the corporation to an unincorporated entity pursuant to subchapter 9E. As with the previous type of transaction, this form of conversion is so fundamental that appraisal rights are provided to all of the shareholders.~~

2. Market ~~Out~~ Exception to Appraisal Rights

Chapter 13 provides a limited exception to appraisal rights for those situations where shareholders can either accept the appraisal-triggering corporate action or ~~can~~ sell their shares in a liquid and reliable market~~ or an equivalent transaction~~. ~~This provision, the so-called market out, is predicated on the theory that where an efficient market exists, the market price will be an adequate proxy for the fair value of the corporation's shares, thus making appraisal unnecessary. Furthermore, after the corporation announces an appraisal-triggering action which is a transaction such as a merger, the market operates at maximum efficiency with respect to the corporation's shares because interested parties and market professionals evaluate the proposal and competing proposals may be generated if the original proposal is deemed inadequate. Moreover, the market out reflects an evaluation~~. The market exception reflects a judgment that the uncertainty, costs and time commitment involved in any appraisal proceeding are not warranted where shareholders can sell their shares in an efficient, fair and liquid market.

For purposes of this chapter, the market ~~out~~ exception is provided for a class or series of shares if two criteria are met: the market in which the shares are traded must be ~~“~~liquid~~”~~ as described in section 13.02(b)(1), and the value of the shares established by the appraisal-triggering event must be ~~“reliable.”~~ the result of a process reasonably calculated to arrive at a price reflective of an arm's length transaction. Except as provided in section 13.02(b)(1)(iii), liquidity is addressed in section 13.02(b)(1)~~ and requires the class or series of stock to satisfy either one of two requirements: (1) The class or series must be a covered security under section 18 (a)(1)(A) or (B) of the Securities Act of 1933~~. ~~This means that it must be listed on the New York Stock Exchange or the American Stock Exchange, or on the NASDAQ Global Select Market or the NASDAQ Global Market~~

~~(successors to the NASDAQ National Market), or on certain other markets having comparable listing standards as determined by the Securities and Exchange Commission. (2) If not in these categories, the class or series must be traded in an organized market and have at least 2,000 record or beneficial shareholders (provided that using both concepts does not result in duplication) and have a market value of at least $20 million, excluding the value of shares held by the corporation's subsidiaries, senior executives, directors and beneficial shareholders owning more than 10% of the class or series~~.

~~Shares issued by an open end management investment company registered under the Investment Company Act of 1940 that may be redeemed at the option of the holder at net asset value provide an equivalent quality of liquidity and reliability, and are also included in the market out.~~

Because section 13.02(b)(3) excludes from the market exception those transactions that require shareholders to accept anything other than cash or securities that also meet the liquidity tests of section 13.02(b)(1), shareholders are assured of receiving either appraisal rights, cash from the transaction, or shares or other proprietary interests in the survivor entity that are liquid. Section 13.02(b)(2) ~~provides that~~ specifies when the corporation ~~generally must satisfy the requirements of section 13.02(b)(1) on the record date for a shareholder vote on the appraisal-triggering transaction. For purposes of subsection 13.02(a)(1)(ii),~~ must satisfy the requirements of section 13.02(b)(1) ~~must be met as of the day before the corporate action becomes effective.~~for the market exception to be applicable.

~~3. Appraisal Rights in Conflict Transactions~~

~~The premise of the market out is that the market must be liquid and the valuation assigned to the relevant shares must be "reliable." Section 13.02(b)(1) is designed to assure liquidity. For purposes of these provisions, section 13.02(b)(4) is designed to assure reliability by recognizing~~ Section 13.02(b)(4) recognizes that the market price of, or consideration for, shares of a corporation that proposes to engage in ~~a~~ an interested transaction of the type listed in section 13.02(a) ~~transaction~~ may be subject to influences where a corporation's management, controlling shareholders or directors have conflicting interests that could, if not dealt with appropriately, adversely affect the consideration that otherwise could have been expected. Section 13.02(b)(4) thus provides that the market ~~out~~ exception will not apply in those instances where the transaction constitutes an interested transaction (as defined in section 13.01(5~~.1~~)).

~~4~~3. Elimination of Appraisal Rights for Preferred Shares

Section 13.02(c) permits the corporation to eliminate or limit appraisal rights that would otherwise be available for the holders of one or more series or classes of preferred shares provided that ~~no such elimination or limitation may be effective if the holders of the series or class of preferred shares do not have a group vote~~

~~on the action that would otherwise give rise to appraisal rights, or with respect to a conversion into a nonprofit entity under subchapter 9C or a conversion to an unincorporated entity under subchapter 9E, or a merger having a similar effect. The operative provisions may be set forth in the corporation's articles of incorporation as originally filed or in any amendment thereto, but any such amendment will not become effective for one year with respect to outstanding shares or shares which the corporation is or may be required to issue or sell at some later date pursuant to any rights outstanding prior to such amendment becoming effective. Shareholders who have not yet acquired, or do not have a right to acquire from the corporation, any shares of preferred stock, should have the ability either not to acquire any shares of preferred stock or to have appraisal rights granted or restored for such shares, if such shareholders so desire, before purchasing them. In contrast, because the terms of common shares are rarely negotiated, section 13.02~~ the standards in that section are met. Chapter 13 does not permit the corporation to eliminate or limit the appraisal rights of common shares.

* * *

§ 13.20. Notice of Appraisal Rights

(a) Where any corporate action specified in section 13.02(a) is to be submitted to a vote at a shareholders' meeting or where no approval of such action is required pursuant to section 11.04(j), the meeting notice or, if applicable, the offer made pursuant to section 11.04(j) must state that the corporation has concluded that the shareholders are, are not or may be entitled to assert appraisal rights under this chapter. If the corporation concludes that appraisal rights are or may be available, a copy of this chapter must accompany the meeting notice or offer sent to those record shareholders entitled to exercise appraisal rights.

(b) In a merger pursuant to section 11.05, the parent corporation must notify in writing all record shareholders of the subsidiary who are entitled to assert appraisal rights that the corporate action became effective. Such notice must be sent within 10 days after the corporate action became effective and include the materials described in section 13.22.

(c) Where any corporate action specified in section 13.02(a) is to be approved by written consent of the shareholders pursuant to section 7.04:

(1) written notice that appraisal rights are, are not or may be available must be sent to each record shareholder from whom a consent is solicited at the time consent of such shareholder is first solicited and, if the corporation has concluded that appraisal rights are or may be available, must be accompanied by a copy of this chapter; and

(2) written notice that appraisal rights are, are not or may be available must be delivered together with the notice to nonconsenting and

nonvoting shareholders required by sections 7.04(e) and (f), may include the materials described in section 13.22 and, if the corporation has concluded that appraisal rights are or may be available, must be accompanied by a copy of this chapter.

(d) Where corporate action described in section 13.02(a) is proposed, or a merger pursuant to section 11.05 is effected, the notice or offer referred to in subsection (a) or (c), if the corporation concludes that appraisal rights are or may be available, and in subsection (b) of this section 13.20 shall be accompanied by:

(1) the annual financial statements specified in section 16.20(a) of the corporation that issued the shares that may be subject to appraisal, which shall be as of a date ending not more than 16 months before the date of the notice and shall comply with section 16.20(b); provided that, if such annual financial statements are not reasonably available, the corporation shall provide reasonably equivalent financial information; and

(2) the latest available quarterly financial statements of such corporation, if any.

(e) The right to receive the information described in subsection (d) may be waived in writing by a shareholder before or after the corporate action.

* * *

Official Comment

~~Before a vote at a meeting is taken on a corporate action, the corporation is~~ The notice required by section 13.20(a) ~~to notify shareholders that a transaction is proposed and that the corporation has concluded either that appraisal rights are or are not available; alternatively, if the corporation is unsure about the availability of appraisal rights, it may state that appraisal rights may be available. Notice of appraisal rights is needed~~ is necessary because many shareholders do not know what appraisal rights they may have or how to assert them.

~~Section 13.20(b) provides that notice be given by the parent corporation within 10 days after the effective date of a merger of its subsidiary under section 11.05.~~

~~Section 13.20(d) specifies certain disclosure requirements for corporate actions for which appraisal rights are provided.~~ Because appraisal is an “opt in” remedy, shareholders otherwise entitled to an appraisal of their shares by reason of corporate actions specified in section 13.02 must elect whether to seek that remedy or accept the results of that action. ~~Because an election is needed, the common law duty of disclosure articulated by some states, notably Delaware, has required the corporation to disclose all material facts available to it that would enable affected shareholders to make an informed decision whether or~~

~~not to demand appraisal. See, e.g., *Turner v. Bernstein*, 776 A.2d 530 (Del. Ch. 2000). That duty may include the obligation to provide financial information relating to the value of the company, where such information is relevant to the decision. See, e.g., *Gilliland v. Motorola, Inc.*, 859 A.2d 80 (Del. Ch. 2004). The board of directors typically will have relied upon such information before approving the corporate action and before determining that the consideration offered constitutes fair value for the shares being surrendered or exchanged. Such financial information will normally include the company's financial statements, and it may also include financial expert valuation analyses of the company or summaries of such analyses. See, e.g., *In re Pure Resources Inc. Shareholders Litig.*, 808 A.2d 421 (Del. Ch. 2002). Section 13.20(d) specifies certain financial information disclosure requirements.~~

~~Disclosure of additional information may be necessary depending upon applicable case law. See Official Comment 3, section 8.30(c).~~Section 13.20(d) specifies certain disclosure requirements for corporate actions for which appraisal rights are provided. Disclosure of additional information may be necessary under common law disclosure duties.

By specifying certain disclosure requirements, section 13.20(d) reduces the risk, in the transactions to which it applies, of an uninformed shareholder decision whether or not to exercise appraisal rights. Section ~~13.20(e) permits a shareholder to waive the right to receive the information. The objective served by specifying these disclosure requirements is to facilitate a shareholder's decision whether to exercise appraisal rights. Section 13.20(d) does not address remedies, including those, if any, that shareholders might have against persons other than the corporation, as a result of the failure to provide the required information. Section~~ 13.31(b)(1) provides that a corporation may be liable for the fees and expenses of counsel and experts for the respective parties for failure to comply substantially with ~~section~~ sections 13.20~~, as well as the related section~~ and 13.24.

~~Although the information requirements of section 13.20 would not apply to transactions for which there are no appraisal rights because of the market exception under section 13.02(b), the corporations to which the market exception applies are public companies which in most cases are subject to federal disclosure requirements.~~

§ 13.21. Notice of Intent to Demand Payment and Consequences of Voting or Consenting

(a) If a corporate action specified in section 13.02(a) is submitted to a vote at a shareholders' meeting, a shareholder who wishes to assert appraisal rights with respect to any class or series of shares:

(1) must deliver to the corporation, before the vote is taken, written notice of the shareholder's intent to demand payment if the proposed action is effectuated; and

(2) must not vote, or cause or permit to be voted, any shares of such class or series in favor of the proposed action.

(b) If a corporate action specified in section 13.02(a) is to be approved by less than unanimous written consent, a shareholder who wishes to assert appraisal rights with respect to any class or series of shares must not sign a consent in favor of the proposed action with respect to that class or series of shares.

(c) If a corporate action specified in section 13.02(a) does not require shareholder approval pursuant to section 11.04(j), a shareholder who wishes to assert appraisal rights with respect to any class or series of shares:

(1) must deliver to the corporation before the shares are purchased pursuant to the offer written notice of the shareholder's intent to demand payment if the proposed action is effectuated; and

(2) must not tender, or cause or permit to be tendered, any shares of such class or series in response to such offer.

(d) ~~(c)~~A shareholder who fails to satisfy the requirements of subsection (a) ~~or~~ , (b) or (c) is not entitled to payment under this chapter.

* * *

Official Comment

Section 13.21 applies to all transactions requiring appraisal, except short-form mergers under section 11.05~~. In the latter case,~~ in which shareholders of the subsidiary do not vote on the transaction but are nevertheless entitled to appraisal.

~~Section 13.21(a) requires~~ The notice from the shareholder ~~to give notice of an intent to demand payment before the vote on the corporate action is taken. This notice~~ required by section 13.21(a) or 13.21(c) enables the corporation ~~to determine~~ , among other things, to estimate how much of a cash payment may be required~~. It also serves to limit~~ by reference to the maximum number of shares for which appraisal may be sought. It also limits the number of persons to whom the corporation must give further notice during the remainder of the appraisal process.

~~In order for a shareholder to remain eligible to demand payment, section 13.21(a)(2) mandates that the shareholder must not vote (or, in the case of a beneficial shareholder, cause or permit to be voted) any shares of any class or series for which the shareholder is demanding appraisal in favor of the proposal.~~

§ 13.22. Appraisal Notice and Form

(a) If a corporate action requiring appraisal rights under section 13.02(a) becomes effective, the corporation must send a written appraisal notice and the form required by subsection (b)(1) to all shareholders who satisfy the requirements of section 13.21(a)~~ or ~~, section 13.21(b) or section 13.21(c). In the case of a merger under section 11.05, the parent must deliver an appraisal notice and form to all record shareholders who may be entitled to assert appraisal rights.

(b) The appraisal notice must be delivered no earlier than the date the corporate action specified in section 13.02(a) became effective, and no later than 10 days after such date, and must:

(1) supply a form that (i) specifies the first date of any announcement to shareholders made prior to the date the corporate action became effective of the principal terms of the proposed corporate action, and (ii) if such announcement was made, requires the shareholder asserting appraisal rights to certify whether beneficial ownership of those shares for which appraisal rights are asserted was acquired before that date, and (iii) requires the shareholder asserting appraisal rights to certify that such shareholder did not vote for or consent to the transaction;

(2) state:

(i) where the form must be sent and where certificates for certificated shares must be deposited and the date by which those certificates must be deposited, which date may not be earlier than the date for receiving the required form under subsection (2)(ii);

(ii) a date by which the corporation must receive the form, which date may not be fewer than 40 nor more than 60 days after the date the subsection (a) appraisal notice is sent, and state that the shareholder shall have waived the right to demand appraisal with respect to the shares unless the form is received by the corporation by such specified date;

(iii) the corporation's estimate of the fair value of the shares;

(iv) that, if requested in writing, the corporation will provide, to the shareholder so requesting, within 10 days after the date specified in subsection (2)(ii) the number of shareholders who return the forms by the specified date and the total number of shares owned by them; and

(v) the date by which the notice to withdraw under section 13.23 must be received, which date must be within 20 days after the date specified in subsection (2)(ii); and

(3) be accompanied by a copy of this chapter.

* * *

Official Comment

The purpose of section 13.22 is to require the corporation to provide shareholders with information and a form for perfecting appraisal rights. ~~The content of this notice and form are spelled out in detail to ensure that they accomplish this purpose.~~

~~The appraisal notice must be sent only to those shareholders who satisfy the requirements of section 13.21(a) or section 13.21(b). In a short-form merger under section 11.05, the notice must be sent to all persons who may be eligible for appraisal rights no earlier than the effective date of the merger and no later than 10 days thereafter. In either case, the notice must be accompanied by a copy of this chapter.~~

~~The notice must supply a form to be used by the person asserting appraisal rights in order to complete the exercise of those rights. Under section 13.22(b)(2)(ii), the notice must specify the date by which the shareholder's executed form must be received by the corporation, which date must be at least 40 days but not more than 60 days after the appraisal notice is sent.~~

~~Under section 13.22(b)(2)(i), the notice must also specify where and when share certificates must be deposited; the time for deposit may not be set at a date earlier than the date for receiving the required form under section 13.22(b)(2)(ii).~~

Section 13.22(b)(1) requires that the corporation ~~to~~ specify the date of the first announcement of the terms of the proposed corporate action. This ~~is the critical~~ date ~~for determining~~ determines the rights of shareholder-transferees~~: persons~~. Persons who became shareholders prior to that date are entitled to full appraisal rights, while persons who became shareholders on or after that date are entitled only to the more limited rights provided by section 13.25. See the Official Comments to sections 13.23 and 13.25. The date the principal terms of the transaction were announced by the corporation to shareholders may be the day the terms were communicated directly to the shareholders, included in a public filing with the Securities and Exchange Commission, published in a newspaper of general circulation that can be expected to reach the financial community, or any earlier date on which such terms were first announced by any other person or entity to such persons or sources. Any announcement to news media or to shareholders that relates to the proposed transaction but does not contain the principal terms of the transaction to be authorized at the shareholders' meeting is not considered to be an announcement for the purposes of section 13.22. If a corporation or other person does not make a public announcement of the terms of a proposed corporation action, the requirement of section 13.22(b)(1) is not applicable.

~~Sections 13.22(b)(2)(iii) and (b)(2)(iv) require the corporation to state its estimate of the fair value of the shares and how shareholders may obtain the number of shareholders and number of shares demanding appraisal rights. The information required by sections 13.22(b)(2)(iii) and (b)(2)(iv) is intended to help shareholders assess whether they wish to demand payment or to withdraw their demand for appraisal, but~~ The information required by sections 13.22(b)(2)(iii) and (b)(2)(iv) is intended to help shareholders assess whether they wish to demand payment or to withdraw their demand for appraisal, although the information under section 13.22(b)(2)(iv) is required to be sent only to those shareholders from whom the corporation has received a written request. ~~If such request is received, the corporation must respond within 10 days after forms are due pursuant to section 13.22(b)(2)(ii). Finally, section 13.22(b)(2)(v) requires the corporation to specify the date by which the shareholder's notice to withdraw under section 13.23 must be received.~~

No Registration Opinions (2015 Update)

Report of the Subcommittee on Securities Law Opinions, Federal Regulation of Securities Committee, ABA Business Law Section

Introduction

The Securities Act of 1933 (the Securities Act) makes it unlawful for any person to use jurisdictional means to offer or sell any security unless a registration statement is in effect as to that security or an exemption from registration is available. One of the principal exemptions is section 4(a)(2), which relates to "transactions by an issuer not involving any public offering." These few words are the foundation for securities offerings that take place every day, without any involvement of the Securities and Exchange Commission (the SEC), based on legal advice regarding the application of section 4(a)(2) and related SEC rules to particular transactions. In many of these offerings, lawyers, in addition to advising their clients on the availability of a section 4(a)(2) or other exemption, deliver opinions to the effect that registration of the securities under the Securities Act is not required.

This Subcommittee published a report on no registration opinions in 2007.[1] This report updates the 2007 report in light of amendments adopted by the SEC in 2013 to Rule 144A and Rule 506 of Regulation D under the Securities Act. The amendments implement provisions of the Jumpstart Our Business Startups Act (or "JOBS Act") that directed the SEC to amend those rules to eliminate the prohibition on general solicitation and general advertising (collectively, general solicitation) for securities offerings conducted in reliance upon those rules. In the case of Rule 506, new Rule 506(c) permits general solicitation if all purchasers in the offering are "accredited investors" as defined in Regulation D and the issuer has taken reasonable steps to verify that the purchasers are accredited investors. The amendments also implement a provision of the Dodd-Frank Wall Street Reform and Consumer Protection Act that directed the SEC to make the Rule 506 exemption unavailable for offerings in which certain disqualified persons

[1] *No Registration Opinions*, 63 Bus. Law. 187 (2007). The Federal Regulation of Securities Committee also published a report, *Law of Private Placements (Non-Public Offerings) Not Entitled to Benefits of Safe Harbors—A Report*, 66 Bus. Law. 85 (2010), discussing the underlying substantive standards applicable to these offerings.

("bad actors") participate, subject to a "reasonable care" exception. This report considers implications of these amendments for no registration opinions.[2]

Two illustrative opinion letters are attached to this report. Each addresses a typical transaction in which a no registration opinion is given. In the first, investors are purchasing shares of common or preferred stock directly from the issuer in reliance on section 4(a)(2) or Rule 506 and intend to hold the shares for some period of time. In the second, investment bankers, referred to as the Initial Purchasers, are purchasing debt securities from the issuer and promptly reselling them to "qualified institutional buyers" under Rule 144A and/or to offshore purchasers in reliance on Regulation S. In each transaction, the securities may be convertible into common stock. Each opinion letter is addressed to the purchasers of the securities from the issuer.

The two opinion letters contain the types of opinions that are typically given and the kinds of express assumptions and qualifications that are commonly included. Each opinion letter may need to be tailored to fit a particular transaction and the specific exemption relied on.

Reliance on Representations, Covenants, and Assumptions

In giving no registration opinions, lawyers, when satisfied that they may reasonably do so, rely on various representations, covenants, and assumptions addressing the requirements of the applicable exemption, as described below. The steps opinion preparers take to satisfy themselves that such reliance is reasonable will depend on the particular requirements of that exemption and circumstances of the offering, including (where applicable) their experience with the practices and procedures of the issuer and any placement agent or initial purchasers involved in the offering.[3]

Each of the two illustrative opinion letters contemplates that the Purchase Agreement contains representations by the issuer relating to the offering of the securities. These representations typically confirm, among other things, the absence of prior offerings of similar securities that could be integrated with the offering covered by the opinion and, in the case of sales outside the United States in reliance on Regulation S, the absence of "directed selling efforts." The first opinion letter also contemplates that the Purchase Agreement contains representations by the issuer confirming either the absence of general solicitation or compliance with the requirement to take reasonable steps to verify accredited investor status and, in the case of Rule 506 offerings, compliance with the bad actor disqualification provisions. Each opinion letter states expressly that the

[2] At the time it adopted these amendments, the SEC proposed additional amendments to Regulation D, Form D, and Rule 156 under the Securities Act, including a provision under which failure by an issuer (or its predecessor or affiliates) to timely file a Form D would preclude the issuer from relying on Rule 506 until one year after the delinquent filings were ultimately made. This report does not address the possible implications of those proposed additional amendments.

[3] *See* Am. Bar Ass'n Standing Comm. on Ethics & Prof'l Responsibility, Formal Op. 335 (Feb. 2, 1974); *see also* The Ass'n of the Bar of the City of New York, *Report by Special Committee on Lawyers' Role in Securities Transactions*, 32 Bus. Law. 1879 (1977).

opinions being given are based, as to factual matters, on representations of the issuer and certificates of its officers. Each opinion letter also contemplates that the Purchase Agreement includes covenants by the issuer to limit future offers of the same or similar securities and, in the case of Rule 144A offerings, to provide information to holders of the securities.

The first opinion letter contemplates that the purchasers are agreeing not to resell the securities except pursuant to an effective registration statement under the Securities Act or an exemption, such as the exemption provided by Rule 144 or Rule 144A. The second opinion letter contemplates that the Purchase Agreement requires the Initial Purchasers to sell the securities only to qualified institutional buyers or offshore purchasers who agree not to resell the securities except pursuant to an effective registration statement under the Securities Act or an exemption such as that provided by Rule 144A, or in a transaction outside the United States in reliance on Regulation S.

Lawyers preparing the first opinion letter must be satisfied as to the eligibility of the purchasers to acquire the securities pursuant to the exemption from registration being relied on. For example, an offering made in reliance on Rule 506 may be structured to require all of the purchasers to be accredited investors, either because the issuer wishes to use Rule 506(b) without becoming subject to the information requirements, or to use Rule 506(c), under which all purchasers must be accredited investors. In satisfying themselves as to the eligibility of purchasers, the opinion preparers typically rely, as to factual matters, on representations as to the purchasers' status in the Purchase Agreement, a placement agent's certificate, investor questionnaires, or other procedures—including, where applicable, the verification procedures referred to below. Opinion preparers may also expressly state in each opinion letter (as the illustrative opinion letters do) that they have assumed the accuracy of the representations and compliance with the covenants in the documents on which they are relying.

When a Rule 506 offering is not intended to permit general solicitation, opinion preparers ordinarily rely, as to factual matters, on a representation from the issuer and, if one is involved, the placement agent regarding the absence of general solicitation. Opinion preparers may also expressly state in the opinion letter that they have assumed the absence of general solicitation.

When a Rule 506 offering involves general solicitation, in addition to requiring that all purchasers be accredited investors, Rule 506(c) requires that the issuer take reasonable steps to verify the purchasers' accredited investor status. The SEC has stated that whether the steps taken in any particular offering are reasonable will be an objective determination by the issuer (or those acting on its behalf), considering the particular facts and circumstances of each purchaser and transaction, including the nature of the purchaser, the amount and type of information that the issuer has about the purchaser, and the nature and terms of the offering. Rule 506(c) provides issuers four non-exclusive safe harbors for verifying a natural person's accredited investor status, one of which is to rely on a written confirmation from a registered broker-dealer or investment adviser, licensed attorney, or certified public accountant as to the status of an individual investor.[4] In giving an opinion on a Rule 506(c) offering, the opinion preparers must be satisfied that the issuer has met the verification requirement and once again may rely for that purpose, as to factual matters, on representations in the Purchase Agreement, a placement agent's or third-party verifier's confirmation, or other procedures. The opinion preparers are not required to review or investigate the actual investor verifications, only to understand the basis upon which the issuer has determined that the requirement has been met and to satisfy themselves as to the reasonableness of that basis.

The bad actor disqualification provisions apply to all Rule 506 offerings, whether or not involving general solicitation. In satisfying themselves as to compliance with those provisions,[5] opinion preparers may rely, as to factual matters, on a representation from the issuer and, if one is involved, the placement agent as to the absence of persons or relationships that would give rise to such a disqualification, or on other procedures.

When an opinion is based on representations and covenants of relevant parties, the text of the opinion letter may but need not refer to those representations and covenants. Notwithstanding that they will have satisfied themselves regarding the requirements for the exemption—for example the issuer's compliance with the "reasonable steps to verify" requirement of Rule 506(c) (when applicable) and compliance with the bad actor disqualification provisions—many lawyers include an express assumption regarding those matters in their opinion letters. Some opinion preparers also expressly assume that the purchasers will comply with their covenants not to resell unless the securities are registered or an exemption is available, but many consider this unnecessary.

The amendment to Rule 144A eliminating the prohibition on general solicitation may affect offering practices and procedures, but it should have no effect on how an opinion giver addresses the eligibility of purchasers in the offering, since the only requirement in that regard—that all purchasers be qualified institutional buyers—has not changed.

Covering Shares Issuable on Conversion or Exercise

When the securities being sold are convertible into common stock or accompanied by warrants to purchase common stock, no registration opinions are sometimes given covering the issuance of the underlying common stock on conversion or exercise. In light of the added complexity in giving this opinion, many lawyers prefer not to include it and will do so only if requested. When the issuance of common stock on conversion is covered, some lawyers refer in the opinion letter to the conditions of the Securities Act section 3(a)(9) exemption from registration, for example by expressly assuming that no commission or other re-

[4] The verifier must confirm that it has taken reasonable steps to verify that the purchaser is an accredited investor. This report does not address what steps a verifier, including a licensed attorney, should take when providing the third-party verification contemplated by Rule 506(c).

[5] The opinion preparers may address compliance with these provisions by satisfying themselves that the issuer exercised "reasonable care" as provided in Rule 506(d)(2)(iv).

muneration will be paid or given directly or indirectly for soliciting conversion. Others, regarding these conditions to be so well understood that they need not be stated or for other reasons, do not refer to these conditions.

Because the section 3(a)(9) exemption does not extend to the issuance of common stock on exercise of warrants (except for "net" exercise as discussed below), no registration opinions covering the issuance of common stock on exercise of warrants, when given, are often based on an express assumption that the warrants are exercised by the initial purchasers on the date of the opinion letter, or otherwise drafted to apply only to such an exercise. The opinion also may be given based on net exercise (i.e., part of the common stock issuable on exercise is used to pay the exercise price) that takes place once the Rule 144 holding period has run, where net exercise is required by the terms of the warrants, or it is permitted and the opinion is limited to cases in which it is employed.

Excluding Coverage of Resales

Some lawyers include in the opinion letter a sentence emphasizing that the opinion does not cover resales by the investors in the offering or of common stock issued on conversion. For example, in the first opinion letter: "We express no opinion as to when or under what circumstances any [securities] purchased by you may be reoffered or resold, or any common stock of the Company issuable on conversion of the [securities] may be offered or sold."[6] Other lawyers consider such a sentence unnecessary where the restrictions on resale are adequately disclosed in the offering materials, since the opinion as written does not purport to address resales by purchasers of the securities in the offering or offers or sales of the underlying common stock.

Trust Indenture Act

In offerings of debt securities, including convertible debt securities, it is common practice to include, with the no registration opinion, an opinion that an indenture is not required to be qualified under the Trust Indenture Act of 1939 in connection with the offering. Because the Trust Indenture Act has an exemption covering any transaction exempted from registration by section 4 of the Securities Act, the no qualification opinion may be given whenever a no registration opinion is given in a section 4(a)(2) offering, including under Rule 506, or in a Rule 144A offering.

Information Provided by the Issuer

In offerings made in reliance on Rule 505 or Rule 506(b) of Regulation D or on Rule 144A, specific requirements relating to information to be furnished by the issuer to the purchasers may have to be met. Where these requirements

[6] If such a sentence is included in the second opinion letter, the words "purchased by you" could be replaced with "sold by the Initial Purchasers."

apply, many lawyers expressly assume that they have been satisfied. Neither the statute itself (i.e., section 4(a)(2)) nor Rule 506(c) contains any information requirement, but some lawyers nevertheless expressly assume the adequacy of the information disclosed to investors (whether by delivery or by access) in offerings made under those exemptions.[7] The concern giving rise to this assumption may derive from the decision of the U.S. Court of Appeals for the Second Circuit in *SEC v. Manor Nursing Centers, Inc.*,[8] which imposed "a mandate of truthfulness" on exempt offerings. Although the implications of this holding have been criticized for making every antifraud lawsuit under the securities laws relating to exempt offerings also a potential claim for violation of section 5, and in the private placement context may have been substantially circumscribed by *Gustafson v. Alloyd Co.*,[9] the holding of *Manor Nursing Centers* has never been specifically overruled in the Second Circuit. Other lawyers believe that the assumption is implicit and therefore unnecessary.

Short Positions

If the security being sold is common stock (or is convertible into or accompanied by warrants to purchase common stock) of a class that is publicly traded, and if the purchasers have created or may create short positions in the common stock, issues concerning violation of section 5 of the Securities Act could arise. For example, use of the stock purchased in the exempt offering to cover the short position could result in a violation of section 5. These issues, which are beyond the scope of this report, can be addressed by representations or covenants in the Purchase Agreement, a certificate, or in other ways. If a certificate is being relied on, the opinion letter may refer to it expressly.

Conclusion

The following illustrative opinion letters do not cover all situations in which no registration opinions are given, but they reflect the form and substance of opinion letters commonly delivered.

[7] The assumption as to adequacy of the information may be included even in those circumstances where the opinion giver is also providing negative assurance on the information being disclosed. See the Subcommittee's report, *Negative Assurance in Securities Offerings (2008 Revision)*, 64 Bus. Law. 395 (2009).

[8] 458 F.2d 1082, 1098–1100 (2d Cir. 1972).

[9] 513 U.S. 561 (1995) (holding that the section 12(a)(2) antifraud provision does not apply to private offerings).

Form of opinion letter including no registration opinion for common or convertible preferred stock sold directly to purchasers in reliance on Section 4(a)(2) or Rule 506 of Regulation D

[Letterhead of Opinion Giver]

[Date]

[To the purchasers]

____

____

____

Ladies and Gentlemen:

We have acted as counsel to ____________________, a ___________ corporation (the "Company"), in connection with the sale by the Company to you of _______ shares (the "Shares") of the Company's [Common] [Series __ Convertible Preferred] Stock, [par value $_____ per share] [without par value], pursuant to the Purchase Agreement, dated _________________, between the Company and you (the "Purchase Agreement"). This opinion letter is delivered to you pursuant to Section __ of the Purchase Agreement. Capitalized terms defined in the Purchase Agreement and not otherwise defined herein are used herein as defined in the Purchase Agreement.

We have examined such documents and made such investigation of law as we have deemed appropriate for purposes of the opinions set forth below. In giving these opinions, we have relied without independent verification on certificates of public officials and, as to matters of fact material to our opinions, on the representations, warranties and covenants of the Company in the Purchase Agreement and on certificates of officers of the Company [and others].[1]

Based on the foregoing and subject to the qualifications set forth below, we express the following opinions:

(__) [Opinions as to corporate status, validity of the Shares and any Common Stock into which the Shares are convertible, the Purchase Agreement and consents, authorizations and approvals are omitted.]

(__) Assuming the accuracy of your representations and warranties and compliance with your covenants in the Purchase Agreement, no registration of the Shares [or the Common Stock issuable upon conversion of the Shares] under the Securities Act of 1933 is required in connection with the offer, sale and delivery of the Shares by the Company to you in accordance with the Purchase

[1] If shares are being offered by a placement agent, reference should be made to a certificate or representations of the placement agent describing the manner in which it has offered the shares. Where the issuer has engaged a third party to confirm verification of investor status, a reference to that procedure may be added. See "Reliance on Representations, Covenants, and Assumptions" in the accompanying Report for express assumptions that may be stated in the opinion letter.

Agreement[, or the offer, sale and delivery of the Common Stock issuable on conversion of the Shares].[2] [In connection with our opinion set forth in paragraph (__) above, we have also relied, among other things, on your certificate dated the date hereof as to ________.][3]

The opinions expressed herein are limited to the federal law of the United States [and][, the law of the State of ____________] [and the Delaware General Corporation Law].

This opinion letter is being delivered to you in connection with the above described transaction and may not be relied on by you for any other purpose. This opinion letter may not be furnished to or relied on by any other person without our prior written consent.

Very truly yours,

[2] See "Covering Shares Issuable on Conversion or Exercise" in the accompanying Report.

[3] See "Short Positions" in the accompanying Report. Some lawyers also expressly refer to the *ABA Legal Opinion Principles*, which state that they apply to legal opinions whether or not expressly mentioned. *See* 53 BUS. LAW. 831 (1998).

Form of opinion letter including no registration opinion for debt securities sold to intermediaries for resale in reliance on Rule 144A or Regulation S

[Letterhead of Opinion Giver]

[Date]

[To the Initial Purchasers]

____

____

____

Ladies and Gentlemen:

We have acted as counsel to ____________________, a ___________ corporation (the "Company"), in connection with the offer and sale of $___________ aggregate principal amount of the Company's _________ Notes (the "Notes"), issued pursuant to the Indenture, dated as of _________________, between the Company and ____________________, as trustee (the "Trustee), which are being purchased by you (the "Initial Purchasers") pursuant to the Purchase Agreement, dated ______________, between the Company and the Initial Purchasers (the "Purchase Agreement").[1] This opinion letter is delivered to you pursuant to Section __ of the Purchase Agreement. Capitalized terms defined in the Purchase Agreement and not otherwise defined herein are used herein as defined in the Purchase Agreement.

We have examined such documents and made such investigation of law as we have deemed appropriate for purposes of the opinions set forth below. In giving these opinions, we have relied without independent verification on certificates of public officials and, as to matters of fact material to our opinions, on the representations, warranties and covenants of the Company in the Purchase Agreement and on certificates of officers of the Company [and others].[2]

Based on the foregoing and subject to the qualifications set forth below, we express the following opinions:

(__) [Opinions as to corporate status, execution, delivery and enforceability of the Indenture, validity of the Notes (and any Common Stock issuable on conversion of the Notes), the Purchase Agreement and consents, authorizations and approvals are omitted.]

(__) Assuming the accuracy of the representations and warranties and compliance with the covenants of the Initial Purchasers in the Purchase Agreement, neither registration of the Notes [or the Common Stock issuable upon conversion of the Notes] under the Securities Act of 1933 nor qualification of the Indenture

[1] If the Notes are convertible into or accompanied by warrants to purchase Common Stock, add appropriate references.

[2] See "Reliance on Representations, Covenants, and Assumptions" in the accompanying Report for express assumptions that may be stated in the opinion letter.

under the Trust Indenture Act of 1939 is required in connection with the offer, sale and delivery of the Notes by the Company to the Initial Purchasers[,] [or] the initial offer, sale and delivery of the Notes by the Initial Purchasers [or the offer, sale and delivery of Common Stock on conversion of the Notes],[3] in each case in accordance with the arrangements relating to offers, sales and deliveries of the Notes [and Common Stock] contemplated by the Purchase Agreement, the [Offering Circular] [other document(s)] and the Indenture.

[In connection with our opinion set forth in paragraph (__) above, we have also relied, among other things, on certificates of [____________] dated the date hereof as to ____________________.][4]

The opinions expressed herein are limited to the federal law of the United States [and][, the law of the State of __________] [and the Delaware General Corporation Law]. This opinion letter is being delivered to you in connection with the above described transaction and may not be relied on by you for any other purpose. This opinion letter may not be relied on by or furnished to any other person without our prior written consent.

Very truly yours,

[3] See "Covering Shares Issuable on Conversion or Exercise" in the accompanying Report.

[4] See "Short Positions" in the accompanying Report. Some lawyers also expressly refer to the *ABA Legal Opinion Principles*, which state that they apply to legal opinions whether or not expressly mentioned. *See* 53 BUS. LAW. 831 (1998).

Cross-Border Closing Opinions of U.S. Counsel

By the Legal Opinions Committee, ABA Business Law Section[1]

Foreword

This Report addresses a subject that has never before been the sole focus of a bar association report: third-party legal opinions given by U.S. lawyers in cross-border transactions. It embodies years of work by lawyers experienced in the field.

As international transactions have become more common, requests to U.S. lawyers for cross-border opinions have increased. These opinions often raise issues that differ from those presented in purely domestic U.S. transactions, particularly when the agreement entered into by the parties chooses the law of a jurisdiction outside the United States as its governing law. These issues and other factors, such as language barriers and differences in legal systems, customs, and expectations, often make giving opinions in cross-border transactions more difficult and costly than in domestic U.S. transactions.

The recipients of cross-border opinions often are located in countries whose opinion practices are very different from those followed by U.S. lawyers. The linchpin of this Report is that the customary practice of the jurisdiction whose law is covered by an opinion letter should govern the meaning of standard language used in it and the work opinion preparers are expected to perform in preparing it.

This Report points out that some opinions that are standard in domestic U.S. transactions present challenges in a cross-border setting, and offers practical ways to address those challenges. It also analyzes special issues raised by opinions that are normally given only in cross-border transactions and suggests how they could be worded. The Report notes that sometimes legal uncertainties exist for which the parties to a cross-border transaction cannot look to a third-party legal opinion as the solution; instead those uncertainties must be dealt with by the parties in other ways with advice from their own counsel.

The purpose of this Report is to promote a better understanding of opinion practice in cross-border transactions. We hope that U.S. lawyers who give cross-border opinions and lawyers, both U.S. and non-U.S., who advise the recipients of those opinions will find this Report helpful.

***Timothy G. Hoxie**,*
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Vice Chair, Legal Opinions Committee, ABA Business Law Section

[1] Ettore Santucci, Vice Chair, Legal Opinions Committee, ABA Business Law Section, served as Reporter for this Report.

The other members of the editorial group for this Report were: J. Truman Bidwell, Jr., Daniel Bushner, Peter Castellon, Sylvia Fung Chin, Edward H. Fleischman, Richard N. Frasch, Donald W. Glazer,

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Timothy G. Hoxie, Jerome E. Hyman, Stanley Keller, Noël J. Para, John B. Power, James J. Rosenhauer, and Elizabeth van Schilfgaarde. The views expressed in this Report are not necessarily the views of all members of the editorial group or of their respective law firms.

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As a condition to closing financial transactions in the United States, legal counsel for one party often delivers to the other party a letter expressing counsel's opinion on various legal issues relating to its client and the transaction. That opinion letter is commonly referred to as a "third-party closing opinion" or simply a "closing opinion." U.S. lawyers sometimes are asked to deliver closing opinions to non-U.S. parties in similar transactions that involve both U.S. and non-U.S. parties (cross-border transactions).[2] Those closing opinions, which this Report refers to as "outbound opinions" because they are given by U.S. lawyers to non-U.S. recipients on matters of U.S. law, are the subject of this Report.

I. Introduction

In the United States opinion givers and opinion recipients share a common conceptual framework for preparing and interpreting closing opinions. U.S. customary practice[3] is well established with regard to many standard opinions, and

[2] Michael Gruson, Stephen Hutter & Michael Kutschera, Legal Opinions in International Transactions 10–11 (4th ed. 2003) [hereinafter IBA Report] (a project of the Subcommittee on Legal Opinions of the Committee on Banking Law of the Section on Business Law of the International Bar Association) ("The practice of asking counsel . . . for legal opinions originated in the U.S. It is not a common practice in purely domestic transactions in other countries. . . . Legal opinions, however, are gaining increasing acceptance in international transactions, including transactions involving only non-U.S. parties.").

[3] The term "U.S. customary practice," as used in this Report, refers to the practice of lawyers who regularly give, and lawyers who regularly advise opinion recipients regarding, opinions in transactions between U.S. parties. U.S. customary practice covers both the meaning of standard language used in opinion letters and the work U.S. opinion preparers are expected to perform in preparing them. *See generally* Comm. on Legal Ops., ABA Bus. Law Section, *Legal Opinion Principles*, 53 Bus. Law. 831 (1998) [hereinafter *ABA Principles*]; *Statement on the Role of Customary Practice in the Prep-*

guidance on what specific opinions mean, and the work required to support them, is available in bar association reports and other materials. Applying this guidance in cross-border transactions, however, is not always straightforward, and in some cases what is appropriate in a domestic U.S. transaction is not appropriate in a similar cross-border transaction. Moreover, on many issues that arise in cross-border transactions little, if any, guidance is available.

The dearth of authoritative sources on cross-border opinion practice and the absence of a shared conceptual framework between U.S. opinion givers, on the one hand, and non-U.S. opinion recipients and their counsel, on the other, create the potential for misunderstanding over such matters as: (1) what opinions U.S. lawyers are in a position to give, (2) the meaning of opinions commonly given, and (3) the work U.S. lawyers are expected to perform to support the opinions they give. The risk of misunderstanding can be compounded by differences in legal systems, legal education, opinion practice, and languages (even when documents are in English or are translated into English), and a general lack of familiarity on the part of many non-U.S. recipients and their counsel with U.S. closing opinion practice.[4] The potential for misunderstanding has grown as the number and type of participants in, and the complexity of, cross-border transactions have increased.

The goals of this Report are: (1) to describe what the parties in a cross-border transaction should consider when deciding whether to request a closing opinion from U.S. counsel and, if requested, which opinions are appropriate for U.S. counsel to give; (2) to clarify the application of U.S. customary practice to outbound opinions; (3) to provide guidance on the special considerations that apply to opinions commonly given in domestic U.S. transactions when those opinions are requested in cross-border transactions; (4) to identify opinions U.S. lawyers should not be asked to give in cross-border transactions and to explain why; (5) to provide guidance on both the meaning of, and the work expected to be performed to support, opinions frequently given by U.S. lawyers in cross-border transactions but not in domestic U.S. transactions; and (6) to suggest guidelines for U.S. opinion givers and counsel for non-U.S. opinion recipients to facilitate cross-border opinion practice.

aration and Understanding of Third-Party Legal Opinions, 63 Bus. Law. 1277 (2008) [hereinafter *Statement on Customary Practice*] (a statement approved by many state bar associations and other U.S. bar groups).

[4] *See Guide to the Questions to Be Addressed When Providing Opinion Letters on English Law in Financial Transactions*, City London L. Soc'y 3 11 (Nov. 17, 2011), http://citysolicitors.org.uk [hereinafter *CLLS Opinion Guide*]. ("The approach to giving opinion letters may vary from jurisdiction to jurisdiction, because legal practitioners in each jurisdiction are bound by their own separate professional rules and because the practice of giving opinion letters may have developed differently. In particular, there is a significant difference of practice as between the United States and England.").

In some non-U.S. jurisdictions, lawyers give written opinions primarily to their own clients, sometimes permitting third parties to rely on them. Ordinarily, however, those opinions are reasoned and are not analogous to third-party closing opinions typically given by U.S. lawyers. *See* IBA Report, *supra* note 2, at 8–9.

II. Application of General Principles of U.S. Opinion Practice in Cross-Border Transactions

II-1 The Threshold Question

As stated in section 1.2 of the ABA Guidelines for the Preparation of Closing Opinions,[5] opinions to third parties "should be limited to reasonably specific and determinable matters" and the benefit of an opinion to the third-party recipient "should warrant the time and expense required to prepare it." The opinions expressed in a closing opinion are not guarantees but rather expressions of professional judgment, and the costs of preparing them can be substantial. At the outset of a transaction the opinion giver and the opinion recipient and its legal counsel should work together to weigh the benefit the recipient seeks from each opinion it is requesting against the difficulty and expense of preparing it, as well as the difficulty of understanding its meaning and what it covers and does not cover.[6] In domestic U.S. transactions this cost/benefit analysis has led to requests for fewer and narrower opinions. Indeed, in some types of domestic U.S. transactions in which closing opinions were once routinely requested, closing opinions now are requested infrequently, if at all. In the cross-border setting a cost/benefit analysis is at least as important.

Many of the opinions U.S. lawyers are asked to give in cross-border transactions appear on their surface to be the same as in domestic U.S. transactions. Appearances, however, can be deceiving. For the reasons discussed in this Report, in cross-border transactions giving opinions commonly given in domestic U.S. transactions often is more difficult and costly; in some cases special assumptions, exceptions, or qualifications must be added to the opinion letter, and in other cases the opinion cannot be given at all.

Opinions given by U.S. lawyers also can be problematic from the standpoint of non-U.S. recipients. This is because U.S. opinions often cannot be understood without reference to U.S. customary practice, and for a non-U.S. recipient to understand what particular opinions do and do not cover under U.S. customary practice can be burdensome and costly.

In light of the difficulties in both preparing and interpreting outbound opinions, and of the potential for their being misunderstood by non-U.S. recipients, this Committee recommends that early in a cross-border transaction[7] the U.S. opinion preparers and the non-U.S. recipient (and its counsel) discuss: (1) the

[5] Comm. on Legal Ops., ABA Bus. Law Section, *Guidelines for the Preparation of Closing Opinions*, 57 Bus. Law. 875, 876 (2002) (§ 1.2) [hereinafter *ABA Guidelines*].

[6] For a discussion of the cost-effectiveness of a third-party opinion on the enforceability of the agreement, see Bus. Law Section, State Bar of Cal., Report on Third-Party Remedies Opinions: 2007 Update app. 4, at 15 (2007). ("In the absence of special factors, the benefit to be obtained by an opinion recipient from a third-party remedies opinion can often be realized in a more cost-efficient and informative manner through advice provided by the opinion recipient's own counsel, especially as it relates to documents regularly prepared by counsel to the opinion recipient for the opinion recipient. In general, it would seem inappropriate for a third-party remedies opinion to be requested or given in that circumstance.").

[7] *See ABA Guidelines*, *supra* note 5, at 877 (§ 2.1). ("Early in the negotiation of the transaction documents, counsel for the opinion recipient should specify the opinions the opinion recipient

cost of preparing each of the opinions the recipient is considering requesting; (2) the benefit the recipient is seeking from each opinion and whether, if given, the opinion would provide that benefit; and (3) if the recipient is not familiar with U.S. customary practice, the additional cost to it in time and resources (possibly including the cost of retaining U.S. counsel) of understanding what each opinion means.

Closing opinions seldom are given in transactions that have no U.S. nexus. In cross-border transactions in which U.S. lawyers are involved, however, they sometimes are the only lawyers who are asked to deliver a closing opinion even though no good reason exists for treating the U.S. lawyers differently from the non-U.S. lawyers involved in the transaction.[8] This Committee recommends that, rather than automatically expecting U.S. lawyers to give opinions in cross-border transactions, non-U.S. parties and their counsel consider whether they can obtain the benefit they are seeking from a closing opinion in other or better ways (for example, by obtaining the advice of their own counsel).

II-2 U.S. Customary Practice

U.S. customary practice covers the meaning of words and phrases commonly used in closing opinions. Thus, it amplifies the meaning of standard language, supplies customarily understood limitations, and permits the opinion preparers to rely on many generally understood assumptions, exceptions, and qualifications without stating them expressly.[9] U.S. customary practice also establishes the scope and nature of the work the opinion preparers are expected to perform in preparing specific opinions.[10] Important sources of guidance on U.S. customary practice can

wishes to receive. The opinion giver should respond promptly with any concerns or proposed exceptions, providing, to the extent practicable, the form of its proposed opinions.").

Beginning discussions early is even more important in cross-border transactions because the non-U.S. lawyers representing the opinion recipient may not appreciate fully the work required for the U.S. lawyers to give the requested opinions. Also, before the U.S. lawyers can commit to giving an opinion, they may need time to understand how non-U.S. law affects their analysis even though their opinion letter only covers matters of U.S. law. U.S. counsel may be involved in some, but not all, aspects of the transaction and may need extra time to become familiar with relevant issues. Early discussions may lead the opinion preparers to conclude that they need to consult with non-U.S. counsel or lead the opinion recipient to conclude that it needs to consult with U.S. counsel.

[8] If non-U.S. lawyers are also delivering closing opinions and in that connection are limiting their liability to the recipient, consideration should be given to whether U.S. lawyers similarly should be permitted to limit their liability to the recipient.

[9] *See generally Statement on Customary Practice*, *supra* note 3.

[10] *See generally Statement on Customary Practice*, *supra* note 3; *see also* Restatement (Third) of the Law Governing Lawyers § 51(2)(a) (2000) (lawyer owes duty of care to non-client when lawyer or client "invites the non-client to rely on the lawyer's opinion"); *id.* § 95 cmt. c (stating that the standard of care a lawyer giving a third-party closing opinion owes the recipient is to exercise "the competence and diligence normally exercised by lawyers in similar circumstances"). For a general discussion of the duty of care of opinion givers and the relevance of U.S. customary practice, see Donald W. Glazer, Scott FitzGibbon & Steven O. Weise, Glazer and Fitzgibbon on Legal Opinions: Drafting, Interpreting, and Supporting Closing Opinions in Business Transactions § 1.6.1 (3d ed. 2008) [hereinafter Glazer Treatise].

be accessed through the Legal Opinion Resource Center maintained by the ABA Legal Opinions Committee.[11]

U.S. customary practice governs the preparation and interpretation of closing opinions of U.S. lawyers, whether delivered in domestic U.S. or cross-border transactions. In cross-border transactions, when giving opinions to non-U.S. recipients on matters of U.S. law, U.S. lawyers are not expected to ascertain opinion practices in the recipient's country or any other countries connected with the transaction, much less to conform their opinion letters to those practices.[12] They also are not expected to determine how the opinions they are giving are being interpreted by the non-U.S. recipient or its legal counsel.

When U.S. lawyers deliver closing opinions in cross-border transactions, they necessarily rely on U.S. customary practice for the meaning and scope of the opinions they give and the work they are expected to perform to support each opinion—just as they do when giving opinions in domestic U.S. transactions. If that were not the case, opinions in cross-border transactions could not take the same abbreviated form as domestic U.S. closing opinions and instead would need to spell out—in what is probably impossible detail—all of the assumptions, exceptions, and qualifications that as a matter of U.S. customary practice are understood to be implicit.[13]

When a non-U.S. opinion recipient is not represented by U.S. counsel and neither the recipient nor its counsel is familiar with U.S. customary practice, the recipient runs a serious risk of misunderstanding an outbound opinion that is based on U.S. customary practice.[14] That risk increases when the opinion request prepared by the recipient's non-U.S counsel uses terms not commonly

[11] *See Legal Opinion Resource Center*, Am. B. Ass'n, http://apps.americanbar.org/buslaw/tribar/home.shtml (last visited Sept. 4, 2015); Glazer Treatise, *supra* note 10, apps.

[12] In some countries a generally understood practice may not exist on which lawyers can rely for the meaning and scope of their legal opinions in the same way U.S. opinion givers rely on U.S. customary practice. *See, e.g.*, *CLLS Opinion Guide*, *supra* note 4, at 13 (¶¶ 63–64) (terms of opinion should be complete and self-reliant, because there is no English law on whether it is possible to rely on "customary practice" being implied; good practice to use language that is easily intelligible and for the letter to be clearly laid out, or the reader may fail to detect the true message or draw the correct conclusion). Nevertheless, in England, at least, lawyers recognize that U.S. opinion givers rely on customary practice rather than stating expressly matters that English lawyers usually state expressly in opinion letters on English law. *See, e.g.*, *CLLS Opinion Guide*, *supra* note 4, at 12 (¶ 60) (advising English lawyers on opinions given by U.S. lawyers in cross-border transactions).

[13] U.S. closing opinions express legal conclusions in a streamlined manner and depend on U.S. customary practice to supply many assumptions, exceptions, and qualifications that otherwise would have to be stated expressly in every opinion letter. The ABA Legal Opinion Accord, a document of almost seventy pages, illustrates the magnitude of the task of trying to spell out all of those assumptions, exceptions, and qualifications. *See generally* Comm. on Legal Ops., ABA Bus. Law Section, *Third-Party Legal Opinion Report, Including the Legal Opinion Accord, of the Section of Business Law, American Bar Association*, 47 Bus. Law. 167, 179 (1991).

[14] The same concerns apply to a U.S. recipient of an opinion of non-U.S. counsel if the recipient is not familiar with the non-U.S. opinion practice under which the opinion was prepared. The U.S. recipient ordinarily should not assume that the opinion can be interpreted in accordance with U.S. customary practice or that it can rely on the apparent meaning of the words used in the opinion. *See generally* Glazer Treatise, *supra* note 10, § 5.3; IBA Report, *supra* note 2, at 19.

used in U.S. opinions and the U.S. opinion givers respond with an opinion letter that uses standard U.S. terminology.

To help reduce the risk of misunderstanding, this Committee recommends that opinion givers include in their third-party closing opinions an express statement that the opinions they are giving are intended to be interpreted in accordance with U.S. customary practice.[15] That statement would: (1) alert non-U.S. recipients to the need for them to obtain informed advice regarding the meaning and scope of the opinions they are receiving; and (2) make clear, if a suit later is brought against the U.S. opinion giver in a court outside the United States, that the opinions are intended to be read, and supported by work done by the U.S. lawyers who give them, in accordance with U.S. customary practice.

Whether or not such a statement is included in an outbound opinion, U.S. customary practice necessarily governs the preparation and interpretation of closing opinions delivered by U.S. lawyers in cross-border transactions, just as it does for those delivered in domestic U.S. transactions. Not including such a statement (even if included in a draft but omitted from the final opinion letter) should not be taken to imply that U.S. customary practice does not apply. An opinion giver has no responsibility to advise an opinion recipient that U.S. customary practice applies or of its significance or to confirm that a non-U.S. recipient understands the meaning of and limitations on the opinions it is receiving. Non-U.S. opinion recipients are responsible for deciding what they need to do to understand the opinions they receive from U.S. lawyers, including, to the extent that they deem appropriate, consulting their own counsel on the application of U.S. customary practice.[16] A U.S. opinion giver has no responsibility to counsel the opinion recipient because the opinion recipient is not the opinion giver's client.

[15] The language could read as follows:

> *This opinion letter shall be interpreted in accordance with the Legal Opinion Principles prepared by the Legal Opinions Committee of the American Bar Association's Business Law Section as published in 53 Bus. Law. 831 (1998)[, a copy of which is attached to this opinion letter].*

Instead of incorporating the *ABA Principles* expressly in their opinion letter, some U.S. lawyers refer to U.S. customary practice generally using language such as the following:

> *This opinion letter shall be interpreted in accordance with the customary practice of United States lawyers who regularly give, and lawyers who regularly advise recipients regarding, opinions of the kind included in this opinion letter.*

See, e.g., Donald W. Glazer & Stanley Keller, *A Streamlined Form of Closing Opinion Based on the ABA Legal Opinion Principles*, 61 Bus. Law. 389, 393 (2005). If the ABA Principles are incorporated by reference, they may be attached to the opinion letter for greater clarity and easier access by a non-U.S. recipient. *See ABA Principles*, *supra* note 3.

[16] Nevertheless, as stated in the *ABA Guidelines*, an opinion giver should not give an opinion that the opinion giver recognizes will mislead the recipient with regard to matters covered by the opinion. *ABA Guidelines*, *supra* note 5, at 877 (§ 1.5).

II-3 Omnibus Cross-Border Assumption

In many cross-border transactions the agreement between the parties chooses the law of a jurisdiction other than the United States as its governing law (the Chosen Law). Opinions given by U.S. counsel cover the law of a specified U.S. state (or states) and often federal U.S. law (the Covered Law). Because U.S. counsel's opinions do not cover the non-U.S. Chosen Law, the opinion preparers necessarily must assume that each provision of the agreement (including its governing law clause) is valid, binding, and enforceable under the Chosen Law. The assumption covers the choice of law rules of the jurisdiction of the Chosen Law (the Chosen Law Country), the substantive and procedural law of the Chosen Law Country, and the procedural rules governing matters such as the jurisdiction of courts, venue, and service of process that a court in the Chosen Law Country or in another non-U.S. jurisdiction would apply if an action regarding the enforceability of the agreement were brought in that court. This Report refers to the foregoing assumption as the "Omnibus Cross-Border Assumption." This Committee recommends that the Omnibus Cross-Border Assumption be stated expressly in outbound opinion letters.[17] Even if the assumption is not stated, however, this Committee believes that it should be understood to apply because non-U.S. recipients cannot expect U.S. lawyers to give opinions without assuming matters covered by the assumption (or to confirm matters under foreign laws that their opinions do not cover).

[17] The Omnibus Cross-Border Assumption could be worded as follows:

> *We have assumed that the choice of the law of [FOREIGN COUNTRY] in the Agreement is valid and the Agreement and each of its provisions are valid, binding and enforceable under the law of [FOREIGN COUNTRY] and of any other jurisdiction whose law applies, other than law covered expressly in an opinion included in this opinion letter. [IF THE AGREEMENT CONTAINS A FORUM SELECTION CLAUSE, ADD—We also have assumed that, other than the courts of [COVERED LAW STATE] and United States federal courts, any court named in the forum selection clause of the Agreement will have jurisdiction over the parties and the subject matter of any action brought in that court under the Agreement.]*

Because procedural matters ordinarily are governed by the law of the jurisdiction where a legal action is brought (commonly referred to as the *lex fori*), the third sentence of the illustrative language above covers both (i) the Chosen Law and (ii) if a court named in the forum selection clause is located in a jurisdiction outside the United States other than the Chosen Law Country, the law of that jurisdiction. *See infra* text accompanying note 123.

The Omnibus Cross-Border Assumption complements the statement traditionally included in an opinion letter regarding the law it is covering (the coverage limitation) because, as discussed in later sections of this Report, some of the legal conclusions the opinion preparers must reach under the Covered Law depend on assumptions as to matters governed by the Chosen Law or the *lex fori* even though neither one is covered by the opinion. If the opinion preparers expressly state that their opinions are to be interpreted in accordance with U.S. customary practice, for consistency they also ordinarily should state the Omnibus Cross-Border Assumption expressly. *See supra* note 16 and accompanying text.

III. Opinions Frequently Requested in Cross-Border Transactions and Their Relationship to Opinions Frequently Given in Domestic U.S. Transactions

Some opinions frequently requested in cross-border transactions are the same as, or very similar to, opinions U.S. lawyers frequently give in domestic U.S. transactions (these opinions are discussed in Parts III-1, -2, -6, -7, and -9). In the cross-border context, however, these opinions can raise issues not presented in the domestic U.S. context that make them difficult or impossible to give, necessitate additional qualifications, or require other changes in their wording.[18] Other opinions frequently requested in cross-border transactions are not usually requested or given in domestic U.S. transactions (these opinions are discussed in Parts III-2, -3, and -4).

III-1 Avoidance of Enforceability Opinions Given "As If" the Agreement Were Governed by the Law of a U.S. Jurisdiction Rather than the Chosen Non-U.S. Law

In domestic U.S. transactions the state whose law is covered by the closing opinion (the Covered Law State) may not be the state whose law is the Chosen Law. In that event, U.S. lawyers sometimes give an opinion on the enforceability of the agreement as if the Covered Law were the Chosen Law.[19] In cross-border transactions, however, when the Chosen Law is the law of a jurisdiction outside the United States, U.S. lawyers ordinarily do not give "as if" enforceability opinions for the reasons discussed below.

To give an "as if" enforceability opinion, the opinion preparers must consider how the highest court of the Covered Law State, in deciding whether to enforce the agreement, would interpret the terms of the agreement under the Covered Law (rather than the Chosen Law). Differences in how the agreement would be interpreted under the Covered Law and under the Chosen Law normally pose a serious problem for the opinion preparers when the law governing the agreement is the law of a jurisdiction outside the United States, because the agreement may use terms from the Chosen Law having no counterparts under the Covered Law. Thus, the opinion preparers have no way to make a profes-

[18] To make the opinions they are giving easier for non-U.S. recipients to understand, U.S. opinion preparers may choose to be somewhat more expansive in their cross-border opinion letters than in opinion letters they deliver in domestic U.S. transactions. For example, they may choose to spell out assumptions, exceptions, or qualifications that under U.S. customary practice are generally understood without being stated (even though they may not always spell them out in their domestic U.S. opinion letters), while at the same time making clear that the stated assumptions, exceptions, and qualifications are not intended to be exclusive.

[19] That may be because the opinion giver's client does not have local counsel in the Chosen Law State, or because the opinion recipient does not insist on receiving an opinion on the enforceability of the agreement under the Chosen Law (perhaps because it is receiving that opinion from its own counsel). *See* TriBar Op. Comm., *Special Report of the TriBar Opinion Committee: The Remedies Opinion—Deciding When to Include Exceptions and Assumptions*, 59 Bus. Law. 1483, 1497 n.70 (2004) [hereinafter *TriBar Remedies Opinion Report*] (discussing practice of rendering "as if" enforceability opinions).

sional judgment with the confidence needed to give an opinion as to how the highest court of the Covered Law State would interpret the agreement under the Covered Law.[20] Applying the "as if" approach to agreements governed by non-U.S. law also can produce a meaningless opinion because provisions that do not appear in the agreement, such as so-called "non-derogable norms" of contract law in civil law countries, may be among a cross-border transaction's most material terms, but the opinion preparers cannot be expected to be aware of them.[21]

Therefore, an "as if" opinion would be of no practical use to the recipient, particularly when one considers that the parties meant for the transaction to be governed by the non-U.S. Chosen Law both to the extent that terms are stated in the agreement and to the extent that provisions of the Chosen Law otherwise apply. The opinion recipient and its non-U.S. counsel presumably know how the agreement would be enforced in the Chosen Law Country. Conversely, neither the opinion recipient nor counsel for the U.S. party knows with any degree of confidence how a court in the Covered Law State that chose to apply the Covered Law, rather than the Chosen Law, might enforce a "hypothetical" agreement (i.e., the "as if" agreement rather than the actual agreement the parties entered into). Moreover, a court in the Covered Law State would likely see no reason to apply its own jurisdiction's law rather than the law the parties chose and, were it to do so, it would likely have little, if any, precedent to guide it. Thus, rather than speculating about hypothetical scenarios that might make an "as if" opinion meaningful, the opinion recipient would be better served by focusing on whether a court in the Covered Law State, if asked to enforce the agreement, would do what the parties intended: apply the Chosen Law. That topic is discussed in the next section of this Report, which deals with choice-of-law opinions. If a court in the Covered Law State applies the Chosen Law, it will rely on

[20] These interpretive issues are equally present when the agreement is drafted in English, or when the opinion preparers are allowed to rely on a translation of the agreement into English, because the problem is not simply language, but legal concepts and technical terms that do not always lend themselves to translation. Even if the parties approve dual versions of the agreement, one in a foreign language and one in English, the situation is not necessarily better and may in fact be worse if suit against the U.S. opinion giver is brought in a court of the Chosen Law Country and ambiguities or conflicts exist between the two versions, because the English version on which the opinion giver relied for the "as if" analysis may or may not be the version on which the court relies.

[21] This is not the same issue addressed above (how a provision of the agreement would be interpreted by a court in the Covered Law State). Rather, because a U.S. lawyer willing to give an "as if" opinion is permitted to disregard the Chosen Law, the issue is whether that U.S. lawyer would, in applying the "as if" logic, be analyzing a set of terms that under the Covered Law are in fact different from the those to which the parties intended to agree as they are under the Chosen Law. This issue results from likely differences between the legal system on which the opinion is based and the legal system on which the agreement is based. In many civil law jurisdictions, for example, the parties do not have the same latitude they have in the United States, subject to limited exceptions, to negotiate whatever business terms they wish, which in U.S. practice ordinarily are spelled out in the agreement itself. By contrast, statutes in many code-based jurisdictions supply terms that need not be, and ordinarily are not, set forth expressly in the agreement, or require that agreements conform to a statutory scheme that permits limited deviations from the norm (i.e., a statute either supplements or overrides negotiated contract clauses). Similar problems may arise even when the Chosen Law Country is a common law country. *See infra* note 33.

testimony from experts knowledgeable about that law and practice in the Chosen Law Country. In so doing, the court will not engage in the exercise in which the preparers of an "as if" enforceability opinion would have to engage: pretending that the agreement is governed by a law (the Covered Law) that the parties did not choose.

These interpretive problems are inherent in giving an outbound "as if" enforceability opinion on an agreement governed by non-U.S. law and create the potential for misunderstanding by the opinion recipient in a cross-border transaction. In giving that opinion U.S. opinion preparers may interpret the terms of the agreement, even those that appear to have counterparts under the Covered Law, in ways that would come as a surprise to the non-U.S. recipient because those interpretations are based on U.S. legal principles with which the recipient is not familiar. Moreover, as discussed above, the opinion preparers may not have considered material terms because, instead of appearing in the agreement itself, they are prescribed by a statute or other law of the Chosen Law Country. The non-U.S. recipient would have little or no way of knowing how the opinion preparers using the "as if" approach came to the conclusion that a court applying the Covered Law would enforce the agreement, and may not be aware that the opinion does not address what the recipient believes to be the "true" commercial bargain.

For these reasons, this Committee regards as well-advised the practice of U.S. lawyers not to give an "as if" enforceability opinion in cross-border transactions when the agreement is governed by the law of a jurisdiction outside the United States, and believes that insisting that U.S. lawyers give it normally is inappropriate.[22]

III-2 Choice of Non-U.S. Law as Governing Law

When the Chosen Law is the law of a non-U.S. jurisdiction, a non-U.S. party to a cross-border transaction may request an opinion from U.S. counsel for the U.S. party that, in an action relating to the parties' agreement in a court of the Covered Law State, that court will give effect to the governing law clause and

[22] This position is consistent with the IBA Report's conclusion regarding inbound "as if" enforceability opinions of non-U.S. counsel ("as if" formulation "makes no sense . . . where foreign countries are involved; . . . difference[s] in law and contract practice [make it] ludicrous to suggest to a lawyer from a civil law country or even from a non-U.S. common law jurisdiction that he read a New York law agreement as if it were governed by his law"). IBA Report, *supra* note 2, at 168. Sometimes, but infrequently, U.S. lawyers may be willing to give an "as if" opinion if they are satisfied that the agreement would be interpreted under the Covered Law in the same general way it would under the Chosen Law (for example because they also happen to have expertise in the Chosen Law Country's law and practice with respect to agreements of the type on which they are giving the opinion). When giving the opinion, they often make clear in the opinion letter that the opinion (i) is based on a reading of the agreement within its four corners and as its provisions would be understood by a lawyer in the Covered Law State, which may be different in meaningful ways from how lawyers in the Chosen Law Country may understand them, and (ii) does not cover any substantive provisions of the non-U.S. Chosen Law that may be incorporated by reference in the agreement or supplied by the law of the Chosen Law Country. Some U.S. lawyers also add a statement to the effect that they are not qualified to interpret the terms of the agreement under the Chosen Law.

apply the Chosen Law.[23] In the case of contracts, many states have choice-of-law rules based on section 187(2) of the American Law Institute's Restatement (Second) of Conflict of Laws.[24] Under section 187(2), a governing law clause is given effect unless one or both of the following exceptions apply: (1) the state whose law is chosen (the Chosen Law State) does not have a substantial relationship to the parties or the transaction and no other reasonable basis exists for the parties' choice of law; or (2) giving effect to the agreement under the Chosen Law would be contrary to a fundamental policy of the state whose law would have applied had the agreement not contained a governing law clause (the Default State), if the Default State has a materially greater interest in the issue than the Chosen Law State.[25] This Report refers to the second exception under section 187(2)—as described in clause (2) above—as the "Second Prong of the Restatement Test."

In domestic U.S. transactions, when U.S. lawyers give an opinion on the effectiveness of a governing law clause that chooses the law of another state[26] and the

[23] This opinion addresses the concern of the recipient that the Chosen Law will not be given effect should it choose to seek enforcement of the agreement in the courts of the Covered Law State (particularly when, as is often the case, the opinion giver's client has significant operations there), rather than the courts of the Chosen Law Country. For example, in a cross-border loan, if the lender is located in Germany, the borrower is located in California, and the agreement chooses German law, the lender may ask a California lawyer for an opinion that the agreement's choice of German law will be given effect under California law if the lender sues the borrower in the California courts. *See* IBA Report, *supra* note 2, at 250. Unlike the "as if" enforceability opinion discussed earlier in this Report (which would cover the agreement generally), the choice-of-law opinion only covers the specific issue whether, if a dispute relating to the agreement were litigated in a California court, the governing law clause would be given effect under California choice-of-law rules.

[24] Restatement (Second) of Conflict of Laws § 187 (1971). This Report assumes that section 187(1) (which provides that the law chosen by the parties will be applied if the particular issue is one that the parties could have resolved by an explicit provision in their agreement directed to that issue) does not apply and, thus, that the applicable test is set forth in section 187(2). The first exception under section 187(2) applies when sufficient contacts are not present between the parties or the transaction and the state whose law is chosen. That may be a concern in cross-border transactions when the parties as a matter of convenience or for other reasons (for example, the chosen law's being better developed for the type of the transaction) choose the governing law of a jurisdiction with which neither they nor the transaction have any relationship. Some states have enacted statutes that validate, if specified conditions relating to the nature and size of the transaction are met, contractual provisions selecting that state's law regardless of whether contacts exist with that state. *See, e.g.*, Cal. Civ. Code § 1646.5 (West 2006 & Supp. 2011); Del. Code Ann. tit. 6, § 2708 (2011); N.Y. Gen. Oblig. Law § 5-1401 (McKinney 2010). Such statutes, however, typically do not address the enforceability of choice-of-law clauses selecting the law of *another* jurisdiction, and thus have no bearing on whether a court in the state that enacted the statute would give effect to the parties' choice of the law of a jurisdiction outside the United States as the law governing their agreement. Other states have enacted statutes that validate contractual provisions selecting the law of another jurisdiction, whether a different state or foreign county, if specified conditions are met. *See, e.g.*, Tex. Bus. & Com. Code §271.005 (West 2013). Some states, for example New York, have developed their own rules for enforcing choice-of-law clauses selecting the law of another jurisdiction. This Report only deals with choice-of-law rules based on section 187(2) of the Restatement.

[25] Restatement (Second) of Conflict of Laws § 187(2).

[26] In many domestic U.S. transactions in which the Chosen Law is not the Covered Law, recipients do not insist on receiving an opinion that specifically addresses the effectiveness of the governing law clause under the Covered Law. In lieu of a choice-of-law opinion, recipients often are willing to accept an enforceability opinion that is given "as if" the Covered Law were the Chosen Law. In the cross-border context, as discussed in Part III-1, "as if" enforceability opinions normally are not given. *See supra* text accompanying note 22.

choice-of-law rules of the Covered Law State follow the Restatement, many opinion preparers limit the opinion's coverage of the Second Prong of the Restatement Test or avoid covering it altogether.[27] They do so because of the difficulty U.S. lawyers have determining with the confidence needed to give an opinion (1) whether the Covered Law would govern in the absence of a governing law clause, (2) whether the state whose law would govern—i.e., the Default State—has a materially greater interest in the issue, and (3) whether giving effect to the agreement under the Chosen Law would violate a fundamental policy of the Default State. Covering the Second Prong of the Restatement Test is even more problematic in the cross-border context because foreign legal systems are involved and each of these three determinations calls for an analysis U.S. lawyers ordinarily are not in a position to make.[28]

Even if the Covered Law State is, or is treated for purposes of the choice-of-law opinion as if it were, the Default State, determining whether a fundamental policy of the Covered Law State would be violated requires the opinion preparers to have a full understanding of what the agreement provides and means under the Chosen Law.[29] When, as this Report assumes, the Chosen Law is the law of a jurisdiction outside the United States, U.S. lawyers will not have that understanding because of their limited, if any, familiarity with that law. Thus, they are not in a position to determine whether giving effect to the agreement as interpreted under the Chosen Law would violate a fundamental policy of *any* jurisdiction, including one of the Covered Law State.[30] Statutes or other laws in the Chosen Law Country may supply provisions that do not appear in the agreement or may override or modify provisions that do appear. In addition, terms in the agreement, some of which are likely to have no counterparts in U.S. law, may

[27] *See generally* TriBar Op. Comm., *Supplemental Report: Opinions on Chosen-Law Provisions Under the Restatement of Conflict of Laws*, 68 Bus. Law. 1161, 1168 & n.25 (2013) [hereinafter *TriBar Supplemental Chosen-Law Report*] (some lawyers are unwilling to give choice-of-law opinions; others treat the Covered Law State as if it were the Default State; others make clear opinion does not cover possibility that choice-of-law rules of Covered Law State might require consideration of fundamental policies of some other state, e.g., by expressly excluding fundamental policies of other states; and others expressly exclude coverage of fundamental policies of Covered Law State as well as other states).

[28] *See generally id.* at 1163–64 & nn.5–13 (factors for determining Default State include needs of interstate and international systems, protection of justified expectations, and needs of judicial system; breadth and inherent imprecision of factors can (and often do) prevent opinion preparers from being able to identify Default State with the confidence opinions require). In the cross-border context the facts needed to determine what jurisdiction is the Default State are even more complex than in the domestic U.S. context, and the analysis is harder because of the possible relevance of the laws of countries of which the opinion preparers have limited, if any, knowledge. For an example of the kind of fact-intensive inquiry needed for a proper application of the Second Prong of the Restatement Test, see *Wise v. Zwicker & Associates, P.C.*, 780 F.3d 710 (6th Cir. 2014).

[29] *TriBar Supplemental Chosen-Law Report*, *supra* note 27, at 1166 & n.14 (noting that Restatement requires that agreement be interpreted under the Chosen Law for purposes of determining whether giving effect to agreement will violate fundamental policy of the Default State; meaning of contractual provisions under Chosen Law may be different than under Covered Law and that possibility may prevent opinion preparers from giving choice-of-law opinion, depending on type of agreement, matters covered, and terminology used).

[30] *See supra* note 21 and accompanying text (discussing this interpretive difficulty in context of as-if opinions).

have a meaning under the Chosen Law that would come as a surprise to U.S. lawyers.[31] The inevitable imprecision of translating into English agreements written in another language[32] ordinarily will exacerbate the problem.[33] As a result, even when the terminology of the agreement looks familiar to the opinion preparers, for example because it is based on a U.S. form of agreement, they cannot be expected to know whether the terms used have the same meaning under the Chosen Law as they do under the Covered Law.

Some U.S. lawyers are unwilling to give choice-of-law opinions in cross-border transactions in which the Chosen Law is the law of a jurisdiction outside the United States. Non-U.S. recipients, however, may request this opinion and regard it as important. This Committee believes that when the choice-of-law rules of the Covered Law State follow section 187(2) of the Restatement U.S. lawyers can give an opinion on the effectiveness under the Covered Law of a governing law clause choosing the law of a jurisdiction outside the United States, but, for the reasons discussed above, only if the opinion does not cover the Second Prong of the Restatement Test.[34] Accordingly, this Committee recommends

[31] The IBA Report recognizes this interpretive problem but concludes that the challenges it poses for the opinion preparers can be reduced to a manageable level if the agreement sets forth comprehensively the rights and obligations of, and the remedies available to, the parties and does not rely extensively on a general body of applicable foreign law to govern the relationship between the parties. IBA Report, *supra* note 2, at 168. The IBA Report also concludes that the opinion could be given based on the opinion giver's reading of the agreement "on its face and within the four corners of the document" even though the opinion giver is not familiar with the foreign law governing the agreement. *Id.* at 260. For the reasons discussed later in this Part, this Committee disagrees with these conclusions and recommends that the opinion expressly exclude coverage of the fundamental policies of any jurisdiction (whatever the Default State may be) that under the Second Prong of the Restatement Test might lead a court in the Covered Law State to decline to enforce the governing law clause. *See infra* note 33 and accompanying text.

[32] When the opinion preparers rely on a translation, they often disclose that reliance in the opinion letter and expressly assume that the translation is a complete, fair, and accurate English rendition of the foreign language text of the agreement.

[33] The same problems can arise even when the agreement is in English and the language of the Chosen Law Country also is English. An example is the phrase "best efforts," a phrase that U.S. opinion preparers would likely not know has a different meaning in England than in many U.S. states. Under English law, "best efforts" means that a party to an agreement will do whatever is required to perform the obligation involved, no matter how onerous. In the United States, "best efforts" in many states means that a party will use the highest level of effort that is commercially reasonable under the circumstances. Depending on the facts, a U.S. court might find that an agreement using "best efforts" as interpreted under English law violates a fundamental policy of the Covered Law State against the imposition of a penalty if, for example, it requires a party to spend extravagant sums to cure a minor defect in performance. Because a choice-of-law opinion covering the Second Prong of the Restatement Test would cover the terms of the agreement as interpreted in accordance with English law, the failure (albeit understandable) of U.S. opinion preparers to understand the English interpretation of "best efforts" might result in an erroneous opinion that the choice of English law will be given effect by the courts of the Covered Law State (even assuming that the Default State is the Covered Law State).

[34] The exclusion of fundamental policies from the opinion's coverage should be readily understood by non-U.S. opinion recipients because the choice-of-law rules of many foreign countries are similar to the Restatement test: first determine whether the parties' choice of law can be recognized in general, then identify any specific limitations, including public policy limitations, on the application of the chosen law. *Cf.* IBA Report, *supra* note 2, at 164–68 (acknowledging the existence of an "unavoidable gap" in confirming the effectiveness of the governing law clause, as neither foreign nor U.S. counsel can say whether giving effect to the agreement under the non-U.S. law selected by

that, when giving choice-of-law opinions in cross-border transactions in which the Chosen Law is the law of a jurisdiction outside the United States, U.S. lawyers exclude coverage of the Second Prong by making clear in the opinion letter, by means of an express exception or assumption, that the opinion does not cover the fundamental policies of the Covered Law State or any other state or country that may be the Default State.[35]

An outbound choice-of-law opinion that does not cover fundamental policies under the Second Prong of the Restatement Test still covers matters important to non-U.S. recipients. Among those matters are: (1) the presence under the Covered Law of a sufficient nexus with the Chosen Law State to satisfy the first prong of the Restatement test; (2) the inapplicability under the Covered Law of mechanical rules (for example a rule that the governing law shall be the law of the place where the contract was entered into or the law of the jurisdiction with the closest relationship to the transaction) that would prevent a court in the Covered Law State from giving effect to the governing law clause; (3) the satisfaction of formal or procedural requirements under the conflict-of-laws rules of the Covered Law State; and (4) the absence of a general prohibition against application of the Chosen Law by the courts of the Covered Law State.[36]

When the Chosen Law is the law of a jurisdiction outside of the United States, the opinion preparers are entitled to base a choice-of-law opinion on an assumption

the parties would violate a fundamental policy of the jurisdiction whose law would otherwise apply without having expertise in all laws that may apply, and stating that "although the practical implications of this problem are small, it should be noted that this gap does exist and cannot be closed. The risk it creates must be assumed by the person who ultimately relies on the opinion.").

[35] The opinion could be worded as follows:

> *Under the law of [COVERED LAW STATE], the choice of the law of [FOREIGN COUNTRY] in the Agreement is valid except to the extent that giving effect to the law of [FOREIGN COUNTRY] would violate a fundamental policy of (i) the jurisdiction whose law is covered by this opinion letter or (ii) any other jurisdiction having a materially greater interest than [FOREIGN COUNTRY] in the determination of the issue, if the law of that jurisdiction would apply to the Agreement or any of its provisions in the absence of a governing law clause.*

Some U.S. lawyers include in their outbound choice-of-law opinions a statement that they "*do not believe*" that application of the non-U.S. law chosen in the agreement would be contrary to a fundamental policy of the Covered Law State or other jurisdictions whose law may apply. This Committee recommends against including such language because of the difficulty discussed earlier in this Part of establishing a reasonable basis for that belief and because statements regarding an opinion giver's knowledge or belief should be limited to matters of fact, not law. *See* TriBar Op. Comm., *Third-Party "Closing" Opinions: A Report of the TriBar Opinion Committee*, 53 Bus. Law. 591, 619 n.59 (1998) [hereinafter *TriBar 1998 Report*].

[36] These are some of the reasons why governing law clauses are not enforced in many countries. They explain why non-U.S. recipients ordinarily expect to receive choice-of-law opinions even though subject to "public policy" limitations. *See* IBA Report, *supra* note 2, at 165. Not all states apply choice-of-law rules based on section 187(2) of the Restatement, and even those that do may not follow the Restatement in all respects. *See TriBar Supplemental Chosen-Law Report*, *supra* note 27, at 1162 & n.2. When applying section 187(2) of the Restatement, opinion preparers need to make a determination that the Chosen Law State has a reasonable relationship to the parties or the transaction. The opinion preparers in each particular state need to assess what other determinations, if any, are required under the Covered Law. New York, for example, applies common law principles in determining whether to give effect to a choice-of-law clause choosing the law of another state. *Id.*

that the agreement generally and the governing law clause specifically are valid, binding, and enforceable under the Chosen Law. For this purpose they are entitled to rely, without so stating, on the Omnibus Cross-Border Assumption.[37]

III-3 International Arbitration

The parties to cross-border transactions often choose arbitration as the method for resolving disputes that may later arise between them and to that end include in their agreements mandatory arbitration clauses.[38] Arbitration clauses, however, would be of no value if courts were unwilling to compel the parties to arbitrate or to enforce arbitral awards made under them.[39] Consequently, when an arbitration clause is included in an agreement in a cross-border transaction, a non-U.S. party may ask U.S. counsel for the U.S. party for an opinion that, under the Covered Law, (1) the agreement of the parties to arbitrate is an enforceable obligation of the U.S. party and (2) an arbitral award against the U.S. party made in accordance with the clause will be recognized and enforced by courts in the Covered Law State without a re-hearing on the merits.

The United States is a signatory to the 1958 United Nations Convention on the Recognition and Enforcement of Foreign Arbitral Awards (which is commonly referred to as the New York Convention).[40] As discussed in greater detail in Parts

[37] *See supra* text accompanying note 17. Because the Chosen Law is the law of a jurisdiction outside the United States, the validity and binding effect of the agreement as a whole are not governed by the Covered Law. Often non-U.S. parties will request opinions from U.S. counsel that the U.S. party has the corporate power to enter into the agreement and that it has duly authorized, executed, and delivered the agreement. *See infra* text accompanying notes 168–72.

[38] Parties typically adopt so-called "broad form" arbitration clauses pursuant to which they elect to submit to arbitration the full range of disputes that may arise out of or relate to their contractual relationship, including issues relating to contract formation, such as fraudulent inducement to contract.

[39] Although international arbitration is a private method of dispute resolution, it requires the support of a legal system if a party refuses to arbitrate or the losing party refuses to honor an arbitral award. *See generally* Alan Redfern et al., Law and Practice of International Commercial Arbitration 328 (4th ed. 2004). The court asked to enforce an arbitral award often will not be located where the arbitration took place, but rather where the losing party has operations or assets. Because the law of any one country may not be sufficient to deal with international arbitration, countries have entered into treaties and conventions. These treaties and conventions have the force of law in all signatory countries and are applied by their national courts.

[40] June 10, 1958, 21 U.S.T. 2517 [hereinafter New York Convention]. As of the date of this Report, the New York Convention has more than 155 signatories, including both developed and less-developed countries. For an updated list of signatory countries, see *Status*, *Convention on the Recognition and Enforcement of Foreign Arbitral Awards (New York, 1958)*, U.N. Comm'n on Int'l Trade L., http://www.uncitral.org/uncitral/en/uncitral_texts/arbitration/NYConvention_status.html (last visited Sept. 4, 2015) [hereinafter *New York Convention Status*]. Initiatives are ongoing to clarify or modify the New York Convention to reflect over fifty years of practice and jurisprudence. In 1985 the United Nations Commission on International Trade Law (UNCITRAL) approved the Model Law on International Commercial Arbitration, designed to modernize and harmonize arbitration laws applicable to both domestic and cross-border transactions. UNCITRAL Model Law on Int'l Commercial Arbitration, U.N. Doc. A/40/17 (June 21, 1985) [hereinafter Model Law], *available at* http://www.uncitral.org/pdf/english/texts/arbitration/ml-arb/07-86998_Ebook.pdf. The Model Law incorporates the provisions of the New York Convention but is more comprehensive and detailed. The U.N. General Assembly recommended the Model Law to member states for adoption, and many countries have adopted it, in some cases with minor changes. *See UNCITRAL Model Law on International Commercial*

III-3.1 and III-3.2,[41] if the New York Convention applies to the transaction, U.S. counsel for the U.S. party usually will have no difficulty giving an opinion that, subject to the exceptions provided in the New York Convention, the agreement to arbitrate is enforceable under U.S. federal law against the U.S. party and an arbitral award made in accordance with the clause will be recognized and enforced in the United States.[42] This opinion does no more than confirm that the prerequisites for application of the New York Convention have been satisfied. It does not cover the applicability of any of the exceptions provided in the New York Convention, whether in the context of a suit to compel arbitration or a suit to have an arbitral award recognized and enforced.[43]

Chapter 2 of the Federal Arbitration Act (the FAA) brings the provisions of the New York Convention into the framework of the U.S. legal system.[44] The FAA preempts state law if state law conflicts with or departs significantly from the policies of the New York Convention or the FAA.[45] While the New York Convention is not the only treaty that applies to international arbitration,[46] it is

Arbitration (1985), with amendments as adopted in 2006, U.N. Comm'n on Int'l Trade L., http://www.uncitral.org/uncitral/en/uncitral_texts/arbitration/1985Model_arbitration_status.html (last visited Sept. 4, 2015). The Model Law, although not binding as a matter of U.S. law, provides valuable guidance on the interpretation of principles and practice under the New York Convention.

[41] *See infra* notes 54–71 and accompanying text.

[42] The New York Convention in the form ratified by the United States is not applicable to agreements to arbitrate in countries that are not signatories. *See infra* note 48. While this Report only deals with arbitration clauses subject to the New York Convention, if another international treaty to which the United States is a party applies to the arbitration clause, the ability of a U.S. lawyer to give an opinion on its enforceability will depend on the wording of the treaty and practice in its application. In the absence of a governing international treaty, the opinion preparers often will be unable to give an opinion on the arbitration clause because of the cost of doing the legal analysis and the difficulty of making the necessary determinations.

[43] *See infra* text accompanying notes 56, 65–66. As a practical matter, the opinion preparers cannot address whether a U.S. court will determine that an exception provided in the New York Convention applies to a future dispute because that determination will depend on the specific claims made and the legal issues raised when a suit actually is brought.

[44] *See* 9 U.S.C. §§ 201–208 (2012). Sections 203–205 of the FAA give U.S. federal courts nonexclusive jurisdiction over actions to enforce international arbitration agreements and awards, regardless of the amount in controversy, and allow defendants to remove actions brought in state court to federal court. *See id.* §§ 203–205. Pursuant to sections 206–207 of the FAA, a federal court may compel arbitration in accordance with the parties' agreement and, subject to a three-year time limit, may issue an order confirming a foreign arbitral award unless one of the exceptions enumerated in the New York Convention applies. *See id.* §§ 206–207. Domestic, rather than international, arbitration clauses are covered by Chapter 1 of the FAA, not Chapter 2.

[45] That is the case for both domestic arbitration in interstate U.S. commerce and international arbitration. This Report does not address how opinion preparers deal with arbitration clauses in closing opinions delivered in domestic U.S. transactions, where practice is not uniform. While beyond the scope of this Report, opinion preparers should be aware that the case law dealing with domestic U.S. arbitration clauses has not always been consistent when state law and Chapter 1 of the FAA do not line up precisely. Some aspects of state law also may apply to international arbitration, so long as they do not conflict with the New York Convention. Depending on the state, therefore, the opinion preparers may have to consider state law on arbitration in addition to Chapter 2 of the FAA.

[46] For example, the United States is a party to the Inter-American Convention on International Commercial Arbitration, Jan. 30, 1975, 14 I.L.M. 336 [hereinafter Panama Convention], which Congress has implemented in Chapter 3 of the FAA. *See generally* 9 U.S.C. §§ 301–307 (2012). Chapter 3 of the FAA incorporates by reference sections 202–207 of the FAA. *See id.* § 302. As a result, implementation of the Panama Convention tracks closely that of the New York Convention. Under both the

the most important.[47] This Report covers only opinions on arbitration clauses subject to the New York Convention. If the arbitration clause is not subject to the New York Convention and related provisions of the FAA, this Report does not address whether an opinion can be given.

Pursuant to section 202 of the FAA, the New York Convention applies to any arbitration agreement or foreign arbitral award arising out of an international contractual transaction. For purposes of the FAA, a transaction is not international if it is entirely between U.S. citizens, unless it otherwise involves international commerce, for example because it concerns property located outside the United States, the contract is to be performed outside the United States, or the transaction bears some other reasonable relationship to a foreign country. In addition, in the United States the New York Convention is subject to two important reservations[48]: (1) a reciprocity requirement that limits its application to awards made in other countries that are parties to the Convention;[49] and (2) a requirement that limits its application to transactions considered "commercial."[50] Neither the New York Convention nor the FAA defines the term "commercial," leaving that issue to the courts.

New York Convention (as implemented by the United States) and the Panama Convention, U.S. courts will only recognize and enforce arbitral awards made in arbitrations conducted in countries that are parties to the respective Convention (the reciprocity requirement). The FAA further provides that the Panama Convention applies when both conventions are applicable if a majority of the parties to the arbitration agreement are citizens of countries that have ratified or acceded to the Panama Convention and that are member states of the Organization of American States. *See id.* § 305. In all other cases the New York Convention applies.

[47] The New York Convention has more signatories than any other convention relating to arbitration. *See generally New York Convention Status*, *supra* note 40. It expressly recognizes, however, the right of the parties to an arbitration agreement to invoke, if applicable, remedies and procedures available under other multilateral or bilateral treaties or the law of the country where enforcement is sought.

[48] These reservations were adopted by the United States through a 1970 instrument of accession. *See New York Convention Status*, *supra* note 40.

[49] U.S. courts have interpreted reciprocity as a formal requirement, not as a substantive issue. *See* Fertilizer Corp. v. IDI Mgmt., Inc., 517 F. Supp. 948, 953 (S.D. Ohio 1981) (holding that reciprocity only required determination that India was signatory to New York Convention, not analysis of how Convention was applied in India).

[50] The New York Convention allows signatory countries to declare, as the United States has done, that they will apply the Convention only to disputes arising out of legal relationships, whether contractual or not, that are considered commercial under the national law of the country making the declaration. *See* New York Convention, *supra* note 40. Examples of matters that under the law of many countries are not deemed "commercial" are civil rights, employment discrimination, and family law and child custody. *See generally* William W. Park, Arbitration of International Business Disputes 120 & n.18 (2006). Building upon practice under the New York Convention, the Model Law seeks to make the term more uniform and precise, stating that legal relationships of a commercial nature include: (1) trade transactions for the supply or exchange of goods or services; (2) distribution agreements; (3) commercial representation or agency arrangements; (4) factoring; (5) leasing; (6) construction of works; (7) consulting; (8) engineering; (9) licensing; (10) investment; (11) financing; (12) banking; (13) insurance; (14) exploitation agreements or concessions; (15) joint ventures or other forms of industrial or business cooperation; and (16) carriage of goods or passengers by air, sea, rail, or road. *See* Model Law, *supra* note 40. When U.S. courts have considered whether particular activities are "commercial" under the New York Convention and the FAA, they often have treated "commercial" in the international context as encompassing a broader range of matters than in the domestic context. For a discussion of the separate, but related, concept of subject matter arbitrability, see *infra* notes 55 & 60.

The New York Convention applies only to "foreign arbitral awards," which it defines as any arbitral award that: (1) is made in the territory of a country other than the country where recognition and enforcement of the award is sought, or (2) is not considered a domestic award under the law of the country where recognition and enforcement of the award are sought.[51] As discussed later in this Part, the Convention's definition of "foreign arbitral award" may present an issue for the opinion preparers if the agreement does not require that the arbitration take place outside the United States or is silent as to the location of the arbitration.[52]

The New York Convention promotes international arbitration as a dispute resolution mechanism, and, consistent with that policy objective, U.S. courts have consistently compelled international arbitration, recognized and enforced international arbitral awards, and construed narrowly the grounds for judicial review of arbitral awards.[53] Outbound opinions on the enforceability under U.S. law of

[51] New York Convention, *supra* note 40, art. 1. This definition reflects a compromise among signatory countries that favored a strict territorial approach (the first clause) and those that favored taking into account the nationality of the parties, the subject of the dispute, and the rules of the arbitration, including the governing law. *See generally* Paolo Contini, *International Commercial Arbitration: The United Nations Convention on the Recognition and Enforcement of Foreign Arbitral Awards*, 8 Am. J. Comp. L. 283, 293–94 (1959). Application of the first part of the definition of foreign arbitral award is purely mechanical. Application of the second part, however, requires a facts-and-circumstances analysis because, if an arbitral award regarding a cross-border transaction is made in the United States, the New York Convention may or may not apply depending on whether U.S. law considers the award a "domestic" or "non-domestic" award. The New York Convention leaves it to signatory countries to define "non-domestic" awards. The United States has not adopted a statutory definition, leaving the term for the courts to define. *See* Bergesen v. Joseph Muller Corp., 710 F.2d 928 (2d Cir. 1983) (award made in New York involving Norwegian and Swiss parties a "foreign" award because award made within the legal framework of another country, e.g., under foreign law or involving non-U.S. parties, is not considered domestic).

[52] Section 202 of the FAA provides that an agreement or award entirely between U.S. citizens does not fall within the New York Convention unless it involves property located abroad, performance or enforcement abroad, or "has some other reasonable relation with one or more foreign states." The New York Convention clearly applies to: (1) arbitral awards made outside the United States, because they satisfy the "territorial" part of the definition discussed earlier in this Part so long as the transaction itself has a foreign nexus; and (2) arbitral awards made in the United States if the parties are all non-U.S. parties. What is not as clear under the Convention and cases interpreting it, however, is whether and when an award made in the United States involving a transaction between a U.S. party and a non-U.S. party will be held under U.S. law to be a "domestic" award rather than a "foreign" award. *See, e.g.*, Yusuf Ahmed Alghanim & Sons, W.L.L. v. Toys "R" Us, Inc., 126 F.3d 15 (2d Cir. 1997) (New York Convention clearly applies to disputes involving two non-domestic parties and a U.S. corporation and contract performance in the Middle East; yet domestic arbitration provisions of the FAA apply as well, giving U.S. district court power to vacate or modify award under the domestic law of the state in which, or under which, the award was made); Jain v. de Méré, 51 F.3d 686 (7th Cir. 1995) (arbitration dispute between French and Indian parties governed by French law clearly within Chapter 2 of the FAA, but where agreement failed to specify a location for arbitration U.S. district court had same power under Chapter 1 of the FAA to compel arbitration in its own U.S. district as it would for domestic arbitration), *cert. denied*, 516 U.S. 914 (1995). In those situations the opinion preparers may need to assume expressly that the transaction and the dispute subject to arbitration have a foreign nexus sufficient to satisfy the second part of the definition of "foreign arbitral award" in the New York Convention or that the arbitration will take place outside the United States so as to satisfy the first part of that definition. *See infra* text following notes 55 & 63.

[53] The New York Convention imposes two principal requirements on U.S. courts: first, it requires them to defer to the jurisdiction of arbitrators when actions are brought concerning matters covered by arbitration agreements; and second, it requires them to enforce foreign arbitral awards

agreements to arbitrate outside the United States are discussed in Part III-3.1. Outbound opinions on the recognition and enforcement in the United States of future foreign arbitral awards are discussed in Part III-3.2.

III-3.1 Enforceability of the Agreement to Arbitrate

The New York Convention requires the courts of a signatory country to enforce "an agreement in writing"[54] in which the parties undertake to submit to arbitration all or any differences that may arise between them in respect of a defined legal relationship, whether contractual or not, concerning a subject matter "capable of settlement by arbitration."[55] Giving an opinion in reliance on the

without reviewing the merits of the arbitration decision. *See* Gerald Asken & Wendy S. Dorman, *Applications of the New York Convention by United States Courts: A Twenty-Year Review (1970–1990)*, 2 Am. Rev. Int'l Arb. 65 (1991); *see also* Peter Gillies, *Enforcement of International Arbitration Awards—The New York Convention*, 9 Int'l Trade & Bus. L. Rev. 19, 27–28 (2005) (citing The Bremen v. Zapata Off-Shore Co., 407 U.S. 1 (1972); Société Nationale Algerienne pour la Recherche, la Production, le Transport, la Transformation et la Commercialisation des Hydrocarbures v. Distrigas Corp., 80 B.R. 606, 612 (Bankr. D. Mass. 1987)).

[54] The New York Convention provides that the term "agreement in writing" includes an arbitration clause in a contract, as well as a separate arbitration agreement. New York Convention, *supra* note 40, art. II.2. The New York Convention does not prescribe the precise form of the agreement to arbitrate, however, and courts have treated as "an agreement in writing" an exchange of letters or telexes through agents and brokers or subsequent conduct by parties who have received (but not signed) contract forms that include or incorporate by reference an arbitration clause. *See, e.g.*, Chloe Z Fishing Co. v. Odyssey Re (London) Ltd., 109 F. Supp. 2d 1236 (S.D. Cal. 2000) (interpreting article II.2 requirement as exhaustive and mandatory, but then deeming it met by marine insurance broker's slip and insurer's certificate of insurance, although letters were not exchanged); *see generally* Asken & Dorman, *supra* note 53. The requirement that an agreement be in writing rarely is a problem for the opinion preparers because closing opinions ordinarily are given only in transactions in which the parties execute and deliver a "traditional" written agreement. Even though the opinion preparers are allowed to rely on the Omnibus Cross-Border Assumption with respect to contract formation and validity generally when the agreement chooses non-U.S. law as its governing law, they should decline to give an opinion if the agreement to arbitrate is not in an agreement signed by both parties, unless they are willing to deal with issues such as whether an exchange of e-mails satisfies the requirement that an arbitration agreement be in writing.

[55] *See* New York Convention, *supra* note 40, art. II(2). Whether the subject matter of a dispute arising under an agreement in a cross-border transaction is capable of being settled by arbitration is referred to as the "arbitrability" issue. Arbitrability is decided by the court being asked to enforce an arbitration clause under the law of the jurisdiction in which the court is located. Redfern et al., *supra* note 39, at 163–64. Although in theory the subject matter of all disputes is as capable of being decided by a qualified arbitrator as by a judge, in most countries some areas of the law are reserved for the courts and, therefore, under the New York Convention are not "capable of settlement by arbitration." *See, e.g.*, Park, *supra* note 50, at 115, 121 (noting that courts have resisted giving effect to agreements to arbitrate "core" public law claims for fear that private adjudicators may under-enforce laws designed to protect society at large). Courts in the United States generally presume that disputes in cross-border transactions are capable of settlement by arbitration and show significant deference to arbitrators' decisions regarding threshold arbitration issues. *See, e.g.*, BG Grp. Plc v. Republic of Argentina, 134 S. Ct. 1198 (2014); s*ee generally* Redfern et al., *supra* note 39, at 172. Accordingly, while arbitrability is a requirement for the application of the New York Convention, it normally will not prevent U.S. lawyers from giving an opinion that an agreement to arbitrate is enforceable under the Covered Law because arbitrability is rarely an issue in the types of cross-border transactions on which opinions are requested.

The term "arbitrability" is sometimes used to refer to the separate issue of whether the parties to an agreement intended that a particular dispute be arbitrated. *See, e.g.*, Howsam v. Dean Witter Reynolds, Inc., 537 U.S. 79, 83 (2002) (party cannot be required to submit to arbitration a dispute it

New York Convention on the enforceability of an agreement to arbitrate requires the opinion preparers to determine that the New York Convention applies. If the agreement to arbitrate is silent or ambiguous as to whether arbitration must take place outside the United States, or expressly allows arbitration to take place either in the United States or elsewhere, the New York Convention may not apply because an award made in an arbitration conducted pursuant to that type of agreement may not qualify as a foreign arbitral award. In those situations many opinion givers include in their opinions an express assumption that arbitration will take place outside the United States. Alternatively, they may base the opinion on an express assumption that the transaction and the dispute subject to arbitration have a sufficient foreign nexus to satisfy the second part of the definition of a "foreign arbitral award" in the New York Convention.

A court may refuse to enforce an agreement to arbitrate to which the New York Convention otherwise applies if it finds that it is null and void, inoperative, or incapable of being performed.[56] Enforcement by a U.S. court of an arbitration clause under Chapter 2 of the FAA can take one of two forms. First, a party to an

has not agreed to submit); Opalinski v. Robert Half Int'l, Inc., 761 F.3d 326, 334 (3d Cir. 2014) (arbitrability a "gateway" issue for judicial determination unless parties unmistakably provide otherwise; court to decide whether arbitration clause applies to a particular type of controversy); *see generally* PARK, *supra* note 50, at 111 & n.41 (suggesting that American courts' increasing use of "arbitrability" interchangeably with "jurisdiction" is regrettable since it blurs distinction between refusing to compel arbitration because of parties' drafting choice and refusing to compel because non-waivable legal rules prohibit arbitrator from considering subject matter). Lack of intent to arbitrate a particular matter is one of the defenses the New York Convention provides a party resisting enforcement. Unlike subject matter arbitrability, however, the intent of the parties to arbitrate a particular dispute cannot be determined (if it can at all) until after an actual dispute arises and, therefore, is not covered by an opinion on the validity of an arbitration clause. Moreover, as discussed later in this Report, the applicability of specific defenses or exceptions under the Convention is not covered by the opinion. *See infra* notes 59–60. Consistent with international practice, this Report uses the term "arbitrability" only as described in the preceding paragraph.

[56] Courts in the United States (as in most of the jurisdictions that have adopted the New York Convention) construe these grounds for refusing to compel arbitration narrowly in light of the goal of the Convention to promote international arbitration. In deciding whether an arbitration clause that is part of a broader agreement (as opposed to a stand-alone agreement) is invalid under this exception, a court theoretically could approach "validity" in one of two ways: it could consider the validity of the broader agreement of which the clause is part, or it could consider only the validity of the arbitration clause itself. Courts in the United States generally have chosen not to focus on whether the broader agreement is valid as a whole. Instead, they usually consider the validity of the arbitration clause standing alone, and, if they determine that the clause itself (separately from the agreement of which it is a part) is not "null and void, inoperative or incapable of being performed," New York Convention, *supra* note 40, art. II(3), they refer the parties to arbitration and leave the validity of the broader agreement, as well as any other disputed issues raised by the parties, for the arbitrators to decide. Consistent with the parties' intent that substantive issues be resolved by arbitration, not the judicial system, U.S. courts applying the New York Convention tend to favor the validity of arbitration clauses absent compelling grounds for invalidity, for example that the agreement to arbitrate has been obtained by fraud, mistake, or duress. The New York Convention gives courts authority to assist the parties in implementing their intent to arbitrate disputes. For example, if an agreement specifies that arbitration is to take place in a particular country pursuant to the rules of an arbitration organization that does not exist in that country, a court considering whether the arbitration clause is capable of being performed may, instead of refusing to enforce the agreement, specify an alternative arbitral forum and rules so as to give effect to the parties' intent that disputes between them be resolved outside of the courts. This authority, however, is used rarely.

arbitration agreement can ask a court to compel the other party to arbitrate.[57] Second, if a party to an arbitration agreement brings suit in a U.S. court with respect to a matter subject to the agreement, the other party can ask the court to stay the proceeding pending arbitration.

An opinion normally can be given that an agreement subject to the New York Convention requiring arbitration outside the United States of future disputes arising in connection with a cross-border transaction is enforceable under U.S. federal law,[58] subject to the exceptions in the New York Convention.[59] To give the opinion, the opinion preparers need to satisfy themselves that the five prerequisites for application of the New York Convention and the FAA (the Five Arbitration Prerequisites) are met: (1) the parties have entered into a written agreement to arbitrate; (2) the agreement provides for arbitration in the territory of a signatory country to the New York Convention; (3) the agreement is between a U.S. and a foreign party or between foreign parties or, if it is entirely between U.S. parties, the underlying transaction is international in nature; (4) the agreement arises out of a legal relationship that qualifies as commercial under U.S. law; and (5) the agreement does not relate to a subject matter that is within one of the few categories that are not arbitrable under U.S. law. The

[57] Commentators have pointed out that enforcing an agreement to arbitrate is different from enforcing other commercial agreements. *See, e.g.*, Redfern et al., *supra* note 39, at 8. An award of damages for breach of the arbitration clause is unlikely to be a practical remedy given the difficulty of quantifying the loss. Under the FAA, a court order compelling arbitration carries the same force and sanctions (including contempt of court) as other injunctive relief. Although authorized by the FAA and not uncommon, court orders for specific performance may be difficult to enforce if the non-U.S. parties against whom they are issued continue to refuse to arbitrate and are beyond the reach of the court. Indirect enforcement of an agreement to arbitrate may be the most effective remedy: if a dispute arises between the parties and one party brings suit in violation of the arbitration clause, the New York Convention requires the court to stay the proceeding, leaving arbitration as the only available route for resolving the dispute.

[58] This opinion addresses a federal statute (the FAA). Thus, to reduce the risk of misunderstanding, the opinion letter should cover U.S. federal law expressly, at least for purposes of this opinion.

[59] The opinion could be worded as follows:

> *The arbitration clause in Section ___ of the Agreement is valid and enforceable under the federal law of the United States and the law of [COVERED LAW STATE], except to the extent that an exception set forth in the Convention on the Recognition and Enforcement of Foreign Arbitral Awards or the Federal Arbitration Act, 9 U.S.C. §§ 201–208, applies.*

Some opinion givers choose to be specific about the scope of the arbitration clause in the agreement (instead of just referring to it as an "arbitration clause") to make it clear that the agreement to arbitrate must fall within the coverage of the New York Convention and the FAA by using language such as the following:

> *The Company's covenant in Section ___ of the Agreement to submit to mandatory arbitration in [ARBITRAL TRIBUNAL OUTSIDE THE UNITED STATES] is valid and enforceable under the federal law of the United States and the law of [COVERED LAW STATE] to the extent that the arbitration relates to contract claims arising under the Agreement, except to the extent that an exception set forth in the Convention on the Recognition and Enforcement of Foreign Arbitral Awards or the Federal Arbitration Act, 9 U.S.C. §§ 201–208, applies.*

Some opinion givers refer expressly to the exceptions provided in Article II.3 of the New York Convention, which allows a U.S. court to refuse to refer the parties to arbitration if it finds that the agreement to arbitrate is null and void, inoperative, or incapable of being performed. New York Convention, *supra* note 40, art. II(3); *see also supra* note 56 and accompanying text.

first three requirements are primarily matters of form. The "commercial" and "arbitrable" prerequisites require the opinion preparers to reach substantive legal conclusions that will rarely be a problem in the kind of cross-border transactions in which outbound opinions typically are requested.[60] When the agreement

[60] For a general discussion of subject matter arbitrability, see *supra* note 55. Although many cases decided under the FAA discuss which matters are arbitrable, cases discussing the meaning of "commercial" are scarce. Nonetheless, in practice, the two concepts overlap to a great extent. U.S. courts will enforce almost all arbitration clauses in cross-border transactions, regardless of whether the subject matter of the agreement is governed by contract or statute. *See* Joseph T. McLaughlin, *Arbitrability: Current Trends in the United States*, 59 Alb. L. Rev. 905, 906 (1996). The U.S. Supreme Court has held repeatedly that the FAA creates a strong presumption of arbitrability and over time has narrowed significantly the types of transactions in which contracting parties cannot agree to arbitration, particularly in international commerce. *Id.* at 940; *see, e.g.*, Gilmer v. Interstate/Johnson Lane Corp., 500 U.S. 20 (1991) (finding claim for discrimination under Age Discrimination in Employment Act of 1967 arbitrable); Rodriquez de Quijas v. Shearson/Am. Express, Inc., 490 U.S. 477 (1989) (finding claims under Securities Act of 1933 arbitrable); Shearson/Am. Express, Inc. v. McMahon, 482 U.S. 220 (1987) (finding claims under Securities Exchange Act of 1934 and RICO arbitrable); Mitsubishi Motors Corp. v. Soler Chrysler-Plymouth, Inc., 473 U.S. 614 (1985) (finding antitrust claims arising under Sherman Act arbitrable in case involving international agreements); Scherk v. Alberto-Culver Co., 417 U.S. 506, 517 (1974) (upholding compulsory arbitration of fraud-based claims where subject matter of transaction was sale of securities in case involving international commerce to prevent "damage [to] the fabric of international commerce and trade," even though subject matter may not have been arbitrable in domestic transactions). Lower courts often cite the U.S. Supreme Court's statement in *Mitsubishi* that "international comity, respect for the capacities of foreign and transnational tribunals, and sensitivity to the need of the international commercial system for predictability in the resolution of disputes" compel them to enforce arbitration. *See Mitsubishi Motors*, 473 U.S. at 629.

When international commerce is the subject of a transaction, the presumption of arbitrability applies even though the arbitration of disputes between the parties may implicate what are often regarded as "core" public laws for the protection of broad societal interests, such as antitrust and insolvency. McLaughlin, *supra*, at 936, 937; *see, e.g.*, *Mitsubishi Motors*, 473 U.S. at 629; Hays & Co. v. Merrill Lynch Pierce Fenner & Smith, Inc., 885 F.2d 1149 (3d Cir. 1989) (arbitration of churning claim brought by bankruptcy trustee enforced); Société Nationale Algerienne Pour La Recherche, La Production, Le Transport, La Trasnsformation et La Commercialisation des Hydrocarbures v. Distrigas Corp., 80 B.R. 606, 613–14 (Bankr. D. Mass. 1987) (bankruptcy stay modified to allow international arbitration).

Licenses of intellectual property commonly include arbitration clauses. Although at one time arbitrability sometimes was an issue when the subject of a dispute was intellectual property (*see generally* Julian D.M. Lew, *Final Report on Intellectual Property Disputes and Arbitration*, 9 ICC Int'l Ct. Arb. Bull. 37 (1998) (federal patent and trademark protections considered matters reserved for the courts)), in 1982 Congress expressly provided for the arbitration of patent-related issues (*see* 35 U.S.C. § 294 (2012)), and courts have found that U.S. law does not forbid arbitration of disputes relating to copyrights and trademarks even in the absence of a specific federal statute. *See* McLaughlin, *supra*, at 939–40.

Employment disputes, as opposed to disputes relating to collective bargaining/labor relations, normally have been held to be arbitrable, particularly because Congress included in key statutes (section 512 of the Americans with Disabilities Act of 1990 and section 118 of the Civil Rights Act of 1991) language expressly encouraging arbitration of sex, race, and disability discrimination claims. *See* 42 U.S.C. § 12212 (2012) (Americans with Disabilities Act); *id.* § 1981 (Alternative Means of Dispute Resolution) (Civil Rights Act); *see also* McLaughlin, *supra*, at 916, 918, 921. *But see* Ionosphere Clubs, Inc. v. Shugrue, 22 F.3d 403, 409 (2d Cir. 1994) (holding that priority of vacation pay claims in Chapter 11 case were for court to resolve and not subject to arbitration under collective bargaining agreement).

Whether a matter is arbitrable continues to be a significant issue for agreements relating to the following: matrimonial and family matters; inheritance, wills, and estates; consumer transactions; and labor relations. In the unlikely event that a cross-border agreement on which a closing opinion is requested covers one of these matters, the opinion preparers ordinarily should decline to give the opinion because courts may be reluctant to sever claims involving non-arbitrable matters from other claims if they all arise under the same agreement.

selects non-U.S. law as its governing law, the opinion preparers are entitled to assume that the agreement generally and the arbitration clause specifically are valid, binding, and enforceable under the non-U.S. Chosen Law. For this purpose they are entitled to rely without so stating on the Omnibus Cross-Border Assumption.[61]

III-3.2 Recognition and Enforcement of Foreign Arbitral Awards in the United States

If the losing party refuses to honor a foreign arbitral award, the winner typically will seek to enforce it in the courts of a jurisdiction where the losing party has operations or assets.[62] An objective of the New York Convention is to make international arbitral awards that satisfy its conditions readily transportable from country to country. It does so by requiring that arbitral awards be treated as final as to the merits of the dispute and that they be recognized and enforced by courts in all signatory countries pursuant to a uniform and streamlined set of standards.[63]

Giving an opinion on the recognition and enforcement in the United States of a foreign arbitral award against a U.S. party requires a determination by the opinion preparers that the New York Convention applies. This is the same issue the opinion preparers are required to address when giving an opinion on the enforceability of an agreement to arbitrate, as discussed earlier in this Report.

Apart from some simple formalities (producing authenticated copies of the award and the arbitration agreement with certified translations into the language of the forum court), the New York Convention allows each signatory country to establish its own procedures for enforcing foreign arbitral awards. The Convention does require, however, that signatory countries not subject the enforcement of foreign arbitral awards to substantially more onerous conditions or charges than apply to domestic awards. The United States established its procedures in Chapter 2 of the FAA.[64]

[61] *See supra* note 17 and accompanying text. Typically non-U.S. parties will request an opinion from U.S. counsel that the U.S. party has the corporate power to enter into the agreement containing the arbitration clause and that it has duly authorized, executed, and delivered the agreement. *See infra* text accompanying notes 168–72.

[62] Often, the parties to cross-border transactions choose as the place for arbitration a "neutral" country where none of them has connections. That means that an arbitral award usually will have to be enforced in a country other than the country in which the arbitration took place (typically the "home" country of the losing party).

[63] *See generally* New York Convention, *supra* note 40. Both recognition and enforcement of an arbitral award deal with giving effect to the decision of the arbitrators, as opposed to compelling the parties to submit their dispute to the arbitrators for a decision. Typically, the winning party asks the court to recognize the award and enforce it against the losing party. Sometimes the winning party will ask a court to treat an arbitral award as a defense or counterclaim if the losing party brings a suit relating to a dispute that was the subject of the arbitration in which the award was made.

[64] *See* 9 U.S.C. §§ 201–208 (2012). The FAA grants U.S. federal district courts non-exclusive subject matter jurisdiction over actions arising under the New York Convention regardless of the amount in controversy, addresses issues of venue, and permits removal of an action from state court to federal court by the defendant at any time prior to trial. The FAA requires the court to have personal jurisdiction over the party against whom enforcement of the foreign award is sought,

The New York Convention limits both the defenses that a party resisting enforcement of an arbitration award may assert and the scope of judicial review by a court in which enforcement is sought. The New York Convention lists seven grounds for refusing recognition and enforcement of an arbitral award and provides that the list is exhaustive, not illustrative.

Only the party resisting enforcement (not the court) may assert five of the seven grounds for refusing recognition and enforcement under the New York Convention: (1) lack of legal capacity to enter into the agreement under the law applicable to the parties or invalidity of the arbitration agreement under the law chosen by the parties or otherwise applicable in the place where the award was made; (2) lack of proper notice of the arbitration to the party against whom enforcement is sought or failure of the arbitration proceedings to meet minimum standards of due process; (3) lack of jurisdiction, for example because the award relates to a dispute not covered by the arbitration agreement or exceeds the arbitrators' authority; (4) failure of the composition of the arbitral panel or its procedure to conform to the requirements of the agreement or, if not specified in the agreement, to the law of the country where the arbitration took place; and (5) the award's not becoming binding in, or being set aside or suspended by a competent authority of, the country in which the award was made. Consistent with the U.S. policy of favoring enforcement of foreign arbitral awards, U.S. courts generally have applied these grounds narrowly so as not to undermine the reliability of international arbitration for resolving disputes.[65]

Either the party resisting enforcement or the court on its own motion may raise the remaining two grounds for refusing recognition and enforcement under the New York Convention: (i) the dispute was not capable of resolution by arbitration under the law of the jurisdiction where enforcement is sought, and (ii) recognition and enforcement of the award would be contrary to the public policy of that jurisdiction. As noted above, U.S. courts have rarely held disputes arising under cross-border agreements to be non-arbitrable.[66] While the

for example because that party is a resident of or owns property in the United States. Personal jurisdiction and venue may be consented to in writing by parties who otherwise would not be subject to jurisdiction or who might have an objection to venue. The period for enforcement of an award under the New York Convention is three years. *See id.*

[65] *See, e.g.*, Parsons & Whittemore Overseas Co. v. Société Générale de l'Industrie du Papier (RAKTA), 508 F.2d 969 (2d Cir. 1974) (endorsing "pro enforcement bias" of New York Convention); *see generally* PARK, *supra* note 50, at 127 (noting that five procedural defenses are not intended to permit judicial review of merits of dispute, but merely allow courts to reject awards resulting from fraudulent, unfair, or basically unjust arbitration). U.S. courts have generally interpreted these defenses narrowly. If one or more of the specified grounds for refusal of recognition and enforcement are proven to exist, the New York Convention permits the forum court to refuse enforcement but does not require it to do so. New York Convention, *supra* note 40, art. V.

[66] *See supra* notes 55 & 60 and accompanying text. When a U.S. court is considering whether to recognize and enforce a foreign arbitral award made pursuant to a valid arbitration clause that is subject to the New York Convention, its determination whether a dispute is arbitrable focuses narrowly on the specifics of the dispute that was actually submitted to arbitration rather than on the general subject matter of the agreement. Although the term "arbitrability" is used in connection with both an agreement to arbitrate's being enforced by a court and a foreign arbitral award's being recognized by a court under the New York Convention, the work the opinion preparers are expected to perform to support opinions on enforcement of an agreement to arbitrate and on recognition and enforcement of

claim that recognition and enforcement of the award would be contrary to public policy is raised frequently, U.S. courts generally have construed that defense narrowly out of concern that refusing to give effect to an award on public policy grounds would disrupt the reliance many parties to cross-border agreements place on arbitration as a dispute resolution mechanism.[67]

An opinion normally can be given that a foreign arbitral award made pursuant to an arbitration clause to which the New York Convention applies will be recognized and enforced in the United States under federal law,[68] subject to the exceptions set forth in the New York Convention.[69] To give the opinion, the opinion preparers need to satisfy themselves that the New York Convention and the FAA will apply to the award by determining that the Five Arbitration Prerequisites

an award is different. To give an opinion that an agreement to arbitrate is enforceable, the opinion preparers must consider the broader issue of whether the subject matter of the agreement can be included in a pre-dispute agreement to arbitrate. *See supra* notes 55 & 60 and accompanying text. To give an opinion that a future arbitral award will be recognized and enforced, however, the opinion preparers do not have to consider arbitrability because it is one of seven exceptions in the New York Convention and the opinion does not cover their possible application to awards made after an opinion is given. *See* Mitsubishi Motors Corp. v. Soler Chrysler-Plymouth, Inc., 473 U.S. 614, 628 (1985) (noting that after allowing arbitration of antitrust issues to go forward, courts have another opportunity at award enforcement stage to ensure that government's legitimate interest in enforcing antitrust laws has been addressed appropriately by arbitrators); *see also* PARK, *supra* note 50, at 116, 139 (stating that Justice Blackmun's opinion in *Mitsubishi Motors* promotes transnational commercial arbitration because courts may compel arbitration of public law claims and still reserve "second look" after award is made to protect public interest, though second look might open door to rehearing on merits).

[67] The language first used by the court in *Parsons & Whittemore Overseas Co. v. Société Générale de l'Industrie du Papier (RAKTA)* has become the standard for public policy challenges: "enforcement of foreign arbitral awards may be denied on this basis only where enforcement would violate the forum state's most basic notions of morality and justice." 508 F.2d at 974; *see also* PARK, *supra* note 50, at 128; *see generally* Gillies, *supra* note 53.

[68] This opinion addresses a federal statute (the FAA). Thus, the opinion letter should cover U.S. federal law expressly, at least for purposes of this opinion.

[69] The opinion could be worded as follows:

> *Except to the extent that an exception set forth in the Convention on the Recognition and Enforcement of Foreign Arbitral Awards (the "New York Convention") and the Federal Arbitration Act, 9 U.S.C. §§ 201–208 (the "FAA"), applies, an arbitral award made under Section __ of the Agreement will be recognized and enforced under the New York Convention and the FAA, if a proceeding to enforce the award is properly brought in a United States federal court within three years after the arbitral award is made.*

Some lawyers choose to make clear that the arbitral award must be a "foreign" award under the New York Convention and the FAA by using language such as the following:

> *Except to the extent that an exception set forth in the Convention on the Recognition and Enforcement of Foreign Arbitral Awards (the "New York Convention") and the Federal Arbitration Act, 9 U.S.C. §§ 201–208 (the "FAA"), applies, an arbitral award made by [ARBITRAL TRIBUNAL OUTSIDE THE UNITED STATES] in accordance with the requirements of Section __ of the Agreement will be recognized and enforced under the New York Convention and the FAA to the extent that the arbitration relates to contract claims arising under the Agreement, if a proceeding to enforce the award is properly brought in a United States federal court within three years after the arbitral award is made.*

Some opinion givers refer expressly to the exceptions provided in Article V.2(a) or (b) of the New York Convention (subject matter of the dispute not capable of settlement by arbitration or recognition and enforcement of the award contrary to U.S. public policy). New York Convention, *supra* note 40, art. V.2; *see also supra* notes 66–67 and accompanying text.

discussed in Part III-3.1 are met. The exceptions to enforceability provided by the New York Convention include a finding by the court asked to enforce the award, applying the law of its country, that the dispute was not arbitrable or that the award violates public policy.[70] Prior to the making of a specific award, the opinion preparers cannot determine whether an arbitral award would be subject to the exceptions in the New York Convention for arbitrability or public policy. Therefore, an opinion that a foreign arbitral award will be recognized and enforced in the United States under the New York Convention does not cover the possible application of those exceptions. While this is the case whether or not the opinion includes an express qualification to that effect, many opinion givers make clear in the opinion letter that they are not covering those exceptions, and this Committee endorses that approach.[71]

III-4 Litigation in the Cross-Border Context

Although the parties to cross-border agreements often choose arbitration as the method for resolving disputes (in part because arbitration is governed by a network of international treaties), they also often leave disputes for the courts to decide. When they do, to avoid having to litigate in unfamiliar courts under unfamiliar laws,[72] they often include a clause naming the courts of one or more countries as the forum for resolving disputes relating to the agreement, as well as a choice-of-law clause, opinions on which are discussed in Part III-2. Taken together, these clauses are intended to determine both the court or courts in which suit will be brought and the law to be applied. A court named expressly in a forum selection clause is referred to in this Report as a "named court."

When a forum selection clause is included in a cross-border agreement, the non-U.S. party may request an opinion from counsel for the U.S. party that the clause will be given effect by courts in the Covered Law State. This opinion, which is discussed in Part III-4.1, provides comfort to the non-U.S. party that courts in the Covered Law State will defer to the parties' choice of courts when deciding whether to consider the merits of a dispute. In domestic U.S. transactions separate opinions are rarely requested or given on the enforceability of forum selection clauses.[73]

Non-U.S. parties to cross-border agreements that do not provide for arbitration but name a non-U.S. court as the forum for resolving disputes also may request an opinion that courts in the Covered Law State will recognize and enforce

[70] *See generally* Comm. on Int'l Commercial Arbitration, Int'l Law Ass'n, Interim Report on Public Policy as a Bar to Enforcement of International Arbitral Awards (2000), *available at* http://www.ila-hq.org/en/committees/index.cfm/cid/19.

[71] *See supra* note 69 and accompanying text.

[72] The courts of all the jurisdictions involved in a cross-border transaction ordinarily can claim jurisdiction over a dispute between the parties. Therefore, the parties often specify in the agreement the courts they want to resolve disputes under the agreement. The desire to establish a uniform international framework for doing so with assurance of a consistent outcome was the impetus behind the Hague Convention on Choice of Courts Agreements (the Hague Convention). *See infra* Part III-4.3 and text accompanying notes 141–56.

[73] *See infra* text accompanying note 74.

a foreign judgment rendered by the named court. This opinion, which is discussed in Part III-4.2, provides comfort to the non-U.S. party that, if it prevails in litigation before a court located in a jurisdiction outside the United States, it will be able to enforce that court's judgment against the U.S. party in a court in the Covered Law State without a rehearing on the merits. This opinion typically is not requested in domestic U.S. transactions principally because the Full Faith and Credit Clause of the U.S. Constitution requires that a judgment obtained in any U.S. state be enforced in all other U.S. states.

Cross-border agreements often specify how process can be served on parties in different countries. Non-U.S. parties sometimes request an opinion from U.S. counsel that service on the U.S. party it represents in the manner specified in the agreement will be given effect in the courts of the Covered Law State. This opinion is discussed in Part III-4.4.

III-4.1 Forum Selection

This Part deals primarily with opinions on forum selection clauses that name non-U.S. courts as the forum for resolving disputes under the agreement (referred to in this Report as "outbound forum selection clauses"). This Part also deals with opinions on forum selection clauses that name courts in the Covered Law State (referred to in this Report as "inbound forum selection clauses"). Opinions on inbound forum selection clauses are not unusual when cross-border agreements name U.S. courts (often federal courts) as an alternative to non-U.S. courts.

In domestic U.S. transactions in which the agreement includes a forum selection clause a separate opinion ordinarily is not given on the effectiveness of that clause. Instead, unless expressly excluded, the enforceability of the forum selection clause usually is covered by an opinion on the enforceability under the Covered Law of the agreement of which the clause is a part.[74] Similarly, in cross-border transactions in which the Covered Law is the Chosen Law (for example New York law is chosen and New York courts are named), an opinion on the enforceability of the agreement under New York law covers the effectiveness of the inbound forum selection clause unless coverage of that clause is expressly excluded from the opinion.[75]

This Report, however, focuses on cross-border transactions in which the agreement chooses the law of a jurisdiction outside the United States as the governing law. When that is the case, U.S. lawyers are not in a position, as noted earlier, to give an opinion on the enforceability of the agreement as a whole.

[74] *See generally TriBar Remedies Opinion Report*, *supra* note 19, at 1498 & n.72 (discussing forum selection clause designating courts of the Covered Law State). In domestic U.S. transactions the remedies opinion ordinarily covers agreements that choose the Covered Law as their governing law and the courts of the Covered Law State as the forum for resolving disputes. The TriBar Remedies Opinion Report does not address opinions on forum selection clauses that do not name the courts of the Covered Law State, which often is the case in cross-border agreements choosing non-U.S. law as their governing law, where often the courts of the Chosen Law Country are named.

[75] *See generally* IBA REPORT, *supra* note 2, at 192–95.

As a result, non-U.S. parties may ask U.S. counsel for a separate opinion that addresses whether a court in the Covered Law State applying the Covered Law would give effect to the forum selection clause specifically.[76] The opinion does not address the related, but different, matter of venue selection (i.e., designation in the agreement of a specific federal district court or a specific court of the Covered Law State as the only one in which suit may be brought).[77]

III-4.1.1 Permissive and Mandatory Forum Selection Clauses

A forum selection clause can be either permissive or mandatory. A permissive clause, often described also as a "consent to jurisdiction clause," typically permits the parties to bring suit in courts of a specified state or country, but does not prohibit the parties from bringing suit elsewhere.[78] A mandatory clause requires

[76] As discussed in Parts II-4.1.3 and II-4.1.4, the opinion is worded differently depending on the type of forum selection clause and is subject to different assumptions, exceptions, and qualifications, which may be stated or unstated.

[77] As a matter of U.S. customary practice, if the agreement contains an inbound forum selection clause the opinion is understood to be based on an assumption, which may be stated or unstated, that an action brought in a named court in the United States will meet applicable federal or state venue requirements. Some U.S. lawyers choose to include an express exception for venue requirements, particularly when the agreement names a specific federal district court, because of the wide discretion federal courts have exercised under 28 U.S.C. § 1404(a) to transfer venue from one federal district to another. *But see infra* note 129.

Opinions specifically covering venue selection are rarely requested or given because of the inability to know whether venue requirements will be satisfied when an action is actually brought. Depending on the law of the Covered Law State, state courts may have discretion to decide the proper venue, without necessarily according significant deference to the parties' choice. Federal venue generally is governed by 28 U.S.C. § 1391, which provides three alternative grounds for establishing whether venue is proper: (1) if all parties reside in the state where the court is located, a federal district where any defendant resides; (2) a federal district where the events occurred or the property is located; or (3) any federal district in which the court has personal jurisdiction over the defendant. Ordinarily the opinion preparers have no way of knowing whether the first or second ground will be satisfied, and in cross-border transactions often they will not be satisfied. The third ground ordinarily should be satisfied if the forum selection clause includes an express consent of the parties to be sued in the federal district court named in the agreement; in some circumstances, however, that may not be so, for example when neither the parties nor the transaction has any connection with the United States. If venue is improper, the case must be dismissed or transferred under 28 U.S.C. § 1406(a) or Federal Rule of Civil Procedure 12(b)(3). *See, e.g.*, Richards v. Lloyd's of London, 135 F.3d 1289, 1295 (9th Cir. 1998) (dismissing for improper venue under Rule 12(b)(3)); Jones v. Weibrecht, 901 F.2d 17, 19 (2d Cir. 1990) (dismissing claim covered by mandatory forum selection clause for improper venue under Rule 12(b)(3)); *cf.* Stewart Org., Inc. v. Ricoh Corp., 487 U.S. 22, 33 (1988) (valid forum selection clause given controlling weight in all but the most exceptional cases); Lambert v. Kysar, 983 F.2d 1110, 1112 n.1 (1st Cir. 1993) (applying Rule 12(b)(6)).

[78] In an agreement containing a permissive clause the parties typically submit themselves to the jurisdiction of a specified court, which assures a party who chooses to bring suit in that court that the court will have personal jurisdiction over the other party. *See* Michael Gruson, *Forum Selection Clauses in International and Interstate Commercial Agreements*, 1982 U. Ill. L. Rev. 133, 192–205 [hereinafter Gruson, *Forum Selection*] (discussing contractual submission to personal jurisdiction). Permissive forum selection clauses in cross-border agreements often provide a non-U.S. party flexibility to bring suit against a U.S. party in the non-U.S. party's own jurisdiction or in a U.S. state where the U.S. party has assets or operations. *See infra* notes 97–108 and accompanying text.

Permissive clauses often are accompanied by a waiver of the right to assert the doctrine of *forum non conveniens* in suits brought in courts named in the agreement. The waiver is intended to prevent a court in which suit has been brought from granting a party's request that the suit be dismissed in the parties to bring suit only in the courts of the specified state or country to the exclusion of all others. Both permissive and mandatory forum selection clauses typically include the voluntary consent by the parties to the jurisdiction of the named courts.[79]

Cross-border agreements governed by non-U.S. law that include a forum selection clause[80] may provide that in the event of a dispute, the parties either: (1) may bring suit in the courts of the Chosen Law Country (referred to in this Report as a "permissive outbound forum selection clause"), or (2) shall bring suit *only* in the courts of the Chosen Law Country (referred to in this Report as a "mandatory outbound forum selection clause").[81] Sometimes, a cross-border agreement either: (1) permits the parties to bring suit in courts in the U.S. state[82] where the U.S. party to the agreement is located or owns substantial assets (referred to in this Report as a "permissive inbound forum selection clause"), or (2) requires the parties to bring suit only in a specified court in the United States (referred to in this Report as a "mandatory inbound forum selection clause").[83]

An opinion that a permissive outbound forum selection clause will be given effect under the Covered Law requires the opinion preparers to conclude that, if the non-U.S. party sues the U.S. party in the non-U.S. court named in the clause, courts in the Covered Law State, if presented with the question, would find that the consent of the opinion giver's client to be sued in that non-U.S. court is effective under the Covered Law.[84]

favor of another court (e.g., a court in that party's own jurisdiction) on the ground that proceeding in that other court would be more convenient to the parties, the witnesses, or the court itself. *See, e.g.*, Vivendi S.A. v. T-Mobile USA Inc., 586 F.3d 689 (9th Cir. 2009). Therefore, a permissive forum selection clause accompanied by a waiver of *forum non conveniens* is the functional equivalent for the party being sued of a mandatory clause because, once the plaintiff chooses to bring the suit in a court named in the clause, the party being sued cannot claim that a different court would be more convenient.

[79] Even if the consent is not expressed, U.S. courts ordinarily deem it implicit in the clause. *See infra* note 104 and accompanying text. *But see* Global Packaging Inc. v. Superior Court of Orange Cty., 196 Cal. App. 4th 1623 (2011) (if parties mean forum selection clause to include consent to jurisdiction, they should not leave it to implication because courts should not be called upon to function as a backstop for sloppy contract drafting).

[80] As noted above, forum selection clauses in cross-border transactions serve the parties' desire for predictability, in light of concerns about being forced to litigate in an unfamiliar legal system or in an inconvenient forum. *See generally* Michael E. Solimine, *Forum-Selection Clauses and the Privatization of Procedure*, 25 CORNELL INT'L L.J. 51 (1992) (discussing contractual choice-of-forum clauses).

[81] This Part focuses on the typical situation in which the courts selected in the forum selection clause are those of the Chosen Law Country.

[82] Often, when a permissive clause names U.S. courts, it names both the state courts of the Covered Law State and federal courts sitting in that state. *See infra* note 103 and accompanying text.

[83] When an agreement chooses non-U.S. law as its governing law, a forum selection clause ordinarily will not require that suit be brought only in the United States. When it does, it rarely requires that suit be brought only in a state court in the United States. It is more common that the agreement requires that suit be brought only in a federal court in the United States. Some agreements simply refer to "courts in the State of __________," which could be interpreted to mean either that state's courts or U.S. federal courts sitting in that state.

[84] *See infra* text accompanying note 100; *see also infra* note 136 and accompanying text (discussing a party's agreement to submit to the jurisdiction of a foreign court in connection with the enforcement by a court in the Covered Law State of a judgment of that foreign court).

An opinion that a permissive inbound forum selection clause naming the courts of the Covered Law State will be given effect under the Covered Law requires the opinion preparers to: (1) make the same determinations regarding personal and subject matter jurisdiction they would have to make if they were giving an enforceability opinion under the Covered Law on an agreement containing a forum selection clause naming the courts of the Covered Law State in a domestic U.S. transaction;[85] and (2) determine that the Covered Law does not prevent the non-U.S. opinion recipient, by reason of its status as a non-U.S. person, from bringing suit in the court or courts in the Covered Law State named in the clause.

An opinion on a mandatory outbound forum selection clause requires the opinion preparers to conclude that courts in the Covered Law State applying the Covered Law would grant the request of the non-U.S. opinion recipient to refuse to hear the case on its merits, and therefore would dismiss it, if the opinion giver's client, contrary to the agreement, sues the non-U.S. party in those courts. This dismissal is sometimes referred to as an "ouster" of the case to the courts of the Chosen Law Country named in the agreement.

An opinion on a mandatory inbound forum selection clause requires the opinion preparers to conclude that, under the Covered Law, the parties' choice of the named state or federal court would be given effect.

The work required to give an opinion on a permissive forum selection clause (discussed in Part III-4.1.3) is different from that required for a mandatory forum selection clause (discussed in Part III-4.1.4). Thus, an initial question for the opinion preparers is whether they should treat the clause on which they are giving an opinion as permissive or mandatory. Although, depending on the wording of a particular clause, answering that question might appear easy, it often is not for the reasons discussed below.[86]

As discussed later in this Part, courts in the Covered Law State may look to the non-U.S. Chosen Law when deciding whether a particular forum selection clause

[85] *See TriBar Remedies Opinion Report*, *supra* note 19, at 1500 & n.81 (opinion on permissive clause means that parties may bring suit in the designated forum and addresses requirements for personal and subject matter jurisdiction); *see also infra* text accompanying notes 104–08.

[86] This is a threshold question that a court in the Covered Law State must resolve before addressing the effectiveness of a forum selection clause. Whether the clause is permissive or mandatory is a question of law in most cases. *See, e.g.*, Global Seafood Inc. v. Bantry Bay Mussels Ltd., 659 F.3d 221 (2d Cir. 2011) (clause held permissive because it contained no specific language of exclusion depriving U.S. court of jurisdiction); Hunt Wesson Foods, Inc. v. Supreme Oil Co., 817 F.2d 75, 77 (9th Cir. 1987). In the United States, forum selection clauses usually are presumed to be permissive unless the parties clearly provide that they are mandatory. *See, e.g.*, New Moon Shipping Co. v. Man B&W Diesel AG, 121 F.3d 24 (2d Cir. 1997); Caldas & Sons, Inc. v. Willingham, 17 F.3d 123 (5th Cir. 1994) (despite use of word "shall," clause deemed permissive because lack of clear, unequivocal, and mandatory language indicated parties merely submitted to the jurisdiction of Zurich courts).

Outside the United States, forum selection clauses often are presumed to be mandatory unless the parties clearly provide that they are permissive. *See, e.g.*, Council Regulation (EC) 44/2001 of 22 December 2000, art. 23, 2001 O.J. (L 12) 8 (Jurisdiction and the Recognition and Enforcement of Judgments in Civil and Commercial Matters) [hereinafter Brussels Regulation]; TH Agric. & Nutrition, LLC v. Ace European Grp. Ltd. (TH Agric. II), 488 F.3d 1282 (10th Cir. 2007) (same clause found to be permissive under Kansas law, mandatory under Dutch law).

is permissive or mandatory.[87] The opinion preparers, on the other hand, would read the clause as it would be interpreted under the Covered Law in deciding whether it is permissive or mandatory.[88] In the event the two readings produce different results, the opinion preparers, to clarify for the recipient the manner in which they are analyzing the forum selection clause for purposes of the opinion, should consider including in the opinion letter language making clear whether they are treating the clause as permissive or mandatory.[89] If the opinion preparers choose not to do so, an alternative approach is for them to analyze the clause

[87] *See infra* text accompanying notes 92–96; *see, e.g.*, Rio Tinto PLC v. Vale SA, No. 14 Civ. 03042 (RMB) (AJP), 2014 WL 7191250 (S.D.N.Y. Dec. 17, 2014) (parties brought in English law experts to determine whether clause was mandatory); Baxter Int'l Inc. v. AXA Versicherung AG, 908 F. Supp. 2d 920, 923, 925 (N.D. Ill. 2012) (parties used German law experts to interpret clause); Ashall Homes Ltd. v. Rok Entm't Grp., Inc., 992 A.2d 1239 (Del. 2010) (court interpreted clause in accordance with law (English) chosen to govern the contract); *TH Agric. II*, 488 F.3d at 1294–1296 (Dutch law applied to interpretation of clause because the agreement selected it as the governing law).

[88] If the opinion giver's client has counsel in the Chosen Law Country, the opinion preparers' reading of the clause might be based on that counsel's advice as to how the clause would be interpreted under the chosen non-U.S. law. If the opinion preparers have received such advice, they might choose to indicate their reliance on it in the opinion letter.

[89] Nevertheless, after considering the issue the opinion preparers might choose not to make clear how they are reading a clause for a variety of reasons. These reasons include uncertainty whether a court in the Covered Law State would look to the Covered Law or the non-U.S. Chosen Law to determine the nature of the clause and uncertainty whether, even if the court were to apply the Covered Law, it would interpret the clause as permissive or mandatory. The interpretation adopted by a court may depend on whether the court finds clear evidence of the parties' intent. That intent, however, may be unclear (the agreement, for example, may expressly contemplate that suit may be brought in a court of the Chosen Law Country but neither expressly permit nor prohibit suit from being brought elsewhere), and that lack of clarity may lead some courts to conclude that the parties intended the named court to be the exclusive forum and other courts to conclude that the parties intended to allow for suit to be brought in multiple courts. *See, e.g.*, Boland v. George S. May Int'l Co., 969 N.E.2d 166 (Mass. App. Ct. 2012) (clause declaring that "jurisdiction shall vest in the State of Illinois" permissive absent plain statement that jurisdiction should be exclusive). U.S. courts dealing with an ambiguous forum selection clause often attempt to discern the parties' intent from the agreement as a whole. *See, e.g.*, Autoridad de Energia Eléctrica de Puerto Rico v. Ericsson Inc., 201 F.3d 15, 18–19 (1st Cir. 2000) (forum selection clause accompanied by choice-of-law language that indicated intent to make named court exclusive forum). The task is made more difficult when the drafters of a forum selection clause, rather than simply identifying courts where disputes are to be resolved and stating whether the selection is exclusive or non-exclusive, use less precise terms such as courts having jurisdiction or venue, which are sometimes used interchangeably. *See, e.g.*, Global Seafood Inc. v. Bantry Bay Mussels Ltd., 659 F.3d 221 (2d Cir. 2011).

Small differences in terminology may be deemed sufficient by a court to treat differently two clauses that seem virtually indistinguishable, and case law in the Covered Law State may not provide much, if any, clear guidance. *See, e.g.*, Terra Int'l Inc. v. Miss. Chem. Corp., 119 F.3d 688 (8th Cir. 1997); Boutari & Sons Wines & Spirits S.A. v. Attiki Imp. & Distrib. Inc., 22 F.3d 53 (2d Cir. 1994). Some courts have adopted interpretive rules under which certain words are deemed to make a clause mandatory and others to make it permissive. Case law is inconsistent, however, and contract language that the opinion preparers regard as clear may be interpreted differently by a court. *See, e.g.*, K&V Sci. Co. v. Bayerische Motoren Werke Aktiengesellschaft, 314 F.3d 494 (10th Cir. 2002) (holding "jurisdiction for all and any disputes [. . .] is Munich" permissive because parties did not use words like "exclusive," "sole," or "only" that would indicate parties' intent to make it mandatory); Nascone v. Spudnuts, Inc., 735 F.2d 763, 767 (3d Cir. 1984) (reference to venue indicates a mandatory clause); Hull 753 Corp. v. Elbe Flugzeugwerke GmbH, 58 F. Supp. 2d 925 (N.D. Ill. 1999) (deeming "place of jurisdiction shall be Dresden" a permissive clause in light of reference to jurisdiction and not venue).

both ways—i.e., as both permissive and mandatory.[90] That approach, however, will require them to do additional work and that work likely will be difficult to justify on a cost-benefit basis. Moreover, depending on the Covered Law, it may not be possible to give the opinion if the clause is analyzed as both mandatory and permissive, while the opinion could have been given had the clause been treated only as permissive.[91]

III-4.1.2 Applicable Law

In deciding whether to give effect to a forum selection clause, a court in the Covered Law State will have to determine, as to each issue it is required to resolve, whether to apply: (1) the Covered Law, (2) the substantive law of the Chosen Law Country (the Chosen Contract Law), or (3) the procedural law of the named non-U.S. court (the Selected Forum Law).[92] This Report focuses primarily on the common cross-border situation in which the Chosen Contract Law and the Selected Forum Law are the law of the Chosen Law Country.[93] The

[90] An opinion that does not characterize the forum selection clause as permissive or mandatory could be worded as follows:

> *The forum selection clause in Section __ of the Agreement is valid and enforceable under the law of [COVERED LAW STATE] for actions relating to contract claims arising under the Agreement.*

Analyzing the clause as both permissive and mandatory may allow the opinion preparers to give the opinion even if they have been unable to decide with the confidence needed to give an opinion whether a court of the Covered Law State would find the provision to be permissive or mandatory. When the Covered Law is not the Chosen Law, the opinion recipient should seek advice from its own counsel whether the forum selection clause will be interpreted as permissive or mandatory under the Chosen Law. An opinion giver is not responsible for providing the recipient, who is not its client, legal advice. If a court in the Covered Law State, for example, interpreted the clause under the Covered Law as permissive and declined a request by the opinion recipient (who had intended to negotiate for a mandatory outbound forum selection clause) to dismiss an action brought in that court by the opinion giver's client, the opinion would be correct even though under the Chosen Law the clause would have been interpreted as mandatory. See *infra* notes 95 and 96 and accompanying text regarding the law a U.S. court would apply to the interpretation of a forum selection clause contained in an agreement that chooses non-U.S. law as the governing law.

[91] See, for example, *infra* text accompanying notes 110–17 regarding states that have not adopted the so-called modern view. In addition, other issues discussed later in this Report bear on the opinion preparers' ability to conclude that a forum selection clause would be given effect under the Covered Law.

[92] If the clause names a U.S. federal court, federal law, including the Federal Rules of Civil Procedure, will apply. *See infra* text accompanying note 103; *see also supra* text accompanying note 77 (regarding venue). If the agreement containing the forum selection clause does not contain a governing law clause, the opinion preparers may be able to give an opinion on the enforceability of the forum selection clause under the Covered Law even though they cannot determine which law a named court would apply. The Omnibus Cross-Border Assumption permits the opinion preparers to assume that the agreement containing the clause is enforceable under whatever foreign law may govern the agreement. *See supra* note 17 and accompanying text. Some commentators, particularly outside the United States, maintain that in the absence of an explicit choice-of-law clause the substantive law of the jurisdiction where the named court is located should always be regarded as the governing law because it was implicitly chosen by the parties when they named a court for the resolution of disputes.

[93] When this is not the case, for example if Germany is the Chosen Law Country, but French courts are named in the forum selection clause, a French court could be expected to apply French law to procedural issues and German law to substantive issues, but also may apply French law to some substantive issues. Effective January 10, 2015, the Brussels Regulation was amended to clarify

issues a court in the Covered Law State typically will consider are: (i) whether a forum selection clause is presumptively effective under the Covered Law (this is often referred to as "enforceability in principle"); (ii) whether the specific circumstances of the case before it rebut the presumptive effectiveness of the parties' choice of forum; (iii) whether the forum selection clause is invalidated by defects in the formation of the agreement such as fraud, duress, or mistake; (iv) whether the agreement itself is valid under the Chosen Contract Law; (v) whether the forum selection clause is permissive or mandatory; and (vi) whether it covers the dispute in question. Prior to 2006 U.S. courts generally applied the law of the state where they were located to all these issues, even when the agreement selected non-U.S. law as its governing law.[94] Starting with a decision by the U.S. Court of Appeals for the Tenth Circuit in 2006, however, a trend has developed of applying the Chosen Contract Law to questions relating to the validity and interpretation of forum selection clauses in cross-border agreements.[95]

that the law governing the validity of a forum selection clause is the law of the jurisdiction where the named court is located, not the Chosen Contract Law. Brussels Regulation, *supra* note 86, *as amended by* EU Council Regulation 1215/2015 of 12 December 2012, art. 23. Assuming that the agreement chooses the law of the Chosen Law Country to govern, the conclusions in this section of the Report generally apply whether the courts named in a forum selection clause are located in the Chosen Law Country or in some other jurisdiction outside the United States, because neither the law of the jurisdiction where the named court is located (in the example, French law) nor the Chosen Contract Law (in the example, German law) is covered by the opinion letter and, in giving an opinion on the effectiveness of the forum selection clause, the opinion preparers can rely on the Omnibus Cross-Border Assumption with respect to the law of all jurisdictions outside the United States that may be applicable. *See supra* note 17 and accompanying text.

[94] Jason Webb Yackee, *Choice of Law Considerations in the Validity & Enforcement of International Forum Selection Clauses: Whose Law Applies?*, 9 UCLA J. INT'L L. & FOREIGN AFF. 43, 46, 63, 67 (2004) (criticizing tendency of U.S. courts considering the validity of forum selection clauses to reflexively apply their own law (the *lex fori*)); *see generally* J. Zachary Courson, Survey, Yavuz v. 61 MM, Ltd.: *A New Federal Standard—Applying Contracting Parties' Choice of Law to the Analysis of Forum Selection Agreements*, 85 DENV. U. L. REV. 597, 601, 604–07, 610 (2008).

[95] Yavuz v. 61 MM, Ltd., 465 F.3d 418 (10th Cir. 2006). The *Yavuz* court, citing Professor Yackee's article (*see supra* note 94) and the Restatement (Second) of Conflict of Laws § 187 cmt. e (1971), held that courts ordinarily should honor a cross-border agreement's choice of forum as it is construed under the law chosen by the parties to govern the agreement. The court found no reason why a U.S. court should apply to the forum selection clause a law different from the law governing other clauses, noting that international commerce requires the security parties derive from knowing that their contractual choices will be respected. *Id.* at 428–31 ("if parties agree on forum selection clause that has particular meaning under the law of a specific jurisdiction, and also agree that the contract is to be interpreted under the law of that jurisdiction, respect for the parties' autonomy and demands of predictability in international transactions require that courts give effect to that meaning under that law"); *see also* Martinez v. Bloomberg LP, 740 F.3d 211 (2d Cir. 2014) (Chosen Contract Law (English law) applied to determine whether forum selection clause is permissive or mandatory and claim subject to clause, even though federal U.S. law ultimately must govern enforceability of clause); Phillips v. Audio Active Ltd., 494 F.3d 378 (2d Cir. 2007) (citing *Yavuz,* court should not single out forum selection clause for interpretation under law other than the law chosen to govern contract as a whole). The holding in *Yavuz* is consistent with decisions in the domestic U.S. context where: (1) an agreement chooses as its governing law the law of a U.S. state other than the state whose court is asked to enforce the forum selection clause; and (2) that court (which was not selected as the forum in the agreement), after holding the outbound choice-of-law clause effective, interprets the forum selection clause under the Chosen Contract Law. *See* Jacobson v. Mailboxes Etc. USA, Inc., 646 N.E.2d 741, 744 n.6 (Mass. 1995) (where agreement chose California law as governing law and California courts as exclusive forum, Massachusetts court applied governing law (California) both to enforceability of forum selection clause generally and to interpretation of that clause).

While this view has gained widespread acceptance, its acceptance is not universal.[96]

Therefore, when a court in the Covered Law State is asked to give effect to a forum selection clause in an agreement that chooses the law of a jurisdiction outside the United States as its governing law, the court can be expected to apply the law of the Chosen Law Country to at least some issues bearing on effectiveness of the clause, depending on the state and the wording of the agreement. The result, as discussed in detail in Part III-4.1.3 for permissive forum selection clauses and Part III-4.1.4 for mandatory forum selection clauses, is that in giving an opinion that a clause naming non-U.S. courts will be given effect under the Covered Law, the opinion preparers need to rely on assumptions regarding issues governed by non-U.S. law (such as the formation, validity, and interpretation of the contract and personal and subject matter jurisdiction of the named court), which they can do by relying on the Omnibus Cross-Border Assumption.

III-4.1.3 Opinions Addressing Permissive Forum Selection Clauses

The purpose of a permissive forum selection clause is to give a party wishing to bring a legal action the ability to bring it in any of the courts named in the clause. Thus, a clause may provide a non-U.S. party flexibility to bring suit against a U.S. party in a court in the Chosen Law Country or in a court in a U.S. state (which may be the Covered Law State) where the U.S. party has assets or operations by naming both courts. While the same flexibility might be provided by not having a forum selection clause in the agreement, having a permissive clause, particularly one stating the consent of all parties to being sued in the named courts helps ensure that the named courts will have personal jurisdiction over the parties when they otherwise might not.

An opinion that a permissive forum selection clause will be given effect under the Covered Law confirms the right of the recipient to bring suit against the U.S. party in the named courts of a jurisdiction that is named in the clause. A permissive clause does not prohibit the parties, either expressly or implicitly, from bringing suit in courts in other jurisdictions (which thus include courts in the Covered Law State if they are not named). If, however, a permissive forum selec-

[96] *See also*, *e.g.*, Albemarle Corp. v. AstraZeneca UK Ltd., 628 F.3d 643 (4th Cir. 2014) (court stated that federal law must be applied, but then looked at chosen English law to hold clause mandatory); Doe 1, Doe 2 & Ramkissoon v. AOL, 552 F.3d 1077 (9th Cir. 2009); Abbott Labs. Inc. v. Takeda Pharm. Co., 476 F.3d 421, 423 (7th Cir. 2007); Manetti-Farrow, Inc. v. Gucci Am., Inc., 858 F.2d 509 (9th Cir. 1988) (applying federal law to all issues regarding forum selection clause); *see generally* Courson, *supra* note 94, at 615–20. Courts and commentators continue to differ as to which specific aspects of forum selection relate to contract formation and interpretation as opposed to enforceability, and which issues are procedural (and therefore presumptively governed by the Covered Law as the *lex fori*) and which issues are substantive (and therefore presumptively governed by the Chosen Contract Law). *See* Courson, *supra* note 94, at 621–24; *see also* Peter M. Haver, Enforceability of Forum Selection Clauses in U.S. Court Proceedings: What Law Applies in an International Setting? 1–2, 4–6 (Apr. 22, 2010) (unpublished manuscript, on file with the Reporter, as presented to the meeting of the Joint Cross Border Finance and International Commercial Law Subcommittee of the ABA Business Law Section in Denver on April 22, 2010).

tion clause does not name courts in the Covered Law State, the opinion does not address whether those courts will hear the case if suit is brought there.

Whether a clause is permissive outbound or permissive inbound, as discussed below, an opinion on its effectiveness only covers issues governed by the Covered Law. The effectiveness of a forum selection clause, however, also depends on matters that are governed by non-U.S. law, for example formation of the contract and validity of the forum selection clause under the Chosen Law.[97] To the extent that these matters are not governed by the Covered Law, the opinion preparers are entitled to assume that the agreement generally and the forum selection clause specifically are valid, binding, and enforceable under the Chosen Law, which they can do by relying, without so stating, on the Omnibus Cross-Border Assumption.[98]

III-4.1.3.1 Permissive Clauses Naming Courts Outside the United States

A U.S. lawyer normally will be able to give an opinion that under the Covered Law a court in the Covered Law State will give effect to a forum selection clause permitting suit to be brought in a named court in a non-U.S. jurisdiction named in a cross-border agreement.[99] The opinion means that the Covered Law does not prohibit a U.S. party represented by the opinion giver from consenting to the jurisdiction of the named court and that conditions imposed by the Covered

[97] *See generally* Yackee, *supra* note 94, at 50–56. Formal conditions for validity, which may include the form, content, or location of the forum selection clause, are not uncommon outside the United States. *See, e.g.*, Brussels Regulation, *supra* note 86 (establishing four specific "forms" in which forum selection agreements must be made, which the European Court of Justice has suggested should be strictly construed); Code de procédure civile [C.P.C.][Civil Procedure Code] art. 48 (Fr.) (requiring forum selection clause to be specified in an instrument signed by the party against whom enforcement is sought and specification to be "very apparent"); Cour de casation [Cass.] [supreme court for judicial matters] com., Feb. 27, 1996, Rev. Critique Droit Int'l 'Privé 1996, 734 (French court finding invalid forum selection clause printed in very small type on back of first page of contract); Bundesgerichtshof [BGH] [Federal Court of Justice] Feb. 22, 2001 (Ger.) (German Supreme Court finding forum selection clause included in loan guarantee form invalid because not physically signed by borrower). Contrary to the law of many U.S. states and European Union law, the law of some jurisdictions may provide that forum selection clauses are unenforceable in principle or valid only under limited circumstances. In addition, in some civil law countries to be valid certain categories of contracts must be executed in the presence of a notary public acting, depending on the circumstances, as a witness or as a public official.

[98] *See supra* text accompanying note 17. In particular, the opinion does not address whether a court outside the Covered Law State, whether in another U.S. state or in a jurisdiction outside the United States, would have personal or subject matter jurisdiction, because those issues would not be governed by the Covered Law. Non-U.S. parties may request an opinion that a U.S. party has the corporate power to agree to a forum selection clause choosing a court outside the United States and that the agreement has been duly authorized, executed, and delivered by the U.S. party. *See infra* text accompanying notes 168–71.

[99] The opinion could be worded as follows:

> *The Company's agreement in Section __ of the Agreement to submit to the non-exclusive jurisdiction of the courts of [FOREIGN LAW COUNTRY] is valid and enforceable under the law of [COVERED LAW STATE] for actions relating to contract claims arising under the Agreement.*

If a forum selection clause names U.S. federal courts, the opinion letter should cover U.S. federal law expressly, at least for the purposes of this opinion.

Law, if any, on the U.S. party's agreement to be sued in the named non-U.S. jurisdiction have been met. The opinion does not mean that a court in the Covered Law State would be bound by a decision of a named non-U.S. court if the non-U.S. party later brings an action in the Covered Law State to have a foreign judgment enforced.[100]

As a matter of U.S. customary practice, the opinion is understood not to cover specialized federal or state statutes, rules, or regulations that may prohibit or restrict commerce with jurisdictions outside the United States in which a named court is located, unless they are addressed expressly.[101] The opinion also does not address the effectiveness of the submission by the opinion giver's client to the jurisdiction of the named non-U.S. court under the Chosen Contract Law or the Selected Forum Law, which are covered by the Omnibus Cross-Border Assumption. Thus, the opinion provides a non-U.S. recipient comfort only on the narrow legal issue that the Covered Law does not shield the opinion giver's client from its agreement to be sued by the recipient in a named court located outside the United States.

III-4.1.3.2 Permissive Clauses Naming Courts in the United States

A U.S. lawyer ordinarily will be able to give an opinion that under the Covered Law a court in the Covered Law State will give effect to a permissive forum selection clause naming courts in the Covered Law State. The opinion means that the clause is enforceable against the parties because they submitted voluntarily to the jurisdiction of courts in the Covered Law State, even though the agreement requires those courts to apply the law of another country in resolving the dispute.[102] If the clause names a U.S. federal court as one of the courts where the parties may bring suit, the opinion means that the named federal court

[100] *See infra* notes 136–37 and accompanying text. Opinions on the recognition and enforcement of foreign judgments are discussed in Part III-4.2. Grounds on which a U.S. court can refuse to recognize and enforce a foreign judgment include the foreign judicial system's not providing for impartial tribunals or having procedures incompatible with basic due process of law and questionable integrity of the court rendering the judgment in the specific case. The opinion preparers cannot make a professional judgment regarding any of these matters. *See also* IBA Report, *supra* note 2, at 194, 279.

[101] *See infra* text accompanying notes 185–95. A number of U.S. statutes, rules, and regulations, mostly federal, that rarely apply to domestic U.S. transactions apply to similar cross-border transactions because non-U.S. parties are involved or because performance is to occur outside the United States. For example, the Office of Foreign Asset Control (OFAC) within the U.S. Treasury Department manages sanctions and trade restrictions with particular countries and parties pursuant to the International Emergency Economic Powers Act (50 U.S.C. § 1701 *et seq.*), the National Emergencies Act (50 U.S.C. § 1601 *et seq.*), and other similar statutes (*see, e.g.*, OFAC regulations regarding Syria, 31 C.F.R. pt. 542, and OFAC's Specially Designated Nationals List of persons and entities with whom, and with whose affiliates, U.S. citizens are not permitted to conduct business).

[102] The opinion could be worded as follows:

> *The Company's agreement in Section __ of the Agreement to submit to the non-exclusive jurisdiction of the courts of [COVERED LAW STATE] [and United States federal courts] is valid and enforceable under the law of [COVERED LAW STATE] [and the federal law of the United States] for actions relating to contract claims arising under the Agreement.*

If a forum selection clause names U.S. federal courts, the opinion letter should cover U.S. federal law expressly, at least for the purposes of this opinion.

also will give the clause effect under the Federal Rules of Civil Procedure. While many opinion givers do not take an exception for the possible lack of federal subject matter jurisdiction, some do.[103]

Giving an opinion on the enforceability of a permissive inbound forum selection clause in an agreement choosing the law of a jurisdiction outside the United States as its governing law requires the opinion preparers to be satisfied that under the Covered Law the named courts of the Covered Law State would have personal jurisdiction over the parties and subject matter jurisdiction over the matters covered by the clause.[104] The opinion preparers also must be satisfied that the Covered Law does not prevent the opinion recipient, by reason of its status as a non-U.S. person, from bringing suit in the named court in the Covered Law State as a procedural matter.[105] The opinion does not, however, cover

[103] *See generally TriBar Remedies Opinion Report*, *supra* note 19, at 1499 n.78 (when a forum selection clause permits but does not require an action to be brought in federal court, many lawyers do not take an exception for the possible lack of federal subject matter jurisdiction. Some, however, do. Both practices are common.) The opinion preparers cannot know the facts and circumstances of a future suit when they give the opinion and therefore cannot predict whether requirements for federal court jurisdiction will be satisfied. See also *supra* note 77 for a discussion of venue.

[104] *See TriBar Remedies Opinion Report*, *supra* note 19, at 1499. The personal and subject matter jurisdiction of a named court of the Covered Law State is governed by the Covered Law not the Chosen Law. Therefore, the analysis the opinion preparers are required to conduct is the same as the analysis required to give an opinion on the enforceability of an agreement governed by the Covered Law that contains a permissive forum selection clause (unless coverage of the clause is excluded from that opinion). The opinion is based on the facts as of the date of the opinion letter, and the opinion letter need not point out that the jurisdictional requirements may no longer be satisfied when suit actually is brought. *TriBar Remedies Opinion Report*, *supra* note 19, at 1499 & n.76; *see also* GLAZER TREATISE, *supra* note 10, at 387; Gruson, *Forum Selection*, *supra* note 78, at 136–37.

Even if the forum selection clause is not accompanied by an express consent of the parties to personal jurisdiction, U.S. courts ordinarily deem that consent implicit. Some states, however, require the parties or the transaction to have sufficient contacts with that state. *See, e.g.*, McRae v. J.D./M.D., Inc., 511 So. 2d 540 (Fla. 1987) (forum selection clause alone not sufficient to establish personal jurisdiction absent some minimum contacts or long-arm statute). In those states the opinion preparers must either expressly assume or satisfy themselves that there are sufficient contacts for the named court to take the case. That may be a concern in cross-border transactions if the parties choose the named state court even though neither they nor the transaction have any relationship with that state.

Normally, the requirement of subject matter jurisdiction is satisfied if the named state court is a court of general jurisdiction. *TriBar Remedies Opinion Report*, *supra* note 19, at 1499 & n.78 (if a clause specifies a particular type of court, such as, for example, the Delaware Chancery Court, the opinion preparers must determine whether the disputes covered by the clause are within that court's subject matter jurisdiction, because the parties cannot by contract confer subject matter jurisdiction on a specialized court).

Some states, such as New York and California, have enacted statutes expressly validating forum selection clauses for transactions above a specified size if the clause selects the courts of that state as the forum for resolving disputes *and* the agreement containing the clause chooses the law of that state as its governing law. Some statutes also provide that the parties are deemed to have waived the right to assert the doctrine of *forum non conveniens*. Such statutes, however, do not apply to an agreement that chooses the law of another state or country as its governing law.

[105] Thus, the opinion provides comfort to the non-U.S. recipient that it would not face automatic dismissal if it were to bring suit in a court in the Covered Law State named in the agreement, as would be the case, for example, in countries whose law prohibits private parties from voluntarily electing to sue or be sued in their courts. The Covered Law State also may have other requirements that the opinion recipient must satisfy to bring suit there, such as, for example, being qualified to do business in the state. If those requirements relate to the opinion recipient, the opinion does not cover them.

issues other than jurisdiction that may impair the ability of the recipient to maintain an action in the Covered Law State, such as a failure to qualify to do business there when otherwise required to initiate suit.[106] If the agreement includes a waiver of the doctrine of *forum non conveniens*, the opinion also covers the effectiveness of the waiver, absent an express exception. If the agreement does not include such a waiver, the opinion does not cover the possible refusal of the named court to hear the case based on the application of that doctrine.[107]

When an agreement contains a permissive forum selection clause, different parties may bring suit in different courts over the same disputed matter. An opinion on a permissive forum selection clause does not address whether a court in the Covered Law State would grant a motion to dismiss or stay the case if one party has brought suit in that court and another party has brought suit with regard to the same disputed matter in another court.[108]

III-4.1.4 Opinions Addressing Mandatory Forum Selection Clauses

III-4.1.4.1 Mandatory Clauses Naming Courts Outside the United States

To give an opinion on the effectiveness under the Covered Law of a mandatory forum selection clause naming a non-U.S. court as the exclusive forum for resolving disputes, the opinion preparers need to satisfy themselves that, if the U.S. party they represent sues the other party in a court in the Covered Law State in violation of the agreement, the court will decline to consider the merits of the case.[109] Although state law varies, most U.S. states have adopted the so-called modern view that forum selection clauses will be given effect unless doing so would be unfair or unreasonable or violate a strong public policy of the state.[110] Some U.S. states, however, adhere to an older view that courts are gen-

[106] *See, e.g.*, Credit Suisse Int'l v. Urbi, DeSarrollos Urbanos, S.A.B. de C.V., 971 N.Y.S.2d 177 (Sup. Ct. 2013) (foreign corporation doing business in New York without qualifying to do so prohibited from bringing suit there even if New York law prevents the defendant, who agreed to inbound forum selection clause, from asserting that New York courts are inconvenient or lack jurisdiction).

[107] *TriBar Remedies Opinion Report*, *supra* note 19, at 1501 (permissive clause does not foreclose suit elsewhere or prevent application of doctrine of *forum non conveniens* (absent waiver); thus opinion does not mean that a party may not bring suit in another court or that named court will hear case). Although not required, in the absence of a waiver, some opinion preparers state expressly that the named court may decline to hear the case on the grounds that it is an inconvenient forum.

[108] Whether the court would grant the motion may depend on which suit was brought first (*lis alibi pendens* rule), the convenience of the parties, witnesses, or the court (absent a waiver of *forum non conveniens*), or other priority/ordering considerations that cannot be known by the opinion preparers when they give the opinion.

[109] When a party to an agreement brings suit in a court that is not named in a mandatory forum selection clause, that court typically enforces the clause by granting the other party's motion to dismiss or stay the proceedings, thus requiring the plaintiff, if it wishes to pursue the action, to bring a new suit in the named court.

[110] *See TriBar Remedies Opinion Report*, *supra* note 19, at 1501 & n.84 (as interpreted by the courts, for enforcement to be unfair or unreasonable, a judicial determination is required that "enforcement of the clause would be so unreasonable and unjust as to make a trial in the selected forum so gravely difficult and inconvenient that the challenging party would, for all practical purposes, be deprived of his or her day in court").

erally free to determine for themselves whether to take jurisdiction over cases brought before them based on a variety of discretionary factors, without giving meaningful weight to the parties' contractual choice.

III-4.1.4.2 *Bremen* and the Modern View

The modern view was adopted in the cross-border context by the U.S. Supreme Court in 1972 in *M/S Bremen & Unterweser Reederel, GmbH v. Zapata Off-Shore Co.*[111] In *Bremen* the Court held[112] that a forum selection clause is presumptively effective and should not be set aside unless the party challenging it makes a strong showing that: (i) enforcement would be unreasonable and unjust; (ii) the clause is invalid for such reasons as fraud or overreaching, undue influence, or abuse of bargaining power; or (iii) giving effect to a forum selection clause when it would require the case to be dismissed in favor of another court will result in the enforcement by that other court of a contractual provision that would contravene a strong public policy of the jurisdiction where suit is brought, whether declared by statute or by judicial decision.[113] This Report

[111] 407 U.S. 1 (1972). Prior to 1972 U.S. courts considered agreements selecting foreign courts as the exclusive forum for resolving disputes involving a U.S. party to be an impermissible ouster of their jurisdiction. *Bremen* marked the U.S. Supreme Court's rejection of the "*per se* invalidity" rule in favor of a "*prima facie* validity" rule. The over forty years since the *Bremen* decision have witnessed a sea change in the willingness of U.S. courts to enforce mandatory forum selection clauses in cross-border agreements. *See generally* Yackee, *supra* note 94, at 47–50, 64–67. The following *dicta* in *Bremen* is often quoted by U.S. courts: "The expansion of American business and industry will hardly be encouraged if, notwithstanding solemn contracts, we insist on the parochial concept that all disputes must be resolved under our laws and in our courts. . . . The elimination of all such uncertainties by agreeing in advance on a forum acceptable to both parties is an indispensable element in international trade, commerce and contracting." *See Bremen*, 407 U.S. at 9, 14. In *Phillips v. Audio Active Ltd.*, 494 F.3d 378, 383–84 (2d Cir. 2007), the U.S. Court of Appeals for the Second Circuit adopted a four-part analysis for determining the validity and enforceability of a forum selection clause in a cross-border agreement: (1) Was the clause reasonably disclosed to the resisting party? (2) Is the clause mandatory or permissive? (3) Does the clause extend to the claims involved in the suit? and (4) Has the *Bremen* presumption been rebutted? Some aspects of the *Bremen* exception are factual in nature, for example whether consent was coerced or otherwise invalid. Others are legal or equitable, for example, whether a strong public policy is implicated.

[112] Although *Bremen* was decided under federal admiralty and maritime jurisdiction, it expresses the prevailing view in the United States on the issue of ouster. Recently the U.S. Supreme Court held, in a diversity jurisdiction case, that clauses choosing a particular federal court as the exclusive forum for resolving disputes are presumptively enforceable under the Federal Rules of Civil Procedure. Atl. Marine Constr. Co. v. U.S. Dist. Court for the W.D. of Texas, 134 S. Ct. 568, 581 (2013) (when an agreement contains a forum selection clause and an action is brought in federal court, in all but the most unusual cases the interest of justice is served by holding parties to their choice of forum). When a mandatory forum selection clause names the courts of a particular state and an action is brought in those courts, those courts will apply their state's law in determining the enforceability of the forum selection clause. Many state courts follow *Bremen*.

[113] The public policy ground only comes into play when the court considering whether to enforce a mandatory forum selection clause is not a named court. Thus, it applies when a court that is not named is asked to dismiss a suit brought in that court in violation of the forum selection clause. In *Atlantic Marine* the Court held that when a party to an agreement has violated a contractual obligation by filing suit in a court other than the one named in a valid mandatory forum selection clause, "[that court's] dismissal would work no injustice on the plaintiff" even though, as a result of the running of a statute of limitations or otherwise, the plaintiff is unable to pursue its action in the named court. *Id.* at 582–84. The court noted that claiming that a suit was brought in violation of a mandatory forum selection clause is different from claiming *forum non conveniens*, where the burden is on the

refers to these grounds collectively as the "*Bremen* exception." To protect identified classes of contracting parties from exploitative contractual terms, some states have adopted statutes codifying specific non-waivable public policy rules that the courts of those states often treat as exceptions to the enforceability of mandatory forum selection clauses naming courts in other states or countries.[114]

If the Covered Law State has adopted the modern view, an opinion normally can be given that under the Covered Law a court in the Covered Law State will give effect to a mandatory outbound forum selection clause when the agreement chooses the law of a jurisdiction outside the United States as its governing law[115] and names a court in that or another jurisdiction outside the United States as the exclusive forum for resolving disputes.[116] Different states, however, have

party seeking to move the case to a different court because of the potentially harsh results of dismissal. *Id.* at 580–81; *see, e.g.*, Sinochem Int'l v. Malaysia Int'l Shipping Corp., 549 U.S. 422, 430 (2007); Norwood v. Kirkpatrick, 349 U.S. 29, 39 (1955).

Although a key issue in *Bremen* was whether giving effect to a forum selection clause choosing English courts would violate a U.S. policy of not enforcing exculpation provisions in some situations, U.S. courts generally are reluctant to apply the public policy exception to deny enforcement of a forum selection clause in agreements between sophisticated commercial parties. *See* Yackee, *supra* note 94, at 48–49, 79–83, 95 & n.276; *see also* Yackee, *supra* note 94, at 81 & n.202 (observing that, to deflect criticism of the *Bremen* exception as "unmanageably elastic" and "muddled and ambiguous," courts apply it only when strong public policies are involved).

[114] *See, e.g.*, Jones v. GNC Franchising, Inc., 211 F.3d 495, 495 (9th Cir. 2000) (refusing to enforce mandatory forum selection clause choosing Pennsylvania courts, because to do so would contravene "strong public policy to protect California franchisees from expense, inconvenience, and possible prejudice of litigating in non-California venue" as articulated by California franchising statute); Verdugo v. Alliantgroup, L.P., 237 Cal. App. 4th 141 (2015) (holding forum selection clause unenforceable because it would operate as a waiver of unwaivable California Labor Code right in violation of California public policy); *but see* Brooks v. Sotheby's, No. 13-CV-02183 RS, 2013 WL 3339356 (N.D. Cal. July 1, 2013) (mandatory forum selection clause given effect because plaintiff did not show English courts would not provide same or equivalent remedies, despite California public policy against waiving claims under consumer protection statute). In some states the modern view is codified in a statute, while in many others it has been adopted in judicial decisions.

[115] For the same reasons separate opinions on the effectiveness of forum selection clauses normally are not requested or given in domestic U.S. transactions, they normally are not requested or given in cross-border transactions when the agreement chooses the Covered Law as its governing law: in those situations, absent an express exception, an opinion that the agreement is valid, binding, and enforceable under the Covered Law covers the effectiveness of the forum selection clause. *See supra* text accompanying note 74. If a forum selection clause names a U.S. federal court in the Covered Law State, the opinion letter should cover U.S. federal law expressly, at least for purposes of this opinion.

[116] The opinion could be worded as follows:

> *The Company's agreement in Section __ of the Agreement that the courts of [FOREIGN COUNTRY] shall have exclusive jurisdiction is valid and enforceable under the law of [COVERED LAW STATE] for actions relating to contract claims arising under the Agreement.*

For sample wording of a qualification regarding the possible application of the *Bremen* exception, see *infra* note 120.

Opinion givers may need to consider whether an exception is necessary when a forum selection clause expressly covers not only disputes arising under the agreement, but also claims arising in tort and disputes involving extra-contractual claims relating to the transaction broadly. This type of clause appears most frequently in agreements with parties from EU member countries because Council Regulation (EC) 864/2007 (Law Applicable to Non-Contractual Obligations) art, 14, 2007 O.J. (L 199) 40, 46 [hereinafter Rome II Regulation], governing choice of law by EU courts in non-contractual (e.g., tort) matters, specifically allows the parties to provide in their agreement that the law that governs the agreement also applies to non-contractual causes of action; the same construct extends to forum selection under the Rome II Regulation. Depending on the law of the speadopted different versions of the modern view, and some versions may lead the opinion preparers to question whether the state whose law they are covering has, in fact, adopted the modern view. Thus, the opinion preparers need to tailor their opinion to the specifics of the Covered Law. Even if the opinion does not expressly refer to the *Bremen* exception, an opinion on the effectiveness of a mandatory forum selection clause, whether or not it names a U.S. court, is understood as a matter of U.S. customary practice not to cover the possibility that a court, applying the *Bremen* exception, will decline to give the clause effect.[117]

When giving an opinion on the effectiveness of a mandatory outbound forum selection clause, the opinion preparers need to consider whether to refer expressly to the *Bremen* exception. In domestic U.S. transactions, the forum selection clause, which normally names a court in the Covered Law State, is covered by an opinion on the enforceability of the entire agreement under the Covered Law (which also is the Chosen Law when an enforceability opinion is given on the entire agreement).[118] In cross-border transactions, however, a forum selection clause often names the courts of a jurisdiction other than the Covered Law State when it is included in an agreement that does not choose the Covered

cific state, a U.S. court may be unwilling to defer to the parties' choice of forum for extra-contractual disputes, with the court's determination often turning on whether the claims are intertwined with, or dependent upon the construction of, the parties' contractual relationship. *See, e.g.,* Lambert v. Kysar, 983 F.2d 1110, 1121 (1st Cir. 1993) (refusing effort to evade enforcement of forum selection clause through artful pleading of tort claim in context of contract dispute); Coastal Steel Corp. v. Tilghman Wheelabrator Ltd., 709 F.2d 190, 203 (3d Cir. 1983) (pleading of alternative non-contractual theories of liability does not prevent enforcement of forum selection clause when relationship is contractual), *overruled on other grounds,* 490 U.S. 495 (1989); Ashall Homes Ltd. v. Rok Entm't Grp., Inc., 992 A.2d 1239, 1248 (Del. 2010) (in policing boundary between contract and tort, court should consider extent to which tort claims relate to contractual relationship or hinge on contract's scope). Depending on the law of the specific state, when tort claims are involved a U.S. court may decide that the law of the place where the claim arose, e.g., where the wrongful conduct took place or harm occurred, must be applied by a court in that jurisdiction, rather than deferring to the parties' agreement as to a different governing law and forum. In some states, courts may focus instead on the intent of the parties with respect to the scope of the forum selection clause, thus being willing to broadly enforce the clause in a manner similar to what the Rome II Regulation requires if, for example, the language of the agreement provides that "all disputes arising out of or relating to the contract or the relationships formed thereby, including statutory claims and related tort claims," are covered by the clause.

[117] A court will apply the various prongs of the *Bremen* exception based on the nature of the claims made by the parties and the facts and circumstances at the time of the dispute, none of which the opinion preparers can ascertain when the opinion is given.

[118] While the analysis is the same in domestic U.S. transactions as in cross-border transactions, the limited impact in domestic U.S. transactions of the *Bremen* exception is so well understood that many U.S. lawyers do not expressly refer to it when giving enforceability opinions. *See TriBar Remedies Opinion Report*, *supra* note 19, at 1501 & n.87, 1502 & nn.88–89. The TriBar report, however, only addresses opinions on the enforceability of agreements, including forum selection clauses in those agreements, that choose as their governing law the law covered by the opinion. The TriBar report does not address an opinion that is directed specifically at the effectiveness under the Covered Law of a forum selection clause in an agreement that is not governed by the Covered Law. The TriBar report therefore does not consider the desirability of including in that opinion an express reference to the *Bremen* exception. It also points out that the practice of not referring to the *Bremen* exception even in the opinions it does address is not universal, with some lawyers pointing out the possible application of the *Bremen* exception.

Law as its governing law. When the named court is not in the Covered Law State and the Chosen Law is not the Covered Law, a court applying the Covered Law may decline to give a mandatory forum selection clause effect not only on the basis of the first two prongs of the *Bremen* exception, but also on the basis of the third—strong public policy—prong.[119] Nevertheless, as in domestic U.S. transactions, an opinion on the effectiveness of a mandatory outbound forum selection clause is understood, as a matter of U.S. customary practice, not to cover the possibility that a court will decline to give the clause effect on the basis of the third prong of the *Bremen* exception as well as the first two. Because of the greater likelihood that the *Bremen* exception, particularly the public policy prong, will apply in cross-border transactions and because non-U.S. recipients are less likely than U.S. recipients to be familiar with the *Bremen* exception, this Committee recommends that an express reference to the *Bremen* exception be included in opinion letters containing opinions on mandatory forum selection clauses naming courts outside the United States.[120]

While the opinion only covers issues governed by the Covered Law, the effectiveness of a mandatory forum selection clause also depends on matters governed by the non-U.S. Chosen Law such as the validity of the agreement as a whole and

[119] As a practical matter the opinion preparers cannot be expected to determine whether a U.S. court will decline to give effect to a mandatory outbound forum selection clause on the basis of the third prong of the *Bremen* exception because that determination requires knowledge they cannot be expected to have of how the named court would go about enforcing each obligation of the opinion giver's client in the agreement containing the clause.

[120] *See supra* text accompanying note 113. The reference could be worded as follows:

> *The opinion in numbered paragraph __ is limited to the extent that a court may decline to give effect to the forum selection clause in Section __ of the Agreement because enforcement would be unreasonable or unjust under the principles enunciated in the decision of the U.S. Supreme Court in M/S* Bremen & Unterweser Reederel, GmbH v. Zapata Off-Shore Co., *402 U.S. 1 (1972) and in related cases, including that it would contravene a strong public policy of [COVERED LAW STATE].*

If the opinion letter contains an opinion on the enforceability of the forum selection clause but not of the governing law clause, the opinion preparers should consider including in the opinion letter an express assumption that the choice of non-U.S. law as the governing law of the agreement will be given effect under the Covered Law. One could argue that the assumption is technically unnecessary because, if the forum selection clause is mandatory, it names a non-U.S. court, and a court in the Covered Law State gives the clause effect, no court in the Covered Law State would have the opportunity to consider independently the merits of the case and, therefore, to reach the choice-of-law issue. *See, e.g.*, Gruson, *Forum Selection*, *supra* note 78, at 191 (once parties to agreement validly agree that foreign forum should adjudicate disputes, it is difficult to see what legitimate concern an excluded forum in which suit was brought would protect by deciding choice-of-law question). As discussed earlier, however, to decide that a mandatory outbound forum selection clause is effective, a court in the Covered Law State applying the Covered Law first must give effect to the choice of the Chosen Law Country's law in the agreement. *See supra* notes 93–96 and accompanying text. Absent a choice-of-law opinion, assuming that a court in the Covered Law State would give effect to the choice-of-law clause will eliminate any risk that an opinion on the effectiveness of a forum selection clause naming courts in the Chosen Law Country could be interpreted as including an implicit, unqualified opinion that a court in the Covered Law State also will give effect to the choice of the Chosen Law Country's law. Not all U.S. lawyers see a need to include this assumption, instead wording the Omnibus Cross-Border Assumption in a way that addresses the choice-of-law issue. *See supra* note 17 and accompanying text.

the enforceability of the clause itself.[121] These matters, however, are covered by the Omnibus Cross-Border Assumption, whether stated or not, and, therefore, need not be addressed specifically in the opinion letter.[122]

A court in the Covered Law State may only be willing to decline jurisdiction over the case if it is satisfied that the named non-U.S. court will give effect to the parties' choice of forum and hear the case if suit is brought in that court; otherwise the parties might not have *any* forum in which to resolve their dispute. These and other procedural matters ordinarily will be governed by the law of the jurisdiction where the named court is located (*lex fori*). Therefore, an opinion on a mandatory forum selection clause naming a court outside the United States must be based on an assumption that the named court will recognize the parties' submission to its jurisdiction and decide the merits of the claims being made. As with other issues governed by non-U.S. law, such as the formation, validity, and interpretation of the contract, the personal and subject matter jurisdiction of the named court is covered by the Omnibus Cross-Border Assumption.[123]

To conclude, an opinion on the effectiveness of a mandatory forum selection clause naming a court outside the United States provides comfort to the non-U.S. recipient that courts in the Covered Law State will defer to the parties' choice of the named court as the exclusive forum for resolving disputes.[124] This deference is particularly important for non-U.S. parties who want not only the Chosen Law to govern but also the courts of the Chosen Law Country to be the only courts that can resolve disputes relating to the agreement (for example because of their

[121] This is the same as for opinions on the effectiveness of permissive forum selection clauses. *See supra* text accompanying notes 99–101.

[122] *See supra* text accompanying note 17. Typically a non-U.S. party will want comfort from a U.S. lawyer that a U.S. party has the corporate power to agree that a non-U.S. court will be the exclusive forum under the agreement. That issue is covered by the standard opinion on due authorization, execution, and delivery of the agreement under the Covered Law. *See infra* text accompanying notes 168–72.

[123] *See supra* note 17. The last sentence of the illustrative Omnibus Cross-Border Assumption covers this issue not only under the Chosen Law but also under the *lex fori* so as to address the possibility that the court named in the forum selection clause is in a jurisdiction other than the Chosen Law Country.

[124] This conclusion is consistent with the modern view, which requires a court to give substantial weight to the parties' choice of courts. A non-U.S. recipient whose goal is not to be exposed to the risk of litigation in U.S. courts often seeks comfort on this issue because in many countries, instead of deferring to the parties' choice of forum, a court decides whether to take a case by applying broad discretionary standards such as reasonableness, fairness, the extent of contacts with the parties and the transaction, the burden on the court, and the convenience of the parties or the witnesses. *See generally* Haver, *supra* note 96, at 2–3. The opinion also gives a non-U.S. recipient comfort that, in drafting the forum selection clause, it does not have to satisfy special form requirements imposed by the Covered Law, such as capitalized, special, or bold-face type, a specific placement within the agreement, or special signing formalities. If the Chosen Law imposes such form requirements, the Omnibus Cross-Border Assumption covers them. In addition, the opinion could be important to a non-U.S. recipient because the validity under the Covered Law of the submission by a U.S. party to the exclusive jurisdiction of a non-U.S. court may be relevant to the enforcement of the clause by the named non-U.S. court. *See generally* Michael Gruson, *Controlling Site of Litigation*, *in* SOVEREIGN LENDING: MANAGING LEGAL RISK 29, 35–36 (Michael Gruson & Ralph Reisner eds., 1984). The opinion also supports a conclusion that a judgment obtained in the named non-U.S. court will be recognized and enforced by courts in the Covered Law State, as discussed in Part III-4.2.

expertise in applying the Chosen Law). As discussed above, a U.S. lawyer usually will be able to give the opinion when the Covered Law State has adopted the modern view, but, whether or not the opinion letter so states expressly, the opinion is subject to the *Bremen* exception and the Omnibus Cross-Border Assumption.

III-4.1.4.3 Mandatory Clauses Naming Courts in the United States

In the unusual case in which a cross-border agreement that does not choose U.S. law as its governing law selects courts in the Covered Law State as the exclusive forum for resolving disputes relating to the agreement, a U.S. lawyer ordinarily can give an opinion that under the Covered Law the mandatory inbound forum selection clause will be given effect.[125] The opinion means that the clause is enforceable against the parties because they submitted voluntarily to the jurisdiction of the named courts in the Covered Law State, even though those courts will be applying the law of another country in resolving the dispute.[126] The opinion does not cover issues other than jurisdiction that may prevent the recipient from maintaining an action in the named courts of the Covered Law State, such as the opinion recipient's failure to qualify to do business in the Covered Law State when otherwise required.[127] The opinion does not cover venue.

Prior to 2013, federal law was unclear as to how much deference a U.S. federal court was required to give a mandatory forum selection clause if suit was brought in a federal court other than the named court. The U.S. Supreme Court clarified the law in *Atlantic Marine*,[128] holding that, so long as the federal

[125] The opinion could be worded as follows:

> *The Company's agreement in Section __ of the Agreement that the courts of [COVERED LAW STATE] [and United States federal courts] shall have exclusive jurisdiction is valid and enforceable under the law of [COVERED LAW STATE] [and the federal law of the United States] for actions relating to contract claims arising under the Agreement.*

[126] Some states, however, require the parties or the transaction to have sufficient contacts with the state for a court in the state to take a case. *See generally supra* note 104 and accompanying text. The fact that a named court in the Covered Law State will be required to apply the law of another country will not prevent it from taking jurisdiction and deciding the case. *Cf.* Cambridge Biotech Corp. v. Pasteur Sanofi Diagnostics, 740 N.E.2d 195 (Mass. 2000) (upholding parties' choice of French courts as forum for resolving disputes arising under agreement that chose Massachusetts law to govern, even though result was that Massachusetts law would be applied by French courts). If the clause specifies a U.S. federal court as the exclusive forum, the opinion preparers need to consider federal rules governing subject matter and personal jurisdiction. *See supra* note 103 and accompanying text.

[127] *See, e.g.*, Credit Suisse Int'l v. Urbi, DeSarrollos Urbanos, S.A.B. de C.V., 971 N.Y.S.2d 177 (Sup. Ct. 2013); *supra* text accompanying note 106.

[128] *See supra* note 77. Under federal venue rules, (i) if an action is commenced in the named federal district court, in most cases that court will have venue under 28 U.S.C. § 1391 by reason of the parties' express consent to be sued there; (ii) if an action is commenced in a federal district court other than the named federal district court and that other court does not have venue under § 1391, pursuant to 28 U.S.C. § 1406 the case can be transferred to the named court; and (iii) if an action is commenced in a federal district court other than the named federal district court, even if that other court has venue under § 1391 a party can request transfer of the case to the named court in reliance on the U.S. Supreme Court's holding in *Atlantic Marine* that "§ 1404 permits transfer to any district where venue is also proper . . . or to any other district to which the parties have agreed by contract [. . . because] the federal venue statute is not the right set of rules to deal with

courts have jurisdiction under federal law, federal courts are required to give controlling weight to the parties' choice of the named court as the exclusive forum in all but the most exceptional cases.[129]

III-4.2 Recognition and Enforcement of Foreign Judgments in the United States

Because the non-U.S. parties to a cross-border agreement may obtain a judgment for breach of the agreement outside the United States but then have to enforce the judgment in the United States (where the U.S. party's assets are located),[130] they may request an opinion that courts in the Covered Law State will recognize and enforce[131] judgments obtained in non-U.S. courts without a rehearing on the merits of the case.[132] As discussed below, a U.S. lawyer usu-

mandatory forum selection." Atl. Marine Constr. Co. v. U.S. Dist. Court for the W.D. of Texas, 134 S. Ct. 568, 574 (2013). Thus, as a practical matter venue should not be a concern for non-U.S. parties when the agreement requires that suit be brought only in a specified federal district court. If asked, however, a U.S. lawyer typically will not be in a position to give an opinion covering federal venue rules. *See supra* note 77. Many opinion givers have continued the pre-*Atlantic Marine* practice of including an express exception for the federal venue rules in their opinion letters.

[129] *See supra* note 112. In *Atlantic Marine* the Court stated that a refusal to transfer the case to the federal district court named in a mandatory forum selection clause is "conceivable," but "will not be common" and requires "extraordinary circumstances unrelated to the convenience of the parties." *Atl. Marine Constr. Co.*, 134 S. Ct. at 581–82. Contrary to the wide discretion federal courts generally have under 28 U.S.C. § 1404(a) to allocate venue within the federal system, under *Atlantic Marine* a federal district court in which suit was brought in violation of the agreement cannot consider the convenience of the court, parties, or witnesses and must transfer the case to the named federal district court. According to the U.S. Supreme Court, the same standard would apply to mandatory forum selection clauses naming state courts even though in that situation a federal court cannot transfer the case to the named state court and instead must dismiss it.

[130] A non-U.S. party often will seek to enforce an agreement that chooses non-U.S. law as its governing law in the courts of the non-U.S. jurisdiction whose law is chosen. If, however, the U.S. party's assets or operations are in the United States, the non-U.S. party may need a U.S. court to enforce a judgment it has obtained outside the United States.

[131] Recognition and enforcement are related but distinct concepts. Recognition of a foreign judgment means that a U.S. court accepts the determination of legal rights and obligations made by the non-U.S. court that decided the case on its merits. Enforcement involves the use of legal process in the United States to require the losing party to comply with the judgment of the foreign court. Recognition is a prerequisite to enforcement.

[132] For many years enforcement of foreign judgments in the United States was solely a common law issue, with the U.S. Supreme Court's decision in *Hilton v. Guyot*, 159 U.S. 113 (1895), as the leading authority. Today, however, state statutes or state court decisions provide the applicable legal framework. The Hague Convention (which is discussed in Part III-4.3) is the first international treaty signed by the United States on this subject but has not yet become effective. If and when it does and is ratified by the U.S. Senate, it will govern many judgments relating to cross-border transactions in which the agreement contains a mandatory forum selection clause. Until then, and even after for judgments relating to agreements that do not contain a mandatory forum selection clause covered by the Hague Convention, state law will continue to govern the enforceability of foreign judgments. In 2005, the American Law Institute completed work on a proposed federal statute that would preempt state law. *See* Am. Law Inst., Recognition and Enforcement of Foreign Judgments: Analysis and Proposed Federal Statute (proposed final draft Apr. 11, 2005), *available at* https://www.ali.org/publications/show/recognition-and-enforcement-foreign-judgments-analysis-and-proposed-federal-statute/. One of the ALI's objectives was to provide a comprehensive uniform regime designed to address concerns about U.S. law frequently voiced by other countries and, thereby, to promote bilateral or multi lateral treaties broader in scope than the Hague Convention.

ally can give this opinion when the Covered Law State has a statute in effect that provides for the enforceability of foreign judgments.[133]

Many U.S. states have adopted a version of the Uniform Foreign-Country Money Judgments Recognition Act (the Uniform Act).[134] The Uniform Act governs the recognition of a judgment by a court of a foreign country that grants or denies recovery of a sum of money,[135] other than for taxes, fines, or domestic support, and that is final, conclusive, and enforceable under the law of that country, unless one of the grounds for nonrecognition specified in the Uniform Act applies. The

[133] The opinion could be worded as follows:

> *To the extent that it relates to contract claims arising under the Agreement, a final and conclusive judgment granting or denying recovery of a sum of money, other than a judgment for taxes, a fine or other penalty, rendered by a court of [FOREIGN COUNTRY] against the Company that is enforceable in [FOREIGN COUNTRY] will be recognized as valid and enforced under the law of [COVERED LAW STATE] by the courts of [COVERED LAW STATE] or by United States federal courts having jurisdiction and applying the law of [COVERED LAW STATE], without a re-examination of the substantive issues underlying the judgment, subject to (i) grounds for non-recognition and exceptions to enforcement set forth in the Uniform Foreign Money-Judgments Recognition Act as adopted in [COVERED LAW STATE] (the "Act") [IF OPINION GIVER WISHES TO REFER TO PARTICULAR EXCEPTIONS FROM THE STATUTE, ADD —, which include, but are not limited to, __________________] and (ii) the court's power to stay proceedings to enforce a foreign judgment pending determination of any appeal or until the expiration of time sufficient to enable the defendant to prosecute an appeal. [IF APPLICABLE IN THE COVERED LAW STATE, ADD—This opinion is based on the assumption that the law of [FOREIGN COUNTRY] requires a court of competent jurisdiction in [FOREIGN COUNTRY], in a reciprocal manner, to recognize and enforce a final and conclusive judgment of a court of [COVERED LAW STATE] without reconsideration of the merits.]*

See IBA Report, *supra* note 2, at 196 (noting that, though of limited value, the opinion is frequently requested because legal requirements vary significantly in number and specificity from country to country (most often including requirements relating to fair and due process, no violation of public policy, and reciprocity)).

[134] Unif. Foreign-Country Money Judgment Recognition Act (Unif. Law Comm'n 2005) [hereinafter Uniform Act]. While establishing minimum standards under which state courts are required to enforce foreign judgments, the Uniform Act leaves courts free to recognize foreign judgments for other reasons applying widely accepted principles of comity. The Uniform Act does not apply to judgments enforcing foreign arbitral awards, because arbitral awards are covered by the FAA. *See supra* notes 40 & 44–46 and accompanying text. Approximately thirty-five states (including California, Delaware, Florida, Illinois, Massachusetts, New York, and Texas) have adopted the Uniform Act (or a prior version with largely similar rules and procedures—the Uniform Foreign Money Judgment Recognition Act of 1962). In other states the case law may or may not provide the opinion preparers a basis for reaching conclusions with the confidence needed to give an unqualified opinion.

[135] When the foreign judgment is expressed in a currency other than U.S. dollars, a U.S. court must also decide how it should be satisfied. Many states have adopted the Uniform Foreign Money Claims Act (Unif. Foreign Money Claims Act (Unif. Law Comm'n 1989) [hereinafter Foreign-Money Claims Act]). That act (1) recognizes the parties' right to select the currency for their transaction and allocate the risk of exchange rate fluctuations; and (2) in the absence of an agreement, codifies the basic principle that the aggrieved party should be restored to the economic position in which it would have been had the breach not occurred. In deciding how a foreign judgment should be satisfied, courts normally apply the so-called "payment day rule" (conversion of foreign currency into U.S. dollars at the exchange rate in effect when the judgment is paid), but alternatively sometimes apply other rules (such as the "breach day rule" or the "judgment day rule"). The Foreign Money Claims Act is intended to promote uniform judicial determination of claims expressed in a foreign currency, thereby reducing forum shopping and uncertainty, and to address related issues such as adjustments to and interest on foreign money claims. An opinion on the recognition and enforcement of foreign judgments under the Uniform Act does not cover currency conversion and related issues.

Uniform Act provides three mandatory grounds for nonrecognition[136] and eight discretionary grounds.[137] With the exception of reciprocity as a condition for recognition of a foreign judgment,[138] the Uniform Act codifies general common law rules of comity.

In states that have adopted a version of the Uniform Act, U.S. lawyers normally can give an opinion that a foreign judgment against the U.S. party they represent will be recognized and enforced by a court applying the Covered Law subject to the prerequisites and exceptions set forth in the version of the Uniform Act enacted in the Covered Law State. Some opinion givers choose to spell out the precise statutory prerequisites or grounds for nonrecognition under the statute, while others limit the opinion's coverage by incorporating the statutory prerequisites and exceptions by reference in the opinion without restating or summarizing them.[139] Whether the opinion so states or not, the opinion does not cover compliance with statutory prerequisites because that determination can be made only after a foreign judgment has actually been rendered.

In states that have not adopted the Uniform Act or a statute to similar effect, the law of comity normally governs the recognition and enforcement of foreign judgments. Depending on the case law in their state, lawyers in those states may or may not be able to give an opinion under the law they are covering that a

[136] They are: (1) the judgment was rendered under a judicial system that does not provide impartial tribunals or procedures compatible with the requirements of due process of law; (2) the foreign court did not have personal jurisdiction over the defendant, except that jurisdiction is deemed established, if the defendant: (i) was served with process personally in the foreign country; (ii) voluntarily appeared other than to contest jurisdiction; (iii) agreed to submit to the jurisdiction of the foreign court; or (iv) had an office in the foreign country (the specified grounds are not exclusive and the forum court may find that the foreign court had personal jurisdiction on some other basis); or (3) the foreign court did not have jurisdiction over the subject matter of the dispute. UNIFORM ACT, *supra* note 134, §§ 4(b), 5.

[137] They are: (1) the defendant did not receive notice of the proceeding in sufficient time to prepare a defense; (2) the judgment was obtained by "extrinsic" fraud on the part of the prevailing party that deprived the losing party of an adequate opportunity to present its case (such as deliberately serving the defendant at the wrong address), as opposed to "intrinsic" fraud (such as false testimony or forged evidence), which is a matter for the foreign court to deal with; (3) the judgment is repugnant to the public policy of the forum state or the United States (a stringent test, requiring clear injury to public health, public morals, or public confidence in the administration of law, as opposed to a mere difference in law, no matter how significant); (4) the judgment conflicts with another final and conclusive judgment; (5) the proceeding in the foreign court was contrary to a valid agreement such as an exclusive forum selection or arbitration clause; (6) judgment was rendered by the foreign court solely on the basis of personal service and the forum court believes that the original action should have been dismissed on grounds of *forum non conveniens*; (7) substantial doubt exists regarding the impartiality or integrity of the specific court that rendered the judgment (such as corruption of the judge); or (8) the specific proceeding leading to the judgment (as opposed to the entire judicial system in the foreign country) was incompatible with the due process of law. UNIFORM ACT, *supra* note 134, § 4(c).

[138] The drafters of the Uniform Act decided, after lengthy debate, not to include a reciprocity requirement, noting that "while recognition of U.S. judgments continues to be problematic in a number of foreign countries, there [is] insufficient evidence to establish that a reciprocity requirement would have greater effect on encouraging foreign recognition of U.S. judgments." UNIFORM ACT, *supra* note 134, prefatory note.

[139] *See supra* note 133.

judgment by a foreign court will be recognized and enforced in the Covered Law State.[140] As a condition of enforcement, some states require that the courts of the foreign country where the judgment was obtained recognize and enforce, in a reciprocal manner, judgments by their state courts. A determination that the reciprocity requirement is met may be difficult or impossible to make without the advice of a lawyer with expertise in the law of the foreign country, and therefore, a U.S. lawyer who is willing to give an opinion may need to rely on an express assumption to that effect.

III-4.3 2005 Hague Convention on Choice of Court Agreements

In 2005 the Hague Conference on Private International Law adopted the Convention on Choice of Courts Agreements (the Hague Convention) with the goal of achieving for mandatory forum selection clauses in cross-border agreements and resulting judgments what the New York Convention achieved for arbitration clauses and resulting awards.[141] The Hague Convention was signed by the United States (subject to Senate consent) on January 19, 2009, and was also signed by Singapore on March 25, 2015, the European Community on April 1, 2009, and Mexico on September 26, 2007.[142] It is expected to be signed in the near future by Argentina, Australia, and Canada, among others. The Hague Convention

[140] In some cases the cost of preparing the opinion may be prohibitive. In other cases only a reasoned or qualified opinion may be possible.

[141] *Convention on Choice of Court Agreements*, Hague Conf. on Priv. Int'l L. (June 30, 2005), http://www.hcch.net/upload/conventions/txt37en.pdf [hereinafter Hague Convention]. This was the culmination of a twenty-five-year process promoted by the United States with the goal of creating a multilateral treaty that would allow litigants to obtain and enforce judgments internationally on a scale comparable to that of the Full Faith and Credit Clause of the U.S. Constitution. Currently parties to cross-border agreements have no assurance that a judgment they obtain in one country will be recognized as final and legally binding by courts in other countries. As discussed in Part III-4.2, U.S. courts generally recognize and enforce foreign judgments under the Uniform Act or principles of comity, typically without a reciprocity requirement. *See supra* text accompanying notes 134–38. The same is not always true for the enforcement of U.S. judgments abroad. *See* Matthew H. Adler & Michele Crimaldi Zarychta, *The Hague Convention on Choice of Court Agreements: The United States Joins the Judgment Enforcement Band*, 27 Nw. J. Int'l L. & Bus. 1 (2007). In the absence of treaties between the United States and other countries on the enforcement of judgments, U.S. judgment creditors must seek enforcement abroad under non-treaty rules, which can be slow, procedurally complex, and uncertain. Moreover courts in some countries may have reservations about fully recognizing and enforcing U.S. judgments because of discomfort with U.S. notions of expansive jurisdiction and some aspects of U.S.-style litigation such as jury verdicts, pre-trial discovery, class actions, contingent fees, and punitive or multiple damages. *Id.* at 7 n.24; *see* Comm. on Foreign & Comparative Law, N.Y. City Bar Ass'n, *Survey of Foreign Recognition of U.S. Money Judgments*, 56 Rec. Ass'n B. City N.Y. 378 (2001), *discussed in* Richard W. Hulbert, *Some Thoughts on Judgments, Reciprocity and the Seeming Paradox of International Commercial Arbitration*, 29 U. Pa. J. Int'l L. 641, 647 (2008). The Hague Convention will give commercial parties greater certainty as to the effectiveness of mandatory forum selection clauses and the enforceability of judgments in signatory countries. Hague Conference on Private Int'l Law, Outline—Hague Choice of Court Convention (2008) [hereinafter Hague Conference Outline], *available at* http://www.hcch.net/upload/outline37e.pdf.

[142] *Status Table, 37: Convention of June 30, 2005 on Choice of Court Agreements*, Hague Conf. on Priv. Int'l L., http://www.hcch.net/index_en.php?act=conventions.status&cid=98#nonmem (last updated Nov. 19, 2010).

came into effect on October 1, 2015.[143] Although commentators expect the U.S. Senate to consent to its becoming effective in the United States, full ratification by the United States likely will be delayed until implementing legislation has been enacted (as was the case with U.S. accession to the New York Convention).[144]

For the Hague Convention to apply to a forum selection clause, the clause must: (1) be agreed to by at least two parties, (2) be in writing or expressed in another acceptable means of communication, (3) designate the courts of one signatory country to the exclusion of all other courts for the resolution of disputes arising under the agreement, and (4) relate to international civil or commercial cases (the Four Hague Prerequisites).[145] The Hague Convention by its terms applies only to mandatory forum selection clauses, but it permits a signatory country to declare that it also will apply to permissive forum selection clauses meeting its other prerequisites.[146] The Hague Convention provides that: (i) the named court must hear the case if the mandatory forum selection clause is effective according to the standards established by the Hague Convention, unless the clause is null and void under the law of the named court's country;[147] and (ii) if a party to the agreement commences an action in a court other

[143] The European Union had exclusive authority to ratify the Hague Convention, which does not have to be signed by individual member countries, except for Denmark, to be binding on them. When the European Union gave its approval on June 1, 2015, enough countries had ratified the Hague Convention for it to become effective for European Union members (other than Denmark) and Mexico. When additional countries will sign and ratify the Hague Convention to make it meaningful for cross-border transactions remains an open question. *See* Hague Conference Outline, *supra* note 141, at 2.

[144] The State Department is working with Congress to determine the best way to implement the Hague Convention. On January 19, 2013, the State Department recommended implementing the Hague Convention in a memorandum that included draft implementing legislation. The memorandum recommended that implementing legislation take the form of a combination of federal and state statutes in what has been referred to as a "cooperative federalism" approach, under which a state could opt out of the federal implementing law and instead enact its version of a uniform act. Although the objective would be for the federal implementing law and the uniform state act to be as similar as possible to ensure consistency throughout the United States, the precise balance between federal and state law on issues the Hague Convention leaves to be determined under the law of each signatory country remains an open question.

[145] Under the Hague Convention a case is not "international" if all parties are from the country where recognition and enforcement is sought and all issues relating to the dispute, other than the location of the named court, involve only that country. Hague Convention, *supra* note 141, art. 1(2). Entities are resident where they were formed, have their statutory seat, or have their headquarters or other principal place of business. Hague Convention, *supra* note 141, art. 4(2).

[146] Hague Convention, *supra* note 141, art. 22. The Hague Convention applies to permissive forum selection clauses only if both the country of the named court that issued the judgment and the country of the court being asked to enforce it have made the optional declaration (reciprocity requirement). If they have, judgments by a court named in a permissive clause will be recognized and enforced if: (1) suit was brought in that court first and (2) a judgment has not already been rendered by another court that also was permitted to hear the case. Hague Convention, *supra* note 141, art. 22. The declaration would also limit the availability of the doctrine of *forum non conveniens*. Commentators see the potential for this optional declaration, if made widely, to increase greatly the impact of the Hague Convention because forum selection clauses in cross-border agreements often name multiple courts on a non-exclusive basis.

[147] Hague Convention, *supra* note 141, art. 5(1). In particular, the named court may not decline jurisdiction because it believes that a court of another country is more appropriate (*forum non conveniens*) or that a suit was brought first in another court (*lis alibi pendens*). The jurisdictional rules

than the named court, that court must dismiss the case if the complaint relates to matters covered by the mandatory forum selection clause, unless one of five exceptions applies.[148] The Hague Convention applies to commercial agreements and specifically excludes, among others: agreements involving consumers; employment agreements; real property and tenancies; the validity, nullity, or dissolution of business entities and the validity of decisions of their governing bodies; and the validity of intellectual property rights other than copyright unless the action is brought for a breach of contract.[149]

III-4.3.1 Effectiveness of Forum Selection Clause Under the Hague Convention

If it is signed and ratified by enough countries, the Hague Convention should achieve a meaningful degree of harmonization of legal standards that are currently a source of uncertainty, as discussed earlier in this Report. For example, Article 2 provides that the Hague Convention does not apply to tort or criminal claims that do not arise under the agreement, Article 3 provides that a forum selection clause shall be deemed mandatory unless the parties expressly provide otherwise, and Article 6 provides that determinations by a court that is not named in a forum selection clause as to whether an agreement is null and void must be made under the law of the jurisdiction in which the named court is located. On some of these topics U.S. courts currently are divided, and differences between their interpretation of U.S. law and the law of other countries can be meaningful. The Hague Convention also allows a court that is not named in the forum selection clause to apply, at least in part, the law of the jurisdiction where it is located (as opposed to the Chosen Contract Law or the Selected Forum Law) to some issues that bear upon the enforcement of the clause. For example, Article 6 of the Convention provides that grounds for not enforcing a forum selection clause include lack of capacity to enter

of the Hague Convention do not affect signatory countries' internal rules as to the named court's subject matter jurisdiction, minimum value of the claim, or venue, although the Hague Convention recommends that when the named court has discretion on these issues it give due consideration to the contractual choice of the parties. Hague Convention, *supra* note 141, art. 5(3)(b). The named court also may refuse jurisdiction if it determines that the country in which it is located has no connection with the defendant or the claim because the Hague Convention discourages "random" forum shopping. Hague Convention, *supra* note 141, art. 19.

[148] Those exceptions are: (1) the forum selection clause is null and void under the law of the jurisdiction in which the named court is located, including its conflict-of-law rules, (2) a party lacked the capacity to enter into the forum selection clause under the law of the country in which the court asked to enforce the agreement is located, (3) giving effect to the agreement would lead to a manifest injustice or would be manifestly contrary to the public policy of the country of the court asked to enforce the agreement, (4) for reasons beyond the parties' control, the agreement cannot reasonably be performed, and (5) the named court has declined to hear the case. Hague Convention, *supra* note 141, art. 6.

[149] Hague Convention, *supra* note 141, art. 2. Other subjects excluded are: status and legal capacity of natural persons; spousal and child support obligations; family law; will and succession; insolvency; common carriers, both of passengers and goods; most maritime matters; antitrust and competition law; nuclear damage; personal injury; tort claims for damage to property not arising out of a contractual relationship; real property and tenancies; public registers; and arbitration. Hague Convention, *supra* note 141, art. 2.

into the agreement, manifest injustice, or violation of public policy, in each case as determined under the law of the jurisdiction where the court being asked to enforce a mandatory forum selection clause naming a court in another jurisdiction is located.

Assuming that the Hague Convention is ratified by the United States without additional qualifications, U.S. opinion givers should be able to give an opinion that a court in the Covered Law State will give effect to a mandatory forum selection clause that satisfies the Four Hague Prerequisites and names the courts of a jurisdiction outside the United States that is a signatory to the Convention, subject to the exceptions set forth in the Hague Convention.[150] To give the opinion, the opinion preparers would need to confirm that the Four Hague Prerequisites are satisfied. Because the Hague Convention provides that exceptions similar to the *Bremen* exception can be invoked by a court not named in a mandatory forum selection clause to deny enforcement of the clause, the discussion in Part III-4.1.4.2 regarding the *Bremen* exception would apply to opinions under the Convention.[151]

If a mandatory forum selection clause names a court outside the United States and the agreement containing the clause chooses non-U.S. law as its governing law, the opinion would not cover the threshold issue of whether the clause is valid under either the Chosen Contract Law or the law of the jurisdiction outside the United States where the named court is located. Because these matters are not governed by the Covered Law, the opinion preparers are entitled to assume that both the agreement generally and the forum selection clause specifically are valid, binding, and enforceable under all applicable non-U.S laws. For this purpose, the opinion preparers may rely without so stating on the Omnibus Cross-Border Assumption.[152]

III-4.3.2 Recognition and Enforcement of Judgments Under the Hague Convention

The Hague Convention provides that, if a court named in a mandatory forum selection clause satisfying the Four Hague Prerequisites renders a judgment on the merits[153] of a case and that court is in a signatory country, the courts of all other signatory countries must recognize and enforce that judgment without

[150] Because the matters addressed by the opinion would be governed by a treaty to which the United States is a party and, therefore, are a matter of federal law, the opinion letter should cover U.S. federal law expressly, at least for purposes of this opinion.

[151] *See supra* text accompanying notes 117–18.

[152] *See supra* note 17 and accompanying text. Sometimes, non-U.S. parties request a specific opinion that a U.S. party has the corporate power to choose a non-U.S. court as the forum for resolving disputes. This opinion is generally subsumed in the typical opinion that a U.S. party has duly authorized, executed, and delivered the agreement. *See infra* text accompanying notes 168–71.

[153] Injunctions and other interim measures of protection or relief are excluded from the scope of the Hague Convention. The Hague Convention, therefore, neither requires nor precludes the grant, refusal, or termination of interim protective measures, such as preliminary injunctions, by a court that is not named, and does not require a named court to abide by them, if granted. Hague Convention, *supra* note 141, art. 7. The Hague Convention requires that settlements approved by the named court that have the force of judgments under the law of the jurisdiction in which it is located be rec-

reviewing the merits, unless the judgment falls within one of the exceptions established by the Hague Convention.[154] Except for the right to review the named court's decision to determine whether one of the exceptions set forth in the Hague Convention applies, the courts of signatory countries will be bound by the findings of fact and decisions of law of the named court. The Hague Convention provides that the amount of compensatory damages awarded is not reviewable, but allows a court of a signatory country that is asked to enforce a foreign judgment to refuse to recognize awards of punitive or exemplary damages. The enforcing court may postpone recognition and enforcement of a judgment if the named court is reviewing the case or the time limits to seek review of that court's decision have not expired.

Assuming that the Hague Convention is ratified by the United States without additional qualifications, U.S. opinion givers normally should be able to give an opinion that a judgment by a court named in a mandatory[155] forum selection clause that is located in a country that is a signatory to the Hague Convention will be recognized and enforced in the United States, subject to the exceptions set forth in the Hague Convention.[156] To give the opinion, the opinion preparers would need to determine that the forum selection clause satisfies the Four Hague Prerequisites on the date of the opinion letter. Because the Hague Convention provides that a violation of the public policy of the country where enforcement

ognized and enforced in every signatory country in the same manner as foreign judgments. Hague Convention, *supra* note 141, art. 12.

[154] The exceptions include the following: (1) the judgment was given by default, such that the court being asked to enforce the judgment is not bound by the findings of fact on which the named court based its jurisdiction; (2) the judgment does not have effect or is subject to review in the country in which the named court is located; (3) the agreement was null and void under the law of the country in which the named court is located, including its conflict-of-law rules, unless the named court has determined that the agreement is valid; (4) a party lacked the capacity to conclude the agreement under the law of the country in which the court being asked to enforce the judgment is located; (5) the defendant either (i) did not receive notice of the complaint in sufficient time and in such a way as to enable it to arrange for its defense, unless the defendant entered an appearance and presented its case in the named court without contesting lack of notice, or (ii) was notified of the complaint in the country in which the court being asked to enforce the judgment is located in a manner that is incompatible with fundamental principles of that country's law concerning service of process; (6) the judgment was obtained by fraud in connection with a matter of procedure; (7) recognition or enforcement would be manifestly incompatible with the public policy of the country in which the court being asked to enforce the judgment is located, including because the specific proceedings leading to the named court's judgment were incompatible with fundamental principles of procedural fairness of that country; (8) the judgment is inconsistent with another judgment rendered in a signatory country (including the countries in which the named court and the court being asked to enforce the judgment are located) in a dispute between the same parties that satisfies the conditions for being recognized and enforced under the Hague Convention; or (9) the judgment awards damages, including exemplary or punitive damages, that do not compensate a party for actual loss or harm suffered. Hague Convention, *supra* note 141, arts. 8–9.

[155] If the United States makes the declaration discussed earlier in this Report, *see supra* note 146 and accompanying text, the opinion also could be given when a non-U.S. court is named in a permissive forum selection clause if the country where that court is located also has made the declaration.

[156] Because the matters addressed by the opinion would be governed by a treaty to which the United States is a party and, therefore, a matter of federal law, to help reduce the risk of misunderstanding, the opinion letter should cover U.S. federal law expressly, at least for the purposes of this opinion.

is sought is one of the grounds for refusing recognition and enforcement of a foreign judgment, U.S. opinion preparers should not have to include an express public policy exception in their opinion letters (although to help reduce the risk of misunderstanding they may choose to do so).

III-4.4 Service of Process

Agreements in cross-border transactions often contain a provision that specifies the manner in which a party wishing to bring suit can serve process on the other party. Such a clause provides certainty and allows parties such as international lenders to avoid the complexity, cost, and delay of resorting to procedures established by multilateral conventions or bilateral treaties for international service of process if the party being sued is not in the same country as the party bringing suit.[157] When a cross-border agreement contains a service of process clause, non-U.S. parties sometimes request an opinion from counsel for the U.S. party that service on the U.S. party in the manner specified in the agreement will be effective under the Covered Law. This opinion addresses the non-U.S. party's concern that a court in the Covered Law State would find service in the manner specified in the agreement inadequate to establish jurisdiction over the opinion giver's client.

III-4.4.1 Service of Process for Suits in Named Courts Outside the United States

When the agreement contains an outbound forum selection clause naming a court outside the United States and the agreement does not choose U.S. law as its governing law, an opinion of U.S. counsel that service of process in the manner specified in the agreement is effective provides a non-U.S. recipient comfort that

[157] The principal treaty is the Hague Convention on the Service Abroad of Judicial and Extrajudicial Documents in Civil or Commercial Matters, Nov. 15, 1965, 20 U.S.T. 361, 68 U.N.T.S. 164 [hereinafter Hague Service Convention]. The Hague Service Convention provides for one main channel of transmission to be used when documents need to be transmitted between parties in different signatory countries. That channel relies on governmental authorities in both countries involved. The Hague Service Convention also provides for four alternative channels involving different parties, both governmental and non-governmental, in the country of origin and in the destination country in which service is to be made. The destination country may object to the use of some of the alternative channels and "derogatory channels" are allowed in bilateral or multilateral agreements among specific countries.

The Hague Service Convention does not provide substantive rules on actual service of process in signatory countries. Instead, those rules are provided by the internal law of each country. Depending on which channel of transmission is chosen, the country in which service of process is made may require that additional steps be taken (not governed by the Hague Service Convention) for service of process to be effective. Some countries allow service to be made using channels provided in the Hague Service Convention without acceptance by the addressee (service with compulsion), while other countries require voluntary acceptance of service by the addressee.

The Hague Service Convention also has provisions protecting a defendant, both prior to and after a judgment by default, that operate differently depending on which channel is used and legal requirements in the destination country. Among other things, at least six months must elapse between the date of transmission of the complaint and the entry of a default judgment, and the defendant has at least one year after the entry of a default judgment to challenge the effectiveness of service of process.

a court in the Covered Law State will not refuse to recognize a judgment of the named non-U.S. court against the opinion giver's client on the grounds that the service made on the opinion giver's client was inadequate.[158] The opinion does not address whether the service of process clause is effective under the Chosen Law or whether the methods specified in the clause satisfy the requirements for validly commencing the suit in the named court outside the United States. These matters, which are not governed by U.S. law, are covered by the Omnibus Cross-Border Assumption, on which the opinion preparers are entitled to rely without so stating.[159]

If a court in the Covered Law State is later asked to enforce a judgment of the named non-U.S. court against the U.S. party, the law of the Covered Law State will determine whether the method used to serve process for purposes of bringing suit in the named court outside the United States was permissible under the Covered Law. If it is held not to be permissible, the court in the Covered Law State will likely refuse to recognize and enforce the non-U.S. court's judgment, even though (i) under the named non-U.S. court's procedural rules it had personal jurisdiction over the U.S. party against whom the judgment was rendered and (ii) under the Chosen Contract Law the forum selection clause was valid.[160]

Giving the opinion should present no difficulty if under the Covered Law the non-U.S. party seeking to have a judgment of a court outside the United States enforced could have used the methods for service of process specified in the agreement to bring suit against the U.S. party in a court in the Covered Law State (assuming for this purpose that bringing suit in the Covered Law State is permitted under the agreement).[161] Thus, the opinion normally will present no difficulty when the agreement only permits service in person on the U.S. party or on its duly appointed agent.[162]

[158] See *supra* text accompanying notes 130–40 for a discussion of recognition and enforcement of foreign judgments. If the Covered Law State has adopted some version of the Uniform Act, a court in the Covered Law State may refuse to enforce a foreign judgment if the defendant did not receive notice of the proceeding in sufficient time to prepare a defense. *See supra* text accompanying note 137. If the Covered Law State has not adopted the Uniform Act, the opinion preparers will have to look to the law of comity and U.S. due process standards. *See supra* text accompanying note 140. The Hague Convention (which is discussed in Part III-4.3) allows for nonrecognition of a foreign judgment if the defendant was notified of the proceedings in an untimely fashion or in a manner incompatible with fundamental principles concerning service of process under the law of the jurisdiction in which the court being asked to enforce the judgment is located. *See supra* text accompanying note 154.

[159] *See supra* note 17 and accompanying text.

[160] *See* IBA Report, *supra* note 2, at 195.

[161] The opinion could be worded as follows:

> *The methods for service of process set forth in Section __ of the Agreement are valid under the law of [COVERED LAW STATE].*

Ordinarily what those methods are will be obvious from a review of the agreement. Sometimes, however, that will not be the case, for example, because the service of process provision refers to methods of service under non-U.S. law. In that event the opinion preparers may decide to consult with non-U.S. counsel (and if they receive advice from non-U.S. counsel, may choose to state their reliance on that advice in the opinion letter).

[162] Although many different methods for service of process may be permissible under the law of the jurisdiction outside the United States in which the named court is located, as a practical matter

If the Covered Law does not clearly permit the methods for service of process specified in the agreement to be used to bring suit against the U.S. party in a court in the Covered Law State, the opinion preparers will need to consider whether service by those methods would be grounds for a court in the Covered Law State to refuse to recognize a judgment of a court outside the United States.[163] The laws of many states impose special conditions on, or expressly disallow, waivers of service of process and may restrict the effectiveness of service of process by mail, publication, or methods other than personal service or service on an agent, if they do not assure adequate and timely notice to a defendant that a suit has been brought against it. Depending on the method in question, the law may not be clear enough to permit an opinion to be given or may only permit a reasoned opinion.

III-4.4.2 Service of Process When Suit Can Be Brought in the United States

If a forum selection clause in a cross-border agreement choosing non-U.S. law as its governing law names courts in the Covered Law State as a forum in which the parties may bring suit to resolve disputes under the agreement, the opinion provides a non-U.S. recipient comfort that under the Covered Law service of process in the manner specified in the agreement will establish personal jurisdiction over the opinion giver's client if the recipient sues the opinion giver's client in those courts. The opinion also provides the non-U.S. party comfort that under the Covered Law the methods for serving process specified in the agreement will be effective if, after obtaining a judgment from a court outside the United States, the non-U.S. party sues the U.S. party in a court in the Covered Law State to enforce that judgment.[164]

Whether the opinion can be given will, again, depend on the methods for service of process specified in the agreement and the law of the Covered Law State. Some states have adopted statutes or rules of court specifying which methods of service of process are permissible, while others have left that matter for the

parties to cross-border agreements in transactions in which closing opinions are delivered usually choose methods on which an opinion can be given. An opinion on service of process does not cover other provisions often included in an agreement, such as (i) an express consent to be sued in a particular court, (ii) a waiver of procedural or substantive defenses, or (iii) a covenant not to claim that service of process was ineffective.

[163] If the agreement provides for alternative methods of service of process, the opinion preparers will have to consider whether each method is permissible under the law of the Covered Law State and take an exception for methods they find problematic. If the agreement provides for service on one party by a particular method but not on the other or otherwise treats different parties differently under comparable circumstances (for example a non-U.S. lender may bring suit against a U.S. borrower in a particular way or court, but not *vice versa*), the opinion preparers also will have to consider whether the Covered Law permits such an agreement.

[164] In either case, the Covered Law alone governs the adequacy of service of process for commencing a suit. In the case of enforcement of a foreign judgment, as discussed earlier in this Part, the opinion preparers also need to consider whether the method used to serve process in the non-U.S. court was permissible under the Covered Law. As a practical matter, if, as discussed earlier in this Part, an opinion can be given that all methods specified in the agreement for service of process to bring suit in the non-U.S. court are permissible under the Covered Law, this opinion also can be given.

courts to decide. Sometimes, the law covering a particular method specified in the agreement will not be clear enough to permit an opinion to be given or may only permit a reasoned opinion.

III-4.4.3 Service of Process Through Agents Outside the United States

Cross-border agreements often provide for the appointment by the U.S. party of an attorney-in-fact or other agent in a foreign country and permit notices to be given to the U.S. party and service of process to be made on the U.S. party through that agent. The non-U.S. party to a cross-border agreement sometimes requests an opinion of U.S. counsel that the agent has been duly and validly appointed by the U.S. party. State law in the United States generally permits the appointment of agents for service of process. If the creation and scope of the agency are governed by the Covered Law, the requested opinion normally can be given.

The non-U.S. party sometimes requests an additional opinion that under the Covered Law it is permitted to serve the U.S. party through the U.S. party's appointed agent in the manner specified in the agreement.[165] Giving this opinion should present no difficulty if an opinion could be given that (i) the agent was duly appointed and (ii) as discussed earlier in this Part, the methods of service of process specified in the agreement are permissible under the Covered Law. If the agency relationship is not governed by the Covered Law (for example because it is created under an agreement governed by non-U.S. law), the opinion giver may assume the validity of the agent's appointment under the governing non-U.S. law by relying, without so stating, on the Omnibus Cross-Border Assumption.[166] The opinion in that event would mean that under the Covered Law the U.S. party duly authorized, executed, and delivered the document appointing the agent,[167] the appointment of the agent is effective against the U.S. party, assuming the validity of the agency relationship under applicable non-U.S. law, and service can be made on the U.S. party by serving the agent.

III-5 Entity Status, Power, and Action

If an agreement designates non-U.S. law as its governing law, that law governs the validity, binding effect, and enforceability of the agreement. The Chosen Law, however, does not govern the corporate power of the U.S. party to the agreement to enter into and perform its obligations under the agreement or its authorization, execution, and delivery of the agreement. Closing opinions typically cover these matters in domestic U.S. transactions, and the non-U.S. parties to cross-border agreements ordinarily request opinions on these matters from U.S. counsel. The wording of these opinions and the work the opinion preparers

[165] If the agent is appointed in the agreement itself, this opinion would be subsumed in the opinion discussed earlier in this Part on the status under the Covered Law of the methods of service of process. *See generally* IBA Report, *supra* note 2, at 276–77.

[166] *See supra* note 17 and accompanying text.

[167] *See infra* text accompanying notes 168–71.

are expected to perform to support them are the same in cross-border transactions and domestic U.S. transactions because the law governing them is the same—i.e., the law of the state of the U.S. party's organization.[168]

In deciding whether they can give an opinion that a U.S. corporation or other legal entity has the power to enter into and perform its obligations under, and has duly authorized, the agreement (a power and authority opinion), the opinion preparers need to understand the general scope of the activities their client is committing to perform because some activities may exceed the client's power under its organizational documents or the law under which it was formed.[169] To give the opinion, however, the opinion preparers do not have to consider every provision of the agreement. Rather, all they need to understand is the nature of the business activities covered by, and the general scope of their client's undertakings in, the agreement. Ordinarily, as in domestic U.S. transactions, the activities a client is committing to perform, for example repayment of a loan with interest, purchase of goods or services, or issuance of shares of capital stock or other securities, are readily apparent based on the opinion preparers' familiarity with the client, transaction, and agreement. When those activities are not obvious, however, for example because an agreement governed by non-U.S. law uses concepts or terminology having no counterpart in the Covered Law, the opinion preparers may wish to seek clarification.[170]

In the cross-border context, some aspects of due execution and delivery, such as authentication by a notary, attestation by witnesses, or special form requirements for specific types of agreements or undertakings, may be governed by the non-U.S. Chosen Contract Law or by some law other than the Covered Law, such as the law of the jurisdiction where the agreement is executed and delivered.[171] Because due execution and delivery are required for an agreement to

[168] *See generally TriBar 1998 Report*, *supra* note 35, at 641–42 (§ 6.1), 652–54 (§§ 6.3 & 6.4).

[169] For example, the business activities a corporation has the power to engage in may be restricted by its charter or, in the case of banking and insurance activities, by the corporation law under which it was incorporated. *See TriBar 1998 Report*, *supra* note 35, at 653 & nn.142–44 (§ 6.3), 654 & n.146 (§ 6.4); *see also* Glazer Treatise, *supra* note 10, at 236–44, 264–80. In addition, the applicable corporation law and the corporation's charter and bylaws will determine which matters may be approved by directors and officers and which require shareholder approval. As a matter of U.S. customary practice the power and authority opinion is understood to address only restrictions on the entity's power that derive from the statute under which the entity was formed or its governing documents, and not restrictions that derive from other statutes, rules, or regulations such as those requiring licenses or permits to engage in specific activities.

[170] Depending on the circumstances, reliance on the client's representations regarding the business activities it is undertaking in the agreement may be sufficient. Alternatively or in addition, the opinion preparers may consult with non-U.S. counsel on aspects of the transaction or non-U.S. law that bear on their analysis of their client's power to enter into and perform its obligations under the agreement (and if the opinion preparers receive the advice of non-U.S. counsel, they may choose to state their reliance on that advice in the opinion letter).

[171] *See* IBA Report, *supra* note 2, at 146 (under most countries' choice-of-law rules, the law of the place where the agreement was executed, as well as the law chosen in the agreement, the law of the entity's home jurisdiction, or possibly some other law may apply, so that advice from counsel in each jurisdiction as to proper execution and delivery may be appropriate on matters such as proper evidence of corporate authority, witness attestation, notarization requirements, signing procedures, sworn affidavit requirements, etc.).

be an enforceable obligation, the opinion preparers are permitted to rely, without so stating, on the Omnibus Cross-Border Assumption to the extent that they are not governed by the Covered Law.[172]

III-6 No Breach or Default

The non-U.S. party to a cross-border agreement may ask U.S. counsel for the U.S. party for an opinion that the execution and delivery of the agreement and its performance by the opinion giver's client will not result in a breach of or default under other contracts to which the opinion giver's client is a party.[173] This opinion addresses the concern of the opinion recipient that the transaction might have an adverse effect on the U.S. party under its existing contracts, for example because the transaction would violate a negative covenant, or on the opinion recipient, for example because the transaction might expose the non-U.S. party to a claim that entering into the agreement tortiously interferes with an existing contract of the U.S. party.

When a cross-border agreement chooses non-U.S. law as its governing law, giving a no breach or default opinion can be more difficult than in a domestic U.S. transaction even though the wording of the opinion is the same. That is because the opinion requires an understanding of the specific contractual obligations the opinion preparers' client is undertaking (not just the transaction's general scope and structure as is required to give a power and authority opinion) and the opinion preparers cannot be expected to have expertise in the non-U.S. law governing those obligations. Nevertheless, giving a no breach or default opinion may be possible to the extent that the opinion preparers do not need a complete understanding of every obligation their client is undertaking but instead only of those obligations being undertaken by the client pursuant to the agreement that could result in a breach of or default under the particular contracts to which the client is already a party that the opinion preparers specify they are covering in the opinion.[174] What those obligations are in a particular situation, and therefore whether the opinion can be given, will depend on: (1) the nature of the transaction and (2) the terms of the contracts being covered

[172] This is the same as in domestic U.S. transactions when the Chosen Law is not the Covered Law. In states that follow the Restatement (Second) of Conflict of Laws, the Chosen Law normally governs at least some of the formalities required to execute and deliver a contract. For example, a "duly executed" opinion for a Delaware corporation means that persons having the actual authority to bind the corporation signed the agreement in such a manner as to bring it into effect as a binding obligation of the corporation, based on the Delaware General Corporation Law, the corporation's charter and by-laws, resolutions of the board of directors, and evidence of the incumbency of signing officers. If, however, the agreement chooses as its governing law the law of a jurisdiction other than Delaware, an opinion whose coverage is limited to Delaware law would not cover the legal requirements for execution and delivery to the extent that the law of that other jurisdiction governs those matters.

[173] *See generally TriBar 1998 Report*, *supra* note 35, at 654–61 (§ 6.5) (no breach or default). Sometimes the requested opinion is broader, covering acceleration of the company's obligations, creation of rights in others to exercise remedies or require payments, creation of liens on the company's assets, or termination of a contract.

[174] Normally, those contracts will be specifically identified. *See infra* note 177.

by the opinion. For example, for U.S. counsel to give a no breach or default opinion in a cross-border loan transaction in which the loan agreement is governed by German law, the opinion preparers need not have the level of understanding of the agreement they would need when giving an enforceability opinion on behalf of the U.S. borrower in a comparable domestic U.S. transaction on a loan agreement choosing the Covered Law as its governing law. Instead, all the opinion preparers need is an understanding of those provisions of the loan agreement (for example the granting of a security interest) that may cause other contracts to which the borrower is already a party to be breached.

Recognizing that they may not fully understand each and every obligation their client is undertaking under an agreement governed by non-U.S. law, the opinion preparers nevertheless may decide, depending on the nature of the agreement, its complexity, and other factors, that they can give a no breach or default opinion based on their general familiarity with the client, the transaction, and the agreement.[175] In making that decision, the opinion preparers may choose to seek additional clarification about the client's obligations from their client or from counsel knowledgeable about the Chosen Law.[176]

Normally a company is a party to many contracts, only some of which are likely to be of practical concern. Therefore, the parties and their counsel should identify which contracts are to be covered by the opinion and consider the practicality of doing the work needed to address them.[177] The contracts identified for coverage may include contracts governed by the law of a jurisdiction other than the Covered Law State. In domestic U.S. transactions, when a contract covered

[175] In many transactions in which non-U.S. law is the governing law and a closing opinion of U.S. counsel is requested, the U.S. party will have retained non-U.S. counsel to work with U.S. counsel on the structure of the transaction and the terms of the agreement. Depending on their respective roles, U.S. counsel may be able to look to non-U.S. counsel for help in gaining the understanding needed to give a no breach or default opinion. The type of business the client engages in, the nature and complexity of the transaction, and other circumstances will all affect what the opinion preparers do in order to be able to give the opinion.

[176] The client, for example, may be able to provide sufficient clarification about the commercial terms of the transaction and the business activities to be performed under the agreement. If the opinion preparers conclude that further clarification is necessary, for example because the agreement refers to foreign statutes or uses concepts under non-U.S. law with which the opinion preparers are not familiar, they may decide they need to consult with non-U.S. counsel for guidance on what the agreement means. In some circumstances, however, the cost of consulting non-U.S. counsel may not be justified by the benefit of the opinion to the recipient, or the transaction may be too complex or the governing non-U.S. law may be too intricate for U.S. counsel to give an unqualified opinion. If the opinion preparers receive advice from non-U.S. counsel, they may choose to state their reliance on that advice in the opinion letter.

In some cases, the opinion preparers may choose to describe in the opinion letter their understanding of those aspects of the transaction or agreement on which they have based their analysis or to rely on express assumptions about specific matters that are governed by non-U.S. law. A combination of these steps may be needed before U.S. counsel can give a no breach or default opinion in a cross-border transaction, and in some circumstances U.S. counsel may conclude that it does not have a sufficient understanding to give the opinion.

[177] *See ABA Guidelines*, *supra* note 5, at 879 (§ 3.4). Practice has shifted away from covering contracts "known to counsel" and toward limiting the coverage of the opinion to specific contracts listed on a schedule, which may be part of the agreement or some other existing document, or may be prepared specifically for the opinion letter.

by a no breach or default opinion chooses as its governing law the law of another U.S. state, U.S. customary practice permits the opinion preparers to interpret that contract as lawyers in the Covered Law State would understand it.[178] This approach applies whether or not stated, but to help reduce the risk of misunderstanding, some U.S. lawyers spell it out in their opinion letters.[179]

When a no breach or default opinion covers contracts governed by the law of a U.S. state other than the Covered Law State, the same approach works as well for cross-border transactions as it does for domestic U.S. transactions. That approach does not, however, work well if the opinion preparers are asked to give a no breach or default opinion covering contracts governed by the law of a jurisdiction other than a U.S. state. Foreign contracts to which the opinion giver's client is a party are likely to contain terms that are unfamiliar to a U.S. lawyer and their interpretation may depend on legal concepts that do not have counterparts in U.S. law. Foreign contracts also may incorporate (with or without explicit reference) provisions supplied by statutes in the non-U.S. jurisdictions whose law they choose as their governing law. Thus, foreign contracts may have a meaning that is materially different from what the opinion preparers would think if they based their analysis on the approach permitted by U.S. customary practice for interpreting contracts governed by the laws of U.S. states other than the Covered Law State. Therefore, U.S. lawyers giving no breach or default opinions should not be expected to cover contracts that are governed by the law of jurisdictions outside the United States.[180]

In addition to a no breach or default opinion, non-U.S. opinion recipients (like opinion recipients in domestic U.S. transactions) sometimes request an opinion that the execution, delivery, and performance of the agreement will not violate judgments, injunctions, orders, or decrees to which the opinion giver's client is subject. The analysis discussed above for giving a no breach or default opinion in a cross-border transaction also applies to giving this opinion. As they do when identifying contracts to be covered by a no breach or default opinion, the parties and their counsel should discuss early in the transaction whether judgments, injunctions, orders, or decrees are to be covered and, if so, how they should be identified in the opinion letter.

[178] *See TriBar 1998 Report*, *supra* note 35, at 661 & n.161.

[179] The wording could be as follows:

> *We have interpreted the provisions of the contracts addressed by the opinion in numbered paragraph __ as those provisions would be understood in [COVERED LAW STATE] whether they are governed by the law of [COVERED LAW STATE] or by the law of another jurisdiction.*

[180] The *CLLS Opinion Guide* reaches a similar conclusion. *CLLS Opinion Guide*, *supra* note 4, at 10 (¶ 45) (English lawyers should give a no breach or default opinion only on contracts governed by English law and then only when the opinion giver is fully familiar with their terms). See also Part III-1, which discusses similar reasons why, when an agreement is governed by non-U.S. law, U.S. lawyers ordinarily will not give an "as if" opinion on its enforceability.

III-7 No Violation of U.S. Statutes, Rules, or Regulations; No Approvals or Filings

Opinion recipients sometimes request an opinion that execution and delivery of an agreement by the company do not, and performance by the company of its obligations under the agreement will not, violate statutes, rules, and regulations under the Covered Law.[181] This opinion covers statutes, rules, and regulations that, if violated, will subject the company to a fine, penalty, or other governmental sanction.[182]

Despite its apparent breadth, a no violation opinion does not cover all statutes, rules, and regulations of the Covered Law because no lawyer, no matter how diligent, can reasonably be expected to be familiar with every law that might possibly apply. Instead, as a matter of U.S. customary practice, the opinion is understood to cover only statutes, rules, and regulations[183] that a lawyer in the Covered Law State exercising customary professional diligence would reasonably be expected to recognize as being applicable to the entity, transaction, or agreement to which the opinion relates.[184] Moreover, as a matter of U.S. customary practice, even some laws that are clearly applicable, such as tax, insolvency, and securities laws, are not covered unless an opinion refers to them expressly.[185]

[181] *See generally TriBar 1998 Report*, *supra* note 35, at 661–62 (§ 6.6) (violation of law). Whether the opinion is cast in the present or future tense, it covers not only violations resulting from the company's entering into the agreement but also violations that could result from future performance by the company of its obligations under the agreement. *TriBar 1998 Report*, *supra* note 35, at 657–58, 662. Depending on the transaction, covering future performance may broaden significantly the analysis the opinion preparers must conduct, particularly if the agreement imposes on the company contingent as well as fixed obligations. As a matter of U.S. customary practice the opinion preparers are not required to speculate about future facts or to take into account the possibility of changes in statutes, rules, or regulations after the date of the opinion letter (except for changes then enacted but not yet in effect). *TriBar 1998 Report*, *supra* note 35, at 658 & nn.155–56. Some opinion preparers give a more limited opinion that removes the future element by covering only the execution and delivery of the agreement and "*consummation of the transaction on the date of the closing*." In most, if not all, situations, this more limited opinion should strike the right balance between the benefit of the opinion to the recipient and its cost. If the recipient also wants an opinion on particular aspects of the company's future performance, it should request that those aspects be specifically addressed.

[182] A statute might, for example, make the export of certain types of goods illegal and impose sanctions ranging from a fine to an order prohibiting the company's performance of its contractual obligations to deliver the goods (e.g., technology with military applications). In domestic U.S. transactions the no violation opinion complements the remedies opinion because statutes, rules, or regulations that, if violated, may subject the company to fines, penalties, or governmental sanctions may not render the agreement unenforceable as against the company and thus not require an exception to an opinion on the agreement's enforceability. *See TriBar 1998 Report*, *supra* note 35, at 661. The no violation opinion does not address the enforceability of the agreement under the Covered Law (even though enforceability will not be addressed at all by U.S. counsel when the agreement chooses non-U.S. law as its governing law).

[183] The no violation opinion does not cover ordinances or regulations adopted by political subdivisions below the federal and state level. *See TriBar 1998 Report*, *supra* note 35, at 661–62 & nn.164–65 (§ 6.6).

[184] *See ABA Principles*, *supra* note 3, at 832 (¶ II.B); *see also TriBar 1998 Report*, *supra* note 35, at 627–28 (opinion preparers do not ordinarily seek (nor are they expected to seek) guidance from experts in every specialized field of law that might be implicated by the undertakings in an agreement; effort would seldom be cost-justified even in very large transactions).

[185] Which statutes, rules, and regulations are understood not to be covered depends on the parties and the transaction. *See, e.g.*, *TriBar 1998 Report*, *supra* note 35, at 628 & n.81 (while federal securities

A no violation opinion in a cross-border transaction raises the same issues as its counterpart in a domestic U.S. transaction: (1) what statutes, rules, and regulations would the opinion preparers, exercising customary professional diligence, reasonably be expected to recognize as being applicable to the entity, transaction, or agreement to which the opinion relates; and (2) which statutes, rules, and regulations, even if applicable, should be understood not to be covered unless they are addressed expressly. The answers to these questions are not always clear in domestic U.S. transactions; they are even less clear in cross-border transactions because of the absence of a consensus over which statutes, rules, or regulations among those specifically applicable to cross-border transactions should be understood to be covered. In addition, the answers may differ from transaction to transaction. As a result, although practice varies, in cross-border transactions many opinion givers include a *non-exclusive* list of statutes, rules, and regulations that may apply but that they nonetheless are not covering.[186]

As a technical matter a U.S. party's execution, delivery, or performance of its obligations under the agreement may not "violate" some U.S. statutes, rules, and regulations relating to cross-border transactions. For example, the Committee on Foreign Investment in the United States, or "CFIUS," a federal interagency committee empowered to review foreign investments in U.S. companies for national security concerns, has the power to require that the parties to an agreement mitigate those concerns, or, if they cannot be mitigated, to block a transaction. The parties can submit the transaction to CFIUS for pre-closing review, which prevents CFIUS from reviewing a completed transaction or ordering post-closing mitigation. While a pre-closing filing with CFIUS is voluntary, and thus a failure to make the filing does not violate a U.S. statute or regulation, the consequences of a failure to file can be significant (including divestiture).[187] Thus, if a pre-

laws customarily not covered, opinion preparers should consider application of the Investment Company Act of 1940 when subject of opinion is a registered investment company), 661 (opinion preparers should consider laws regulating sale of narcotics when company in the pharmaceutical business is selling assets that include controlled substances, the sale of which without proper licenses could expose parties to serious sanctions). Discussions with U.S. counsel regarding the coverage of the no violation opinion may lead a non-U.S. opinion recipient to request that particular statutes, rules, or regulations be covered expressly, leaving it to the opinion preparers to decide whether and, if so, how they can cover them. *See, e.g.*, *TriBar 1998 Report*, *supra* note 35, at 628–29 (opinion does not cover statutes or regulations applicable solely to opinion recipient; custom not clear regarding coverage of application of Federal Reserve Board's margin regulations to specific bank loan and, therefore, better practice is for recipient to request separate opinion if it wants margin regulations to be covered).

[186] This approach is less common in domestic U.S. transactions, where opinion givers often choose not to state expressly what is understood as a matter of U.S. customary practice. *See generally TriBar 1998 Report*, *supra* note 35, at 630 (ordinarily counterproductive for opinion givers to try to list in opinion letter each area of law that is not covered, as list can never be complete).

[187] *See, e.g.*, William McConnell, *Polaris Pares off U.S. Digital Security Arm*, THE DEAL (Sept. 16, 2013) (discussing CFIUS order that Polaris Financial Technology Ltd., an Indian company, divest its 85.3 percent ownership stake in IdenTrust Inc., a U.S. company providing digital identification services); Richard Metheny, *3 Things to Know About CFIUS' Recent Activism*, LAW360 (Sept. 16, 2015, 4:51 PM EST), http://www.law360.com/articles/477329/3-things-to-know-about-cfius-recent-activism (discussing CFIUS order that Huawei Technologies, a Chinese company, divest the assets of U.S.-based 3Leaf Systems, a cloud computing technology company); *see also infra* note 192.

closing filing is not being made, many U.S. lawyers expressly exclude CFIUS review from the coverage of their no violation opinions.[188]

One way opinion givers can help reduce the risk of misunderstanding about the coverage of a no violation opinion in a cross-border transaction is for them to include in the opinion letter: (1) a general statement that the opinion only covers statutes, rules, and regulations that a lawyer in the Covered Law State exercising customary professional diligence would reasonably be expected to recognize as being applicable to the entity, transaction, or agreement to which the opinion relates; and (2) a non-exclusive list of specific U.S. statutes, rules, and regulations affecting cross-border transactions that might be applicable but nevertheless are not covered.[189] Many specialized statutes, rules, and regulations (mostly federal) that rarely apply to domestic U.S. transactions apply to similar cross-border transactions because non-U.S. parties are involved or performance is to occur outside the United States.[190] Whether these laws apply to a particular cross-border transaction often depends on many factors, including the national-

[188] An alternative to an exception is to point out in the opinion letter that no filing with CFIUS has been made, thereby putting the recipient on notice that under the statute a post-closing review of the transaction is possible and mitigation measures may be imposed.

[189] The opinion could be worded as follows:

> *Except as set forth below, the execution and delivery of the Agreement by the Company and consummation by the Company of the transactions contemplated by the Agreement do not result in any violation by the Company of statutes of the United States or [COVERED LAW STATE], or rules or regulations thereunder, that, subject to the limitations in the following sentence, we would reasonably be expected to recognize as being applicable to an entity, transaction or agreement to which this opinion letter relates. The opinion in this paragraph __ does not cover, without limitation, the following statutes, rules, and regulations: [. . .].*

Whether it says so or not, the list should be understood not to be exhaustive or exclusive. Some opinion preparers couple a list of excluded statutes, rules, and regulations with wording such as the following:

> *[. . .], or other statutes, rules, or regulations customarily understood to be excluded even though they are not expressly stated to be excluded.*

This wording, although not required as a matter of U.S. customary practice, is intended to put the recipient on notice that an opinion covers some matters (such as tax, insolvency, and securities laws) only if it does so expressly. Whether or not the opinion letter says so, however, those matters are not covered.

[190] Among these statutes, rules, and regulations are: (i) the Exon-Florio Amendment to the Defense Production Act of 1950 (Exon-Florio), as amended by the Foreign Investment and National Security Act of 2007, including procedures governing CFIUS reviews thereunder; (ii) the Trading with the Enemy Acts; (iii) the International Emergency Economic Powers Act, the National Emergencies Act and regulations issued thereunder, as well as other laws prohibiting or restricting, or imposing sanctions on persons engaging in certain types of activities involving specified countries; (iv) the Export Administration Regulations (EAR) of the U.S. Department of Commerce, Bureau of Industry and Security; (v) the International Traffic in Arms Regulations (ITAR) of the U.S. Department of State, Directorate of Defense Trade Controls; (vi) the Foreign Assets Control Regulations of the U.S. Department of the Treasury, Office of Foreign Assets Control (OFAC); (vii) the USA PATRIOT Act and other anti-money laundering (AML) laws and regulations; (viii) a variety of U.S. executive orders (such as Executive Order 13224: Blocking Property and Prohibiting Transactions with Persons Who Commit, Threaten to Commit or Support Terrorism, 66 Fed. Reg. 49079 (Sept. 24, 2001)); and (ix) the Foreign Corrupt Practices Act. Many opinion preparers believe that some or all of these laws are not covered by a no violation of law opinion even if not expressly excluded. Including a specific exception in the opinion letter, however, seems advisable to help reduce the risk of misunderstandings.

ity of entities that are not the opinion giver's clients or that may be controlled, directly or indirectly, by persons from different jurisdictions. Often in these situations the opinion preparers cannot determine the relevant facts with the confidence needed to give an opinion.[191] In addition, many of these statutes, rules, and regulations have an expansive reach and their possible impact on a particular cross-border transaction may be uncertain because of the broad discretion they grant to the agencies of the U.S. federal government charged with their interpretation and enforcement.[192] A non-exclusive list of statutes, rules, and regulations not covered by a no violation opinion on a cross-border agreement, if tailored thoughtfully to the circumstances, will make the opinion clearer and help reduce the cost of its preparation.

In many cross-border transactions, in the course of advising their clients the parties' own counsel identify particular U.S. statutes, rules, and regulations that may be applicable to the entity, transaction, or agreement, and then help their clients structure the transaction to comply with those statutes, rules, and regulations, or to take advantage of available exemptions.[193] When the opinion preparers are willing to cover those statutes, rules, or regulations in a no violation opinion, for example because they have done the work to ensure compliance, they can reduce the risk of misunderstanding over the opinion's coverage by referring expressly in the opinion letter to the particular statutes, rules, and regulations they are covering.[194]

Because customary practice for no violation opinions in cross-border transactions is continuing to evolve, the opinion preparers should discuss with the recipient early in the transaction which of the many specialized statutes, rules, and regulations that might apply to the entity, transaction, or agreement they are prepared to cover in the opinion. In those discussions, each side should be guided (as in domestic U.S. transactions) by the practicality of addressing particular statutes, rules, or regulations, considering such matters as the degree of

[191] For example, a statute or regulation may apply to a transaction if it involves a party from a "black-listed" jurisdiction. The facts necessary to establish with the confidence needed to give an opinion the true "provenance" of parties involved in the transaction whom the opinion preparers may not even represent, as well as their direct and indirect affiliates, often are not ascertainable by U.S. counsel.

[192] For example, in recent years CFIUS's authority to scrutinize the effect on U.S. national security of foreign investments that could result in foreign control (evaluated functionally) of U.S. businesses has been extended to an ever broader range of transactions. The term "national security" is not defined by statute or regulation, and, while the statute under which CFIUS was established (50 App. U.S.C.A. § 2170) does list some factors CFIUS may consider and while CFIUS has provided some guidance about the types of national security considerations it has reviewed, those factors (such as "critical infrastructure" or "critical technologies") are non-exclusive and general in nature.

[193] This is often the case when failure to comply with particular statutes, rules, or regulations could result in serious governmental sanctions rather than a small fine or penalty.

[194] This could be as simple as adding at the end of the first sentence in the italicized opinion language in note 189 above "*including, without limitation, [. . .].*" *See generally TriBar 1998 Report*, *supra* note 35, at 627–30, 662 (noting that in the absence of custom or in areas where custom is unclear, the opinion recipient should request specifically that the opinion cover those matters it wishes to have covered; custom is unclear as to many statutes, rules, and regulations that may bear on an agreement, including among others antitrust laws and Exon-Florio).

certainty that is possible, the significance of specific statutes, rules, or regulations to the particular transaction, and the cost of performing the additional work, if any, required to give the opinion.[195]

In addition to a no violation opinion, non-U.S. opinion recipients (like opinion recipients in domestic U.S. transactions) sometimes request an opinion that the execution and delivery by the opinion giver's client of the agreement and the consummation by it of the transactions contemplated by the agreement do not require, except as set forth in the opinion, any consent, approval, license, or exemption by, order or authorization of, or filing, recording, or registration by the opinion giver's client with, any governmental authority pursuant to the Covered Law.[196] Some of the U.S. statutes, rules, and regulations that apply to cross-border transactions provide for review or approval by or require filings with the federal government. The analysis in this Part III-7 also applies to no approvals or filings opinions in cross-border transactions. If specific approvals or filings are to be covered, they should be identified in a similar manner early in the transaction.

If the agreement chooses non-U.S. law as its governing law, to give either a no violation or no approvals or filings opinion, the opinion preparers need to have a general understanding of the transaction and the obligations the parties are undertaking in the agreement as interpreted under the Chosen Law. What they need to do to gain that understanding and to conduct the necessary legal analysis under the Covered Law will depend on the statutes, rules, and regulations to be covered and may require advice from others about the transaction or agreement.[197] In many cases an understanding comparable to that required to give a no breach or default opinion (which is discussed in Part III-6) may suffice. When, however, the opinion covers specialized statutes, rules, or regulations specifically affecting cross-border transactions, giving the opinion may require a more in-depth understanding of matters covered by the Chosen Law, such as the legal status of the transaction, the respective rights and obligations of the parties under the agreement, and the status, domicile, and affiliations of non-U.S. parties.[198] In some cases, the opinion preparers may not be able to gain a sufficient understanding to give an opinion.

[195] *See TriBar 1998 Report*, *supra* note 35, at 627–28, 662 & n.166 (analyzing which bodies of law are covered by the remedies opinion). That analysis also is referenced in that report's discussion of the no violation opinion. *Id.* at 661. Delaying a discussion with the opinion recipient regarding the coverage of the no violation opinion may have the practical effect of limiting what the opinion preparers can analyze in the available time and may prevent them from addressing some statutes, rules, or regulations they might otherwise have been willing to cover in the opinion.

[196] *See generally TriBar 1998 Report*, *supra* note 35, at 664–65 (§ 6.7) (opinion on approvals and filings overlaps considerably with no violation opinion).

[197] Depending on the circumstances, reliance on the client's factual representations about the scope of its undertakings in the agreement may be sufficient. Alternatively or in addition, the opinion preparers may decide to seek legal advice of non-U.S. counsel on some aspects of the agreement or on the governing non-U.S. law (and if the opinion preparers receive that advice, they may choose to state their reliance on it in the opinion letter).

[198] *See supra* notes 175–76 and accompanying text.

III-8 Sovereign Immunity

Depending on the circumstances, under U.S. law, the federal government, the governments of the various states, and the governments of foreign nations, as well as their respective instrumentalities, may be immune from suit and from having their properties attached by creditors and claimants.[199] Sovereigns can waive their immunity and ordinarily are not immune when they act in a private or commercial capacity. The scope of sovereign immunity for states, their agencies, and their instrumentalities, as well as political subdivisions of the state, including counties and municipalities and their instrumentalities, is a matter of state law and differs from state to state.[200] Federal law governs the immunity

[199] *See generally* IBA Report, *supra* note 2, at 211. Dating back centuries, sovereign immunity has been recognized as a legal principle in most legal systems, either as a procedural matter (one cannot sue the king in the courts he created) or as a substantive matter (the king can do no wrong).

[200] In many jurisdictions the legal doctrine that traditionally has shielded state and local governments, as well as their instrumentalities, from litigation consists of two elements: (1) sovereign immunity, which applies to the state itself and its agencies, officers, and employees and immunizes them from suit in that state's own courts without the state's consent (*see, e.g.*, Fernald Corp. v. Governor, 31 N.E.3d 47 (Mass. 2015) (history and character of corporation materially different from those characteristic of state agencies); *see generally* Restatement (Second) of Torts § 895B(1) (1979)); and (2) governmental immunity, which derives from but is narrower in scope than sovereign immunity and applies to political subdivisions of the state, such as counties and municipal corporations (*see, e.g.*, Evans v. Bd. of Cty. Comm'rs of El Paso Cty., 482 P.2d 968 (Colo. 1971); Bd. of Educ. of Prince George's Cty. v. Mayor & Common Council of Town of Riverdale, 578 A.2d 207 (Md. 1990); Tilton v. Dougherty, 493 A.2d 442 (N.H. 1985); Tilli v. Northampton Cty., 370 F. Supp. 459 (E.D. Pa. 1974) (Pennsylvania law)). The difference stems from the fact that political subdivisions and municipal corporations have the dual character of governmental entities and corporate bodies functioning as private entities. Both sovereign and governmental immunity are procedural in nature and, unless waived, shield states and political subdivisions from judicial authority. Technically, they only apply when a state is sued in its own courts, but another state's courts may give them effect voluntarily as a matter of comity. *See* Nevada v. Hall, 440 U.S. 410 (1979).

Immunity may be based on common law, constitutional provisions, or state statutes. Under traditional common law principles, governmental immunity applies with respect to governmental or discretionary functions, but not corporate, ministerial, or proprietary functions. State constitutions may recognize a state's sovereign immunity but generally do not deal with the governmental immunity of political subdivisions. Many state constitutions neither adopt nor abolish sovereign immunity but rather give the legislature express authority to determine its scope. In most if not all states, common law doctrines of both sovereign and governmental immunity have been replaced by statutes taking a variety of approaches, such that the scope of immunity may range from nearly absolute to nearly nonexistent.

Whether governmental or administrative bodies below the level of state government are protected from suit varies from state to state and typically depends on the relationship between the state and a particular body based on a wide variety of tests and factors. *See, e.g.*, Ky. Ctr. for Arts Corp. v. Berns, 801 S.W.2d 327 (Ky. 1990); Rucker v. Hartford Cty., 558 A.2d 399 (Md. 1989); Ohio Valley Contractors v. Bd. of Educ. of Wetzel Cty., 293 S.E.2d 437 (W. Va. 1982). Statutory provisions, and in particular nomenclature like "agency," "department," or "division," can affect a court's determination whether a particular body has immunity. Statutes, however, are not always dispositive. Other questions courts often ask are: Was the body created by the legislature? Is it subject to the control of the legislature or the state's executive branch? Is its funding part of the state budget? Does the body operate statewide? Examples of governmental bodies that often are entitled to share in the state's immunity include: departments of the state's executive branch and their divisions, state law enforcement agencies, state hospitals, state prisons, state agencies engaged in some non-governmental business functions, state universities, and local school districts. In the absence of statutory provisions that grant immunity for specific bodies or functions or types of claims, counties and municipal corporations may be subject to suit to the same extent as private parties. *See, e.g.*, *Fernald Corp.*, 31 N.E.3d 47 (suit to clarify title to land does not implicate concerns that support finding of sovereign immunity).

of the U.S. government, its agencies, and its instrumentalities.[201] A federal statute, the Foreign Sovereign Immunities Act of 1976 (FSIA),[202] governs the immunity in the United States of foreign sovereigns and their instrumentalities.

III-8.1 Opinions Addressing the Immunity of U.S. Parties

In a cross-border transaction, the non-U.S. party sometimes asks for an opinion from counsel for the U.S. party that neither the U.S. party nor its property is entitled to sovereign immunity under federal law or the law of the Covered Law State.[203] This opinion typically deals with both aspects of sovereign immunity: the absence of immunity from the jurisdiction of courts in the Covered Law State (including legal process required to commence a suit or to enforce a foreign

Identification and application of the rules on sovereign immunity and governmental immunity may be straightforward in some situations and not in others.

[201] The sovereign immunity of the U.S. government is inherent in the constitutional structure of the federal government and not based on specific provisions of the U.S. Constitution. *See, e.g.*, Cohens v. State of Virginia, 19 U.S. 264 (1821); Christensen v. Ward, 916 F.2d 1462 (10th Cir. 1990); Williamson v. U.S. Dep't of Agric., 815 F.2d 368 (5th Cir. 1987). As a jurisdictional defense, when sovereign immunity applies it operates as a complete bar to lawsuits against the U.S. government, its departments and agencies, and their officers and employees in their official capacity, even if the government's conduct may have been wrongful. *See, e.g.*, Drake v. Panama Canal Comm'n, 907 F.2d 532 (5th Cir. 1990); Kozera v. Spirito, 723 F.2d 1003 (1st Cir. 1983). Congress has the power to grant immunity to governmental corporations even though they have functions that are comparable to private entities and may not inherently possess sovereign immunity. *See, e.g.*, Edmonds v. Fed. Crop Ins. Corp., 684 F. Supp. 656 (N.D. Ala. 1988). The government's waiver of immunity or consent to suit is a prerequisite for a court's jurisdiction. *See* United States v. Mitchell, 463 U.S. 206 (1983). Congress alone has authority to enact legislation waiving immunity and giving consent to suit. United States v. Testan, 424 U.S. 392 (1976). Congress's authority includes the power to place conditions and limitations on a waiver (Honda v. Clark, 386 U.S. 484 (1967); United States v. Sherwood, 312 U.S. 584 (1941)) and to withdraw a waiver at any time it deems proper (Maricopa Cty., Ariz.v. Valley Nat'l Bank of Phoenix, 318 U.S. 357 (1943)).

Statutes creating federal administrative agencies and corporations often contain clauses permitting them to sue and be sued. These clauses have been construed as waiving sovereign immunity broadly for the entity. *See, e.g.*, Roche v. Am. Red Cross, 680 F. Supp. 449 (D. Mass. 1988). General "sue and be sued" provisions are liberally construed because the U.S. Supreme Court has stated that, when Congress authorizes federal corporations to engage in commercial and business transactions with the public, those corporations, to establish they are entitled to sovereign immunity, must clearly show that implied restrictions on the ability of a plaintiff to sue them are necessary to avoid grave interference with their performance of a governmental function or that Congress plainly intended that the "sue and be sued" clause be read narrowly. *See, e.g.*, Franchise Tax Bd. of Cal. v. U.S. Postal Serv., 467 U.S. 512 (1984); Fed. Hous. Admin., Region No. 4 v. Burr, 309 U.S. 242 (1940).

[202] 28 U.S.C. §§ 1330, 1332(a)(2)–(a)(4), 1391(f), 1441(d), 1602–1611 (2012). Native American tribes are technically "foreign" sovereigns in the United States and as such they, as well as tribal corporations and in some cases their agents and counsel, are entitled to sovereign immunity under federal law. The sources of the law applicable to a particular tribe may include, in addition to federal statutes, regulations, and case law, treaties between the United States and the tribe, as well as tribal law and administrative ordinances of tribal courts. The resulting complexity can make the legal analysis required to give an opinion in a transaction involving an entity controlled by a Native American tribe challenging.

[203] The reason why opinions regarding sovereign immunity are requested in cross-border transactions and not in domestic U.S. transactions is largely historical: in the past sovereigns accounted for a much larger proportion of cross-border transactions; the resulting practice of requesting opinions on sovereign immunity in those transactions has continued even though today most cross-border transactions in which opinions are given involve private parties.

judgment in those courts) and the absence of immunity from attachment of assets (which a plaintiff may seek before or after obtaining a judgment).[204] Normally U.S. lawyers can give this opinion either because (1) the U.S. party is a private business entity and not under the control of the federal government, a state government, or another entity that is entitled to sovereign immunity (a U.S. sovereign); or (2) the U.S. party has legally waived sovereign immunity.

When the U.S. party is a private business and the opinion recipient knows that the U.S. party is neither a U.S. sovereign nor controlled by one, the U.S. party's inability to claim sovereign immunity is self-evident, and an opinion that it is not entitled to sovereign immunity serves no purpose and ordinarily should not be requested. Nevertheless, should an opinion be requested and given, to satisfy themselves that their client is a private business not under the control of a U.S. sovereign, the opinion preparers may rely on express factual assumptions or a certificate from an officer of the client regarding the client's owners and the absence of voting or other arrangements that would subject it to the control of a U.S. sovereign.

If the U.S. party is an agency or instrumentality of a U.S. sovereign, it may or may not be entitled to sovereign immunity depending on the circumstances of the specific transaction and applicable federal and state law. For example, U.S. sovereigns generally are not immune when they engage in commercial activities or enter into or perform agreements involving commercial activities. Generally, however, the opinion preparers will start with a presumption that, if their client is a state or the federal government, a state or federal agency or instrumentality, or a political subdivision of a state such as a county or municipality, it is entitled to immunity absent a clear provision to the contrary in the Covered Law.

Determining with confidence that a U.S. sovereign is engaging in a commercial transaction and is not therefore entitled to sovereign immunity under the Covered Law with respect to the agreement covered by the opinion often is difficult and, therefore, giving an unqualified opinion to that effect may be impossible. That, however, ordinarily is not an opinion problem because despite the possible, or even likely, availability of an exception from sovereign immunity for the commercial activities of a U.S. sovereign (or of some other exception under the Covered Law), the non-U.S. party ordinarily will insist on including in the agreement a provision that unconditionally and irrevocably waives the U.S. party's sovereign immunity with respect to its obligations under the agreement. In the absence of such a waiver, U.S. lawyers ordinarily are unwilling to give an opinion that a U.S. sovereign is not immune or at the most will give only a qualified, reasoned opinion.

When an opinion on sovereign immunity is based on a contractual waiver, it means that, under the Covered Law: (i) the U.S. party's constituent documents

[204] The opinion could be worded as follows:

> *Neither [U.S. PARTY] nor its assets are immune on grounds of sovereign immunity from (i) suit in connection with the Agreement in the courts in [COVERED LAW STATE] [or United States federal courts] or (ii) related legal process, including service of process, attachment of assets, or enforcement by those courts of a judgment against the Company related to the Agreement.*

and any enabling legislation and implementing regulations give the U.S. party the power (corporate or governmental) to grant the waiver,[205] (ii) the U.S. party has taken all action (corporate or governmental) required to waive sovereign immunity,[206] and (iii) the waiver is valid and binding and cannot be unilaterally withdrawn or revoked by the U.S. party or by the U.S. sovereign of which it is an agency or instrumentality.[207]

Although a waiver of sovereign immunity may be worded broadly to cover more than the U.S. party's obligations under the agreement, the opinion should be drafted to cover only the non-U.S. party's ability under the Covered Law to bring suit to enforce the agreement against the U.S. party, to execute a judgment obtained in such a suit, and to attach the assets of the U.S. party pursuant to such a judgment.[208]

If the agreement containing the waiver chooses non-U.S. law as its governing law, the opinion may be based, without so stating, on the Omnibus Cross-Border Assumption to the extent that the waiver's effectiveness depends on the Chosen Law or some other non-U.S. law.[209]

[205] Even if a U.S. sovereign waives its immunity, a creditor may be unable to attach assets the U.S. sovereign needs to fulfill a public purpose. *See, e.g.*, Tooke v. City of Mexia, 197 S.W.3d 325, 330 (Tex. 2006) (legislation allowing for waiver of sovereign immunity may include measures designed to insulate public resources from the reach of judgment creditors). As a matter of U.S. customary practice the opinion is understood not to cover limitations, including but not limited to public interest, public policy, or equity, on the ability of a judgment creditor to exercise ordinary remedies with respect to properties of a U.S. sovereign that are integral to its governmental or non-commercial function. If, however, the opinion preparers are aware of a specific provision of the Covered Law that places onerous limits on the effectiveness of a waiver of sovereign immunity, they should consider taking a specific exception.

[206] The action required may include approval not only by the U.S. party's governing body or authorized officers but also by specific government agencies or officials with oversight authority over the U.S. party.

[207] This assumes that the opinion letter covers the statutes, rules, and regulations governing the U.S. party's status and power to waive sovereign immunity. Depending on the circumstances and the law covered by the opinion letter, the opinion preparers may have to interpret specialized statutes, rules, and regulations that affect the U.S. party's status as a sovereign, or its power to waive sovereign immunity, and the judicial decisions that interpret them. If the opinion preparers cannot make the necessary legal determinations with sufficient confidence, they will need to qualify the opinion (or may not be able to give it at all). Sometimes an opinion also is requested that the waiver is valid, binding, and irrevocable under the Covered Law. Because giving that opinion would not require the opinion preparers to make any different or additional determinations than are required to give a typical sovereign immunity opinion (*see supra* note 204), a separate opinion on the effectiveness of the waiver adds nothing and therefore should not be requested.

[208] An overly broad waiver might refer, for example, to "*all immunities, including sovereign immunity, in any jurisdiction and under all applicable laws.*" In the extreme, the concept of "legal immunity" is the opposite of the concept of "legal liability." Ordinarily, U.S. sovereigns are subject to a different legal liability regime than private parties. For example, a state agency often is shielded from some aspects of tort liability, is exempt from taxation, and is excused from complying with some statutes, rules, or regulations that apply to private parties. While the opinion preparers may be able to give an opinion that the agency has effectively waived immunity from suit with respect to specific contractual obligations, ordinarily they will not be able to give an opinion that the waiver is effective as to all of the agency's privileges and exemptions under all laws.

[209] *See supra* text accompanying note 17. If, for example, the Chosen Law Country has a statute like the FSIA governing the immunity of sovereigns of other countries when they engage in transactions in that country (*see infra* text accompanying notes 202–12), it may include requirements for a

III-8.2 Opinions Addressing the Immunity of Non-U.S. Parties

U.S. counsel representing a party that is, or may be, a foreign state or one of its agencies or instrumentalities (a foreign sovereign) in a transaction in the United States sometimes is asked for an opinion that, under the FSIA, the foreign sovereign is not entitled to sovereign immunity in the United States with respect to the transaction. Under the FSIA, (1) a foreign sovereign is immune from suit in federal and state courts in the United States, and (2) property in the United States of a foreign sovereign is immune from attachment and execution, except as otherwise specifically provided in the FSIA.[210] The FSIA provides seven specific exceptions from immunity, one of which is a waiver of immunity by a foreign sovereign.

In the absence of a waiver, the exception most often applicable in the types of transactions in which a closing opinion typically is requested is for activities of a foreign sovereign that are commercial in nature and that either are carried on in the United States or are the direct effect in the United States of a foreign sovereign's commercial activity elsewhere.[211] Other exceptions may be available in

valid waiver of immunity. The Omnibus Cross-Border Assumption also would cover compliance with that statute.

[210] *See* 28 U.S.C. §§ 1604, 1609 (2012). The FSIA defines a "foreign state" to include a political subdivision of a foreign state and an agency or instrumentality of a foreign state. The FSIA defines an agency or instrumentality to include a separate legal person that is an organ of a foreign state or political subdivision of a foreign state and an entity organized under the laws of, and the majority of whose shares or other ownership interests are owned by, a foreign state or political subdivision. Thus, a corporation that is majority-owned by a foreign state and incorporated in it is a "foreign state" within the meaning of the FSIA. Examples of when this definition may raise issues include financings by public-private partnerships, investment in or by sovereign wealth funds, and business transactions by enterprises in which the government owns a minority stake but also holds a "golden share" that gives it a veto over specified matters. *See generally* GSS Grp. Ltd. v. Nat'l Port Auth., 680 F.3d 805, 811 (D.C. Cir. 2012); Gang Chen v. China Cent. Television, 320 F. App'x 71, 72–73 (2d Cir. 2009); Globe Nuclear Servs. & Supply, Ltd. v. AO Teshsnabexport, 376 F.3d 282, 285 (4th Cir. 2004); Corporacion Mexicana de Servicios Maritimos, S.A. de C.V. v. The M/T Respect, 89 F.3d 650 (9th Cir. 1996) (discussing the status of indirect subsidiaries); Proyecfin de Venezuela, S.A. v. Banco Industrial de Venezuela, S.A., 760 F.2d 390 (2d Cir. 1985); O'Connell Mach. Co. v. M.V. "Americana," 734 F.2d 115 (2d Cir. 1984), *cert. denied*, 469 U.S. 1086 (1984); Kao Hwa Shipping Co., S.A. v. China Steel Corp., 816 F. Supp. 910 (S.D.N.Y. 1993).

[211] 28 U.S.C. §§ 1605(a)(2), 1603(d) (2012). The legislative history of the FSIA indicates, for example, that a foreign state's borrowing of money from U.S. commercial banks is "commercial" in nature and that a foreign state's incurrence of indebtedness in the United States (if the loan agreement is negotiated and executed in the Untied States) is a commercial activity carried out in the United States. *See, e.g.*, Republic of Argentina v. Weltover, Inc., 504 U.S. 607 (1992) (foreign state engages in commercial activity when it acts not as a regulator of a market, but in the manner of a private player within it). For other examples of commercial activities, see Universal Trading & Inv. Co. v. Bureau for Representing Ukrainian Interests in Int'l & Foreign Courts, 727 F.3d 10 (1st Cir. 2013); Shapiro v. Republic of Bolivia, 930 F.2d 1013 (2d Cir. 1991); Eckert Int'l, Inc. v. Gov't of Sovereign Democratic Republic of Fiji, 834 F. Supp. 167 (E.D. Va. 1993), *aff'd*, 32 F.3d 77 (4th Cir. 1994). Courts have great latitude in determining what activities are commercial and whether a particular commercial activity has been performed in the United States, sometimes with surprising results. *See, e.g.*, EM Ltd. v. Republic of Argentina, 389 F. App'x 38, 44 (2d Cir. 2010) (securities held by Argentine law trust in New York banks on behalf of foreign state for investment and eventual sale is "the kind of activity that a private player in the market would carry on for profit and, therefore, a commercial activity in the U.S. under the FSIA"); *see also* Birch Shipping Corp. v. Embassy of Republic of Tanzania, 507 F. Supp. 311 (D.D.C. 1980).

specific circumstances.[212] However, rather than relying on the commercial nature of the transaction or another exception to sovereign immunity provided by the FSIA, U.S. parties typically require a non-U.S. party that might be a "foreign state" as defined in the FSIA to waive sovereign immunity through an express, unconditional, and irrevocable waiver in the agreement itself.[213]

A U.S. lawyer ordinarily can give an opinion that a foreign sovereign's waiver of sovereign immunity is valid, binding, and effective under the FSIA.[214] The opinion, however, would not cover matters not governed by the Covered Law such as: (i) the foreign sovereign's status, power, and authority to waive sovereign immunity; (ii) governmental approvals required for the waiver to be valid and binding in the foreign sovereign's jurisdiction; (iii) effectiveness of the waiver under the law chosen to govern the agreement (if not the Covered

[212] For example, the FSIA contains an exception for the judicial enforcement of an agreement to arbitrate to which a foreign sovereign is a party, whether in an action to compel arbitration or an action to confirm an arbitral award. 28 U.S.C. § 1605(a)(6) (2012). This exception is consistent with section 15 of the FAA, which provides that the enforcement of arbitration agreements and the recognition and enforcement of arbitral awards cannot be avoided by a foreign sovereign's claiming the act of state doctrine (which states that every sovereign nation is bound to respect the independence of every other sovereign nation) if they are otherwise covered by the New York Convention.

[213] While an implicit waiver is not prohibited by the FSIA, it lacks the certainty of an express waiver, particularly one that is part of the agreement the parties are entering into in connection with the transaction and that expressly (i) covers immunity from suit, immunity from execution upon a judgment, and immunity from attachment prior to or after a judgment; and (ii) provides that it remains in effect notwithstanding any attempt to revoke or withdraw it. S*ee generally* Capital Ventures Int'l v. Republic of Argentina, 552 F.3d 289 (2d Cir. 2009); Atwood Turnkey Drilling, Inc. v. Petroleo Brasileiro, S.A., 875 F.2d 1174, 1177 (5th Cir. 1989), *cert. denied*, 493 U.S. 1075 (1990); Proyecfin de Venezuela, S.A. v. Banco Industrial de Venezuela, S.A., 760 F.2d 390, 393 (2d Cir. 1985); Libra Bank Ltd. v. Banco Nacional de Costa Rica, S.A., 676 F.2d 47 (2d Cir. 1982); ICC Chem. Corp. v. Indus. & Commercial Bank of China, 886 F. Supp. 1 (S.D.N.Y. 1995).

Determining how far a waiver extends under the FSIA may not be straightforward. In *First National City Bank v. Banco para el Comercio Exterior de Cuba*, 462 U.S. 611, 627 (1983) (*Bancec*), the U.S. Supreme Court held that duly created instrumentalities of a foreign state are to be accorded a presumption of independent status, such that the property of an instrumentality that has not waived immunity cannot be used to satisfy a judgment against another that has. This presumption, however, can be overcome if the instrumentality is so extensively controlled by its owner that a relationship of principal and agent is created or if recognizing the instrumentality's separate juridical status would work fraud or injustice. *See generally EM Ltd.*, 473 F.3d at 476–80. Courts have been unwilling, however, to take the *Bancec* analysis too far. *See, e.g.*, EM Ltd. v. Banco Central de la Republica Argentina, No. 13-3819, slip op. at 24 (2d Cir. Aug. 31, 2015) ("both *Bancec* and the FSIA legislative history caution against too easily overcoming the presumption of separateness"); NML Capital, Ltd. v. Banco Central de la Republica Argentina, 652 F.3d 172, 195–96 (2d Cir. 2011) (waiver under FSIA must be clear and unambiguous; broadly worded waiver not clear and unambiguous enough to waive central bank's immunity); *see also* Latelier v. Republic of Chile, 748 F.2d 790 (2d Cir. 1984) (cautions against too easily overcoming the *Bancec* presumption of separateness).

[214] The opinion could be worded as follows:

> *Under the Foreign Sovereign Immunities Act of 1976, as amended, [NON-U.S. PARTY] has validly waived its sovereign immunity (if any) from (i) suit in the courts in [COVERED LAW STATE] and United States federal courts and (ii) related legal process, including service of process, attachment of assets, or enforcement by those courts of a judgment against [NON-U.S. PARTY] related to the Agreement.*

Law) or under mandatory provisions of foreign law; or (iv) the foreign sovereign's right to revoke the waiver.[215]

If a non-U.S. party has not waived sovereign immunity, whether an opinion can be given that the non-U.S. party is not immune under the FSIA depends on the circumstances. The opinion preparers could give an unqualified opinion if they are able to conclude with sufficient confidence that the non-U.S. party is not a "foreign state" as defined in the FSIA.[216] In rare situations a U.S. lawyer may believe, but not with the confidence needed to give an unqualified opinion, that a foreign sovereign's activities in the transaction are commercial in nature and, therefore, fall within the FSIA exception for commercial activities; if so, if asked, the lawyer may be willing to give a qualified, reasoned opinion to that effect.

III-9 No Requirement to Qualify to Do Business in the United States

Lenders sometimes request an opinion that making a loan and, in the case of a secured loan, taking a security interest in a borrower's property[217] will not require the lender to qualify to do business as a foreign company in the Covered Law State.[218] This opinion ordinarily is requested only when a non-U.S. lender is making a loan to a borrower in the Covered Law State and the lender is not

[215] On these issues the opinion can be based, without so stating expressly, on the Omnibus Cross-Border Assumption. *See supra* text accompanying note 17. Alternatively, the opinion preparers may expressly assume that under any applicable non-U.S. law the foreign state's waiver is valid, binding, and effective, is unconditional, and cannot be unilaterally withdrawn or revoked.

[216] The opinion preparers may need to base the opinion on stated assumptions as to factual matters and qualify it to the extent that the non-U.S. party's status depends on non-U.S. law.

[217] The opinion preparers ordinarily rely on a factual assumption that the non-U.S. lender has no other activities in or contacts with the Covered Law State or phrase the opinion to relate solely to specific activities involved in the transaction, or both.

[218] *See generally TriBar 1998 Report*, *supra* note 35, at 646–47 & n.119 (§ 6.1.6) (opinion provides comfort that that recipient is not exposed to fines, penalties, or administrative sanctions for failure to qualify); Glazer Treatise, *supra* note 10, at 229 & n.26. Failing to qualify to do business in a state, if required, can expose an entity to adverse consequences, including the inability to enforce its rights under contracts in that state, typically unless and until the failure is cured. *See, e.g.*, Cal. Corp. Code § 191(d) (West 2014) (discussing foreign lenders); Credit Suisse Int'l v. Urbi, DeSarrollos Urbanos, S.A.B. de C.V., 971 N.Y.S.2d 176 (Sup. Ct. Aug. 21, 2013) (unauthorized foreign corporation doing business in New York prohibited from bringing suit even if choice of New York forum valid). An opinion that a foreign judgment may be enforced in the Covered Law State does not address a lender's need to qualify to do business in that state before it can sue to enforce the judgment. *See supra* text accompanying notes 106 & 127.

The opinion that a party is not required to qualify to do business as a result of a particular transaction requires an analysis of the legal definition of "doing business." That distinguishes it from an opinion that an out-of-state entity is duly qualified to do business in a particular state, which, when given as it sometimes is in domestic U.S. transactions, is normally based on a certificate from state officials that the company has qualified to do business in the state. State officials do not issue certificates that qualification is not required. *See also ABA Guidelines*, *supra* note 5, at 877 (§ 4.1) (opinion that company is qualified as a foreign corporation in all jurisdictions in which its properties or activities require qualification should not be requested; analysis of "doing business" requirements in all relevant states is rarely cost-justified and requires knowledge of facts and expertise opinion preparers typically do not have).

otherwise conducting activities, and therefore is not qualified to do business generally, in that state. Although this opinion was once common, today it is rarely requested or given in domestic U.S. transactions. Some non-U.S. lenders, however, continue to request it in cross-border transactions. If the opinion is requested, U.S. lawyers ordinarily are willing to give it (if they are willing to give it at all) only when the transaction is a bank loan.[219] The opinion is not typically requested, and is almost never, if ever, given in transactions such as cross-border joint ventures or investments in U.S. businesses by non-U.S. parties because of the difficulty of analyzing a complex web of contractual rights and obligations and of concluding with the confidence needed to give an opinion that none of the non-U.S. party's activities contemplated by the agreement will constitute "doing business" in the Covered Law State.

Some U.S. lawyers are willing to give the opinion with respect to activities of a non-U.S. lender contemplated by the agreement, but only when the Covered Law clearly provides that those activities do not require the lender to qualify to do business in the Covered Law State. The activities covered by the opinion ordinarily should be limited to the lender's making a loan to a borrower in, or obtaining a guaranty from a guarantor in, the Covered Law State and its taking a security interest in collateral located there.[220] To give the opinion, the opinion preparers do not have to determine whether the lender's possible future activities in the Covered Law State, such as exercising remedies under the loan agreement against a borrower or guarantor or enforcing rights against collateral, would constitute "doing business" under the Covered Law.[221]

Sometimes non-U.S. lenders request an opinion that covers additional matters under the Covered Law, such as licensing requirements, treatment as a resident for tax or other purposes, and exposure to being sued in the Covered Law State. Such requests are generally inappropriate because they relate to matters as to

[219] Even in lending transactions the opinion preparers may be unwilling to give the opinion if the loan is not straightforward and requires them to address the difficult issues often presented by complex corporate financing transactions. For example, if the agreement provides for a series of loan advances, the opinion preparers may not be comfortable with activities that the lender may have the right to engage in under the agreement over the term of the transaction, which may, for example, be contingent on how the project being financed progresses (or fails to progress) over time.

[220] The opinion could be worded as follows:

> *Lender is not required to qualify to do business as a foreign corporation in [COVERED LAW STATE] solely by reason of its execution and delivery of the Agreement and consummation on the date of this letter of the transactions contemplated by the Agreement.*

[221] Depending on the facts and the Covered Law, steps a lender can later take to enforce its rights under the agreement, such as attachment of assets to execute on a judgment, foreclosure on collateral, or taking possession or disposing of the borrower's or a guarantor's property, may require it to qualify to do business in the Covered Law State. While some state statutes include in their list of activities that do not constitute "doing business" foreclosure by a lender on property in which it has a security interest and taking possession of collateral, many state statutes do not. If the lender requests that future activities in which it may engage in the Covered Law State be covered by the opinion but, as often will be the case, the Covered Law is not clear on whether those activities would constitute "doing business" for purposes of the qualification requirement, the opinion preparers may not be able to give the opinion or may have to qualify it.

which the lender should be seeking advice from its own counsel rather than counsel for the borrower.[222]

IV. Other Outbound Opinion Issues: Some Guidelines for Constructive Engagement

Although this Report covers most of the opinions that are commonly given by U.S. lawyers in cross-border transactions,[223] it does not cover every opinion a non-U.S. party may request. Moreover, non-U.S. parties and their counsel may seek formulations of opinions that are different from what U.S. lawyers commonly use. Thus, notwithstanding the guidance provided by this Report, opinion giving in cross-border transactions will continue to present challenges and opportunities for misunderstanding.[224]

Bar groups in the United States have articulated a Golden Rule[225] to provide guidance on what opinions U.S. lawyers can properly be asked and expected to give in domestic U.S. transactions.[226] The Golden Rule, however, does not translate easily to cross-border opinion giving.[227] That is principally because the Golden Rule relies on an assumption that the opinion giver and counsel for

[222] State and federal regulations governing financial services and financial institutions determine what filings or permits are required for different types of lending. To determine whether and how they apply would require an opinion giver to conduct an analysis of the lender's structure and operations in the United States that goes well beyond what can reasonably be expected of counsel for a borrower. Eligibility for the benefits of bilateral treaties against double taxation often depends on non-resident status or whether a non-U.S. entity has a "permanent establishment" in the United States, issues that go well beyond the specific transaction. Whether a non-U.S. party's activities subject it to taxation in the United States at the federal, state, or local level is often a complex issue that does not bear on the question of whether a bank is required to qualify to do business as a foreign entity in a particular state.

[223] The *CLLS Opinion Guide* contains a list of comparable opinions English lawyers give when transaction documents are governed by foreign law. *CLLS Opinion Guide*, *supra* note 4, at 11 (¶ 55).

[224] The risk of misunderstanding is magnified by the growing number of countries and parties involved in cross-border transactions. Moreover, opinion discussions can be complicated by language barriers and widely different legal systems. Also, as discussed earlier in this Report, in many countries limited guidance is available on what third-party opinions can be given, what assumptions, exceptions, and qualifications are reasonable, what various opinions mean, and what work is required to support them.

[225] The *ABA Guidelines* express the Golden Rule as follows:

> *An opinion giver should not be asked to render an opinion that counsel for the opinion recipient would not render if it were the opinion giver and possessed the requisite expertise. Similarly, an opinion giver should not refuse to render an opinion that lawyers experienced in the matters under consideration would commonly render in comparable situations, assuming that the requested opinion is otherwise consistent with these Guidelines and the opinion giver has the requisite expertise and in its professional judgment is able to render the opinion.*

ABA Guidelines, *supra* note 5, at 878 (§ 3.1).

[226] *See infra* note 233. Many of the opinions which U.S. lawyers should not give are identified in bar association reports, which often characterize even requests for these opinions as inappropriate.

[227] *CLLS Opinion Guide*, *supra* note 4, at 2 (¶ 8), 12 (¶ 59) (the Golden Rule can minimize difficulties and costs, but can be difficult to apply). As discussed in prior sections of this Report, opinions given in cross-border transactions often raise issues that do not arise when the same opinions are given in domestic U.S. transactions. Moreover, some opinions U.S. lawyers regularly give in cross-border transactions are not normally given in domestic U.S. transactions (e.g., separate opinions on choice of law, forum selection, and arbitration).

the recipient will be in analogous but opposite positions in other transactions. That assumption does not hold true when opinion givers and recipients' counsel practice in different countries having different legal systems, rules of professional conduct, and opinion practices. Moreover, the opinions requested and given in one country are often different from those requested and given in another, and market expectations are different as well.[228]

While opinion discussions between U.S. lawyers and non-U.S. counsel for the recipient present challenges that U.S. lawyers on opposite sides do not face in domestic U.S. transactions, this Committee believes that the guidelines below, which derive in part from experience with the Golden Rule, will facilitate the giving of opinions in cross-border transactions, and often will reduce friction and cost, if followed by all parties and their counsel.

First, lawyers give opinions in accordance with the customary practice of the jurisdiction in which they practice and should not be expected to know or take into account any other jurisdiction's practice.[229]

Second, the parties to a cross-border agreement and their counsel should consider whether the cost of preparing each opinion requested is justified by its benefit to the recipient in the specific transaction.[230]

Third, a non-U.S. recipient should not insist on receiving an opinion simply because U.S. lawyers give it in domestic U.S. transactions.[231] If the opinion is one that a non-U.S. recipient does not regularly ask non-U.S. lawyers to give in comparable circumstances, questions can legitimately be raised why it is asking U.S. counsel to give that opinion and whether the opinion's benefit to the recipient justifies the cost to the opinion giver's client. Conversely, if the opinion is one that is both regularly requested in the recipient's jurisdiction and regularly given by U.S. lawyers in domestic U.S. practice, and the incremental cost of pre-

[228] Even when a law firm has lawyers with expertise in, and is giving opinions covering, the law of more than one of the jurisdictions whose laws are involved in the transaction, it generally provides a separate opinion letter covering the law of each jurisdiction. This Committee endorses that approach because it reduces potential confusion if matters of both U.S. law and non-U.S. law were addressed in the same opinion letter. The different opinion letters can refer to each other, just as advice from, or reliance on opinions of, non-U.S. counsel from a different law firm can be referred to in opinion letters of U.S. counsel.

[229] *See supra* text accompanying notes 9–16; *see also CLLS Opinion Guide*, *supra* note 4, at 12 (¶ 60).

[230] The principle that the benefit of an opinion to the recipient should warrant the time and expense required to prepare it is particularly important in cross-border transactions. *See ABA Guidelines*, *supra* note 5, at 878 (§ 1.2); *see generally supra* text accompanying notes 6–7. The cost-benefit analysis should take into account such factors as the type of transaction, the importance of the agreement to the transaction, the role played by U.S. law (when the opinion is requested of U.S. counsel), and the relevance of the issues to be covered by the opinion to the commercial bargain between the parties. *See CLLS Opinion Guide*, *supra* note 4, at 11 (¶ 54). These factors may be weighted differently in the cross-border setting than in the domestic U.S. setting. In some jurisdictions or transactions, legal advice from a party's own counsel may take the form of a written opinion; in that case, the cost of an opinion by U.S. counsel that duplicates an opinion the recipient already is receiving from its own counsel may well not be justified by the incremental benefit to the recipient.

[231] Some opinions that are worded the same as opinions routinely given in domestic U.S. transactions are more difficult to give in cross-border transactions. *See supra* Parts III-6 & III-7 (regarding no breach or default and no violation of law opinions); *see also supra* text following note 6.

paring it in a cross-border transaction is not significant, a question can legitimately be raised why a U.S. lawyer is refusing to give it to a non-U.S. recipient even though non-U.S. counsel for the recipient, acting under its jurisdiction's practice, would not give an analogous opinion if the roles were reversed.

Fourth, opinion preparers and counsel for the recipient should always deal with each other professionally and should not treat a closing opinion as a bargaining chip in an economic exchange. Each side should work in good faith to bridge gaps in opinion coverage and achieve a sensible result for all parties under the circumstances. Gaps, however, cannot always be bridged; when U.S. counsel is unable to give a requested opinion, the non-U.S. party is put on notice that a legal issue may exist and faces a choice, with advice from its own counsel, between proceeding without a third-party legal opinion on the issue or changing the terms of the transaction to address the issue (if possible).[232] The opinion process should not be approached as a game in which one side wins and the other side loses.[233]

Fifth, non-U.S. counsel for the recipient should recognize that U.S. opinions are normally worded in particular ways and should not press U.S. opinion givers to deviate from commonly used language for which U.S. customary practice supplies a well-understood meaning (referred to as "customary usage").[234] Customary usage is more than a matter of style. Sometimes, opinion requests by a non-U.S. party use different words and phrases than a U.S. opinion giver would use. The requested wording may stem from differences in law or practice between jurisdictions and not necessarily signal a substantive opinion issue. Misunder-

[232] Closing opinions serve as part of the recipient's diligence, providing the opinion giver's professional judgment on legal issues the recipient has determined to be important to it in the transaction. *See ABA Guidelines*, *supra* note 5, at 875 (§ 1.1). Recipients, however, should not expect opinions given to them by counsel for the other party to address all important legal issues. *See generally* IBA Report, *supra* note 2, at 23–25 (some gaps will remain; opinion recipient should understand those gaps).

[233] An opinion request requiring more than an expression of professional judgment on legal issues or seeking overly broad opinions is inappropriate. *See ABA Guidelines*, *supra* note 5, at 876 (§ 1.2) (opinion should be limited to reasonably specific and determinable matters that involve the exercise of professional judgment by the opinion giver). Examples cited by the *ABA Guidelines* of inappropriate requests include: an opinion that a client is qualified to do business wherever such qualification is required, possesses all necessary licenses and permits to conduct its business, is not in violation of any applicable laws or regulations, or is not in default under any of its contracts; a statement that a client's assets are not subject to any prior security interests; a statement that the client's representations and warranties in the agreement are accurate; and a blanket statement as to the absence of pending or threatened litigation or as to the expected outcome of litigation. Inappropriate opinion requests are not rendered appropriate by limiting them to the opinion giver's knowledge or subjecting them to broadly worded disclaimers.

See also CLLS Opinion Guide, *supra* note 4, at 4 (¶ 9) (inappropriate for scope of opinion to become part of commercial negotiation; law firm instructed to request opinion it would be unwilling to give might explain to client that opinion is unlikely to assist in practice and could lead to difficulty and greater cost, pressuring opinion giver to give opinion will not change the law, and reasonableness of client's reliance on opinion, if given, could be undermined in view of opinion giver's reluctance).

[234] Starting with a seminal 1979 report (TriBar Op. Comm., *Legal Opinions to Third Parties: An Easier Path*, 34 Bus. Law. 1891 (1979)), U.S. customary practice has evolved over the past thirty-five years, with U.S. lawyers developing a common understanding of the meaning of many standard opinions.

standings and delays can be reduced if non-U.S. recipients and their counsel are sensitive to the importance to U.S. opinion givers of adhering to customary usage and, therefore, are willing to accept opinion language commonly used in the United States even if that language does not track the language of the initial opinion request.

Sixth, non-U.S. recipients should not treat an opinion given by U.S. counsel as providing anything more than U.S. counsel's professional judgment on the particular legal issues the opinion addresses. They should not expect U.S. opinion givers to provide confirmations of what are essentially factual, rather than legal, matters or to state a lack of knowledge of acts or events.[235] The parties to a transaction should look to their own counsel to advise them on legal matters, structure the transaction, and negotiate agreements. This is particularly important in transactions involving countries where opinion practice is not well established and each party is represented by lawyers with the necessary expertise to advise it on the relevant issues without incurring the cost and delay of negotiating and preparing a third-party opinion.

V. Conclusion

When U.S. lawyers give opinions in cross-border transactions, they have to deal with legal and interpretive issues that do not arise in domestic U.S. transactions. In addition, they have to deal with expectations of non-U.S. opinion recipients that often are different from those of U.S. recipients. These factors, as well as others discussed in this Report, create a greater risk of misunderstanding in cross-border opinion practice than in domestic U.S. opinion practice.

U.S. lawyers rely on U.S. customary practice when giving opinions in cross-border transactions, just as they do in domestic U.S. transactions. As a result, non-U.S. parties and their non-U.S. counsel must be prepared to commit the time and resources (possibly including retaining U.S. counsel to advise them) required for them to understand the opinions being given. Early in a cross-border transaction counsel for the parties should discuss: (1) the work required to deliver each requested opinion, (2) the cost of preparing each opinion requested compared to its benefit to the recipient, and (3) the assumptions, exceptions, and qualifications that are required to give the requested opinions.

One way of reducing the risk of misunderstanding in cross-border transactions is for U.S. opinion givers to spell out in their opinion letters assumptions, exceptions, or qualifications that do not have to be stated in opinion letters in domestic U.S. transactions. The goal of doing so is greater clarity for the benefit of both non-U.S. opinion recipients and non-U.S. courts that later may be called upon to interpret the opinion letter. To achieve that goal, the opinion preparers should seek to strike the right balance between specificity in the opinion letter's language and reliance on U.S. customary practice, which provides that com-

[235] *See ABA Guidelines*, *supra* note 5, at 875 (§ 1.1), 880 (factual confirmations do not require the exercise of professional judgment and are inappropriate subjects for legal opinions even when limited by broadly worded disclaimers).

monly understood assumptions, exceptions, and qualifications apply whether stated or unstated.

In some cases legal uncertainties will require that exceptions be taken to opinions being given or may make it impossible to give an opinion. In those cases, the parties, working together and with advice from their own counsel, will need to deal with those uncertainties by finding ways to reduce or allocate the risks they pose. Third-party legal opinions, either in domestic U.S. or in cross-border transactions, should not be expected to—and in any event cannot—bridge gaps that the parties are unwilling or unable to fill.

This Committee hopes that this Report will help U.S. lawyers who give opinions in cross-border transactions and lawyers, both U.S. and non-U.S., who advise the recipients of those opinions gain a better understanding of U.S. opinion practice so as to facilitate both requesting and giving outbound opinions on matters subject to U.S. law.

APPENDIX A

List of Defined Terms

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APPENDIX B

Illustrative Opinion Language, Including Selected Assumptions, Exceptions, and Qualifications

The following language, which also appears in various footnotes in this Report (as indicated below in parentheses), is intended only as illustrative of how certain opinions and related assumptions, exceptions, and qualifications discussed in this Report could be drafted. The illustrative language may need to be customized to suit the circumstances of particular transactions and applicable law. Also, this Report contains numerous suggestions as to the phrasing of the opinion as well as related assumptions, exceptions, and qualifications, both in text and in footnotes, concerning the opinions covered by the illustrative language that the opinion preparers may want to consider when drafting their opinion letters.

Assumptions, Exceptions, and Qualifications

1. **Reference to U.S. customary practice** (*see* note 15 and accompanying text):

   Alternative 1: *This opinion letter shall be interpreted in accordance with the Legal Opinion Principles prepared by the Legal Opinions Committee of the American Bar Association's Business Law Section as published in 53 Bus. Law. 831 (1998)[, a copy of which is attached to this opinion letter].*

   Alternative 2: *This opinion letter shall be interpreted in accordance with the customary practice of United States lawyers who regularly give, and lawyers who regularly advise recipients regarding, opinions of the kind included in this opinion letter.*

2. **Omnibus Cross-Border Assumption** (*see* note 17 and accompanying text):

   We have assumed that the choice of the law of [FOREIGN COUNTRY] in the Agreement is valid and the Agreement and each of its provisions are valid, binding and enforceable under the law of [FOREIGN COUNTRY] and of any other jurisdiction whose law applies, other than law covered expressly in an opinion included in this opinion letter. [IF THE AGREEMENT CONTAINS A FORUM SELECTION CLAUSE, ADD—We also have assumed that, other than the courts of [COVERED LAW STATE] and United States federal courts, any court named in the forum selection clause of the Agreement will have jurisdiction over the parties and the subject matter of any action brought in that court under the Agreement.]

3. ***Bremen* exception for opinions on the validity of forum selection clauses** (*see* note 120 and accompanying text):

   The opinion in numbered paragraph __ is limited to the extent that a court may decline to give effect to the forum selection clause in Section __ of the

Agreement because enforcement would be unreasonable or unjust under the principles enunciated in the decision of the U.S. Supreme Court in M/S Bremen & Unterweser Reederel, GmbH v. Zapata Off-Shore Co., 402 U.S. 1 (1972) and in related cases, including that it would contravene a strong public policy of [COVERED LAW STATE].

4. **Interpretation of contracts for purposes of the no breach or default opinion** (*see* note 179 and accompanying text):

   We have interpreted the provisions of the contracts addressed by the opinion in numbered paragraph __ as those provisions would be understood in [COVERED LAW STATE] whether they are governed by the law of [COVERED LAW STATE] or by the law of another jurisdiction.

Opinions

1. **Validity of choice of non-U.S. law** (*see* note 35 and accompanying text):

   Under the law of [COVERED LAW STATE], the choice of the law of [FOREIGN COUNTRY] in the Agreement is valid except to the extent that giving effect to the law of [FOREIGN COUNTRY] would violate a fundamental policy of (i) the jurisdiction whose law is covered by this opinion letter or (ii) any other jurisdiction having a materially greater interest than [FOREIGN COUNTRY] in the determination of the issue, if the law of that jurisdiction would apply to the Agreement or any of its provisions in the absence of a governing law clause.

2. **Enforceability of cross-border arbitration clause** (*see* note 59 and accompanying text):

   The arbitration clause in Section ___ of the Agreement is valid and enforceable under the federal law of the United States and the law of [COVERED LAW STATE], except to the extent that an exception set forth in the Convention on the Recognition and Enforcement of Foreign Arbitral Awards or the Federal Arbitration Act, 9 U.S.C. §§ 201–208, applies. (*)

   (*) If the opinion is being given on the basis that the arbitration clause falls under the New York Convention and Chapter 2 of the Federal Arbitration Act, some lawyers choose to be specific about the scope of the arbitration provision by using language such as the following:

   The Company's covenant in Section ___ of the Agreement to submit to mandatory arbitration in [ARBITRAL TRIBUNAL OUTSIDE THE UNITED STATES] is valid and enforceable under the federal law of the United States and the law of [COVERED LAW STATE] to the extent that the arbitration relates to contract claims arising under the Agreement, except to the extent that an exception set forth in the Con-

vention on the Recognition and Enforcement of Foreign Arbitral Awards or the Federal Arbitration Act, 9 U.S.C. §§ 201–208, applies.

3. **Recognition and enforcement of foreign arbitral award** (*see* note 69 and accompanying text):

   Except to the extent that an exception set forth in the Convention on the Recognition and Enforcement of Foreign Arbitral Awards (the "New York Convention") and the Federal Arbitration Act, 9 U.S.C. §§ 201–208 (the "FAA"), applies, an arbitral award made under Section __ of the Agreement will be recognized and enforced under the New York Convention and the FAA, if a proceeding to enforce the award is properly brought in a United States federal court within three years after the arbitral award is made. (*)

   (*) If the opinion is being given on the basis that the arbitration clause falls under the New York Convention and Chapter 2 of the Federal Arbitration Act, some lawyers choose to make it clear that the arbitral award must be a "foreign" award by using language such as the following:

   Except to the extent that an exception set forth in the Convention on the Recognition and Enforcement of Foreign Arbitral Awards (the "New York Convention") and the Federal Arbitration Act, 9 U.S.C. §§ 201–208 (the "FAA"), applies, an arbitral award made by [ARBITRAL TRIBUNAL OUTSIDE THE UNITED STATES] in accordance with the requirements of Section __ of the Agreement will be recognized and enforced under the New York Convention and the FAA to the extent that the arbitration relates to contract claims arising under the Agreement, if a proceeding to enforce the award is properly brought in a United States federal court within three years after the arbitral award is made.

4. **Validity of forum selection clause if the opinion does not characterize the clause as permissive or mandatory** (*see* note 90 and accompanying text):

   The forum selection clause in Section __ of the Agreement is valid and enforceable under the law of [COVERED LAW STATE] for actions relating to contract claims arising under the Agreement.

5. **Validity of permissive outbound forum selection clause** (*see* note 99 and accompanying text):

   The Company's agreement in Section __ of the Agreement to submit to the non-exclusive jurisdiction of the courts of [FOREIGN LAW COUNTRY] is valid and enforceable under the law of [COVERED LAW STATE] for actions relating to contract claims arising under the Agreement.

6. **Validity of permissive inbound forum selection clause** (*see* note 102 and accompanying text):

   The Company's agreement in Section __ of the Agreement to submit to the non-exclusive jurisdiction of the courts of [COVERED LAW STATE] [and United States federal courts] is valid and enforceable under the law of [COVERED LAW STATE] [and the federal law of the United States] for actions relating to contract claims arising under the Agreement.

7. **Validity of mandatory outbound forum selection clause** (*see* note 116 and accompanying text):

   The Company's agreement in Section __ of the Agreement that the courts of [FOREIGN COUNTRY] shall have exclusive jurisdiction is valid and enforceable under the law of [COVERED LAW STATE] for actions relating to contract claims arising under the Agreement.

8. **Validity of mandatory inbound forum selection clause** (*see* note 125 and accompanying text):

   The Company's agreement in Section __ of the Agreement that the courts of [COVERED LAW STATE] [and United States federal courts] shall have exclusive jurisdiction is valid and enforceable under the law of [COVERED LAW STATE] [and the federal law of the United States] for actions relating to contract claims arising under the Agreement.

9. **Recognition and enforcement of foreign judgments** (*see* note 133 and accompanying text):

   To the extent that it relates to contract claims arising under the Agreement, a final and conclusive judgment granting or denying recovery of a sum of money, other than a judgment for taxes, a fine or other penalty, rendered by a court of [FOREIGN COUNTRY] against the Company that is enforceable in [FOREIGN COUNTRY] will be recognized as valid and enforced under the law of [COVERED LAW STATE] by the courts of [COVERED LAW STATE] or by United States federal courts having jurisdiction and applying the law of [COVERED LAW STATE], without a re-examination of the substantive issues underlying the judgment, subject to (i) grounds for nonrecognition and exceptions to enforcement set forth in the Uniform Foreign Money-Judgments Recognition Act as adopted in [COVERED LAW STATE] (the "Act")[IF OPINION GIVER WISHES TO REFER TO PARTICULAR EXCEPTIONS FROM THE STATUTE, ADD— , which include, but are not limited to, __________________] and (ii) the court's power to stay proceedings to enforce a foreign judgment pending determination of any appeal or until the expiration of time sufficient to enable the defendant to prosecute an appeal. [IF APPLICABLE IN THE COVERED LAW STATE, ADD—This opinion is based on the assumption that the law of [FOREIGN COUNTRY] requires a court of competent jurisdiction in [FOREIGN COUNTRY], in a *reciprocal manner, to recognize and enforce a final and conclusive judgment of a court of [COVERED LAW STATE] without reconsideration of the merits.]*

10. **Validity of service of process** (*see* note 161 and accompanying text):

    The methods for service of process set forth in Section __ of the Agreement are valid under the law of [COVERED LAW STATE].

11. **No violation of U.S. statutes, rules, or regulations** (*see* notes 189 & 194 and accompanying text):

    Except as set forth below, the execution and delivery of the Agreement by the Company and consummation by the Company of the transactions contemplated by the Agreement do not result in any violation by the Company of statutes of the United States or [COVERED LAW STATE], or rules or regulations thereunder, that, subject to the limitations in the following sentence, we would reasonably be expected to recognize as being applicable to an entity, transaction or agreement to which this opinion letter relates. **(*)**

    (*) Some lawyers choose to be specific about statutes, rules, or regulations that are not covered by the no violation opinion by using language such as the following:

    The opinion in paragraph __ does not cover, without limitation, the following statutes, rules, and regulations: [. . .], or other statutes, rules, or regulations customarily understood to be excluded even though they are not expressly stated to be excluded.

12. **No sovereign immunity of U.S. party** (*see* note 204 and accompanying text):

    Neither [U.S. PARTY] nor its assets are immune on grounds of sovereign immunity from (i) suit in connection with the Agreement in the courts in [COVERED LAW STATE] [or United States federal courts] or (ii) related legal process, including service of process, attachment of assets, or enforcement by those courts of a judgment against the Company related to the Agreement.

13. **Waiver of sovereign immunity under FSIA** (*see* note 214 and accompanying text):

    Under the Foreign Sovereign Immunities Act of 1976, as amended, [NON-U.S. PARTY] has validly waived its sovereign immunity (if any) from (i) suit in the courts in [COVERED LAW STATE] and United States federal courts and (ii) related legal process, including service of process, attachment of assets, or enforcement by those courts of a judgment against [NON-U.S. PARTY] related to the Agreement.

14. **Foreign lender not required to qualify to do business** (see note 220 and accompanying text):

    Lender is not required to qualify to do business as a foreign corporation in [COVERED LAW STATE] solely by reason of its execution and delivery of the Agreement and consummation on the date of this letter of the transactions contemplated by the Agreement.

Corporate Compliance Survey

*By Paul E. McGreal**

This is the tenth survey from the Corporate Compliance Committee.[1] This survey summarizes selected legal developments regarding corporate compliance and ethics programs, which consist of an organization's code of conduct, policies, and procedures designed to achieve compliance with applicable legal regulations and internal ethical standards.[2] For an overview and introduction to the subject, as well as updates from prior years, please see the prior surveys.[3] This update assumes familiarity with the background and overview discussed there.

The developments discussed here relate to revised federal guidance under the Foreign Corrupt Practices Act; a recent federal court decision interpreting the Foreign Corrupt Practices Act; application of the attorney-client privilege to internal investigations; and caselaw developments under corporate law, federal employment discrimination law, and state employment law. Part I reviews significant developments under the anti-bribery provisions of the Foreign Corrupt Practices Act, Part II reviews recent decisions under the attorney-client privilege, and Part III reviews significant caselaw developments.

I. Foreign Corrupt Practices Act

The U.S. Foreign Corrupt Practices Act (FCPA) has two parts: the accounting provision and the anti-bribery provision. The accounting provision requires that all public companies keep accurate financial records and maintain internal controls adequate to produce such records. The anti-bribery provision, which is the

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[1] This survey incorporates background and related textual discussions from prior surveys throughout the text. *See* Corporate Compliance Comm., Am. Bar Ass'n Section of Bus. Law, *Corporate Compliance Survey*, 60 Bus. Law. 1759 (2005) [hereinafter *Survey I*]; Corporate Compliance Comm., Am. Bar Ass'n Section of Bus. Law, *Corporate Compliance Survey*, 61 Bus. Law. 1645 (2006) [hereinafter *Survey II*]; Corporate Compliance Comm., Am. Bar Ass'n Section of Bus. Law, *Corporate Compliance Survey*, 63 Bus. Law. 195 (2007) [hereinafter *Survey III*]; Paul E. McGreal, *Corporate Compliance Survey*, 64 Bus. Law. 253 (2008) [hereinafter *Survey IV*]; Paul E. McGreal, *Corporate Compliance Survey*, 65 Bus. Law. 193 (2009) [hereinafter *Survey V*]; Paul E. McGreal, *Corporate Compliance Survey*, 66 Bus. Law. 125 (2010); Paul E. McGreal, *Corporate Compliance Survey*, 67 Bus. Law. 227 (2011); Paul E. McGreal, *Corporate Compliance Survey*, 68 Bus. Law. 163 (2012) [hereinafter *Survey VIII*]; Paul E. McGreal, *Corporate Compliance Survey*, 69 Bus. Law. 107 (2013).

[2] While compliance programs can take an even broader view, managing all of the organization's risks, I focus here on legal compliance.

[3] *See supra* note 1.

focus of this discussion, makes it a federal crime to bribe a foreign government official.[4] The anti-bribery provision applies to a wide range of actors, including companies with securities registered under federal law; companies incorporated or located in the United States; U.S. citizens, nationals, and residents; and any person or company that took action in furtherance of a prohibited bribe "while in the territory of the United States."[5] An unlawful bribe occurs when a person or entity covered under the statute uses interstate commerce to give anything of value to a foreign official with the corrupt purpose of obtaining or retaining business.[6]

Making matters more complicated, the FCPA applies when an organization directly makes the forbidden payment to a foreign government official and when that organization makes a payment to a third party (such as an agent or contractor) *knowing* that the third party will then make a forbidden payment to a foreign government official.[7] "Knowing" is defined to include circumstances where "a person is aware of a high probability of the existence of [the forbidden payment], unless the person actually believes that such circumstance does not exist."[8] Thus, a company or individual may be deemed to know of an agent's bribe if the company were "aware of a high probability" that a bribe might be made.[9] Such awareness could exist when an agent's activities raise red flags, such as a request for payment in cash or under an assumed name, a higher than usual commission, or a refusal to document expense-reimbursement requests. To avoid a finding that the organization "knew" such an agent was making bribes, the organization should implement compliance controls to prevent and detect agent misconduct.

Many terms within the anti-bribery provision are open to interpretation: What does it mean to take action "while in the territory of the United States"? What constitutes anything of value? Who is a foreign official? Because most FCPA

[4] Foreign Corrupt Practices Act of 1977, Pub. L. No. 95-213, § 103(a), 91 Stat. 1494, 1495–96 (codified as amended at 15 U.S.C. § 78dd-1 (2006)).

[5] FCPA § 105(a), 15 U.S.C. § 78dd-3(a) (2012).

[6] The full text of the prohibition is as follows:

> It shall be unlawful for any issuer which has a class of securities registered pursuant to section 78*l* of this title or which is required to file reports under section 78o(d) of this title, or for any officer, director, employee, or agent of such issuer or any stockholder thereof acting on behalf of such issuer, to make use of the mails or any means or instrumentality of interstate commerce corruptly in furtherance of an offer, payment, promise to pay, or authorization of the payment of any money, or offer, gift, promise to give, or authorization of the giving of anything of value to—
>
> (1) any foreign official for purposes of—
>
> (A)(i) influencing any act or decision of such foreign official in his official capacity, (ii) inducing such foreign official to do or omit to do any act in violation of the lawful duty of such official, or (iii) securing any improper advantage; or
>
> (B) inducing such foreign official to use his influence with a foreign government or instrumentality thereof to affect or influence any act or decision of such government or instrumentality . . . .

FCPA § 103(a), 15 U.S.C. § 78dd-1(a)(1).

[7] FCPA § 103(a), 15 U.S.C. § 78dd-1(a)(3).

[8] 15 U.S.C. § 78dd-1(f)(2)(B).

[9] *Id.*

investigations settle, there are few decided cases interpreting these terms.[10] Therefore, the government's interpretation takes on added significance; that is, because settlement with the government is almost certain, compliance professionals want to know what kinds of behavior are likely to trigger an investigation by the U.S. Department of Justice (DOJ) or the U.S. Securities and Exchange Commission (SEC). This will inform the design and implementation of the company's compliance program, such as its FCPA policy, training, monitoring, and auditing. Until recently, the DOJ's only written guidance directed to the FCPA was a rather slim document that added little gloss to the statute's text and provided no enforcement or compliance guidance.[11] This left to compliance professionals the task of reviewing a wide array of sources to decipher the government's likely disposition, including deferred prosecution agreements, speeches, press releases, opinion procedure releases,[12] and the like.

Not surprisingly, compliance professionals were greatly encouraged by the November 2012 release of a document titled *A Resource Guide for the U.S. Foreign Corrupt Practices Act*.[13] At 120 pages, including footnotes, the document more than lived up to its name, and it instantly became a must-read for compliance professionals facing FCPA issues. While the *Resource Guide* broke no new ground on either the government's interpretation or enforcement priorities under the FCPA, it did the tremendous service of collecting a wide array of FCPA sources into a single document. Furthermore, the selection of sources provides some insight into the DOJ's and SEC's current thinking on FCPA interpretation and enforcement. Given its scope and relative detail, the *Resource Guide* quickly became an essential volume on the compliance and ethics officer's bookshelf.

A recent criticism of the *Resource Guide* is that revisions over the last three years have been "opaque, making it difficult to know whether and when changes have been made."[14] For example, a comparison of various versions of the *Resource Guide* shows that in around December 2012, the DOJ and SEC revised

[10] The government's first FCPA trial against a corporation was not until 2011, which resulted in a jury verdict of guilty. *See* Press Release, U.S. Dep't of Justice, California Company, Its Two Executives and Intermediary Convicted by Federal Jury in Los Angeles on All Counts for Their Involvement in Scheme to Bribe Officials at State-Owned Electrical Utility in Mexico (May 11, 2011) (No. 11-596), http://www.justice.gov/opa/pr/2011/May/11-crm-596.html. The conviction was later overturned by the trial court judge. U.S. v. Aguilar, 831 F. Supp. 2d 1180 (C.D. Cal. 2011).

[11] U.S. Dep't of Justice & U.S. Dep't of Commerce, Foreign Corrupt Practices Act: Antibribery Provisions (2011).

[12] The FCPA charges the DOJ with responding to requests for guidance regarding application of the FCPA to specific transactions. *See* Foreign Corrupt Practices Act Amendments of 1988 § 5003(a), 15 U.S.C. §§ 78dd-1, 78dd-2 (2012). Also, the DOJ has promulgated rules governing such requests, which are answered in a document known as an "opinion procedure release." *See* Foreign Corrupt Practices Act Opinion Procedure, 28 C.F.R. §§ 80.1–80.16 (2015). The DOJ collects these opinion procedure releases on its web page. *See Foreign Corrupt Practices Act: Opinion Procedure Releases*, U.S. Dep't of Justice, http://www.justice.gov/criminal/fraud/fcpa/opinion/ (last visited Sept. 28, 2015).

[13] Criminal Div., U.S. Dep't of Justice & Enforcement Div., U.S. Sec. & Exch. Comm'n, A Resource Guide to the U.S. Foreign Corrupt Practices Act (2012), *available at* http://www.justice.gov/sites/default/files/criminal-fraud/legacy/2015/01/16/guide.pdf.

[14] Marc Alain Bohn, *A Closer Look at the Revisions to the FCPA Guide*, FCPA Blog (Aug. 6, 2015, 7:05 PM), http://www.fcpablog.com/blog/2015/8/6/a-closer-look-at-the-revisions-to-the-fcpa-guide.html#sthash.SjBYGwDZ.dpuf.

the substantive discussion of joint ventures to correct errors. Sometime later, with one commentator dating the change between April 2013 and April 2014, the text of the *Resource Guide* was revised concerning the available fine ranges.[15] Neither change was announced by the DOJ or the SEC, nor does the text of the *Resource Guide* indicate that any changes were made from the original document. Indeed, the only indication that the document posted online may be different from the original version appears in the web address for the PDF file, which includes the date "2015/01/16."[16] In light of this inconsistent practice, the following advice from an FCPA commentator is well taken: "[P]ractitioners relying on the FCPA Guide would be wise to consult the current online version of the guidance posted to the DOJ's and SEC's respective websites."[17]

In a rare judicial development, the U.S. Court of Appeals interpreted the Act's use of the term "foreign official." The statute defines the term to include employees of "a foreign government or any department, agency, or *instrumentality thereof*."[18] In *United States v. Esquenazi*,[19] the United States prosecuted two executives for using agents to make allegedly improper payments to employees of Telecommunications D'Haiti S.A. (Haiti Teleco), the state-owned national telecommunications entity of Haiti. The payments were made allegedly to gain the business advantage of "reduced international telecommunications rates and unearned credits."[20]

The Eleventh Circuit brief for the United States explains the factual background for the argument that Haiti Teleco was a government instrumentality:

> During the relevant time period, Teleco was controlled by its Board of Directors and General Director, and those individuals were appointed through an executive order issued by the President of Haiti and signed by Haiti's Prime Minister, the Minister of Public Works, Transportation and Communications, and the Minister of Economy and Finance. At least three of the five board members were public officials, including the Board's president and vice-president. In March 2001, President Jean-Bertrand Aristide appointed Patrick Joseph as General Manager of Teleco, and in June 2003, the Minister of Public Works appointed Duperval as Teleco's Deputy General Director and set his salary.
>
> Haitian law recognized Teleco as a state-owned company. In 1996, Haiti passed a "modernization law" to partially privatize "public institutions" that were "not well managed by . . . [the] government" and "were losing money." One of the law's provisions specifically named "telephones" as a "State-owned compan[y]."

[15] *Id.*

[16] The full web address is http://www.justice.gov/sites/default/files/criminal-fraud/legacy/2015/01/16/guide.pdf.

[17] Bohn, *supra* note 14.

[18] FCPA § 103(f)(2), 15 U.S.C. § 78dd-1(f)(2) (2012) (emphasis added).

[19] 752 F.3d 912 (11th Cir. 2014).

[20] Corrected Brief of Appellant at 7, United States v. Esquenazi, 752 F.3d 912 (11th Cir. 2014) (No. 11-15331-C) [hereinafter Appellant's Brief].

> Teleco also enjoyed the benefits of a state-owned corporation. It did not pay corporate income tax or custom duties, and the bank paid its expenses and covered its losses when it failed to realize any profits. If Teleco had been profitable, Haitian law dictated that the profits would have been distributed to the public treasury and the bank's reserve funds.[21]

The government relied on a multifactor test to argue that the entity performs a governmental function. These factors include government ownership of and subsidy to the entity, appointment of the entity's management and board by the government, how the entity is treated by the country's domestic laws, and whether the entity carries out a purpose or function of the government.[22] Esquenazi countered that government instrumentality should be limited to entities that perform traditional governmental functions akin to a "political subdivision."[23] He argued that Haiti Teleco operated as a private telecommunications company and not as a traditional government department or agency.[24]

In May 2014, the Eleventh Circuit sided with the government's more expansive definition.[25] The court focused on how the foreign government viewed the entity at issue:

> [T]o decide in a given case whether a foreign entity to which a domestic concern makes a payment is an instrumentality of that foreign government, we ought to look to whether that foreign government considers the entity to be performing a governmental function. And the most objective way to make that decision is to examine the foreign sovereign's actions, namely, whether it treats the function the foreign entity performs as its own. Presumably, governments that mutually agree to quell bribes flowing between nations intend to prevent distortion of the business they conduct on behalf of their people. We ought to respect a foreign sovereign's definition of what that business is.[26]

Based on this interpretation, the court adopted a test with two elements: government control of the entity at issue and the government's treatment of the work performed by the entity. An instrumentality, then, is "an entity controlled by the government of a foreign country that performs a function the controlling government treats as its own."[27] The court adopted this test as more consistent with the FCPA's text and history, including amendments to the FCPA to conform the statute to the United States' obligations under the Anti-Bribery Convention of the Organization for Economic Cooperation and Development. Further, the court rejected the defendant's proposed "traditional government function" test as unworkable. For one, the list of activities considered government "functions" changes over time; therefore, it would be inappropriate to define an instrumen-

[21] Brief of the United States at 7, United States v. Esquenazi, 752 F.3d 912 (11th Cir. 2014) (No. 11-15331-C).

[22] *Id.* at 29–31.

[23] Appellant's Brief, *supra* note 20, at 29, 32.

[24] Appellant's Brief, *supra* note 20, at 45, 48.

[25] United States v. Esquenazi, 752 F.3d 912 (11th Cir. 2014).

[26] *Id.* at 924–25.

[27] *Id.* at 925.

tality by a traditional conception tied to past practices.[28] In addition, what constitutes "government functions" differs from country to country, and "the most objective way to make that decision is to examine the foreign sovereign's actions, namely, whether it treats the function the foreign entity performs as its own."[29]

The court's opinion explained that its two-prong test is heavily "fact-bound," and then it offered a list of nonexhaustive factors for each.[30] On the question of government control, the court provided the following guidance:

> To decide if the government "controls" an entity, courts and juries should look to the foreign government's formal designation of that entity; whether the government has a majority interest in the entity; the government's ability to hire and fire the entity's principals; the extent to which the entity's profits, if any, go directly into the governmental fisc, and, by the same token, the extent to which the government funds the entity if it fails to break even; and the length of time these indicia have existed.[31]

On the question of how the government treats the entity's work, the court provided the following factors:

> Courts and juries should examine whether the entity has a monopoly over the function it exists to carry out; whether the government subsidizes the costs associated with the entity providing services; whether the entity provides services to the public at large in the foreign country; and whether the public and the government of that foreign country generally perceive the entity to be performing a governmental function.[32]

The court concluded that the trial court's jury instruction had adequately covered both prongs of the instrumentality test and that Haiti Teleco easily met both prongs.[33]

II. Attorney-Client Privilege

Over the last two years, Judge James Gwin of the U.S. District Court for the District of Columbia has been in an extraordinary exchange with the U.S. Court of Appeals for the D.C. Circuit over application of the attorney-client privilege to a company's internal investigation. The litigation involves a Federal Claims Act lawsuit brought by Henry Barko, who had worked in Iraq as a contract administrator for Kellogg Brown and Root, Inc. (KBR). Barko claimed that KBR had defrauded the U.S. government by submitting false charges for services performed in Iraq. Upon learning of the possible wrongdoing, KBR conducted

[28] *Id.* at 924.

[29] *Id.* at 925.

[30] *Id.* ("It would be unwise and likely impossible to exhaustively answer them in the abstract. Because we only have this case before us, we do not purport to list all of the factors that might prove relevant to deciding whether an entity is an instrumentality of a foreign government. For today, we provide a list of some factors that may be relevant to deciding the issue.").

[31] *Id.*

[32] *Id.* at 296.

[33] *Id.* at 927–29.

an internal investigation as required by its business code of conduct; the code itself was required by Department of Defense regulations applicable to all defense contractors.[34] In a request for production of documents, Barko asked for "documents relating to internal audits and investigations of the subject matter of the" litigation.[35] KBR asserted the attorney-client privilege to protect its internal investigation from discovery, and Barko filed a motion to compel production.

The district court found that the attorney-client privilege did not protect the internal investigation and ordered production of the requested documents. The court explained that the privilege only protects communications made with the "primary purpose" "of securing . . . either (i) an opinion on law or (ii) legal services or (iii) assistance in some legal proceeding."[36] The court further explained that a primary purpose must be a "but for" cause.[37] In this case, because KBR's code required an internal investigation, legal advice could not be the "but for" cause of the investigation, and the documents were not privileged. The court ordered production.

The district court's decision effectively deprived an organization with an effective compliance and ethics program of the attorney-client privilege for an internal investigation. The Sentencing Guidelines provide that "[a]fter criminal conduct has been detected, the organization shall take reasonable steps to respond appropriately to the criminal conduct."[38] One critical step in responding "appropriately" is to investigate the wrongdoing that has been detected; moreover, an effective compliance and ethics program will mandate a thorough internal investigation. Because of this mandate, obtaining legal advice would not be the "but for" cause of an internal investigation, and the attorney-client privilege could not attach.[39]

When the district court refused to certify its order for appeal and then set a quick deadline for document production, KBR filed a petition for writ of mandamus in the court of appeals. The court of appeals rejected the district court's "but for" standard, adopting instead a "significant purpose" test:

> Given the evident confusion in some cases, we also think it important to underscore that the primary purpose test, sensibly and properly applied, cannot and does not draw a rigid distinction between a legal purpose on the one hand and a business purpose on the other. After all, trying to find the one primary purpose for a communication motivated by two sometimes overlapping purposes (one legal and one business, for example) can be an inherently impossible task. It is often not useful or even feasible to try to determine whether the purpose was A or B when the pur-

[34] *See* 48 C.F.R. §§ 203.7000–.7001(a) (2015).

[35] United States *ex rel.* Barko v. Halliburton Co., 37 F. Supp. 3d 1, 3 (D.D.C. 2014).

[36] *Id.* at 5.

[37] *Id.*

[38] U.S. Sentencing Guidelines Manual § 8B2.1(b)(7) (U.S. Sentencing Comm'n 2014).

[39] In ruling on KBR's petition for writ of mandamus, the court of appeals reached a similar conclusion: "the District Court's novel approach would eradicate the attorney-client privilege for internal investigations conducted by businesses that are required by law to maintain compliance programs, which is now the case in a significant swath of American industry." *In re* Kellogg Brown & Root, Inc., 756 F.3d 754, 759 (D.C. Cir. 2014).

> pose was A and B. It is thus not correct for a court to presume that a communication can have only one primary purpose. It is likewise not correct for a court to try to find the one primary purpose in cases where a given communication plainly has multiple purposes. Rather, it is clearer, more precise, and more predictable to articulate the test as follows: Was obtaining or providing legal advice a primary purpose of the communication, meaning one of the significant purposes of the communication? As the Reporter's Note to the Restatement says, "In general, American decisions agree that the privilege applies if one of the significant purposes of a client in communicating with a lawyer is that of obtaining legal assistance." We agree with and adopt that formulation—"one of the significant purposes"—as an accurate and appropriate description of the primary purpose test. Sensibly and properly applied, the test boils down to whether obtaining or providing legal advice was one of the significant purposes of the attorney-client communication.[40]

The court explained that under the "significant purpose" test an internal investigation could be protected by the attorney-client privilege even if it were required by a company policy mandated by legal regulation.[41] A significant purpose of seeking legal advice is not precluded by the additional purpose of conducting a required internal investigation. Because KBR was seeking legal advice in addition to following its code, a significant purpose of the internal investigation was to provide legal advice, and thus documents related to the internal investigation were protected by the attorney-client privilege.[42]

After the court of appeals ruling, the district court took up the question of whether KBR had waived the attorney-client privilege. Specifically, the court considered whether KBR had made an implied waiver,[43] which occurs when "[t]he party asserting the privilege . . . put[s] a communication at issue through some affirmative act."[44] Here, the district court concluded that KBR had put the internal investigation at issue in the litigation through the deposition of its in-house counsel. On questioning by KBR's attorney, the in-house counsel testified that: (1) Department of Defense regulations required KBR to disclose to the government whenever it has "reasonable grounds to believe" that a legal violation has occurred; (2) KBR had made such disclosures in the past; and, (3) after an investigation of the alleged wrongdoing underlying this litigation, KBR had not made a report to the government.[45] KBR then cited this testimony in its motion for summary judgment where it repeated the assertion that it had reported wrongdoing to the government in the past when it had found reasonable grounds for doing so and that it made no report in this matter after conducting the required internal investigation.[46]

[40] *Id.* at 760 (citation omitted).

[41] *Id.*

[42] *Id.*

[43] The court also referred to implied waiver as "at issue waiver" throughout its opinion. For simplicity, I use only "implied waiver" in the text above.

[44] United States *ex rel.* Barko v. Halliburton Co., 37 F. Supp. 3d 1, 9 (D.D.C. 2014).

[45] *Id.* at 11–17.

[46] *Id.*

The district court concluded that KBR was using the internal investigation to advocate inferences in support of summary judgment:

> KBR's message is obvious: KBR's COBC reports—which are a privileged investigation of Barko's allegations—contain no reasonable grounds to believe a kickback occurred. And KBR gives a second message: do not worry about the production of the COBC documents because they show nothing. KBR does not state this conclusion explicitly. It does not need to. KBR's statements make its preferred conclusion both unspoken and unavoidable.[47]

According to the court, KBR put the contents of the internal investigation at issue on a key question: Did the fraud occur? The district court concluded that KBR's actions by implication waived the privilege and once again ordered production of the internal investigation documents on a short timeline. KBR again filed a petition for writ of mandamus in the court of appeals, and that court stayed production of the documents.

The court of appeals again overturned the district court, this time finding no implied waiver. The court of appeals first concluded that the in-house counsel's deposition testimony did not waive the privilege.[48] The testimony simply stated facts on the record, and those facts, standing alone, did not raise or advocate an inference concerning the content of the internal investigation.[49] Consequently, any such inference would have had to come from other actions by KBR in the litigation.[50]

The court of appeals next considered whether use of the deposition testimony in KBR's motion for summary judgment constituted an implied waiver. The court of appeals rejected the district court's conclusion that KBR had offered the "unavoidable inference" that the contents of the internal investigation did not contain evidence of wrongdoing. Instead, the court of appeals read the motion as making the descriptive assertion that KBR's consistent practice was not to waive the attorney-client privilege.[51] To emphasize KBR's seriousness on this point, the motion noted that KBR had followed this practice even in cases where an internal investigation discovered wrongdoing that had to be disclosed to the government.[52] It did so despite the fact that failure to waive the privilege could lead the government to conclude that KBR had not fully cooperated with the government or adequately disclosed the wrongdoing as required by law.[53] The intended inference was that, if KBR did not waive the privilege in making disclosures despite potentially serious negative consequences, it surely did not waive the privilege in this matter when no disclosure was made.[54]

[47] *Id.* at 17.

[48] *In re* Kellogg Brown & Root, Inc., 796 F.3d 137, 146 (D.C. Cir. 2015).

[49] *Id.* ("The deposition transcript is simply a record of what was said, not itself an argument.").

[50] The court of appeals noted that a party could waive the privilege in a deposition by disclosing otherwise privileged material. *Id.* at 145–46.

[51] *Id.* at 147.

[52] *Id.*

[53] *Id.* ("Where companies choose not to waive privilege, '[t]hey will, of course, bear the risk that their reports will not be accepted as full disclosures.'").

[54] *Id.* at 148.

The court of appeals concluded that KBR's reference to the deposition and the internal investigation did not put privileged materials at issue, and therefore KBR did not by implication waive the privilege. This ruling gives an additional layer of comfort to organizations undertaking an internal investigation because it holds that mere reference to the investigation in litigation will not waive the privilege. That said, to avoid protracted litigation of the question, counsel for an organization should clearly state the purpose of any references to an internal investigation and perhaps even specifically negate any inferences that could be used to advocate a waiver.

III. Caselaw Developments

Part III reviews compliance-related caselaw developments in state corporate law,[55] federal employment discrimination law, and state employment law.[56] Section A reviews developments regarding the duty of corporate officers and directors, first discussed in *In re Caremark International Inc. Derivative Litigation*,[57] to oversee a corporation's legal compliance efforts. This discussion emphasizes the recent caselaw development of a possibly heightened oversight duty for corporate officers. Section B then reviews a recent U.S. Supreme Court case deciding the pleading standard for claims of pregnancy discrimination. Section C then discusses a state employment law case concerning the employment-at-will doctrine.

A. The *Caremark* Claim

In dicta in its 1996 decision, *In re Caremark International Inc. Derivative Litigation*, the Delaware Court of Chancery addressed the board's duty to oversee a corporation's legal compliance efforts.[58] As part of its duty to monitor, the board must make good-faith efforts to ensure that a corporation has adequate reporting and information systems.[59] The court described a claim for breach of that duty as "possibly the most difficult theory in corporation law upon which a plaintiff might hope to win a judgment,"[60] with liability attaching only for "a sustained or systematic failure of the board to exercise oversight" or "an utter failure to attempt to assure a reasonable information and reporting system exists."[61]

[55] *See generally* Charles M. Elson & Christopher J. Gyves, *In re* Caremark: *Good Intentions, Unintended Consequences*, 39 Wake Forest L. Rev. 691 (2004); H. Lowell Brown, *The Corporate Director's Compliance Oversight Responsibility in the Post* Caremark *Era*, 26 Del. J. Corp. L. 1 (2001).

[56] *See generally* Rebecca S. Walker, *What We Can Learn About Effective Compliance Policies from Recent Employment Discrimination Cases*, Ethikos (July/Aug. 2000), http://www.ethikospublication.com/html/discrimination.html.

[57] 698 A.2d 959 (Del. Ch. 1996). The inaugural survey discusses the background and compliance context of this case. *See Survey I*, *supra* note 1, at 1773–76.

[58] *Caremark*, 698 A.2d at 970–71.

[59] *Id.* at 967–70.

[60] *Id.* at 967.

[61] *Id.* at 971.

Since the decision, this Delaware dicta has morphed into what has become known as a *Caremark* claim, as federal and state courts, both within and outside Delaware, have recognized a cause of action against boards for failing to take minimal steps to achieve legal compliance.[62] As the phrases "utter failure" and "systematic failure" suggest, a board's *Caremark* duty is relatively low.[63] Only egregious lapses breach this duty, such as when board members ignore obvious red flags signaling illegal behavior,[64] fail to appoint or convene an audit committee,[65] or do not address obvious concerns such as large loans to corporate insiders.[66]

In *Stone ex rel. AmSouth Bancorporation v. Ritter*, the Delaware Supreme Court formally embraced the *Caremark* claim.[67] The court both confirmed the elements of a *Caremark* duty and clarified that breach of that duty constitutes a breach of the director's duty of loyalty:

> We hold that *Caremark* articulates the necessary conditions predicate for director oversight liability: (a) the directors utterly failed to implement any reporting or information system or controls; *or* (b) having implemented such a system or controls, consciously failed to monitor or oversee its operations thus disabling themselves from being informed of risks or problems requiring their attention. In either case, imposition of liability requires a showing that the directors knew that they were not discharging their fiduciary obligations. Where directors fail to act in the face of a known duty to act, thereby demonstrating a conscious disregard for their responsibilities, they breach their duty of loyalty by failing to discharge that fiduciary obligation in good faith.[68]

The court in *Stone*, then, adopted the *Caremark* duty and restated it as having two components. First, there is a director's *initial duty* to address compliance and ethics.[69] The director breaches this branch of the *Caremark* duty by failing to take *any* action directed toward establishing a compliance and ethics program.[70]

Second, there is an *ongoing duty* to address compliance and ethics.[71] The director breaches this branch of the *Caremark* duty if she learns of a specific gap or weakness in the organization's compliance and ethics program but

[62] For a more detailed discussion of the *Caremark* case and development of the *Caremark* claim, see Brown, *supra* note 55, at 7–32. For a critique of *Caremark*'s impact, see Elson & Gyves, *supra* note 55, at 691–706.

[63] *See Caremark*, 698 A.2d at 971.

[64] *See, e.g.*, McCall v. Scott, 250 F.3d 997, 999 (6th Cir. 2001); Benjamin v. Kim, No. 95 CIV. 9597 (LMM), 1999 WL 249706, at *13–14 (S.D.N.Y. Apr. 28, 1999) (quoting Graham v. Allis-Chalmers Mfg. Co., 188 A.2d 125, 130 (Del. 1963)).

[65] *See, e.g.*, Guttman v. Huang, 823 A.2d 492, 506–07 (Del. Ch. 2003) (remarking in dicta that failure to have an audit committee would be the type of egregious failing that would support a *Caremark* claim).

[66] *See, e.g.*, Pereira v. Cogan, 294 B.R. 449, 532–33 (S.D.N.Y. 2003), *vacated & remanded sub nom.* Pereira v. Farace, 413 F.3d 330 (2d Cir. 2005), *cert. denied*, 547 U.S. 1147 (2006).

[67] 911 A.2d 362 (Del. 2006).

[68] *Id.* at 370 (footnotes omitted).

[69] *Id.*

[70] *See id.*

[71] *Id.*

takes no action to address that failing.[72] For example, a director may actually know of a new regulatory scheme or requirement that directly affects the business of her corporation and then fail to inquire whether the organization is taking measures to comply with the new law. Another example would be a board that charged management with implementing a compliance and ethics program never receives or requests reports on the design, implementation, and operation of the program. Note that in both of these examples the board member's failure consists of not inquiring of management; the board member need not actually design or implement the program itself. This is because the director's duty is one of oversight, and the board may rely on management in satisfying this duty.

The Delaware courts have been demanding of plaintiffs who allege breach of either component of the *Caremark* duty—the initial or ongoing duty of oversight. First, as to breach of a director's initial duty, the reported decisions require the plaintiff to plead that the director took no actions related to compliance and ethics. A prior survey discussed a case in which the plaintiff adequately pleaded that the directors consciously did *nothing* to prevent legal wrongdoing.[73] In that case, the directors were described as "stooges" for the corporation's president, who was looting the corporation of its assets.[74] Because the directors did nothing at all—they never even met—the inference of conscious disregard was inescapable.[75] Indeed, given that the directors were "stooges," it is possible they did not know a duty of oversight existed.[76] The court's decision implies, then, that conscious disregard does not require that the director was specifically aware of her *Caremark* duty. Of course, this makes sense; directors should not be rewarded for ignorance of the fiduciary duties they have voluntarily undertaken.

The pleading standard is also quite rigorous when a plaintiff alleges breach of the ongoing duty to oversee compliance and ethics. In those cases, the Delaware courts have confirmed the high threshold for pleading a director's *Caremark* liability: the plaintiffs must plead specific facts that show the director knowingly disregarded his ongoing duty to oversee the organization's compliance and ethics program.[77] The courts in these same cases have consistently held that a plaintiff will *not* meet this burden by simply pleading that the organization committed egregious or widespread wrongdoing; thus, the director *must have* known about and ignored the legal problem.[78] In short, the degree or scope of wrong-

[72] *See id.*

[73] *See Survey III*, *supra* note 1, at 212–13.

[74] ATR-Kim Eng Fin. Corp. v. Araneta, No. 489-N, 2006 WL 3783520, at *1, *19 (Del. Ch. Dec. 21, 2006).

[75] *See id.* at *21.

[76] For examples of the directors' actions that led the court to identify them as "stooges," see *id.* at *20–21.

[77] *Survey V*, *supra* note 1, at 207.

[78] *See* Stone *ex rel.* AmSouth Bancorporation v. Ritter, 911 A.2d 362, 373 (Del. 2006) ("The lacuna in the plaintiffs' argument is a failure to recognize that the directors' good faith exercise of oversight responsibility may not invariably prevent employees from violating criminal laws, or from causing the corporation to incur significant financial liability, or both . . . ."); Desimone v. Barrows, 924 A.2d 908, 940 (Del. Ch. 2007) ("Delaware courts routinely reject the conclusory allegation that because illegal behavior occurred, internal controls must have been deficient, and the board must have

doing when standing alone, however severe, will not give rise to an inference that the director was conscious of the organization's legal problems. Instead, the plaintiff must allege facts showing that the director actually knew of the wrongdoing or utterly failed to address potential wrongdoing.

A prior survey highlighted a potential for the *Caremark* duty to impose more stringent obligations on compliance officers than those shouldered by directors.[79] In *Gantler v. Stephens*, the Delaware Supreme Court held that "the fiduciary duties of officers are the same as those of directors."[80] As these duties include the "fiduciary duties of care and loyalty," and the *Caremark* duty of oversight is part of the duty of loyalty, *Gantler* meant that corporate officers owe the *Caremark* duty of oversight.[81] This holding, however, left two difficult questions for future development. First, which corporate officers owe the *Caremark* duty? And second, what specifically does the *Caremark* duty require of officers, as opposed to directors?

While acknowledging a distinction between officers and mere agents and employees,[82] the Delaware courts have not clearly identified the dividing line. And while Delaware's General Corporation Law addresses appointment of officers,[83] that law does not identify which corporate agents owe parallel fiduciary duties to directors. In lieu of such a definition, here is the definition of "officer" from section 1.27 of the American Law Institute Principles of Corporate Governance (ALI Principles):

known so."); Guttman v. Huang, 823 A.2d 492, 506–07 (Del. Ch. 2003) ("Their conclusory complaint is empty of the kind of fact pleading that is critical to a *Caremark* claim, such as contentions that . . . the audit committee had clear notice of serious accounting irregularities and simply chose to ignore them or, even worse, to encourage their continuation."); Morefield v. Bailey, 959 F. Supp. 2d 887, 906 (E.D. Va. 2013) ("The existence of deficiencies in the internal audit practice does not equate to the Board members being conscious of a failure to do their jobs."); Kococinski v. Collins, 939 F. Supp. 2d 909, 924 (D. Minn. 2013) (shareholder's "presentation of . . . red flags falls short of pleading particularized facts supporting an inference that the outside directors actually knew the financial reports were false and misleading").

[79] Survey V, *supra* note 1, at 211–14. The following background discussion of the *Gantler* and the *Caremark* duties of corporate officers incorporates text from this prior survey.

[80] Gantler v. Stephens, 965 A.2d 695, 709 (Del. 2009).

[81] *Id.*

[82] *See* Goldman v. Shahmoon, 208 A.2d 492, 493 (Del. Ch. 1965) ("[T]here appears to be a historically rigid view of the attributes which set a corporate officer apart from an employee.").

[83] Section 142 of Delaware's General Corporation Law provides in relevant part:

> (a) Every corporation organized under this chapter shall have such officers with such titles and duties as shall be stated in the bylaws or in a resolution of the board of directors which is not inconsistent with the bylaws and as may be necessary to enable it to sign instruments and stock certificates which comply with §§ 103(a)(2) and 158 of this title. One of the officers shall have the duty to record the proceedings of the meetings of the stockholders and directors in a book to be kept for that purpose. Any number of offices may be held by the same person unless the certificate of incorporation or bylaws otherwise provide.
>
> (b) Officers shall be chosen in such manner and shall hold their offices for such terms as are prescribed by the bylaws or determined by the board of directors or other governing body. Each officer shall hold office until such officer's successor is elected and qualified or until such officer's earlier resignation or removal. Any officer may resign at any time upon written notice to the corporation.

Del. Code Ann. tit. 8, § 142(a)–(b) (2013).

> "Officer" means (a) the chief executive, operating, financial, legal, and accounting officers of a corporation; (b) to the extent not encompassed by the foregoing, the chairman of the board of directors (unless the chairman neither performs a policymaking function other than as a director nor receives a material amount of compensation in excess of director's fees), president, treasurer, and secretary, and a vice-president or vice-chairman who is in charge of a principal business unit, division, or function (such as sales, administration, or finance) or performs a major policymaking function for the corporation; and (c) any other individual designated by the corporation as an officer.[84]

While the ALI Principles extend the duty of care to all officers,[85] the duty of loyalty extends only to "senior executives,"[86] who are defined in (a) and (b) above.[87] For purposes of analysis, we will assume that the *Caremark* duty will be limited to the first two classes of officers. Of course, if that duty is extended to category (c), the analysis would be straightforward—did the corporation designate the compliance and ethics professional at issue as an officer?

Category (a) includes the chief compliance and ethics officer who holds a second title, such as general counsel.[88] The only question that might arise is whether different duties are attached to different titles. Given the connection between legal compliance and the general counsel's role as legal adviser, however, the general counsel already owes a *Caremark* duty. Addition of the title chief compliance and ethics officer would only reinforce that conclusion.

If the chief compliance and ethics officer does not serve in a dual role, the officer would have to fall within the provision in category (b) for "a vice-president or vice-chairman who is in charge of a principal business unit, division, or function (such as sales, administration, or finance) or performs a major policymaking function for the corporation."[89] If the chief compliance and ethics officer is designated as a vice-president or vice-chairman, the issue will be whether that person (1) "is in charge of a principal business . . . function" or (2) "performs a major policymaking function."[90] Consider each in turn.

When compared to the listed functions of "sales, administration, or finance," the compliance and ethics function should be considered a "principal business . . . function."[91] First, as discussed in prior surveys, both state and federal government guidance and regulation emphasize the important role of an organization's internal compliance and ethics program.[92] Tending to this critical aspect of an organization's business should be a principal function.

[84] AM. LAW INST., PRINCIPLES OF CORPORATE GOVERNANCE § 1.27 (1994) [hereinafter ALI PRINCIPLES].

[85] *Id.* § 4.01.

[86] *Id.* § 5.01. The ALI Principles refer to the duty of loyalty as the duty of fair dealing. *See id.* pt. V (duty of fair dealing).

[87] *Id.* § 1.27.

[88] *See id.*

[89] *Id.*

[90] *Id.*

[91] *See id.*

[92] *Survey I*, *supra* note 1, at 1780–95; *Survey II*, *supra* note 1, at 1650–57; *Survey III*, *supra* note 1, at 197–209; *Survey IV*, *supra* note 1, at 271–74.

Second, responsibility for the compliance and ethics program is comparable to two other functions listed at the officer level: legal and finance. On the one hand, compliance and ethics programs are charged with ensuring compliance with the organization's *legal* obligations, which American Bar Association guidance places within the scope of the chief legal officer's responsibilities.[93] On the other hand, compliance and ethics programs design and implement internal controls to track corporate behavior, which is akin to the internal controls overseen by finance. Thus, compliance and ethics can be seen as a business function at the crossroads of the finance and legal functions.

The chief compliance and ethics officer could also be an officer charged with "a major policymaking function for the corporation."[94] The comments to the ALI Principles elaborate on this provision:

> The "major policymaking" test in Subsection (b) is intended to be applied to the corporation's business as a whole. Therefore, a vice-president who has policymaking functions in connection with only a unit or division would not fall within Subsection (b) for that reason alone, unless that unit or division represents a substantial part of the total business. A staff member who gives advice on policy but does not have authority, alone or in combination with others, to make policy, does not perform a major policymaking function within the meaning of Subsection (b).[95]

This comment raises two aspects of the "major policymaking function": scope of responsibility and degree of authority. If an organization follows the Federal Sentencing Guidelines, the chief compliance and ethics officer should meet both criteria.[96] First, the guidelines require that "[s]pecific individual(s) within high-level personnel shall be assigned overall responsibility for the compliance and ethics program."[97] The person who is delegated "overall responsibility" for the organization's compliance and ethics program will necessarily have the broad, entity-wide scope of authority contemplated by the ALI Principles. Second, the guidelines provide that compliance and ethics officers "shall be given

[93] Report of the American Bar Association Task Force on Corporate Responsibility 20–23 (Mar. 31, 2003), *available at* http://www.abanet.org/buslaw/corporateresponsibility/final_report.pdf.

[94] *See* ALI Principles, *supra* note 84, § 1.27.

[95] *Id* § 1.27 cmt. c. The comment continues with a reference to the federal securities laws:

> Corporations filing a Form 10-K under the Securities Exchange Act must determine the identity of their executive officers under Item 401 of Regulation S-K. Corporations subject to the SEC's Proxy Rules must also identify each of their executive officers in the annual report accompanying the proxy statement for the annual meeting. Rule 14a-3(b)(8). It is intended that in the case of such corporations, the group of officers falling within Subsection (b) would be no wider (and, with the possible exception of the four specifically designated officers, would normally be narrower) than the group of executive officers that are presently contemplated by Form 10-K and the Proxy Rules.

Id. If companies list the chief compliance and ethics officer as an executive officer in the above filings, that would arguably require treating the chief compliance and ethics officer as an officer for fiduciary duty purposes. *See, e.g.*, Baker Hughes Inc., Form 10-K, at 13 (Feb. 27, 2009) (listing the positions of vice-president, chief compliance officer, and senior deputy counsel among the company's executive officers).

[96] *See* U.S. Sentencing Guidelines Manual § 8B2.1(b)(2) (U.S. Sentencing Comm'n 2014).

[97] *Id.* § 8B2.1(b)(2)(B).

adequate resources, appropriate authority, and direct access to the governing authority or an appropriate subgroup of the governing authority."[98] Again, meeting the Federal Sentencing Guidelines should also meet the ALI Principles. The more difficult question will be which compliance personnel beyond the chief compliance officer, if any, fall within the ALI Principles.[99]

The answer to the next question, "What does the *Caremark* duty require of compliance personnel who are deemed corporate officers?" is much less clear. As noted above, the Delaware Supreme Court has framed the *Caremark* duty as follows: "(a) the directors utterly failed to implement any reporting or information system or controls; *or* (b) having implemented such a system or controls, consciously failed to monitor or oversee its operations thus disabling themselves from being informed of risks or problems requiring their attention."[100] The question is how these twin duties, phrased in terms of *directors*, apply to compliance and ethics *officers*. Consider the standard that a board member not "utterly fail[] to implement any reporting or information system or controls." It makes sense to put the director's duty at this high a level because the board oversees the corporation, leaving day-to-day operations to management. Further, the board may rely on the reporting and work of management in discharging its duty of oversight.[101] Conversely, the officers charged with day-to-day operations may owe a more precisely defined *Caremark* duty. For example, one could frame breach of the chief compliance and ethics officer's initial *Caremark* duty as an utter failure to take steps to implement any one of the components of a compliance and ethics program—i.e., risk assessment, policies, training, monitoring, auditing, or discipline. Under this view, the board's duty is to get the compliance ball rolling, and the chief compliance and ethics officer's duty is to keep that ball moving in the right direction.

The second component of the *Caremark* duty will be more difficult to define. Recall that the second *Caremark* branch, the ongoing duty, imposes liability on a fiduciary who "consciously failed to monitor or oversee its operations thus disabling themselves from being informed of risks or problems requiring their attention."[102] A director likely satisfies this duty simply by receiving and reviewing reports in connection with periodic board meetings or by inquiring of management after learning of compliance red flags.[103] This duty, however, likely requires more of a chief compliance and ethics officer charged with overall respon-

[98] *Id.* § 8B2.1(b)(2)(C).

[99] As noted above, the comments to section 1.27 refer to federal securities law filings in their definition of "officer." ALI PRINCIPLES, *supra* note 84, § 1.27 cmt. c. To the extent that companies do not list other compliance personnel as executive officers in these filings, the comments suggest that the definition of "officer" does not reach those personnel. *See id.*

[100] Stone *ex rel.* AmSouth Bancorporation v. Ritter, 911 A.2d 362, 370 (Del. 2006).

[101] DEL. CODE ANN. tit. 8, § 141(e) (2013) ("A member of the board of directors . . . shall, in the performance of such member's duties, be fully protected in relying in good faith upon . . . such information, opinions, reports or statements presented to the corporation by any of the corporation's officers or employees . . . .").

[102] *Stone*, 911 A.2d at 370.

[103] *See supra* note 9 and accompanying text (discussing the red flags identified by the DOJ).

sibility for the organization's compliance and ethics program. In that role, the chief compliance and ethics officer will be continuously updated regarding operation of the compliance and ethics program and should therefore be familiar with the program's ongoing strengths and weaknesses. Also, that role will place many more matters within the scope of "risks or problems requiring . . . attention."[104] Whereas the board may engage with compliance only periodically, the chief compliance and ethics officer must do so continuously.

The chief compliance and ethics officer's enhanced *Caremark* duty poses a potential trap for such officers who are overworked or whose departments are understaffed. For example, consider the chief compliance and ethics officer who performs a dual role—e.g., the combined chief compliance and ethics officer and general counsel. If this officer's department is understaffed, she cannot possibly perform all the assigned duties, and oversight of the compliance and ethics program will likely suffer. This is because compliance and ethics work is largely preventive and compliance omissions often have few immediate observable consequences. Conversely, the general counsel often responds to current or periodic needs and crises, which is work that may demand constant attention. An overworked chief compliance and ethics officer may now be set up for a *Caremark* claim; the compliance and ethics program generates continuous feedback to a chief compliance and ethics officer who cannot adequately address all the information that the feedback offers. And if a critical compliance issue falls through the cracks, a plaintiff's attorney may argue that the chief compliance and ethics officer consciously disregarded that risk. After all, mere receipt of compliance and ethics information may raise an inference that the chief compliance and ethics officer was aware of that information. To avoid this problem, it is critical for chief compliance and ethics officers to secure the necessary time and resources to succeed in their role.

Two cases from the last year involved *Caremark* claims against corporate officers. The first case, *In re Galena Biopharma, Inc. Derivative Litigation*,[105] is curious for its failure to acknowledge the issue. There, the plaintiffs had alleged that both directors and officers had breached their duty to oversee internal controls needed to ensure preparation of accurate financial statements. Concerning the claim against corporate officers, the court made the following statement: "Plaintiffs cite to no case holding that non-director officers can be liable for failing to maintain internal company controls, and Plaintiffs do not explain the basis for asserting this claim against Defendants Dunlap and Schwartz, who are alleged to be non-director officers." This statement is true enough: the plaintiffs' response to the defendants' motion to dismiss does not separately discuss officer liability under *Caremark*, and it does not cite *Gantler* for the proposition that officers owe the same fiduciary duties as directors.[106] The defendants' filings on

[104] *See Stone*, 911 A.2d at 370.

[105] 83 F. Supp. 3d 1047 (D. Or. 2015).

[106] Plaintiffs' Response in Opposition to Defendants' Motion to Dismiss Plaintiffs' Verified Amended Consolidated Shareholder Derivative Complaint and Defendant Mark J. Ahn's Motion to Dismiss at 23–25, *In re* Galena Biopharma Inc. Derivative Litig., Nos. 3:14-cv-00382-SI LEAD, 3:14-cv-514-SI, 3:14-cv-516-SI, 83 F. Supp. 3d 1047 (D. Or. 2015), 2014 WL 7273836.

the motion to dismiss, however, did not argue that the *Caremark* duty does not apply to corporate officers.[107] Thus, the district court appears to have raised this distinction on its own. If so, it is not clear why the court did not discover the *Gantler* case or other writings on officer fiduciary duties. Regardless, the statement that there is no basis for officer *Caremark* liability is clear error and should be reversed on appeal. The question would remain whether the facts alleged would satisfy any applicable pleading standard for such officer liability.

A federal district court discussed, but did not decide, the issue of an officer's *Caremark* duty in *Iron Workers Mid-South Pension Fund v. Davis*.[108] The case involved a claim that directors and officers of U.S. Bancorp breached their duty to oversee internal controls that would have prevented wrongdoing related to transactions involving mortgage-backed securities. The court dismissed the *Caremark* claim against the directors for failure to plead facts that showed that they had consciously disregarded weaknesses in the company's internal controls.[109] The plaintiffs' alleged red flags, such as the directors' alleged knowledge that lenders were experiencing problems with delinquencies on residential mortgages, were too general to support an inference of knowledge of problems at U.S. Bancorp.[110] This decision is an unremarkable application of the stringent pleading standard for *Caremark* claims against directors.

When the court turned to the *Caremark* claim against officers, it noted that the plaintiffs invoked the fiduciary duty of care in addition to the duty of loyalty. The court explained that this distinction matters because the duty of loyalty imposes the familiar "conscious disregard" standard, while the duty of care may hold plaintiffs to a less stringent "gross negligence" standard:

> Insofar as Iron is bringing an independent claim for a violation of the duty of care on factual allegations very similar to those constituting its breach of the duty of loyalty claim, Iron argues that the duty of care claim is subject to a lower standard of review than a duty of loyalty claim. Specifically, Iron maintains that "duty of care violations are actionable only if the directors acted with gross negligence." Courts are divided on the question of whether an officer may be liable for a breach of the duty of care under the standard of gross negligence or the higher standard of bad faith or conscious disregard.[111]

The court left this question for another day, deciding that even if "gross negligence" is the proper standard, the plaintiffs' allegations did not meet even that lower pleading standard.[112]

[107] *See* Motion to Dismiss Plaintiffs' Verified Amended Consolidated Shareholder Derivative Complaint at 19–21, *In re* Galena Biopharma Inc. Derivative Litig., Nos. 3:14-cv-00382-SI LEAD, 3:14-cv-514-SI, 3:14-cv-516-SI, 83 F. Supp. 3d 1047 (D. Or. 2015), 2014 WL 6480477.

[108] Civil No. 13-289, 2015 WL 1275338 (D. Minn. Mar. 19, 2015).

[109] *Id.* at *8–*9.

[110] *Id.*

[111] *Id.* at *10 (citations omitted).

[112] *Id.* at *11 ("The Court will assume without deciding that the proper standard for evaluating an officer's duty of care is gross negligence.").

In applying the gross negligence standard to the plaintiffs' allegations, the court quoted a definition from Delaware case law: "[P]leading [gross negligence] successfully in a case like this requires the articulation of facts that suggest a wide disparity between the process the directors used to ensure the integrity of the company's financial statements and that which would have been rational."[113] The court gave great weight to the "wide disparity" language, faulting the plaintiffs' complaint because it did not "articulate what would have been rational or reasonable on the part of the officer defendants" and did "not explain what actions the officer defendants should have reasonably taken in light of the alleged red flags."[114]

Under this definition of "gross negligence," the question going forward is what plaintiffs must plead to show a "rational or reasonable" alternative course of conduct. For compliance officers, one way to satisfy this pleading standard could be to refer to the growing body of writing on best practices in corporate compliance. Indeed, the purpose of compliance and ethics best practices and other recommendations is to guide actions by compliance officers, so such material should be probative of what is "rational and reasonable" conduct for such an officer. This could prove a double-edged sword for compliance and ethics officers. On the one hand, following best practices could protect compliance and ethics officers, allowing them to show that no "wide disparity" exists between their conduct and what is "rational and reasonable." On the other hand, failure to follow best practices, especially when those practices are contested or unclear, could leave a compliance and ethics officer vulnerable to the inference that a "wide disparity" exists. It will take future caselaw development to flesh out this emerging standard of officer liability.

B. Pregnancy Discrimination

In *Young v. United Parcel Service, Inc.*,[115] the U.S. Supreme Court decided the pleading standard for claims under the Pregnancy Discrimination Act.[116] The case involved a pregnant female employee of United Parcel Service (UPS) who worked as a part-time driver. UPS required drivers to be able to lift seventy or more pounds, and the female driver was told by her doctor not to lift more than twenty pounds. The female driver requested that UPS accommodate her lifting restriction by assigning her to other work assignments within the company. Under its collective bargaining agreement, UPS accommodated other employees who were unable to drive or lift packages, such as employees injured on the job or who had lost their driving certification with the U.S. Department of Transportation. UPS, however, did not have a policy to accommodate pregnant employees, and so the female driver was put on unpaid leave. The female driver filed a lawsuit in federal court claiming that the failure to accommodate her pregnancy-related lifting restriction violated the Pregnancy Discrimination Act.

[113] *Id.* (quoting Guttman v. Huang, 823 A.2d 492, 507 n.39 (Del. Ch. 2003)).

[114] *Id.*

[115] 135 S. Ct. 1338 (2015).

[116] *See* 42 U.S.C. § 2000e(k) (2012).

In the lower courts, UPS argued that it had a neutral policy that did not discriminate against pregnant female employees.[117] The company noted that it did not accommodate any employees whose physical limitations arose from outside the workplace and were not covered by the Americans with Disabilities Act.[118] Because the female driver's lifting restriction was neither an on-the-job injury nor a disability covered by the ADA, UPS's neutral policy did not require an accommodation. The female driver countered that UPS had discriminated because it accommodated some employees with similar lifting restrictions (i.e., those with on-the-job-injuries) but not pregnant employees.[119] She argued that this different treatment should violate the Pregnancy Discrimination Act.[120] Both lower courts found for UPS, and the female driver appealed to the Supreme Court.[121]

The Court took an intermediate approach between the arguments advocated by UPS and the female driver, adopting the burden-shifting test from *McDonnell Douglas Corp. v. Green*,[122] which governs gender discrimination claims under Title VII. The following passage describes how that framework applies to a claim of pregnancy discrimination:

> [A] plaintiff alleging that the denial of an accommodation constituted disparate treatment under the Pregnancy Discrimination Act's second clause may make out a prima facie case by showing, as in *McDonnell Douglas*, that she belongs to the protected class, that she sought accommodation, that the employer did not accommodate her, and that the employer did accommodate others "similar in their ability or inability to work."
>
> The employer may then seek to justify its refusal to accommodate the plaintiff by relying on "legitimate, nondiscriminatory" reasons for denying her accommodation. But, consistent with the Act's basic objective, that reason normally cannot consist simply of a claim that it is more expensive or less convenient to add pregnant women to the category of those ("similar in their ability or inability to work") whom the employer accommodates. . . .
>
> If the employer offers an apparently "legitimate, non-discriminatory" reason for its actions, the plaintiff may in turn show that the employer's proffered reasons are in fact pretextual. We believe that the plaintiff may reach a jury on this issue by providing sufficient evidence that the employer's policies impose a significant burden on pregnant workers, and that the employer's "legitimate, nondiscriminatory" reasons are not sufficiently strong to justify the burden, but rather—when considered along with the burden imposed—give rise to an inference of intentional discrimination.
>
> The plaintiff can create a genuine issue of material fact as to whether a significant burden exists by providing evidence that the employer accommodates a large per-

[117] *Young*, 135 S. Ct. at 1347–48.

[118] The Court noted that the ADA had since been amended to clarify that temporary lifting restrictions can qualify as a covered disability. *Id.* at 1348.

[119] *Id.* at 1347.

[120] *Id.*

[121] *Id.* at 1347–48.

[122] 411 U.S. 792 (1973).

> centage of nonpregnant workers while failing to accommodate a large percentage of pregnant workers. Here, for example, if the facts are as Young says they are, she can show that UPS accommodates most nonpregnant employees with lifting limitations while categorically failing to accommodate pregnant employees with lifting limitations. Young might also add that the fact that UPS has multiple policies that accommodate nonpregnant employees with lifting restrictions suggests that its reasons for failing to accommodate pregnant employees with lifting restrictions are not sufficiently strong—to the point that a jury could find that its reasons for failing to accommodate pregnant employees give rise to an inference of intentional discrimination.[123]

The Court sent the case back to the lower courts to determine whether Young had met this revised pleading standard.

The burden-shifting test adopted in *Young* holds important lessons for employers as they consider policies and practices for accommodating employees with physical limitations. Once an employer accommodates one or more classes of employees with a physical limitation, it must decide whether to accommodate pregnant employees with a similar physical limitation. To ignore this issue is to leave the company open to the inference of a "substantial burden" because some employees are accommodated while pregnant employees are not. Also, if an employer decides not to accommodate pregnant employees with physical limitations, it should specifically identify and document the "legitimate, nondiscriminatory" reason for doing and steer clear of the specifically forbidden reasons that it would be "more expensive or less convenient to do so."

C. Wrongful Discharge of Chief Compliance Officer

A compliance officer often occupies a vulnerable position within an organization. Charged with the responsibility for preventing and detecting legal wrongdoing, a compliance officer might discover wrongdoing by senior management, which could make the compliance officer a target of retaliation. One might reasonably question whether a compliance officer can adequately withstand these pressures if she is only an at-will employee. That question was in the background when the New York Court of Appeals decided whether it should recognize a common law claim of retaliatory discharge for a chief compliance officer who was an at-will employee.

With one exception, New York common law does not recognize a wrongful discharge claim by an at-will employee.[124] The court in *Wieder v. Skala* recognized that exception, holding that a law firm associate could sue an employer for wrongful discharge for terminating the associate in retaliation for internally reporting an ethics breach of a fellow associate.[125] In *Sullivan v. Harnisch*, the

[123] *Young*, 135 S. Ct. at 1354–55.

[124] *See* Wieder v. Skala, 609 N.E.2d 105, 109–10 (N.Y. 1992); Murphy v. Am. Home Prods. Corp., 448 N.E.2d 86, 89–90 (N.Y. 1983). An employee, however, may show that the employer promised more than at-will employment in a written employment contract or other writing such as an employee handbook. *See* Weiner v. McGraw-Hill, Inc., 443 N.E.2d 441, 445 (N.Y. 1982).

[125] *Wieder*, 609 N.E.2d at 109–10.

compliance officer for a hedge fund sought to extend *Wieder* to a claim that he was terminated for reporting wrongdoing discovered as part of his job.[126]

Prior to *Wieder*, the New York Court of Appeals had repeatedly rejected wrongful discharge claims by at-will employees. For example, in *Murphy v. American Home Products Corp.*, the assistant treasurer of a corporation claimed that he was discharged "in retaliation for his revelation to officers and directors of the defendant corporation that he had uncovered at least $50 million in illegal account manipulations of secret pension reserves that improperly inflated the company's growth in income and allowed high-ranking officers to reap unwarranted bonuses from a management incentive plan, as well as in retaliation for his own refusal to engage in the alleged accounting improprieties."[127] The court held that the employee's wrongful discharge claim was properly dismissed because he had no written employment agreement promising anything other than employment at will.[128] Similarly, in *Sabetay v. Sterling Drug, Inc.*,[129] the court upheld dismissal of an employee's claim that he was wrongfully discharged for not participating in illegal financial transactions and later blowing the whistle on the wrongdoing. Again, the court relied on the absence of any contractual promise beyond at-will employment. In both cases, the court left recognition of a wrongful discharge claim to the state legislature.

Like the employees in *Murphy* and *Sabetay*, the law firm associate in *Wieder* did not have an employment agreement or other writing promising more than at-will employment. The court, however, went on to consider whether "an implied-in-law duty" might limit the law firm's otherwise free hand in terminating an associate.[130] The court found such a duty relating to the legal profession's ethics rules:

> [With] any hiring of an attorney as an associate to practice law with a firm there is implied an understanding so fundamental to the relationship and essential to its purpose as to require no expression: that both the associate and the firm in conducting the practice will do so in accordance with the ethical standards of the profession. Erecting or countenancing disincentives to compliance with the applicable rules of professional conduct, plaintiff contends, would subvert the central professional purpose of his relationship with the firm—the lawful and ethical practice of law.[131]

The court rested this conclusion on the single purpose of the associate–law firm employment relationship, namely, the practice of law:

> Defendants, a firm of lawyers, hired plaintiff to practice law and this objective was the only basis for the employment relationship. Intrinsic to this relationship, of course, was the unstated but essential compact that in conducting the firm's legal practice both plaintiff and the firm would do so in compliance with the prevailing

[126] 969 N.E.2d 758 (N.Y. 2012).
[127] *Murphy*, 448 N.E.2d at 87.
[128] *Id.* at 90.
[129] 506 N.E.2d 919, 923 (N.Y. 1987).
[130] *Wieder*, 609 N.E.2d at 108.
[131] *Id.*

> rules of conduct and ethical standards of the profession. Insisting that as an associate in their employ plaintiff must act unethically and in violation of one of the primary professional rules amounted to nothing less than a frustration of the *only legitimate purpose of the employment relationship*.[132]

In addition, the court emphasized that the law firm had terminated the associate for complying with an ethics rule that required attorneys to report ethical misconduct—a rule crucial to preserving the legal profession's right to self-regulate.[133] Combined, the single purpose of the employment relationship and the significance of the ethics rule supported an implied-in-law term of his employment.

In *Sullivan*, the chief compliance officer for a hedge fund sought to fit his claim within *Wieder*'s narrow exception. In addition to serving as the compliance officer, he was a 15 percent partner in the firms constituting the hedge fund and also "Executive Vice President, Treasurer, Secretary, [and] Chief Operating Officer."[134] The plaintiff alleged that he was terminated in retaliation for reporting wrongdoing by the chief executive officer and president, specifically "stock sales amount[ing] to 'front-running'—selling in anticipation of transactions by the firm's clients—and enabled [the CEO and President] to take advantage of an opportunity from which the clients were excluded."[135]

The plaintiff did not have an employment agreement with the hedge fund that promised anything other than at-will employment. The plaintiff, however, relied on three factors to support extension of *Wieder* to his case. First, federal securities laws and the hedge fund's own code of ethics both prohibited the conduct that the plaintiff reported.[136] Second, as the hedge fund's chief compliance officer, the plaintiff was required by federal securities laws and the hedge fund's own policies to monitor and report wrongdoing that the plaintiff had discovered.[137] Third, under the hedge fund's policy, the plaintiff's employment could have been terminated if he did not report the misconduct.[138] To avoid the Catch 22 of being fired for reporting or not reporting, the plaintiff argued for protection under *Wieder* despite his status as an at-will employee.

The court began its analysis by stating that *Wieder*'s exception to at-will employment is to be construed narrowly:

> [W]e intended the exception to the at-will doctrine we recognized in *Wieder* to be a narrow one. The Appellate Division in this case said that *Wieder* is "sui generis," but we do not need to go that far to decide this case. Assuming that there are some

[132] *Id.* at 110 (emphasis added).

[133] *Id.* at 108–09.

[134] *Sullivan*, 969 N.E.2d at 759.

[135] *Id.* The complaint alleged a separate claim that termination was in connection with a dispute over the plaintiff's ownership interest in the hedge fund. *Id.* ("[T]he complaint alleges that the dismissal occurred within hours after a lawyer for [the plaintiff] contacted [the hedge fund's] counsel to voice objections to a proposed agreement that would have eliminated [the plaintiff's] ownership interest.").

[136] *Id.*

[137] *Id.* at 761; *see* 17 C.F.R. § 275.206(4)-7(a), (c) (2015).

[138] *Sullivan*, 969 N.E.2d at 759.

> employment relationships, other than those between a lawyer and a law firm[] that might fit within the *Wieder* exception, the relationship in this case is not one of them.[139]

So, while not closing the *Wieder* door to *all* compliance officers, the court did not allow *this* compliance officer to enter. The court specifically rejected the existence of a complex regulatory scheme, such as the federal regulation of hedge funds, as a reason to extend *Wieder*'s protection. While such a scheme surely requires extensive compliance efforts, the court would not modify state common law for that reason alone. This makes much sense in light of the increasingly complex regulatory landscape in which most businesses operate. If the complexity of regulation and corresponding efforts to comply with regulations were sufficient, the at-will employment doctrine would be in danger of extinction.

The court wrote more narrowly when addressing the plaintiff's status as a compliance officer, suggesting how future litigants might come within *Wieder*'s protection:

> Important as regulatory compliance is, it cannot be said of [the plaintiff], as we said of the plaintiff in *Wieder*, that his regulatory and ethical obligations and his duties as an employee "were so closely linked as to be incapable of separation." [The plaintiff] was not associated with other compliance officers in a firm where all were subject to self-regulation as members of a common profession. Indeed, [the plaintiff] was not even a full-time compliance officer. He had four other titles at [the hedge fund], including Executive Vice–President and Chief Operating Officer, and was, according to his claim, a 15% partner in the business. It is simply not true that regulatory compliance, in the words of *Wieder*, "was at the very core and, indeed, the only purpose" of [the plaintiff's] employment.[140]

This crucial passage makes two points that will be key to future litigation. First, and hopefully not dispositive, the court notes that the plaintiff, as chief compliance officer, was not employed in a firm where he was associated with other chief compliance officers for the purpose of practicing compliance. If this factor is enough to negate application of *Wieder*, then compliance officers will never gain common law protection against retaliatory termination. Unlike lawyers, compliance officers do not associate with one another in firms. Indeed, regulations and guidance almost uniformly speak of a business or organization appointing a compliance officer as one of its officers or employees.[141] If this first factor is enough to bar application of *Wieder*, the court would be artificially elevating the form of business association over substance in an effort to cabin artificially a legal doctrine of which it is not particularly fond.

The second factor is more substantive: compliance was not "at the very core and, indeed, the only purpose" of the plaintiff's employment. As noted above,

[139] *Id.* at 760–61.

[140] *Id.* at 761 (quoting Wieder v. Skala, 609 N.E.2d 105, 108 (N.Y. 1992)).

[141] U.S. Sentencing Guidelines Manual § 8B2.1(b)(2)(C) (U.S. Sentencing Comm'n 2014), *available at* http://www.ussc.gov/Guidelines/Organizational_Guidelines/guidelines_chapter_8.htm ("Specific individual(s) within the organization shall be delegated day-to-day operational responsibility for the compliance and ethics program.").

the plaintiff not only was the hedge fund's chief compliance officer, but he also wore several other hats, including that of chief operating officer. These various roles may be in conflict or tension at times, making it difficult to know which hat a person is wearing while acting within the organization. This can be seen in the literature discussing whether the chief compliance officer should also either serve as general counsel or report through that position.[142] There, the concern is that delivering legal advice to the corporation may on occasion give rise to conflicts when the same person is also charged with independently evaluating compliance with legal responsibilities. The same could easily be said of serving as both chief operating officer and the chief compliance officer charged with independently overseeing that these same operations comply with the law. When an employee's roles are potentially in conflict, as in these cases, the compliance role is not so central to the employment relationship as to imply a limitation on termination of employment for proper performance of that role. Only when compliance constitutes the employee's sole job responsibility will a court imply such a limitation on termination of employment. This reading of the court's opinion leaves extension of *Wieder* open in future cases.

In light of *Sullivan*'s demanding standard, it is not surprising that the Second Circuit recently refused to extend *Wieder* in *Cruz v. HSBC Bank USA, N.A.*[143] There, the plaintiff "was hired by HSBC as a Vice President and Senior Business Relationships Manager, and his core role at HSBC was to manage accounts and supervise clients."[144] While he "was required to report fraudulent or criminal activity pursuant to the terms of his employment and federal law," the same can be said of many employees in heavily regulated industries. The simple duty to report does not make an employee's "core role" akin to that of a compliance and ethics professional. Thus, not surprisingly, the court decided that the *Wieder* exception did not apply to the plaintiff's employment.[145]

[142] *See* Ben W. Heineman, Jr., *Don't Divorce the GC and Compliance Officer: Independence Won't Guarantee Ethical Behavior—Good Culture Will*, Corp. Couns., Jan. 29, 2010, at 48.

[143] 586 F. App'x 723 (2d Cir. 2014).

[144] *Id.* at 725.

[145] *Id.* ("We conclude that Cruz's employment with HSBC, as alleged in the first amended complaint, does not fall within the Wieder exception.").

Survey of the Law of Cyberspace: An Introduction

By *John A. Rothchild**

This survey marks the twentieth anniversary of a momentous year in the history of the Internet. In 1995, the National Science Foundation (NSF) relinquished its role in administering the network of networks that was to have such a transformative effect on communication, culture, commerce, politics, law enforcement, and nearly every other field of human endeavor. From the mid-1980s, when the NSF funded the creation of a high-speed communications link that connected five supercomputing centers across the United States, until 1995, when the NSF turned over a greatly expanded network to the private sector, use of what was then called the NSFNet was governed by an Acceptable Use Policy that prohibited commercial use of the network. Privatization resulted in a lifting of the prohibition, and commercial use of the Internet began in earnest: this was the year that Amazon.com, craigslist, and eBay (as AuctionWeb) debuted. The year 1995 was also a pivotal one in the history of the World Wide Web, as America Online, CompuServe, and Prodigy began offering access to the Web; Netscape, whose browser helped bring the Web to the masses, made a big splash with a blockbuster initial public offering; and the Web became the most popular service offered on the Internet.[1]

The contributions to this year's survey fall into five categories: cybersecurity and privacy, social media, intellectual property, contracting and payments, and network neutrality.

Cybersecurity and privacy. This year's survey gives prominence to developments in cybersecurity and privacy law. Roland Trope and Lixian Hantover lead off with a review of cybersecurity developments, wondering rhetorically in the title of their piece whether this might be the year when business and government finally begin to take seriously the threats posed by network intrusions.[2] The November 2014 cyberattack against Sony Pictures Entertainment, which resulted in exposure of internal company data and unreleased films, focused

* Associate Professor, Wayne State University Law School. I wish to acknowledge the invaluable research and editorial assistance provided by University of San Francisco School of Law student Seamus Brugh, as well as the contributions of recent USF Law graduate Noah S. Johnson.

[1] For a classic history of the early years of the Internet, see Barry M. Leiner et al., Brief History of the Internet (2003), *available at* http://www.internetsociety.org/sites/default/files/Brief_History_of_the_Internet.pdf.

[2] Roland L. Trope & Lixian Loong Hantover, *What Made the Ostrich Lift Its Head? Significant Developments in Cybersecurity*, 71 Bus. Law. 257 (2015).

public attention on the reality and seriousness of destructive cyberattacks, and offers context for the developments that Trope and Hantover review. They describe an executive order that the attack prompted, calling for the imposition of sanctions against cyberattackers located outside the United States. They also describe the Securities and Exchange Commission's new regulation, called *System Compliance and Integrity*, which is aimed at improving the resilience of the U.S. securities markets' network infrastructure to cyberattacks.

Security breaches give rise to litigation. In his contribution, David Silverman reviews the current crop of cases triggered by well-publicized breaches of corporate data systems, which have resulted in the exposure of payment card and other private data belonging to millions of consumers who made purchases from a compromised retailer or obtained services from a compromised provider.[3] One set of cases addresses the standing to sue of plaintiffs who have brought putative class actions against the owners of the compromised systems, in which the alleged injury is the risk of future misuse of the misappropriated information. Applying a 2013 Supreme Court standing decision,[4] some courts found that plaintiffs had established the injury-in-fact required for standing, while others concluded they had not. Silverman also reviews cases that deal with allocating the losses among the merchants and financial services providers harmed by security breaches.

In his review of European privacy law, Gregory Voss discusses the impact of two shocks to the system: the recognition of a "right to be forgotten" by the European Court of Justice (ECJ) and the terrorist attack on the satirical journal *Charlie Hebdo*.[5] The ECJ's 2014 *Google Spain* decision[6] established that individuals in the European Union have the right to compel search engines to cease displaying links to certain types of personal information. Voss reviews the continuing efforts by European Union and member state institutions and by Google itself to digest this decision. The *Charlie Hebdo* attack gave impetus to heightened security measures by European governments that create some tension with privacy protections, including requirements that social media websites remove material that is deemed to incite terrorism and a proposal for greater sharing of airline passenger name record information. Voss also details the progress made in finalizing the proposed new General Data Protection Regulation, which is expected to replace the 1995 Data Protection Directive and result in uniformity and consistent application of European privacy law.

The final chapter of this year's cybersecurity and privacy quartet is Greg Dickenson's review of litigation under the Telephone Consumer Protection Act (TCPA) and a look at Federal Trade Commission (FTC) privacy enforcement ac-

[3] David L. Silverman, *Developments in Data Security Breach Liability*, 71 Bus. Law. 271 (2015).

[4] Clapper v. Amnesty Int'l USA, 133 S. Ct. 1138 (2013).

[5] W. Gregory Voss, *After* Google Spain *and* Charlie Hebdo: *The Continuing Evolution of European Union Data Privacy Law in a Time of Change*, 71 Bus. Law. 281 (2015).

[6] Case C-131/12, Google Spain SL v. Agencia Española de Protección de Datos (AEPD), 2014 E.C.R. 317, http://eur-lex.europa.eu/legal-content/EN/TXT/HTML/?uri=CELEX:62012CJ0131&rid=14.

tions and policy development.[7] Courts handling TCPA litigation considered the availability of class actions, the question whether particular types of technology constitute "automatic telephone dialing systems" within the scope of the Act, and consumer consent to reception of automated telemarketing calls. Dickenson also looks at the current crop of FTC privacy enforcement actions and discusses a report by FTC staff containing recommendations about protecting privacy on the growing collection of networked consumer devices known as the Internet of Things.

Social media. This year's survey includes, for the first time, a segment addressing developments involving social media. Brandon Huffman leads off with a look at cases involving free speech, privacy, and ownership of social media conduct.[8] Courts considered the scope of the First Amendment protection of social media posts involving threats, sharp workplace speech, and cyberbullying. Huffman also discusses the status of privacy actions against social media giants Facebook, LinkedIn, and Snapchat, and finishes up with a look at some cutting-edge activity involving the ownership of Facebook "likes" and actions against revenge pornography.

Charles Stiegler next offers a roundup of developments involving use of social media in the workplace.[9] During the past few years Facebook and other social media have become forums of choice for employees who seek to organize concerted action against an employer or simply to vent their frustrations with the workplace. Employers have responded with rules purporting to govern employee use of social media. Stiegler gives us a taste of the National Labor Relations Board's application of the federal labor laws to controversies thus engendered. He also explains the state of play regarding state laws restricting employers from demanding access to their social media accounts, and the use of employee social media postings as evidence in lawsuits brought by the employer.

Intellectual property. In his contribution, Jonathan Rubens takes us through the latest developments in the law of copyright online.[10] The saga of actress Cindy Garcia's efforts to require Google to take down from YouTube an anti-Islam film in which she was induced to perform under false pretenses came to an end with the en banc Ninth Circuit's dramatic reversal of a panel decision that had found she held a sufficient copyright interest in her performance to have a claim against Google. Two high-profile cases decided fair use issues, involving Google's book-scanning project and the use by universities of coursepacks containing copyrighted material. Another case considered the liability of CafePress for producing mugs and tee shirts displaying copyrighted material uploaded by its customers.

[7] Greg Dickenson, *Privacy Developments: TCPA Litigation, FTC Privacy Enforcement Actions, and the FTC's* Internet of Things, 71 Bus. Law. 293 (2015).

[8] Brandon J. Huffman, *Developments in Social Media: First Amendment, Privacy, and Misappropriation*, 71 Bus. Law. 305 (2015).

[9] Charles J. Stiegler, *Developments in Employment Law and Social Media,* 71 Bus. Law.321 (2015).

[10] Jonathan Rubens, *Copyright In Cyberspace: Sword and Shield in the Dissemination of Online Content*, 71 Bus. Law. 333 (2015).

Lois Mermelstein tackles the ongoing efforts of the courts to apply the Supreme Court's latest pronouncement on the eligibility for patent protection of computer-implemented inventions, particularly business methods.[11] In a 2014 decision,[12] the U.S. Supreme Court set out a two-step procedure that courts are to follow in determining whether a computer-implemented invention is no more than an abstract idea that is ineligible for patent protection. The Court's newest instructions on how to determine whether an invention is patent-eligible raise as many questions as they answer, and Mermelstein chronicles the lower courts' efforts to apply the rules in a principled and consistent manner.

Contracting and payments. Online contracting cases continue to present variations on well-established themes. Robert Hale surveys cases that deal with clickwrap and browsewrap contracting.[13] Several cases address the issue of what makes notice of the contract terms conspicuous enough to result in a browsewrap agreement. Another case introduces some new terminology aimed at promoting a more nuanced analysis of these contracting situations, coining the terms "scrollwrap" and "sign-in wrap," and delivers a rare pro-consumer outcome in an online contracting case.

An online contract calls for an online payment. Sarah Jane Hughes and Stephen Middlebrook update us on new payment technologies and financial services regulation.[14] They shine a light on the growing prominence of bitcoin, discussing new state-law regulation of the virtual currency as well as enforcement actions against those who have used it in the service of criminal activity or to evade regulatory requirements. They also address proposed regulation and ongoing litigation involving prepaid cards, settlements of enforcement actions against PayPal, and mobile cramming cases.

Network neutrality. The final contribution in this year's survey is Doug Jarrett's take on the Federal Communications Commission's (FCC) network neutrality order.[15] After its previous effort to prohibit broadband Internet access providers from engaging in certain types of discrimination was invalidated in a 2014 court decision, the FCC initiated a rulemaking that culminated in the present order, one that it hopes will survive the court challenges that have already been filed against it. Jarrett provides a guide to those of us who might otherwise be perplexed by this complex regulation, explaining the impact of the nearly four million comments filed by members of the public, as well as a very influential public statement on the matter delivered by President Obama.

[11] Lois D. Mermelstein, *Cyberspace-Related Patents Since* Alice, 71 Bus. Law. 343 (2015).

[12] Alice Corp. Pty. Ltd. v. CLS Bank Int'l, 134 S. Ct. 2347, 2352–53 (2014).

[13] Robert V. Hale II, *Recent Developments in Online Consumer Contracts*, 71 Bus. Law. 353 (2015).

[14] Sarah Jane Hughes & Stephen T. Middlebrook, *Developments in the Law Affecting Electronic Payments and Financial Services*, 71 Bus. Law. 361 (2015).

[15] C. Douglas Jarrett, *The Federal Communications Commission's Network Neutrality Order*, 71 Bus. Law. 373 (2015).

What Made the Ostrich Lift Its Head? Significant Developments in Cybersecurity

By Roland L. Trope and Lixian Loong Hantover***

I. Introduction

During the year covered by this essay, May 2014–May 2015, the profile of cyber threats and risks to U.S. business enterprises changed profoundly. Nation-states and adversaries sought increasingly to cause enterprise-wide damage and disruption. On November 24, 2014,[1] in what U.S. government officials characterized as a "game-changer,"[2] North Korea triggered[3] (via servers in Taiwan[4]) a cyber attack against Sony Pictures Entertainment that "introduced hard drive erasing malware into the company's network infrastructure."[5] The

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The views expressed in this article are solely those of the authors and, in the case of Mr. Trope, have not been reviewed or approved by, and should not be attributed to the U.S. Military Academy, the Department of the Army, the Department of Defense, or the U.S. government, and, in the case of Ms. Hantover, have not been reviewed or approved by, and should not be attributed to, Wilson Sonsini Goodrich & Rosati.

The authors thank Professor John A. Rothchild for his excellent editing of this survey and for the many places in which his close reading and comments improved the final text.

[1] Lori Grisham, *Timeline: North Korea and the Sony Pictures Hack*, USA Today (Jan. 5, 2015), http://www.usatoday.com/story/news/nation-now/2014/12/18/sony-hack-timeline-interview-north-korea/20601645/.

[2] Warren Strobel, *U.S. Creates New Agency to Lead Cyberthreat Tracking*, Reuters (Feb. 10, 2015), http://www.reuters.com/article/2015/02/10/us-cybersecurity-agency-idUSKBN0LE1EX20150210.

[3] *See* Sam Frizell, *NSA Director on Sony Hack: "The Entire World is Watching,"* Time (Jan. 8, 2014), http://time.com/3660757/nsa-michael-rogers-sony-hack/; David E. Sanger & Martin Fackler, *N.S.A. Breached North Korean Networks Before Sony Attack, Officials Say*, N.Y. Times (Jan. 18, 2015), http://www.nytimes.com/2015/01/19/world/asia/nsa-tapped-into-north-korean-networks-before-sony-attack-officials-say.html.

[4] Aimee Chanthadavong, *Sony Attacks Launched Inside North Korea Routed via Taiwan*, ZDNet (Dec. 19, 2014), http://www.zdnet.com/article/sony-attacks-launched-inside-north-korea-routed-via-taiwan-report/.

[5] *Hearing Before the S. Comm. on Armed Services to Receive Testimony on Worldwide Threats*, 114th Cong. 3 (2015) (statement of James R. Clapper, Director of National Intelligence), *available at* http://www.dni.gov/files/documents/Unclassified_2015_ATA_SFR_-_SASC_FINAL.pdf.

attack reportedly destroyed more than 3,000 computers and 800 servers.[6] The severity of the attack prompted Sony to interrupt its reliance on digital communications and revert to pre-digital operations:

> Sony made the decision to take itself off the grid. All connections with the Internet, all connections to the rest of Sony, and all connections to third parties were shut off, effectively disconnecting an international corporation from the outside world, and plunging itself into a pre-digital age of landline telephones and hand-delivered messages written with pen and paper.[7]

The tactic of hard drive wiping had been used before, by North Korea on March 20, 2013, to erase the drives of "tens of thousands of computers" operated by the South Korean military[8] and by Iran on August 15, 2012, to erase "three-quarters of Aramco's corporate PCs."[9] But the North Korean attack on Sony, and a February 10, 2014, Iranian attack that wiped hard drives at the Las Vegas Sands Casino Corporation,[10] marked the first time that "destructive cyber attacks [were] carried out on U.S. soil by nation-state entities."[11]

In response to, or in anticipation of, the increased use of destructive malware, U.S. intelligence agencies, the U.S. military, and regulators of U.S. critical infrastructure companies urged and directed enterprises to recognize that their computer networks are "vulnerable in this wired world" and that their "data systems

[6] *See, e.g.*, *The Attack on Sony*, 60 MINUTES (Apr. 12, 2015), http://www.cbsnews.com/news/north-korean-cyberattack-on-sony-60-minutes/.

Although media reports refer to destruction of "computers," the malware apparently wiped computer hard drives and rendered the computers inoperable, which we infer from information provided in a United States Computer Emergency Readiness Team (US-CERT) Alert. The US-CERT Alert, referring to "cyber exploitation activities recently targeting a major entertainment company," describes the attack as involving a "destructive hard drive tool" and a "destructive target cleaning tool." The US-CERT Alert explains how the tools operate and the irreparable damage they inflict on computers and their hard drives:

> Destructive Hard Drive Tool: . . . a tailored *hard-drive wiping tool* that is intended to destroy data past the point of recovery and to complicate the victim machine's recovery. . . .
>
> Destructive Target Cleaning Tool: . . . renders victim machines *inoperable* by overwriting the Master Boot Record.

Alert (TA14-353A): Targeted Destructive Malware, US-CERT (Dec. 25, 2014), https://www.us-cert.gov/ncas/alerts/TA14-353A (emphasis added).

[7] *The Attack on Sony*, *supra* note 6.

[8] RYAN SHERSTOBITOFF & ITAI LIBA, DISSECTING OPERATION TROY: CYBERESPIONAGE IN SOUTH KOREA 3 (2013) (McAfee White Paper), *available at* http://www.mcafee.com/us/resources/white-papers/wp-dissecting-operation-troy.pdf.

[9] Nicole Perlroth, *In Cyberattack on Saudi Firm, U.S. Sees Iran Firing Back*, N.Y. TIMES (Oct. 23, 2012), http://www.nytimes.com/2012/10/24/business/global/cyberattack-on-saudi-oil-firm-disquiets-us.html. The North Korean attack on Sony reportedly "borrowed a wiping tool" from the attack on Aramco. David E. Sanger & Nicole Perlroth, *U.S. Said to Find North Korea Ordered Cyberattack on Sony*, N.Y. TIMES (Dec. 17, 2014), http://www.nytimes.com/2014/12/18/world/asia/us-links-north-korea-to-sony-hacking.html.

[10] Ben Elgin & Michael Riley, *Now at the Sands Casino: An Iranian Hacker in Every Server*, BLOOMBERG BUS. (Dec. 11, 2014), http://www.bloomberg.com/bw/articles/2014-12-11/iranian-hackers-hit-sheldon-adelsons-sands-casino-in-las-vegas.

[11] *Hearing Before the S. Comm. on Armed Services to Receive Testimony on Worldwide Threats*, 114th Cong. 11 (2015) (remarks by James R. Clapper, Director of National Intelligence), *available at* http://www.armed-services.senate.gov/download/15-18_-2-26-15.

remain open and susceptible to rudimentary and dangerous forms of exploitation and attack."[12] The Federal Financial Institutions Examination Council (FFIEC), for example, issued on March 30, 2015, a *Joint Statement on Destructive Malware* notifying financial institutions "of the increasing threat of cyber attacks involving destructive malware."[13] Proceeding from the growing recognition that all enterprises are vulnerable to cyber attacks, several U.S. government agencies emphasized the need for enterprises to improve their resilience to cyber incidents that might cause widespread, prolonged, and costly disruptions of operations. For example, the five-year *DoD Cyber Strategy* released in April 2015 exhorts enterprises—governmental and corporate—to focus on developing the resilience needed to continue operations if post-attack critical infrastructure services cannot be restored to pre-attack levels and enterprises must operate in a degraded cyber environment:

> [O]rganizations of every kind must build business continuity plans and be ready to operate in a degraded cyber environment where access to networks and data is uncertain. To mitigate risks in cyberspace requires a comprehensive strategy to counter and if necessary withstand disruptive and destructive attacks.[14]

Similarly, the FFIEC's *Joint Statement on Destructive Malware* notes that "comprehensive resilience depends on the ability to identify and contain damage, recover data, and restore operations from a broader set of scenarios that include cyber attacks involving destructive malware on critical information systems or the institution's underlying infrastructure."[15] Although the FFIEC *Joint Statement* expressly disclaims that it is imposing any "new regulatory expectations,"[16] it cautions: "An institution's management is expected to maintain sufficient business continuity planning processes to ensure the rapid recovery, resumption, and maintenance of the institution's operations after a cyber attack involving destructive malware."[17]

Of particular interest for corporate lawyers is a caution issued by Commissioner Luis A. Aguilar of the Securities and Exchange Commission (SEC) in June 2014 that boards should "prepare the company for the inevitable cyber attack and the resulting fallout from such an event," and be mindful that

> the primary distinction between a cyber attack and other crises that a company may face is the speed with which the company must respond to contain the rapid spread

[12] U.S. Dep't of Defense, The Department of Defense Cyber Strategy 1 (2015) [hereinafter DoD Cyber Strategy], *available at* http://www.defense.gov/home/features/2015/0415_cyber-strategy/Final_2015_DoD_CYBER_STRATEGY_for_web.pdf.

[13] Fed. Fin. Insts. Examination Council, Joint Statement: Destructive Malware 1 (2015) [hereinafter Joint Statement: Destructive Malware], *available at* https://www.ffiec.gov/press/PDF/2121759_FINAL_FFIEC%20Malware.pdf. Concurrently, the FFIEC published a statement alerting financial institutions of "the growing trend of cyber attacks for the purpose of obtaining online credentials for theft, fraud, or business disruption" and recommending that they engage in "risk mitigation techniques." Fed. Fin. Insts. Examination Council, Joint Statement: Cyber Attacks Compromising Credentials 1 (2015), *available at* https://www.ffiec.gov/press/PDF/2121758_FINAL_FFIEC%20Credentials.pdf.

[14] DoD Cyber Strategy, *supra* note 12, at 2.

[15] Joint Statement: Destructive Malware, *supra* note 13, at 1.

[16] *Id.*

[17] *Id.* at 2.

> of damage. Companies need to be prepared to respond within hours, if not minutes, of a cyber event to detect the cyber event, analyze the event, prevent further damage from being done, and prepare a response to the event.[18]

Reinforcing that concern, in November 2014, the SEC issued *Regulation System Compliance and Integrity* (Reg. SCI). In drafting the regulation, the SEC drew on the ultimate resilience test—the impact of Superstorm Sandy on the U.S. securities exchanges[19]—and required enhanced business continuity and disaster recovery (BC/DR) planning and testing participation to close the apparent gap between BC/DR plans and demonstrable resilience.

In this survey, we therefore review legal developments that meet two criteria: first, they respond to destructive cyber attacks or aim at improving critical infrastructure enterprise resilience, and second, their potential impact is so significant that they should cause even the most obdurate ostriches to lift their heads and take notice.

Part II examines executive orders issued in response to destructive cyber attacks. Part III reviews the SEC's Reg. SCI. Part IV identifies other noteworthy decisions with brief bullet-point explanations of their significance. And Part V concludes with a brief discussion of the paradox reflected in the rapidly growing threats to enterprises from destructive malware, combined with the lamentably slow pace at which enterprises are improving their resilience to disruptive cyber attacks.

II. Executive Orders that Target Cyber Adversaries

U.S.-based enterprises have suffered multitudinous cyber intrusions designed to probe for vulnerabilities, gather intelligence on network structures and processes, misappropriate intellectual property, plant malware to gain remote command and control of business and operational systems, and trigger destructive software. Federal government responses, to the extent reported and acknowledged, had not previously involved our armed forces in the cyber equivalent of a "close-in fight with an adversary" or our federal agencies in enforcement actions. That changed this year. DoD officials disclosed cyber actions by U.S. forces in terms that suggest sustained hostile engagements:

> DoD often finds itself rushing to close vulnerabilities once an adversary has penetrated a system.[20]

> Collectively, we in USCYBERCOM have gained priceless experience in cyberspace operations, and that experience has given us something even more valuable: insight into how force is and can be employed in cyberspace. We have had the equivalent of

[18] Luis A. Aguilar, Comm'r, U.S. Sec. & Exch. Comm'n, Boards of Directors, Corporate Governance and Cyber-Risks: Sharpening the Focus (June 10, 2014), *available at* http://www.sec.gov/News/Speech/Detail/Speech/1370542057946.

[19] Regulation Systems Compliance and Integrity, 78 Fed. Reg. 18084, 18091 (proposed Mar. 25, 2013) (to be codified at 17 C.F.R. pts. 242 & 249).

[20] DoD Cyber Strategy, *supra* note 12, at 20.

> a close-in fight with an adversary, which taught us how to maneuver and gain the initiative that means the difference between victory and defeat.[21]

Responding to destructive cyber attacks and cyber threats against U.S.-based enterprises, President Obama in 2015 twice issued executive orders directing federal action against foreign adversaries responsible for such actions. On January 2, 2015, expanding the scope of an earlier national emergency declaration, the President issued Executive Order 13687, which responded, in part, to North Korea's "destructive, coercive cyber-related actions during November and December 2014," and directed the blocking of property and interests in property of officials, agencies, instrumentalities, and controlled entities of the Government of North Korea and the Workers' Party of Korea.[22]

Then, on April 1, 2015, President Obama declared a national emergency and issued Executive Order 13694 (EO) to deal with the "increasing prevalence and severity of malicious cyber-enabled activities originating from, or directed by persons located, in whole or in substantial part, outside the United States."[23] The EO targets foreign-based "persons" who harm or threaten the United States through "cyber-enabled activities."[24] The EO instructs the Secretary of the Treasury, in consultation with the Attorney General and Secretary of State, to identify the targeted "persons" who meet either of two sets of criteria: one identifies the EO's direct targets and the other identifies its indirect targets.[25]

The EO's direct target criteria identify "persons" determined, first, "to be responsible for or complicit in, or to have engaged in, directly or indirectly, cyber-enabled activities originating from, or directed by persons located, in whole or in substantial part, outside the United States";[26] second, whose activities "are reasonably likely to result in, or have materially contributed to, a significant threat" to the national security or the financial stability of the United States;[27] and third, whose activities have the purpose or effect of

- "harming, or otherwise significantly compromising," a computer or computer network that supports one or more critical infrastructure entities;
- "significantly compromising" a critical infrastructure entity's provision of services;
- "causing a significant disruption to the availability" of a computer or computer network; or

[21] *Hearing Before the S. Comm. on Armed Services to Receive Testimony on U.S. Strategic Command, U.S. Transportation Command, and U.S. Cyber Command in Review of the Defense Authorization Request for Fiscal Year 2016 and the Future Years Defense Program*, 114th Cong. 8 (2015) (statement of Admiral Michael S. Rogers, Commander, United States Cyber Command), *available at* http://www.armed-services.senate.gov/imo/media/doc/Rogers_03-19-15.pdf.

[22] Exec. Order No. 13687, 80 Fed. Reg. 819, 819–20 (Jan. 6, 2015).

[23] Exec. Order No. 13694, 80 Fed. Reg. 18077, 18077 (Apr. 2, 2015).

[24] *Id.*

[25] *Id.*

[26] *Id.*

[27] *Id.*

- "causing a significant misappropriation" of assets such as funds, economic resources, or trade secrets.[28]

In short, the EO directly targets any person offshore who commits (or directs the commission of) cyber acts in the United States that damage or disrupt critical infrastructure operations or any entity's computers, or misappropriate an enterprise's intangible assets.

The EO's indirect targets are persons whom the Secretary of the Treasury determines to have met any of the following criteria:

- A person responsible for, complicit in, or engaged in the receipt for commercial advantage "outside the United States of trade secrets misappropriated through cyber-enabled means," knowing they were misappropriated, and where the misappropriation significantly threatens U.S. "national security, foreign policy, or economic health or financial stability."
- A person who materially assists in an attack or misappropriation.
- A person owned or controlled by, or who has acted on behalf of, any person whose property is blocked pursuant to the EO.
- A person who attempts to engage in any of the cyber-enabled activities targeted by the EO.[29]

For enforcement, the EO imposes financial sanctions of the kind that are typically deployed in the Economic Sanctions Regulations enforced by the U.S. Treasury Department's Office of Foreign Assets Control (OFAC) against targets such as the governments of Iran, Russia, Syria, and Venezuela.[30] Thus, the EO provides that any persons determined to be responsible for or complicit in the EO's prohibited activities will have all their property and interests in property blocked, to the extent that such property or interests are located in the United States or in the possession or control of any U.S. person.[31] The EO thus has an extraterritorial, worldwide reach.

But how will these sanctions actually work? Although innumerable persons already engage in the EO's prohibited activities, none are identified in the EO. Who will decide whom to sanction under the EO's authority? If it is OFAC,

[28] *Id.*

[29] *Id.*

[30] As OFAC explains, its primary mission

> is to administer and enforce economic sanctions against targeted foreign countries and regimes, terrorists and terrorist organizations, weapons of mass destruction proliferators, narcotic traffickers, and others, in furtherance of U.S. national security, foreign policy, and economic objectives. OFAC acts under Presidential national emergency powers . . . to prohibit transactions and block (or "freeze") assets subject to U.S. jurisdiction. Economic sanctions [set forth in the separate Economic Sanctions Regulations programs] are designed to deprive the target of the use of its assets and to deny it access to the U.S. financial system and the benefits of trade, transactions, and services involving U.S. markets, businesses, and individuals.

Economic Sanctions Enforcement Guidelines, 74 Fed. Reg. 57593, 57594 (Nov. 9, 2009).

[31] Exec. Order No. 13694, 80 Fed. Reg. at 18077.

who will OFAC identify and sanction? Since many of the EO's key terms remain undefined—e.g., "cyber-enabled activities," "harming," and "significantly compromising the provision of services"—how should counsel guide clients to avoid the EO's prohibited activities, especially those involving the EO's indirect targets?

As of this writing, the best guidance rests in FAQs that OFAC issued on April 1, 2015, at least until OFAC promulgates implementing regulations that it has said will be forthcoming.[32] The FAQs explain that acting pursuant to authority the EO delegates to the Secretary of Treasury, OFAC "will work in coordination with other U.S. government agencies to identify individuals and entities whose conduct meets the criteria set forth in EO 13694 and designate them for sanctions" and that persons OFAC designates under the EO's authority "will be added to OFAC's list of Specially Designated Nationals and Blocked Persons (SDN List)."[33] The FAQs also state that, because the EO included no "initial set of designations, there are no specific steps that U.S. persons need to take now in order to comply with" the EO.[34] However, that might not be entirely accurate. The EO does not identify a commencement date and thus could be interpreted to reach back to cyber-enabled activities planned or started months or years before the EO's April 1, 2015, issuance. Because forensic analysis has revealed that many cyber adversaries have been active within U.S. enterprises for years before detection of the intrusion, the EO, when supplemented by regulations to be issued by OFAC, may apply retroactively. And, as OFAC cautions, once the Treasury makes designations under the EO, "U.S. persons (and persons otherwise subject to OFAC jurisdiction) must ensure that they are not engaging in trade or other transactions with" any persons placed on the SDN List.[35] Moreover, enforcement will not be limited to those persons placed on the SDN List, but almost certainly will include those found directly or indirectly complicit in any of the prohibited cyber-enabled activities. These activities may, for instance, include marketing or selling zero-day vulnerability data; or misappropriating information about a critical infrastructure company's confidential or proprietary cyber defenses, business continuity, or disaster recovery plans or other information that supports or reinforces its resilience to cyber attacks.[36]

[32] *FAQs re Cyber-related Sanctions: Blocking the Property of Certain Persons Engaging in Significant Malicious Cyber-Enabled Activities (Executive Order 13694)*, U.S. Dept. Treasury (Apr. 1, 2015), http://www.treasury.gov/resource-center/faqs/Sanctions/Pages/faq_other.aspx#cyber (No. 447).

[33] *Id.* (No. 444).

[34] *Id.* (No. 445).

[35] *Id.* (No. 446).

[36] The breadth of potential penalties is evidenced by OFAC's FAQ explanation of the meaning of "cyber-enabled" activities:

> We anticipate that regulations to be promulgated will define "cyber-enabled" activities to include any act that is primarily accomplished through or facilitated by computers or other electronic devices. For purposes of E.O. 13694, malicious cyber-enabled activities include deliberate activities accomplished through unauthorized access to a computer system, including by remote access; circumventing one or more protection measures, including by bypassing a firewall; or compromising the security of hardware or software in the supply chain.

Id. (No. 447).

III. SEC Issues Regulation Systems Compliance and Integrity—Reg. SCI

On November 19, 2014, the SEC adopted Reg. SCI,[37] which supersedes its voluntary Automation Review Policy (ARP).[38] In its ARP, adopted in 1989, the SEC declared that "self-regulatory organizations should voluntarily establish comprehensive planning and assessment programs to determine systems capacity and vulnerability."[39] Abandoning the ARP's voluntary approach, the SEC adopted Reg. SCI to apply a set of mandatory rules[40] to covered "SCI entities." Reg. SCI is designed to improve the computer network infrastructure of the U.S. securities markets by reducing the frequency and impacts of "failures, disruptions, delays," and cyber intrusions into automated systems and to enhance the resilience of the entities' operations to ensure rapid recovery from disruptions and resumption of services even if primary facilities are rendered inoperable.[41]

In the adopting release, the SEC explained that a confluence of factors contributed to its proposal of Reg. SCI, including the high dependence of the markets upon "sophisticated, complex and interconnected technology" and "increased concerns over 'single points of failure' in the securities markets."[42]

> Given the speed and interconnected nature of the U.S. securities markets, a seemingly minor systems problem at a single entity can quickly create losses and liability for market participants, and spread rapidly across the national market system, potentially creating widespread damage and harm to market participants, including investors.[43]

The SEC also noted that certain "systems problems among market participants,"[44] such as outages disrupting trading[45] and "software bugs" delaying the opening of trading,[46] had demonstrated the need to bolster "the robustness of U.S. market infrastructure to help ensure its stability, integrity, and resiliency"[47] and that "risks associated with cybersecurity, and how to protect against systems intrusions," were a growing concern to all types of entities.[48] The SEC also appears to have been concerned that business continuity and disaster recovery (BC/DR) planning by covered SCI entities did not ensure that the enterprises would have sufficient resilience to resume operations promptly after wide-scale severe disrup-

[37] Regulation Systems Compliance and Integrity, 79 Fed. Reg. 72252 (Dec. 5, 2014).

[38] The ARP was established by two SEC policy statements, each titled Automated Systems of Self-Regulatory Organizations. 54 Fed. Reg. 48703 (Nov. 24, 1989); 56 Fed. Reg. 22490 (May 15, 1991).

[39] Automated Systems of Self-Regulatory Organizations, 54 Fed. Reg. at 48703.

[40] *See* Regulation Systems Compliance and Integrity, 79 Fed. Reg. at 72259, 72265.

[41] As the SEC explained, "technological advances have generated an increasing risk of operational problems with automated systems, including failures, disruptions, delays, and intrusions." Regulation Systems Compliance and Integrity, 79 Fed. Reg. at 72253.

[42] *Id.*

[43] *Id.*

[44] *Id.* at 72254.

[45] *Id.* at 72255 n.32.

[46] *Id.* at 72254 n.28.

[47] *Id.* at 72254.

[48] *Id.* at 72256.

tions of operations—and attributed this deficiency, in part, to a failure of some entities to conduct rigorous testing of the BC/DR plans. To combat this, the SEC included a testing participation requirement in Reg. SCI.[49] Although BC/DR testing by the securities industry immediately preceded Superstorm Sandy, the tests did not reveal that the exchanges lacked resilience to such an event, which appears to have profoundly influenced the SEC.[50]

Reg. SCI defines "SCI entity" to include "an SCI self-regulatory organization."[51] And it defines "SCI self-regulatory organization" to mean (and thus apply to) "any national securities exchange, registered securities association, or registered clearing agency, or the Municipal Securities Rulemaking Board."[52]

Reg. SCI focuses on an SCI entity's "SCI systems," which it defines as "all computer, network, electronic . . . or similar systems of, or operated by or on behalf of, an SCI entity that . . . directly support[s] trading, clearance and settlement, order routing, market data, market regulation, or market surveillance."[53]

The regulation imposes obligations on each SCI entity to ensure such system's operational capability. Under Reg. SCI each SCI entity must

> establish, maintain, and enforce written policies and procedures reasonably designed to ensure that its SCI systems . . . have levels of capacity, integrity, resiliency, availability, and security adequate to maintain the SCI entity's capability and promote the maintenance of fair and orderly markets.[54]

Reg. SCI further requires that an entity adopt, at a minimum, seven specified policies and procedures. Some of these are remarkable in their rigor, in their focusing on "wide-scale disruption," and in their demand for resiliency evidenced by plans to ensure resumption of operations in "next day" and "two-hour" time frames. For example, the SCI entity's policies and procedures must include

> (iv) [r]egular reviews and testing, as applicable, of such systems, including backup systems, to identify vulnerabilities pertaining to internal and external threats, physical hazards, and natural or manmade disasters; [and]

[49] *Id.* at 72348.

[50] The SEC said:

> The market closures occurred even though the securities industry's annual test of how trading firms, market operators, and their utilities could operate through an emergency using backup sites, backup communications, and disaster recovery facilities occurred . . . just two days before the storm. . . . [T]he test did not uncover issues that would preclude markets from opening two days later with backup systems, if they so chose.

Regulation Systems Compliance and Integrity, 78 Fed. Reg. 18084, 18091 (proposed Mar. 25, 2013); *see also id.* ("The Commission also has considered the impact of Superstorm Sandy on the securities markets, particularly with respect to business continuity planning and testing, in formulating proposed Regulation SCI.").

[51] 17 C.F.R. § 242.1000 (2015) (definition of "SCI entity").

[52] *Id.* (definition of "SCI self-regulatory organization or SCI SRO"). The rule's definition excludes "an exchange that is notice registered with the Commission . . . or a limited purpose national securities association registered with the Commission."

[53] *Id.* (definition of "SCI systems").

[54] *Id.* § 242.1001(a)(1).

> (v) [b]usiness continuity and disaster recovery plans that include maintaining backup and recovery capabilities sufficiently resilient and geographically diverse that are reasonably designed to achieve next business day resumption of trading and two-hour resumption of critical SCI systems following a wide-scale disruption.[55]

The SEC explains that the specified recovery times are "goals, rather than inflexible requirements"[56]—but the goals are nonetheless challenging and set high standards.

The SEC declined to limit such plans to only the most critical SCI systems because the "U.S. securities market infrastructure is highly interconnected and seemingly minor systems problems at a single entity can spread rapidly across the national market system."[57] However, the SEC adopted a definition of "critical SCI systems" as a subset of SCI systems, making them subject to the "highest level of requirements"[58] and "subject to certain heightened resilience and information dissemination provisions."[59]

Under the regulation, if an SCI entity experiences an "SCI event," the event triggers three kinds of obligations: corrective, SEC notification, and dissemination to other SCI entities. Reg. SCI defines an "SCI event" to mean an event at an SCI entity that constitutes "(1) [a] systems disruption; (2) [a] systems compliance issue; or (3) [a] systems intrusion."[60] Disruption and intrusion are defined in terms that focus on cybersecurity of the entity's operations. A "systems disruption" means "an event in an SCI entity's SCI systems that disrupts, or significantly degrades, the normal operation of an SCI system."[61] A "systems intrusion" means "any unauthorized entry into the SCI systems or indirect SCI systems of an SCI entity."[62]

The regulation provides that the triggering of SCI event obligations (corrective, notification, and dissemination) occur when "any responsible SCI personnel" has "a reasonable basis to conclude that an SCI event has occurred."[63] At that point, each SCI entity must "begin to take appropriate corrective action which shall include, at a minimum, mitigating potential harm to investors and market integrity resulting from the SCI event and devoting adequate resources to remedy the SCI event as soon as reasonably practicable."[64]

The SCI entity also has successive reporting obligations. It must immediately notify the SEC of the SCI event. Within twenty-four hours, it must "submit a written notification" to the SEC that includes the following: a description of the event and the systems affected, an assessment of the number of market par-

[55] *Id.* § 242.1001(a)(2)(iv) & (v).

[56] Regulation Systems Compliance and Integrity, 79 Fed. Reg. 72252, 72294 (Dec. 5, 2014).

[57] *Id.* at 72272.

[58] *Id.* at 72277.

[59] *Id.*

[60] 17 C.F.R. § 242.1000 (2015) (definition of "SCI event").

[61] *Id.* (definition of "systems disruption").

[62] *Id.* (definition of "systems intrusion").

[63] *Id.* § 242.1002(a); *cf. id.* § 242.1002(b)(1) (triggering notification obligation), § 242.1002(c)(1)(i) (triggering dissemination obligation).

[64] *Id.* § 242.1002(a).

ticipants potentially affected, its potential impact on the market, a description of the corrective steps it is taking or plans to take, the time frame within which the event was resolved or is expected to be resolved, and any other pertinent information the SCI entity knows about the SCI event.[65]

The SCI entity also must fulfill certain dissemination obligations. In the case of an SCI event involving "systems disruption" or "systems compliance," it must immediately disseminate information that includes the systems affected by the SCI event and a summary description of the SCI event. When known, it must also disseminate a detailed description of the SCI event, its current assessment of the "types and number of market participants potentially affected by the SCI event," a description of the progress of its corrective action, and a statement of when the SCI event has been resolved or "is expected to be resolved."[66] The recipients of the promptly disseminated information are "those members or participants of the SCI entity that any responsible SCI personnel have reasonably estimated may have been affected by the SCI event." That group is extended to include "any additional members or participants that any responsible SCI personnel subsequently reasonably estimates may have been affected by the SCI events."[67] In the case of an SCI event involving a "system intrusion," the SCI entity must promptly disseminate a description of such intrusion and include a description of what corrective action(s) the SCI entity is undertaking and when the intrusion "has been or is expected to be resolved."[68] However, the SCI entity may refrain from disseminating such information if it determines that releasing the information "would likely compromise the security of the SCI entity's SCI systems . . . or an investigation of the systems intrusion."[69] In that instance, the SCI entity must document the "reasons for such determination."[70]

The notification and dissemination obligations create liability risks for SCI entities, but they should also motivate them to act vigorously to correct and resolve the SCI event and thus to make good plans to improve their resiliency. Other critical infrastructure regulators may find it prudent to follow Reg. SCI by setting commensurately high standards for achieving resilience after wide-scale disruptive events and requiring all covered entities to participate in rigorous testing of BC/DR plans. The SEC decided to adopt (with a few exceptions) a compliance date of November 3, 2015.[71]

[65] *Id.* § 242.1002(b). Note that additional reporting obligations arise until the SCI event is closed or resolved, and other obligations arise if a resolution does not occur within thirty days. *Id.*

[66] *Id.* § 242.1002(c)(1). Note that there are additional similar dissemination obligations for SCI events that are "system intrusions." *Id.* § 242.1002(c)(2).

[67] *Id.* § 242.1002(c)(3). Note that in the case of a "major SCI event," the information must be disseminated to all of the SCI entity's members or participants. *Id.*

[68] *Id.* § 242.1002(c)(2).

[69] *Id.*

[70] *Id.*

[71] Regulation Systems Compliance and Integrity, 79 Fed. Reg. at 72252, 72366–68 (Dec. 5, 2014).

IV. Other Noteworthy Developments

Other developments during the year in review reflected the growing concern with destructive malware, the response to that concern by introducing or recommending the use of cybersecurity assessments, and efforts by companies to enhance critical infrastructure enterprise resilience. Those developments warrant close study by clients and counsel both within and outside of the regulated sector and should include the following:

- The Financial Industry Regulatory Authority published its *Report on Cybersecurity Practices* in the broker-dealer industry. The report recommends that firms conduct cybersecurity risk assessments, implement governance frameworks, "identify and maintain an inventory of . . . critical assets that should be accorded prioritized protection,"[72] and ensure that their incident response plan "reduces recovery time and costs."[73]
- The U.S. Department of Justice released a "best practices" guide to assist organizations in "preparing a cyber incident response plan and . . . preparing to respond to a cyber incident."[74] The guide details steps that organizations should take *before* a disruptive cyber intrusion and the crucial elements that an actionable incident response plan should, at a minimum, seriously consider.[75]
- The New York State Department of Financial Services issued a guidance letter to banks, representing the formal commencement of its new "cyber security assessment process."[76] The guidance letter outlines specific issues and factors on which all banks regulated by the Department will be examined as part of "new targeted, DFS cyber security preparedness assessments."[77] The letter explains that the Department will focus more attention on cybersecurity and will incorporate new cyber assessment questions and topics in its pre-examination "First Day Letters."[78] The letter goes on to identify eleven such topics, such as "incident detection and response processes, including monitoring."[79]

[72] Fin. Indus. Regulatory Auth., Report on Cybersecurity Practices 12 (2015), *available at* https://www.finra.org/file/report-cybersecurity-practices.

[73] *Id.* at 23.

[74] U.S. Dep't of Justice, Best Practices for Victim Response and Reporting of Cyber Incidents 1 (v.1 2015), *available at* http://www.justice.gov/sites/default/files/opa/speeches/attachments/2015/04/29/criminal_division_guidance_on_best_practices_for_victim_response_and_reporting_cyber_incidents2.pdf.

[75] *Id.* at 6–12.

[76] Press Release, N.Y. Dep't of Fin. Servs., NYDFS Issues Examination Guidance to Banks Outlining New Targeted Cyber Security Preparedness Assessments (Dec. 10, 2014), http://www.dfs.ny.gov/about/press/pr1412101.htm.

[77] *Id.*

[78] Memorandum from Benjamin M. Lawsky, Superintendent of Fin. Servs., N.Y. Dep't of Fin. Servs., to All NYS-Chartered or Licensed Banking Institutions 1 (Dec. 10, 2014), *available at* http://www.dfs.ny.gov/banking/bil-2014-10-10_cyber_security.pdf.

[79] *Id.* at 1–2.

The Department also announced that it is updating its examination process—namely, that it will "schedule IT/cyber security examinations following the comprehensive risk assessment of each institution" and, to aid such assessments, that it will seek, by separate request, responses to twelve cybersecurity assessment questions (such as "Provide a copy of . . . or otherwise describe, the organization's incident response program, including how incidents are reported, escalated, and remediated.").[80] Notably, the Department encouraged institutions to view cybersecurity not as a subset of their information technology (IT) functions, but as integral to their overall risk management strategy. That encouragement appears to be, in part, the Department's response to its industry survey on cybersecurity, published in May 2014, which found that "[c]orporate governance around cyber security tends to be highly IT-centered," and highlighted the fact that "certain divisions and employees appeared to be underrepresented in institutions' cyber security governance structure—specifically, General Counsel (29%)."[81]

V. Conclusion

The developments reviewed in this survey reflect a continuing paradox: (1) adversaries are developing increasingly potent destructive malware, (2) critical infrastructure regulators urge enterprises to assume the worst—that they will be among the targets of such malware—and to enhance their BC/DR plans to ensure resilience of their systems, and yet (3) until required to do so, enterprise officers and directors seem ploddingly slow to get their enterprises to adopt that objective and to devote the attention, efforts, and resources necessary to achieve and adequately test their resilience. Reg. SCI would probably not have been adopted but for the failure of voluntary standards to drive entities to achieve and verify resilience. The lack of participation by SCI entities in BC/DR testing, and the continuing evidence of system and operations disruptions that adversaries presumably have observed and may seek to exploit, also likely contributed to the adoption of Reg. SCI.[82] An August 2014 survey of "global deal-makers from corporates, financial institutions, investors and legal services providers (63 percent

[80] *Id.* at 2–3. The Department sent a similar letter to insurers. Letter from Benjamin M. Lawsky, Superintendent of Fin. Servs., N.Y. Dep't of Fin. Servs. to Insurers (Mar. 26, 2015), *available at* http://www.dfs.ny.gov/about/press2015/pr150326-ltr.pdf.

[81] N.Y. Dep't of Fin. Servs., Report on Cyber Security in the Banking Sector 6–7 (2014), *available at* http://www.dfs.ny.gov/about/press2014/pr140505_cyber_security.pdf.

[82] Note, for instance, the incident of July 8, 2015, in which the New York Stock Exchange (NYSE) had to shut down from 11:32 AM EST until 3:10 PM EST, prompting doubts about the resilience achieved with NYSE's BC/DR procedures, particularly because NYSE officials decided it would be too disruptive to activate those procedures. As NYSE president Tom Farley explained:

> [S]uspending trading on the floor was actually the lesser of two evils compared to shifting trading to the emergency recovery center in Chicago. "It was never really an option for us to go to the disaster recovery." . . . The NYSE would have shifted to Chicago only in the event of a "catastrophe, a hurricane" or something similar . . . . "[O]ur plan is to choose the least disruptive option to customers whenever possible."

from North America)"[83] evidenced that this paradox of denial appears entrenched among corporate transaction deal-makers:

> The results show that 78 percent of respondents believe cyber security is not analysed in great depth or specifically quantified as part of the M&A due diligence process, despite 83 percent saying they believe a deal could be abandoned if previous cyber security breaches were identified and 90 percent saying such breaches could reduce the value of a deal.[84]

Regrettably, the survey did not appear to inquire into whether resilience of the target is analyzed or quantified in the mergers and acquisitions (M&A) due diligence process, but its omission suggests that the issue has yet to be taken seriously in such transactions. The developments reviewed in this survey reveal that regulators now view resilience, and the BC/DR planning and testing needed to achieve and sustain that resilience, as high priorities for critical infrastructure enterprises and will examine them accordingly.[85] Therein may be a lesson worth considering by business lawyers. There is no advantage and considerable risk for the last ostrich to lift its head.

Alan Yuhas, *Stock Trading Closed on NYSE After Glitch Caused Major Outage—As It Happened*, GUARDIAN (July 8, 2015), http://www.theguardian.com/business/live/2015/jul/08/new-york-stock-exchange-wall-street.

[83] FRESHFIELDS BRUCKHAUS DERINGER, CYBER SECURITY IN M&A 6 (2014), *available at* http://www.freshfields.com/uploadedFiles/SiteWide/News_Room/Insight/Campaigns/Cyber_security_in_MandA/01214_BS_MBD_Media_MA%20Cyber%20Security%20Report_WEB_AW.PDF.

[84] *Id.*

[85] Note in particular the repeated references to "resilience" and BC/DR in the materials cited at *supra* notes 56–57 and 60–63.

Developments in Data Security Breach Liability

By *David L. Silverman**

I. Introduction

In 2014–2015, as data security breaches continued to spawn litigation, motions to dismiss kept the focus on what kinds of alleged injury arising from a breach can support Article III standing.[1] Multiple courts applied the "certainly impending" standard from the U.S. Supreme Court's recent *Clapper* decision[2] to claims predicated on an increased risk of future harm from the data breach. Under this developing caselaw, standing remains a major hurdle.[3] Plaintiffs who manage to establish standing must also state a claim for relief, and the period surveyed includes examples of claims that were adequately pleaded.[4]

The *Target* case[5] brought the plaintiffs' bar new hope for claims premised on delayed notification, with the first judicial analysis of which state notification laws include a private right of action. In cases involving litigation among retailers and financial institutions, the fees and fines assessed by the credit card companies after breaches involving payment card data continued to drive litigation, shaping the nature and effectiveness of the mechanisms merchants, processors, insurers, and the credit card companies use to allocate the risk of breach.[6]

II. Standing Found—Class Actions

On the right set of facts, the risk of future loss or damage from a data security breach may be sufficiently concrete to satisfy the injury-in-fact requirement for standing.

In *Adobe Systems, Inc.*, the breach began in July 2013 and continued undetected until September 2013, when copies of unreleased source code for certain Adobe programs began to appear on the Internet.[7] Over time, the intruders were

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[1] For a review of developments in 2013–2014, see David L. Silverman, *Developments in Data Security Breach Liability*, 70 Bus. Law. 231 (2014). For online tracking and reporting of breaches, see *id.* at 231 nn.1–2. For a study of outcomes in U.S. data breach cases through 2010, see Sasha Romanosky et al., *Empirical Analysis of Data Breach Litigation*, 11 J. Empirical Legal Stud. 74 (2014).

[2] Clapper v. Amnesty Int'l USA, 133 S. Ct. 1138, 1147 (2013).

[3] *See infra* Part III.

[4] *See infra* Part IV.

[5] *In re* Target Corp. Customer Data Sec. Breach Litig., 66 F. Supp. 3d 1154 (D. Minn. 2014).

[6] *See infra* Part V.

[7] *In re* Adobe Sys., Inc. Privacy Litig., 66 F. Supp. 3d 1197, 1206 (N.D. Cal. 2014).

able to use Adobe's own systems to decrypt stored payment card data.[8] These alleged facts supported an inference of criminal intent to misuse the data and thus made the prospect of future harm more concrete.[9] The risk of future harm met the Ninth Circuit's *Krottner* standard for injury-in-fact, that the plaintiff must be "*immediately* in danger of sustaining some *direct* injury as the result of the challenged conduct."[10] The court rejected Adobe's argument that *Krottner* is incompatible with *Clapper*'s requirement that, to constitute an injury-in-fact, a risk of future harm must be "certainly impending,"[11] and held that *Krottner* remains good law.[12] Furthermore, the court determined that "even if *Krottner* is no longer good law, the threatened harm alleged here is sufficiently concrete and imminent to satisfy *Clapper*."[13] As Judge Koh asked rhetorically: "[W]hy would hackers target and steal personal customer data if not to misuse it?"[14]

In *Adobe*, costs incurred to mitigate the risk of future harm were sufficient injury-in-fact.[15] *Clapper* had made short work of quasi-voluntary prophylactic expenditures as a basis for injury, because plaintiffs "cannot manufacture standing merely by inflicting harm on themselves based on their fears of hypothetical future harm that is not certainly impending."[16] It follows that, when the future harm is "certainly impending," prophylactic expenditures may be injury-in-fact, and the *Adobe* court so held for the two named plaintiffs who alleged they paid for their own credit monitoring services.[17]

The *Adobe* plaintiffs also managed to place the company's current data security practices at issue, seeking a declaratory judgement that Adobe was in breach of its privacy policy, which states that Adobe provides "reasonable administrative, technical, and physical security controls to protect [customer] information."[18] Adobe argued that the disclaimer immediately following that statement—"despite our efforts, no security controls are 100% effective and Adobe cannot ensure or warrant the security of your personal information"[19]—meant there was no "definite and concrete" dispute over its current and future data security practices,[20]

[8] *Id.*

[9] *Id.* at 1215–16 (distinguishing cases involving theft of physical devices, such as of a laptop from an automobile, because the target may be the device rather than the data, and the indicators of future harm are less certain).

[10] *Id.* at 1212 (quoting Krottner v. Starbucks Corp., 628 F.3d 1139, 1142 (9th Cir. 2010)) (alteration omitted) (internal quotation marks omitted).

[11] Clapper v. Amnesty Int'l USA, 133 S. Ct. 1138, 1147 (2013) ("[W]e have repeatedly reiterated that 'threatened injury must be certainly impending to constitute injury in fact,' and that '[a]llegations of possible future injury' are not sufficient." (quoting Whitmore v. Arkansas, 495 U.S. 149, 158 (1990))) (emphasis added by *Clapper* court) (internal quotation marks omitted).

[12] *Adobe*, 66 F. Supp. 3d at 1213–14.

[13] *Id.* at 1214.

[14] *Id.* at 1216.

[15] *Id.* at 1216–17.

[16] *Clapper*, 133 S. Ct. at 1151.

[17] *Adobe*, 66 F. Supp. 3d at 1216–17.

[18] *Id.* at 1206 (quoting Adobe's Privacy Policy).

[19] *Id.* (quoting Adobe's Privacy Policy).

[20] *Id.* at 1220 (quoting MedImmune, Inc. v. Genentech, Inc., 549 U.S. 118, 127 (2007)).

a jurisdictional requirement under the federal Declaratory Judgment Act.[21] But the court held that the disclaimer did not negate the obligations created by the comforting language, so the claim went forward.[22]

In *Remijas v. Neiman Marcus Group, LLC*, a district court dismissed, for lack of standing, claims by individual plaintiffs and the class based on future harm, even though the breach involved a remote attack, and at least 9,200 payments cards of the class of about 350,000 customers allegedly had been used fraudulently.[23] The Seventh Circuit reversed, confirming that *Krottner* is reconcilable with *Clapper*, and that, on the alleged facts, the risk of fraudulent charges was certainly impending.[24] The Seventh Circuit indicated that causation, if properly pled, should be addressed at the summary judgment stage, and that, if the data breach affecting the defendant is one of multiple possible causes of harm, the burden should shift to the defendant to show an alternative cause.[25] The panel also held that credit monitoring fees are cognizable damages when the risk is certainly impending, because, while some credit card issuers offer customers zero liability for fraudulent charges, the statutory minimal protection for credit and debit card users is less than complete.[26]

III. Standing—Still a High Barrier for Data Security Breach Claims

In other data security breach class actions, plaintiffs were less successful in establishing standing. Several courts rejected the theory that the risk of future harm flowing from a security breach could constitute the injury-in-fact required for standing.

In *Galaria v. Nationwide Mutual Insurance Co.*, the court held that "the increased risk that Plaintiffs will be victims of identity theft, identity fraud, medical fraud, or phishing at some indeterminate point in the future" generally will not confer standing.[27] It rejected the reasoning of cases that had held to the contrary, on the ground that they were decided prior to *Clapper*, noting that "[t]he

[21] 28 U.S.C. § 2201 (2012).

[22] *Adobe*, 66 F. Supp. 3d at 1221. If any reader is aware of a U.S. district court granting declaratory judgment after trial in a data security breach consumer class action suit, requiring the defendant to meet court-approved standards for data security in the future, please inform the author. Ongoing supervision may be part of consent decrees obtained by the FTC. *See, e.g.*, *In re* Google, Inc., No. C-4336 (F.T.C. Oct. 13, 2011) (decision and order), *available at* https://goo.gl/PJ0eOF.

[23] No. 14-C-1735, 2014 WL 4627893, at *1 (N.D. Ill. Sept. 16, 2014), *rev'd*, No. 14-3122, 2015 WL 4394814 (7th Cir. July 20, 2015).

[24] *See Remijas*, 2015 WL 4394814, at *5 (citing *Adobe*, 66 F. Supp. 3d at 1214–15 for its treatment of *Clapper*). *Compare* Pisciotta v. Old Nat'l Bancorp, 499 F.3d 629, 634 (7th Cir. 2007) (affirming dismissal, but concurring in the view that "the injury-in-fact requirement can be satisfied by a threat of future harm or by an act which harms the plaintiff only by increasing the risk of future harm that the plaintiff would have otherwise faced, absent the defendant's actions").

[25] *Remijas*, 2015 WL 4394814, at *7.

[26] *Id.* at *8 (citing 15 U.S.C. § 1643 (limiting customer liability for unauthorized use of a credit card to $50 under specified circumstances); *id.* § 1693 *et seq.* (requiring timely report to bank by customer to limit liability for unauthorized use of a debit card)).

[27] 998 F. Supp. 2d 646, 657 (S.D. Ohio 2014).

increased risk of harm may satisfy" the standards established by prior law, "but under *Clapper,* more is required to show an injury is certainly impending."[28] A study purporting to show that almost 20 percent of people whose personal financial data is stolen suffer identity theft was turned against the plaintiffs, as the court reasoned that a harm expected to befall only one person in five is not "certainly impending."[29] The court also held that *Clapper* precluded standing premised on the costs that plaintiffs allegedly incurred to mitigate the risk of future harm, such as for credit monitoring and identity theft insurance: "Such injury does not suffice to confer standing because 'respondents cannot manufacture standing merely by inflicting harm on themselves based on their fears of hypothetical future harm that is not certainly impending.'"[30]

In *Strautins v. Trustwave Holdings, Inc.*, an Illinois district court dismissed claims for increased risk of future injury based on a breach involving tax returns and related documents that the defendant data security company was hired to secure for the South Carolina Department of Revenue.[31] In so doing, the court (ruling before the decision in *Remijas*) found that the prevailing Seventh Circuit caselaw, which had arguably allowed the injury-in-fact requirement to be satisfied by even a slight degree of increased risk of harm, was inconsistent with the "certainly impending" requirement in the Supreme Court's *Clapper* decision.[32]

The *Zappos.com* security breach case looked to be going plaintiffs' way: based on an earlier ruling, the parties almost reached a settlement, before negotiations broke down over attorney's fees.[33] Then the court reconsidered the motion to dismiss for lack of standing.[34] Although it joined the other district court decisions in the Ninth Circuit, including the *Adobe* case discussed above,[35] in holding that *Krottner* remains good law after *Clapper*, the *Zappos.com* court held that allegations of increased risk of future harm and prophylactic expenditures failed to establish injury-in-fact under either test, emphasizing that more than three-and-a-half years had passed since the intrusion, and none of the twelve named plaintiffs could allege any actual harm attributable to the breach.[36] The

[28] *Id.* at 656.

[29] *Id.* at 654. The court found that plaintiffs did have standing to bring a state law invasion of privacy claim, but dismissed that claim for failure to allege required elements. *Id.* at 660–63.

[30] *Id.* at 657 (quoting Clapper v. Amnesty Int'l USA, 133 S. Ct. 1138, 1151 (2013)).

[31] 27 F. Supp. 3d 871, 872–74 (N.D. Ill. 2014).

[32] *Id.* at 877–79 (declining to follow—as inconsistent with *Clapper*—Pisciotta v. Old Nat'l Bancorp, 499 F.3d 629 (7th Cir. 2007)).

[33] *In re* Zappos.com, Inc. Customer Data Sec. Breach Litig., No. 3:12-CV-00325-RCJ-VPC, 2015 WL 3466943, at *2 (D. Nev. June 1, 2015) (discussing settlement); *cf.* Silverman, *supra* note 1, at 236–37 (discussing earlier ruling allowing claims to proceed, *In re* Zappos.com, Inc. Customer Data Sec. Breach Litig., No. 3:12-CV-00325-RCJ-VPC, 2013 WL 4830497 (D. Nev. Sept. 9, 2013)).

[34] *Zappos.com*, 2015 WL 3466943, at *2.

[35] *Id.* at *5–6.

[36] *Id.* at *4–9 (addressing increased risk), *10 (addressing prophylactic expenditures), *8–9 (discussing the passage of time); *see id.* at *4 (discussing Green v. eBay Inc., No. CV-14-1688, 2015 WL 2066531, at *3–4 (E.D. La. May 4, 2015); Storm v. Paytime, Inc., No. 14-CV-1138, 2015 WL 1119724, at *6–7 (M.D. Pa. Mar. 13, 2015); Peters v. St. Joseph Servs. Corp., 74 F. Supp. 3d 847, 849–50 (S.D. Tex. 2015)).

court also distinguished the contrary holding in the *Adobe* case, stressing factual differences between the two situations.[37] Finally, the court dismissed the theory that standing can be based on injury measured by the decreased value of personal information on the black market.[38] Dismissing, with leave to amend only for plaintiffs able to allege "instances of actual identity theft or fraud,"[39] the court emphasized both the uncertainty over the hackers as third-party actors and the public policy implications of allowing these kinds of claims to proceed.[40]

In *Lewert v. P.F. Chang's China Bistro, Inc.*, the plaintiffs propounded a theory of injury-in-fact premised on overpayment, arguing "that the cost of the food they purchased implicitly contained the cost of sufficient protection of [Personal Identifying Information]," and that they had been injured by being deprived of that protection.[41] Rejecting this theory, the court noted that cash customers of P.F. Chang's paid the same price as those using payment cards.[42] A novel theory of injury based on loss of rewards points from not using the payment cards during the card-replacement period also failed.[43]

Peters v. Saint Joseph Services Corp.[44] involved a two-day breach of a hospital computer system. The named plaintiff alleged that an attempt had been made to place a fraudulent charge on her Discover card but, as a result of a fraud alert, the charge was not approved.[45] She also claimed to be beset by telemarketing calls to her home number, that telemarketers knew personal facts about her family members, that someone tried to access her Amazon.com account using her son's name, and that she was receiving e-mail messages targeted to people suffering the particular medical conditions for which she sought treatment at St. Joseph's.[46] None of this was enough to convince the court that the risk of future injury was "certainly impending."[47]

[37] *Id.* at *9 (noting, for example, that, in *Adobe*, entire credit card numbers were stolen, but in *Zappos.com*, only the last four digits of the card numbers were accessed).

[38] *Id.* at *3 (citing and following *In re* Sci. Applications Int'l Corp. (SAIC) Backup Tape Data Theft Litig., 45 F. Supp. 3d 14, 30 (D.D.C. 2014); Galaria v. Nationwide Mut. Ins. Co., 998 F. Supp. 2d 646, 660 (S.D. Ohio 2014)).

[39] *Id.* at *11.

[40] The court said:

> [F]or a court to require companies to pay damages to thousands [and in this case millions] of customers, when there is yet to be a single case of identity theft proven, strikes us as overzealous and unduly burdensome to business. . . . [C]ourts cannot be in the business of prognosticating whether a particular hacker was sophisticated or malicious enough to both be able to successfully read and manipulate the data and engage in identity theft.

Id. at *10 (quoting *Storm*, 2015 WL 1119724, at *7) (internal quotation marks omitted) (second alteration by court).

[41] No. 14-CV-4787, 2014 WL 7005097, at *2 (N.D. Ill. Dec. 10, 2014), *appeal docketed*, No. 14-3700 (7th Cir. Dec. 12, 2014).

[42] *Id.*

[43] *Id.* at *3.

[44] 74 F. Supp. 3d 847, 850 (S.D. Tex. 2015).

[45] *Id.*

[46] *Id.* at 850–51.

[47] *Id.* at 853–56. The court also held that plaintiff could not establish standing based on her alleged actual injuries, because she could not satisfy the requirements of the "causation" and "redressability" elements of the standing inquiry. *Id.* at 857.

In *Maglio v. Advocate Health & Hospitals Corp.*, an Illinois appellate court held that, under state standing law, an alleged increased risk of identity theft does not satisfy the injury-in-fact requirement for standing.[48] Four computers, containing unencrypted medical records of four million people, but no payment card data, were stolen from defendant's offices.[49] With nothing to suggest that the data was the object of the crime, little or nothing to suggest the data was being misused, and no basis in Illinois law to make exposure of medical data an injury per se, the claims were deemed too speculative for standing.[50]

IV. Stating a Claim in a Data Breach Case

In the consolidated consumer class action against Target Corp., most claims of the 114 named plaintiffs survived a motion to dismiss, leading to the announcement of a proposed settlement agreement, with $10 million set aside for claimants.[51] These claims arose from the December 2013 revelations of an extended attack against Target's in-store payment terminals and stored payment data systems.[52]

The *Target* case sheds new light on whether claims for delayed notification of a data breach are viable. No other district court has treated, in detail, the issue of whether each of various state data breach notification laws includes an express or implied private right of action, because such claims usually have been dismissed as failing to show causation, with no damages deemed caused by the delay in notification, as opposed to those caused by the breach itself.[53]

Of the thirty-eight states under whose data breach notification laws claims were asserted in *Target*, Target conceded that nine have an embedded private right of action, and the plaintiffs conceded that three bar such actions; of the twenty-six contested states, six expressly allow for private enforcement as a violation of the state's consumer protection act (often referred to as "little FTC acts"), so the claims under the laws of those six states survived.[54] For North Dakota and Oregon, violations of the notification statute are likewise violations of the little FTC act, and although enforcement is entrusted to state officials, the

[48] Nos. 2-14-0782, 2-14-0098, 2015 WL 4659757, at *6 (Ill. App. Ct. Aug. 6, 2015). In its analysis of state law on standing, the court deemed federal caselaw, including *Clapper*, to be "instructive." *Id.*

[49] *See id.* at *1.

[50] *Id.* at *7–8.

[51] *In re* Target Corp. Customer Data Sec. Breach Litig., 66 F. Supp. 3d 1154 (D. Minn. 2014). The settlement notice is available at https://goo.gl/DZQsBJ.

[52] *See Target*, 66 F. Supp. 3d at 1157–58; Class Action Complaint at paras. 56–65, Trustmark Nat'l Bank v. Target Corp., No. 1:14CV02069, 2014 WL 1229602 (N.D. Ill. Mar. 24, 2014); Silverman, *supra* note 1, at 241–42 (analyzing the case).

[53] *See, e.g.*, *In re* Adobe Sys., Inc. Privacy Litig., 66 F. Supp. 3d 1197, 1217–18 (N.D. Cal. 2014); *In re* Sony Gaming Networks & Customer Data Sec. Breach Litig., 996 F. Supp. 2d 942, 1009–10 (S.D. Cal. 2014).

[54] *Target*, 66 F. Supp. 3d at 1166–67. The three states held to bar such actions were Florida, Oklahoma, and Utah. *Id.* at 1166. The six states found to have an express private right of action through their little FTC Acts were Alaska, Illinois, Maryland, Montana, New Jersey, and North Carolina. *Id.* at 1166–67.

statutory language implies that consumers also have a private right of action, so the claims under the laws of those two states also survived.[55] Of the remaining eighteen states, four are silent as to enforcement.[56] Of those four states, Rhode Island generally prohibits implied private rights of action, so that claim was dismissed; conversely, Kentucky grants a private right of action for any violation of state law that causes injury, so the Kentucky claims survived, along with those in Georgia and Wisconsin.[57] Of the remaining fourteen states, eight give exclusive enforcement power to the state's Attorney General or other governmental official;[58] while in the last six, although delayed notice is not a violation of the little FTC act, the grant of enforcement power to the state official is either expressly non-exclusive or ambiguous, so the availability of a private right of action could not be ruled out.[59]

The *Target* court also broke new ground in recognizing a type of loss caused by delayed notification. The theory was that Target should have been aware of the prolonged breach and notified customers at once; had the customers known of the risk, they would not have shopped at Target during the period between discovery of the breach and notification.[60] The court deemed those "would not have shopped" damages adequately pleaded for both the delayed notification and unjust enrichment claims.[61] However, plaintiffs' theory that Target was unjustly enriched because "the purchase price of the goods Target sold included a premium for adequate data security"[62] and Target failed to deliver that security was rejected on the ground that Target charged the same prices for its goods regardless of whether they paid using cash or credit cards.[63]

For the rest of the claims, Target managed to narrow the class somewhat. Little FTC act claims failed in twelve states, three that have no private right of action for this type of claim, and nine that bar class action treatment for them.[64] The economic loss rule barred negligence claims in only five states, and for states recognizing an independent duty exception, the factual record was not sufficiently developed to conclude whether there was a heightened duty or special relation-

[55] *Id.* at 1167.

[56] *Id.*

[57] *Id.* at 1169–70.

[58] *Id.* at 1168–69. The eight states found to have no private right of action because enforcement is granted exclusively to state officials were Arkansas, Connecticut, Idaho, Massachusetts, Minnesota, Nebraska, Nevada, and Texas. *Id.*

[59] *Id.* at 1169. The six states with ambiguous or non-exclusive language were Colorado, Delaware, Iowa, Kansas, Michigan, and Wyoming. *Id.*

[60] *See id.* at 1166.

[61] *Id.* at 1166, 1178. The plaintiffs also pleaded that timely notification would have allowed them to avoid unauthorized charges, cancel or change user names, monitor accounts for fraud, and take other prophylactic measures. *Id.* at 1171 (addressing negligence claims). Concluding that the plaintiffs plausibly alleged damages resulting from the delay, the court declined to rule out these various theories at that stage of the proceedings. *Id.*

[62] *Id.* at 1177.

[63] *Id.* at 1177–78.

[64] *Id.* at 1163–66. Delaware, Oklahoma, and Wisconsin bar such claims. *Id.* at 1163. Alabama, Georgia, Kentucky, Louisiana, Mississippi, Montana, South Carolina, Tennessee, and Utah bar resolution of such claims by class action. *Id.* at 1166.

ship.[65] An implied contract claim, premised on the theory that Target impliedly promised to safeguard the data of its retail customers, also survived because dismissal would be premature.[66]

Another plaintiff-friendly decision came in *Falkenberg v. Alere Home Monitoring Inc.*, involving the theft in California of an unencrypted laptop loaded with insurance and medical information from a company specializing in home medical monitoring services.[67] The claim survived a motion to dismiss, buttressed by allegations that, within a few months after the breach, two of the patients had become victims of identity theft, with fraudulent accounts opened in their names.[68] The court found that plaintiffs sufficiently alleged the causation required for a claim under California's Confidentiality of Medical Information Act.[69] To prevail under that statute, a plaintiff must show that his confidential information was viewed by an unauthorized third party.[70] The allegation that two patients had suffered identity theft shortly after the breach was deemed sufficient to support an inference that the thieves had actually viewed their information, given allegations that the patients "had never before suffered identity theft" and "always took extra precautions to ensure their confidential information was not disclosed to unknown third parties."[71]

V. Battles Among the Financial Services Providers

Banks, merchants, payment processors, and insurers fought to avoid liability for data security breaches, testing the arrangements that are supposed to allocate the risk.

Target was the target of another putative class action in Minnesota, brought by the issuing banks for their projected costs to reissue cards and prevent fraud, and here too the outcome went the plaintiffs' way, with three of four claims surviving motions to dismiss and a fourth claim dismissed with leave to amend.[72] The court said plaintiffs plausibly alleged that Target had a duty to the issuing banks for the negligence claims, that violations of Minnesota's Plastic Card Security Act (PCSA) could be negligence per se, and that the PCSA could apply to transactions involving customers from states other than Minnesota because

[65] *Id.* at 1171–76. These five states were Alaska, California, Illinois, Iowa, and Massachusetts. *Id.* at 1176. The court permitted negligence claims under the laws of the remaining states to proceed. *See id.* at 1172–76 (analyzing the laws of the District of Columbia, Georgia, Idaho, New Hampshire, New York, and Pennsylvania).

[66] *Id.* at 1176–77.

[67] 13-CV-00341-JST, 2015 WL 800378, at *1 (N.D. Cal. Feb. 23, 2015).

[68] *Id.* at *1–2, *5.

[69] *Id.* at *3–4 (interpreting Cal. Civ. Code §§ 56.36, 56.101).

[70] *Id.* at *3 (citing Sutter Health v. Super. Ct., 174 Cal. Rptr. 3d 653, 657 (Ct. App. 2014); Regents of the Univ. of Cal. v. Super. Ct., 163 Cal. Rptr. 3d 205, 217 (Ct. App. 2013)).

[71] *Id.* Such allegations of care on the part of the plaintiff have become a standard element of data security breach claims, but it is not yet clear how well they will stand up to scrutiny.

[72] *In re* Target Corp. Customer Data Sec. Breach Litig., 64 F. Supp. 3d 1304, 1308, 1314 (D. Minn. 2014) (denying motions to dismiss claims for negligence and negligence per se, as well as claimed violations of Minnesota's Plastic Security Card Act, but dismissing, with leave to amend, claim for negligent misrepresentation by omission for failure to plead reliance).

the PCSA applies to the data retention practices of any entity "conducting business in Minnesota,"[73] where Target is headquartered.[74]

Not long after this ruling, Target tried to settle—not with the plaintiffs directly, but in a separate agreement with many of MasterCard's issuing banks, reached after MasterCard offered to reduce the amount of its fees/fines.[75] A plausible motive for MasterCard's action is that, when issuing banks litigate against merchants and payment processors, it supplants the orderly processes envisioned by the operating agreements, and casts a spotlight on the fairness of the process and the fees. This settlement fell through, however, after a condition that at least 90 percent of issuing banks sign on was not met.[76]

In *Schnuck Markets, Inc. v. First Data Merchant Data Services Corp.*, a merchant was able to enforce a limitation-of-liability clause in the service contract with its payment processor and avoid the obligation, rooted in the merchant's acceptance of the credit card companies' operating rules, to pay fees or fines imposed by the credit card companies.[77] The contract provided that the merchant's liability would be limited to $500,000 except for violations of PCI-DSS protocols (limited to $3 million) and "chargebacks, servicers' fees, third party fees, and fees, fines or penalties" assessed by the credit card companies (for which there was no limit).[78] After a breach involving payment card data was discovered, the payment processor estimated the total fees/fines likely to be imposed by the credit card companies, and it began withholding funds from third-party payments, to create a reserve for repayment.[79] Although the acquiring bank's addendum to the service contract allocated all of the potential liability for a data security breach to the merchant, the service contract itself had a precise definition of "third-party fees," and compensation to the issuing banks did not fit within the definition.[80] Accordingly, the court enforced the limitation-of-liability clause in favor of the merchant.[81]

In *State Bank of Bellingham v. BancInsure, Inc.*, a small bank in Minnesota was able to enforce its insurance coverage, despite facts suggesting that its employees'

[73] MINN. STAT. § 325E.64 (2012).

[74] *Target*, 64 F. Supp. 3d at 1308–10 (addressing duty for negligence claims), 1312–14 (addressing PCSA and jurisdictional reach), 1314 (addressing negligence per se).

[75] *See In re* Target Corp. Customer Data Sec. Breach Litig., No. 14-2522 (PAM/JJK), 2015 WL 2165432, at *1–2 (D. Minn. May 7, 2015) (chastising defense counsel for the end run around plaintiffs' counsel, but declining to enjoin the settlement discussions, as no serious misconduct warranted judicial interference at such an early stage of the settlement process).

[76] *See* Nick Woltman, *Target Data Breach Settlement with MasterCard Falls Through*, TWIN CITIES (May 22, 2015, 10:48 PM), http://goo.gl/JMFjBz.

[77] No. 4:13-CV-2226-JAR, 2015 WL 224993, at *1–2, *9 (E.D. Mo. Jan. 15, 2015).

[78] *Id.* at *2 (quoting the Master Services Agreement). The Payment Card Industry Data Security Standards (PCI-DSS) are an industry-imposed set of network and data security standards. *Id.*

[79] *Id.*; *see id.* at *5 (noting that 97 percent of the estimated assessments were intended to compensate the issuing banks).

[80] *Id.* at *7–8.

[81] *Id.* at *8. A consumer class action against Schnucks, arising from the same data breach, is ongoing in Illinois. Allen v. Schnucks Mkts., No. 15-cv-0061 (MJR/DGW) (S.D. Ill. Aug. 27, 2015) (order denying defense motions to dismiss or transfer).

poor security practices led to the breach.[82] The bank used a special-purpose computer for wire transfers, with state-of-the-art security features.[83] These were all defeated by employee use of the machine to access personal e-mail.[84] A bank manager clicked on a phishing link and infected the device with a variant of the Zeus virus, leading to fraudulent wire transfers and loss; an anti-virus program running in the background detected the issue, but the employee failed to notice and did not instruct the program to remove the malware.[85] The insurer denied coverage on the grounds that employee error and/or improper maintenance of the system caused the loss.[86] However, under Minnesota law, the errors by the insured party would have had to be the "efficient and proximate cause" of the loss in order for the exclusion to apply.[87] The court reasoned, on cross-motions for summary judgment, that no matter how lax the data security practices at the bank, the loss would not have occurred but for the criminal acts of the third party, and because those actions were the "efficient and proximate cause," the insurer had to honor the coverage.[88]

When banks try to hold payment processors with whom they are not in a contractual relationship responsible for breaches that lead to fraud, they run into the public policy that the risk of loss for fraudulent transfers should lie with the banks, to the extent they are unable to recover from the perpetrators. In *Citizens Bank of Pennsylvania v. Reimbursement Technologies, Inc.*,[89] a medical payment processor's rogue employee stole bank account information belonging to patients of medical providers that used the processor's services, leading to $390,000 in fraudulent transfers from the patients' bank accounts. In an unpublished opinion, the Third Circuit held that, under Pennsylvania law, the processor had no duty to the bank as required for a common law negligence claim.[90] Several factors weighed in favor of a duty, such as the social utility of encouraging payment processors to take care to prevent such acts and the foreseeability of the harm.[91] However, these were outweighed by other considerations: the absence of any relationship between the payment processor and the bank, the fact that the bank was in the best position to prevent the loss, and the absence of a public interest in holding payment processors liable for losses incurred by unrelated financial institutions.[92]

[82] No. 13-cv-0900 (SRN/JJG), 2014 WL 4829184, at *1–2 (D. Minn. Sept. 29, 2014), *appeal docketed*, No. 14-3432 (8th Cir. Oct. 29, 2014).

[83] *See id.* at *2.

[84] *See id.* at *7.

[85] *Id.* at *6–8.

[86] *See id.* at *8.

[87] *Id.* at *20 (quoting Friedberg v. Chubb & Son, Inc., 691 F.3d 948, 952 (8th Cir. 2012) (enforcing homeowner's policy exclusion for faulty construction, because it was the overriding cause of water damage to plaintiff's home)).

[88] *Id.* at *19–22.

[89] No. 14-3320, 2015 WL 1936463, at *1 (3d Cir. Apr. 30, 2015).

[90] *Id.* at *2–3.

[91] *Id.* at *2 (citing Althaus v. Cohen, 756 A.2d 1166, 1169 (Pa. 2000)).

[92] *Id.* at *3 (applying the remaining factors considered under *Althaus*, 756 A.2d at 1169).

After *Google Spain* and *Charlie Hebdo*: The Continuing Evolution of European Union Data Privacy Law in a Time of Change

*By W. Gregory Voss**

I. Introduction

The past year has seen various developments that are modifying data privacy law in the European Union (EU), with consequences for various sectors of business. Over a year ago, the Court of Justice of the European Union (ECJ) issued its now-famous *Google Spain* decision, recognizing a so-called "right to be forgotten."[1] This has been followed by EU member state court decisions raising issues for Internet search engines, publishers of information, and potentially other Internet intermediaries.[2] Coordinated European action with respect to Google's privacy policy, discussed in last year's survey,[3] has continued, with implications for other companies offering services that collect and process individual users' data on the web. Thus, while Google may seem to have been singled out in a year when that firm is also under European competition law scrutiny,[4] the lessons to be drawn are more broadly applicable.

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[1] Case C-131/12, Google Spain SL v. Agencia Española de Protección de Datos (AEPD), 2014 E.C.R. 317, http://eur-lex.europa.eu/legal-content/EN/TXT/HTML/?uri=CELEX:62012CJ0131&rid=14.

[2] *See generally* Press Release, Court of Justice of the European Union, An Internet Search Engine Operator Is Responsible for the Processing that It Carries Out of Personal Data Which Appear on Web Pages Published by Third Parties (May 13, 2014), http://curia.europa.eu/jcms/upload/docs/application/pdf/2014-05/cp140070en.pdf (noting that national courts must dispose of cases in accordance with the decision of the ECJ, which decision is binding on the courts of member states).

[3] W. Gregory Voss, *European Union Data Privacy Law Developments*, 70 Bus. Law. 253, 254–57 (2014).

[4] On April 15, 2015, the European Commission opened a formal competition law investigation into Google's conduct in relation to its Android mobile operating system and sent Google a Statement of Objections on its comparison shopping service regarding alleged abuse of its dominant position. *See* Press Release, European Comm'n, Antitrust: Commission Sends Statement of Objections to Google on Comparison Shopping Service; Opens Separate Formal Investigation on Android (Apr. 15, 2015), http://europa.eu/rapid/press-release_IP-15-4780_en.htm. While not, strictly speaking a privacy law development, the antitrust investigation should be considered in conjunction with concerns that uses of personal data may be examined in the competition law context, after EU antitrust commissioner Margrethe Vestager's statement that "she's studying the U.S.'s 'stringent approach to dealing with personal data as a means to payment' in its review of deals." Aoife White & Peter Levring, *EU Deal Probes May Weigh Value of Personal Data: Vestager*, Bloomberg Bus. (Apr. 9, 2015, 11:09 AM),

In addition, threats of terrorism and the *Charlie Hebdo* terrorist attacks in Paris have led to a strengthening of police powers impacting Internet companies and raised calls for airlines in the EU to furnish information about their passengers to law enforcement authorities.[5] Finally, this survey addresses ongoing work on the EU data protection law reform proposals.[6]

II. *Google Spain* and the "Right to Be Forgotten": The Sequel

On May 13, 2014, the ECJ rendered its decision in the *Google Spain* case,[7] involving the request for a ruling by a Spanish court on points of EU law related to a lawsuit brought by Mr. Costeja González against Google Spain SL and Google Inc. The plaintiff sought a court order prohibiting the Google search engine from displaying, in response to a search of his name, a link to a 1998 article published in the Catalan newspaper, *La Vanguardia,* which disclosed that the plaintiff had been subject to a real-estate auction to satisfy his social security debts.[8] The ECJ ruled that an individual has the right to object to a search engine's linking to personal information about him, and that evaluation of such an objection calls for a balancing of rights and interests.[9] Criteria applicable to this balancing include the relevance or obsolescence of the data, whether there is a public interest in access to the data, and the published information's "sensitivity for the data subject's private life."[10]

As a result of the *Google Spain* decision, Google set up an online form allowing individuals to request exercise of this right.[11] As of August 12, 2015, Google received 294,977 delisting requests and deleted 58.7 percent (or approximately 628,102) of the 1,070,021 URL search engine results that the company examined as a result of the delisting requests.[12]

In addition, Google formed a council of experts that consulted with, among others, representatives of government, business, media, academia, the technology sector, and data protection organizations at seven hearings in certain European capitals from September through November 2014 in order to gather advice on how to handle delisting requests.[13] As a result of those hearings, the council

http://www.bloomberg.com/news/articles/2015-04-09/eu-deal-reviews-may-weigh-value-of-personal-data-vestager-says/.

[5] *See infra* Part IV.

[6] *See infra* Part V.

[7] Case C-131/12, Google Spain SL v. Agencia Española de Protección de Datos (AEPD), 2014 E.C.R. 317, http://eur-lex.europa.eu/legal-content/EN/TXT/HTML/?uri=CELEX:62012CJ0131&rid=14.

[8] *Id.* at para. 14.

[9] *Id.* at para. 100.

[10] *Id.* at paras. 81, 98; *see* W. Gregory Voss, *The Right to Be Forgotten in the European Union: Enforcement in the Court of Justice and Amendment to the Proposed General Data Protection Regulation*, 18 J. Internet L. 3, 5 (2014).

[11] *See Search Removal Request Under Data Protection Law in Europe*, Google, https://support.google.com/legal/contact/lr_eudpa?product=websearch/ (last visited July 28, 2015).

[12] *See Transparency Report: European Privacy Requests for Search Removals*, Google, https://www.google.com/transparencyreport/removals/europeprivacy/ (last updated Aug. 12, 2015).

[13] *See Advisory Council*, Google, https://www.google.com/advisorycouncil/ (last visited July 28, 2015).

issued a report, noting that the privacy right recognized in the *Google Spain* ruling applies regardless of whether there is harm or prejudice to the data subject, but opining that the presence of such harm (assessed on an "ethical, legal, and practical basis") is relevant in the balancing of the interest of the general public to access information against the fundamental rights of the data subject.[14] The report sets out four primary criteria for assessing delisting requests: the data subject's role in public life, the nature/type of information, its source, and how much time has passed since its publication.[15] The council acknowledged that "[m]any people have questioned whether it is appropriate for a corporation to take on what may otherwise be considered a judicial role."[16]

The report also addressed what it described as the "difficult question"[17] of the geographic scope of the delisting right.[18] Based on Google's claim that 95 percent of searches from Europe are made via the nationally directed versions of the search engine (i.e., those with country-code domains, such as "google.de" and "google.fr"), and on competing considerations regarding access to information from those outside of Europe,[19] it concluded that "removal from nationally directed versions of Google's search services within the EU is the appropriate means to implement the Ruling,"[20] thereby not requiring delisting from searches made via generic domains such as ".com."

The EU's independent privacy advisory panel created pursuant to Article 29 of the Data Protection Directive[21]—commonly referred to as the Article 29 Data Protection Working Party (WP 29)[22]—took a different view in guidelines it issued about *Google Spain* on November 26, 2014.[23] The guidelines state that the decision applies not only to search engines with an EU member state country-code domain name, but that "de-listing should also be effective on all relevant domains, including .com."[24] Consistent with such position, on May 21, 2015, the French data protection authority (CNIL) formally ordered Google

[14] Luciano Floridi et al., The Advisory Council to Google on the Right to Be Forgotten 5–6 (2015), *available at* https://drive.google.com/a/google.com/file/d/0B1UgZshetMd4cEI3SjlvV0hNbDA/view?pli=1.

[15] *Id.* at 7–14.

[16] *Id.* at 18.

[17] *Id.*

[18] *Id.* at 18–20.

[19] *Id.* at 19–20.

[20] *Id.* at 20.

[21] Directive 95/46, art. 29, 1995 O.J. (L 281) 31, 48 (EC).

[22] WP 29 is made up, *inter alia*, of representatives of EU member state data protection authorities. *Id.* WP 29 has several roles, including contributing to the harmonizing of EU member state implementations of the Data Protection Directive, making recommendations on data protection, and issuing opinions to the European Commission on various data protection issues. *Id.* art. 30, at 48–49. While consultative and not binding, WP 29's opinions, recommendations, and other documents may be persuasive and are used by various institutions of the EU and its member states. *See id.* For example, WP 29 correspondence, guidance, and recommendations were at the heart of the coordinated Google privacy policy actions by data protection authorities discussed in Part III of this survey.

[23] Art. 29 Data Prot. Working Party, Guidelines on the Implementation of the Court of Justice of the European Union Judgment on "Google Spain and Inc. v. Agencia Española de Protección des Datos (AEPD) and Mario Costeja González" (Nov. 26, 2014) (WP 225) [hereinafter WP 225].

[24] *Id.* at 3.

to apply the delisting decision to all of the search engine's domain names, failing which a procedure could be commenced in view of the potential application of sanctions.[25] The CNIL publicly announced the decision in June 2015.[26] Google responded in a blog post on July 30, 2015, contesting the authority's order,[27] and the CNIL announced that it would study and answer Google's statement within two months.[28]

WP 29 also confirmed that complaints for search engine refusals to delist, which are to be made to the relevant member state data protection authorities (DPAs), are to be treated by the DPAs "under their national legislation in the same manner as all other claims/complaints/requests for mediation."[29] WP 29 also made it clear that the guidelines do not solely target Google, and that *Google Spain* "is specifically addressed to generalist search engines, but that does not mean that it cannot be applied to other intermediaries."[30] Therefore, other operators of websites that link to web content involving personal data of EU residents should study the decision and consider its potential future application to them, even though it has only been applied to search engines to date.

On December 29, 2014, the *Audencia Nacional* (Spain's national appellate court of ordinary jurisdiction) issued its judgment applying the ECJ's *Google Spain* decision,[31] thus firmly fixing the "right to be forgotten" in Spanish law. Earlier that same month, the French *Tribunal de Grande Instance* (the ordinary court of original jurisdiction) of Paris issued an injunctive order for Google Inc. to de-index, or delete the links to, certain web pages of *Le Parisien* newspaper, regarding information about the criminal conviction of an individual published eight years earlier.[32] The claimant argued, *inter alia*, that the results linking to such pages when a search was made using her first and last names harmed her chances of getting a job.[33] The court found claimant's claim well founded.[34]

[25] Commission nationale de l'informatique et des libertés, Décision n° 2015-047 du 21 mai 2015 mettant en demeure la société GOOGLE INC. [Decision No. 2015-047 of May 21, 2015 Giving Formal Notice to GOOGLE INC.], http://www.cnil.fr/fileadmin/documents/approfondir/deliberations/Bureau/D2015-047_MED_GOOGLE_INC.pdf.

[26] *See* Press Release, Commission nationale de l'informatique et des libertés, CNIL Orders Google to Apply Delisting on All Domain Names of the Search Engine (June 12, 2015), http://www.cnil.fr/english/news-and-events/news/article/cnil-orders-google-to-apply-delisting-on-all-domain-names-of-the-search-engine/.

[27] *See* Peter Fleischer, *Implementing a European, Not Global, Right to Be Forgotten*, Google Eur. Blog (July 30, 2015), http://googlepolicyeurope.blogspot.fr/2015/07/implementing-european-not-global-right.html.

[28] *See* Mark Scott, *Google Fights Effort to Apply "Right to Be Forgotten" Ruling Worldwide,* N.Y. Times (July 30, 2015, 12:46 PM), http://nyti.ms/1KBwUR7.

[29] WP 225, *supra* note 23, at 11.

[30] *Id.* at 8.

[31] S.A.N., Dec. 29, 2014 (Recurso No. 725/2010, R.G. 4899/2010) (Spain), http://www.poderjudicial.es/stfls/SALA%20DE%20PRENSA/NOTAS%20DE%20PRENSA/AN%20S1%2029-12-2014.pdf (Google Spain, S.L. v. Agencia Protección de Datos).

[32] Tribunal de grande instance [TGI] [ordinary court of original jurisdiction] Paris, Dec. 19, 2014 (France), http://www.legalis.net/spip.php?page=jurisprudence-decision&id_article=4425 (Marie-France M. v. Google France).

[33] *Id.*

[34] *Id.*

The court's order, which followed the rejection by Google in September 2014 of claimant's request to exercise her right to be forgotten using the form supplied by Google following the *Google Spain* decision, marked the first time Google has been sanctioned in France for failing to respect the "right to be forgotten" after the ECJ's judgment.[35]

III. Further Action on Google's Privacy Policy

During the past year, DPAs in the EU moved forward with actions they had brought against Google based on the 2012 revision of its privacy policies into a single merged policy.[36] Notably, the United Kingdom's DPA, the Information Commissioner's Office (ICO), "required Google to sign a formal undertaking to improve the information it provides to people about how it collects personal data in the UK," based on its finding that the policy was too vague, even though the ICO's head of enforcement stated that its "investigation concluded that th[e] case ha[d]n't resulted in substantial damage and distress to consumers."[37] After setting out the background of the proceedings against Google, the undertaking specifies the search engine's commitments, which may serve as a guide to other online businesses for best practices regarding their privacy policies where they offer a variety of services to consumers.[38] For example, Google undertakes to continuously engage in privacy impact assessment for changes to processing not reasonably expected by users, to have user experience specialists and representative user groups review significant future changes to the policy, and to inform the ICO in advance of any significant changes to the policy, among other commitments.[39]

IV. Enhanced Security Measures in the Aftermath of the *Charlie Hebdo* Attacks

On January 7, 2015, three terrorists killed twelve people (including two police officers) in connection with their attack on the Paris office of the French satirical journal *Charlie Hebdo*.[40] In a related attack that occurred two days thereafter,

[35] *See* Lucie Ronfaut, *Google Condamné pour la Première fois en France sur le Droit à l'Oubli* [Google Sanctioned for the First Time in France on the Right to Be Forgotten], Le Figaro (Jan. 16, 2015, 10:03 AM), http://www.lefigaro.fr/secteur/high-tech/2015/01/16/32001-20150116ARTFIG00005-google-condamne-pour-la-premiere-fois-en-france-sur-le-droit-a-l-oubli.php. For a link to Google's request form, see supra note 11.

[36] For a discussion of earlier stages of the actions against Google brought by the DPAs of France, Spain, Italy, and Germany, see Voss, *supra* note 3, at 254–57.

[37] *Google to Change Privacy Policy After ICO Investigation*, ICO (Jan. 30, 2015), https://ico.org.uk/about-the-ico/news-and-events/news-and-blogs/2015/01/google-to-change-privacy-policy-after-ico-investigation/.

[38] Data Protection Act 1998 Undertaking (Google Inc.), ICO Ref: ENF0492064, https://ico.org.uk/media/action-weve-taken/undertakings/1043170/google-inc-privacy-policy-undertaking.pdf (last visited July 28, 2015). The linked version of the undertaking is unsigned and undated. *Id.* at 7.

[39] *Id.* at 6.

[40] Dan Bilefsky & Maïa de la Baume, *Terrorists Strike Charlie Hebdo Newspaper in Paris, Leaving 12 Dead*, N.Y. Times (Jan. 7, 2015), http://nyti.ms/1xEc8sC.

four people were killed at a kosher grocery on the outskirts of Paris.[41] Those attacks, which involved perpetrators with "deep histories of association with terrorist organizations,"[42] have given impetus to the establishment of additional security measures, certain of which were commenced previously, both on the French national level (websites and surveillance) and on the EU level (airline passenger name records), which will affect businesses in the Internet and airline industries, respectively. Nonetheless, WP 29 rapidly reminded Europeans of their fundamental values, including protection of private life and personal data, and of the need to strike a balance with public security needs, and stated that the EU DPAs looked forward "to contributing to the discussion on how to strike this balance."[43]

A. France—Websites and Surveillance

Prior to the attacks, France adopted a law providing new powers in the battle against terrorism.[44] Article 5 of that law added a new Article 421-2-5 to the French Criminal Code allowing the prosecution of those inciting or justifying acts of terrorism and increasing sanctions if any such violation was committed using the Internet.[45]

Following the attacks, French Interior Minister Bernard Cazeneuve went to Silicon Valley to ask Google, Facebook, and Twitter to cooperate directly with French officials during investigations and to take down terrorist material.[46] Cazeneuve explained: "We emphasized that when an investigation is underway we don't want to go through the usual government to government channels, which can take so long."[47] France reportedly was "pushing to treat jihadi material on the Internet like child porn, a task that before the attacks in Paris was getting scant traction but now seems to have caught the attention of Europe's top security officials."[48] This may have been reflected in the decree France issued on February 5, 2015, providing, *inter alia*, for the blocking of websites inciting

[41] Griff Witte, *In a Kosher Grocery Store in Paris, Terror Takes a Deadly Toll*, Wash. Post (Jan. 9, 2015), http://www.washingtonpost.com/world/europe/paris-kosher-market-seized-in-second-hostage-drama-in-nervous-france/2015/01/09/f171b97e-97ff-11e4-8005-1924ede3e54a_story.html.

[42] *Id.*

[43] Press Release, Art. 29 Data Prot. Working Party, Reaction to Attacks Recently Perpetrated in Paris (Jan. 14, 2015), http://ec.europa.eu/justice/data-protection/article-29/press-material/press-release/index_en.htm.

[44] Loi 2014-1353 du 13 novembre 2014 renforçant les dispositions relatives à la lutte contre le terrorisme [Law 2014-1353 of November 13, 2014 Reinforcing Provisions on the Fight Against Terrorism], Journal Officiel de la République Française [J.O.] [Official Gazette of France], Nov. 14, 2014, p. 19162, *available at* http://legifrance.gouv.fr/eli/loi/2014/11/13/2014-1353/jo/texte.

[45] *Id.* art. 5. The sanctions for inciting or justifying acts of terrorism are up to five years in prison and a fine of up to €75,000. *Id.* If the prohibited speech acts are communicated using a public online service, the penalties are increased to up to seven years in prison and a fine of up to €100,000. *Id.*

[46] *French Minister Meets with Google, Facebook, Twitter*, N.Y. Times (Feb. 21, 2015, 4:21 AM), http://nyti.ms/1Aog81o.

[47] *Id.*

[48] *Id.*

acts of terrorism or justifying them (as well as those distributing child pornography).[49] Internet service providers must block the sites within twenty-four hours after the Ministry of the Interior provides them with a list of prohibited websites.[50] A subsequent decree provides that the Ministry of the Interior may notify search engines and web directories of content inciting acts of terrorism or justifying them, whereupon the search engines and directories have forty-eight hours in which to delist the content.[51] The latter decree would notably be used by the Ministry of the Interior where its corresponding request to a website under the prior decree proved futile. A special office to fight criminality involving information and communication technologies, whose name is abbreviated as "OCLCTIC," has been set up under the Ministry of the Interior for transmission of blocking requests, and a platform called "PHAROS" has been established for web users to report infringing content, which may involve text, photos, videos, etc.[52] The French DPA has a supervisory function that it exercises through the use of a designated authorized person within the DPA who may make recommendations if there is a questionable blocking request made by the authorities and, if the recommendations are not followed, present the issue for resolution by an administrative judge.[53]

On May 5, 2015, the French National Assembly voted on first reading in favor of a version of the so-called French Surveillance Bill, which would add various articles to the French Internal Security Code.[54] The bill reportedly would "give the authorities their most intrusive domestic spying abilities ever, with almost no judicial oversight," allowing intelligence services, *inter alia*, to "read emails and force Internet companies to comply with requests to allow the government to sift through virtually all of their subscribers' communications."[55] The bill

[49] Décret 2015-125 du 5 février 2015 relatif au blocage des sites provoquant à des actes de terrorisme ou en faisant l'apologie et des sites diffusant des images et représentations de mineurs à caractère pornographique [Decree 2015-125 of February 5, 2015 on the Blocking of Websites Inciting Acts of Terrorism or Justifying Them and Websites Disseminating Child Pornography], Journal Officiel de la République Française [J.O.] [Official Gazette of France], Feb. 6, 2015, p. 1811, *available at* http://legifrance.gouv.fr/eli/decret/2015/2/5/2015-125/jo/texte.

[50] *Id.*

[51] Décret 2015-253 du 4 mars 2015 relatif au déréférencement des sites provoquant à des actes de terrorisme ou en faisant l'apologie et des sites diffusant des images et représentations de mineurs à caractère pornographique [Decree 2015-253 of March 4, 2015 on the Delisting of Websites Inciting Acts of Terrorism or Justifying Them and Websites Distributing Child Pornography], Journal Officiel de la République Française [J.O.] [Official Gazette of France], Mar. 5, 2015, p. 4168, *available at* http://legifrance.gouv.fr/eli/decret/2015/3/4/2015-253/jo/texte.

[52] *See Quel Contrôle du Blocage Administratif des Sites Internet?* [What Kind of Supervision for the Administrative Blocking of Websites?], CNIL (Feb. 13, 2015), http://www.cnil.fr/linstitution/actualite/article/article/quel-controle-du-blocage-administratif-des-sites-internet/.

[53] *Id.*

[54] Assemblée Nationale [French National Assembly], Projet de loi relative au renseignement [Bill on Intelligence], Texte adopté n° 511 en première lecture [as passed by the National Assembly on the first reading], May 5, 2015, http://www.assemblee-nationale.fr/14/pdf/ta/ta0511.pdf. The National Assembly is the lower house of the French Parliament.

[55] Alissa J. Rubin, *Lawmakers in France Move to Vastly Expand Surveillance*, N.Y. Times (May 5, 2015), http://nyti.ms/1IdFCmR.

would create a supervisory organization called the National Commission to Control Intelligence Techniques (CNCTR), which would rule on requests to initiate surveillance.[56] Metadata "would be electronically sorted, and only if the sites visited or the searches carried out suggested suspicious behavior as defined by the intelligence services would a human review of a person's emails and Internet browsing occur."[57]

The bill, which was described by the president of the Paris Bar Association as a French analog to the U.S. Patriot Act,[58] and which has been subject to objections from a broad array of Internet-oriented businesses,[59] went before the French Senate, the upper house of the French Parliament, which made various amendments to the bill,[60] and finally adopted an amended version on June 23, 2015,[61] which was then adopted by the French National Assembly on June 24, 2015.[62] On June 25, 2015, French President François Hollande, the President of the French Senate, and sixty members of the French National Assembly submitted the recently adopted French Surveillance Act to the French Constitutional Council (*Conseil Constitutionnel*) for review of its constitutionality.[63] A French Internet users' rights organization (La Quadrature du Net) and French Internet service provider associations (French Data Network and FDN Federation) stated that they had filed amicus briefs against the French Surveillance Act.[64] The European Parliament announced that its Civil Liberties Committee would debate concerns over the Act on July 2, 2015, and that members "are likely to ask the Commission to investigate whether the law is in line with EU treaties and the Charter of Fundamental Rights."[65]

On July 23, 2015, the French Constitutional Council issued its decision, largely upholding the French Surveillance Act; the council, however, invalidated portions

[56] *Id.* The thirteen-member commission would be comprised of "six magistrates from the Council of State and the Court of Appeals, three representatives of the National Assembly, three senators from the upper house of the French Parliament and a technical expert." *Id.*

[57] *Id.*

[58] *Id.*

[59] *Id.*; *see also* Morgane Tual, *"Ni Pigeons, Ni Espions," les Acteurs du Numérique Mobilisés Contre la Loi sur le Renseignement* ["Neither Pigeons, Nor Spies," Digital Actors Are Mobilized Against the Intelligence Act], LE MONDE (Apr. 22, 2015, 10:28 AM), http://www.lemonde.fr/pixels/article/2015/04/22/ni-pigeons-ni-espions-les-acteurs-du-numerique-mobilises-contre-la-loi-sur-le-renseignement_4619971_4408996.html.

[60] *See Projet de Loi relative au Renseignement*, SÉNAT.FR (Aug. 6, 2015), http://www.senat.fr/dossier-legislatif/pjl14-424.html (providing legislative history).

[61] *See Projet de Loi relative au Renseignement*, SÉNAT.FR (June 23, 2015), http://www.senat.fr/petite-loi-ameli/2014-2015/521.html.

[62] *See Projet de Loi relative au Renseignement*, ASSEMBLÉE NATIONALE (June 24, 2015), http://www.assemblee-nationale.fr/14/pdf/ta/ta0542.pdf.

[63] Conseil Constitutionnel [CC] [Constitutional Court], Case No. 2015-713 DC, June 25, 2015, http://www.conseil-constitutionnel.fr/conseil-constitutionnel/francais/affaires-en-instance/affaires-en-instance.28377.html.

[64] *See French Surveillance Bill: LQDN Files an Amicus Brief to the Constitutional Court*, LA QUADRATURE DU NET (June 25, 2015, 11:42 AM), http://www.laquadrature.net/en/french-surveillance-bill-lqdn-files-an-amicus-brief-to-the-constitutional-court.

[65] Press Release, European Parliament, Civil Liberties MEPs to Debate Concerns over French Surveillance Law (July 2, 2015), http://www.europarl.europa.eu/pdfs/news/expert/infopress/20150701IPR72724/20150701IPR72724_en.pdf.

of the law, such as those provisions that permitted emergency surveillance without the approval of the prime minister or another governmental minister.[66]

Internet companies with activities in France should review this legislation and the decision of the Constitutional Council and any subsequent legislative reaction either at the French or EU level, and any potential EU judicial challenge, to determine their possible obligations under the legislation.

B. Europe—Airline Passenger Name Records

In 2004, a few short years after the World Trade Center terrorist attacks in New York, the United States and the EU negotiated an agreement allowing the transfer of personal data of airline passengers traveling from Europe to the United States,[67] where the cross-border data transfer restrictions of the Data Protection Directive would otherwise have prevented such transfer.[68] Years later, in 2011, the European Commission proposed a directive that would harmonize the few member state laws regarding the collection of such passenger name record (PNR) data.[69] PNR data may include travel itineraries and dates, contact details, payment methods, and other personal information that may be useful to law enforcement authorities.[70] The proposed PNR Directive "aims to harmonise Member States' provisions on obligations for air carriers, operating flights between a third country and the territory of at least one Member State, to transmit PNR data to the competent authorities for the purpose of preventing, detecting, investigating and prosecuting terrorist offences and serious crime."[71] On April 29, 2013, the European Parliament's Civil Liberties Committee recommended that the European Parliament reject the Commission's proposed PNR Directive.[72] However, this proposal gained support recently, especially since the *Charlie Hebdo* attacks and the discovery that terrorists have traveled by air between Europe and areas of conflict in Syria.[73]

[66] Conseil Constitutionnel [CC] [Constitutional Court], decision No. 2015-713 DC, July 23, 2015, http://www.conseil-constitutionnel.fr/conseil-constitutionnel/francais/les-decisions/acces-par-date/decisions-depuis-1959/2015/2015-713-dc/decision-n-2015-713-dc-du-23-juillet-2015.144138.html; Sam Schechner & Matthew Dalton, *French Constitutional Court Approves New Powers for Intelligence Services*, Wall St. J. (July 24, 2015, 5:40 AM), http://www.wsj.com/articles/french-constitutional-court-approves-new-powers-for-intelligence-services-1437730809.

[67] Agreement Between the European Community and the United States of America on the Processing and Transfer of PNR Data by Air Carriers to the United States Department of Homeland Security, Bureau of Customs and Border Protection (May 28, 2004), http://ec.europa.eu/justice/policies/privacy/docs/adequacy/pnr/2004-05-28-agreement_en.pdf.

[68] *See* Directive 95/46, arts. 25–26, 1995 O.J. (L 281) 31 (EC).

[69] *Commission Proposal for a Directive of the European Parliament and of the Council on the Use of Passenger Name Record Data for the Prevention, Detection, Investigation and Prosecution of Terrorist Offences and Serious Crime*, COM (2011) 32 final (Feb. 2, 2011).

[70] *Id.* at 32.

[71] *Id.* at 4.

[72] *See* Press Release, European Parliament, MEPs Debate Plans to Use EU Passenger Name Record (PNR) Data to Fight Terrorism (Nov. 11, 2014), http://www.europarl.europa.eu/news/en/news-room/content/20141110IPR78121/html/MEPs-debate-plans-to-use-EU-Passenger-Name-Record-(PNR)-data-to-fight-terrorism.

[73] *See id.* (referencing "concerns over possible threats to the EU's internal security posed by Europeans returning home after fighting for the so-called 'Islamic State'").

WP 29 recognized the changed circumstances, noting that, following the *Charlie Hebdo* and other attacks in Paris in early January 2015, "the potential establishment of an EU PNR system took over the international headlines."[74] It cautioned, however, that, because of the fundamental rights involved, the measure would be justified "only if its necessity was to be demonstrated and the principle of proportionality respected."[75]

In February 2015, a member of the European Parliament, Timothy Kirkhope, circulated an alternative to the proposed PNR Directive, which included coverage of all (including intra-EU) flights, access to terrorism-related PNR data for five years, and other security and data protection measures.[76] While acknowledging that this new draft offers some improvements, WP 29 took the position that the draft "is likely to seriously undermine the rights as set out in Articles 7 and 8 of the Charter of Fundamental Rights in the European Union," that the instrument's necessity still needs to be proved, and that there should be further restrictions "to ensure that the data processing is proportionate to the purpose pursued," especially because the new draft would apply to intra-EU flights.[77] WP 29 added that the use of data should be limited to certain crimes, the system should be periodically evaluated, including a first evaluation after two years at the latest, and that the measure must comply with the requirements of the ECJ decision striking down the Data Retention Directive regarding retention periods for the data, *inter alia*.[78]

On July 15, 2015, the European Parliament's Civil Liberties Committee by a vote of thirty-two to twenty-seven approved the new PNR rules as amended by it, and also mandated the opening of negotiations with the EU Council of Ministers. Use of the PNR data would be limited to the prevention, detection, and investigation of terrorism and serious transnational crimes. Other safeguards inserted in the draft legislation included, *inter alia*, the requirement that data protection officers be appointed by member state Passenger Information Units (PIUs), that PNR data processing be logged or documented, that passengers must be informed about their rights and the collection of their PNR data, and that "stricter conditions would govern any transfer of data to third countries."[79]

[74] Press Release, Art. 29 Data Prot. Working Party, EU PNR (Feb. 5, 2015), http://ec.europa.eu/justice/data-protection/article-29/press-material/press-release/index_en.htm.

[75] *Id.*

[76] Press Release, European Parliament, Changes to Planned European Passenger Name Record (PNR) System Discussed by MEPs (Feb. 26, 2015), http://www.europarl.europa.eu/news/en/news-room/content/20150223IPR24702/html/Changes-to-planned-European-Passenger-Name-Record-(PNR)-system-discussed-by-MEPs.

[77] Letter from Art. 29 Data Prot. Working Party to Claude Moraes, Chairman, LIBE Comm'n of the European Parliament (Mar. 19, 2015), http://ec.europa.eu/justice/data-protection/article-29/documentation/other-document/files/2015/20150319__letter_of_the_art_29_wp_on_eu_pnr.pdf.

[78] *Id.* at 3–6. The referenced ECJ case is Joined Cases C-293/12 & C-594/12, Digital Rights Ireland Ltd v. Minister for Communications, Marine & Natural Resources (Apr. 8, 2014), http://goo.gl/qP2ZaL; *see also* Voss, *supra* note 3, at 257–59 (discussing the joined cases).

[79] Press Release, European Parliament, Passenger Name Records: MEPs Back EU System with Data Protection Safeguards (July 15, 2015), http://www.europarl.europa.eu/pdfs/news/expert/infopress/20150714IPR81601/20150714IPR81601_en.pdf.

The current Luxembourg Presidency of the EU Council expects to be able to reach agreement with the European Parliament on the PNR proposals by the end of the Presidency's term,[80] which terminates on December 31, 2015.

Airlines and other travel businesses such as tour operators and travel agencies are likely to be affected once the PNR Directive is enacted, in terms of collecting and turning over information, but also with potential effects on their relationship with their customers, as they become data collecting agencies for authorities in EU countries, potentially even for intra-EU flights.

V. Ongoing Work on European Union Data Protection Law Reform

On January 25, 2012, the European Commission proposed a new General Data Protection Regulation (GDPR) which, if adopted, would have replaced the Data Protection Directive and applied directly throughout the EU.[81] Two years later, on March 12, 2014, the European Parliament voted overwhelmingly in favor of a compromise text of the GDPR.[82]

In its May 2015 blueprint for a European digital single market, the European Commission stated that the GDPR is "due to be adopted by the end of 2015."[83] In a communication setting out the details of its strategy, the Commission announced that, in 2016, it will propose a European "[f]ree flow of data" initiative, which "will address the emerging issues of ownership, interoperability, usability and access to data in situations such as business-to-business, business to consumer, machine generated and machine-to-machine data."[84]

Though the Council had been partly responsible for delay in the adoption of the GDPR,[85] the Council eventually finalized a common position on all points of the proposed GDPR on June 15, 2015.[86] The European Parliament and the

[80] Press Release, European Parliament, Luxembourg Presidency Priorities Discussed by EP Committees (July 17, 2015), http://www.europarl.europa.eu/pdfs/news/expert/infopress/20150714IPR81309/20150714IPR81309_en.pdf.

[81] *Proposal for a Regulation of the European Parliament and of the Council on the Protection of Individuals with Regard to the Processing of Personal Data and on the Free Movement of Such Data (General Data Protection Regulation)*, COM (2012) 11 final (Jan. 25, 2012).

[82] *See* Press Release, European Comm'n, Progress on EU Data Protection Reform Now Irreversible Following European Parliament Vote (Mar. 12, 2014), http://goo.gl/JszkAX. For a discussion of the GDPR as approved by the Parliament, see Voss, *supra* note 3, at 259–60.

[83] Press Release, European Comm'n, A Digital Single Market for Europe: Commission Sets Out 16 Initiatives to Make It Happen (May 6, 2015), http://europa.eu/rapid/press-release_IP-15-4919_en.htm.

[84] *Communication from the Commission to the European Parliament, the Council, the European Economic and Social Committee and the Committee of the Regions on a Digital Single Market Strategy for Europe*, COM (2015) 192 final (May 6, 2015).

[85] *See* W. Gregory Voss, *Looking at European Union Data Protection Law Reform Through a Different Prism: The Proposed EU General Data Protection Regulation Two Years Later*, 17 J. Internet L. 1, 19 (2014).

[86] Press Release, European Comm'n, Commission Proposal on New Data Protection Rules to Boost EU Digital Single Market Supported by Justice Ministers (June 15, 2015), http://europa.eu/rapid/press-release_IP-15-5176_en.htm; *see* Note from Presidency to Council (June 11, 2015), http://data.consilium.europa.eu/doc/document/ST-9565-2015-INIT/en/pdf (addressing the preparation of a general approach to the GDPR).

Council must agree on the same text under the ordinary legislative procedure in order for it to become law.[87] A trilogue involving the Council, the European Parliament, and the European Commission began on June 24, 2014.[88] WP 29 previously criticized the Council's interim partial draft allowing further processing of data "even if the purpose is incompatible with the original one as long as the controller has an overriding interest in this processing."[89] In addition, the European Parliament's rapporteur and lead negotiator for the GDPR, Jan Philipp Albrecht, "stressed that several important issues still needed to be worked out with the Council, such as the need for consumers to give consent for the use of their data, the duties of data controllers and what fines should be imposed on companies that break the rules."[90] Thus, there is still work to be done in order to reach a full agreement on all points between the European institutions on the GDPR text, in a way that allays the concerns of privacy advisors.

VI. Conclusion

This survey has focused on data privacy developments linked to two major events in the news—the ECJ's *Google Spain* ruling and the *Charlie Hebdo* terrorist attacks. Privacy developments that seemingly involve only one company—namely, Google—have wider implications, and should be of interest to other firms as well. These developments impact various industries and categories of professionals: Internet search engines, certainly, but also other Internet intermediaries and companies that process personal data (including those that publish them on the Internet), media, journalists, airlines, travel industries, and others. Hopefully, this survey will encourage readers to monitor developments in these areas.

[87] For a short discussion of the "ordinary legislative procedure" that applies to the adoption of the GDPR, see Voss, *supra* note 85, at 15.

[88] Press Release, European Parliament, Data Protection: Parliament's Negotiators Welcome Council Negotiating Brief (June 15, 2015), http://www.europarl.europa.eu/sides/getDoc.do?pubRef=-//EP//NONSGML+IM-PRESS+20150615IPR66464+0+DOC+PDF+V0//EN&language=EN. The press release also discusses the Council's prior stalling. *Id.*

[89] Press Release, Art. 29 Data Prot. Working Party, Press Release on Chapter II of the Draft Regulation for the March JHA Council (Mar. 17, 2015), http://ec.europa.eu/justice/data-protection/article-29/press-material/press-release/art29_press_material/20150317__wp29_press_release_on_on_chapter_ii_of_the_draft_regulation_for_the_march_jha_council.pdf.

[90] Press Release, European Parliament, Albrecht on Data Protection Reform: People Will Be Better Informed (June 17, 2015), http://www.europarl.europa.eu/pdfs/news/public/story/20150616STO66729/20150616STO66729_en.pdf.

Privacy Developments: TCPA Litigation, FTC Privacy Enforcement Actions, and the FTC's *Internet of Things*

By Greg Dickenson[*]

For businesses that maintain personal information of consumers, two of the key areas of privacy-related legal risk are private litigation under the Telephone Consumer Protection Act (TCPA)[1] and enforcement actions by the Federal Trade Commission (FTC).[2] This survey reviews the key developments under each over the past year, and reviews the FTC's initial policy foray addressing the *Internet of Things*.

I. Private Actions Under the TCPA

Perhaps it is a truism to note that, in recent years, litigation under the TCPA has proliferated.[3] This is, in part, due to the fact that technology has outpaced the statute.[4] This analysis of the TCPA will focus on recent litigation, which has addressed issues relating to class actions, defining the statutory term "Automatic Telephone Dialing System,"[5] and consent and its revocation.

A. Class Actions

Anecdotally, the number of TCPA class action suits seems to be on the rise. Moreover, as with any class action, the dollar figures involved can be staggering.[6]

Class-action plaintiffs have the burden of establishing that issues are susceptible to classwide proof,[7] even though a defendant may bear the burden of proving or

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[1] 47 U.S.C. § 227 (2012).

[2] *See* Federal Trade Commission Act § 5, 15 U.S.C. § 45 (2012).

[3] *See* John R. Chiles & Zachary D. Miller, *TCPA Litigation Developments: Inconsistent Federal Court Decisions Headline a Hectic Year*, 70 Bus. Law. 573, 573 (2015).

[4] *See, e.g.*, Gragg v. Orange Cab Co., 995 F. Supp. 2d 1189, 1192–93 (W.D. Wash. 2014) (noting that, because most computing systems and cell phones would be capable of storing telephone numbers and dialing them automatically, "capacity" must have a higher threshold than simply pairing the device with software).

[5] 47 U.S.C. § 227(a)(1) (2012).

[6] *See, e.g.*, City Select Auto Sales, Inc. v. David/Randall Assocs., Inc., No. 11-2658 (JBS/KMW), 2015 WL 1421539, at *19 (D.N.J. Mar. 27, 2015) (entering summary judgment on behalf of the plaintiff class and awarding it statutory damages of $22,405,000 based on TCPA violations).

[7] Fed. R. Civ. P. 23.

disproving some of those issues at trial. In *Shamblin v. Obama for America*, the court found that the plaintiff failed to prove that the absence of consent could be established on a classwide basis.[8] Of particular note, the court said that "there can never be common answers to the questions of whether (1) the telephone number dialed was assigned to a cellular telephone at the time of the call and (2) whether the subscriber consented to be called."[9] Because the "TCPA 'allows consent to be given orally, in writing, electronically, or by any other means, as long as the consent is expressly given to the particular entity making the call,' . . . [i]ndividualized inquiries into consent (including where, how, and when) will predominate."[10]

Whether a class action is the superior method for adjudication depends on a number of considerations, among them "the class members' interests in individually controlling the prosecution or defense of separate actions."[11] In a state court TCPA case dealing with unsolicited faxes, the appellate court affirmed the decertification of the class, rejecting arguments that the insurer's petition to intervene had been defective and finding that the prior appellate decision on superiority was controlling and correct.[12] Under similar facts, a different court in a different state noted that TCPA claims are "an archetypical example of a case in which the class action mechanism is superior."[13] The court observed that the "cost of obtaining counsel to litigate each case—particularly given the need for discovery—would likely be greater than the expected value of each claim."[14] And the court held it to be an "error of law to conclude that providing redress for plaintiffs entitled to it by the TCPA would be 'unfair' because of the cumulative cost to the defendant."[15]

B. What Constitutes an Automatic Telephone Dialing System?

The technical question of what devices are within the statutory definition of an Automatic Telephone Dialing System (ATDS) has come to the forefront in litigation, with courts questioning where to place reasonable—and logical—limits on applying the definition of ATDS.[16] Indeed, the Federal Communications Commission (FCC), which enforces and interprets the TCPA's consumer protection

[8] No. 8:13-CV-2428-T-33TBM, 2015 WL 1909765, at *7 (M.D. Fla. Apr. 27, 2015).

[9] *Id.*

[10] *Id.* at *12 (quoting Osorio v. State Farm Bank, F.S.B., 746 F.3d 1242, 1255 (11th Cir. 2014)).

[11] Fed. R. Civ. P. 23(b)(3)(A).

[12] Local Baking Prods., Inc. v. Westfield Rental Mart, Inc., No. A-4852-12T4, 2014 WL 2807536 (N.J. Super. Ct. App. Div. June 23, 2014) (per curiam).

[13] Hazel's Cup & Saucer, LLC v. Around the Globe Travel, Inc., 15 N.E.3d 220, 222–23 (Mass. App. Ct. 2014).

[14] *Id.* at 223.

[15] *Id.*

[16] *See* Gragg v. Orange Cab Co., 995 F. Supp. 2d 1189, 1192–93 (W.D. Wash. 2014) ("[A] broad interpretation that any technology with the *potential* capacity to store or produce and call telephone numbers using a random number generator constitutes an ATDS would capture many of contemporary society's most common technological devices within the statutory definition."); Hunt v. 21st Mortg. Corp., No. 2:12-CV-2697-WMA, 2013 WL 5230061, at *4 (N.D. Ala. Sept. 17, 2013) (holding that a device is not an ATDS "if substantial modification or alteration of the system would be required to achieve" automatic dialing capability).

provisions,[17] has found that the definition of ATDS[18] covers any equipment that has the specified *capacity*[19] to generate numbers and dial them *without human intervention*,[20] regardless of whether the numbers called are randomly or sequentially generated or come from calling lists. Yet even with such guidance from the FCC, the meaning of the term "capacity" remains unclear. For example, does "capacity" mean a present ability, or is it enough that a capacity is inherent to the technology?[21] In June 2015, the FCC adopted a declaratory ruling,[22] apparently affirming its prior interpretations of ATDS,[23] and setting forth its view that "robocallers cannot skirt consumer consent requirements through changes in calling technology design or by calling from a list of numbers."[24]

Given inadequate clarification by the FCC, courts have wrestled with applying the definition of ATDS. In *Johnson v. Yahoo!*, plaintiffs claimed that Yahoo! violated the TCPA when it sent text messages to their cell phones.[25] The messages were sent in connection with a function of Yahoo! Messenger that allows a user to send an online message that is received as a text message on the recipient's cell phone.[26] The challenged messages were ones that Yahoo!'s system sent to the recipient to explain why the recipient had received a message from the sender.[27] Yahoo! argued that its system did not constitute an ATDS because it was not capable of sending messages "without human intervention," as the FCC had interpreted the statute to require.[28] The basis of Yahoo!'s argument was that the challenged messages "never would have been sent absent the Yahoo! user's

[17] *See* 47 U.S.C. § 227(b)(2) (2012).

[18] *Id.* § 227(a)(1) ("The term 'automatic telephone dialing system' means equipment which has the capacity—(A) to store or produce telephone numbers to be called, using a random or sequential number generator; and (B) to dial such numbers.").

[19] *Id.*

[20] *See* Rules and Regulations Implementing the Telephone Consumer Protection Act (TCPA) of 1991, 68 Fed. Reg. 44144, 44161 (July 25, 2003) (to be codified at 47 C.F.R. pts. 64 & 68) ("without human intervention").

[21] *See* Petition for Rulemaking of ACA International at 6–12, CG Docket No. 02-278 (Jan. 31, 2014), *available at* http://apps.fcc.gov/ecfs/document/view?id=7521069730 (urging the FCC to clarify that not all predictive dialers are categorically autodialers and to define "capacity" under the TCPA to mean present ability to store and dial numbers); Professional Association for Customer Engagement's Petition for Expedited Declaratory Ruling and/or Expedited Rulemaking at 3, CG Docket No. 02-278 (Oct. 18, 2013), *available at* http://apps.fcc.gov/ecfs/document/view?id=7520947489 (seeking clarification that "(1) a system is not an [ATDS] unless it has the capacity to, *inter alia*, dial numbers *without human intervention*; and (2) a system's 'capacity' is limited to what it is capable of doing, without further modification, *at the time the call is placed*").

[22] *In re* Rules and Regulations Implementing the Telephone Consumer Protection Act of 1991, CG Docket No. 02-278 (June 18, 2015) (declatory ruling and order), *available at* https://apps.fcc.gov/edocs_public/attachmatch/FCC-15-72A1.pdf. A full discussion of this ruling exceeds the scope of this survey.

[23] *Id.* at 11–18.

[24] Press Release, Fed. Commc'ns Comm'n, FCC Strengthens Consumer Protections Against Unwanted Calls And Texts (June 18, 2015), http://transition.fcc.gov/Daily_Releases/Daily_Business/2015/db0619/DOC-333993A1.pdf.

[25] No. 14 CV 2028, 2014 WL 7005102, at *1 (N.D. Ill. Dec. 11, 2014).

[26] *See id.*

[27] *See id.* at *2.

[28] *Id.* at *5; *see* Rules and Regulations Implementing the Telephone Consumer Protection Act (TCPA) of 1991, 68 Fed. Reg. 44144, 44161 (July 25, 2003) (to be codified at 47 C.F.R. pts. 64 & 68) ("without human intervention").

underlying personalized message."[29] The court rejected Yahoo!'s position, reasoning that "[e]very ATDS requires some initial act of human agency—be it turning on the machine or pressing 'Go.' It does not follow, however, that every subsequent call the machine dials—or message it sends—is a product of that human intervention."[30] The court concluded that "the FCC's 'human intervention' gloss on the statute requires more than but-for causation."[31] Thus, because there was evidence suggesting that Yahoo!'s system can pull and dial numbers without a person ordering a specific system message, there was insufficient evidence to grant Yahoo!'s motion for summary judgment.[32]

On the other hand, a platform that sends "calls" at the consumer's direction was found not to be an ATDS because human intervention is on the critical path for operation. In *McKenna v. WhisperText*, a text messaging platform sent messages only at the *user's* affirmative discretion.[33] In that context, the court found persuasive that "two other district courts in the Ninth Circuit have held that, under such circumstances, the action taken is with human intervention —disqualifying the equipment at issue as any kind[] of ATDS."[34]

In another case, where a defendant uploaded a file containing phone numbers to be called by a cloud-based application, the application was held to be an ATDS.[35] At issue was whether the defendant's application, which functioned as a predictive dialer, had the capacity for random or sequential number generation.[36] The court held that it did, based both on testimony to that effect from the defendant's own Rule 30(b)(6) witness and on the FCC's ruling determining "that a 'predictive dialer' that relies on lists of numbers qualifies as an ATDS under the TCPA."[37]

A critical TCPA issue is the applicability of the statute to mobile text messaging platforms. As early as 2003, the FCC ruled that text messages are "calls" under the TCPA,[38] and it does not appear to be changing its position on the matter.[39]

[29] *Johnson*, 2014 WL 7005102, at *5.

[30] *Id.*

[31] *Id.* at *5 n.11.

[32] *Id.* at *5. *But see* Dominguez v. Yahoo!, Inc., 8 F. Supp. 3d 637, 644 (E.D. Pa. 2014) (finding absence of "evidence to show that Yahoo's system had the capacity to randomly or sequentially generate telephone numbers (as opposed to simply storing telephone numbers), as required by the statutory definition of ATDS").

[33] No. 5:14-CV-00424-PSG, 2015 WL 428728, at *3 (N.D. Cal. Jan. 30, 2015).

[34] *Id.*

[35] Davis v. Diversified Consultants, Inc., 36 F. Supp. 3d 217, 221 (D. Mass. 2014).

[36] *Id.* at 225–27.

[37] *Id.* at 226 (citing Rules and Regulations Implementing the Telephone Consumer Protection Act (TCPA) of 1991, 68 Fed. Reg. 44144, 44161–62 (July 25, 2003) (to be codified at 47 C.F.R. pts. 64 & 68)).

[38] Rules and Regulations Implementing the Telephone Consumer Protection Act (TCPA) of 1991, 68 Fed. Reg. at 44165 (determining that the TCPA's prohibition on ATDSs "encompasses both voice calls and text calls to wireless numbers including, for example, short message service calls"); *see also* Satterfield v. Simon & Schuster, Inc., 569 F.3d 946, 954 (9th Cir. 2009) (finding "the FCC's interpretation of the TCPA is reasonable, and therefore afford[ing] it deference to hold that a text message is a 'call' within the TCPA").

[39] *See* Press Release, Fed. Commc'ns Comm'n, *supra* note 24, at 2 ("Equipment used to send Internet-to-phone text messages is an autodialer . . . .").

In *Marks v. Crunch San Diego, LLC*, the central issue was whether the technology used by the defendant to send text messages had "the capacity to store or produce telephone numbers to be called using a random or sequential number generator."[40] The defendant, Crunch San Diego LLC (Crunch), was a gym operator that used a third-party web-based platform to send promotional text messages to the cell phones of its members and prospective members.[41] The numbers to which the messages were sent were entered into the system in three ways: (1) manually by Crunch, (2) through an individual's response by text to a marketing campaign, or (3) by an individual via Crunch's website.[42] Crunch selected the date when the messages were to be sent.[43] The platform sent the text messages to those phone numbers on the designated date via a Short Messaging Service gateway aggregator that transmitted the messages directly to the cell phone carrier.[44] The court held that the phrase "random or sequential number generator" in the statute's definition of an ATDS had to be given effect.[45] Because the numbers that the system dialed were entered through one of the three specified methods, rather than through use of a "random or sequential number generator," the calling system was not an ATDS.[46]

C. Consent

As the FCC has observed, "the TCPA is silent on the issue of what form of express consent—oral, written, or some other kind—is required for calls that use an automatic telephone dialing system or prerecorded voice to deliver a telemarketing message."[47] The U.S. Court of Appeals for the Eleventh Circuit has been active on this topic over the past year.

For example, in *Mais v. Gulf Coast Collection Bureau*, the Eleventh Circuit held that completion and execution of hospital admissions forms, which include a privacy notice disclosure stating that the hospital may use information or disclose it to its business partners for payment and collection, constitutes prior express consent to receive calls from debt collectors to collect payment for hospital services.[48] In doing so, the Eleventh Circuit found that the plaintiff had provided express consent through an intermediary, his wife, when she completed hospital intake forms on the plaintiff's behalf.[49]

The Eleventh Circuit's decision in *Mais* is also significant for bringing the Eleventh Circuit into alignment with other courts that have considered the FCC's

[40] 55 F. Supp. 3d 1288, 1291 (S.D. Cal. 2014) (quoting 47 U.S.C. § 227(a)(1)).
[41] *Id.* at 1289.
[42] *Id.*
[43] *Id.*
[44] *Id.*
[45] *Id.* at 1292 (quoting 47 U.S.C. § 227(a)(1)).
[46] *Id.*
[47] Telephone Consumer Protection Act of 1991, 77 Fed. Reg. 34233, 34234 (June 11, 2012) (to be codified at 47 C.F.R. pt. 64).
[48] 768 F.3d 1110, 1123–24 (11th Cir. 2014).
[49] *Id.* at 1124.

interpretation of express prior consent.[50] In *Mais*, the district court granted partial summary judgment against the defendant because it found the FCC's interpretation inconsistent with the language of the TCPA.[51] The Eleventh Circuit overruled the district court because Congress had unambiguously granted federal appellate courts—not district courts—the power to consider the validity of FCC rulings.[52]

The Eleventh Circuit also found that consent may be orally revoked. In *Osorio v. State Farm Bank, F.S.B.*, the court interpreted the TCPA's silence concerning consent to mean that Congress intended the statute to incorporate the common law concept of consent and determined that the common law generally allows oral revocations.[53] The court also relied on the FCC's "persuasive guidance confirming that called parties may revoke their consent orally."[54]

II. Privacy Enforcement Actions by the Federal Trade Commission

The Federal Trade Commission (FTC) considers failure to protect consumers' personal information to be an "unfair or deceptive act[] or practice[]."[55] In a few high-profile cases, regulated entities challenged the FTC's authority to take enforcement action in this area, but such challenges have not been successful.[56] In the past year, there have been several noteworthy privacy enforcement matters, which provide some insight into the FTC's enforcement philosophy.

A. Nomi Technologies, Inc.

The FTC initiates enforcement action against any company that fails to live up to the representations it makes in its privacy policy. In its complaint against Nomi Technologies, Inc. (Nomi), the FTC alleged that "Nomi uses mobile device tracking technology to provide analytics services to brick and mortar retailers through its 'Listen' service," collecting information from consumers' mobile de-

[50] *See, e.g.*, Hudson v. Sharp Healthcare, No. 13-CV-1807-MMA NLS, 2014 WL 2892290, at *9 (S.D. Cal. June 25, 2014) (granting summary judgment, on facts similar to *Mais*, due to existence of prior express consent).

[51] *Mais*, 768 F.3d at 1113, *rev'g in part* 944 F. Supp. 2d 1226, 1240 (S.D. Fla. 2013).

[52] *Id.*

[53] 746 F.3d 1242, 1255 (11th Cir. 2014).

[54] *Id.* at 1256 (citing *In re* Rules and Regulations Implementing the Telephone Consumer Protection Act of 1991, 27 FCC Rcd. 15391, 15398 (Nov. 29, 2012) ("[R]equests to stop receiving voice calls . . . can be confirmed during the same call in which a consumer has expressed a desire to opt out . . . .")).

[55] 15 U.S.C. § 45(a) (2012) (empowering the FTC to regulate "unfair or deceptive acts or practices" affecting commerce); Gina Stevens, Cong. Research Serv., R43723: The Federal Trade Commission's Regulation of Data Security Under Its Unfair or Deceptive Acts or Practices (UDAP) Authority 5 (2014).

[56] *See* LabMD, Inc. v. FTC, 776 F.3d 1275, 1280 (11th Cir. 2015) (holding court lacks jurisdiction to hear challenge to FTC's authority over healthcare privacy until the completion of the administrative proceedings); FTC v. Wyndham Worldwide Corp., 10 F. Supp. 3d 602, 612–15 (D.N.J. 2014) (denying challenge to FTC's enforcement authority involving data security breach), *aff'd*, No. 14-3514, 2015 WL 4998121 (3d Cir. Aug. 24, 2015).

vices.[57] It does so by "plac[ing] sensors in its clients' retail locations that detect the media access control (MAC) address broadcast by a mobile device when it searches for WiFi networks."[58] While Nomi does not store the MAC address, it stores a "persistent unique identifier for each mobile device."[59] According to the complaint, Nomi stated in its privacy policy that consumers could opt out of the tracking either via Nomi's website or at any store using Nomi's technology, but in fact it was not possible to opt out at the stores.[60] The complaint also alleged that Nomi falsely represented that it would disclose to consumers that the Listen service was being used at a retail location.[61] The Commission voted three-two to issue the complaint and accept the proposed consent order.[62] Two members of the FTC dissented because—among other reasons—they found no evidence of consumer harm.[63]

B. TRUSTe, Inc.

TRUSTe, Inc. provides seals to businesses that meet specific requirements for consumer privacy programs that it administers.[64] A TRUSTe seal assures consumers that a business's privacy practices are in compliance with specific privacy standards, such as the safe harbor of the Children's Online Privacy Protection Act or the U.S.-E.U. Safe Harbor.[65] The FTC's complaint alleged that TRUSTe violated the FTC Act in two ways: first, by representing that it conducted an annual recertification of all holders of its privacy seals, when, in many cases, it failed to do so;[66] and second, by allowing seal holders to continue stating in their privacy policies that TRUSTe was a non-profit organization even after it had become a for-profit corporation in 2008.[67] The final order included a requirement that TRUSTe pay $200,000 as disgorgement.[68]

C. Bayview Solutions, LLC

The FTC expects companies to ensure that they have taken appropriate steps to protect consumers' personal information, and failure to do so can result in an enforcement action even in the absence of any misrepresentations. In *FTC v.*

[57] Complaint at 1, *In re* Nomi Techs., Inc., No. 132-3251 (F.T.C. Apr. 23, 2015), *available at* https://www.ftc.gov/system/files/documents/cases/150423nomicmpt.pdf.

[58] *Id.*

[59] *Id.* at 2.

[60] *See id.* at 3.

[61] *Id.*

[62] Nomi Technologies, Inc.; Analysis of Proposed Consent Order to Aid Public Comment, 80 Fed. Reg. 24923, 24927–29 (May 1, 2015).

[63] *Id.*

[64] Compliant at 2–3, *In re* True Ultimate Standards Everywhere, Inc., No. C-4512 (F.T.C. Mar. 12, 2015), *available at* https://www.ftc.gov/system/files/documents/cases/150318trust-ecmpt.pdf.

[65] *Id.* at 3.

[66] *Id.* at 3–4.

[67] *Id.* at 4–5.

[68] *In re* True Ultimate Standards Everywhere, Inc., No. C-4512 (F.T.C. Mar. 12, 2015) (decision and order), *available at* https://www.ftc.gov/system/files/documents/cases/150318trust-edo.pdf.

Bayview Solutions, LLC, defendants were debt brokers that "purchase and sell portfolios of charged-off consumer debt for eventual collection by third-party debt collectors."[69] Bayview Solutions, LLC (Bayview) maintained websites that provide a venue for debt sellers and buyers to identify one another and exchange information about portfolios they sought to trade.[70] According to the FTC's complaint, one of Bayview's websites was publicly accessible and not password-protected, so that visitors to this website could view and download its contents.[71] The FTC alleged that the defendants, on multiple occasions, posted debt portfolios on this website in a manner that exposed "the unencrypted, unmasked, sensitive personal information of more than 28,000 consumers,"[72] including "consumers' first names, cities and states, e-mail addresses, dates of birth, driver's license numbers, full bank account and bank routing numbers, employers' names and contact information, the consumers' status as purported debtors, and the amount of each consumer's purported debt."[73] The FTC charged that this conduct was an unfair practice in violation of the FTC Act.[74]

The Stipulated Final Order for Permanent Injunction requires Bayview to have a comprehensive information security program that is reasonably designed to protect the security, confidentiality, and integrity of personal information collected from or about customers.[75] The program must establish risk controls, including "(1) employee training and management; (2) information systems, including network and software design, information processing, storage, transmission, and disposal; and (3) prevention, detection, and response to attacks, intrusions, or other systems failures."[76]

D. Jerk, LLC

Jerk, LLC operated a website, at Jerk.com, "that invited users to create profiles of other individuals and rate those profiled as a 'jerk' or 'not a jerk.'"[77] The website made money "by selling memberships for $30, charging consumers a $25 customer service fee to contact the website, and placing third-party advertise-

[69] Complaint for Permanent Injunction and Other Equitable Relief at 3, FTC v. Bayview Sols., LLC, No. 1:14-cv-01830 (D.D.C. Oct. 31, 2014), *available at* https://www.ftc.gov/system/files/documents/cases/111014bayviewcmp.pdf.

[70] *Id.*

[71] *Id.* at 3–4.

[72] *Id.* at 5.

[73] *Id.* at 7.

[74] *Id.*

[75] Stipulated Final Order for Permanent Injunction at 3, FTC v. Bayview Sols., LLC, No. 1:14-cv-01830-RC (D.D.C. Apr. 20, 2015), *available at* https://www.ftc.gov/system/files/documents/cases/150421bayviewstip.pdf.

[76] *Id.* at 4. The FTC brought a similar action against another debt broker, named Cornerstone and Company, LLC. *See* Press Release, Fed. Trade Comm'n, Debt Brokers Settle FTC Charges They Exposed Consumers' Information Online (Apr. 13, 2015), https://www.ftc.gov/news-events/press-releases/2015/04/debt-brokers-settle-ftc-charges-they-exposed-consumers.

[77] *In re* Jerk, LLC, No. 9361 (F.T.C. Mar. 13, 2015) (opinion of the Commission), *available at* https://www.ftc.gov/system/files/documents/cases/150325jerkopinion_0.pdf.

ments on Jerk.com."[78] The FTC issued an administrative complaint, alleging that Jerk.com falsely represented to consumers that the content on Jerk.com was user generated, when it was nearly all improperly obtained from Facebook, and that Jerk.com falsely represented that by purchasing a membership users received additional benefits, including the ability to dispute information, but in fact received nothing in return for their memberships.[79]

The Commission granted complaint counsel's motion for summary decision.[80] In its final order, the Commission enjoined the respondents from making any further misrepresentations, and from "[d]isclosing, using, selling, or benefitting from" the personal information it had gathered through their operation of Jerk.com.[81] The order also requires Jerk.com to "dispose of" that information.[82]

III. FTC's Staff Report on the *Internet of Things*

In a report titled *Internet of Things: Privacy & Security in a Connected World*,[83] the FTC staff sets out the Commission's recommendations of best practices to protect privacy and security in connection with the developing Internet of Things (IoT). The report, which is based on a workshop that the FTC held in November 2013, draws lessons from many of its privacy enforcement actions and applies them to the IoT.[84] The bulk of the report focuses on four of the traditional Fair Information Practice Principles: data security, data minimization, notice, and choice.[85]

The meaning of the term Internet of Things is not well established. For purposes of the report, the term refers to "'things' such as devices or sensors—other than computers, smartphones, or tablets—that connect, communicate or transmit information with or between each other through the Internet," but limited to "devices that are sold to or used by consumers."[86] The consumer-centric ap-

[78] *Id.* at 2.

[79] *Id.* at 3.

[80] *Id.* at 5. Rule 3.24 of the Commission's Rules of Practice permits the Commission to issue summary decision when it "determines that there is no genuine issue as to any material fact regarding liability or relief." 16 C.F.R. § 3.24(a)(2) (2015).

[81] *In re* Jerk, LLC, No. 9361 (F.T.C. Mar. 13, 2015), *available at* https://www.ftc.gov/system/files/documents/cases/150325jerkorder.pdf.

[82] *Id.*

[83] Fed. Trade Comm'n Staff, Internet of Things: Privacy & Security in a Connected World (2015) [hereinafter Internet of Things Report], *available at* https://www.ftc.gov/system/files/documents/reports/federal-trade-commission-staff-report-november-2013-workshop-entitled-internet-things-privacy/150127iotrpt.pdf.

[84] For example, the FTC cites actions against the operators of Credit Karma and Fandango mobile apps, its letter to the founders of XY magazine, and its action against Google regarding the Buzz social network. *Id.* at 29, 35, 44–45.

[85] *Id.* at 19–46; *see id.* at 19 (identifying those principles: notice, choice, access, accuracy, data minimization, security, and accountability).

[86] *Id.* at 6. The exclusion of personal computers, smart phones, and tablet computers is presumably due to the fact that the privacy and security issues relating to those devices have been widely addressed in other contexts.

proach makes sense given that the FTC's privacy enforcement and policy roles have grown out of its consumer protection mission.[87] The report includes FTC staff guidance regarding (1) reasonable security requirements, (2) data minimization, and (3) notice and choice.[88]

A. Reasonable Security Requirements

According to the report, "what constitutes reasonable security for a given device will depend on a number of factors, including the amount and sensitivity of data collected, the sensitivity of the device's functionality, and the costs of remedying the security vulnerabilities."[89] But the report also provides a roadmap to six "specific security best practices."[90] First, security should be incorporated into devices at the design stage—what the report calls "security by design."[91] The design should be driven by a privacy or risk assessment, which may include consideration of how to minimize data collection.[92] Smart defaults, such as a requirement for consumers to change default passwords, should be incorporated into products.[93] Companies should also test their products for security before releasing them.[94]

Second, the report urges companies to ensure that their personnel practices promote good security, including appropriate oversight from executive-level management and adequate training for the employees.[95]

Third, FTC staff expects companies to hire vendors that have the capability of "maintaining reasonable security" and to "provide reasonable oversight to ensure that those service providers do so."[96] The report notes that inadequate supervision of outsourced service providers has previously resulted in FTC enforcement from a privacy and security standpoint.[97]

Fourth, where a system contains significant risk, companies should "implement a defense-in-depth approach, where security measures are considered at several levels."[98] This effectively means the use of encryption for sensitive data, although the FTC is less focused on a particular technology than the result that sensitive data is secure in transit and while in storage.[99]

[87] *See* Julie Brill, Comm'r, Fed. Trade Comm'n, The Intersection of Privacy and Consumer Protection: Some Thoughts from FTC Commissioner Julie Brill (Apr. 15, 2015), *available at* https://www.ftc.gov/system/files/documents/public_statements/636911/150414icpen.pdf.

[88] Internet of Things Report, *supra* note 83, at 27–46.

[89] *Id.* at 28.

[90] *Id.*

[91] *Id.*

[92] *Id.*

[93] *Id.*

[94] *Id.* at 28–29.

[95] *See id.* at 29.

[96] *Id.* at 30.

[97] *Id.* (referencing *In re* GMR Transcription Servs., Inc., No. C-4482 (F.T.C. Aug. 14, 2014), *available at* https://www.ftc.gov/system/files/documents/cases/140821gmrdo.pdf).

[98] *Id.*

[99] *Id.*

Fifth, companies should implement "reasonable access control measures to limit the ability of an unauthorized person to access a consumer's device, data, or even the consumer's network."[100] Such measures might include strong authentication and defined privileges based on validated user identity.[101]

Sixth, companies should monitor their products throughout the lifecycle, and—to the extent feasible—patch vulnerabilities.[102] While companies may "reasonably" decide to place limitations on the period for which security updates and software patches are provided, they must "weigh these decisions carefully."[103] To the extent that updates and patches are limited, companies must be forthright and clear in their representations.[104]

B. Data Minimization

The concept of data minimization helps to address the twin risks of data breach and use of data that exceeds the reasonable expectations of the consumer.[105] To address these risks, the report states that "companies should examine their data practices and business needs"[106] and develop policies that put "reasonable limits on the collection and retention of consumer data."[107] One function of the self-examination is to assess whether the objective could be achieved by a method that collects less information.[108] If not, a prominent disclosure may be necessary, together with "consumers' affirmative express consent."[109]

If companies must collect and maintain data for a business purpose, FTC staff recommends considering whether maintaining the data in a de-identified form is appropriate.[110] But the key to de-identification is ensuring that the data cannot be *re*-identified.[111] The report notes that the FTC has previously required companies to "(1) take reasonable steps to de-identify the data, including by keeping up with technological developments; (2) publicly commit not to re-identify the data; and (3) have enforceable contracts in place with any third parties with whom they share the data, requiring the third parties to commit not to re-identify the data."[112]

[100] *Id.* at 31.
[101] *Id.*
[102] *Id.*
[103] *Id.*
[104] *Id.*
[105] *Id.* at 34–35.
[106] *Id.* at 35–36.
[107] *Id.* at 36.
[108] *Id.*
[109] *Id.* at 36–37.
[110] *Id.* at 37.
[111] *Id.*
[112] *Id.* at 38 (citing Fed. Trade Comm'n, Protecting Consumer Privacy in an Era of Rapid Change: Recommendations for Businesses and Policymakers 21 (2012), *available at* https://www.ftc.gov/sites/default/files/documents/reports/federal-trade-commission-report-protecting-consumer-privacy-era-rapid-change-recommendations/120326privacyreport.pdf). "In addition, if a company enables the collection of consumers' data and de-identifies that data immediately and effectively, it need not offer choices to consumers about this collection." *Id.* at 43.

C. Notice and Choice

The report explains that not all of the current technologies and methods for providing notice and choice for data use will be applicable to the IoT, but the concepts themselves are important and that importance is heightened when sensitive data is collected.[113] While not all data collection will require that consumers be offered a choice,[114] this creates the vexing question of identifying criteria for when choice is necessary, as "there is no one-size-fits-all approach."[115] Companies may wish to consider a menu of options in combination: choice at the point of sale; tutorials; codes on the device; choices during set-up; management portals or dashboards; connectivity icons; "out of band" communications; general privacy menus; or a smart function, perhaps based on a device hub, that could "learn" the consumer's preferences.[116] Regardless of the particular approach, the privacy choices must "be clear and prominent, and not buried within lengthy documents."[117]

IV. Conclusion

Recipients of unwanted telephone calls, text, and faxes continue to bring actions under the TCPA. The results of recent efforts to certify class actions have been mixed, making such lawsuits a potent threat for companies making questionable use of automated communication methods. The FTC continues to take aggressive enforcement action against privacy violations, and its *Internet of Things* staff report indicates its intention to keep a close eye on privacy and security issues in the new world of interconnected devices.

[113] *Id.* at 40.

[114] *Id.*

[115] *Id.* at 41.

[116] *Id.* at 41–42.

[117] *Id.* at 43.

Developments in Social Media: First Amendment, Privacy, and Misappropriation

*By Brandon J. Huffman**

I. Introduction

During the past year, courts have continued catching up with a changing social media landscape, and decisions involving free speech, privacy, and misappropriation are becoming more common. The U.S. Supreme Court decided *Elonis v. United States*,[1] which many wrongly predicted would be an extremely important decision on First Amendment rights concerning threats made on Facebook. In *Garcia v. Google, Inc.*,[2] the U.S. Court of Appeals for the Ninth Circuit, sitting en banc, reversed a panel's confounding interpretation of copyright law, remedying the potential First Amendment issues created by the panel's earlier opinion. Facebook, Zynga, Snapchat, and LinkedIn each contended with privacy lawsuits, while the National Labor Relations Board provided additional guidance to employers regarding social media.[3] A Florida court concluded that there is no ownership interest in Facebook "likes."[4]

II. First Amendment

A. *Elonis v. United States*

The U.S. Supreme Court disappointed many First Amendment scholars in its most recent term by failing to address the free speech arguments raised in *Elonis v. United States*.

Section 875(c) of Title 18 of the U.S. Code criminalizes "any communication containing any threat . . . to injure the person of another" transmitted in interstate commerce.[5] After his wife left him, Anthony Elonis took to Facebook, where he made a series of posts including original rap lyrics that contained violent imagery regarding his wife, co-workers, a kindergarten class, and law

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[1] 135 S. Ct. 2001 (2015).

[2] 786 F.3d 733 (9th Cir. 2015) (en banc).

[3] *See infra* Parts II.E, III.

[4] Mattocks v. Black Entm't Television LLC, 43 F. Supp. 3d 1311 (S.D. Fla. 2014).

[5] 18 U.S.C. § 875(c) (2012).

enforcement.[6] He was later charged with five, and convicted of four, counts of violating section 875(c).[7]

The district court instructed the jury that a statement is a "true threat," and therefore not protected by the First Amendment, when it is intentionally made in circumstances in which "a reasonable person would foresee that the statement would be interpreted" as an expression of intent to harm an individual.[8] The government's closing argument emphasized that, under those instructions, the speaker's intent was irrelevant.[9] Elonis challenged the jury instructions, arguing that the jury should have been required to find that he *subjectively* intended his posts to be threats.[10] The U.S. Court of Appeals for the Third Circuit disagreed and affirmed the conviction based on the objective standard.[11]

The Supreme Court's analysis began by explaining that, although the statute does not specify the requisite mental state for a conviction under section 875(c), the omission does not mean there is no mental state requirement, invoking the "general rule" that some sort of guilty mind is "a necessary element in the indictment and proof of every crime."[12] Rejecting the positions advocated by both the defendant and the government, the Court held that the "mental state requirement . . . is satisfied if the defendant transmits a communication for the purpose of issuing a threat, or with knowledge that the communication will be viewed as a threat."[13] The Court, however, declined to address whether a mental state of recklessness would also suffice.[14]

The Court explained that the lower court decisions, and Elonis's conviction, were premised on how his posts would be understood by a reasonable person—equivalent to a negligence standard in tort law.[15] Because a negligence standard is inconsistent with the criminal law, and does not apply the level of intent required by the statute, the Court reversed the conviction and remanded the case.[16] Because the Court was able to dispose of the case through its statutory, mental-state analysis, it expressly declined to consider any First Amendment issues.[17]

This outcome fails to provide any new guidance on how the First Amendment bears upon the "true threats" doctrine,[18] but does portend that future convictions under section 875(c), albeit on a standard more stringent than what the government sought, are likely to come.

[6] *Elonis*, 135 S. Ct. at 2005–07.

[7] *Id.* at 2007.

[8] *Id.* (quoting the jury instruction).

[9] *Id.*

[10] *Id.*

[11] *Id.*

[12] *Id.* at 2009 (quoting United States v. Balint, 258 U.S. 250, 251 (1922)).

[13] *Id.* at 2012.

[14] *Id.*

[15] *Id.* at 2011.

[16] *Id.* at 2012–13.

[17] *Id.* at 2012.

[18] *See* Watts v. United States, 394 U.S. 705, 708 (1969) (per curiam) (distinguishing political hyperbole from a true threat).

B. *Garcia v. Google, Inc.*

In one of the most-anticipated decisions of the year, the Ninth Circuit, sitting en banc, reversed the panel decision in *Garcia v. Google, Inc.*[19] Plaintiff Garcia, an actress, appeared in a film, titled *Innocence of Muslims*, that she was told would be "an action-adventure thriller set in ancient Arabia," but that was, in fact, a virulently "anti-Islamic polemic."[20] Shortly after a video trailer for the film was posted to YouTube in June 2012, "an Egyptian cleric issued a fatwa against anyone associated with *Innocence of Muslims*, calling upon the 'Muslim Youth in America[ ] and Europe' to 'kill the director, the producer[,] and the actors and everyone who helped and promoted this film,'" and Garcia received multiple death threats.[21] Garcia asserted that she held a copyright interest in her five-second performance, and submitted to Google a series of takedown notices under the Digital Millennium Copyright Act.[22] When Google refused to remove the video from YouTube, Garcia brought a lawsuit against Google for copyright infringement.[23] The district court denied Garcia a preliminary injunction, but a divided panel of the Ninth Circuit reversed, requiring Google to take down the video within twenty-four hours.[24]

After a rehearing en banc, the Ninth Circuit determined, as the Copyright Office had in the interim, that Garcia's performance was not a copyrightable work.[25] The en banc court invoked circuit precedent evaluating copyright claims by persons who made some contribution to a motion picture, particularly *Aalmuhammed v. Lee*,[26] and observed: "Garcia's theory of copyright law would result in the legal morass we warned against in *Aalmuhammed*—splintering a movie into many different 'works,' even in the absence of an independent fixation. Simply put, as Google claimed, it 'make[s] Swiss cheese of copyrights.'"[27]

The en banc court also addressed the First Amendment implications of the case, writing:

> The takedown order . . . gave short shrift to the First Amendment values at stake. The mandatory injunction censored and suppressed a politically significant film—based upon a dubious and unprecedented theory of copyright. In so doing, the panel deprived the public of the ability to view firsthand, and judge for themselves, a film at the center of an international uproar.

[19] 786 F.3d 733 (9th Cir. 2015) (en banc).

[20] *Id.* at 737.

[21] *Id.* at 738 (alterations by the court).

[22] *Id.*; *see* 17 U.S.C. § 512(c) (2012). Google, Inc. owns YouTube LLC. *Garcia*, 786 F.3d at 737.

[23] *Garcia*, 786 F.3d at 738.

[24] *Id.* at 738–39. The panel decision is Garcia v. Google, Inc., 743 F.3d 1258 (9th Cir.), *amended & superseded by* 766 F.3d 929 (9th Cir. 2014), *rev'd en banc*, 786 F.3d 733 (9th Cir. 2015).

[25] *Garcia*, 786 F.3d at 740–41.

[26] 202 F.3d 1227 (9th Cir. 2000).

[27] *Garcia*, 786 F.3d at 742 (alteration by court).

> Although the intersection between copyright and the First Amendment is much-debated, the Supreme Court teaches that copyright is not "categorically immune from challenges under the First Amendment."[28]

The en banc court accordingly dissolved the panel's injunction.[29]

C. Other Circuit Court Decisions

Like the Supreme Court in *Elonis*, the U.S. Court of Appeals for the Fifth Circuit also tangled with threats posted to the Internet, though in the context of a challenge to a high school student's suspension, rather than a criminal prosecution. In *Bell v. Itawamba County School Board*, a public high school student was suspended after posting an original rap video to Facebook and YouTube that criticized, "with vulgar and violent lyrics," two male coaches at his school for harassing female students.[30] The student sued, alleging violation of his First Amendment free speech rights.[31] The district court granted summary judgment for the school board, holding that, under the test the Supreme Court established in *Tinker v. Des Moines Independent Community School District*,[32] the song's lyrics had caused disruption and therefore the First Amendment did not prevent the school from disciplining the student.[33] A panel of the Fifth Circuit reversed.[34]

The appellate court, assuming but not deciding that the *Tinker* test applied to off-campus activity, held that the evidence did not support a finding that the song "either substantially disrupted the school's work or discipline or that the school officials reasonably could have forecasted such a disruption."[35] The court also rejected the school board's argument that the video constituted a "true threat" outside the scope of the First Amendment.[36] Among other factors, the court noted that the song "was broadcast publicly over the Internet and not conveyed privately or directly to the coaches. Courts have recognized that statements communicated directly to the target are much more likely to constitute true threats than those, as here, communicated as part of a public protest."[37]

In February 2015, the Fifth Circuit granted rehearing en banc,[38] and on August 20, 2015, issued an opinion concluding that the *Tinker* test does, in fact apply to off-campus speech, that the recording was made with the intention that it would reach the school community, and that "regardless of whether Bell's statements in the rap recording qualify as "true threats" . . . they constitute threats, harassment, and intimidation as a layperson would understand the

[28] *Id.* at 747 (footnote omitted) (quoting Eldred v. Ashcroft, 537 U.S. 186, 221 (2003)).

[29] *Id.*

[30] 774 F.3d 280, 282 (5th Cir. 2014), *reh'g en banc granted*, 782 F.3d 712 (5th Cir. 2015).

[31] *Id.*

[32] 393 U.S. 503 (1969).

[33] *Bell*, 774 F.3d at 290.

[34] *Id.* at 291. Bell's mother was also a plaintiff in the trial court, but the Fifth Circuit affirmed the district court's grant of summary judgment to the school board on her claims. *See id.* at 289 & n.33.

[35] *Id.* at 304.

[36] *Id.*

[37] *Id.* at 302.

[38] Bell v. Itawamba Cty. Sch. Bd., 782 F.3d 712 (5th Cir. 2015).

terms."[39] Thus, the en banc court reversed the panel decision and affirmed the trial court's order.[40] In so doing, it concluded that the rap was in violation of the school's disciplinary policy, and that, based in part on the logic of *Elonis*, the court need not reach the question of whether it constituted a "true threat."[41]

In *Graziosi v. City of Greenville,* the Fifth Circuit considered an appeal from summary judgment for the defendants in a wrongful termination case.[42] The plaintiff, a police officer, was terminated following several posts to Facebook on both her personal page and the mayor's public page critical of the department and her superior officer.[43] The appellate court determined, contrary to the district court, that the plaintiff made the statements as a private citizen outside the scope of her employment.[44] However, the appellate court held that plaintiff's postings did not address a matter of public concern.[45] As part of its analysis, the court noted that the "form" of plaintiff's speech, namely "a public post on the mayor's Facebook page," weighs in favor of a finding that she spoke on a matter of public concern.[46] Nevertheless, consideration of the "content" and "context" of the speech led the court to conclude that, on balance, it did not address a matter of public concern and that plaintiff therefore was not entitled to First Amendment protection.[47] With respect to content, the court reasoned that the plaintiff's primary motivation was her personal dissatisfaction with the department, not corruption or other matters important to the public.[48] As for context, the timing of the posts likewise supported the conclusion that the matter was a private one.[49] Finally, the court explained that, even if the plaintiff had been speaking on a matter of public concern, she failed to persuade that those interests outweighed the department's substantial interest in maintaining discipline and order within the department.[50] Thus, the Fifth Circuit affirmed the district court decision.[51]

[39] Bell v. Itawamba Cty. Sch. Bd., No. 12-60264 (5th Cir. Aug. 20, 2015) (en banc).

[40] *Id.*

[41] *Id.*

[42] 775 F.3d 731, 733 (5th Cir. 2015).

[43] *Id.* at 733–34.

[44] *Id.* at 737.

[45] *Id.* at 737–38.

[46] *Id.* at 739.

[47] *Id.* at 739–40.

[48] *Id.* at 739.

[49] *Id.*

[50] *Id.* at 740–41. In performing this balancing analysis, the court relied on the premise that, "[b]ecause 'police departments function as paramilitary organizations charged with maintaining public safety and order, they are given *more* latitude in their decisions regarding discipline and personnel regulations than an ordinary government employer.'" *Id.* at 740 (quoting Nixon v. City of Houston, 511 F.3d 494, 498 (5th Cir. 2007)). It is unclear whether the court would have applied the same standard to a plaintiff who was not a police officer, but, because the court also found that the speech was not protected, the point is moot in this case.

[51] *Id.* at 741.

D. Cyberbullying

The past year also saw the rise of regulation promulgated in response to increased media coverage of cyberbullying over the past several years. There have also been challenges to such regulation.

For example, in *Beverly v. Watson*, two professors at Chicago State University filed suit against the university, challenging the school's computer usage and cyberbullying policies on First Amendment free speech grounds.[52] The plaintiffs were regular contributors to a blog that was critical of the university's administration, and defendants sent them a cease-and-desist letter demanding that they discontinue the blog.[53] In response to the university's motion to dismiss for lack of standing, the trial court held that plaintiffs had sufficiently alleged that the letter conveyed a threat to take action against them under the challenged policies, thereby meeting the "actual or imminent injury requirement" for standing.[54]

In another case, the New York Court of Appeals reversed the conviction of a sixteen-year-old high school student under a county cyberbullying law.[55] The student created a Facebook page on which he "anonymously posted photographs of high-school classmates and other adolescents, with detailed descriptions of their alleged sexual practices and predilections, sexual partners and other types of personal information," together with vulgar captions.[56] The court found that cyberbullying is not categorically immune from government regulation, but determined that it had to consider whether the law was unconstitutionally overbroad or vague.[57] The county admitted that the statute was overbroad, but contended that the severability clause in the law should save it from invalidation by the court.[58] The court expounded at length about the problem bullying presents, as well as the state's efforts to combat it, and lauded the county for its efforts.[59] In the end, however, the court determined that it could not, without exceeding the scope of its judicial role, "rewrite" the law in a way that would cure its First Amendment infirmities.[60] Accordingly, the court reversed the conviction.[61]

E. Workplace Use of Social Media

The National Labor Relations Board (NLRB or Board) continued its ongoing efforts to promulgate helpful guidelines for employers' handling of employee social media usage.

[52] No. 14 C 4970, 2015 WL 170409, at *1 (N.D. Ill. Jan. 13, 2015).

[53] *Id.* at *1, *3.

[54] *See id.* at *4.

[55] People v. Marquan M., 19 N.E.3d 480, 488 (N.Y. 2014).

[56] *Id.* at 484.

[57] *Id.* at 485.

[58] *Id.* at 486–87.

[59] *Id.* at 488.

[60] *Id.* at 487–88.

[61] *Id.* at 488.

In *Three D, LLC*,[62] a former employee of a sports bar and restaurant complained in disparaging terms on her Facebook page about the company's handling of her state income tax. One current employee "liked" her post, and another added a comment expressing agreement with the post.[63] Within two days, both of those employees were fired.[64] Having found that the fired employees were engaged in concerted activity that was protected under the National Labor Relations Act (NLRA or Act), the Board addressed the restaurant's position that the employees had lost the Act's protection by expressing support for the disparaging posting.[65] The Board wrote that the analytical framework set forth in *Atlantic Steel Co.*,[66] which was formulated in the context of verbal outbursts in a face-to-face workplace setting, is "not well suited" to address issues involving employees' off-duty, offsite use of social media.[67] The Board instead analyzed the employees' conduct under its "precedent relating to disloyal or defamatory statements."[68] Finding that, in context, the posting was not so disloyal as to warrant withdrawal of the Act's protection (and that the posting was not defamatory), the Board concluded that the activity was protected by the Act, and held that the company's discharge of the employees violated their protected rights.[69]

In *Weigand v. NLRB*, the U.S. Court of Appeals for the D.C. Circuit upheld an NLRB decision that a union was not responsible for threatening remarks posted by union members on a Facebook page that the union maintained for its members.[70] The Acting General Counsel

> advanced a theory that the Union had a "duty to disavow" any statements posted on the Facebook page that were "unlawful threats." In support of this theory, the Acting General Counsel relied on case law that holds a labor organization responsible for its members' picket-line misconduct when it does not correct or disavow the misconduct.[71]

The Board, however, found that the Facebook page had little in common with a picket line:

> A picket line proclaims to the public, in a highly visible way, that the striking union has a dispute with the employer, and thus seeks to enlist the public in its effort to place economic pressure on the employer. . . . In contrast, Respondent's Face-

[62] 361 N.L.R.B. No. 31, 2014 WL 4182705 (Aug. 22, 2014).

[63] *See id.* at *2.

[64] *Id.* at *3.

[65] *Id.* at *3–4.

[66] Atl. Steel Co., 245 N.L.R.B. 814 (1979). Under the *Atlantic Steel* framework, the Board determines whether an employee's verbal outburst causes him to lose the protection of the NLRA by balancing four factors: "(1) the place of the discussion; (2) the subject matter of the discussion; (3) the nature of the employee's outburst; and (4) whether the outburst was, in any way, provoked by the employer's unfair labor practices." *Three D*, 2014 WL 4182705, at *4.

[67] *Three D*, 2014 WL 4182705, at *4.

[68] *Id.* at *5.

[69] *Id.* at *7.

[70] 783 F.3d 889 (D.C. Cir. 2015).

[71] *Id.* at 893 (citations omitted).

> book page does not serve to communicate a message to the public. To the contrary, it is private. Moreover, it does not draw any line in the sand or on the sidewalk.
>
> Unlike a website in cyberspace, an actual picket line confronts employees reporting for work with a stark and unavoidable choice: To cross or not to cross. Should someone acting as a union's agent make a threat while on the picket line, the coercive effect is immediate and unattenuated because it falls on the ears of an employee who, at that very moment, must make a decision concerning the exercise of his Section 7 rights.
>
> Considering the marked differences, the Respondent's Facebook page certainly does not amount to an extension of Respondent's picket line . . . .[72]

The court emphasized that it was expressing no opinion on whether the same outcome would follow if the persons posting on Facebook were agents of the union, or if the postings were on an open Internet website, rather than on a forum that was accessible only by members of the union.[73]

III. Privacy

A. Facebook

In *Campbell v. Facebook Inc.*, Facebook users brought an action seeking to represent a nationwide class and alleging that Facebook violated the Wiretap Act,[74] California's Invasion of Privacy Act (CIPA), and California's Unfair Competition Law by scanning private direct messages sent between users on the site, identifying any links to web pages in the messages, and then using that information to increment a "like" counter on the corresponding web page and to deliver targeted advertising.[75] Facebook moved to dismiss for failure to state a claim.[76]

On the Wiretap Act claim, Facebook argued that it had not engaged in any "interception" of the messages.[77] Applying a decision of the Ninth Circuit that held that an "interception" occurs when the contents are "captured or *redirected* in any way,"[78] the district court held that Facebook's use of a "web crawler" to scan the URLs in the messages could constitute "redirection."[79] Facebook also

[72] *Id.* at 893–94 (quoting the ALJ's opinion, which, on those points, was adopted by the Board).

[73] *Id.* at 897.

[74] Congress enacted the Wiretap Act in 1968. *See* Wiretapping and Electronic Surveillance Act, Pub. L. No. 90-351, §§ 801–803, 82 Stat. 197, 211–25 (1968) (codified as amended at 18 U.S.C. §§ 2510–2520 (2012)). Congress repeatedly has amended the act, including in 1986. *See* Electronic Communications Privacy Act of 1986, Pub. L. No. 99-508, §§ 101–111, 100 Stat. 1848, 1848–59 (1986) (amending the Wiretap Act and other sections of the U.S.C.).

[75] Campbell v. Facebook Inc., No. C 13-5996 PJH, 2014 WL 7336475, at *1 (N.D. Cal. Dec. 23, 2014).

[76] *Id.*

[77] *Id.* at *3.

[78] *Id.* (quoting Noel v. Hall, 568 F.3d 743, 749 (9th Cir. 2009)); *see* 18 U.S.C. § 2511(1)(a) (2012) (providing remedies against one who "intentionally intercepts . . . any . . . electronic communication").

[79] *Campbell*, 2014 WL 7336475, at *3.

argued that there was no "interception" because it accessed the messages while in "storage," not during "transmission," but the court held that that determination too had to await development of the factual record.[80]

The court also found that the issue of whether Facebook's conduct fell into the "ordinary course of business" exception of the Wiretap Act could not be resolved on a motion to dismiss.[81] Discussing at length the broader and narrower interpretations of the scope of this exception, the court ultimately concluded that "Facebook has not offered a sufficient explanation of how the challenged practice falls within the ordinary course of its business."[82] The court also rejected Facebook's argument "that any activity that generates revenue for a company should be considered within the 'ordinary course of its business.'"[83]

Finally, the court rejected Facebook's argument that its users had consented to the scanning of their private messages when they agreed to Facebook's website terms of service (TOS).[84] Facebook pointed to language in the TOS that Facebook "may use the information [it] receive[s] about you . . . for . . . data analysis,"[85] but the court held "this disclosure is not specific enough to establish that users expressly consented to the scanning of the content of their messages—which are described as 'private messages'—for alleged use in targeted advertising."[86]

Plaintiffs also alleged two violations of CIPA.[87] The first claim, under a provision analogous to the Wiretap Act, withstood the motion to dismiss for the same reasons that the federal claim survived.[88] However, the court granted Facebook's motion to dismiss the second claim, predicated on a provision of CIPA that makes it unlawful to intercept a "confidential communication."[89] Relying on California precedent, the court held that "Internet-based communications," including chats, e-mail, and the "private messages" involved in the case, were not "confidential" under CIPA, because such communications can easily be shared by the recipients.[90]

The court also dismissed plaintiffs' Unfair Competition Law claim, on the ground that they could not satisfy the statute's "injury in fact" requirement because they "ha[d] not alleged that they . . . lost any money or property as a result of Facebook's conduct."[91]

In another case involving the Facebook ecosystem, *In re Zynga Privacy Litigation*,[92] users of the social network and gaming apps developed by Zynga brought

[80] *Id.*

[81] *Id.* at *4–8; *see* 18 U.S.C. § 2510(5) (2012) (defining "electronic, mechanical, or other device" as any device that can be used for interception, but excluding those devices "being used by a provider of wire or electronic communication service in the ordinary course of its business").

[82] *Campbell*, 2014 WL 7336475, at *6.

[83] *Id.* at *7 (quoting 18 U.S.C. § 2510(5)).

[84] *Id.* at *8–10.

[85] *Id.* at *9 (quoting the TOS).

[86] *Id.*

[87] *Id.* at *10–11.

[88] *Id.* at *10 (interpreting CAL. PENAL CODE § 631).

[89] *Id.* at *11 (interpreting CAL. PENAL CODE § 632).

[90] *Id.* (applying People v. Nakai, 107 Cal. Rptr. 3d 402 (Ct. App. 2010)).

[91] *Id.* at *11–12 (interpreting CAL. BUS. & PROF. CODE § 17200).

[92] 750 F.3d 1098 (9th Cir. 2014).

a class action claiming that Zynga and Facebook violated the Electronic Communications Privacy Act of 1986 (ECPA)[93] through automatic transmissions of user data from Zynga to Facebook. Zynga's apps used "referer headers"[94] that transmitted to Facebook two pieces of information in response to the user clicking on a Facebook web page: "the user's Facebook ID and the address of the Facebook webpage the user was viewing when the user clicked the link."[95] The information enabled third parties to target their advertising to Facebook's users.[96] The Ninth Circuit affirmed the district court's dismissal of the claims.[97] It explained that plaintiffs' claims could succeed only if the defendants had divulged the "contents of any communication," and held that the two pieces of information in question did not constitute "contents" but rather "record information."[98] The court drew a clear distinction between the two categories of communications, holding that "under the ECPA, the term 'contents' refers to the intended message conveyed by the communication and does not include record information regarding the characteristics of the message that is generated in the course of the communication."[99]

B. LinkedIn

In *Perkins v. LinkedIn Corp.*, plaintiffs filed a complaint alleging that LinkedIn violated several state and federal laws by "harvesting email addresses from the contact lists of email accounts associated with Plaintiffs' LinkedIn accounts and by sending repeated invitations to join LinkedIn to the harvested email addresses."[100] Upon receiving a member's authorization, LinkedIn would send an invitation email to the member's contacts who were not already LinkedIn members.[101] If a recipient did not respond within a week, LinkedIn sent a second e-mail with the same message, and after another week, LinkedIn sent a third such message.[102] LinkedIn moved to dismiss.[103]

[93] While Title I of the ECPA amended the Wiretap Act, Title II of the ECPA set forth the Stored Communications Act. Electronic Communications Privacy Act of 1986, Pub. L. No. 99-508, §§ 201–202, 100 Stat. 1848, 1860–68 (codified as amended at 18 U.S.C. §§ 2701–2710 ((2012)).

[94] A "referer header" is a component of the HTTP specification that allows a user's computer to transmit information to the server hosting a website. *Zynga*, 750 F.3d at 1102 & n.3.

[95] *Id.* at 1102–03.

[96] *See id.* at 1102.

[97] *Id.* at 1100.

[98] *Id.* at 1103–06 (interpreting 18 U.S.C. §2511(3)(a) (2012) (prohibiting any person from intentionally divulging the "contents of any communication" to anyone other than the intended addressee); 18 U.S.C. § 2702 (2012) (prohibiting a service provider from divulging "record or other information" pertaining to a customer *to any governmental entity*, while prohibiting any such provider from divulging the "contents of a communication" *to any person*), *amended by* Pub. L. No. 114-23, § 602(d), 129 Stat. 268, 295 (2015)).

[99] *Id.* at 1106.

[100] 53 F. Supp. 3d 1190, 1195 (N.D. Cal. 2014).

[101] *Id.* at 1198–99.

[102] *Id.* at 1199–200.

[103] *Id.* at 1195.

The district court denied the motion in part, and granted it in part.[104] The court noted at the outset of its analysis that plaintiffs challenged two steps in LinkedIn's processes: (1) the collection of e-mail addresses from users' contacts, and (2) the use of those e-mails in sending out endorsements with the users' names included.[105] The court concluded, based on screenshots of the LinkedIn signup process, that users consented to both the collection and the use of the data.[106] Thus, the court granted the motion to dismiss the claims brought under the ECPA.[107]

The court next addressed the common law right of publicity claim, which could succeed only if plaintiffs demonstrated their "lack of consent" to the e-mails.[108] The court found that plaintiffs had consented to the sending of an initial invitation e-mail to each of their contacts, including the implied endorsement of LinkedIn.[109] However, the court held "that Plaintiffs have plausibly alleged that they did not consent to the second and third reminder endorsement emails."[110] The court further found that plaintiffs had sufficiently pled that the sending of the reminder e-mails caused them injury, another element of the claim.[111] As the court explained, the sending of these messages "could injure users' reputations by allowing contacts to think that the users are the types of people who spam their contacts or are unable to take the hint that their contacts do not want to join their LinkedIn network."[112]

In a subsequent opinion in the same case, the district court denied LinkedIn's First Amendment defense, finding that the reminder messages constituted commercial speech.[113]

C. Snapchat

In December 2014, the Federal Trade Commission (FTC) gave final approval to a settlement of its charges against Snapchat.[114] The FTC had alleged, *inter alia,* that Snapchat made false promises about the disappearing nature of the images sent through the service, falsely stated that it did not collect users' location information, and misrepresented the security measures it took to protect users' data from disclosure.[115] The failure to use reasonable security measures allegedly allowed hackers "to compile a database of 4.6 million Snapchat usernames

[104] *Id.*

[105] *Id.* at 1206.

[106] *Id.* at 1211–14.

[107] *Id.* at 1214.

[108] *Id.* at 1214–17.

[109] *Id.* at 1217.

[110] *Id.* at 1216.

[111] *Id.* at 1214, 1216.

[112] *Id.* at 1216.

[113] Perkins v. LinkedIn Corp., 53 F. Supp. 3d 1222, 1249–54 (N.D. Cal. 2014).

[114] *In re* Snapchat, Inc., No. C-4501 (F.T.C. Dec. 23, 2014) (decision and order) [hereinafter FTC Decision and Order], *available at* https://www.ftc.gov/system/files/documents/cases/141231snapchatdo.pdf.

[115] Complaint at 2–9, *In re* Snapchat, Inc., No. C-4501 (F.T.C. Dec. 23, 2014), *available at* https://www.ftc.gov/system/files/documents/cases/141231snapchatcmpt.pdf.

and the associated mobile phone numbers . . . [which] . . . could lead to costly spam, phishing, and other unsolicited communications."[116] The settlement prohibits Snapchat from misrepresenting the extent to which it protects the privacy, security, or confidentiality of users' information.[117] It also requires Snapchat to implement a comprehensive privacy program to be monitored by an independent privacy professional for twenty years.[118]

Likewise, Snapchat entered into a settlement with the Maryland Attorney General following claims that the company misled users about the ephemeral and private nature of their use of the app.[119] Snapchat's settlement with Maryland is similar to its settlement with the FTC, but the former requires Snapchat to make affirmative disclosures to its users that recipients of their messages may copy or capture those messages.[120] The settlement also requires Snapchat to get affirmative consent before collecting information from users' address books, and, for ten years, to take steps to ensure children under the age of thirteen are not using the app.[121] Finally, it requires Snapchat to make a $100,000 payment to the state.[122]

D. Legislation on Employer Access to Employee Social Media Accounts

In May 2015, Connecticut became the twenty-first state to enact a law banning (with some exceptions) employers from requiring their employees to provide them with the username or password necessary to access the employee's social media account.[123] The first such law was enacted by Maryland in 2012.[124] Some of these laws apply similar restrictions to schools and landlords.[125] Employers in a growing number of states should take heed of these restrictions when seeking methods to oversee the behavior of their employees.

[116] *Id.* at 8.

[117] FTC Decision and Order, *supra* note 114, at 2.

[118] *Id.* at 3–4.

[119] *See* Press Release, Office of the Md. Att'y Gen., Attorney General Gansler Secures Settlement from Snapchat, Inc. (June 12, 2014), http://www.oag.state.md.us/Press/2014/061214.html.

[120] Jeff Clabaugh, *Snapchat Pays Maryland $100K in Settlement*, Wash. Bus. J. (June 13, 2014), http://www.bizjournals.com/washington/news/2014/06/12/snapchat-pays-maryland-100k-in-settlement.html.

[121] *See* Press Release, Office of the Md. Att'y Gen., *supra* note 119.

[122] *Id.*

[123] Bruce H. Raymond, *Keeping Your Online Accounts Private—Can Employers Request Access to Your Facebook?*, Nat'l L. Rev. (June 22, 2015), 2015 WLNR 18347459. For the current status of such legislation, see *Access to Social Media Usernames and Passwords,* Nat'l Conf. St. Legislatures (July 9, 2015), http://www.ncsl.org/research/telecommunications-and-information-technology/employer-access-to-social-media-passwords-2013.aspx [hereinafter *Access to Social Media*].

[124] *See Access to Social Media*, *supra* note 123 (referencing Md. Code Ann., Lab. & Empl. § 3-712).

[125] *See id.*

IV. Misappropriation

In *Mattocks v. Black Entertainment Television LLC*, a novel case out of the Southern District of Florida, the court was asked to consider whether a user has an ownership interest in a Facebook "like."[126] Mattocks created a Facebook fan page about a television series on the CW Network.[127] Black Entertainment Television LLC (BET) later acquired rights to the series and hired Mattocks to manage the fan page.[128] During that time, the number of likes grew from two to six million.[129] After a dispute arose, Mattocks reduced BET's administrative rights on the page, preventing BET from posting on the page.[130] BET responded by asking Facebook to migrate the "likes" from the fan page to an official BET page, and Facebook did so.[131] BET also persuaded Twitter to disable the account that Mattocks had used to promote the series.[132]

Mattocks sued BET alleging, *inter alia,* that BET tortiously interfered with her contracts with Facebook and Twitter, and that it converted a business interest she had in the page.[133] The district court granted BET summary judgment on the claims.[134]

The court reasoned that the tortious interference claim must fail because BET was not "a stranger to the business relationship" between Mattocks and the social networks, given its control over Mattocks' use of the accounts.[135] BET's contacts with Facebook and Twitter were therefore justified and not tortious.[136] The conversion claim failed because Mattocks could not establish a property interest in the "likes."[137] The court explained:

> "[L]iking" a Facebook Page simply means that the user is expressing his or her enjoyment or approval of the content. At any time, moreover, the user is free to revoke the "like" by clicking an "unlike" button. So if anyone can be deemed to own the "likes" on a Page, it is the individual users responsible for them. . . . Given the tenuous relationship between "likes" on a Facebook Page and the creator of the Page, the "likes" cannot be converted in the same manner as goodwill or other intangible business interests.[138]

Mattocks' appeal to the Eleventh Circuit is currently pending.[139] Depending on the outcome of the appeal, going forward, Facebook and LinkedIn "likes," Twit-

[126] Mattocks v. Black Entm't Television LLC, 43 F. Supp. 3d 1311 (S.D. Fla. 2014).

[127] *Id.* at 1315.

[128] *Id.* at 1314–16.

[129] *Id.* at 1316.

[130] *Id.*

[131] *Id.* at 1316–17.

[132] *Id.* at 1317.

[133] *Id.*

[134] *Id.* at 1321.

[135] *Id.* at 1319 ("For interference with a contract to be *un*justified, the interfering defendant must be a third party, a stranger to the business relationship." (internal quotations omitted)).

[136] *Id.* at 1318–19.

[137] *Id.* at 1321.

[138] *Id.*

[139] Notice of Appeal, Mattocks v. Black Entm't Television LLC, No. 14-14238 (11th Cir. Sept. 19, 2014).

ter "favorites," and similar endorsements may be treated as transient, fleeting speech, rather than intangible property. By contrast, individual or business social media *accounts* have been treated as property.[140]

V. Revenge Pornography

In the past year, legislatures and courts around the country have responded to the increased incidence of "revenge porn."[141]

In what may be the first conviction of the operator of a revenge porn website, Kevin Bollaert, who operated a website that allowed postings of revenge porn images, and who charged the victims $250 to $350 to take down the images, was convicted by a California jury of extortion and identity theft.[142] He was sentenced to eighteen years in prison.[143] In a similar case, the FTC agreed to settle claims under the FTC Act against Craig Brittain for soliciting nude photographs which he posted on the website isanybodydown.com, and then charging the victims money to remove the photographs.[144]

In 2013, California enacted the first law specifically addressing revenge porn, and by one count, twenty-four additional states now have such a law.[145] As in the Bollaert prosecution, existing laws of more general applicability may also criminalize the conduct associated with revenge porn. For example, the Supreme Court of Maine upheld an order, issued pursuant to a "protection from abuse" law, prohibiting a defendant from carrying out a threat to post nude photographs of plaintiff on a website he created in her name.[146]

[140] *See, e.g.*, *In re* CTLI, LLC, 528 B.R. 359, 366–67 (Bankr. S.D. Tex. 2015) (holding that the social media accounts of a debtor limited liability company were the property of the bankruptcy estate).

[141] Revenge porn

> involves the distribution of nude or sexually explicit photographs or videos of an individual without that individual's consent. These sexually explicit images include photographs and videos taken by the victim, as well as images taken by the poster or another. Though hackers sometimes obtain and distribute the images, the photos often surface after a romantic relationship.

Amanda L. Cecil, Note, *Taking Back the Internet: Imposing Civil Liability on Interactive Computer Services in an Attempt to Provide an Adequate Remedy to Victims of Nonconsensual Pornography*, 71 Wash. & Lee L. Rev. 2513, 2520 (2014) (footnotes omitted).

[142] Press Release, Office of the Att'y Gen. of Cal., Attorney General Kamala D. Harris Announces 18 Year Prison Sentence for Cyber-Exploitation Website Operator (Apr. 3, 2015), https://www.oag.ca.gov/news/press-releases/attorney-general-kamala-d-harris-announces-18-year-prison-sentence-cyber; *see* Complaint, People v. Bollaert, No. SCD252338 (Cal. Super. Ct. Dec. 10, 2013), *available at* https://www.oag.ca.gov/system/files/attachments/press_releases/Complaint_3.pdf.

[143] Steve Almasy, *"Revenge Porn" Operator Gets 18 Years in Prison*, CNN (Apr. 4, 2015, 10:12 AM), http://www.cnn.com/2015/04/03/us/califomia-revenge-porn-sentence/.

[144] Agreement Containing Consent Order, *In re* Brittain, No. 132-3120 (F.T.C. Jan. 29, 2015), *available at* https://www.ftc.gov/system/files/documents/cases/150129craigbrittainagree.pdf; *see* Complaint, *In re* Brittain, No. 132-3120 (F.T.C. Jan. 29, 2015), *available at* https://www.ftc.gov/system/files/documents/cases/150129craigbrittaincmpt.pdf.

[145] *25 States Have Revenge Porn Laws*, End Revenge Porn, http://www.endrevengeporn.org/revenge-porn-laws/ (last visited Aug. 5, 2015) (referencing Cal. Penal Code § 647(j)(4)).

[146] Clark v. McLane, 86 A.3d 655 (Me. 2014) (interpreting "abuse" under Me. Rev. Stat. Ann. tit. 19-A, § 4002).

As restrictions of speech, such laws are subject to challenge on First Amendment grounds. The U.S. Court of Appeals for the First Circuit upheld a conviction under a federal law criminalizing cyberstalking, where the defendant posted sexually explicit videos of a victim on pornography websites without her permission, against a First Amendment challenge.[147] The court decided that the statute was not unconstitutionally overbroad, and that defendant had waived any argument that it was impermissibly vague.[148]

VI. Conclusion

Social media continues to develop and businesses continue to innovate new ways to communicate. Legislatures and courts will need to address the issues these new technologies present. As evidenced by the developments discussed in this survey, lawmakers may struggle to catch up to the pace of innovation. Practitioners should work to stay abreast of changes in the law, but should also consider the potential legal consequences of new technologies as they emerge in the marketplace.

[147] United States v. Sayer, 748 F.3d 425, 427–28 (1st Cir. 2014) (interpreting 18 U.S.C. § 2261A(2)(A)).

[148] *Id.* at 435–36. The Ninth Circuit upheld the same statute against both overbreadth and vagueness challenges. United States v. Osinger, 753 F.3d 939, 940–41 (9th Cir. 2014).

Developments in Employment Law and Social Media

*By Charles J. Stiegler**

This survey addresses recent employment law developments as they pertain to social media, both within and outside the workplace. Part I addresses a recent wave of legislation that places strict limits on how and why employers may access their employees' personal social media accounts. Part II addresses cases in which the National Labor Relations Board (NLRB or Board) has granted increasing protection to employees who use their social media accounts to engage in protected concerted activity—and the limits to that protection. Part III briefly discusses how some employers are using social media evidence in defending against employee lawsuits, and Part IV concludes.

I. Social Media Privacy Protection

May employers require an employee (or applicant) to divulge social media passwords or other information as a condition of employment? In much of the country, they apparently can. However, while there is no federal law directly addressing the issue,[1] an increasing number of states have passed laws forbidding employers from requiring—and, in some cases, from even requesting—information related to employees' personal social media and other online accounts.

Twenty-one states have passed some version of a law intended to protect employees from employer intrusion into personal online accounts, beginning with Maryland in 2012.[2] Most of these laws are loosely based on the Maryland provision, which forbids any employer from requiring or requesting that an employee or job applicant disclose his or her username, password, or other means for

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[1] To the author's knowledge, there is no NLRB decision addressing whether demanding the passwords to an employee's personal social media account would qualify as an unfair labor practice. *See infra* Part II.

[2] *State Laws About Social Media Privacy*, Nat'l Conf. St. Legislatures (June 12, 2015), http://www.ncsl.org/research/telecommunications-and-information-technology/state-laws-prohibiting-access-to-social-media-usernames-and-passwords.aspx (listing states that impose limitations on employers: Arkansas, California, Colorado, Connecticut, Illinois, Louisiana, Maryland, Michigan, Montana, Nevada, New Hampshire, New Jersey, New Mexico, Oklahoma, Oregon, Rhode Island, Tennessee, Utah, Virginia, Washington, and Wisconsin); *see id.* (listing 2012 legislation, with Maryland first to enact such a statute). Delaware passed a similar law applicable to students, but not to employees. *See id.* (citing Del. Code Ann. tit. 14, § 8103).

accessing a "personal account or service" through an "electronic communications device."[3] However, the Maryland law does contain two exceptions: the first allows an employer, upon learning that an employee has used his personal account for "business purposes," to conduct an investigation "for the purpose of ensuring compliance with applicable securities or financial law, or regulatory requirements"; the second allows an employer to conduct an investigation upon learning that the employee has downloaded the employer's "proprietary information or financial data" to a personal website or account without authorization.[4] Finally, an employer is forbidden from discharging an employee (or taking any other disciplinary steps) for refusing to disclose information related to his personal account and may not decline to hire an applicant on that basis.[5]

While most state laws follow the broad contours set forth in the Maryland statute, they diverge widely in the details. For example, a Virginia employer may not "require" its employees to disclose information about their personal accounts, but, unlike Maryland, there is no prohibition against merely "requesting" that information.[6] In Louisiana, an employer may request a username and password to access any device paid for, in whole or in part, by the employer.[7] In Arkansas, an employer may not request that its employees add an employer or supervisor to the "list or contacts associated with his or her social media account" (i.e., a friend request);[8] however, an employee loses the protection of the Arkansas statute if he or she "impersonates" the employer by using the employer's name, logo, or trademark on the social media site.[9] In short, the potential variations are limited only by the creativity of each state's legislature.

An exhaustive review of all twenty-one state laws is outside the scope of this survey, but these examples demonstrate the essence of those laws and provide a flavor of the idiosyncrasies that employers must contend with. Any employer considering reviewing or accessing an employee's or applicant's personal online or social media account—for any reason—would be well served to tread carefully and to carefully review the legislation (and pending legislation) of all states where it does business.

II. NLRB Review of Employers' Policies and Practices Relating to Employee Use of Social Media

While there has been no notable federal legislation or regulation involving employer/employee relations on social media, that is not to say that the federal government has been completely passive in this area. To the contrary, the NLRB increasingly has scrutinized employer policies and practices as they relate to employee social media accounts.

[3] Md. Code Ann., Lab. & Empl. § 3-712(b)(1) (LexisNexis Supp. 2014).

[4] *Id.* § 3-712(e)(1)–(2).

[5] *Id.* § 3-712(c)(1).

[6] Va. Code Ann. § 40.1-28.7:5 (Supp. 2015).

[7] La. Stat. Ann. § 51:1953(B)(1)(a) (2015).

[8] Ark. Code Ann. § 11-2-124(b)(1)(B) (Supp. 2013).

[9] *Id.* § 11-2-124(a)(3)(B)(iv).

The NLRB is responsible for enforcing the National Labor Relations Act (NLRA).[10] Section 7 of the NLRA grants certain workplace rights to employees, including the right to engage in "concerted activities for the purpose of . . . mutual aid or protection."[11] This includes the right to publicly discuss the terms and conditions of their employment.[12] Section 8 of the NLRA forbids employers from interfering with, restraining, or coercing employees in the exercise of their section 7 rights.[13]

NLRB decisions involving social media can be divided into two categories. The first category involves an employer who fires or disciplines an employee for comments made on social media (such as a critical tweet or Facebook post). The second category involves social media or blogging policies, such as those in employee handbooks, that seek to limit how employees discuss work online. The Board tends to view these policies skeptically if it believes that they may have a chilling effect on the employee's engagement in protected concerted activity. Notably, the NLRB has found these types of policies unlawful even where there is no evidence that the employer ever disciplined an employee for violating the policy. The mere *existence* of a policy has, in some cases, been found to have a chilling effect on potential protected activity.

Some cases address both types of issues. In *Three D, LLC*,[14] the respondent employer operated a sports bar called Triple Play located in Connecticut.[15] In January 2011, a former Triple Play employee named Jamie LaFrance complained in a post on Facebook that she would have to pay state income taxes for the year, rather than receive a refund. The post said that the respondent's co-owner "fucked up the paperwork."[16] Several current employees responded to the post, including Jillian Sanzone, who wrote, "I owe too. Such an asshole."[17] When Sanzone next reported to work, she was terminated for her Facebook comment.[18] Another current employee, Vincent Spinella, did not make any comments of his own but clicked "like" on LaFrance's original post.[19] He too was terminated.[20] The ALJ found that the Facebook comment thread qualified as "concerted" activity because four current employees commented on it, and that it qualified as "protected" activity because "the discussion concerned workplace complaints about tax liabilities."[21]

Triple Play did not challenge either of those findings, including the ALJ's finding that simply clicking "like," without posting anything further, was sufficiently

[10] *See* 29 U.S.C. §§ 156, 160 (2012) (referencing rule-making and enforcement authority).

[11] *Id.* § 157.

[12] *See* Medeco Sec. Locks, Inc. v. NLRB, 142 F.3d 733, 746 (4th Cir. 1998).

[13] 29 U.S.C. § 158(a)(1) (2012).

[14] Three D, LLC, 361 N.L.R.B. No. 31 (2014), 2014 WL 4182705.

[15] *Id.* at *10.

[16] *Id.* at *2.

[17] *Id.* at *3.

[18] *Id.*

[19] *See id.*

[20] *Id.*

[21] *Id.*

meaningful to qualify as protected activity under the NLRA.[22] Instead, it urged that Sanzone and Spinella had adopted LaFrance's "allegedly defamatory and disparaging comments" and thus lost the protection of the NLRA.[23] In support of this contention, the respondent cited *Atlantic Steel*,[24] which held that an employee may lose the protection of the NLRA if, when engaging in what otherwise may qualify as concerted protected activity, he or she engages in "opprobrious conduct"—in that case, by bursting into obscenities on the production floor.[25] The NLRB found that the *Atlantic Steel* analysis was not well suited to the social media context, as it is generally applied to "face-to-face workplace confrontations with a manager or supervisor,"[26] not "off-duty, offsite use of social media to communicate with other employees or with third parties."[27]

The NLRB then analyzed whether Sanzone and Spinella had lost the protection of the NLRA by making defamatory or disloyal statements.[28] The Board found that the employees simply claimed that respondent had made a "tax-withholding error," and that neither employee "accused the Respondent of pocketing employees' money."[29] This, it found, "clearly disclosed the existence of an ongoing labor dispute concerning the Respondent's tax-withholding practices."[30] Notably, Sanzone later admitted that she had no reason to believe that Triple Play had made any errors in filing her tax withholding documents,[31] but the Board found this admission irrelevant because "the fact that a statement may ultimately prove inaccurate does not in itself remove the statement from the protections of the Act."[32] Similarly, the reference to one of Respondent's owners as an "asshole" was held to be a statement of negative personal opinion, not a defamatory statement.[33]

The Board then addressed Triple Play's Internet/Blogging Policy, which states:

> The Company supports the free exchange of information and supports camaraderie among its employees. However, when internet blogging, chat room discussions, e-mail, text messages, or other forms of communication extend to employees revealing

[22] *Id.* at *4. Interestingly, the Board sua sponte disagreed with the ALJ on this issue, at least to an extent. The ALJ interpreted Spinella's clicking on "like" as expressing approval of *all* prior posts in the thread at the time he clicked. *Id.* at *6 n.18. The Board disagreed and interpreted the "like" as referring only to the specific post that was actually "liked." *Id.* Arguably, this degree of hair-splitting was not strictly necessary to the decision in this case. However, it is not difficult to imagine a case in which that kind of distinction would matter. In this author's opinion, parsing the semantic nuances of a Facebook "like" seems roughly as reliable as casting entrails. Nonetheless, there is a surprisingly robust body of legal scholarship on this issue. *See, e.g.*, Ira P. Robbins, *What Is the Meaning of "Like"?: The First Amendment Implications of Social-Media Expression*, 7 Fed. Cts. L. Rev. 127 (2013).

[23] *Three D, LLC*, 2014 WL 4182705, at *4.

[24] Atlantic Steel Co., 245 N.L.R.B. No. 107 (1979), 1979 WL 10011.

[25] *Id.* at *1, *4.

[26] *Three D, LLC*, 2014 WL 4182705, at *5.

[27] *Id.* at *4.

[28] *See, e.g.*, NLRB v. Local Union No. 1229, IBEW, 346 U.S. 464, 471 (1953) (holding that "making a sharp, public, disparaging attack upon the quality of the company's product and its business policies" is not protected under the NLRA).

[29] *Three D, LLC*, 2014 WL 4182705, at *6.

[30] *Id.*

[31] *Id.* at *7 n.19.

[32] *Id.*

[33] *Id.* at *7.

> confidential and proprietary information about the Company, or engaging in inappropriate discussions about the company, management, and/or co-workers, the employee may be violating the law and is subject to disciplinary action, up to and including termination of employment. Please keep in mind that if you communicate regarding any aspect of the Company, you must include a disclaimer that the views you share are yours, and not necessarily the views of the Company. In the event state or federal law precludes this policy, then it is of no force or effect.[34]

The parties agreed that this policy did not explicitly restrict any protected activity; the NLRB nevertheless found that the general reference forbidding "inappropriate discussions" could potentially be interpreted as "proscribing any discussions about [the employees'] terms and conditions of employment deemed 'inappropriate' by the Respondent."[35] This interpretation, it held, was confirmed by the termination of Spinella and Sanzone.[36] Thus, the policy was found to be in violation of the NLRA.[37] Notably, the savings clause, which states that the policy was of "no force or effect" if it violated federal law, was not enough to rescue the policy.[38] One Board member dissented and would have found that the policy was not facially unlawful (while agreeing that the actual act of terminating the employees was an unlawful labor practice).[39] As of this writing, an appeal of this decision was pending before the Second Circuit.[40]

Similar facts were presented in *Design Technology Group, LLC*.[41] Three retail store employees were embroiled in an ongoing argument with their manager regarding what they believed were unsafe conditions arising from the store's hours of operations.[42] In short, the employees complained that they felt unsafe leaving late at night because the store closed one hour later than the surrounding

[34] *Id.* at *8.

[35] *Id.* at *9 (citing First Transit, Inc., 360 N.L.R.B. No. 72 (2014), 2014 WL 1321108; 2 Sisters Food Grp., Inc., 357 N.L.R.B. No. 168 (2011), 2011 WL 7052272). The inquiry employed by the Board sometimes is called the "Lutheran Heritage" test; Martin Luther Memorial Home, Inc. did business as Lutheran Heritage Village-Livonia, which is how some refer to the case that gave rise to the inquiry. *See* Martin Luther Mem'l Home, Inc., 343 N.L.R.B. 646 (2004), 2004 WL 2678632.

[36] *Three D, LLC*, 2014 WL 4182705, at *9.

[37] *See id.*

[38] *Id.* This holding is in line with several other NLRB decisions. *See* Echostar Techs., LLC, No. 27-CA-066726, 2012 WL 4321039 (NLRB Div. of Judges Sept. 20, 2012); Tower Indus. Inc., 349 N.L.R.B. No. 100 (2007), 2007 WL 1450348, at *1 n.1. *But see First Transit, Inc.*, 2014 WL 1321108, at *4 (agreeing that "an employer's express notice to employees advising them of their rights under the Act may, in certain circumstances, clarify the scope of an otherwise ambiguous and unlawful rule").

[39] *Three D, LLC*, 2014 WL 4182705, at *11 (Miscimarra, M., dissenting in part).

[40] Brief and Special Appendix for Petitioner-Cross-Respondent, Three D, LLC v. NLRB, No. 14-3284 (2d Cir. Jan. 15, 2015), 2015 WL 301737.

[41] Design Tech. Grp., LLC, 359 N.L.R.B. No. 96 (2013), 2013 WL 1753561, *reconsidered and re-adopted,* 361 N.L.R.B. No. 79 (2014), 2014 WL 5524147. The original order in *Design Technology* was vacated as a result of the U.S. Supreme Court's decision in *NLRB v. Noel Canning*, 134 S. Ct. 2550 (2014), which held that the appointments of three Board members were invalid on constitutional grounds, but only two of which participated in the original *Design Technology* order. *Design Tech. Grp., LLC*, 2014 WL 5524147, at *1. In October 2014, the Board, acting through three validly appointed members, issued a second opinion reaffirming its prior ruling and incorporating that ruling by reference. *Id.*

[42] *Design Tech. Grp., LLC*, 2013 WL 1753561, at *1.

businesses.[43] When the manager ignored their complaints, the employees brought them to the store owner.[44] When they again received no satisfaction, they aired their concerns on Facebook, where they publicly complained about the manager and the store's general treatment of employees.[45] During the conversation, one of the employees mentioned that "tomorrow I'm bringing a California Worker's Rights book to work. My mom works for a law firm that specializes in labor law and BOY will you be surprised by all the crap that's going on that's in violation 8) see you tomorrow! [sic]."[46] Another employee brought these posts to the owner's attention and, shortly thereafter, the two complaining employees were terminated.[47] A third employee was fired a month later and, in response to her unemployment claim, the respondent submitted copies of her Facebook posts as evidence of "defamation" against the company.[48]

The NLRB found sufficient evidence to uphold the ALJ's conclusion that the "Facebook postings were complaints among employees about the conduct of their supervisor as it related to their terms and conditions of employment and about management's refusal to address the employees' concerns."[49] The Board found that the initial in-person complaints constituted protected activity, and the Facebook posts were a "continuation" of those efforts and therefore protected.[50] It also held, in the alternative, that the Facebook posts alone would have qualified as protected activity, even in the absence of any in-person complaints.[51]

Respondents also argued that the employees had engaged in a knowing conspiracy to goad the company into firing them, citing a Facebook post stating that the company had "fallen into my crutches [sic]."[52] Both the ALJ and the NLRB rejected this defense as "nonsensical," but noted that, even if the employees had been engaging in a purposeful conspiracy, that would not have taken them outside the bounds of protected activity.[53] As of this writing, this case is pending on appeal before the D.C. Circuit.[54]

Not all NLRB social media decisions have favored employees. In *Richmond District Neighborhood Center*,[55] the Board held that the NLRA does not protect open calls for insubordination disseminated via Facebook. The respondent operated a

[43] *See id.* at *10.

[44] *See id.*

[45] *Id.* at *10–11.

[46] *Id.* at *11.

[47] *Id.*

[48] *Id.* at *14–15.

[49] *Id.* at *1.

[50] *Id.*

[51] *Id.*

[52] *Id.* at *1 & n.4. The substitution of "crutches" for "clutches" was apparently intentional: it references a 1967 episode of *The Monkees* television show titled Chow Mein. *See The Monkees: Chow Mein* (Raybert Prods. Mar. 13, 1967), http://www.imdb.com/title/tt0650679/quotes.

[53] *Design Tech. Grp., LLC*, 2013 WL 1753561, at *1.

[54] Petition for Review, Design Tech. Grp., LLC v. NLRB, No. 14-1232 (D.C. Cir. Nov. 5, 2014). An appeal previously pending before the Ninth Circuit ended when the parties jointly moved for remand in light of *NLRB v. Noel Canning*, 134 S. Ct. 2550 (2014). Design Tech. Grp., LLC v. NLRB, No. 13-71702 (9th Cir. July 23, 2014) (final order).

[55] Richmond Dist. Neighborhood Ctr., 361 N.L.R.B. No. 74 (2014), 2014 WL 5465462.

teen center in San Francisco that provided afterschool and summer activities to students.[56] Ian Callaghan and Kenya Moore were staff members at the center.[57] At the end of the 2011–2012 school year, both were given offer letters to return for the next school year; however, Moore was offered an "activity leader" position rather than a "program leader" position, which constituted a demotion.[58]

Like the disgruntled retail workers in *Design Technology*, Callaghan and Moore resorted to Facebook, where they (along with a student who joined the conversation) discussed their unhappiness with the center and their plans for the next year.[59] Those plans included: holding "crazy events" without permission; "teach[ing] the kids how to graffiti up the walls"; skipping work when they felt like it ("I AINT GOBE NEVER BE THERE"); doing unspecified "cool shit, and let them figure out the money"; and taking "field trips all the time to wherever the fuck we want!"[60] Screenshots of these conversations were forwarded to management, which rescinded the offers to Callaghan and Moore based on those posts.[61]

The NLRB, applying what it characterized as an objective standard of review,[62] held that the Facebook comments were not protected by the NLRA and upheld the ALJ's determination in favor of the respondent.[63] It noted that the "Facebook exchange contains numerous statements advocating insubordination" and "numerous detailed descriptions of specific insubordinate acts."[64] This conduct was "objectively so egregious" that, even in the absence of prior insubordinate actions by Callaghan or Moore, their comments were outside the scope of NLRA protection.[65]

While *Richmond District Neighborhood Center* shows that not *all* Facebook activity is protected under the NLRA, the NLRB distinguished that decision in *Pier Sixty, LLC*.[66] The respondent operated a catering service company in Manhattan that was facing a union organizing campaign.[67] The election was scheduled for October 27, 2011.[68] On October 25, Hernan Perez, a server, was working at a fundraising event when he heard a manager, Bob McSweeney, speak to other servers in a way he found disrespectful.[69]

During a rest break, Perez took out his smartphone and posted an extraordinarily obscene Facebook message calling McSweeney a "NASTY MOTHER FUCKER" who "don't know how to talk to people!!!!!!" and insulted McSweeney,

[56] *Id.* at *1.

[57] *Id.*

[58] *Id.*

[59] *Id.* at *1–2.

[60] *Id.*

[61] *Id.* at *2.

[62] The Board found that the ALJ erred in applying a *subjective* standard, but did not clearly articulate how the difference between an objective and subjective standard would have changed the analysis in this case. *Id.*

[63] *Id.*

[64] *Id.* at *3.

[65] *Id.*

[66] Pier Sixty, LLC, 362 N.L.R.B. No. 59 (2015), 2015 WL 1457688.

[67] *Id.* at *1.

[68] *Id.*

[69] *Id.* at *2.

McSweeney's mother, and McSweeney's entire family in vulgar terms.[70] The post ended with "Vote YES for the UNION!!!!!!!"[71]

The next day, a co-worker notified respondent's HR Director, Dawn Bergman, about Perez's Facebook comments.[72] On October 31 (shortly after the election), Bergman brought the comments to McSweeney's attention.[73] McSweeney confirmed that he had already seen the posts.[74] After an investigation, Perez was terminated the next week.[75]

The ALJ held that Perez's comments qualified as protected concerted activity and were not sufficiently egregious to exceed the bounds of the NLRA.[76] The Board agreed.[77] As in *Three D, LLC*,[78] the Board rejected the four-factor test set forth in *Atlantic Steel*, as inappropriate for the social media context.[79] Instead, it found that a "totality of the circumstances" test should apply.[80] Under this somewhat amorphous test, the NLRB reviewed nine factors addressed by the ALJ to determine whether Perez's conduct took him outside the protection of the NLRA and resolved all nine in favor of Perez.[81] Thus, there is some ambiguity in the NLRB's holding—it is unclear whether the test truly takes account of the "totality of the circumstances," which may change from case to case, or whether the nine-factor test discussed therein should be considered a generally applicable framework for social media cases.

There can be no question that Perez's comments were vulgar and obscene. However, the ALJ found that "vulgar language is rife in the Respondent's workplace, among managers and employees alike,"[82] and that other employees and managers had not been terminated for uttering on-the-job obscenities in the past.[83] The NLRB placed great weight on this factor, and it held that Perez's profanity was not "qualitatively different from profanity regularly tolerated by the

[70] *Id.*
[71] *Id.*
[72] *Id.*
[73] *Id.*
[74] *Id.*
[75] *Id.*
[76] *Id.*
[77] *Id.* at *3.
[78] *See supra* notes 14–40 and accompanying text.
[79] *Pier Sixty, LLC*, 2015 WL 1457688, at *3.
[80] *Id.*
[81] *Id.* at *3–4. The factors were:

> (1) whether the record contained any evidence of the Respondent's antiunion hostility; (2) whether the Respondent provoked Perez' conduct; (3) whether Perez' conduct was impulsive or deliberate; (4) the location of Perez' Facebook post; (5) the subject matter of the post; (6) the nature of the post; (7) whether the Respondent considered language similar to that used by Perez to be offensive; (8) whether the employer maintained a specific rule prohibiting the language at issue; and (9) whether the discipline imposed upon Perez was typical of that imposed for similar violations or disproportionate to his offense.

Id. at *3.

[82] *Id.* at *2.
[83] *Id.* at *4 n.12 (noting that five other employees had received written warnings for obscenity, but none had been terminated).

Respondent."[84] Nor did it give much weight to the obscene insults made against McSweeney's mother or family; those insults, it found, were simply intended to "intensify" Perez's criticism of McSweeney himself.[85]

Finally, although it is not strictly a social media decision, *Purple Communications, Inc.*[86] signaled a significant change in the law regarding an employee's right to use employer e-mail for union organizing campaigns. In *Register Guard*, the Board had held that "employees have no statutory right to use the [employer's] e-mail system for Section 7 purposes."[87] In *Purple Communications*, the Board reversed course and held that *Register Guard* was "clearly incorrect" and that the "consequences of that error [were] too serious to permit it to stand."[88]

The case arose out of a policy in Respondent's handbook forbidding use of company e-mail for the purposes of "[e]ngaging in activities on behalf of organizations or persons with no professional or business affiliation with the Company" or "[s]ending uninvited email of a personal nature."[89] A union that sought to represent the employees filed a challenge to this policy, claiming that it interfered with the employees' right to freely communicate about union elections.[90] (Notably, there was no evidence—or even any allegation—that the Respondent had actually enforced this policy against any employee in an unlawful manner.[91]) The ALJ dismissed the charge; however, the NLRB reversed.[92]

The Board found that *Register Guard* "undervalued employees' core section 7 right to communicate in the workplace about their terms and conditions of employment, while giving too much weight to employers' property rights."[93] The Board also placed great weight on the "importance of email as a means by which employees engage in protected communications," which had only increased in the years since *Register Guard* was decided.[94] It therefore overruled *Register Guard* and held that, in at least some circumstances, employees' section 7 rights extend to the use of company e-mail.[95]

However, that right is limited. It only applies to e-mail systems, as the Board expressly declined to extend its ruling to other "interactive electronic communications, like instant messaging or texting . . . [or] their employer's social media accounts."[96] The right only applies to employees, meaning that non-employees (such as unions) have no right under the NLRA to access or use an employer's

[84] *Id.* at *4.

[85] *Id.*

[86] Purple Commc'ns, Inc., 361 N.L.R.B. No. 126 (2014), 2014 WL 6989135.

[87] Guard Publ'g Co., 351 N.L.R.B. 1110, 1110 (2007). The Guard Publishing Co. did business as The Register-Guard, which is how the case is generally known.

[88] *Purple Commc'ns, Inc.*, 2014 WL 6989135, at *1.

[89] *Id.* at *3.

[90] *See id.*

[91] *Id.* at *16.

[92] *See id.* at *1–2.

[93] *Id.* at *5.

[94] *Id.*

[95] *Id.*

[96] *Id.* at *14 n.70. By the same token, the NLRB did not foreclose the possibility that the right might be extended in a future case. *See id.*

e-mail system.[97] It only applies where the employer has already granted e-mail access to the employees—presumably, an employer does not have to *create* a company e-mail account for an employee on demand, solely so that he may exercise section 7 rights.[98] Critically, it permits an employer to "establish[] uniform and consistently enforced restrictions, such as prohibiting large attachments or audio/video segments, if the employer can demonstrate that they would interfere with the email system's efficient functioning."[99] Finally, it recognizes that employers have the right to "monitor their computers and email systems for legitimate management reasons, such as ensuring productivity and preventing email use for purposes of harassment or other activities that could give rise to employer liability."[100] The Board also reaffirmed that the employer retains a corollary right to "use their email systems to convey their own viewpoints," or to disassociate themselves from any viewpoints expressed by their employees.[101]

There is lingering uncertainty about the impact of this decision. Employers are faced with unclear rules regarding what reasonable restrictions are permissible in the Board's eyes and how closely they may monitor employee e-mail usage. Moreover, the Board chose to apply this decision retroactively, finding that there would be no "manifest injustice" resulting from a retroactive application.[102] Thus, employers may find themselves facing charges arising out of past conduct for policies that they believed were lawful at the time, relying on *Register Guard*.

Finally, in March 2015, the NLRB's Office of General Counsel issued a report presenting recent case developments arising in the context of employee handbook rules.[103] The first section of the report compares and contrasts handbook rules that have been found lawful against seemingly similar rules that have been found unlawful.[104] While this section does not separately address social media, many of the categories of rules discussed—such as rules related to confidentiality, third-party communications, and use of an employer's trademarks—may be highly relevant to social media policies.[105]

The second section of the report discusses a settlement reached between the Office of General Counsel and Wendy's International, LLC, and does expressly address the company's social media policy.[106] This section is particularly instructive

[97] *Id.* at *14.

[98] *Id.*

[99] *Id.*

[100] *Id.* at *15 & n.73. However, an employer may not increase its monitoring during a union campaign or focus its monitoring on known union activists. *Id.* at *15.

[101] *Id.* at *15.

[102] *Id.* at *16.

[103] Memorandum GC 15-04 from Richard F. Griffin, Jr., Gen. Counsel, NLRB, to Regional Directors, Officers-in-Charge, and Resident Officers (Mar. 18, 2015), http://apps.nlrb.gov/link/document.aspx/09031d4581b37135 [hereinafter G.C. Memo]. The General Counsel is primarily responsible for enforcing the NLRA, but his memoranda are not binding on the Board or the Administrative Law Judges. *See* Kroger Co. of Michigan, No. 07-CA-098566, 2014 WL 1620730, at *12 (NLRB Div. of Judges Apr. 22, 2014).

[104] G.C. Memo, *supra* note 103, at 4–20.

[105] *Id.* at 4–6, 12–15.

[106] *Id.* at 20–30.

because the Office of General Counsel proceeds paragraph-by-paragraph through the handbook and provides a detailed look at how each individual policy is analyzed.[107] Wendy's policy, which required employees to "[r]efrain from commenting on the company's business, financial performance, strategies, clients, policies, employees or competitors in any social media,"[108] was found to be overbroad in several respects. Notably, the company's blanket prohibition on the use of "copyrighted or otherwise protected information or property" without consent was held to be overly restrictive, because it could conceivably be read to forbid employees from using Wendy's name or trademark for purposes of commentary or criticism.[109] The same was true of the rule forbidding employees from posting any photographs taken on company premises, or of company events.[110]

The company also forbade employees from posting anonymously, on the grounds that it may be traceable back to the employee or the company.[111] While this type of provision was not addressed in any of the cases discussed previously in the memorandum, the Office of General Counsel found that "[r]equiring employees to publicly self-identify in order to participate in protected activity imposes an unwarranted burden on Section 7 rights."[112] Even a provision stating that an employee could not make "false or misleading representations about your . . . work" was stricken, because only "*maliciously* false" statements lose NLRA protection.[113] Similarly, the rule stating that employees cannot "harass, threaten, libel, malign, defame, or disparage" co-workers, clients, or competitors was found overbroad because it could "go beyond unprotected defamation and encompass concerted communications protesting or criticizing Wendy's treatment of employees."[114] And a rule requiring employees to report any negative statements they found online was overly broad because it required employees to obtain permission from the company before responding to a co-worker's complaint about his or her working conditions.[115]

III. Social Media Accounts as Evidence

While much of this survey focuses on potential legal pitfalls which employers may face regarding employee use of social media, in at least some cases employers are using social media to their advantage in court by introducing employees' social media posts against them in lawsuits brought against the employer. Below are summaries of two decisions where a Facebook post was used as an admission against the plaintiff—in one case, to show that he was an independent contractor (not an employee as he claimed); and, in the other case,

[107] *See, e.g.*, *id.* at 20–23 (addressing social media).

[108] *Id.* at 20–21.

[109] *Id.* at 21.

[110] *Id.* at 21–22.

[111] *Id.* at 22.

[112] *Id.*

[113] *Id.* (emphasis added).

[114] *Id.* at 23.

[115] *Id.*

to show that her worker's compensation disability demand was not as cut and dried as she claimed.

In *Staton v. Josey Lumber Co.*,[116] the plaintiff was a welder who was injured while working on the defendant's worksite. He sought worker's compensation, but the ALJ denied it on the grounds that he was an independent contractor, not an employee.[117] The court of appeals affirmed, noting (among other factors) that plaintiff "identified himself as an independent welding business on social media."[118] Specifically: "On Staton's own Facebook page he stated, '[m]ost everyone knows I'm a welder. . . . I do shutdown work. That is when a company takes off a week or so and contractors go in and fix whatever is broke.'"[119]

Employers have also used Facebook posts to show that an employee's claimed on-the-job injuries are not as severe as they appear—with varying degrees of success. For example, in *Young v. City of Gonzales*, the employer sought to "impeach[] Ms. Young's testimony [about her disability] with Facebook postings showing trips to the beach, where she went snorkeling, nights out in the French Quarter, and more."[120] While the court of appeals ultimately affirmed the underlying worker's compensation award, it reversed the penalties and attorney's fees and found that the employer's challenge to the benefits claim was reasonable in light of the facts.[121] In making this finding, the court specifically noted the "Facebook postings showing Ms. Young in active leisure activities," which "provided an additional factual basis considered by the City pertaining to her employability."[122]

IV. Conclusion

It is no secret that Facebook is a fertile ground for oversharing. One overarching theme of this survey is that users of social media do not always consider exactly how widely a post may spread—not only to its intended recipients, but to managers, employers, and even their attorneys.[123] Legislatures, agencies, and courts are all faced with new and challenging issues with little in the way of precedent to guide them, and the state of the law remains unsettled at best.

[116] Staton v. Josey Lumber Co., No. COA14-1001, 2015 WL 2061933 (N.C. Ct. App. May 5, 2015).

[117] *Id.* at *2.

[118] *Id.* at *1.

[119] *Id.* at *3 (alterations by the court).

[120] Young v. City of Gonzales, 166 So. 3d 1070, 1074 (La. Ct. App. 2015).

[121] *Id.* at 1078.

[122] *Id.* at 1078 n.4; *see also* Mason v. Willis-Knighton Med. Ctr., 149 So. 3d 1260, 1262 (La. Ct. App. 2014) (referencing Facebook photos of claimant wearing high heels and shopping in reversal of worker's compensation award).

[123] Attorneys should carefully check their state's ethical rules before accessing an opposing party's social media pages in a quest for evidence. *See, e.g.*, Robertelli v. N.J. Office of Att'y Ethics, No. C-275-12, 2014 WL 7735836, at *1 (N.J. Super. Ct. App. Div. Feb. 3, 2015) (per curiam) (dismissing, on jurisdictional grounds, an action for declaratory judgment that the Office of Attorney Ethics lacked authority to prosecute, and to enjoin the prosecution of, two attorneys for asking a paralegal to "friend" an opposing party on Facebook under false grounds in order to find impeaching testimony).

Copyright in Cyberspace: Sword and Shield in the Dissemination of Online Content

*By Jonathan Rubens**

I. Introduction

Last year's survey[1] considered two closely watched copyright infringement lawsuits that involved analyses of performance rights and online content distribution: the U.S. Supreme Court's opinion in *American Broadcasting Cos. v. Aereo, Inc.*,[2] in which the Court held that Aereo's video streaming service infringed copyright holders' public performance rights; and the Ninth Circuit panel opinion in *Garcia v. Google, Inc.*,[3] which seemed to strain the contours of copyright law to find that an actor's copyright interest in a very brief filmed performance supported an injunction against distribution of the film online. We also considered two decisions involving fair use defenses: *Oracle America, Inc. v. Google, Inc.*,[4] finding that Oracle's Java APIs are indeed copyrightable and remanding the case for reconsideration of Google's fair use defense; and *Authors Guild, Inc. v. Google, Inc.*,[5] finding that Google Books met all requirements for fair use under U.S. copyright law.

This year, we consider a new set of cases in which litigants invoke copyright, desperately or ingeniously, to thwart or protect the online dissemination of material. First, we revisit *Garcia v. Google, Inc.* to report on the subsequent en banc opinion from the Ninth Circuit, reversing the panel decision and dissolving the injunction ordering Google to remove content. We cannot yet report on the resolution of the fair use issue in *Oracle America, Inc. v. Google, Inc.*, but we consider several other cyberspace fair use cases involving the online distribution and sharing of copyrighted material. We also consider several cases involving the Digital Millennium Copyright Act (DMCA) safe harbors, addressing whether a defendant is truly a "service provider" and whether the defendant exerted sufficient "right and ability to control" the users of a service it provides.

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[1] Janice Rourke Hugener, *Copyrights in Cyberspace: A Year in Review*, 70 Bus. Law. 289 (2015).

[2] 134 S. Ct. 2498 (2014).

[3] 766 F.3d 929 (9th Cir. 2014).

[4] 750 F.3d 1339 (Fed. Cir. 2014).

[5] 954 F. Supp. 2d 282 (S.D.N.Y. 2013).

II. *Garcia v. Google, Inc.* Redux: The Ninth Circuit's En Banc Opinion

In February 2014, a panel of the Ninth Circuit reversed the lower court's refusal to grant an injunction in favor of actress Cindy Lee Garcia, finding her copyright interest in a short filmed performance supported an infringement claim.[6] Because it found there was sufficient risk of irreparable harm in the death threats Garcia received following the online distribution of the film *The Innocence of Muslims*, an anti-Islam screed, the court issued an injunction requiring YouTube to remove the film.[7]

This was too aggressive a use of copyright law for the full Ninth Circuit, many law professors, and other amici who submitted briefs in the appeal.[8] On rehearing en banc, the court found that Garcia did not have a copyright interest in the film, and thus, the district court did not abuse its discretion in denying Garcia's motion for preliminary injunction requiring Google to remove the film from YouTube.[9] The court noted that the copyright office routinely refuses to register copyrights in individual performances in films and explained that to recognize copyright interests in favor of individual actors would be "splintering a movie into many different 'works,' even in the absence of an independent fixation," which would produce a "logistical and financial nightmare."[10] The Ninth Circuit also credited the district court's determination that the plaintiff had granted an implied license in her performance to the director.[11] Additionally, the court found that because the plaintiff had not "fixed" her acting performance in a tangible medium—that had been done by the director and his crew, according to the court—she could not have a copyright interest.[12] Finally, the Ninth Circuit agreed with the lower court that the plaintiff's delay of several months in seeking the injunction undercut her claim of irreparable harm.[13]

The majority was sympathetic to the plaintiff's plight, but its opinion stresses that copyright law is not the avenue for protecting her performance. The Ninth Circuit therefore upheld the district court ruling denying the motion for preliminary injunction.

Judge Kozinski, who wrote the panel opinion, filed a dissent that disputes the majority's theory of copyrightability on multiple grounds. He argues that Garcia's performance was indeed copyrightable subject matter, it was fixed when the di-

[6] Garcia v. Google, Inc., 766 F.3d 929 (9th Cir. 2014).

[7] *Id.* at 940.

[8] Garcia v. Google, Inc., 786 F.3d 733 (9th Cir. 2015) (en banc). A long and diverse list of First Amendment advocates and scholars, digital media companies, intellectual property law professors, and traditional news publications participated in this litigation as *amici curiae*.

[9] *Id.* at 744.

[10] *Id.* at 742–43.

[11] *Id.* at 743.

[12] *Id.* at 743–44. Copyright protects "original works of authorship fixed in any tangible medium of expression," 17 U.S.C. § 102(a) (2012), including motion pictures, against unauthorized distribution, performance, display, reproduction, and the creation of derivative works. The fixation must be done "by or under the authority of the author" of the work. *Id.* § 101.

[13] *Garcia*, 786 F.3d at 746.

rector and crew recorded it on film, and because she did not sign a contract assigning rights to the director and was not an employee, she retained the rights to her performance.[14]

III. Fair Use in Cyberspace: More from the Digitization Front

As we reported last year in *Author's Guild, Inc. v. Google, Inc.*,[15] the U.S. District Court for the Southern District of New York brought to an end eight years of litigation by granting a defense motion for summary judgment on the ground of fair use in the Google Books copyright infringement battle. Since that decision, other efforts to challenge electronic distribution of texts have likewise succumbed to fair use defenses.

In *Authors Guild, Inc. v. HathiTrust*,[16] the Second Circuit considered a project related to Google's book scanning project, the HathiTrust digital library, and concluded it was protected from copyright infringement claims as fair use. HathiTrust, established by a group of research universities, created and operates the HathiTrust Digital Library, a repository of digital books created by Google's efforts to scan the books in the universities' collections.[17] Other institutions became members of HathiTrust and allowed books in their collections to be included in the HathiTrust Digital Library.[18]

The HathiTrust book repository has three intended uses. First, HathiTrust allows the general public to search across all digital copies in the repository. The search results show page numbers on which search terms are found and the number of times the searched term appears, but the results do not display text from the underlying copyrighted work.[19] Second, HathiTrust allows print-disabled persons to access versions of works within the repository in formats accessible to them, such as by accessing text-to-speech versions of text.[20] Third, HathiTrust stores digital copies of works in order to preserve them for future readers.[21] A consortium of authors' groups asserted that each of these three uses constituted copyright infringement and sought to enjoin operation of the repository.[22] The district court granted defense and intervenor motions for summary judgment on the grounds that the uses of the repository were fair uses.[23] Affirming the lower court, the Second Circuit agreed that the uses of the repository for full text search did indeed constitute fair use under the Copyright Act and that use of the repository for access for print-disabled patrons was also fair

[14] *Id.* at 749–50 (Kozinski, J., dissenting).
[15] 954 F. Supp. 2d 282 (S.D.N.Y. 2013).
[16] 755 F.3d 87 (2d Cir. 2014).
[17] *Id.* at 90.
[18] *Id.*
[19] *Id.* at 91.
[20] *Id.*
[21] *Id.* at 92.
[22] *Id.*
[23] *Id.* at 93.

use but found that there was not a sufficient determination whether plaintiffs had standing to challenge the use of the repository for preservation.[24]

Fair use turns on a four-factor test, which includes (1) consideration of the purpose of the use, including whether the use is for noncommercial purposes such as educational or nonprofit purposes, which often include a consideration of whether the work is "transformative," (2) the nature of the original work, (3) how much of the original work is incorporated into the allegedly infringing work, and (4) whether the allegedly infringing work harms the market for the original.[25] The court applied the four fair use factors to the three intended uses of the digital repository and, laying out its analysis one factor at a time, had no apparent difficulty finding fair use all around.

The court stressed that the repository's full text search functionality is "a quintessentially transformative use," being "different in purpose, character, expression, meaning, and message from the page (and the book) from which it is drawn," and that it does not "supersede the objects or purposes of the original."[26] And even though the project, by its very nature, incorporated the full text of the books that were scanned, the court found that this was not too much to constitute fair use because full-text search functionality would not be effective without full texts to search.[27]

With regard to the fourth factor—the effect of the use on the potential market for the original—the court found insufficient evidence of harm. The plaintiffs conceded that there was no present harm but argued that allowing full-text search might threaten future markets for licensing the text for search. The court rejected this argument because "the full-text search function does not serve as a substitute for the books that are being searched."[28] Plaintiffs also argued that the repository lacked sufficient cybersecurity controls, creating a risk that hackers could breach the repository's servers and widely disseminate the texts, thus eroding future markets for the underlying books. The court did not accept this argument, finding HathiTrust's somewhat perfunctory recitation of its security measures to be sufficient.[29]

The court next applied the four-factor analysis to the second use of the repository—allowing print-disabled users to access the texts. Interestingly, the court found that facilitating access to print-disabled users is not a transformative use. It explained that "a transformative use adds something new to the copyrighted work and does not merely supersede the purposes of the original creation," but making a work available to print-disabled users merely expands the work's potential audience.[30] The court still found this to be a fair use, citing

[24] *Id.* at 101–04.

[25] 17 U.S.C. § 107 (2012).

[26] *HathiTrust*, 755 F.3d at 97 (quoting Campbell v. Acuff-Rose Music, Inc., 510 U.S. 569, 579 (1994)).

[27] *Id.* at 98–99.

[28] *Id.* at 100.

[29] *Id.* at 100–01.

[30] *Id.* at 101.

an express allowance for making copies for the blind in the legislative history of the Copyright Act.[31]

Will other projects involving unauthorized electronic dissemination of text survive similar challenges? Fair use defenses may continue to sustain some but not all of these efforts, and the fair use analysis does not seem to get any easier. For example, electronic distribution of a substantial amount of text without paying royalties when reasonable royalty payment structures have been developed for such electronic distribution systems may not survive fair use analysis, even in a not-for-profit or educational setting. In *Cambridge University Press v. Patton*,[32] a group of publishers challenged Georgia State University's practice of uploading copyrighted materials to its electronic reserve (or ERes) system. This system, which is widely used by the students and faculty and similar to programs in place at other U.S. universities, has largely replaced the faculty's prior practice of using hard copy coursepacks that are prepared by a local copy shop and contain excerpts of scholarly articles, books, and other academic publications in support of a college course.[33] Georgia State professors can upload digital copies of books and articles, both the full text and excerpts, to the ERes system, and enrolled students can access the resulting digital coursepacks.[34]

The plaintiffs—academic publishers—challenged the use of the ERes system as copyright infringement, and the university asserted a fair use defense. The plaintiffs claimed that the university's practice exceeded the bounds of fair use, despite the fact that in 2009, the university adopted a detailed copyright policy that, similar to the policies adopted at other institutions, included a four-factor fair use checklist designed to help instructors determine whether proposed distribution of an excerpt or other published material would constitute fair use.[35]

The lower court decided that forty-three of forty-eight instances of prima facie copyright infringement constituted fair use.[36] On appeal, the Eleventh Circuit found that the district court erred in its case-by-case analysis of the fair use factors because it weighed each of the four factors equally in each incident of alleged fair use.[37] A court may not take an "arithmetic approach" in applying the four-factor analysis.[38] Instead, a court must undertake a case-specific analysis of the factors and weigh them as dictated by the context.[39]

The Eleventh Circuit then proceeded to a consideration of the district court's analysis of each fair use factor, observing "[a]lthough we have found that the District Court's method for weighing the four factors against one another was erroneous, this does not mean that the District Court's reasoning under each of the

[31] *Id.* at 102. The court found that plaintiffs lacked standing to pursue their claim that the third use of the repository, its preservation function, was infringing. *Id.* at 104.

[32] 769 F.3d 1232 (11th Cir. 2014).

[33] *Id.* at 1240.

[34] *Id.* at 1239.

[35] *Id.* at 1242–43.

[36] *Id.* at 1252.

[37] *Id.* at 1260.

[38] *Id.*

[39] *Id.*

four factors is also necessarily flawed."[40] The court went through a lengthy analysis of the first factor—the nature of the use—and found that although the use was not transformative, the educational context weighed in favor of fair use.[41] In considering the third factor—how much of the original is used—the Eleventh Circuit disapproved of the lower court's blanket approach, under which copying no more than 10 percent of a work supported a finding of fair use.[42] Instead, the district court should have "analyzed each instance of alleged copying individually, considering the quantity and quality of the material taken—including whether the material taken constituted the heart of the work—and whether the taking was excessive in light of the educational purpose of the use and the threat of market substitution."[43] Finally, the Eleventh Circuit approved the district court's analysis of the fourth factor—the effect of the use on the market for the work—but faulted the lower court for not according the factor sufficient weight.[44] The district court's analysis focused on the availability of a license to distribute a digital excerpt:

> [W]here there was a license for digital excerpts available, the District Court generally held that the fourth factor weighed against a finding of fair use. . . . Where there was no evidence in the record to show that a license for digital excerpts was available . . . the District Court held that the fourth factor weighted in favor of fair use.[45]

Nevertheless, the Eleventh Circuit found that "because Defendants' copying was nontransformative and the threat of market substitution was therefore serious, the District Court erred by not affording the fourth factor additional weight in its overall fair use calculus."[46]

The appellate court accordingly reversed the district court and remanded for further proceedings.[47]

IV. The DMCA Safe Harbors

It is more than fifteen years since the DMCA went into effect, providing safe harbor defenses against infringement for service providers that comply with the requirements of section 512.[48] Yet it can sometimes be hard to tell whether an enterprise is truly acting as a service provider and is entitled to safe harbor protection.

This was the case in *Gardner v. CafePress Inc.*[49] The defendant operates a website where consumers can upload graphic images and have them printed onto t-shirts or other items, subject to some degree of curation and potential (although

[40] *Id.*
[41] *Id.* at 1261–67.
[42] *Id.* at 1271.
[43] *Id.* at 1275.
[44] *Id.* at 1281.
[45] *Id.* at 1278–79.
[46] *Id.* at 1281.
[47] *Id.* at 1284.
[48] 17 U.S.C. § 512 (2012).
[49] No. 3:13-cv-1108-GPC-JMA, 2014 WL 794216 (S.D. Cal. Feb. 26, 2014).

minimal) modification by CafePress.[50] The plaintiff discovered his original photographs on items for sale on the CafePress website and sued for copyright infringement.[51] The court denied CafePress's motion for summary judgment, which claimed protection under the safe harbor defense of section 512(c).[52]

To avail itself of the section 512(c) defense, the defendant must be a "service provider," as defined in section 512(k), and must not interfere with "standard technical measures" under section 512(i).[53] Additionally, if the service provider has the right and ability to control the activity of its users, it must not receive a financial benefit directly attributable to infringement under section 512(c).[54]

The court found that the defendant had failed to demonstrate that it qualified under several of these requirements. First, CafePress had not established that it was a "service provider," because it sells products directly to consumers in an online marketplace, rather than allowing users to use its platform for their own transactions.[55] Second, the court found that there was a material dispute as to whether CafePress was interfering with "standard technical measures" used by copyright owners to identify their copyrights (such as by using watermarks on images to display copyright notices), inasmuch as CafePress deletes metadata regarding an image's copyright information when the image is uploaded to the CafePress system.[56] Third, there were issues of fact as to whether CafePress took actions in addition to those relating to the storage of users' images, such as deciding which user images to offer for sale in the marketplace and whether to make modifications to certain images; this point could take CafePress outside the protection of the safe harbor.[57] Finally, the court found there were issues of fact as to whether CafePress received a "direct financial benefit" from the infringement and whether, through its involvement in the sale, manufacture, and delivery of items bearing the plaintiff's images, CafePress had the "right and ability to control" a user's infringing activity.[58] The court accordingly denied the CafePress motion for summary judgment on the issue of the section 512(c) safe harbor defense.

Meanwhile, in another case involving users of online distribution services, the court addressed whether the materials were stored "at the direction of the user" and whether a service provider has a "right and ability to control" the infringing activities of its users. In *Mavrix Photographs LLC v. LiveJournal, Inc.*,[59] the plaintiff, which owned the copyrights to certain celebrity photos, sued LiveJournal for copyright infringement based on the fact that users posted its photos in one of

[50] *Id.* at *2–3.
[51] *Id.* at *3–4.
[52] *Id.* at *14.
[53] *Id.* at *8–9.
[54] 17 U.S.C. § 512(c)(1)(A), (i) & (k) (2012).
[55] *Gardner*, 2014 WL 794216, at *5.
[56] *Id.* at *5–6.
[57] *Id.* at *7.
[58] *Id.* at *8–9.
[59] No. SACV 13-00517-CJC (JPRx), 2014 WL 6450094 (C.D. Cal. Sept. 19, 2014).

the "communities" hosted by LiveJournal.[60] The court granted LiveJournal's motion for summary judgment on the basis of the section 512(c) safe harbor defense.[61] Mavrix argued that the fact that "all posts had to be approved by a moderator before becoming visible on the site" meant that the posts were not stored "at the direction of the user," as the safe harbor requires.[62] The court disagreed, citing the "broad" statutory language.[63] Mavrix also argued that LiveJournal received a "direct financial benefit" from the infringement and had "the right and ability to control" it, thus losing eligibility for the safe harbor.[64] The court, addressing the latter point, again disagreed, finding it "well settled that having the ability to remove or block access to material, locate infringing material, or terminate users' access does not constitute 'control' sufficient to remove a service provider's safe harbor protection."[65]

V. Direct and Vicarious Infringement: Another Setback for CafePress

An online service provider that is unsuccessful in invoking a section 512 safe harbor defense may also defend on the merits of the claim. The defendant in *Gardiner v. CafePress Inc.* made such an effort later in the year, but the court denied the defendant's motion for summary judgment as to both direct and vicarious infringement.[66]

The court explained that for direct infringement, there is a requirement that the defendant engaged in "volitional conduct."[67] CafePress argued that it engaged in no volitional conduct, likening itself to the operator of a DVR system, who had been found in previous cases not to have acted volitionally, because it was the DVR user who pushed the button to initiate copying.[68] The court disagreed: "While some of the CafePress process is similar to the DVR cases . . . a significant portion of the process is done by CafePress itself, namely the production and sale of the allegedly infringing items."[69]

As for vicarious liability, the court considered the two requirements of direct financial benefit and control. It found a factual dispute as to whether the infringing activity was a "draw" for customers, which would indicate that CafePress received a "direct financial benefit" from the infringing conduct.[70] The court also found a dispute over whether CafePress had "the right and ability to control" the

[60] *Id.* at *1–2.

[61] *Id.* at *2.

[62] *Id.* at *9.

[63] *Id.*

[64] *Id.* at *14–15.

[65] *Id.* at *14.

[66] No. 3:13-cv-1108-GPC-JLB, 2014 WL 6890934 (S.D. Cal. Dec. 4, 2014).

[67] *Id.* at *5–6.

[68] *Id.* at *3 (relying on Cartoon Network, LP v. CSC Holdings, Inc., 536 F.3d 121 (2d Cir. 2008); Fox Broad. Co. v. Dish Network L.L.C., 747 F.3d 1060 (9th Cir. 2014)).

[69] *Id.* at *8.

[70] *Id.* at *9.

infringement, rejecting CafePress's argument that it had no more control than online sellers such as Amazon.com or eBay.[71]

VI. Conclusion

Over the last year, we have seen novel copyright assertions and complications in copyright defenses when plaintiffs confront the ever-widening ease and proliferation of online content distribution. We saw plaintiffs assert copyright interests in a component of a larger copyrighted work in order to stop content distribution, fight expansion of fair use in order to slow the widening uncompensated electronic distribution of copyrighted materials in academia, and attack DMCA safe harbor defenses based on defendant involvement with user content. Novel assertions of copyright performance rights, such as in *Garcia*, may not show up again soon. However, we do expect to see continued complexities in the application of the fair use defense to many kinds of digital content redistribution, and we will be watching for further clarification from the courts on the limits of the DMCA safe harbor defenses and the elements of service provider liability for infringement when those defenses are unavailable.

[71] *Id.* at *10.

Cyberspace-Related Patents Since *Alice*

*By Lois D. Mermelstein**

I. Introduction

Although the U.S. Supreme Court's 2014 *Alice* decision[1] was initially seen as providing little guidance in determining subject matter eligibility for patents involving computer-implemented inventions,[2] the decision has begun to have a significant effect in the lower courts. In the year since that decision, the Federal Circuit and the district courts have invalidated numerous patents under the authority of *Alice* in various stages of litigation and have begun to flesh out the limits of what can be patented and what is impermissibly abstract.

As this survey reveals, many patents have been found to be drawn to abstract ideas, but that alone need not doom a patent. The more firmly rooted claims are in a specific technology and the more they incorporate meaningful technical limitations, the more likely these patents are to survive a section 101 challenge in the post-*Alice* environment.

II. *Alice v. CLS Bank*

Section 101 of the Patent Act defines the subject matter eligible for patent protection—"any new and useful process, machine, manufacture, or composition of matter, or any new and useful improvement thereof."[3] However, "[l]aws of nature, natural phenomena, and abstract ideas are not patentable"[4] because allowing patents covering these basic "'building blocks' of human ingenuity" would preempt their use in all fields.[5]

In *Alice*, the Supreme Court invalidated a patent involving a computerized scheme for mitigating the risk that a party to a financial exchange would fail

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[1] Alice Corp. Pty. Ltd. v. CLS Bank Int'l, 134 S. Ct. 2347 (2014).

[2] *See, e.g.*, Phong Nguyen, *Survey of Patent Law Developments Relevant to Cyberspace*, 70 Bus. Law. 271, 272 (2014).

[3] 35 U.S.C. § 101 (2012).

[4] *Alice*, 134 S. Ct. at 2354 (quoting Ass'n for Molecular Pathology v. Myriad Genetics, Inc., 133 S. Ct. 2107, 2116 (2013)).

[5] *Id.* (quoting Mayo Collaborative Servs. v. Prometheus Labs., Inc., 132 S. Ct. 1289, 1303 (2012) (alterations omitted)).

to satisfy its obligation to another party.[6] Following previous cases, the Court held that adding "apply it with a computer" to an abstract idea—such as intermediated settlement—did not make the idea eligible for a patent.[7]

The specific patent at issue in *Alice* has proven less important than the analytical framework the decision set forth to determine if other patents are drawn to patent-eligible subject matter. Step one, the Court said, is to "determine whether the claims at issue are directed to a patent-ineligible concept" such as an abstract idea.[8] If they are, step two calls for determining whether the claims, considered either separately or as an "ordered combination,"[9] contain an "'inventive concept' sufficient to 'transform' the claimed abstract idea into a patent-eligible application."[10]

In the year since *Alice* was decided, the lower courts have struggled to apply it, particularly when a computer is involved. As one court put it, "Supreme Court decisions on § 101 often confuse more than they clarify."[11] Nor has the Supreme Court defined when software is patentable.[12] Preemption of an entire abstract idea or field—the concern that "allowing a patent on the invention will impede innovation rather than incentivize it"—remains a major factor in the analysis.[13] Many patents, particularly involving computer and Internet implementations, have been invalidated, and the trend continues.

III. *Alice* Step One—Is This an Abstract Idea?

Step one, as noted, is to determine whether the claims are directed to an abstract idea. Unfortunately, "[w]hen it comes to explaining what is to be understood by 'abstract ideas' in terms that are something less than abstract, courts have been less successful."[14] Some courts have simply noted the parties' disagreement on whether the idea is abstract and moved on to step two. However, recent decisions provide some guidance.

Most patent claims involving financial operations implemented on a computer have been found to be abstract ideas. For example, *Alice* itself involved intermediated settlement, with a general-purpose computer as the intermediary.[15]

In one case, the Federal Circuit found "methods and machine-readable media encoded to perform steps for guaranteeing a party's performance of its online

[6] *Id.* at 2351–52.

[7] *Id.* at 2358.

[8] *Id.* at 2355.

[9] *Id.* at 2359 (quoting *Mayo*, 132 S. Ct. at 1298).

[10] *Id.* at 2357 (quoting *Mayo*, 132 S. Ct. at 1298–99).

[11] Cal. Inst. of Tech. v. Hughes Commc'ns, Inc., 59 F. Supp. 3d 974, 980 (C.D. Cal. 2014); *see also* MySpace, Inc. v. GraphOn Corp., 672 F.3d 1250, 1259 (Fed. Cir. 2012) ("Our opinions spend page after page revisiting our cases and those of the Supreme Court, and still we continue to disagree vigorously over what is or is not patentable subject matter.").

[12] *Cal. Inst. of Tech.*, 59 F. Supp. 3d at 983, 985.

[13] *Id.* at 990.

[14] *MySpace, Inc.*, 672 F.3d at 1259.

[15] *Alice*, 134 S. Ct. at 2352–53.

transaction"[16] to be about "creating a contractual relationship—a 'transaction performance guaranty'—that is beyond question of ancient lineage" and thus abstract.[17] Another Federal Circuit case involved patents that claimed "managing a bingo game while allowing a player to repeatedly play the same sets of numbers in multiple sessions."[18] These activities could involve as few as two sets of numbers, and they could be done by hand.[19] Thus they were "directed to the abstract idea of solving a tampering problem and also minimizing other security risks during bingo ticket purchases."[20] And the claims in a third case, "directed to the concept of offer-based price optimization," a way of adjusting prices for goods based on price offers received for those goods, was "similar to other 'fundamental economic concepts' found to be abstract ideas by the Supreme Court and this court."[21]

Computer-implemented ways of organizing information, or exchanging information for other information, have also been found to be abstract.

One such case, *Content Extraction,* involved methods for scanning hard copy documents, recognizing specific information from the scan, and storing that information—for example, automated teller machine software that recognizes information written on a scanned check, such as the check's amount, and populates appropriate data fields with that information.[22] The court found this method to be an abstract idea—that of "1) collecting data, 2) recognizing certain data within the collected data set, and 3) storing that recognized data in a memory."[23] "[H]umans have always performed these functions," the court reasoned, and the addition of both a computer and scanner did not change matters.[24]

Digitech involved a patent drawn to "the generation and use of an 'improved device profile' that describes spatial and color properties of a device within a digital image processing system."[25] This too was an abstract idea "because it describes a process of organizing information through mathematical correlations and is not tied to a specific structure or machine."[26]

Ultramercial involved a patent "directed to a method for distributing copyrighted media products over the Internet where the consumer receives a copyrighted media product at no cost in exchange for viewing an advertisement, and the advertiser pays for the copyrighted content."[27] The Federal Circuit previously found that this method was patentable subject matter, but the Supreme

[16] buySAFE, Inc. v. Google, Inc., 765 F.3d 1350, 1351 (Fed. Cir. 2014).

[17] *Id.* at 1355.

[18] Planet Bingo, LLC v. VKGS LLC, 576 F. App'x 1005, 1007 (Fed. Cir. 2014).

[19] *See id.* at 1008.

[20] *Id.* (alterations and internal quotation marks omitted).

[21] OIP Techs., Inc. v. Amazon.com, Inc., 788 F.3d 1359, 1362 (Fed. Cir. 2015) (citing Alice Corp. Pty. Ltd. v. CLS Bank Int'l, 134 S. Ct. 2347, 2357 (2014) ("fundamental economic practice")).

[22] Content Extraction & Transmission LLC v. Wells Fargo Bank, N.A., 776 F.3d 1343, 1345 (Fed. Cir. 2014).

[23] *Id.* at 1347.

[24] *Id.*

[25] Digitech Image Techs., LLC v. Elecs. for Imaging, Inc., 758 F.3d 1344, 1347 (Fed. Cir. 2014).

[26] *Id.* at 1350.

[27] Ultramercial, Inc. v. Hulu, LLC, 772 F.3d 709, 712 (Fed. Cir. 2014).

Court vacated the decision and remanded after *Alice* was decided.[28] Relying on the *Alice* decision, the Federal Circuit found that this "process of receiving copyrighted media, selecting an ad, offering the media in exchange for watching the selected ad, displaying the ad, allowing the consumer access to the media, and receiving payment from the sponsor of the ad all describe an abstract idea."[29] That abstract idea is "a method of using advertising as an exchange or currency."[30]

Internet Patents involved a patent that "enables use of standard browser Back and Forward button functions without loss of data and without losing the user's 'place' in the application process."[31] The court reasoned that, because "[t]he mechanism for maintaining the state is not described, although this is stated to be the essential innovation . . . the claim is directed to the idea itself—the abstract idea of avoiding loss of data."[32]

The district courts have followed suit. For example, generic computer implementations of "an auction,"[33] "receiving and tracking referrals from referral sources,"[34] "anonymous loan shopping,"[35] and "upselling"[36] have all been found to be abstract ideas. Another advertising patent was found to be drawn to the abstract idea of "targeting advertisements to certain consumers, and using a bidding system to determine when and how advertisements will be displayed."[37]

Many patents involving computerized records management have been invalidated as directed to abstract ideas. For example, a patent relating to "computer processing of certified payroll records . . . and other data relevant to public works construction contracts"[38] was "directed to the abstract idea of cataloging labor data."[39] In another case, one patent in a portfolio describing a service alert system was "directed to the abstract idea of monitoring deadlines and providing an alert when the deadline is approaching."[40] Two other patents in that same portfolio were "so broadly worded as to cover *any* attempt to automate the

[28] *Id.* at 713. The Supreme Court previously vacated and remanded the case following its *Mayo* decision. *Id.*

[29] *Id.* at 715.

[30] *Id.*

[31] Internet Patents Corp. v. Active Network, Inc., No. 2014-1048, 2015 WL 3852975, at *4 (Fed. Cir. June 23, 2015) (quoting the patent specification).

[32] *Id.* at *5.

[33] Advanced Auctions LLC v. eBay Inc., No. 13CV1612 BEN (JLB), 2015 U.S. Dist. LEXIS 39588, at *9 (S.D. Cal. Mar. 26, 2015).

[34] Essociate, Inc. v. Clickbooth.com, LLC, No. SACV 13-01886-JVS (DFMx), 2015 U.S. Dist. LEXIS 26757, at *16 (C.D. Cal. Feb. 11, 2015).

[35] Mortg. Grader, Inc. v. Costco Wholesale Corp., No. SACV 13-00043 AG (ANx), 2015 U.S. Dist. LEXIS 26769, at *13 (C.D. Cal. Jan. 12, 2015).

[36] Tuxis Techs., LLC v. Amazon.com, Inc., No. 13-1771-RGA, 2015 U.S. Dist. LEXIS 37128, at *7 (D. Del. Mar. 25, 2015).

[37] Morsa v. Facebook, Inc., No. SACV 14-161-JLS (JPRx), 2014 U.S. Dist. LEXIS 180968, at *16 (C.D. Cal. Dec. 23, 2014).

[38] Shortridge v. Found. Constr. Payroll Serv., LLC, No. 14-cv-04850-JCS, 2015 U.S. Dist. LEXIS 49126, at *1 (N.D. Cal. Apr. 14, 2015).

[39] *Id.* at *29.

[40] Hewlett Packard Co. v. ServiceNow, Inc., No. 14-cv-00570-BLF, 2015 U.S. Dist. LEXIS 29384, at *13 (N.D. Cal. Mar. 10, 2015).

resolution of IT incidents with a computer. But the automation of IT incident resolution is an abstract idea, not patentable under § 101."[41] Not patentable were claims drawn to the abstract idea of "[e]stablishing relationships between document objects and making those relationships accessible."[42] A patent in the area of "secure record access and management," even if limited to personal health records, was also abstract.[43]

Another patent involved methods and apparatus for communicating confidential information over insecure lines by using coded identifiers for the confidential information.[44] That too was "directed to the abstract idea of compiling, organizing, and transmitting information, using identification codes as shorthand for that information."[45]

And in another case, a "system for groups of people to collaborate and share information without specialized software or expertise [was found to be] . . . a 'method of organizing human activity,' and thus an unpatentable abstract idea."[46]

Some courts have proceeded to step two of the analysis without explicitly determining that the claims cleared the hurdle of step one. For example, in *DDR Holdings*, the Federal Circuit considered claims that sought to retain website visitors by combining the elements of two websites, so that when visitors clicked away from the original website they were presented with not simply the next website but a combination with the look of the first website and content from the second.[47] The court noted the defense's and dissent's "varying formulations of the underlying abstract idea" and moved on to step two, without deciding the step one issue.[48]

As this review of the cases indicates, there is a high likelihood that claims involving (1) financial operations implemented on a computer, or (2) computer-implemented ways of organizing or exchanging information, will be found abstract.

IV. *Alice* Step Two—Is There a Sufficiently Inventive Concept?

If, in step one, a court finds the patent claims are drawn to an abstract idea, then, in step two, the court determines whether the claims contain an "inventive concept sufficient to transform the claimed abstract idea into a patent-eligible application."[49]

[41] *Id.* at *27.

[42] Bascom Research, LLC v. LinkedIn, Inc., No. 12-cv-06293-SI, 2015 U.S. Dist. LEXIS 4606, at *25–26 (N.D. Cal. Jan. 2, 2015).

[43] MyMedicalRecords, Inc. v. Walgreen Co., No. 2:13-cv-00631-ODW (SHx), 2014 U.S. Dist. LEXIS 176891, at *11 (C.D. Cal. Dec. 23, 2014).

[44] OpenTV, Inc. v. Apple, Inc., No. 14-cv-01622 HSG, 2015 U.S. Dist. LEXIS 44856, at *3 (N.D. Cal. Apr. 6, 2015).

[45] *Id.* at *9.

[46] Open Text S.A. v. Box, Inc., No. 13-cv-04910-JD, 2015 U.S. Dist. LEXIS 6309, at *10 (N.D. Cal. Jan. 20, 2015) (quoting Alice Corp. Pty. Ltd. v. CLS Bank Int'l, 134 S. Ct. 2347, 2356 (2014)).

[47] DDR Holdings, LLC v. Hotels.com, L.P., 773 F.3d 1245, 1248–49 (Fed. Cir. 2014).

[48] *See id.* at 1257.

[49] *Alice*, 134 S. Ct. at 2357 (quotation marks omitted).

Where the patent claims have involved generic computer-implemented operations, particularly involving finance, recent Federal Circuit decisions have typically found the inventive concept to be lacking. For example, the patent in *buySAFE* involved "steps for guaranteeing a party's performance of its online transaction."[50] While the steps were implemented on a computer, the court found that this computer implementation was not sufficient. "The computer functionality is generic—indeed, quite limited: a computer receives a request for a guarantee and transmits an offer of guarantee in return. . . . That a computer receives and sends the information over a network—with no further specification—is not even arguably inventive."[51] Similarly, in *Planet Bingo*, where the claims recited "a program that is used for the generic functions of storing, retrieving, and verifying a chosen set of bingo numbers against a winning set of bingo numbers," the use of a computer was also purely conventional and lacked an inventive concept.[52] In *OIP Technologies*, the claims merely described "the automation of the fundamental economic concept of offer-based price optimization through the use of generic-computer functions."[53] Because "relying on a computer to perform routine tasks more quickly or more accurately is insufficient to render a claim patent eligible" and additional claim limitations involved merely routine data-gathering activities, the abstract idea lacked an inventive concept.[54]

In non-financial contexts, courts' findings have often turned on the specifics of the claim limitations. For example, consider the contrasts among three recent Federal Circuit cases: *Ultramercial*, *DDR Holdings*, and *Internet Patents*. All three involved websites. The patent in *Ultramercial* was "directed to a method for distributing copyrighted media products over the Internet where the consumer receives a copyrighted media product at no cost in exchange for viewing an advertisement, and the advertiser pays for the copyrighted content."[55] *DDR Holdings* involved patents "directed to systems and methods of generating a composite web page that combines certain visual elements of a 'host' website with content of a third-party merchant," so that when visitors clicked away from the original website they were presented with, not simply the next website, but a combination with the look of the first website and content from the second.[56] *Internet Patents* concerned a patent that "enables use of standard browser Back and Forward button functions without loss of data and without losing the user's 'place' in the application process."[57]

[50] buySAFE, Inc. v. Google, Inc., 765 F.3d 1350, 1351 (Fed. Cir. 2014).

[51] *Id.* at 1355.

[52] Planet Bingo, LLC v. VKGS LLC, 576 F. App'x 1005, 1009 (Fed. Cir. 2014).

[53] OIP Techs., Inc. v. Amazon.com, Inc., 788 F.3d 1359, 1363 (Fed. Cir. 2015).

[54] *Id.*

[55] Ultramercial, Inc. v. Hulu, LLC, 772 F.3d 709, 712 (Fed. Cir. 2014).

[56] DDR Holdings, LLC v. Hotels.com, L.P., 773 F.3d 1245, 1248 (Fed. Cir. 2014).

[57] Internet Patents Corp. v. Active Network, Inc., No. 2014-1048, 2015 WL 3852975, at *4 (Fed. Cir. June 23, 2015) (quoting the patent specification).

In *Ultramercial* and *Internet Patents*, Federal Circuit panels found the claims simply instructed the practitioner to implement the abstract idea, and included other routine steps, but did not include any meaningful technical limitations.[58] In *DDR Holdings*, though, the court drew a contrast with *Ultramercial*, explaining that "the claims at issue here specify *how* interactions with the Internet are manipulated to yield a desired result—a result that overrides the routine and conventional sequence of events ordinarily triggered by the click of a hyperlink."[59] These claims did not merely recite generic elements or preempt every application of the abstract idea.[60] Instead, "they recite a specific way to automate the creation of a composite web page by an 'outsource provider' that incorporates elements from multiple sources in order to solve a problem faced by websites on the Internet."[61]

In other words, the *DDR Holdings* claims did not merely instruct "do this abstract idea on a computer," but rather "do the following technical steps." As a result, "the claimed solution is necessarily rooted in computer technology in order to overcome a problem specifically arising in the realm of computer networks" and is patent-eligible.[62]

On the other hand, the Federal Circuit found that the patent in *Digitech* merely claimed an abstract idea. *Digitech* involved an image processing system, with patents drawn to an "improved device profile" describing a device's spatial and color properties.[63] The patent claiming the contents of the device profile was "directed to information in its non-tangible form" and thus not patent-eligible.[64] The method patents claimed generation of that data profile, but were not specific—instead calling for "generating first data for describing a device dependent transformation of color information content . . . through use of . . . functions . . . [and] generating second data for describing a device dependent transformation of spatial information content . . . through use of . . . functions."[65] Without additional technical limitations, these claims remained impermissibly abstract and not patent-eligible.[66]

At the district court level, several cases involving computerized solutions to computer problems have been found to have sufficient technical limitations to render the underlying abstract idea patent-eligible. For example, where claims specified how interactions with a network were manipulated to yield a desired result by reallocating bandwidth based on the contents of packet headers, the

[58] *See id.* at *5–6; *Ultramercial*, 772 F.3d at 715–17.

[59] *DDR Holdings*, 773 F.3d at 1258 (emphasis added).

[60] *Id.* at 1258–59.

[61] *Id.* at 1259.

[62] *Id.* at 1257. To date, *DDR Holdings* is the only post-*Alice* Federal Circuit decision to uphold a patent against a section 101 challenge.

[63] Digitech Image Techs., LLC v. Elecs. for Imaging, Inc., 758 F.3d 1344, 1347 (Fed. Cir. 2014).

[64] *Id.* at 1349.

[65] *Id.* at 1351 (quoting the patent claims).

[66] *Id.*

court found the "inventive concept lies in the limitation of using packet headers to allocate bandwidth" and the claims were directed to patent-eligible subject matter.[67] Another patent "directed to a problem unique to text-message telecommunication between a mobile device and a computer" was directed to the abstract idea of translation, but included claim limitations specifying how that translation between message formats was accomplished.[68] Those limitations were enough to prevent preemption of the abstract idea and thus patent-eligible.[69] And patent claims "providing a customized web page with content based on the user's profile and website navigation history" did not preempt all applications of providing customized web pages, but instead recited "a specific method of customizing web pages based on user data."[70] Those claims also covered patent-eligible subject matter.[71]

Thus, following *DDR Holdings*, patents that do not recite merely generic activity, but instead include meaningful technical limitations that, while "rooted in computer technology," solve "a problem specifically arising from computer networks"[72] are more likely to be held valid than those without this feature.

Patents covering specific methods of data manipulation have also been found to be patent-eligible—as long as the claims are specific enough. For example, claims aimed at error correction in data transmissions, though "directed to the abstract idea of encoding and decoding data for the purpose of achieving error correction," did contain elements that provide an inventive concept.[73] Claims that went beyond "manipulating, reorganizing, or collecting data by actually adding a new subset of numbers or characters to the data, thereby fundamentally altering the original confidential information . . . plausibly recite[d] a patent-eligible application of the abstract idea of verifying a transaction."[74] And claims involving the use of distinct memories, data types, and use rules designed to prevent easy and unauthorized reproduction and access, while allowing nearly instantaneous access and permanent storage, also addressed "the unique problem of controlling a user's access to data that the user already possesses by tracking use data and restricting access according to use rules."[75]

[67] Intellectual Ventures I, LLC v. Motorola Mobility LLC, No. 11-908-SLR, 2015 U.S. Dist. LEXIS 21718, at *29 (D. Del. Feb. 24, 2015).

[68] Messaging Gateway Sols., LLC v. Amdocs, Inc., No. 14-732-RGA, 2015 WL 1744343, at *4–5 (D. Del. Apr. 15, 2015).

[69] *Id.* at *5–6.

[70] Intellectual Ventures I LLC v. Mfrs. & Traders Trust Co., No. 13-1274-SLR, 2014 U.S. Dist. LEXIS 174725, at *24–25 (D. Del. Dec. 18, 2014).

[71] *Id.* at *25–26.

[72] DDR Holdings, LLC v. Hotels.com, L.P., 773 F.3d 1245, 1257 (Fed. Cir. 2014).

[73] Cal. Inst. of Tech. v. Hughes Commc'ns, Inc., 59 F. Supp. 3d 974, 993 (C.D. Cal. 2014).

[74] Card Verification Sols., LLC v. Citigroup Inc., No. 13 C 6339, 2014 U.S. Dist. LEXIS 137577, at *13–15 (N.D. Ill. Sept. 29, 2014).

[75] Smartflash LLC v. Apple, Inc., No. 6:13-CV-447-JRG-KNM, 2015 U.S. Dist. LEXIS 18419, at *44 (E.D. Tex. Jan. 21, 2015).

But most patents have not fared so well at the district court level, particularly those that "simply instruct the practitioner to implement the abstract idea with routine, conventional activity."[76]

For example, as in *Ultramercial*, the check scanning and processing methods at issue in *Content Extraction* did not "amount to 'significantly more' than the abstract idea of extracting and storing data from hard copy documents using generic scanning and processing technology."[77]

Claims covering the routine use of a relational database as it was designed to be used—unlike, for example, the specific rules in *Smartflash*[78]—were not patent-eligible.[79] Similarly, "there is no inventive concept in combining computer readable media with the idea of categorizing and organizing information hierarchically."[80] Nor were claims that "amount to instructions to apply an abstract idea—i.e., the concept of establishing relationships between documents and making those relationships accessible to other users" patent-eligible.[81] In another case, claims that limited such activity to the context of personal health records did not constitute sufficient improvement upon the abstract idea.[82]

Claims that "do nothing more than recite the abstract idea of monitoring deadlines and alerting users about upcoming deadlines, along with an instruction to implement the idea on various computing components" were equally invalid.[83] Claims "directed to the abstract idea of automated IT incident resolution . . . contain[ed] no additional 'inventive concept' to render the claim's subject matter patent-eligible."[84] And claims "drawn to the abstract ideas of (1) displaying advertisements to consumers based on their demographic information, and (2) permitting advertisers to bid on whether and how their advertisements will be displayed" fared no better.[85]

V. Conclusion

Since *Alice*, the Federal Circuit has decided eight section 101 cases, while the district courts have ruled on at least a hundred. Although many have been found

[76] Wireless Media Innovations, LLC v. Maher Terminals, LLC, No. 14-7004, 2015 U.S. Dist. LEXIS 51811, at *26 (D.N.J. Apr. 20, 2015).

[77] Content Extraction & Transmission LLC v. Wells Fargo Bank, N.A., 776 F.3d 1343, 1349 (Fed. Cir. 2014) (quoting Alice Corp. Pty. Ltd. v. CLS Bank Int'l, 134 S. Ct. 2347, 2355 (2014)).

[78] For a discussion of those rules, see *supra* text accompanying note 75.

[79] Shortridge v. Found. Constr. Payroll Serv., LLC, No. 14-cv-04850-JCS, 2015 U.S. Dist. LEXIS 49126, at *35 (N.D. Cal. Apr. 14, 2015).

[80] Hewlett Packard Co. v. ServiceNow, Inc., No. 14-cv-00570-BLF, 2015 U.S. Dist. LEXIS 29384, at *24 (N.D. Cal. Mar. 10, 2015).

[81] Bascom Research, LLC v. LinkedIn, Inc., No. 12-cv-06293-SI, 2015 U.S. Dist. LEXIS 4606, at *29 (N.D. Cal. Jan. 2, 2015).

[82] MyMedicalRecords, Inc. v. Walgreen Co., No. 2:13-cv-00631-ODW (SHx), 2014 U.S. Dist. LEXIS 176891, at *12–13 (C.D. Cal. Dec. 23, 2014).

[83] *Hewlett Packard Co.*, 2015 U.S. Dist. LEXIS 29384, at *17–18.

[84] *Id.* at *28–29 (quoting Alice Corp. Pty. Ltd. v. CLS Bank Int'l, 134 S. Ct. 2347, 2355 (2014)).

[85] Morsa v. Facebook, Inc., No. SACV 14-161-JLS (JPRx), 2014 U.S. Dist. LEXIS 180968, at *21 (C.D. Cal. Dec. 23, 2014).

to be drawn to abstract ideas, that conclusion alone need not doom a patent. Claims to an abstract idea that merely recite generic implementation steps are likely to be invalidated. But claims incorporating meaningful technical limitations or a sufficiently inventive concept are more likely to survive a section 101 challenge. How meaningful must these limitations be, or how much of an inventive concept is enough? By next year, the Federal Circuit will have had an opportunity to rule on many of the district court cases currently on appeal, and we should have a better idea of where the line is.

Recent Developments in Online Consumer Contracts

*By Robert V. Hale II**

I. Introduction

Sellers or service providers who offer their products or services online typically rely on website terms of use, or similar online documents, to establish and enforce a contract with their customers regarding each party's rights and obligations. The continued rapid growth and adaption of e-commerce, particularly via mobile devices,[1] will only serve to increase this reliance and the need to establish agreements that are consistently enforceable. In this regard, several recent cases have highlighted the importance of ensuring that website users receive adequate notice of, and demonstrate their assent to, website terms of use.

II. Clickwraps, Browsewraps, Sign-in-wraps, and More

A. *Nguyen v. Barnes & Noble, Inc.*

In *Nguyen v. Barnes & Noble, Inc.*,[2] Barnes & Noble appealed a district court's denial of its motion to compel arbitration relating to a class action filed by Nguyen alleging that Barnes & Noble had engaged in deceptive business practices and false advertising when it cancelled orders from a deeply discounted liquidation sale of its discontinued Touchpad device. Relying on the placement of a "Terms of Use" hyperlink on each page of the website, including the page where Nguyen submitted his order, Barnes & Noble argued that Nguyen had constructive notice of the arbitration agreement via the terms-of-use document and his subsequent use of the website.[3] Nguyen argued that he could not be bound by the arbitration provision because he neither had notice of, nor consented to, the website's terms of use.[4]

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[1] Goldman Sachs predicts that, in 2018, mobile commerce sales ($626 billion) will nearly equal current ecommerce sales ($638 billion). *See* Bill Siwicki, *Mobile Commerce Will Be Nearly Half of E-commerce by 2018*, Internet Retailer (Mar. 10, 2014, 2:32 PM), https://www.internetretailer.com/2014/03/10/mobile-commerce-will-be-nearly-half-e-commerce-2018.

[2] 763 F.3d 1171 (9th Cir. 2014).

[3] *Id.* at 1174–75.

[4] *Id.* at 1174.

Holding in favor of Nguyen, the U.S. Court of Appeals for the Ninth Circuit began by noting the distinction between "clickwrap" (or "clickthrough") agreements ("in which website users are required to click on an 'I agree' box after being presented with a list of terms and conditions of use")[5] and "browsewrap" agreements (in which a "party instead gives his assent simply by using the website").[6] The court discussed a number of cases in which courts enforced the latter where there was evidence that the user had actual notice of the browsewrap contract terms prior to use of the website, or where the user was required to "affirmatively acknowledge" such terms and was therefore deemed to have constructive notice.[7]

As an example of a case finding the user had constructive notice, the court pointed to *Fteja v. Facebook, Inc.*,[8] in which the U.S. District Court for the Southern District of New York upheld a forum selection clause in Facebook's terms of service. In that case, a notice below the "Sign Up" button stated, "By clicking Sign Up, you are indicating that you have read and agree to the Terms of Service," and the user clicked the button.[9] The Ninth Circuit explained that a user will be deemed to have constructive notice of the terms of a browsewrap agreement if "the website puts a reasonably prudent user on inquiry notice of the terms of the contract."[10] In making such a determination, courts look to the "conspicuousness and placement of the 'Terms of Use' hyperlink, other notices given to users of the terms of use, and the website's general design."[11] The court noted several cases in which the placement and design were inadequate, including *Specht v. Netscape Communications Corp.*, where Netscape failed to provide the requisite notice due to positioning the terms-of-use link so that it became visible only if the user scrolled down.[12] Regarding other notices given to users, the court cited several cases, including *Cairo, Inc. v. Crossmedia Services, Inc.*, where the requisite notice was found because every page on the website had a notice stating: "By continuing past this page and/or using this site, you agree to abide by the Terms of Use for this site, which prohibit commercial use of any information on this site."[13]

The court rejected Barnes & Noble's argument that placement of the "Terms of Use" hyperlink in the bottom left-hand corner of every page on the website, in combination with the link's close proximity to the buttons on the webpages that Nguyen used to make the contested purchase, was sufficient to provide

[5] *Id.* at 1175–76.

[6] *Id.* at 1176 (quoting Hines v. Overstock.com, Inc., 668 F. Supp. 2d 362, 366 (E.D.N.Y. 2009)).

[7] *Id.*

[8] 841 F. Supp. 2d 829 (S.D.N.Y. 2012).

[9] *Nguyen*, 763 F.3d at 1177 (quoting *Fteja*, 841 F. Supp. 2d at 835).

[10] *Id.*

[11] *Id.*

[12] *Id.* (discussing Specht v. Netscape Commc'ns Corp., 306 F.3d 17, 23 (2d Cir. 2002)).

[13] *Id.* (quoting Cairo, Inc. v. Crossmedia Servs., Inc., No. C 04-04825 JW, 2005 WL 756610, at *2 (N.D. Cal. Apr. 1, 2005) (quoting CMS's notice)).

constructive notice.[14] While acknowledging that the placement of the link here did a better job of conveying notice than that in *Specht*, the court nevertheless noted that "the proximity or conspicuousness of the hyperlink alone is not enough to give rise to constructive notice."[15] In so doing, the court distinguished *PDC Laboratories, Inc. v. Hach Co.*, where a federal district court in Illinois found the use of hyperlinks appearing on several screens during the order process sufficient when "reinforced" by language on the final checkout screen that read "STEP 4 of 4: Review terms, add any comments, and submit order," and "was followed by a hyperlink to the terms."[16]

It is notable that the only salient difference the court identified between the case before it and the *PDC Laboratories* case was that the latter added some bland language about reviewing the terms on the final checkout screen[17]—a difference that seems to add very little in terms of providing notice of the terms to the user.

B. *Knutson v. Sirius XM Radio Inc.*

In *Knutson v. Sirius XM Radio Inc.*,[18] plaintiff Knutson appealed a district court order dismissing his putative class action and granting defendant Sirius XM Radio's motion to compel arbitration over alleged violations of the federal Telephone Consumer Protection Act.[19] Knutson had purchased a Toyota truck, which came with a ninety-day trial subscription to Sirius XM Radio.[20] A month after it activated his trial subscription, Sirius XM sent Knutson, by postal mail, a Customer Agreement containing an arbitration clause.[21] "The Agreement state[d] that failure to cancel the subscription within three business days of activation legally binds the customer to the agreement."[22] Knutson did not read the Customer Agreement, and did not cancel his subscription.[23]

The Ninth Circuit found the agreement unenforceable due to lack of notice and acknowledgement of the contract terms by Knutson.[24] Looking to Knutson's conduct for evidence of notice and consent, and relying upon both *Nguyen* and *Specht*, the court noted that Knutson neither enrolled in the subscription, nor provided any information, nor paid Sirius XM at any point during the subscription term—he "respond[ed] to an offer that did not carry an immediately visible

[14] *Id.* at 1177–79.

[15] *Id.* at 1178.

[16] *Id.* (quoting PDC Labs., Inc. v. Hach Co., No. 09-1110, 2009 WL 2605270, at *3 (C.D. Ill. Aug. 25, 2009) (quoting Hach's Terms & Conditions of Sale)).

[17] *See id.* at 1178–79.

[18] 771 F.3d 559 (9th Cir. 2014).

[19] *Id.* at 561–64.

[20] *Id.* at 561–62.

[21] *See id.* at 562.

[22] *Id.*

[23] *Id.* at 563.

[24] *See id.* at 565–69.

notice of the existence of [contract] terms or require unambiguous manifestation of assent to those terms."[25]

In relying on those cases, the court evidently recognized that this offline contracting situation was analogous to a browsewrap—in both situations, if one party has not been given any reason to seek out the terms of a purported contract, then no contract is formed, even though the proponent of the terms states that failure to take some action will be deemed acceptance of the terms.

C. *Rodman v. Safeway Inc.*

Like the cases discussed above, *Rodman v. Safeway Inc.*[26] concerned the issue of adequate notice, specifically relating to unilateral modifications by Safeway of the terms of use for its safeway.com grocery delivery service. Rodman filed an action charging Safeway with breach of contract and violations of several state laws through charging higher prices on safeway.com than in its physical stores.[27] Thereafter, Safeway updated the online terms to make clear that the online store did not offer the same prices as its physical stores.[28]

Safeway argued that, as a result of Rodman's agreement to the online terms at the time he registered as a safeway.com user and through his subsequent use of the site, Safeway was not required to notify him of further changes to the terms, as specified in the safeway.com terms of use: "[Safeway] reserves the right to, from time to time, with or without notice to you, in [Safeway's] sole discretion, amend the Terms and Conditions . . . . [Safeway] has no responsibility to notify you of any changes before any such changes are effective."[29] The court rejected this argument, noting that "the imposition of such an onerous requirement on consumers would be particularly lopsided, as Safeway is aware that it has—or has not—made changes to the Terms and is the party to the contract that wishes for the new terms to govern."[30] The court also quoted *Nguyen*: "[T]he onus must be on website owners to put users on notice of the terms to which they wish to bind consumers."[31]

D. *Berkson v. Gogo LLC*

The most recent of the cases discussed herein, *Berkson v. Gogo LLC*,[32] was a class action alleging violations of various consumer protection statutes arising from unauthorized charges for use of in-flight wi-fi service provided by defendant Gogo. The U.S. District Court for the Eastern District of New York, through

[25] *Id.* at 569 (quoting Specht v. Netscape Commc'ns Corp., 306 F.3d 17, 31 (2d Cir. 2002)) (alterations by court).

[26] No. 11-CV-03003-JST, 2015 WL 604985 (N.D. Cal. Feb. 12, 2015).

[27] *Id.* at *1.

[28] *Id.* at *3.

[29] *Id.* at *2 (quoting Safeway's Special Terms of Use).

[30] *Id.* at *11.

[31] *Id.* (quoting Nguyen v. Barnes & Noble, Inc., 763 F.3d 1171, 1179 (9th Cir. 2014)).

[32] No. 14-CV-1199, 2015 WL 1600755 (E.D.N.Y. Apr. 9, 2015).

Judge Jack B. Weinstein, denied several defense motions, including one based on the argument that Berkson had agreed to automatic billing in the online terms when he registered for the service.[33]

The court's lengthy opinion included analysis of a commonly deployed type of online consumer contract, employed by Gogo, which the court dubbed "sign-in-wrap" agreements.[34] As used by Gogo, the "sign-in-wrap" consisted of a button labeled "Sign In," adjacent to a notice stating: "By clicking 'Sign in' I agree to the *terms of use* and *privacy policy*."[35] As defined by the court, "sign-in-wrap" differs from clickwrap, in that the latter requires the user to click on a button labeled "I Agree" or the like, while the former only states that, if the user proceeds to the next step of the online process, she will be deemed to accept the terms, which are available via a hyperlink.[36] "Sign-in-wrap" also differs from browsewrap, in that it directly confronts the user with a statement that proceeding will be deemed assent to terms, while the latter makes no effort to bring the terms to the user's attention.[37]

The court also distinguished another variation on the online contracting theme, which it named "scrollwrap." This it defined as a website so designed that "the user must scroll through the 'terms of use' *and* click 'accept' in order to complete an internet transaction."[38]

Relying on *Nguyen*, *Specht*, and other authorities, the court devised a four-part inquiry for determining whether to enforce "material" terms (such as venue, mandatory arbitration, and automatic payment renewal) that are presented via "sign-in-wraps, and electronic contracts of adhesion generally": (1) Whether there is substantial evidence that the user was aware she was binding herself to more than the proffered offer; (2) Whether the design and content of the website make the online terms "readily and obviously available" to the user; (3) Whether the "importance of the details of the contract [are] obscured or minimized by the physical manifestation of assent"; and (4) Whether the site clearly "draw[s] the consumer's attention to material terms that would alter what a reasonable consumer would understand to be her default rights."[39]

With respect to the first question, the court acknowledged the close resemblance of Gogo's sign-in-wrap to the online contract upheld in *Fteja v. Facebook, Inc.*,[40] but declined to adopt the analysis applied in that case, finding that *Fteja* and other similar cases "mischaracterize important Supreme Court and Court of Appeals precedent regarding contracts and the reasonable person standard that must be applied to inquiry notice of, and manifestation of assent to, the terms in

[33] *See id.* at *2–3.
[34] *Id.* at *29–32.
[35] *Id.* at *7 (quoting Gogo's Terms of Use).
[36] *Id.* at *25.
[37] *Id.*
[38] *Id.* at *17.
[39] *Id.* at *32–33.
[40] 841 F. Supp. 2d 829 (S.D.N.Y. 2012); *see supra* notes 8–11 and accompanying text.

a contract of adhesion."[41] The correct standard, the court explained, is that "[t]he offeror must show that a reasonable person in the position of the consumer would have known about what he was assenting to."[42] Gogo failed to make the required showing, as its evidence did not demonstrate "that Berkson knew he was binding himself to more than a one-time offer of service in exchange for money."[43]

Concerning the second question, the court focused on the prominence of the hyperlink to the "Terms of Use" in comparison with that of the "Sign In" button:

> The hyperlink to the "terms of use" was not in large font, all caps, or in bold. . . . By contrast, the "SIGN IN" button is very user-friendly and obvious, appearing in all caps, in a clearly delineated box in both the upper right hand and the lower left hand corners of the homepage.[44]

It accordingly found that the terms of use were not "readily and obviously available to Berkson."[45]

On the third point, the court found that "[t]he importance of the 'terms of use' was obscured by the physical manifestation of assent," because clicking the "Sign In" button did not cause the terms to appear on a new screen or in a "scrollwrap" presentation.[46]

Regarding the fourth question, the court found, based on the considerations already discussed, that Gogo did not clearly draw Berkson's attention to the automatic renewal feature of the terms.[47]

III. Conclusion

The cases discussed in this survey should prompt companies to review how they present online terms to consumers and capture a consumer's assent to such terms prior to completing a transaction, yet the guidance they offer is not wholly consistent. Under *Nguyen*, the presence of a "Terms of Use" hyperlink on each page of the website did not provide sufficient notice, but the court intimated that one more such hyperlink on the final checkout screen, accompanied by an admonition to "Review terms," would have changed the outcome.[48] However, *Berkson* sets the enforceability bar higher: it rejects the idea that a "sign-in-wrap" presentation is per se adequate, instead calling for consideration of mul-

[41] *Berkson*, 2015 WL 1600755, at *34.

[42] *Id.*

[43] *Id.*

[44] *Id.* at *35.

[45] *Id.*

[46] *Id.*

[47] *See id.*

[48] Professor Eric Goldman summarized the lesson of *Nguyen* as: "set up an airtight clickthrough agreement with a proper call-to-action proximate to the clickable button, and you'll substantially increase the odds that your contract enforceability won't depend on the capriciousness or sloppiness of Ninth Circuit judges." Eric Goldman, Comment to Venkat Balasubramani, *What's a Browsewrap? The Ninth Circuit Sure Doesn't Know*—Nguyen v. Barnes & Noble, Tech. & Mktg. Law Blog (Aug. 19, 2014), http://blog.ericgoldman.org/archives/2014/08/whats-a-browsewrap-the-ninth-circuit-sure-doesnt-know-nguyen-v-barnes-noble.htm.

tiple factors bearing on whether the user was likely to have been aware of the terms. The safest approach for an e-commerce site, according to *Berkson,* is to employ a "scrollwrap": requiring consumers to scroll through the terms and click "I Agree" at the end.[49] Whether that approach consistently withstands judicial scrutiny remains to be seen, but companies that take that approach should increase the odds that their terms of use will be enforceable.

[49] As one commentator observed:

> Certainly, not every court that has considered the issue has found a sign-in wrap to be unenforceable. Yet the importance of Weinstein's ruling cannot be overstated. Indeed, it may prompt companies to change the way they try to ensure that Internet users have a realistic opportunity to read the "terms of use" on their websites. More and more websites may be designed so that a user has to scroll through the "terms of use" and click "accept" in order to complete an Internet transaction—a "scrollwrap" form of agreement.

Shari Claire Lewis, *"Sign-in Wraps" Face the Judicial Microscope in New York*, N.Y. L.J. (Apr. 21, 2015), http://www.newyorklawjournal.com/id=1202723972057/Signin-Wraps-Face-the-Judicial-Microscope-in-New-York?slreturn=20150512153636 (footnotes omitted) (registration required).

Developments in the Law Affecting Electronic Payments and Financial Services

By Sarah Jane Hughes and Stephen T. Middlebrook***

I. Introduction

Electronic payments and financial services have continued to prompt significant regulatory and enforcement-agency attention since our 2014 contribution to the Survey of the Law of Cyberspace.[1] For this year's survey, we have chosen to focus on developments affecting providers of services related to bitcoin and other cryptocurrencies, prepaid cards including payroll cards, and other e-payments products, services, and providers in Parts II, III, and IV of this survey, respectively. Part V mentions other developments that readers will want to follow in the coming year.

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[1] Sarah Jane Hughes & Stephen T. Middlebrook, *Are These Game Changers? Developments in the Law Affecting Virtual Currencies, Prepaid Payroll Cards, Online Tribal Lending, and Payday Lenders*, 70 Bus. Law. 261 (2014) [hereinafter *2014 Survey*].

II. Developments Affecting Providers of Bitcoin and Other Cryptocurrencies

A. State Regulation and Licensing of Virtual Currency Service Providers

On June 3, 2015, New York State's Department of Financial Services (DFS) announced final regulations for the BitLicense,[2] including prudential regulation of "virtual currency,"[3] "virtual currency business activity,"[4] and certain consumer protections.[5] The BitLicense is the first virtual currency-specific state prudential regulation. In addition, other states, in particular North Carolina[6] and California,[7] signaled their intentions to regulate providers of virtual currencies.

In May 2015, the DFS also issued a trust company license for itBit to operate as the itBit Trust Company.[8] The charter allows the company to serve as a custodian for customers' assets, including bitcoin and U.S. dollars, but not to operate as a bank.[9] We believe that this is the first such license, not only in New York State but also in any jurisdiction in the United States.

B. Bitcoin Participants Prosecuted as Unlicensed Money Transmitters

The most notorious criminal action related to bitcoin that took place in the last year was the conviction of Ross Ulbricht, creator and operator of Silk Road, the infamous dark web marketplace for drugs and other illegal items, which exclusively used the virtual currency for payments.[10] Ulbricht was found guilty of nar-

[2] Regulation of the Conduct of Virtual Currency Businesses, 37 N.Y. Reg. 7 (June 24, 2015) (to be codified at N.Y. Comp. Codes R. & Regs. tit. 23, pt. 200), *available at* http://docs.dos.ny.gov/info/register/2015/june24/pdf/rulemaking.pdf. The regulations were proposed in July 2014. Regulation of the Conduct of Virtual Currency Businesses, 36 N.Y. Reg. 14 (proposed July 23, 2014), *available at* http://docs.dos.ny.gov/info/register/2014/july23/pdf/rulemaking.pdf.

[3] N.Y. Comp. Codes R. & Regs. tit. 23, § 200.2(p) (2015).

[4] *Id.* § 200.2(q).

[5] *Id.* §§ 200.7–200.19.

[6] H.R. 289, 2015–2016 Sess. (N.C. 2015) (defining "money transmission" to include "maintaining control of virtual currency on behalf of others" and allowing licensees to hold as "permissible investments" "[v]irtual currency owned by the licensee, but only to the extent of outstanding transmission obligations received by the licensee in like-kind virtual currency"), *available at* http://www.ncleg.net/Sessions/2015/Bills/House/PDF/H289v1.pdf. For analysis of this bill, see *North Carolina Bill Defines Bitcoin as "Permissible Investment,"* Coinfox.com (May 22, 2015), http://www.coinfox.info/news/2085-north-carolina-bill-defines-bitcoin-as-permissible-investment.

[7] A.B. 1326, 2015–2016 Reg. Sess. (Cal. 2015) (last amended June 1, 2015), *available at* https://leginfo.legislature.ca.gov/faces/billNavClient.xhtml?bill_id=201520160AB1326 (extending licensing requirements to persons or entities developing virtual currency network software or providing data storage or cybersecurity services for licensed businesses).

[8] *See Questions from the Community: itBit's Trust Charter*, itBit.com (May 18, 2015, 1:30 PM), www.itbit.com/blog/questions-from-the-community-itbits-trust-charter (providing a chart comparing the operational differences between the trust company charter, the BitLicense, and a traditional money transmitter license).

[9] *Id.*

[10] *See* Benjamin Weiser, *Ross Ulbricht, Creator of Silk Road Website, Is Sentenced to Life in Prison*, N.Y. Times (May 30, 2015), http://www.nytimes.com/2015/05/30/nyregion/ross-ulbricht-creator-of-

cotics trafficking, computer hacking, and money laundering and was given a life sentence.[11]

In a related matter, Robert M. Faiella and Charlie Shrem, both of whom provided bitcoin exchange services to Silk Road users, were prosecuted for operating an unlicensed money transmitter in violation of 18 U.S.C. § 1960.[12] The government alleged that Faiella, also known as "BTCKing," ran an underground bitcoin exchange that sold over $1 million worth of the virtual currency to Silk Road users to facilitate the purchase of illegal drugs.[13] Section 1960 makes it a federal crime to operate a money transmitter without the appropriate license.[14] Faiella moved to dismiss the counts related to section 1960 on the grounds that bitcoin does not qualify as "money" and that exchanging dollars for bitcoin does not constitute money transmission under the statute.[15] The court rejected his argument, focusing on the "ordinary meanings" of the words and electing not to view them as legal terms of art.[16] The court held that bitcoin functions as "money" or "funds" and noted that the Financial Crimes Enforcement Network had issued guidance stating that exchanging virtual currency for legal tender could constitute money transmission under its regulations.[17] Finally, the court rejected Faiella's argument that the application of § 1960 to a bitcoin exchange was a novel application of the statute that would violate the rule of lenity.[18]

In what appears to be a similar case, John D. Powell was indicted in Illinois for operating an unlicensed money transmitting business in violation of state law and § 1960.[19] He pleaded guilty and was sentenced to four years in prison.[20] Although the pleadings do not set forth the underlying facts, a press release

silk-road-website-is-sentenced-to-life-in-prison.html. For a description of how bitcoin was used on Silk Road, see United States v. Ulbricht, 31 F. Supp. 3d 540, 546–47 (S.D.N.Y. 2014).

[11] Indictment, *United States v. Ulbricht*, No. 14-CR-068 (S.D.N.Y. Feb. 4, 2014), *available at* http://www.justice.gov/sites/default/files/usao-sdny/legacy/2015/03/25/US%20v.%20Ross%20Ulbricht%20Indictment.pdf; Press Release, Fed. Bureau of Investigation, Ross Ulbricht, aka Dread Pirate Roberts, Sentenced in Manhattan Federal Court to Life in Prison (May 29, 2015), https://www.fbi.gov/newyork/press-releases/2015/ross-ulbricht-aka-dread-pirate-roberts-sentenced-in-manhattan-federal-court-to-life-in-prison.

[12] Sealed Complaint, United States v. Faiella, No. 14-MAG-0164 (S.D.N.Y. Jan. 24, 2013), *available at* http://www.wired.com/images_blogs/threatlevel/2014/01/Faiella-Robert-M.-and-Charlie-Shrem-Complaint.pdf.

[13] Press Release, U.S. Dep't of Justice, Manhattan U.S. Attorney Announces Charges Against Bitcoin Exchangers, Including CEO of Bitcoin Exchange Company, for Scheme to Sell and Launder over $1 Million in Bitcoins Related to Silk Road Drug Trafficking (Jan. 27, 2014), http://www.justice.gov/usao/nys/pressreleases/January14/SchremFaiellaChargesPR.php.

[14] 18 U.S.C. § 1960(a) (2012) ("Whoever knowingly conducts, controls, manages, supervises, directs, or owns all or part of an unlicensed money transmitting business, shall be fined in accordance with this title or imprisoned not more than 5 years, or both.").

[15] United States v. Faiella, 39 F. Supp. 3d 544, 545 (S.D.N.Y. 2014).

[16] *Id.* at 545 n.2.

[17] *Id.* at 546.

[18] *Id.* at 547.

[19] Indictment, United States v. Powell, No. 14-cr-10037 (C.D. Ill. June 11, 2014), *available at* https://www.scribd.com/doc/249786589/show-temp-pdf.

[20] United States v. Powell, No. 14-cr-10037 (C.D. Ill. June 11, 2014) (judgment), *available at* http://qntra.net/wp-content/uploads/2014/12/judgement.pdf.

from the U.S. Attorney's Office indicates that Powell was prosecuted for operating a bitcoin exchange that "allowed individuals increased anonymity by exchanging cash anonymously for bitcoin."[21]

In addition, the State of Florida is prosecuting Pascal Reid and Michel Abner Espinoza for selling bitcoin in transactions that were arranged through a website that assists buyers and sellers of the virtual currency in arranging face-to-face transfers.[22] The prosecution appears to be the first application of state law to prosecute the buying and selling of virtual currency.

Although § 1960 was used as early as 2007 to prosecute virtual currency pioneer e-gold, Ltd.,[23] the multiple prosecutions of bitcoin participants in the last year suggest that criminal enforcement under this statute will play a significant role in the government's response to bitcoin.

C. Ripple Labs Settles Charges Brought by FinCEN

In the first civil enforcement action against a virtual currency exchange,[24] the U.S. Treasury Department's Financial Crimes Enforcement Network (FinCEN) and the U.S. Department of Justice assessed a $700,000 civil penalty against Ripple Labs, Inc. and its wholly owned subsidiary, XRPII, LLC (formerly known as XRP Fund II, LLC). Charges included willful violations of the Bank Secrecy Act[25] in connection with money services business transactions, including the sale of virtual currencies, without registering as a "money services business" (MSB) with FinCEN. Charges also included failure to implement and maintain an anti-money laundering compliance program as required for MSBs.[26] FinCEN described violations "[f]rom at least March 6, 2013, through April 29, 2013," related to Ripple Labs' sales of a convertible virtual currency known as "XRP."[27] Readers might conclude that because this period bridges the March 18, 2013, issuance of FinCEN's currency guidance,[28] the action was unfair to Ripple

[21] Press Release, U.S. Dep't of Justice, McClean County Man to Serve Four Years in Prison for Operating Unlicensed Internet Bitcoin Exchange (Dec. 9, 2014), http://www.justice.gov/usao/ilc/press/2014/12december/20141209_powell.html.

[22] Susannah Nesmith, *Bitcoin Charges Called Improper Because Currency Not Real*, Bloomberg Bus. (Feb. 28, 2014, 12:01 AM EST), http://www.bloomberg.com/news/articles/2014-02-27/bitcoin-charges-improper-under-florida-law-lawyer-says; *see also* Brian Krebs, *Florida Targets High-Dollar Bitcoin Exchangers*, Krebs on Security (Feb. 7, 2014, 12:48 PM), http://krebsonsecurity.com/tag/pascal-reid/.

[23] For a more detailed analysis of the prosecution of e-gold, see Stephen T. Middlebrook & Sarah Jane Hughes, *Regulating Cryptocurrencies in the United States: Current Issues and Future Directions*, 40 Wm. Mitchell L. Rev. 813, 822–28 (2014).

[24] Press Release, FinCEN Fines Ripple Labs Inc. in First Civil Enforcement Action Against a Virtual Currency Exchanger (May 5, 2015), http://www.fincen.gov/news_room/nr/pdf/20150505.pdf. Attachment A to the press release sets out the basis for FinCEN's civil penalty assessment. *See id.* (Statement of Facts and Violations) [hereinafter Ripple Statement of Facts and Violations]. Attachment A is available at http://www.fincen.gov/news_room/nr/pdf/Ripple_Facts.pdf.

[25] 31 U.S.C. § 5318 (2012).

[26] *See* Ripple Statement of Facts and Violations, *supra* note 24, at paras. 26–28.

[27] *Id.* at para. 17.

[28] Fin. Crimes Enforcement Network, U.S. Dep't of the Treasury, Application of FinCEN's Regulations to Persons Administering, Exchanging, or Using Virtual Currencies, FIN-2013-G001 (2013),

Labs. FinCEN, however, cited Ripple Labs' prior history of describing itself as "a currency *exchange service* providing on-line, real-time currency trading and cash management[29] and its failure in the period (prior to March 18, 2013) to be registered as an MSB.[30] XRP II is charged with selling virtual currency to third-party entities and operating without an MSB registration from "on or about August 4, 2013," to September 4, 2013, when it registered as an MSB;[31] willful failure to implement an effective anti-money laundering program;[32] and failure to report suspicious transactions.[33]

III. Developments Affecting Prepaid Cards

A. The CFPB and Department of Education Propose New Prepaid Card Regulations

On December 23, 2014, the Consumer Financial Protection Bureau (CFPB) proposed amendments to both Regulation E, which implements the Electronic Fund Transfer Act, and Regulation Z, which implements the Truth in Lending Act, to create "comprehensive consumer protections for prepaid financial products."[34] The proposed rule's scope is significantly broader than the Advance Notice of Proposed Rulemaking published in 2012, which focused on extending the existing payroll card provisions of Regulation E to general purpose reloadable (GPR) prepaid cards.[35] The 2014 proposal begins by expanding the definition of "prepaid account" to include not just payroll, government benefit, and GPR cards, but also products that can be used for person-to-person and person-to-business payments, including mobile wallets.[36] The CFPB acknowledges that the proposal may also apply to virtual currency products.[37] Under the proposal, these payment products would have to comply with Regulation E's requirements related to disclosures, error resolution, and limitations on liability.

The proposed rule would create a new and expanded set of disclosure requirements for prepaid products. In addition to the full disclosure of all terms, fees, and conditions that Regulation E already requires, the proposal would require additional short-form and long-form disclosures, which generally must be deliv-

available at http://www.fincen.gov/statutes_regs/guidance/pdf/FIN-2013-G001.pdf (clarifying the coverage of regulations that implement the federal Bank Secrecy Act to persons engaged, among other things, in the receipt, distribution, exchange, and transmittal of virtual currencies).

[29] Ripple Statement of Facts and Violations, *supra* note 24, at para. 16 (citing Motion for Preliminary Injunction, Ripple Labs, Inc. v. Lacroe Enters., LLC, No. 13-cv-5974-RS/KAW (N.D. Cal. Dec. 27, 2013) (emphasis added by FinCEN)).

[30] Ripple Statement of Facts and Violations, *supra* note 24, at para. 18.

[31] *Id.* at paras. 22–24.

[32] *Id.* at para. 26.

[33] *Id.* at paras. 11, 28.

[34] Prepaid Accounts Under the Electronic Fund Transfer Act (Regulation E) and the Truth in Lending Act (Regulation Z), 79 Fed. Reg. 77102, 77102 (proposed Dec. 23, 2014) (to be codified at 12 C.F.R. pts. 1005 & 1026) [hereinafter CFPB Proposed Rule].

[35] Electronic Fund Transfers (Regulation E), 77 Fed. Reg. 30923 (May 24, 2012).

[36] CFPB Proposed Rule, 79 Fed. Reg. at 77125–33.

[37] *Id.* at 77133.

ered before a consumer acquires an account.[38] The short form must disclose seven specific fees, regardless of whether they are actually charged, plus the three fees most commonly incurred by users in the prior twelve months.[39] The long form must disclose all fees, the conditions under which each fee may be imposed or waived, and third-party fees to the extent they are known.[40] In addition to providing copies of disclosures to consumers, prepaid providers must also post their account agreements to their own public websites and submit copies to the CFPB to be included in a website maintained by the Bureau.[41] Providers would be required to update submissions to the CFPB quarterly.[42]

Currently, Regulation E provides for an alternative to monthly statements for payroll card programs that make account balances available by telephone, provide sixty days of transaction history electronically, and provide cardholders with written histories upon request.[43] The proposed rule would continue this alternative but would expand the electronic transaction history requirement from sixty days to eighteen months.[44]

The CFPB's proposed rule also would extend significant portions of Regulation Z to prepaid products that offer overdraft protection to consumers.[45] The proposal would treat overdraft protection on prepaid products as an open-end credit plan and fees associated with overdraft transactions as finance charges.[46] Consequently, providers of prepaid products offering overdraft services would be required to evaluate a consumer's creditworthiness, give additional disclosures, and be subject to certain limitations on fees.[47]

The U.S. Department of Education (DoE) also released a proposed rule that would place new restrictions on prepaid cards that receive funds under Title IV of the Higher Education Act.[48] The DoE's rule would require schools to offer students a choice in how to receive a credit balance of Title IV funds and would require their consent before issuing them a card.[49] Campus card programs would have to provide certain levels of ATM access and fees would be limited.[50] In addition, the rule prohibits card fees for the first thirty days after the account receives a Title IV disbursement.[51] In addition, the DoE reserved the right to establish its own card program for paying credit balances to students.[52]

[38] *Id.* at 77146–75.

[39] *Id.* at 77156–64.

[40] *Id.* at 77168–69.

[41] *Id.* at 77191–203.

[42] *Id.* at 77191.

[43] 12 C.F.R. § 1005.18(b) (2015).

[44] CFPB Proposed Rule, 79 Fed. Reg. at 77176.

[45] *Id.* at 77204–55.

[46] *Id.* at 77204–06.

[47] *Id.* at 77209–46.

[48] Program Integrity and Improvement, 80 Fed. Reg. 28484 (proposed May 18, 2015) (to be codified at 34 C.F.R. pt. 668).

[49] *Id.* at 28500–04.

[50] *Id.* at 28505–09.

[51] *Id.* at 28506.

[52] *Id.* at 28488.

B. Payroll Card Litigation Moves Forward

In last year's survey, we noted that several lawsuits had been filed against employers asserting that their payroll card programs did not comport with applicable law.[53] One of those cases was a class action filed against a fast-food restaurant owner in Pennsylvania who was accused of requiring employees to accept their wages on a payroll card. That case has been certified as a class action under a different name.[54] The court also denied the defendant's motion for summary judgment, finding as a matter of law that a payroll card did not meet the state-law requirement that employees be paid "in lawful money of the United States or check."[55] The court held that the statute required payment in cash ("lawful money") or a check and that a payroll card, which could be used to obtain cash, was not cash itself.[56] A different provision of state law authorized payment by direct deposit, but that option requires consent by the employee and thus was not available in this situation.[57] Noting that the decision addressed an issue of first impression in the state, the court suggested that an appellate court would benefit from a formal opinion on the subject from the Pennsylvania Department of Labor.[58]

C. Developments Related to Federal and State Benefit Payments

The past year saw several legal developments related to state and federal benefit payments made by prepaid cards. On October 17, 2014, the President issued an executive order intended to improve the security of consumer financial information in public and private transactions.[59] It directs federal agencies to move to more secure payment methods, including the use of "chip and PIN," a reference to the Europay, Mastercard, and Visa (EMV) smartcard technology.[60] In particular, it directs the U.S. Treasury Department to begin replacing existing federal benefit cards, including the popular Direct Express card, with versions providing enhanced security.[61]

[53] *2014 Survey*, *supra* note 1, at 266.

[54] Siciliano v. Mueller, No. 2013-07010 (Ct. Common Pleas, Luzerne Cty., Pa., May 14, 2015), *available at* http://hr.cch.com/ELD/SicilianoMueller.pdf.

[55] Siciliano v. Mueller, No. 2013-07010, slip op. at 2 (Ct. Common Pleas, Luzerne Cty., Pa., May 29, 2015).

[56] *Id.* at 3.

[57] *Id.* at 4.

[58] *Id.* at 5.

[59] Exec. Order No. 13681, 79 Fed. Reg. 63491 (Oct. 23, 2014).

[60] *Id.* (suggesting that federal agencies consult the voluntary consensus standards and specifications, as appropriate, consistent with the National Technology Transfer and Advancement Act of 1995 and Office of Management and Budget Circular A-119). EMV takes its name from the three companies that created the payment standard: Europay, Mastercard, and Visa. *About EMV*, EMVco, www.emvco.com/about_emv.aspx (last visited May 31, 2015). For more information on the adoption of EMV technology in the United States, see Mark Scott, *Preparing for Chip-and-PIN Cards in the United States*, N.Y. Times Bits (Dec. 2, 2014), http://bits.blogs.nytimes.com/2014/12/02/preparing-for-chip-and-pin-cards-in-the-united-states/.

[61] Exec. Order No. 13681, 79 Fed. Reg. at 63491.

The Kansas legislature passed a law placing significant restrictions on the use of Temporary Assistance for Needy Families benefits that are delivered by prepaid benefit cards.[62] Under the new law, the cards cannot be used at liquor stores, casinos, jewelry stores, tattoo parlors, body piercing parlors, nail salons, spas, lingerie shops, video arcades, movie theaters, swimming pools, aboard cruise ships, or outside the state of Kansas.[63] The cards can no longer be used to purchase a number of goods and services, including cigarettes, lottery tickets, and tickets to concerts, sporting events, and other entertainment events.[64] In addition, the new law limits cash withdrawals from ATMs to $25 per transaction and limits transactions to one per day.[65] The new measure has been criticized as attacking the poor. The ATM restrictions have been called vindictive, given that they will require benefits recipients to make more ATM withdrawals, each of which incurs an additional fee.[66]

IV. Enforcement Actions and Other Developments Affecting E-Payments or Financial Services Providers

A. Federal Enforcement Actions Against PayPal in 2015

PayPal, Inc. settled enforcement actions with the U.S. Treasury Department's Office of Foreign Assets Control (OFAC) and the CFPB in the first half of 2015. On March 25, 2015, the OFAC announced a settlement with PayPal related to 486 apparent violations of the Weapons of Mass Destruction Proliferators Sanctions Regulations[67] and other U.S. economic sanctions regulations.[68] The settlement agreement, which requires PayPal to pay a $7,658,300 penalty,[69] recites that, during a period lasting into 2013, PayPal failed to employ adequate screening technology and procedures to identify targets of these sanctions regulations and the transactions that PayPal processed on their behalf.[70] The OFAC described PayPal's WMD violations as "egregious,"[71] which, in our view, explains the high penalty in this settlement compared to the roughly $7,000 in value handled by PayPal.

[62] H.B. 2258, § 9(b)(14), 2015 Leg. Sess. (Kan. 2015) (to be codified at Kan. Stat. Ann. § 39-709).

[63] *Id.*

[64] *Id.*

[65] *Id.*

[66] Max Ehrenfreund, *Kansas Has Found the Ultimate Way to Punish the Poor*, Wash. Post Wonkblog (May 21, 2015), http://www.washingtonpost.com/blogs/wonkblog/wp/2015/05/21/kansas-has-found-the-ultimate-way-to-punish-the-poor/.

[67] Office of Foreign Assets Control, U.S. Dep't of the Treasury, Settlement Agreement with PayPal, Inc., at para. 12 (Mar. 25, 2015), *available at* http://www.treasury.gov/resource-center/sanctions/CivPen/Documents/20150325_paypal_settlement.pdf (citing violations of 31 C.F.R. § 544.201).

[68] *Id.* at paras. 8–9 (Iranian Transactions and Sanctions Regulations, 31 C.F.R. §§ 560.204, 560.206), para. 7 (Cuban Assets Control Regulations, 31 C.F.R. § 515.201), para. 10 (Sudanese Sanctions Regulations, 31 C.F.R. § 538.205), para. 11 (Global Terrorism Sanctions Regulations, 31 C.F.R. § 594.201).

[69] *Id.* at para. 20(a)(ii).

[70] *Id.* at para. 4.

[71] *Id.* at para. 15.

On May 19, 2015, PayPal, Inc. and Bill Me Later, Inc. settled a CFPB action alleging unfair, deceptive, and abusive acts or practices in violation of the Consumer Financial Protection Act of 2010 in connection with a credit product called PayPal Credit.[72] The CFPB charged that defendants *unfairly* (a) enrolled consumers in PayPal Credit without their knowledge or consent, including automatically enrolling some consumers who were opening regular PayPal accounts, and enrolling those who canceled the application process or closed out of the application window before completing the enrollment process; (b) caused consumers to pay for purchases with PayPal Credit even when the consumers chose a different payment method; (c) failed to process consumers' payments promptly or at all; and (d) mishandled billing disputes and caused consumers to incur late fees and interest charges.[73] The defendants also *deceptively* advertised and failed to honor and apply promotional offers,[74] and they engaged in *abusive* deferred-interest acts or practices.[75] Under the stipulated final judgment and order filed on May 19, 2015, PayPal and Bill Me Later will pay $15 million in consumer redress and a $10 million civil penalty.[76] They also will undertake disclosure and account-management practices responsibilities.[77]

B. Five More "Mobile Cramming" Actions Brought by the FTC, FCC, and State AGs—and, Last but Not Least, the CFPB

Since mid-2014, five wireless providers have agreed to pay significant sums in consumer refunds and civil penalties in actions brought by federal and state agencies for billing unauthorized third-party providers' charges, a practice known as "mobile cramming."[78] AT&T's October 2014 settlement with the FTC and other agencies requires payment of $105 million in consumer refunds and penalties.[79] According to the FTC, AT&T's customer service department had

[72] Complaint, Consumer Fin. Prot. Bureau v. PayPal, Inc., No. 1:15-cv-01426 (D. Md. May 19, 2015), *available at* http://files.consumerfinance.gov/f/201505_cfpb_complaint-paypal.pdf. Bill Me Later, Inc. is a wholly owned subsidiary of PayPal. *Id.* at para. 8.

[73] *Id.* at para. 40 (untimely payments processing causing late fees and interest charges to accrue), para. 41 (online payment platform problems causing late fees and interest charges to accrue), para. 42 (mishandling billing disputes), para. 43 (charging late fees and interest on disputed balances and failing to correct errors or make refunds).

[74] *Id.* at paras. 66–69.

[75] *Id.* at paras. 70–75.

[76] Stipulated Final Judgment and Order at paras. 23–26, 29, Consumer Fin. Prot. Bureau v. PayPal, Inc., No. 1:15-cv-01426 (D. Md. May 19, 2015), *available at* http://files.consumerfinance.gov/f/201505_cfpb_consent-order-paypal.pdf.

[77] *Id.* at paras. 17–22.

[78] *See* Press Release, Fed. Trade Comm'n, AT&T to Pay $80 Million to FTC for Consumer Refunds in Mobile Cramming Case (Oct. 8, 2014), https://www.ftc.gov/news-events/press-releases/2014/10/att-pay-80-million-ftc-consumer-refunds-mobile-cramming-case (explaining the term "mobile cramming" as "unlawful" billing for "unauthorized third-party charges" and describing the unauthorized charges on AT&T bills as for ringtones and text messages containing "love tips, horoscopes, and 'fun facts'").

[79] *Id.* The total represents $80 million in consumer refunds, $20 million in penalties to the fifty states and the District of Columbia, and a $5 million penalty to the Federal Communications Commission.

received more than 1.3 million calls about unauthorized charges.[80] On December 19, 2014, T-Mobile USA, Inc. settled similar charges, agreeing to pay at least $90 million.[81] T-Mobile received as much as 35–40 percent of each charge. Up to 40 percent of its consumer customers had sought refunds, a red flag that charges were not authorized.[82] In October 2014, the FTC also settled with Acquinity Interactive, LLC for violations including mobile cramming.[83]

The CFPB and other agencies settled an action against Verizon and Sprint in May 2015. Together, the two companies agreed to pay $120 million in refunds to consumers and $38 million in fines to settle charges of mobile cramming.[84] The alleged violations were long-lived—in Sprint's case lasting from 2004 to 2013.[85]

C. More E-Payments and "Operation Choke Point" Actions

Actions related to Operation Choke Point, first reported in our 2014 survey,[86] have continued.[87] In an action originally filed in 2012,[88] the FTC obtained summary judgment against several of the defendants, including Universal Processing Services of Wisconsin, LLC (UPS),[89] for assisting and facilitating violations of the Telemarketing Sales Rule.[90] On May 19, 2015, the court approved a stipulated permanent injunction and monetary relief as to defendant UPS.[91] The court's order prohibits payment processing for certain restricted clients and requires screening of prospective clients.[92] The order also requires ongoing monitoring

[80] *Id.*

[81] *See* Press Release, Fed. Trade Comm'n, T-Mobile to Pay at Least $90 Million, Including Full Consumer Refunds to Settle Mobile Cramming Case (Dec. 19, 2014), https://www.ftc.gov/news-events/press-releases/2014/12/t-mobile-pay-least-90-million-including-full-consumer-refunds.

[82] *Id.*

[83] *See* Press Release, Fed. Trade Comm'n, Defendants in Massive Spam Text Message, Robocalling and Mobile Cramming Scheme to Pay $10 Million to Settle FTC Charges (Oct. 22, 2014), https://www.ftc.gov/news-events/press-releases/2014/10/defendants-massive-spam-text-message-robocalling-mobile-cramming.

[84] Press Release, Consumer Fin. Prot. Bureau, CFPB Takes Action to Obtain $120 Million in Redress from Sprint and Verizon for Illegal Mobile Cramming (May 12, 2015), http://www.consumerfinance.gov/newsroom/cfpb-takes-action-to-obtain-120-million-in-redress-from-sprint-and-verizon-for-illegal-mobile-cramming/.

[85] Complaint at para. 1, Consumer Fin. Prot. Bureau v. Sprint Corp., No. 14-cv-09931 (S.D.N.Y. Dec. 17, 2014), *available at* http://www.consumerfinance.gov/f/201412_cfpb_cfpb-v-sprint-complaint.pdf.

[86] *2014 Survey*, *supra* note 1, at 267–69.

[87] For a pithy description of other efforts aimed at Operation Choke Point, see Mark Chesnut, *The Effort to Strangle Operation Choke Point,* America's 1st Freedom (June 11, 2015), http://www.americas1stfreedom.org/articles/2015/6/11/the-effort-to-strangle-operation-choke-point.

[88] FTC v. WV Universal Mgmt., LLC, No. 6:12-cv-1618-Orl-22KRS (M.D. Fla. Oct. 29, 2012), *available at* https://www.ftc.gov/sites/default/files/documents/cases/2012/11/121101treasuresuccesscmpt.pdf.

[89] FTC v. HES Merch. Servs. Co., No. 6:12-cv-1618-Orl-22KRS (M.D. Fla. Nov. 18, 2014) (order), *available at* https://www.ftc.gov/system/files/documents/cases/141018universalorder.pdf.

[90] 16 C.F.R. pt. 310 (2011).

[91] FTC v. WV Universal Mgmt., LLC, No. 6:12-cv-1618-Orl-22-KRS (M.D. Fla. May 19, 2015) (permanent injunction as to Universal Processing Services of Wisconsin, LLC), *available at* https://www.ftc.gov/system/files/documents/cases/150520universalmanagementinjunction.pdf.

[92] *Id.* at 6–8.

of clients and the commencement of investigations in cases of elevated return rates or chargeback rates.[93]

Since the DOJ's first action under Operation Choke Point against Four Oaks Fincorp, Inc.,[94] the DOJ has settled with two other banks—Plaza Bank[95] and CommerceWest Bank.[96] In addition, since late July 2014, the Federal Deposit Insurance Corporation (FDIC) issued two additional financial institution letters pertaining to insured banks' relationships with third parties, including payments processors and others.[97]

In addition to efforts made in 2014 to halt Operation Choke Point,[98] in 2015, members of both houses of Congress introduced the Firearms Manufacturers and Dealers Protection Act.[99] The bill prohibits expenditures by the FDIC, DoJ, and other federal agencies that "discourage the provision or continuation of credit or the processing of payments by financial institutions for dealers and manufacturers of firearms and ammunition."[100] As it did in May 2014,[101] the U.S. House of Representatives again passed an amendment to prohibit spending on Operation Choke Point.[102] Unless the U.S. Senate concurs, the funding amendment will have only symbolic value, and Operation Choke Point is likely to continue.

[93] *Id.* at 9–10.

[94] *See 2014 Survey*, *supra* note 1, at 268.

[95] Consent Decree for Permanent Injunction and Civil Penalty, United States v. Plaza Bank, No. CV-15-00394 (C.D. Cal. Mar. 12, 2015) (civil penalties of $1.225 million to U.S. Treasury and U.S. Postal Inspection Service), *available at* http://www.justice.gov/file/348831/download. For additional discussion of this enforcement action, see Alan Zibel, *Operation Choke Point: Plaza Bank Becomes Third to Settle*, Wall St. J. (Mar. 12, 2015, 5:24 PM EST), http://blogs.wsj.com/moneybeat/2015/03/12/operation-choke-point-plaza-bank-becomes-third-to-settle/ (describing knowing facilitation by bank of consumer frauds by merchants after efforts by chief compliance officer of bank were "brushed aside" by bank's COO, who was a part owner of a payments processing firm involved in the practices alleged).

[96] Consent Decree for Permanent Injunction and Civil Money Penalty, United States v. CommerceWest Bank, No. CV-15-00379 (C.D. Cal. Mar. 10, 2015), *available at* http://www.justice.gov/file/347431/download. The bank agreed to pay $4.9 million in civil and criminal penalties. Press Release, U.S. Dep't of Justice, CommerceWest Bank Admits Bank Secrecy Act Violation and Reaches $4.9 Million Settlement with Justice Department (Mar. 10, 2015), http://www.justice.gov/opa/pr/commercewest-bank-admits-bank-secrecy-act-violation-and-reaches-49-million-settlement-justice.

[97] Fed. Deposit Ins. Corp., Statement on Providing Banking Services, FIL-5-2015 (Jan. 28, 2015), *available at* https://www.fdic.gov/news/news/financial/2015/fil15005.pdf; Fed. Deposit Ins. Corp., FDIC Clarifying Supervisory Approach to Institutions Establishing Account Relationships with Third-Party Payment Processors, FIL-41-2014 (July 28, 2014), *available at* https://www.fdic.gov/news/news/financial/2014/fil14041.pdf.

[98] *See 2014 Survey*, *supra* note 1, at 268–69.

[99] S. 477, 114th Cong. (2015) (introduced Feb. 12, 2015); H.R. 1413, 114th Cong. (2015) (introduced Mar. 17, 2015).

[100] S. 477, § 3; H.R. 1413, § 3.

[101] *See 2014 Survey*, *supra* note 1, at 269 & n.64.

[102] *See* 161 Cong. Rec. H3805–07 (daily ed. June 3, 2015) (approving the Luetkemeyer Amendment to defund Operation Choke Point).

V. Developments to Watch

In the coming year, federal developments to watch include (1) recent litigation challenging state statutes banning the imposition of surcharges on credit card transactions,[103] (2) the CFPB's 2015 framework for small-business review of payday and other small-value loans,[104] and (3) likely more enforcement actions under U.S. BSA/AML regulations.[105] There are two European Union developments to watch: the EU's regulation on interchange fees, which becomes effective starting in June 2015,[106] and the July 2014 European Banking Authority Opinion on Virtual Currencies.[107] Finally, readers will want to follow efforts by both the Conference of State Bank Supervisors and the Uniform Law Commission to create uniform prudential regulatory schemes for virtual currency providers.[108]

[103] *E.g.*, Italian Colors Rest. v. Harris, No. 2:14 Civ. 00604, 2015 WL 1405507 (E.D. Cal. Mar. 25, 2015), *appeal docketed*, No. 15-15873 (9th Cir. Apr. 30, 2015); Rowell v. Abbott, No. 1:14 Civ. 190 (W.D. Tex. Feb. 4, 2015), *appeal docketed*, No. 15-50168 (5th Cir. Mar. 3, 2015); Dana's R.R. Supply v. Bondi, No. 4:14-cv-00134-RH-CAS (N.D. Fla. Sept. 2, 2014), *appeal docketed*, No. 14-14426 (11th Cir. Sept. 30, 2014). As this survey went to final editing, the U.S. Court of Appeals for the Second Circuit issued its opinion vacating the district court's judgment and remanding for dismissal of plaintiffs' claims in *Expressions Hair Design, LLC v. Schneiderman* that New York State's credit-card surcharge ban was unconstitutional. Nos. 13-4533, 13-4537, 2015 WL 5692296, at *6 (2d Cir. Sept. 29, 2015). Judge Rakoff's 2013 decision had held the statute unconstitutional for vagueness under the Due Process Clause of the Fourteenth Amendment to the U.S. Constitution and as an impermissible regulation of speech under the First Amendment, 975 F. Supp. 2d 430, 444 (S.D.N.Y. 2013).

[104] *See* Consumer Fin. Prot. Bureau, Small Business Advisory Review Panel for Potential Rulemakings for Payday, Vehicle Title, and Similar Loans: Outline of Proposals Under Consideration and Alternatives Considered (Mar. 26, 2015), *available at* http://files.consumerfinance.gov/f/201503_cfpb_outline-of-the-proposals-from-small-business-review-panel.pdf. This outline contains a useful summary of the requirements of the consultation process prescribed in the Small Business Regulatory Enforcement Fairness Act, 5 U.S.C. § 609(b). *Id.* at 5–6.

[105] *See, e.g.*, Kate O'Keeffe, *U.S. Fines Pacific Island Casino Operator $75 Million for Anti-Money-Laundering Violations,* Wall St. J. (June 5, 2015), http://www.wsj.com/articles/u-s-fines-pacific-island-casino-operator-75-million-for-anti-money-laundering-violations-1433412878 (describing largest civil fine issued against a casino, Tinian Dynasty Hotel & Casino, Northern Mariana Islands, for "'willful and egregious' violations of anti-money laundering rules back to 2008"); Rachel Louise Ensign & Julie Steinberg, *Treasury Scrutinizes Credit Unions,* Wall St. J. (June 2, 2015), http://www.wsj.com/articles/treasury-scrutinizes-credit-unions-1433286795.

[106] Regulation (EU) 2015/751 of 29 April 2015 on Interchange Fees for Card-Based Payment Transactions, art. 18, 2015 O.J. (L 123) 1.

[107] EBA Opinion on "Virtual Currencies," EBA/Op/2014/08 (July 4, 2014), *available at* https://www.eba.europa.eu/documents/10180/657547/EBA-Op-2014-08+Opinion+on+Virtual+Currencies.pdf.

[108] Final Study Committee on Alternative and Mobile Payment Systems Report (Dec. 19, 2014), *available at* http://www.uniformlaws.org/shared/docs/Alternative%20and%20Mobile%20Payments/AMPS%20Final%20Study%20Committee%20Report%2012-19-14.pdf. The report focuses on policy areas such as consumer protection, market stability, and law enforcement goals and also makes recommendations on covered activities, policy implementation, and possible exclusions. *Id.* at 2–3. Note that both authors were involved in the Uniform Law Commission Study Committee.

The Federal Communications Commission's Network Neutrality Order

*By C. Douglas Jarrett**

The *Open Internet Order*[1] adopted by the Federal Communications Commission (FCC) in late February 2015 regulates Internet service providers, including cable companies, telephone companies, fixed wireless (principally fee-based Wi-Fi service), and mobile service carriers, such as Verizon and Sprint (collectively "broadband providers"). The *Open Internet* rules are currently in effect.[2]

Prior to the *Open Internet Order*, Internet access service was classified as an interstate "information service."[3] The rates, terms and conditions, and related business practices of broadband providers were largely unregulated, and the largest Internet backbone providers (which are also the largest broadband service providers) set the rules governing the exchange of Internet traffic. The FCC's initial Internet conduct rules—anti-blocking and anti-discrimination—and a transparency rule were adopted in 2010,[4] but the conduct rules were vacated by the D.C. Circuit in *Verizon Communications Inc. v. FCC.*[5] In response, the FCC released a *Notice of Proposed Rulemaking* setting forth proposed rules intended to proscribe potential inappropriate business practices on the part of broadband providers.[6]

The public's cognizance of, and participation in, this rulemaking are unprecedented. In most FCC rulemaking proceedings, even highly contested matters,

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[1] Protecting and Promoting the Open Internet, GN Docket No. 14-28 (Feb. 26, 2015) (released Mar. 12, 2015) [hereinafter *Open Internet Order*], *available* at http://transition.fcc.gov/Daily_Releases/Daily_Business/2015/db0312/FCC-15-24A1.pdf.

[2] With limited exceptions, the rule became effective on June 12, 2015. Petitions for review of the *Open Internet Order* are pending before the U.S. Court of Appeals for the D.C. Circuit. *See, e.g.*, Protective Petition for Review, U.S. Telecom Ass'n v. FCC, No. 15-1063 (D.C. Cir. Mar. 23, 2015). The court denied motions for a stay of the *Order* pending appeal, but granted the petitioners' motions for expedition. U.S. Telecom Ass'n v. FCC, No. 15-1063 (D.C. Cir. June 11, 2015) (order denying stay pending appeal). Whether petitioners or the government obtain a favorable ruling from the D.C. Circuit, it is widely expected that the non-prevailing party or parties will seek Supreme Court review.

[3] *See* 47 U.S.C. § 153(24) (2012) (defining "information service"); Nat'l Cable & Telecomms. Ass'n v. Brand X Internet Servs., 545 U.S. 967, 987, 1003 (2005), *aff'g In re* Inquiry Concerning High-Speed Access to the Internet over Cable and Other Facilities, 17 FCC Rcd. 4798 (2002).

[4] Preserving the Open Internet, 25 FCC Rcd. 17905 (2010).

[5] 740 F.3d 623 (D.C. Cir. 2014).

[6] Protecting and Promoting the Open Internet, 29 FCC Rcd. 5561 (proposed May 15, 2014).

the only persons who file comments are the affected companies, interested trade associations, and public interest groups. Occasionally, several hundred parties file comments. Nearly *four million* persons submitted filings to the FCC in response to the *Notice of Proposed Rulemaking*, emphasizing potential abuses by the largest broadband providers and the importance of preserving the openness of the Internet.[7] In his widely publicized statement in November 2014,[8] President Obama stressed the importance of an open Internet and opined that broadband providers should be regulated as telecommunications carriers under Title II of the Communications Act of 1934, as amended (the Act).[9]

This survey provides a basic overview of the *Open Internet Order*. Readers who seek additional detail may consult the full *Order*, weighing in at 400 single-spaced pages.

Covered Entities: Providers of "Broadband Internet Access Service"

The *Open Internet Order* focuses on the business relationships between and among end users, edge providers, broadband providers, and Internet backbone operators.[10] The definition of "broadband Internet access service" (BIAS) and the significance of classifying BIAS as a telecommunications service are central to understanding the *Open Internet Order*.

The *Order* defines BIAS as a "mass-market retail service by wire or radio that provides the capability to transmit data to and receive data from all or substantially all Internet endpoints."[11] "Mass market," in turn, is defined as "sold on a standardized basis to residential customers, small businesses, and other end-user customers such as schools and libraries."[12] Internet access services sold

[7] *Open Internet Order*, *supra* note 1, at para. 6.

[8] *See Net Neutrality: President Obama's Plan for a Free and Open Internet*, The White House (Nov. 10, 2014), http://goo.gl/zn8w9z.

[9] 47 U.S.C. § 153(51) (2012) (defining "telecommunications carrier"); *see id.* §§ 201–276 (regulating common carriers).

[10] These relationships are aptly summarized in *Verizon Communications Inc. v. FCC*:

> Four major participants in the Internet marketplace are relevant to the issues before us: backbone networks, broadband providers, edge providers, and end users. Backbone networks are interconnected, long-haul fiber-optic links and high-speed routers capable of transmitting vast amounts of data. Internet users generally connect to these networks—and, ultimately, to one another—through local access providers like petitioner Verizon, who operate the "last-mile" transmission lines. . . . Today, access is generally furnished through "broadband," i.e., high-speed communications technologies, such as cable modem service. Edge providers are those who, like Amazon or Google, provide content, services, and applications over the Internet, while end users are those who consume edge providers' content, services, and applications. . . . These categories of entities are not necessarily mutually exclusive. For example, end users may often act as edge providers by creating and sharing content that is consumed by other end users, for instance by posting photos on Facebook. Similarly, broadband providers may offer content, applications, and services that compete with those furnished by edge providers.

740 F.3d at 628–29 (citations omitted).

[11] *Open Internet Order, supra* note 1, at para. 187.

[12] *Id.* at para. 189.

to "enterprise" customers are excluded from the definition of BIAS;[13] however, the *Open Internet Order* indicates that mobile broadband service is subject to the rules even though different network management practices may be appropriate.[14] The FCC stated explicitly that "premises operators," such as bookstores, airlines, and private end-user networks, including those operated by universities, are not subject to the rules of the *Open Internet Order* inasmuch as these services "are typically offered by the premise operator as an ancillary benefit to patrons."[15]

The FCC also established a new category of specialized services apart from BIAS, referred to as "non-BIAS data services." These services share several characteristics: they rely on the "last mile" services of wireless or wireline broadband providers, are application-specific, and are not intended to reach all Internet endpoints.[16] Examples include VoIP services, heart monitors, e-readers, and energy consumption sensors. The rules of the *Open Internet Order* do not apply to those services.[17]

BIAS Classified as a Telecommunications Service

Despite objections from the major broadband providers, the *Open Internet Order* classifies BIAS as an interstate telecommunications service subject to FCC regulation under Title II,[18] essentially reversing the FCC's decision in the *Cable Broadband Decision* in which the agency classified broadband as an interstate information service, as opposed to a telecommunications service.[19] Classifying BIAS as a telecommunications service substantially expands the scope of the FCC's authority to regulate the business practices of BIAS providers.[20] Inasmuch as many Title II statutory provisions and related regulations are not relevant to Internet access service, the FCC exercised its authority under section 10 of the Act[21] to "forbear" from imposing these sections of the Act and the related regulations on BIAS providers.[22] The FCC also expressly declined to set rates for BIAS.[23]

[13] *Id.* at paras. 189–90.

[14] *Id.* at paras. 86–101, 421–26.

[15] *Id.* at para. 191.

[16] *Id.* at paras. 207–09.

[17] *Id.*

[18] *Id.* at paras. 310–35.

[19] *In re* Inquiry Concerning High-Speed Access to the Internet over Cable and Other Facilities, 17 FCC Rcd. 4798, 4820–32 (2002).

[20] Title II of the Act provides the FCC with authority to regulate "telecommunications services." *See* 47 U.S.C. § 151 (2012) (creating the FCC to enforce federal policy); *id.* § 153(53) (defining "telecommunications service"). On the other hand, there is no express authority in the statute to regulate information services. *Id.* § 153(24) (defining "information service").

[21] *Id.* § 160.

[22] *See Open Internet Order*, *supra* note 1, at para. 458.

[23] *Id.* at para. 451.

On the other hand, the FCC retained the authority to review and assess on a case-by-case basis any practice, charge, or rule of a BIAS provider under the "just and reasonable" and "nondiscriminatory" standards of sections 201 and 202 of the Act.[24] Under section 208 of the Act,[25] end-users, edge providers, other broadband services providers, and other telecommunications carriers may file a complaint with the FCC alleging that a broadband provider has violated either sections 201 or 202, other designated provisions of Title II, or the rules or standards adopted in the *Open Internet Order*.[26]

Rules of Conduct Imposed by the *Open Internet Order*

The *Open Internet Order* adopted three so-called "bright-line" rules.

1. *No Blocking*. BIAS providers cannot block lawful content, applications, or services, or restrict the use of non-harmful devices to access BIAS, subject to reasonable network management practices.[27]

2. *No Throttling*. BIAS providers cannot slow down or otherwise impair or degrade lawful traffic on the Internet based on its content, or on the end-user's use of particular applications, services, or non-harmful devices, except as required for reasonable network management.[28]

3. *No Paid Prioritization*. BIAS providers cannot engage in paid prioritization that includes direct or indirect favoring of some Internet traffic over other traffic for consideration.[29] A waiver of this rule may be granted, but only if the requestor "demonstrates that the practice would provide some significant public interest benefit and would not harm the open nature of the Internet."[30]

The three "bright-line" rules are supplemented by a "no-unreasonable interference/disadvantage" standard that broadly prohibits any other practice that might undermine "the open nature of the Internet," ensuring that end-users can choose the sites they wish to access and edge providers can reach end-users without restriction.[31] Among other objectives, this standard is intended to: (1) protect and enable end-user control over use of the Internet,[32] (2) restrict broadband providers from engaging in practices that disadvantage other edge providers offering content or services in competition with those offered by broadband providers,[33] and (3) function as a consumer protection rule.[34] Alleged violations of this standard will be assessed on a case-by-case basis.[35]

[24] *Id.* at paras. 441–50; *see also* 47 U.S.C. §§ 201, 202 (2012).

[25] 47 U.S.C. § 208 (2012).

[26] *Open Internet Order*, *supra* note 1, at paras. 453–85.

[27] *Id.* at paras. 111–18.

[28] *Id.* at paras. 119–24.

[29] *Id.* at paras. 125–29.

[30] *Id.* at paras. 130–32.

[31] *Id.* at paras. 136–38.

[32] *Id.* at para. 139.

[33] *Id.* at para. 140.

[34] *Id.* at para. 141.

[35] *Id.* at para. 138.

Enhanced Transparency Rule

The FCC reaffirmed and expanded upon the transparency rule it adopted in its 2010 order.[36] Among an array of prescriptive rules, the FCC requires BIAS providers to disclose promotional rates, all fees and/or surcharges, and all data caps or data allowances; to disclose packet loss as a measure of network performance; and to include specific notifications to consumers in the event a network management practice is likely to significantly affect their use of the service.[37] The FCC deferred the effectiveness of the enhanced transparency rule for BIAS providers having up to 100,000 customers until a rulemaking is concluded.[38]

Applicability of Rules to Mobile Broadband

Over the strenuous objections of the major wireless carriers, the FCC included mobile broadband service within the scope of the *Open Internet Order*. The FCC reassessed prior agency decisions that held mobile broadband service is not a commercial mobile radio service in concluding that mobile broadband service is subject to Title II and regulated as BIAS.[39]

Internet Exchange Traffic Arrangements

The exchange of Internet traffic by an edge provider (such as Netflix) or an intermediary (such as Akamai or another content delivery network) or an entity having a peering or transit agreement (such as Level 3 or another carrier) with an Internet backbone provider that is also the operator of a broadband provider network is necessary for all end-users and edge providers to reach all or substantially all Internet endpoints. The FCC acknowledges the conflicting interests and positions that have arisen in connection with the exchange of Internet traffic.[40] The *Open Internet Order* grants the FCC jurisdiction to review and assess Internet traffic exchange arrangements set out in interconnection arrangements on a case-by-case basis under the just and reasonable and nondiscrimination principles in sections 201 and 202 of the Act, but declines to apply the "bright-line" rules and the no-unreasonable interference/disadvantage standard.[41]

Advisory Opinions

The *Open Internet Order* also establishes the use of advisory opinions "similar to those issued by the DOJ's Antitrust Division."[42] Advisory opinions will be

[36] *See* Preserving the Open Internet, 25 FCC Rcd. 17905 (2010).

[37] *Open Internet Order, supra* note 1, at paras. 23–24; *see also id.* at paras. 164–71.

[38] *Id.* at paras. 173–74.

[39] *Id.* at paras. 88–101.

[40] *Id.* at paras.196–201.

[41] *Id.* at paras. 195, 202.

[42] *Id.* at para. 229.

issued by the FCC's Enforcement Bureau; however, the Enforcement Bureau retains discretion over both timing and whether or not to respond to a request.[43] An advisory opinion is not a Commission-level decision and is not a binding on the FCC, and it may be revoked or revised by the Enforcement Bureau.[44] An advisory opinion may be requested by any entity subject to the FCC's jurisdiction, but the request must pertain to prospective or proposed conduct by the requesting entity, not hypothetical matters.[45] Requests for advisory opinions will not be subject to public comment.[46]

Deferred Issues

In addition to deferring the applicability of the network transparency rules to small BIAS providers, the FCC deferred action on two matters stemming from the classification of BIAS as a telecommunications service. First, the FCC exercised its forbearance authority to exclude BIAS revenues from universal service fund contribution obligations, pending resolution of an ongoing proceeding considering modifications to the universal service contribution rules.[47] Under section 254(d) of the Act,[48] interstate telecommunications services revenues are subject to universal service assessments.

Second, the FCC committed to developing customer propriety network information (CPNI) rules for BIAS[49] under section 222 of the Act.[50] As long as broadband was classified as an information service, section 222 did not apply. CPNI is customer-specific information that relates to the quantity, type, technical configuration, origination, and destination points of a customer's service that a telecommunications carrier obtains by virtue of the carrier-customer relationship.[51] The service provider may use CPNI in connection with or directly related to the category or categories of service it currently provides to the customer; other usage of CPNI would require customer consent.[52] The FCC's rules require that telecommunications carriers notify each customer of its right to restrict or allow the carrier to use CPNI in connection with the marketing of services unrelated to the services from which the CPNI is derived.[53] In the event there is a security breach involving a customer's CPNI, the service provider must notify the FBI and the Secret Service, but notice of the breach cannot be provided publicly or to the customer until seven business days after notice to those law enforcement agencies.[54]

[43] *Id.* at paras. 230–37.

[44] *Id.*

[45] *Id.*

[46] *Id.*

[47] *Id.* at paras. 486–92.

[48] 47 U.S.C. § 254(d) (2012).

[49] *Open Internet Order*, *supra* note 1, at paras. 462–67.

[50] 47 U.S.C. § 222 (2012).

[51] *Id.* § 222(h)(1).

[52] *Id.* § 222(c)(1).

[53] 47 C.F.R. § 64.2008 (2014).

[54] *Id.* § 64.2011.

Implications for Broadband Access Providers, Edge Providers, and End-Users

Broadband providers, including small local telephone companies, rural wireless carriers, small cable operators, broadband networks operated by local governments and non-profit organizations, and providers of fixed wireless service (principally fee-based Wi-Fi service) are subject to the *Open Internet Order*. Companies that provide Internet access service as an amenity for their patrons—such as hotels and universities—and businesses that deploy Wi-Fi for employees and invitees should take some comfort that the rules of the *Open Internet Order* do not apply to them.

Internet access service is the dominant platform for ecommerce, consumer and small business data communications, and all forms of information exchange and sharing. The enhanced transparency rule, the no-unreasonable interference/disadvantage standard, and the FCC's authority to regulate broadband providers under sections 201 and 202 of the Act establish a new and largely open-ended regulatory regime. It will require BIAS providers to reassess how they market and offer their broadband services. Individuals benefit because the widely held belief that the Internet should be an open forum for speech and information exchange is now codified in enforceable regulations. The *Open Internet Order* provides small businesses focused on ecommerce with a higher level of confidence that their websites will be as accessible as those of more established ecommerce firms. The enhanced transparency rule should provide all purchasers of BIAS with a better understanding of the broadband services they are acquiring. In light of the prohibition against paid prioritization, edge providers concerned about maximizing end-user access to their content should acquaint themselves, if they have not already done so, with the services offered by content delivery networks, such as Akamai and Limelight Networks.

The largely undefined distinction between BIAS and high speed Internet access provided to enterprises could prove problematic. Many edge providers and large businesses acquire Internet access service at data rates far in excess of mass market services intended for consumers and small businesses. The distinction could turn on the nature of the contract provided by the broadband provider. To the extent the service is not BIAS, the rules of the *Open Internet Order* do not apply.

Purchasers of enterprise-grade Internet access should consider including in the service agreements with their broadband providers the "bright-line" rules, the core principles of the no-unreasonable interference/disadvantage standard, the substantive aspects of the enhanced transparency rule, and relevant elements of the CPNI rule that the FCC is expected to adopt later this year.