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SUMMER 2018

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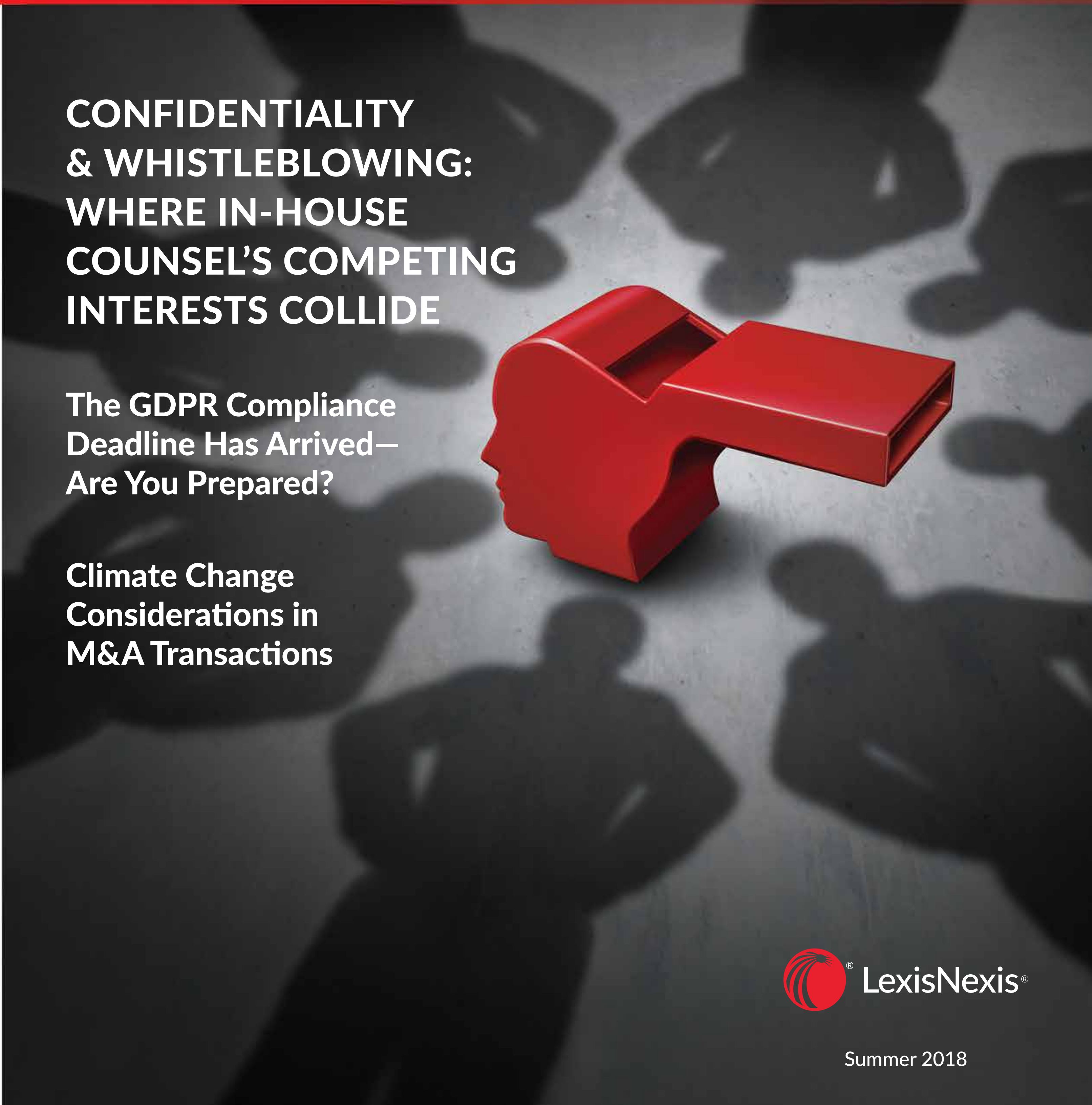

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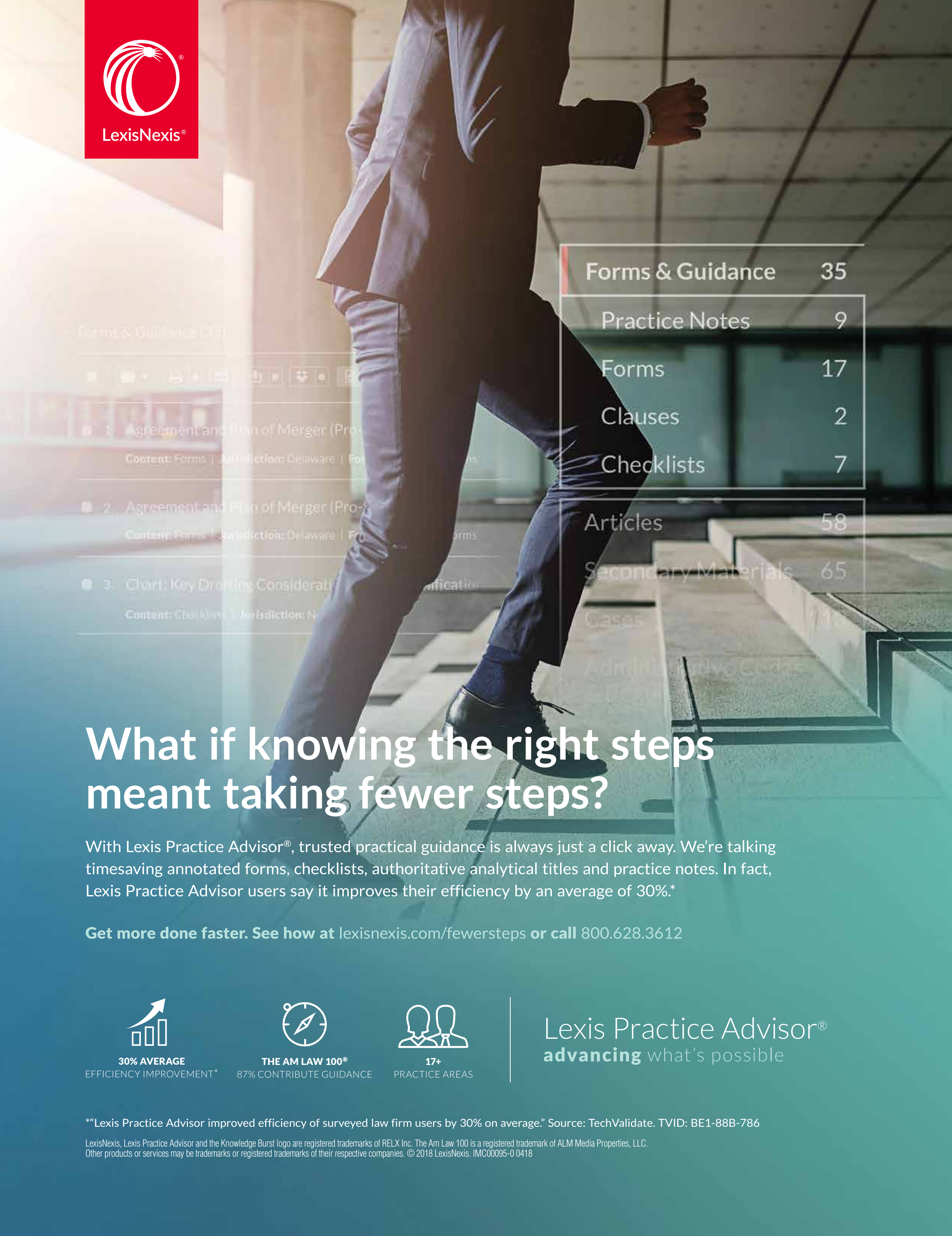
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Eric Bourget, Editor-in-Chief

SUMMER 2018 BRINGS WITH IT THE European Union's newly enacted General Data Protection Regulation (GDPR). The GDPR stretches far beyond Europe to American businesses as the regulations impact any companies offering goods and services and collecting personal data on EU citizens. Due to the widespread ramifications of these new regulations, it is important to understand how you or your client's business may potentially be impacted and how to comply. To assist you in understanding the GDPR, this edition of the Lexis Practice Advisor Journal reviews 10 key compliance areas that should be evaluated by all companies and organizations subject to the GDPR.

The GDPR is just one example of the increasing regulatory compliance in-house counsel must consider while facing greater pressure to meet business objectives. Our in-house ethics article discusses the delicate balance between serving as a trusted corporate advisor and honoring attorney-client privilege, while at the same time meeting the obligation to abide by federal and state reporting and disclosure requirements. Several recent decisions indicate a trend toward expanding whistleblower protections while also providing guidance on when in-house counsel may disclose privileged information without violating ethical obligations.

In order to introduce our new Federal Civil Practice offering released earlier this year, this edition features an article by renowned author, litigator, and lecturer James M. Wagstaffe, about various types of alternative dispute resolution (ADR) for federal cases and when courts may require parties to consider or participate in ADR. Additional litigation content focuses on strategies for counsel whose clients are involved in patent infringement and validity actions under the Drug Price Competition and Patent Term Restoration Act of 1984, commonly known as the Hatch-Waxman Act.

One of the highest-profile issues facing businesses today is climate change and finding ways to potentially mitigate risks associated with the same. Companies entering into certain merger and acquisition deals may need to be involved in climate change-related diligence as a growing number of industries are subject to regulations related to climate change. Direct risks to property and supply chains must also be considered. This edition includes questions that should be considered in M&A transactions regardless of whether the target company operates in a carbon-intensive industry.

Another important concern regarding mergers is compliance with antitrust laws throughout the due diligence process. This issue of the Lexis Practice Advisor Journal features guidance from our new Antitrust offering and provides advice on avoiding inappropriate information sharing, how to create documents related to the transaction, and the potential impact of these documents in a government investigation. It also discusses preparation for government document requests, and potential legal strategies to achieve antitrust clearance.

Our Top 10 Practice Tips article offers advice related to private placement transactions. Companies have a broad range of potential private financing opportunities that are less costly than traditional public registered securities offerings because of recent changes to laws and SEC interpretations. We provide these important tips for lawyers guiding companies through planning, implementation, and execution of private placement transactions.

The Lexis Practice Advisor Journal provides you with a broad sampling of practical guidance and insights that may be found in our online Practical Guidance workflow tool, Lexis Practice Advisor, as well as relevant articles that will bring you up to speed on current issues and trends and will undoubtedly serve as entry points into deeper analytical research.

Our mission

The Lexis Practice Advisor Journal™ is designed to help attorneys start on point. This supplement to our online practical guidance resource, Lexis Practice Advisor®, brings you a sophisticated collection of practice insights, trends, and forward-thinking articles. Grounded in the real-world experience of our 850+ seasoned attorney authors, the Lexis Practice Advisor Journal offers fresh, contemporary perspectives and compelling insights on matters impacting your practice.

SUPREME COURT AFFIRMS CONSTITUTIONALITY OF AIA PATENT REVIEW PROCESS

A PROVISION IN THE AMERICA INVENTS ACT (AIA) allowing for pre-trial review of existing patents does not violate Article III or the Seventh Amendment of the U.S. Constitution, the U.S. Supreme Court has held.

In Oil States Energy Servs., LLC v. Greene's Energy Grp., LLC, 2018 U.S. LEXIS 2630 (April 24, 2018), the high court affirmed, 7-2, a decision of the U.S. Court of Appeals for the Federal Circuit upholding a decision by the U.S. Patent and Trademarks Appeal Board (PTAB) of the U.S. Patent and Trademark Office (PTO) invalidating several claims of a patent held by Oil States Energy Services LLC.

Oil States filed an infringement action against a competitor, Greene's Energy Group. Greene's responded with an allegation of patent invalidity and sought review by the PTAB under Section 311 of the AIA, which allows any party other than the patent owner to seek inter partes review of an existing patent. The PTAB found several claims of the Oil States patent invalid. The Federal Circuit affirmed, and the Supreme Court granted Oil States' petition for writ of certiorari.

Before the high court, Oil States argued that the AIA review process allows a government panel to extinguish property rights in violation of Article III and the Seventh Amendment. In response, Greene's contended that patents constitute public rights subject to review by a non-Article III tribunal.

In an opinion by Justice Clarence Thomas, the Supreme Court said, "This Court has recognized, and the parties do not dispute, that the decision to grant a patent is a matter involving public rights—specifically, the grant of a public franchise. Inter partes review is simply a reconsideration of that grant, and Congress has permissibly reserved the PTO's authority to conduct that reconsideration. Thus, the PTO can do so without violating Article III."

Based on that reasoning, the court also dismissed the Seventh Amendment challenge, citing its own precedents holding that "when Congress properly assigns a matter to adjudication in a non-Article III tribunal, 'the Seventh Amendment poses no independent bar to the adjudication of that action by a nonjury factfinder.'"

Justices Anthony Kennedy, Ruth Bader Ginsburg, Stephen Breyer, Samuel Alito, Sonia Sotomayor and Elena Kagan joined in the majority opinion. Justice Neil Gorsuch filed a dissenting opinion, in which Chief Justice John Roberts joined.

- Lexis Practice Attorney Team

RESEARCH PATH: *Intellectual Property & Technology > Patents > PTAB Proceedings > Articles*

U.S., UK GOVERNMENT AGENCIES WARN OF RUSSIAN CYBER EXPLOITATION

THE U.S. DEPARTMENT OF HOMELAND SECURITY, the Federal Bureau of Investigation (FBI), and the United Kingdom's National Cyber Security Centre issued a warning in joint Technical Alert TA-18-106A, https://www.us-cert.gov/ncas/alerts/TA18-106A, about the "worldwide cyber exploitation of network infrastructure devices (e.g., router, switch, firewall, Network-based Intrusion Detection System (NIDS) devices) by Russian state-sponsored cyber actors."

According to the technical alert, targets are "primarily government and private-sector organizations, critical infrastructure providers, and the internet service providers (ISPs) supporting these sectors."

The report contains technical details on the tactics, techniques, and procedures used by Russian state-sponsored cyber actors to compromise victims.

The agencies said the FBI has "high confidence that Russian state-sponsored cyber actors are using compromised routers to conduct man-in-the-middle attacks to support espionage, extract intellectual property, maintain persistent access to victim networks, and potentially lay a foundation for future offensive operations."

- Pratt's Bank Law & Regulatory Report, Volume 52, No. 5

RESEARCH PATH: *Finance > Financial Services Regulation > Financial Institution Activities > Articles*

FDIC MOVES TO ELECTRONIC FINGERPRINTING FOR BACKGROUND CHECKS

THE FEDERAL DEPOSIT INSURANCE CORPORATION (FDIC) is moving to electronic fingerprinting to facilitate background checks performed in connection with applications and notices submitted to the FDIC, including applications for federal deposit insurance, notices of acquisition of control, requests for participation in the banking industry by individuals with certain criminal convictions, and notices to replace board members or senior management in certain institutions.

During the second quarter of 2018, the FDIC will begin using electronic fingerprinting technology to capture individuals' fingerprints and transmit them to the FBI. Individuals will be able to be fingerprinted at more than 1,000 collection sites, across all 50 states, the District of Columbia, Puerto Rico, and the Virgin Islands.

The FDIC said the new fingerprinting technology automatically rates the quality of the fingerprints, thereby significantly reducing poor quality fingerprint samples.

The new process applies to all FDIC-insured institutions.

- Pratt's Bank Law & Regulatory Report, Volume 52, No. 5

RESEARCH PATH: *Finance > Financial Services Regulation > Financial Institution Activities > Articles*

HUD, DOJ TARGET SEXUAL HARASSMENT IN HOUSING

THE U.S. DEPARTMENT OF HOUSING AND URBAN Development (HUD) and Department of Justice (DOJ) announced the nationwide rollout of an initiative aimed at increasing awareness and reporting of sexual harassment in housing. The initiative includes an interagency task force to combat sexual harassment in housing, an outreach toolkit, and a public awareness campaign.

"All discrimination stains the very fabric of our nation, but HUD is especially focused on protecting the right of everyone to feel safe and secure in their homes, free from unwanted sexual harassment," said HUD Secretary Ben Carson. "No person should have to tolerate unwanted sexual advances in order to keep a roof over his or her head."

"Sexual harassment in housing is illegal, immoral, and unacceptable," said Attorney General Jeff Sessions. "It is all too common today, as too many landlords, managers, and their employees attempt to prey on vulnerable women. We will not hesitate to pursue these predators and enforce the law. An enforcement initiative launched in October 2017 has already led to relief for 15 victims."

HUD highlighted three major components in the initiative:

- A new HUD-DOJ Task Force to Combat Sexual Harassment in Housing focusing on five key areas: continued data sharing and analysis, joint development of training, evaluation of public housing complaint mechanisms, coordination of public outreach and press strategy, and review of federal policies
- An outreach toolkit providing templates, guidance, and checklists based on pilot program feedback
- A public awareness campaign with three major components: a partnership package with relevant stakeholders, launch of a social media campaign, and public service announcements run by the Executive Office of U.S. Attorneys

- Pratt's Bank Law & Regulatory Report, Volume 52, No. 5

RESEARCH PATH: *Finance > Financial Services Regulation > Financial Institution Activities > Articles*

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Timothy Murray MURRAY, HOGUE & LANNIS

Liquidated Damages
Drafting Blunders

Parties drafting contracts often want to set in stone the precise dollar amount of damages that will be awarded in the event of a breach, commonly called liquidated damages. The idea is that if a breach occurs, this provision makes it unnecessary for the aggrieved party to prove actual damages. The benefits of such a provision—promoting certainty and eliminating the litigation expense of proving damages—are obvious.

BUT EVEN WHEN THESE PROVISIONS ARE FREELY ENTERED into by sophisticated parties, they are often not enforced. The fact that clients, and it seems too many attorneys, do not understand *why* they aren't enforced can lead to costly drafting errors.

In order for a liquidated damages provision to be enforceable (1) the loss or harm from a breach of the contract must be uncertain or difficult to prove with certainty, and (2) the liquidated damages must be reasonable in light of the anticipated or actual damages caused by the breach.[1] The second prong of this test is a modification of the traditional common law test, which required liquidated damages to be a reasonable forecast of damages at the time of contract formation.[2] In contrast, the modern test allows a second look—even if liquidated damages were an unreasonable forecast at the time of contract formation, the provision will be enforced if it turns out to be a reasonable approximation of the actual damages incurred.[3]

For attorneys steeped in the tradition of freedom of contract, a rule that negates a freely negotiated provision might seem jarring. Esteemed former Judge Richard Posner called the law of liquidated damages "mysterious" and voiced what a lot of attorneys have pondered: "[I]t is difficult to see why the law should take an interest in whether the estimate of harm underlying the liquidation of damages is reasonable. Courts don't review the other provisions of contracts for reasonableness; why this one?"[4]

Another jurist provided a more biting critique:

> As children, we learn that the rules of the playground dictate that if someone makes a promise, no matter how solemnly, it is unenforceable if the person making the promise had his fingers crossed behind his back. As we grow up, we learn instead that many promises are moral and legal obligations, with consequences properly attached to breaking them. Still, some grown-ups prefer the playground rules.[5]

If the law of liquidated damages is baffling for judges, it can be downright nonsensical to clients who often want to include a liquidated damages provision in their contracts, not to provide a reasonable estimate of possible damages but to motivate the other party to perform. The thinking goes, if the agreed damages are sufficiently severe, the other party will be all the more reluctant to breach. While there is nothing wrong with using liquidated damages to motivate the other party to perform, clients need to understand that the amount of liquidated damages can't be plucked out of the air—it must bear a reasonable nexus to the actual harm, anticipated or actual.

Why are so many liquidated damages provisions held to be unenforceable, and how can this result be avoided? A closer look at the two-prong test is necessary.

The Two Prongs

Uncertainty. The first prong of the test—the actual damages arising from a breach of the contract must be uncertain or difficult to prove with certainty—usually is not the problem. "[N]ot many cases have appeared to turn primarily" on this prong, but "a liquidated damages clause is most useful to the parties and most likely to be upheld in cases where actual damages are most difficult to prove, as in the case of a covenant not to compete ancillary to the sale of a business, for breach of a franchise agreement . . . ."[6] This is because the more uncertain the damages, the greater the free reign the parties have in arriving at a reasonable estimate of them.[7] The corollary is that the more certain the actual damages, the less freedom drafters have in setting liquidated damages.

In *Ramada Worldwide v. Key Hotel of Brewton*,[8] Ramada entered into a franchise agreement with Key Hotel requiring the latter to operate a 90-room hotel under the Ramada name for 15 years. The contract provided that in the event Key Hotel breached, it would owe Ramada $1,000 per guest room. Less than four years into the contract term, Ramada terminated the franchise due to Key Hotel's breaches. In the ensuing litigation, the court held that $90,000 in liquidated damages ($1,000 per room) was not excessive. The liquidated damages were "meant to replace the income that Ramada would have received if [not] for the premature termination of the License Agreement. . . . I accept that such damages cannot be known with precision, and must be estimated."

Another apt candidate for liquidated damages is a restrictive covenant that accompanies the sale of a business and obligates the seller to refrain from competing with the buyer for a certain period of time after the transaction. In the event the seller takes customers from the buyer in breach of the agreement, the buyer likely will suffer damages far in excess of the dollar amount of immediate business lost—damages that cannot be known with precision. Absent the breach, the customers wrongly taken might have remained customers of the buyer far into the future.[9]

All manner of agreements might be apt candidates for liquidated damages, including confidentiality and non-disclosure agreements. Breaches of these sorts of agreements might also merit injunctive relief, and a valid liquidated damages clause does not in itself bar such relief.[10]

Reasonable in light of anticipated or actual damages. The second prong of the test is the real battleground—it's the reason courts generally give for holding liquidated damages unenforceable. This prong promotes the very purpose of contract law damages: to compensate aggrieved parties, not to punish breaching parties. In fact, the word "compensation" routinely pops up in judicial decisions explaining liquidated damages. When a provision stipulating to damages is punitive in nature—that is, when it is unreasonable in light of anticipated or actual damages—the provision will be stricken, but the contract otherwise will still be enforced. In that case, the aggrieved party can attempt to prove his or her actual damages with reasonable certainty. The damages may not be sufficiently certain to afford a remedy if the prospective uncertainty of damages inspired the parties to agree on a liquidated damages provision in the first place.

Though it is impossible in a short article to chronicle the many ways contracts run afoul of this prong of the test, here are some common traps for the unwary.

A Number Is Plucked Out of the Air

In *Dobson Bay Club II DD, LLC v. La Sonrisa de Siena, LLC,*[11] a bank loaned Dobson Bay $28.6 million to purchase commercial properties. To repay the loan, Dobson Bay agreed to make interest-only payments until the loan maturity date, at which time the entire principal would be due in a balloon payment. For any delay in payment, Dobson Bay agreed to pay interest, default interest, collection costs including reasonable attorney fees, *and* a 5% late fee assessed on the payment amount (the 5% late fee would become the point of contention). Dobson Bay missed the deadline to make the balloon payment. The lender sued, and Dobson Bay proceeded to pay off everything—except the 5% late fee, amounting to nearly $1.4 million. The court held that the 5% late fee was an unenforceable penalty because it did not reasonably forecast the lender's anticipated

1. *See, e.g.*, Restatement (Second) of Contracts § 356 (Am. Law Inst. 1981) and U.C.C. § 2-718(1). 2. John E. Murray, Murray on Contracts § 126 (5th ed. 2011). 3. Make sure to check the law in the governing jurisdiction to see if it follows the modern or traditional test. Note that even if a jurisdiction has adopted the modern test, it is not uncommon for courts to still cite the traditional test—the court might have to be educated on this point. 4. XCO Int'l, Inc. v. Pac. Sci. Co., 369 F.3d 998, 1001 (7th Cir. 2004). 5. Dobson Bay Club II DD, LLC v. La Sonrisa de Siena, LLC, 393 P.3d 449, 457-458 (Ariz. 2017) (Bolick, J., dissent).

6. 11-58 Corbin on Contracts § 58.7 (2017). 7. Metlife Capital Fin. Corp. v. Wash. Ave. Assocs. L.P., 732 A.2d 493, 498 (N.J. 1999). "If the damages caused by a breach are difficult to estimate, either at the time of contracting or at the time of breach, the likelihood that a liquidated damages clause will be sustained is greatly increased." 11-58 Corbin on Contracts § 58.7 (2017). 8. 2016 U.S. Dist. LEXIS 95790 (D.N.J. July 22, 2016). 9. Ferraro v. M & M Ins. Group, 2017 Pa. Super. Unpub. LEXIS 4551 (Dec. 12, 2017). 10. 12-65 Corbin on Contracts § 65.33 (2017). 11. 393 P.3d 449.

damages likely to result from an untimely balloon payment. The handling and processing costs, and the loss of use of that money, were addressed in other fees assessed against Dobson Bay aside from the 5% late fee. The lender was not able to articulate how, precisely, anything approaching $1.4 million was necessary to compensate for any other alleged damages due to a late payment.

One Size Does Not Fit All

Among the common drafting errors is to assign as liquidated damages a single dollar amount for all possible breaches, even when they vary in severity. In the *Dobson Bay* case, discussed above, the court found it important that the 5% late fee was payable regardless of how late a payment would be: "Five percent of the loan principal is a significant sum of money, which did not likely reflect losses from a short delay in payment. Because the fee did not account for the length of time [the lender] would be deprived of the balloon payment, the fee could not reasonably predict the Bank's loss."[12]

In another case,[13] two companies offered competing training programs for cheerleading and gymnastics students. The parties explored the possibility of a complete merger and agreed that in the event they didn't merge, they would not "contact, recruit, train or except [accept] any athlete training" with the other party for one year. The contract provided: "Violating this clause will result in a $10,000 fine." The parties decided not to merge, and the defendant breached by contacting and recruiting plaintiff's athletes. The court held that the contract called for an unenforceable penalty and was not based on anticipated or actual loss. It "provides for the award of liquidated damages of $10,000 whenever defendant has only contacted or recruited a student," yet those kinds of breaches would not result in actual damages "unless the athlete moved to the other program."[14]

A Penalty Can't Be Gussied up as Liquidated Damages

To justify the agreed damages provisions in their contracts, parties routinely include pro forma language pronouncing that the agreed damages are "liquidated and not a penalty." Courts generally don't credit these characterizations,[15] though some courts have stated that they are entitled to some weight.[16] It is widely settled that the aforementioned two prongs are what really matter.

Instead of plopping boilerplate language into the contract to justify the liquidated damages provision, it would be more persuasive if the drafter succinctly summarized the specific rationale for the dollar amount chosen.

Disguised Penalties

Sometimes parties agree that one of them will pay the other a sum of money, and if it isn't paid by a certain date, the party in breach must pay a significant additional sum. The parties often characterize this arrangement as a "discount" for early payment, but courts generally see through it and call it what it is—a disguised penalty.

In *Leaman v. Wolfe*,[17] Leaman sued Wolfe, and the two entered into a settlement agreement that required Wolfe to execute a judgment note providing for a series of 31 installment payments totaling $475,000—plus an additional $100,000 to be "waived . . . and not . . . due and owing . . . [u]pon Wolfe's timely payment of the . . . [31] installments." Wolfe twice failed to make installment payments by the due dates. Per the agreement, Leaman filed a judgment note in the amount of $100,000, plus the entirety of the then unpaid balance, attorney's fees, and costs. Wolfe challenged the $100,000 charge, and the court held it was an unenforceable penalty: "[A] $100,000 charge in the event of an untimely payment is extravagant and disproportionate to any reasonable estimate of damages accrued using the applicable interest rate."[18]

Similarly, in *Vitatech Internat., Inc. v. Sporn*,[19] Vitatech and defendants agreed to settle a dispute for $75,000, but they stipulated that Vitatech could enter judgment against the defendants in the full amount of Vitatech's much greater original claim if the defendants did not pay the $75,000 settlement by the designated due date. Defendants failed to pay the $75,000 by the due date, and Vitatech entered judgment against defendants on the original claim for more than $300,000. The court rejected Vitatech's argument that its agreement to accept $75,000 was merely a discount to encourage defendants to make prompt and timely payment. The $300,000 was an unenforceable penalty because it bore no reasonable relationship to the damages from defendants' failure to timely pay the $75,000 settlement. While parties may offer a discount for prompt performance, it will be unenforceable if it is so sizable that it is in reality a disguised penalty.[20]

Per Diem Liquidated Damages

Many contracts state that time is of the essence for completion of construction projects and impose per diem liquidated damages for delay in completing performance.

12. 393 P.3d 453. 13. Premier Gym & Cheer v. All-American Cheer & Dance Elite, 2016 Pa. Dist. & Cnty. Dec. LEXIS 17545 (July 13, 2016). 14. *Id.* at *8-9. 15. Wilmington Housing Authority v. Pan Builders, Inc., 665 F. Supp. 351 (D. Del. 1987). 16. Walter Motor Truck Co. v. State, 292 N.W.2d 321 (S.D. 1980). 17. 629 Fed. Appx. 280 (3d Cir. 2015). 18. *Id.* at 283. 19. 16 Cal. App. 5th 796 (2017). 20. See also Wis-Bay City, LLC v. Bay City Partners, LLC, 2009 U.S. Dist. LEXIS 49806 (N.D. Ohio June 12, 2009). Where the contract spells out a late charge for failure to pay a sum of money owed that is significantly larger than the sum owed beyond the interest value of the sum owed and lost opportunity costs, courts have little difficulty finding the provision unenforceable.

Related Content

For guidance in determining whether a stipulated sum is for valid liquidated damages or an invalid and unenforceable penalty, see

> **UCC LIQUIDATED DAMAGES**

RESEARCH PATH: *Corporate Counsel > Commercial Agreements > Breach and Remedies > Practice Notes*

For a discussion on the intersection of liquidated damages and mitigation of damages, see

> **MITIGATION OF DAMAGES IN SALE OF GOODS CONTRACTS**

RESEARCH PATH: *Corporate Counsel > Commercial Agreements > Breach and Remedies > Practice Notes*

For a list of the types of damages that may be sought for the breach of a contract, see

> **DAMAGES FOR BREACH OF A COMMERCIAL CONTRACT CHECKLIST**

RESEARCH PATH: *Corporate Counsel > Contract Formation > Contract Clauses > Checklists*

"Since the injury caused by such delay is nearly always difficult to determine, the courts strongly incline to accept the estimate as reasonable and to enforce such provision."[21]

Liquidated damages are particularly useful in imposing damages for government infrastructure contracts.[22] In those cases, "the delay in use of, for example, a highway, by the public is difficult to project and measure."[23] Damages arising from a contractor's delay are generally enforced given this uncertainty, especially where "the amounts of liquidated damages [are] graduated according to the size of the project"[24] and the liquidated damages bear a reasonable relation to damages reasonably anticipated.

These sorts of clauses are so common, there is a temptation to think they are automatically enforced. Yet, in many cases, per diem liquidated damages are held to be penalties because the evidence shows that the actual damages were greatly disproportionate to the liquidated damages.[25]

Under the extreme case doctrine, per diem liquidated damages are not enforced because evidence affirmatively shows that the delay caused no loss whatsoever. An example: where a "race track's completion was delayed by 10 days, but the permit for opening the race track was delayed for one month; thus, the delay in construction did not delay the race track's opening and caused no loss."[26]

Making Liquidated Damages Optional

The courts are split as to whether the contract can allow an option to choose between actual and liquidated damages. Some courts have disallowed such an option on the basis that it is penal in nature. There is a fear that with such an option, liquidated damages would only be sought when actual damages do not exceed the amount of liquidated damages. Other courts allow such an option, noting that even if actual damages appear greater, a party might opt for liquidated damages to avoid the uncertainty and proof issues associated with actual damages.[27] This is another area where it is necessary to consult the law in the applicable jurisdiction.

Conclusion

Liquidated damages provisions should not be a drafting landmine—and there should not be anywhere near as many cases holding them unenforceable as there are. It's this simple: if the parties want to include a liquidated damages provision in their contract, they need to anticipate how the contract might be breached and what damages would reasonably result from any such breaches—then they can assign a dollar figure that mirrors that forecast as their liquidated damages. The problem is, too many drafters try to use liquidated damages solely for a purpose the law doesn't recognize: to motivate the other party to perform. These drafters are under the misapprehension that there is such a thing as unbridled freedom of contract.

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RESEARCH PATH: *Corporate Counsel > Commercial Agreements > Breach and Remedies > Practice Notes*

21. 11-58 Corbin on Contracts § 58.21 (2017). 22. Boone Coleman Constr., Inc. v. Vill. of Piketon, 50 N.E.3d 502 (Ohio 2016); United States ex rel. Ash Equip. Co. v. Morris, Inc., 2017 U.S. Dist. LEXIS 126509 (D. S.D. Aug. 8, 2017). 23. 2017 U.S. Dist. LEXIS at *43. 24. Id. 25. Brinich v. Jencka, 757 A.2d 388 (Pa. 2000). *See also* 11-58 Corbin on Contracts § 58.21 (2017). 26. Int'l Marine, L.L.C. v. FDT, L.L.C., 619 Fed. Appx. 342, 351, n. 9 (5th Cir. 2015), citing Restatement (Second) of Contracts § 356 cmt. b, ill. 4 (Am. Law Inst. 1981). 27. *See* Ravenstar, LLC v. One Ski Hill Place, LLC, 401 P.3d 552 (Colo. 2017), explaining the two positions

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Top 10 Practice Tips: **Private Placement Transactions**

IN RECENT YEARS, THE STAFF OF THE U.S. SECURITIES AND Exchange Commission (SEC) has undertaken an initiative to bolster capital formation, including by providing companies more flexibility to access U.S. capital markets. As a result, recent changes to law and SEC interpretations provide companies with a broad range of potential private financing opportunities that can be executed more quickly and with less expense than traditional public registered securities offerings. However, the rapidly changing legal and regulatory landscape has also introduced additional nuances and complexity to be considered in the context of these offerings.

Because the consequences of mistakes in a private placement transaction can be severe, it is important for lawyers advising companies in connection with private placements to maintain a deep understanding of evolving securities laws and their interpretations in order to guide these companies in successfully planning, implementing, and executing their private placement transactions. Below are 10 practice points that you should be mindful of in steering a private placement transaction from start to finish.

1 Understand the company's goals and needs.

Private placements, including private investments in public equities (PIPEs), provide companies with great flexibility, allowing them to issue a variety of instruments—common or preferred equity securities, straight or convertible debt securities, warrants, units, and/or bespoke securities—tailored to meet their particular financing needs. A company considering a private placement may not be familiar with the range of securities available and may not fully appreciate how a particular security fits within its existing capital structure. As a starting point, you should discuss with the company its strategic objectives for the proposed financing within the context of its existing capital structure and, within this

framework, assist the company in deciding what type of security is best suited to the company's goals and needs.

2 Find your U.S. federal securities law exemption for issuance and understand resale limitations.

Private placements occur within a complex and evolving regulatory framework of U.S. federal securities laws, stock exchanges' rules, regulators' interpretations, and companies' own limitations under their existing capital structures. For purposes of U.S. federal securities laws, the fundamental principle is that a company may not offer or sell securities unless the transaction has been registered with the SEC or an exemption from registration is available. For a private placement to comply with the U.S. federal securities laws, there must be a valid exemption from the registration requirements available, and the terms and execution of the proposed offering and sale must comply with the requirements of that exemption. You should engage in a collaborative exercise with the issuing company to identify the exemption that is best suited to the proposed transaction from the range of available exemptions, including, among others:

- Section 4(a)(2) exemption (Section 4(a)(2)) under the Securities Act of 1933, as amended, 15 U.S.C. § 77a et seq., (Securities Act)
- Safe harbors of Regulation D under the Securities Act
- Quasi-public offering structure of Regulation A (informally known as Regulation A+) under the Securities Act
- Crowdfunding exemption under Section 4(a)(6) of the Securities Act (Section 4(a)(6))
- Exemption for private placements under Rule 144A of the Securities Act (Rule 144A)
- Offshore transaction exemption under Regulation S of the Securities Act
- Exchange offer exemption of Section 3(a)(9) of the Securities Act

In order to choose an appropriate exemption, it will be necessary to know various key facts, including the proposed size of the potential offering, identity of the potential investors (and how they will be identified), location of potential investors, whether an investment bank will be engaged to facilitate the offering and, if so, in what capacity, the nature and extent of the marketing and distribution process, and other factors.

Most securities sold in private placements will be restricted securities that may not be resold unless the company registers the resale with the SEC or an exemption from the registration requirements is available for the resale. You should make sure that any restricted securities issued in a private placement bear an appropriate restrictive legend, which indicates these resale restrictions. The company will receive inquiries from holders about how to resell the securities that they acquire in the private placement, and you should familiarize yourself with potential resale exemptions and applicable state law about when and how a restrictive legend can be removed from restricted securities.

The most commonly utilized exemption for the resale of restricted securities is Rule 144 of the Securities Act (Rule 144), which permits the public resale of securities if a number of conditions are met. Among other things, Rule 144 requires that restricted securities be held for a certain period of time before they can be sold in the public market and that there be adequate current information about the issuing company available to potential purchasers. Where the holder of restricted securities is, or has been, an affiliate of the company, these securities are referred to as control securities, and additional technical requirements apply with respect to the volume of securities that can be sold, the manner in which they can be sold, and the filing of a notice of sale with the SEC under certain circumstances.

If the company agrees to register the resale of the restricted securities pursuant to a resale registration rights agreement (as is common in PIPE transactions) or otherwise, you should determine which SEC registration forms are available to the company and ensure that the company is aware of the timing, cost, and effort involved in the registration process. In connection with a registered resale, you should review the SEC's guidance regarding so-called disguised primary offerings (e.g., Securities Act Rules Compliance & Disclosure Interpretation 612.09) and extreme convertibles (i.e., the SEC staff's restrictive application of Rule 415 under the Securities Act for secondary offerings), which can raise issues about the size of the resale transaction relative to the number of the company's shares outstanding.

3 Don't forget the company's existing obligations.

Companies typically have outstanding securities, existing contracts, and regulatory obligations that may impose limitations or requirements on the issuance of new securities in a private placement. It is important at the outset to review the company's existing agreements (e.g., organizational documents, outstanding instruments, preemptive rights agreements, and shareholders agreements, among others) and to consider existing regulatory obligations (e.g., public company disclosure requirements—particularly in the case of PIPEs, stock exchange requirements, and any industry-based ownership limitations) to determine whether any parties have rights in connection with the private placement or whether the private placement will trigger any existing obligations. For example, you should consider:

- Whether the company's organizational documents permit the proposed transaction or require shareholder votes or amendments before the transaction can proceed (such as an amendment to increase the number of authorized equity securities)
- Whether the holders of existing securities have been granted any preemptive rights, rights of first refusal, or similar rights to participate in the transaction, or whether the transaction triggers conversion, anti-dilution, or other rights under existing instruments

- If the company is a public reporting company (particularly, in the case of PIPEs), whether the transaction triggers disclosure obligations pursuant to the requirements of a Current Report on Form 8-K or under Regulation FD

4 Watch your 20% rule.

If the company's stock is listed on the New York Stock Exchange (NYSE) or the Nasdaq Stock Market (Nasdaq) and the offering is of equity or an equity-linked instrument (such as convertible debt, convertible preferred stock, or warrants), then you must pay attention to the relevant exchange's 20% rule. As a general matter, for private placements the 20% rule requires shareholder approval of issuances of stock or equity-linked instruments representing over 20% of the pre-deal outstanding common stock or voting power, if the offering price or strike price is less than the market price of the stock or book value per share immediately preceding the transaction. Some important considerations in assessing the 20% rule are as follows:

- Each transaction must be considered separately, on a case-by-case basis, with attention to when the applicable stock exchange's rules might require aggregating multiple issuances for purposes of the 20% rule.
- The exchanges' rules and interpretations are detailed and differ from each other.
- Registered direct and other hybrid offerings, as well as exchange offers, may be covered by the 20% rule.
- A foreign private issuer is not required to follow the rule, subject to certain procedural requirements to confirm to the stock exchange that the rule is not required by its home country's practices.
- Failure to comply with the rule can result in delisting, disclosure of which is required by the filing with the SEC of a Current Report on Form 8-K.

5 Remember to analyze blue sky and world sky issues.

U.S. state and non-U.S. governments have their own securities laws and regulations—referred to as blue sky laws, in the case of U.S. states, and world sky laws, in the case of foreign governments—which can serve as a trap for the unwary in connection with certain private placement transactions. Federal preemption rules and the National Securities Markets Improvement Act of 1996 (NSMIA) created a limited class of covered securities that are not subject to blue sky registration requirements. Covered securities include:

- Securities listed (or approved for listing) on the NYSE, Nasdaq, or other approved national securities exchanges
- Securities where the same company has a class of securities with equal or greater seniority listed on any exchange identified in the prior bullet
- Securities issued by an investment company registered under the Investment Company Act of 1940
- Securities sold to certain qualified purchasers (a term that the SEC has not yet defined, although it has proposed—but not approved—a definition that would mirror the definition of accredited investors in Regulation D under the Securities Act)
- Securities issued under specified exemptions from the registration requirements of the Securities Act, including secondary market transactions under Sections 4(a)(1) or 4(a)(3) of the Securities Act, securities of an SEC-reporting company brokers' transactions exempt under Section 4(a)(4) of the Securities Act, crowdfunding transactions under Section 4(a)(6), certain (but not all) offers and sales exempt under Section 3(a) of the Securities Act, and securities exempt under Rule 506 of Regulation D under the Securities Act (Rule 506) transactions (but not Section 4(a)(2) itself)

You should carefully analyze whether the securities to be issued in a private placement are covered securities—if not, the offer and sale of these securities remains subject to the requirements of applicable blue sky laws, including state-level registration requirements. In addition, even where securities are covered securities, federal preemption rules still permit states to require notice filings and the payment of fees for offers and sales of covered securities within their borders. Form D, which is required to be filed with the SEC in connection with offerings under Regulation D, can often be used to satisfy blue sky notice requirements, but you should be careful to review all relevant blue sky requirements well ahead of the closing of a private placement transaction. You should also keep in mind that state-level broker-dealer and salesperson compliance requirements are not preempted under NSMIA, and persons or entities selling or distributing securities must always comply with such state requirements or identify an available exemption.

Whether or not securities are covered securities for U.S. federal preemption, any offer and sale of securities in non-U.S. jurisdictions remain subject to the requirements of applicable world sky laws, which you should vet with local counsel in the relevant jurisdictions.

6 Make sure that broker-dealers are aware of applicable FINRA rules.

If you represent a broker-dealer that is participating in a private placement (e.g., as a placement agent), you should remember that certain Financial Industry Regulatory Authority (FINRA) rules apply, including certain filing requirements and due diligence requirements.

With respect to filing requirements, you should familiarize yourself with FINRA Rules 5122 and 5123, among others, which are available at http://finra.complinet.com/en/display/display_main.html?rbid=2403&element_id=4584. Subject to certain exemptions for securities placed solely with specified categories of investors:

- Under Rule 5122, any broker-dealer offering and selling its own securities (or those of a control entity) must include specified disclosures within the offering materials, file with FINRA at or prior to their first use any offering materials provided to prospective investors, and apply the offering proceeds for permitted business purposes.
- Under Rule 5123, any broker-dealer participating in a private placement must within 15 calendar days of the first sale, file with FINRA all offering documents that were provided to potential investors or indicate to FINRA that no such offering materials were used.

With respect to due diligence requirements, FINRA has provided guidance to broker-dealers that they have an obligation to conduct a reasonable investigation of an issuer and the securities offered in connection with private placement transactions. In addition, FINRA's Rule 2111, which is available at http://finra.complinet.com/en/display/display_main.html?rbid=2403&element_id=9859, requires broker-dealers to conduct a suitability analysis when recommending securities to both accredited and non-accredited investors, which should take into account the investors' knowledge and experience.

7 Weigh any integration issues.

Often, companies execute private placement transactions concurrent with, or in close proximity to, separate private or public offerings. In such cases, the SEC's integration doctrine addresses whether a putative private placement should be considered and required to be registered as a public offering. This can occur in two settings: (1) ostensibly distinct exempt offerings that are, in reality, a single offering that does not quality for an exemption from the registration requirements of the federal securities laws, and (2) an exempt offering that is, in reality, part of a purportedly separate registered public offering.

The SEC has clarified that different analytical frameworks apply to concurrent, or temporally serial, transactions solely involving private placements versus involving both a private placement and a public offering. In addition, the SEC has adopted numerous safe harbors, highlighted below, to provide certainty with respect to specific scenarios that might otherwise give rise to integration concerns.

Related Content

For an overview of private placements, see

> PRIVATE PLACEMENTS RESOURCE KIT

RESEARCH PATH: *Capital Markets & Corporate Governance > Private Offerings > Private Placements > Practice Notes*

For more information on issues to consider when conducting a private placement of securities, see

> PRIVATE PLACEMENT CONSIDERATIONS

RESEARCH PATH: *Capital Markets & Corporate Governance > Private Offerings > Private Placements > Practice Notes*

To see a checklist of tasks to be undertaken in the closing of a private offering, see

> CLOSING CHECKLIST (PRIVATE OFFERING OF PREFERRED SHARES)

RESEARCH PATH: *Capital Markets & Corporate Governance > Private Offerings > Private Placements > Checklists*

To learn more about private offering exemptions, see

> PRIVATE OFFERING EXEMPTIONS

RESEARCH PATH: *Capital Markets & Corporate Governance > Private Offerings > Private Placements > Practice Notes*

In the case of concurrent or sequential private placement transactions, the SEC has developed a fulsome—albeit technically complex—integration doctrine to prevent companies from taking a transaction that would require registration with the SEC and breaking it up into several transactions, each of which individually may be claimed to be purportedly exempt from registration. You should carefully consider the integration analysis prior to commencing a private placement. Integration can cause a previously completed private placement to interfere with a new proposed private placement. It can also have the more serious consequence of having a current transaction eliminate the validity of an exemption that was relied upon for a previously consummated private placement. Generally, in the absence of an available integration safe harbor, the SEC's well-known five-factor integration test is applied to determine whether transactions should be integrated. See Nonpublic Offering Exemption, SEC

Release No. 33-4452 (November 6, 1962). This integration test looks at whether the offerings are part of a single plan of financing, involve the same class of securities, are made at about the same time, involve the same type of consideration in each offering, and are made for the same general purpose.

In the case of a concurrent or sequential private placement and public offering, the SEC has updated its earlier integration guidance and has made clear that the appropriate integration analysis is that provided for in the SEC's Revisions of Limited Offering Exemptions in Regulation D, SEC Release No. 33-8828 (August 3, 2007) (the 2007 release). Under the 2007 release, the SEC's analysis focuses on how investors in the private placement are solicited for that offering. If the investors in the private placement become interested in that transaction because of the registration statement being utilized in the public offering, the 2007 release cautions that the registration statement would have served as a general solicitation for the private offering. In light of recent changes permitting general solicitations in connection with certain private placements, the application of the integration analysis in this context is more complicated and will be intertwined with your analysis of which exemptions are being relied upon for the private placement transaction.

As noted above, several safe harbors are available with respect to integration, including:

- Rule 502(a) of Regulation D under the Securities Act, which protects offers and sales of securities that occur at least six months prior to the start of a Regulation D offering or at least six months after the completion of a Regulation D offering, provided that no offers or sales of the same class of securities occur within the applicable six-month period (other than pursuant to an employee benefit plan)
- Rule 152 under the Securities Act, which (1) protects public offerings that are undertaken after a Section 4(a)(2) or Rule 506 private placement is consummated; and (2) pursuant to recent SEC guidance in Securities Act Rules Compliance & Disclosure Interpretation 256.34, protects a Rule 506(c) offering that is undertaken after a Rule 506(b) offering is consummated
- Rule 155 under the Securities Act, which provides protections, upon the satisfaction of conditions specified in the rule, in connection with certain abandoned offerings, where (1) an issuer abandons a private offering under Section 4(a)(2) or Section 4(a)(5) of the Securities Act or Rule 506 and subsequently commences a public offering, or (2) an issuer abandons an SEC-registered public offering and subsequently commences a private offering
- Rule 701(f) under the Securities Act, which provides protections for offerings contemporaneous with stock-based compensation issuances pursuant to Rule 701 under the Securities Act (Rule 701)
- Rule 251(c) of Regulation A under the Securities Act, which protects a Regulation A offering from being integrated with (1) prior offers or sales of securities; (2) subsequent offers or sales of securities pursuant to an effective registration statement (subject to certain conditions), Rule 701, an employee benefit plan, Regulation S, or Section 4(a)(6); or (3) subsequent offerings made more than six months after completion of the Regulation A offering
- SEC guidance regarding crowdfunding offerings under Section 4(a)(6), which protects a crowdfunding offering under Section 4(a)(6) from being integrated with another exempt offering as long as each exempt offering is conducted in accordance with the requirements of the applicable exemption
- Rules 147(g) and 147A(g) under the Securities Act, which protect intrastate offerings under those rules from being integrated with (1) prior offers or sales of securities; (2) subsequent offers or sales of securities pursuant to an effective registration statement (subject to certain conditions), Regulation A, Rule 701, an employee benefit plan, Regulation S, or Section 4(a)(6); or (3) subsequent offerings made more than six months after the completion of the intrastate offering
- SEC guidance included in the adopting release for Regulation S and the Note to Rule 502 of Regulation D under the Securities Act, which protects Regulation S offerings from being integrated with contemporaneous private placements
- Rule 144A(e), which protects resales made in reliance on Rule 144A from affecting the availability of any exemption or safe harbor relating to prior or subsequent offerings

The application of these safe harbors can be nuanced, and you should carefully review the applicable safe harbor rules and available SEC guidance for any conditions that may be applicable for its availability.

8 Disclosure matters.

Depending on the exemption from registration under the Securities Act that is being relied upon, a private placement transaction may or may not be subject to specific requirements relating to the information that must be provided to potential investors. In addition to complying with these exemption-specific requirements, you should remember that the anti-fraud provisions of both state and federal securities laws, including Rule 10b-5 (17 CFR 240.10b-5) under the Securities Exchange Act of 1934, as amended, 15 U.S.C § 78a et seq. (Exchange Act), apply to all sales of securities to offerees. As a result, any material misstatement or omission in the offering document for a private placement is subject to such anti-fraud provisions. Regardless of the medium by which information is provided to potential investors, you should ensure that adequate risk disclosure, specific to the company and its offering of securities, is conveyed.

> Because private placements typically involve direct negotiation between the company and potential investors . . . fundamental characteristics of the offering may change significantly during the course of the transaction.

In addition, where a public company is conducting a private offering, Regulation FD continues to apply and makes no distinction between oral and written statements made in connection with the private placement. As a result, a public company engaging in a private placement transaction must either publicly disclose any material information that it privately discloses to prospective investors in the private placement or obtain a confidentiality agreement from every recipient of the information, which also alerts them to potential public trading restrictions as a result of their possession of material non-public information. Further, you should confirm that a public company conducting a private offering is aware of its obligations with respect to the filing of a Current Report on Form 8-K in connection with unregistered sales of equity securities. This obligation applies unless the aggregate number of equity securities sold since the company's last Exchange Act report constitutes less than 1% of the number of outstanding shares of the class of equity being sold.

9 Don't forget Exchange Act registration triggers.

When a company issues equity securities in a private placement, you should remember that under Section 12(g) of the Exchange Act (Section 12(g)), the company will, subject to limited exceptions, be required to register the securities within 120 days after the last day of its first fiscal year ended on which it has total assets exceeding $10 million and the securities are held of record by either 2,000 or more persons or 500 persons who are not accredited investors. Some key considerations:

- You should make sure that a company undertaking a private placement understands that even if this obligation is not triggered at the closing of the private placement transaction, subsequent resales of the securities could result in this registration requirement being triggered in the future.
- A company that is required to register securities under Section 12(g) becomes subject to the ongoing periodic and current reporting requirements of the Exchange Act, including the filing of Annual Reports on Form 10-K, Quarterly Reports on Form 10-Q, and Current Reports on Form 8-K; the beneficial ownership reporting requirements and short-swing trading rules of under Sections 16 and 13(d) of the Exchange Act; the requirements of the Sarbanes-Oxley Act of 2002 (15 U.S.C. 7201); and certain recordkeeping and internal controls requirements.

Because of the significant consequences of triggering the registration requirements of Section 12(g), you should discuss with your clients what processes and procedures will be put in place in connection with the private placement transaction to ensure that the number of holders of record remains below the thresholds described above.

10 Be prepared to change course.

Because private placements typically involve direct negotiation between the company and potential investors (some of which may be large or sophisticated institutions), fundamental characteristics of the offering may change significantly during the course of the transaction. Revisions to the terms of securities or the structure of the offering may change key facts underlying previous analysis that you have conducted and may implicate new issues that you have not considered. As the company and investors explore new transaction terms, you should constantly revisit your analysis to ensure that new issues and concerns are raised and addressed in a timely manner. L

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RESEARCH PATH: Capital Markets & Corporate Governance > Private Offerings > Private Placements > Practice Notes

Jim Wagstaffe AND THE WAGSTAFFE GROUP

Court-Ordered Alternative Dispute Resolution

The article discusses the various types of alternative dispute resolution (ADR) for a federal case and covers topics such as the courts' requirement to develop ADR procedures and their power to require parties to consider or participate in them, cases exempt from ADR, mediation, arbitration, early neutral evaluations, judicial settlement conferences, and summary jury trials.

THE PURPOSE OF ADR IS TO PROVIDE AN EFFICIENT AND economical means of resolving disputes between parties who might otherwise be involved in lengthy and expensive court proceedings.[1] Federal district courts are required to devise, implement, and administer an ADR program to be used in civil actions.[2] As a result, most federal civil lawsuits may be subject to referral to some type of ADR process during the litigation. At a minimum, every federal litigator needs to be familiar with the local district court ADR processes and rules and any standing orders pertaining to ADR of the particular judge assigned to the case.

Preliminary Matters

Federal district courts are required to develop ADR procedures for use in civil actions. Except as otherwise provided, "(e)ach district court shall provide litigants in all civil cases with at least one alternative dispute resolution process, including but not limited to mediation, early neutral evaluation, mini-trial, and arbitration . . ."[3]

Settlement and ADR are topics that may be considered at a pretrial conference and upon which action may be taken by the court.[4] No particular ADR procedure or timing is mandated. Rather, each court "shall devise and implement" its own ADR program by local rules.[5]

Each court must designate an employee or judicial officer "knowledgeable in alternative dispute resolution practices" to oversee its program. That person may also be responsible for recruiting and screening neutrals to serve in the program.[6]

In appropriate cases, the court has inherent power to order parties to participate in ADR procedures not specifically authorized by local rules, provided adequate procedural safeguards are imposed.[7]

1. *See* 28 U. S. C. § 651(a). 2. Alternative Dispute Resolution Act of 1998, 28 U. S. C. §§ 651–658. 3. 28 U. S. C. § 652(a). 4. *See* former Fed. R. Civ. P. 16(c)(9) advisory committee's note 1993 amendment. 5. 28 U. S. C. § 651(b). 6. 28 U. S. C. § 651(d). 7. In re Atl. Pipe Corp. , 304 F. 3d 135, 143 (1st Cir. 2002).

The court may order an unwilling party to take part in and share costs of mediation conducted by a private mediator, where this method seems reasonably likely to serve the interests of justice and the order contains adequate safeguards on duration of the mediation and fees.[8]

Courts disagree on whether they have inherent power to compel parties to participate in non-binding summary jury trials.

Cases Exempt from ADR Procedures

A district court may (after consulting with members of the bar and the U.S. Attorney for the district) exempt cases or categories of cases in which use of ADR procedures would be inappropriate.[9] In addition, no ADR program can alter or conflict with the authority of the Attorney General or federal agencies to conduct litigation on behalf of the United States.[10]

Mandatory Consideration

Local rules must require civil litigants to "consider the use of an alternative dispute resolution process at an appropriate stage in the litigation."[11] But it is up to each district court to decide whether to require the use of ADR procedures in any case. Only mediation, early neutral evaluation, and voluntary arbitration may be required.[12]

If you can present some compelling argument why your client's case is inappropriate for referral to ADR, advise the court of these reasons. In the event the case has already been referred to ADR, advise the mediator, arbitrator, or other neutral of the reasons why the process likely will not be productive. In that event, an experienced neutral generally will shortcut the process so that the parties do not spend unnecessary time and money.

Confidentiality Protections

There are no national rules on confidentiality. Each district court must adopt local rules that provide for the confidentiality of ADR proceedings and prohibit disclosure of confidential communications.[13]

Most local rules, however, do not apply the rules of confidentiality to private mediations; nor do they create privileges otherwise recognized under federal law. Rather, such private mediations and ADR processes are governed by state law and contractual confidentiality obligations.[14]

Sanctions

Failure to participate in good faith in court-ordered ADR procedures constitutes failure to obey a pretrial order and is sanctionable under Fed. R. Civ. P. 16(f).[15]

Video Related Content

For an overview of the basic structure of the federal court system, watch Video:

> **THE FEDERAL COURT SYSTEM,** IN **FEDERAL COURT SYSTEM OVERVIEW (FEDERAL)**

RESEARCH PATH: *Federal Civil Practice > Pre-litigation > Practice Notes*

For a list of the factors to consider in deciding whether to bring a suit in federal or state court, watch Video:

> **CHOOSING BETWEEN STATE AND FEDERAL COURT,** IN **STATE VS. FEDERAL COURT (FEDERAL)**

RESEARCH PATH: *Federal Civil Practice > Pre-litigation > Practice Notes*

Early Neutral Evaluation and Mediation

Early neutral evaluation (ENE) and mediation are the ADR procedures most widely utilized in federal district courts.

Both programs involve presentations to a neutral third party in a non-binding, non-adjudicatory format. ENE programs typically refer cases to the neutral shortly after commencement of the action; mediation may be utilized at any stage of the proceedings. ENE is intended to help identify the issues and lay a foundation for resolution (i.e., not just relevant to settlement). Mediation is intended to bring about a settlement.

Appointment, Compensation, and Role of Neutrals

District courts that authorize mediation must adopt procedures for making neutrals (ENE evaluators and mediators) available for use by the parties and must establish criteria for the selection of such persons to serve on its panels.[16]

Persons selected as mediators or to serve in ENE programs must be qualified and trained accordingly. Magistrate judges or other persons who have received appropriate training may be selected to serve on such panels.[17] However, there is no provision for certification of mediators as there is for arbitrators.

Under many local rules, neutrals perform quasi-judicial functions and are entitled to the immunities and protections afforded to all persons performing judge-like functions.[18]

8. In re Atlantic Pipe Corp. , 304 F. 3d 144–145. 9. See 28 U. S. C. § 652(b). 10. 28 U. S. C. § 652(c). 11. 28 U. S. C. § 652(a). 12. *Id.* 13. 28 U. S. C. § 652(d); Facebook, Inc. v. Pac. Northwest Software, Inc., 640 F. 3d 1034, 1041 (9th Cir. 2011). 14. Facebook, Inc. v. Pac. Northwest Software, Inc. , 640 F. 3d 1040-1041. 15. Nick v. Morgan's Foods, Inc. , 270 F. 3d 590, 595 (8th Cir. 2001); Lucas Auto. Eng'g, Inc. v. Bridgestone/Firestone, Inc. , 275 F. 3d 762, 769 (9th Cir. 2001) (upholding Rule 16(f) sanctions against corporate president who failed to attend court-ordered mediation). 16. *See* 28 U. S. C. § 653(a). 17. 28 U. S. C. § 653(b). 18. N. D. Cal. ADR L. R. 2-5(e); E. D. Wash. Rule 16. 2(g); D. Ak. LR 16. 2(h); *see* Wagshal v. Foster, 28 F. 3d 1249, 1252–1254 (D. C. Cir. 1994); Todd v. Ellis, 2014 U. S. Dist. LEXIS 90612, at *7–*9 (E. D. Cal. July 1, 2014).

Pending adoption of national rules on the subject, each court must issue local rules for disqualification of neutrals on the same grounds as a judicial officer.[19]

The district court must establish the amount of compensation a neutral receives for his or her services.[20] Presently, the rate varies from court to court.

In addition, the court may reimburse neutrals for actual transportation expenses incurred in performance of their duties.[21] However, the statute is not clear on whether such compensation is paid by the court or the parties. The regulations to be promulgated by the Judicial Conference under 28 U.S.C. § 658(b) may clarify this.

Some court rules governing ENE proceedings require each party to present to the neutral a detailed written statement of its contentions, demands, and defenses. The ENE proceedings themselves, however, are informal, off the record, confidential, and privileged.[22]

Arbitration, Binding and Non-binding

Subject to the exceptions listed below, district courts are generally authorized, with the parties' consent, to refer to non-binding arbitration cases seeking money damages of $150,000 or less.[23] Where parties have agreed to binding arbitration of a dispute (usually in a pre-dispute agreement relating to other matters), courts may enforce their arbitration agreement (for example, by staying litigation, appointing an arbitrator, etc.). Because arbitration generally requires the parties' consent, it is less likely to be utilized than other ADR procedures.

Courts may not refer civil actions to arbitration where either:

- The parties do not consent.
- The relief sought is money damages exceeding $150,000.
- The action is based on an alleged violation of constitutional rights.
- The action is based in whole or in part on an alleged deprivation of civil rights (jurisdiction under 28 U.S.C. § 1343).
- The district court has exempted the specific case or cases of the same category as not "appropriate" for alternative dispute resolution.[24]

To facilitate referral to arbitration, a district court may presume damages are not in excess of $150,000, unless counsel certifies that damages exceed such amount.[25]

19. 28 U. S. C. § 455 plus "other applicable law, and professional responsibility standards". 28 U. S. C. § 653(b). 20. 28 U. S. C. § 658(a). 21. 28 U. S. C. § 658(b). 22. *See* 28 U. S. C. § 652(d). 23. *See* 28 U. S. C. §§ 654–658. 24. 28 U. S. C. §§ 654(a), 652(b). 25. 28 U. S. C. § 654(c).

To overcome this presumption, counsel must certify that the damages reasonably recoverable exceed $150,000. The prayer of the complaint is not sufficient.[26]

Pending adoption of national rules, local rules must ensure that "consent to arbitration is freely and knowingly obtained" and that "no party or attorney is prejudiced for refusing to participate in arbitration."[27]

Appointment, Compensation, Role and Powers of Arbitrators

Each court is required to establish panels of persons qualified to serve as arbitrators and to establish rates of compensation for their services. Each court that authorizes arbitration must establish standards for certification of arbitrators, which shall require the arbitrator to take the same oath as a judicial officer and be subject to the same grounds for disqualification.[28]

Pending adoption of national rules on the subject, each court must issue local rules for disqualification of arbitrators on the same grounds as a judicial officer.[29] Courts may also establish "other appropriate law and professional responsibility standards."[30]

Arbitrators are performing quasi-judicial functions and are entitled to immunities and protections that the law affords to all persons serving in such capacities.[31]

Arbitrators have the power to conduct hearings, to administer oaths and affirmations, and to make awards.[32]

Fed. R. Civ. P. 45 (relating to subpoenas) applies to subpoenas for attendance of witnesses and production of documentary evidence at an arbitration hearing.[33]

Filing and De Novo Review of Award

The prevailing party must promptly file the award and proof of service on the other parties. The clerk shall enter judgment on the award unless any party timely demands a trial de novo.[34]

Within 30 days after an arbitration award is filed, any party may file a written demand for a trial de novo in the district court. This prevents entry of judgment on the award. The action is restored to the court's docket and "treated for all purposes as if it had not been referred to arbitration."[35]

Local rules must provide for sealing the arbitration award after it is filed and that its contents may not be made known to any judge who might be assigned to the case until the action is terminated.[36]

At the trial de novo, the court shall not admit any evidence that there has been an arbitration, the nature or amount of any award, or any other matter concerning the arbitration unless the parties agree or the evidence would otherwise be admissible under the Federal Rules of Evidence.[37]

There is no statutory provision authorizing an award of attorney's fees and costs against the party demanding a trial de novo if he or she fails to obtain a more favorable judgment.

When there is no trial de novo demand, a judgment rendered at a non-binding arbitration "shall not be subject to review in any other court by appeal or otherwise."[38]

Judicial Settlement Conference

The Federal Rules authorize settlement discussions at any pretrial conference.[39] Some courts also require a separate settlement conference. Few judges are willing to conduct settlement conferences in their own cases. Most judges

Related Content

For guidance on how to negotiate and finalize a settlement in federal court litigation, see

> **SETTLEMENT FUNDAMENTALS (FEDERAL)**

RESEARCH PATH: *Federal Civil Practice > Settlement > Practice Notes*

For a review of a federal court's jurisdiction to enforce settlements and consent decrees, see

> **SETTLEMENT: ENFORCING SETTLEMENTS AND CONSENT DECREES (FEDERAL)**

RESEARCH PATH: *Federal Civil Practice > Settlement > Practice Notes*

For a discussion on how a defendant makes a Rule 68 offer of judgment in federal court litigation, see

> **RULE 68 OFFER OF JUDGMENT: MAKING THE OFFER (FEDERAL)**

RESEARCH PATH: *Federal Civil Practice > Settlement > Practice Notes*

For information on how to respond to a Rule 68 offer of judgment in federal court litigation, see

> **RULE 68 OFFER OF JUDGMENT: RESPONDING TO THE OFFER (FEDERAL)**

RESEARCH PATH: *Federal Civil Practice > Settlement > Practice Notes*

26. *Id.* 27. 28 U. S. C. § 654(b). 28. 28 U. S. C. § 655(b). 29. *See* 28 U. S. C. § 455. 30. 28 U. S. C. § 653(b). 31. 28 U. S. C. § 655(c); *see* Myers v. Morris, 810 F. 2d 1437, 1466–1467 (8th Cir. 1987); Wagshal v. Foster, 28 F. 3d 1252–1254 (court-appointed case evaluator entitled to absolute immunity). 32. 28 U. S. C. § 655(a). 33. 28 U. S. C. § 656. 34. 28 U. S. C. § 657(a). 35. 28 U. S. C. § 657(c)(1) & (2). 36. 28 U. S. C. § 657(b); *see also* Tonry v. Sec. Experts, Inc. , 20 F. 3d 967, 973–974 (9th Cir. 1994) (improper to refer to arbitration award on appeal). 37. 28 U. S. C. § 657(c)(3). 38. 28 U. S. C. § 657(a). 39. *See* Fed. R. Civ. P. 16(c)(2)(I).

assign such conferences to others (other judges, mediators, magistrate judges).

Common Procedures During Conference

There are no standardized procedures for conducting settlement conferences. However, there are some common approaches. The judge or magistrate judge may require a settlement conference statement to be submitted at or in advance of the conference.[40] Most judges or magistrate judges require the attendance of an attorney and his or her clients or representatives who are knowledgeable about the case and have authority to settle.[41]

If the settlement conference is ordered pursuant to Rule 16(c)(2)(I), attendance is required of at least one of the attorneys for each party with authority to enter into stipulations and to make admissions.

Judges or magistrates normally meet first with all attorneys (without clients) and then separately with each side. They generally try to evaluate each side's credibility, the prospects of liability, and the evidence regarding damages. They then offer a general opinion about the risks and suggest an appropriate settlement figure or range.

There are limits, of course, on the judge's power to bring about a settlement.[42]

Statements made during settlement negotiations have been held to be privileged against discovery by third parties.43 Where settlement is reached at a court settlement conference, the judge will often cause the agreement to be put on the record (i.e., the terms will be stated in open court, taken down by a court reporter, or entered in the minutes, or both.)[44]

This serves several purposes:

- It provides a record of exactly what was agreed to.
- It assures that all settling parties actually heard and consented to the same settlement terms.
- It provides a basis for enforcement of the settlement, if necessary.

Putting a Settlement on the Record

Settlements are typically put on the record as follows:

- The judge will take the bench and note the presence of the attorneys and the parties (or a representative of the insurance carrier as to parties defended by an insurance carrier).
- One of the attorneys will then be asked to state the terms of the settlement (usually the payment of a certain sum of money in exchange for a dismissal with prejudice, a release, and a mutual waiver of costs).
- Opposing counsel will be asked to confirm that the settlement, as stated, accurately embodies the agreement.
- The judge may then question the parties, asking whether they understand the settlement terms, whether they have any questions for their attorneys, whether they understand that the settlement puts an end to their claims and that they may not later reopen the case or sue again, and whether they accept the settlement as stated.
- The judge may (or may not) proceed to enter a judgment of dismissal based on the proceedings in court.

Alternatively, the judge may render a conditional dismissal and set a time within which the parties are to execute whatever documents are required to memorialize their in-court agreement.

The in-court settlement is generally binding even though it is contemplated that the terms will thereafter be reduced to a signed writing. If a party refuses to sign the written memorial of the oral settlement, the remedy is a motion to enforce the settlement.

Summary Jury Trial

One ADR option occasionally used in very large cases is a non-binding summary jury trial. In such trials, the attorneys make opening and closing arguments combined with a narrative statement of evidence, but no live testimony; the judge then instructs; and the jurors then deliberate and return individual or consensus verdicts. The verdicts are not binding (unless the parties agree otherwise).

Courts are split on whether parties may be compelled to participate in this process.

Several cases decided under an earlier version of Rule 16 hold judges may not force parties to submit to nonbinding mini-trials.[45]

The present Rule 16 may authorize such procedure where required under local rules.[46]

Local court rules in some districts require summary jury trials in certain cases as part of their case management plans under the Civil Justice Reform Act, 28 U.S.C. § 473(a)(6)(B).

Because summary jury trials are treated as settlement tools rather than public adjudication, some courts hold that the proceedings may be closed to the public.[47] L

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For a checklist to assist in making a Rule 68 offer of judgment in federal court litigation, see

> RULE 68 OFFER OF JUDGMENT: MAKING THE OFFER CHECKLIST (FEDERAL)

RESEARCH PATH: *Federal Civil Practice > Settlement > Checklists*

For a settlement agreement and release that may be used in a federal district court case, see

> SETTLEMENT AGREEMENT AND RELEASE (FEDERAL)

RESEARCH PATH: *Federal Civil Practice > Settlement > Forms*

For a sample form of a stipulation of dismissal with prejudice and proposed order for federal district court, see

> STIPULATION OF DISMISSAL AND PROPOSED ORDER (FEDERAL)

RESEARCH PATH: *Federal Civil Practice > Settlement > Forms*

40. Fed. R. Evid. 408. 41. *See* United States v. U. S. Dist. Ct. for Northern Mariana Islands, 694 F. 3d 1051, 1061 (9th Cir. 2012) (although court can order attendance of federal government at settlement conference, it should take a "practical approach" in ordering attendance of critical decision-maker for federal government and should consider less drastic steps before doing so). 42. Kothe v. Smith, 771 F. 2d 667, 669 (2d Cir. 1985) (improper to impose sanctions for not settling at level judge recommended); Dawson v. United States, 68 F. 3d 886, 896–897 (5th Cir. 1995) (court cannot sanction attorneys for failing to make settlement offers: "The horses may be led to water. Whether they drink is up to them"); *see* also Goss Graphics Sys. v. DEV Indus. , Inc. , 267 F. 3d 624, 627 (7th Cir. 2001) (parties' refusal to settle not a valid ground for dismissal). 43. Goodyear Tire & Rubber Co. v. Chiles Power Supply, Inc. , 332 F. 3d 976, 980 (6th Cir. 2003). But see The Wagstaffe Group Practice Guide: Fed. Civ. Proc. Before Trial §34-[IV][G] for a discussion of a split among the courts over whether there is a federal common law settlement negotiation privilege. 44. *See* Doi v. Halekulani Corp. , 276 F. 3d 1131, 1138 (9th Cir. 2002); Lynch, Inc. v. Samata-Mason Inc. , 279 F. 3d 487, 490 (7th Cir. 2002) (standard practice to dictate terms to court reporter where settlement reached during informal conference).

45. *See* Strandell v. Jackson Cty. , 838 F. 2d 884, 887 (7th Cir. 1987); In re NLO, Inc. , 5 F. 3d 154, 157 (6th Cir. 1993). 46. *See* Fed. R. Civ. P. 16(c)(2)(I) (authorizing court's use of "special procedures to assist in resolving the dispute"); In re Southern Ohio Correctional Facility, 166 F. R. D. 391, 395 (S. D. Oh. 1996); Arabian American Oil Co. v. Scarfone, 119 F. R. D. 448, 449 (M. D. Fla. 1988) (mandatory summary jury trial upheld under district court's inherent power and as "conferences" under Fed R. Civ. P. 16(a)(1), (5) & (c)(2)). 47. Cincinnati Gas & Elec. Co. v. General Elec. Co. , 854 F. 2d 900, 903–905 (6th Cir. 1988); In re NLO, Inc., 5 F. 3d 157 (if parties consent to summary jury trial, public may be excluded under some circumstances).

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Pharmaceutical Patent Litigation Strategies

This article discusses strategies that counsel for brand-name and generic drug companies may employ in pharmaceutical patent litigation under the Drug Price Competition and Patent Term Restoration Act of 1984, commonly known as the Hatch-Waxman Act. It focuses on litigating infringement and validity of active pharmaceutical ingredient (API), formulation, and treatment patents using court decisions as a guide to what works and what doesn't for each side in Hatch-Waxman litigation.

THE TERMS BRAND AND GENERIC ARE USED IN THIS ARTICLE as a shorthand to denote a brand-name drug company and a generic drug company respectively. But be aware that in Hatch-Waxman cases, a variety of terms may be used to refer to a generic drug company and a brand-name drug company. The generic drug company may be referred to as the ANDA applicant or the ANDA filer. ANDA is an acronym for Abbreviated New Drug Application, the drug approval application filed by generic drug companies.

A brand-name drug company may be referred to as the innovator, the pioneer, the patent owner, the NDA holder, or the RLD holder. NDA is an acronym for New Drug Application, a type of drug approval application filed by brand-name drug companies. A drug approved based on an NDA is called a reference listed drug or RLD. Also, note that while the patent owner and the NDA holder are often the same person, in some cases they are not. For example, they could be a parent corporation and its licensed subsidiary.

The Hatch-Waxman Patent Arsenal

The Hatch-Waxman patent arsenal typically comprises three classes of patents: the API patent, the formulation patent, and the treatment (i.e., method of use) patent. These three classes of patents are those that can be listed in the FDA's publication

entitled *Approved Drug Products with Therapeutic Equivalence Evaluations*, known as the Orange Book.

A Paragraph IV certification that an Orange Book-listed patent is invalid, unenforceable, and/or will not be infringed by the proposed generic drug, is a trigger for patent litigation under the Hatch-Waxman Act. An application for FDA approval of a generic drug that contains a Paragraph IV certification qualifies as an act of patent infringement exposing the generic to an infringement suit by the patent owner and exposing the patent owner to a counterclaim for a declaration that the patent is invalid, unenforceable, and/or will not be infringed.[1]

While each class of Orange Book-listed patents contains many variations, the patent litigation issues that are typically raised by each class are as follows:

- **The API patent.** The API patent can cover the active chemical itself, but also the chemical's polymorphs (or pseudopolymorphs and amorphous substances) or optically active forms of the API (enantiomers). To qualify for FDA approval of a generic version of an RLD using the ANDA process, the proposed generic drug must copy the chemical structure of the API used in the RLD. This means that the proposed generic drug will usually infringe an API patent covering the RLD. So, a generic's Paragraph IV certification for an API patent typically asserts only that the patent is invalid.
- **Formulation patents.** Formulation patents are directed to the dosage form and can include, for example, immediate-release or delayed-release dosage forms. For a formulation patent, a generic company can often assert a non-infringement defense based on designing around the patent claims (sometimes a claim-construction issue), as well as asserting that the patent is invalid and/or unenforceable.
- **Treatment patents.** Treatment patents are directed to methods of use of a drug and may cover particular indications or titration schedules for the drug. (An indication for a drug refers to the use of the drug to treat a particular disease). Sometimes the generic company will be able to specify in its Paragraph IV certification that its proposed generic drug will not infringe the patent because the generic drug will not be sold for the use covered by the patent, but only for another indication for which the RLD has been approved (a so-called Section viii carve-out or skinny label).

Be aware that the brand can also assert a patent covering a method of making the API. This type of patent is not listed in the Orange Book. Thus, as counsel for a generic, your due diligence should include conducting an early search for this type of patent so that your client can avoid it by designing an alternative synthesis.

Nothing will guide your Hatch-Waxman litigation strategy so well as actual cases. The following is a discussion of what has worked—and what hasn't—for both the brand and generic sides of Hatch-Waxman litigation.

The API Patent: A Formidable Weapon for the Brand

As noted above, the problem with an API patent is that a generic company using the ANDA process is almost always seeking approval of a generic drug that includes the very API covered by the patent. So, unless there is something about the patent claims that provides an opening for a non-infringement argument (which is rare), the generic must invalidate the patent or render it unenforceable.

Absent a viable argument that the patent claims are indefinite or not enabled under 35 U.S.C. § 112, the central attack on the validity of the API patent must be based on lack of novelty (anticipation) or obviousness.

But—and this is what makes the API patent so potent—it is unusual for an API patent to be anticipated by something published in the prior art. Of course, as counsel for the generic company, you should still conduct a comprehensive prior art search, especially looking for slip-ups by the brand in which, for instance, the molecule was disclosed in a scientific meeting or in a patent as a small genus of structurally related compounds.

As to obviousness, while it generally became easier to prove obviousness after the U.S. Supreme Court's decision in KSR Int'l Co. v. Teleflex, Inc., 550 U.S. 398 (2007), establishing obviousness of drug API patents remains challenging. The Federal Circuit has made it known that the pharmaceutical arts are to be treated as inherently unpredictable. In particular, the Federal Circuit has held that mere structural similarity between a prior art compound and the claimed compound does not inform the lead compound selection.[2]

There is a long line of cases in which the patent examiner rejected API patent claims as prima facie obvious based on structural similarities (so-called structural obviousness). But there is only one significant Hatch-Waxman case in which a court has invalidated an API patent for structural obviousness. This successful challenge is hugely instructive for counsel for both brands and generics. Let's see why this API patent proved vulnerable and compare it to a significant case when an API patent did not.

An API Patent Falls to Obviousness: Comparing the Pioglitazone and Entecavir Cases (or a Tale of Two Cyclics)

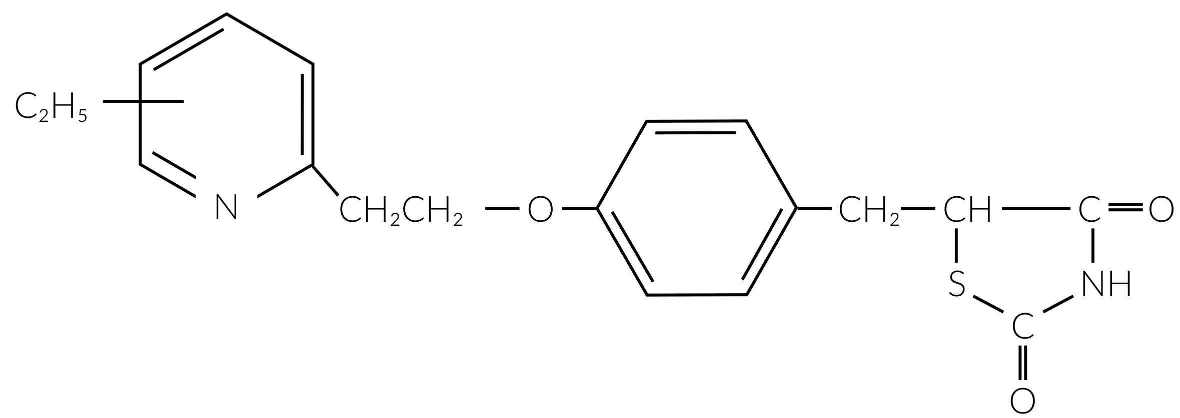
Two structural-obviousness cases that look superficially similar had very different outcomes. The first was an unsuccessful challenge to an API patent on the diabetes drug pioglitazone (sold under the brand name Actos®)[3]. The second invalidated the API patent for the hepatitis B drug entecavir (sold under

1. *See* 35 U.S.C. § 271(e)(2). 2. *See* Otsuka Pharm. Co. v. Sandoz, Inc., 678 F.3d 1280, 1292 (Fed. Cir. 2012). (a lead compound is a chemical compound with known properties, the chemical structure of which a drug company uses as a starting point in drug development). 3. *See* Takeda Chem. Indus. v. Mylan Labs., Inc., 417 F. Supp. 2d 341 (S.D.N.Y. 2006), aff'd 492 F.3d 1350 (Fed. Cir. 2007).

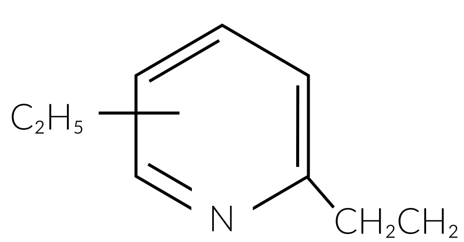
the brand name Baraclude®)[4]. (Note that while, technically, Pfizer, Inc. v. Apotex, Inc., 480 F.3d 1348 (Fed. Cir. 2007) might seem to count as a case that also invalidated an API patent for obviousness, the patent was directed to the besylate salt of the API, rather than the API molecule itself).

In the pioglitazone case, claims 1, 2, and 5 of the asserted API patent were at issue. For the purpose of this discussion, claim 1 is illustrative. It was for a compound with the following formula or a pharmacologically acceptable salt thereof:

An earlier Takeda patent had expressly called out the same basic structure as particularly promising, but instead of 5 ethyl, it had a methyl (CH3—) at the 6 position. In other words, some defendants' argument was that it was obvious to go from (1) the 6 to the 5 position (ring walking, illustrated in claim 1) and (2) a 1-carbon (methyl) substituent to a 2-carbon (ethyl) substituent. This carbon-chain lengthening process, also a common approach in drug development, is called homologisation, with each substituent a homologue of the other. (A homologue here is just a chain of carbons formed by adding or subtracting carbons.)



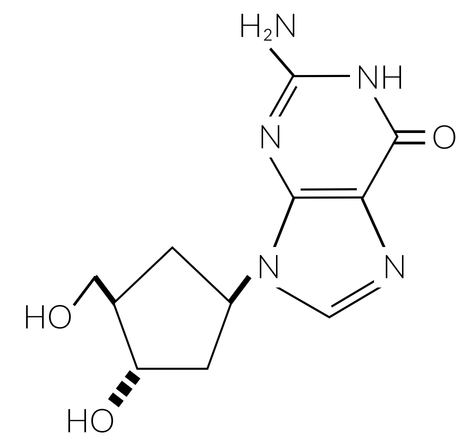
Note that the left-hand C2H5— (ethyl) substituent is hanging out in an indeterminate position. Thus, it can be walked around the pyridine ring and attached at any available position. Ring walking is a straightforward and common approach to drug development, and this reality is reflected in the claim. In claim 2, the ethyl substituent is fixed at the 5 position of the pyridine ring. This is the API, pioglitazone. The following is the formula of claim 2:



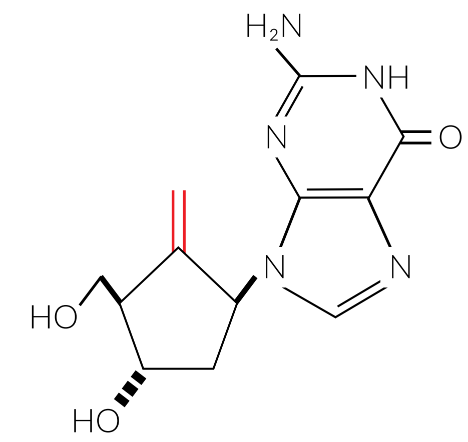
This case involved complicated issues of adequacy of, and changing of, the defendants' positions and ended in an award of attorney's fees and costs to the plaintiffs. But the core of the unsuccessful obviousness argument was this: the common drug-development principles of ring walking and homologisation would have motivated and led a person of ordinary skill in the art from the promising 6-methyl prior-art compound to 5-ethyl pioglitazone. The acceptance of this argument—obviousness by application of general principles—may have been controversial. If general principles of drug development could, as a rule, be applied to prior art lead compounds, this could potentially render many API patents invalid for obviousness. As illustrated by this case, structural-obviousness challenges to API patents in Hatch-Waxman cases typically fail.

But compare the pioglitazone case with the entecavir case. Going from the prior art lead compound (left) to entecavir in the '244 patent (right) was held to be obvious:

4. *See* Bristol-Myers Squibb Co. v. Teva Pharms. USA, Inc., 923 F. Supp. 2d 602 (D. Del. 2013).



2'-CDG



entecavir

The court found that this transformation—prior art dihydro 2'-CDG lead compound to methylene-substituted (in red) entecavir—was specifically motivated by a prior-art reference (Madhavan). Entecavir itself was not disclosed in the prior art. But in the structurally similar Madhavan compound, the methylene substitution was found to impart improved properties within the series of anti-viral compounds.

It is important not to oversimplify here. A lot of proofs in the case fell into place to support a finding of structural obviousness. The patentee itself had admitted the following:

- Researchers had treated 2'-CDG as a lead compound.
- Madhavan disclosed improved properties with the methylene change in other anti-viral series.
- The addition of carbon at the 5' position was reasonable to a person of ordinary skill in the art.

These findings proved prima facie structural obviousness. Indeed, the court indicated that both the excellence of the defendant's expert—and the backpedaling of the plaintiff's expert—created a compelling case of prima facie obviousness.

A prima facie showing of obviousness can be rebutted by secondary indicia of non-obviousness, such as the commercial success of the invention or the invention's unexpected results. But in the entecavir case, these secondary considerations were weak:

- There was limited commercial success.
- The magnitude of the unexpected results (lower toxicity) was comparatively small.

On appeal the Federal Circuit affirmed, finding that:

- The 2'-CDG compound was the lead compound (i.e., the natural choice for further development).
- The extracyclic methylene was a minor change taught by the prior art Madhavan reference as significantly superior to the non-methylene molecule in the structurally similar series of compounds.

As to the secondary considerations, the appellate court found that sales of the patented drug had been sub-optimal and that any improvement in antiviral properties was an expected difference in degree, not an unexpected difference in kind. Thus, the API patent was invalidated for structural obviousness.

The Takeaway from the Pioglitazone and Entecavir Decisions

For the patent challenger, the pioglitazone and entecavir cases teach the following:

- While it is not impossible to invalidate an API patent for structural obviousness, it is difficult to do so, and you should not, if possible, rely on obviousness as the only ground for patent invalidity.
- Do not rely solely on applying general principles of drug development to a prior art lead compound to establish obviousness.
- In the pharmaceutical arts, it is only a specific teaching, motivation, or suggestion in the prior art, directed to very closely related chemical structures, that can be expected to invalidate an API patent for structural obviousness. You should carefully review the prior art for specific teachings on how to modify the lead compound and closely related compounds.

As the counsel for the patent owner, your central strategic considerations will be to minimize admissions about what is a good lead compound. Instruct in-house personnel early on to not speculate, or talk carelessly or loosely about, lead-compound determinations. Carefully vet the prior art to ensure that specific disclosures of how to modify the lead compound and closely related compounds do not leave the API patent claims vulnerable.

The Formulation Patent: A Weaker Weapon for the Brand

Unlike API patents, formulation patents may be susceptible to a finding of obviousness based on the application of general principles of design. Notably, excipients (inactive ingredients that act as a medium for active ingredients) are known to have particular properties, and their selection follows somewhat standardized procedures. A good illustration is the zolpidem case discussed below, for which the author was a member of the trial team.

Generics may also be able to avoid infringement of formulation patents by designing around the patent claims. But, depending on how the claims are construed, a design-around that might appear to be sufficient on first glance may ultimately turn out to be inadequate to distinguish the structure of the generic formulation from that of the patent claims. A good cautionary tutorial is the omeprazole case discussed below. (This is also a case for which the author was a member of the trial team).

The Zolpidem Case

In Purdue Pharm. Prods. L.P. v. Actavis Elizabeth LLC, 2015 U.S. Dist. LEXIS 112253 (D.N.J. Mar. 27, 2015), the patent claims were directed to a sublingual (i.e., absorbed under the tongue), low-dose zolpidem tablet (sold under the brand name Intermezzo®) to treat middle-of-the-night (MOTN) insomnia. The prior art taught full-dose oral (swallow) zolpidem (sold under the brand name Ambien®) to treat a full night's insomnia.

The generics' obviousness argument was essentially as follows:

- Cutting the prior art full night zolpidem dose in half for MOTN insomnia—half an Ambien® for half a night's sleep—is just common sense and avoids the residual effects with overdosing.
- Since a MOTN waker, already in bed and involuntarily awakened, wants an immediate return to sleep—the need for speed—a sublingual formulation is obvious because it has a faster delivery that goes right into the circulatory system, bypassing metabolism through the liver.

The central tenet of the patent holder's rebuttal was this: if one awakes MOTN, some sleep deficit has already been paid. So, a person of ordinary skill in the art would assume that to return to sleep, the patient would need a higher zolpidem dose than the full night dose. But a higher dose is harmful because of its residual sedative effect, leaving an intolerably, even dangerously, groggy commuter behind the wheel of the car heading into work. The patent holder's message was that prior to the patented invention, the problem of treating MOTN sleeplessness thus seemed hopelessly insoluble, so the solution provided by the invention was far from obvious.

Following a bench trial, the court found the patents invalid for obviousness, accepting the generics' common-sense obviousness argument and rejecting the patent holder's rather counterintuitive non-obviousness theory. The Federal Circuit affirmed without opinion.

> You need an expert who can clearly and credibly explain why a formulation choice that appears simple and obvious is not. Avoid a convoluted or counterintuitive explanation.

The Omeprazole Subcoat Patents Case

In Astra Aktiebolag v. Andrx Pharms., Inc., 222 F. Supp. 2d 423 (S.D.N.Y. 2002), the asserted patents were directed to solid dose formulations for the drug omeprazole (a protein pump inhibitor used to treat acid-related conditions such as acid reflux). In particular, the patents were directed to pellets having an acidic enteric coat (to resist stomach acid) with an alkaline (basic) core protecting the API and a separating layer between the enteric coat and the alkaline core. The separating layer was assumed to halt any interaction between the acidic enteric coat and the alkaline core. The enteric coat assured the pellets a pleasant and intact journey through the harsh environment of the stomach.

To avoid the patented pellet structure, some of the generics designed pellets that had just a core (meant to be non-alkaline) and an enteric coat, but no separating layer. But one generic—KUDCo—designed microtablets that avoided any alkaline reacting compound, thereby meant to omit an alkaline core.

Following a bench trial, the court found that the generics that had tried to avoid the patent claims by omitting a separating layer from their formulations were, in fact, infringing. The court found that only KUDCo did not infringe the patents.

On its face, this result may seem surprising. But the underlying chemistry of the generics' formulation provided the basis for the court's finding of infringement. Even though these generics had deliberately omitted a separating layer, an in situ acid-base separating salt layer formed naturally as a result of an acid-base interaction between the alkaline core and acidic coat. It is Chemistry 101 that the result of an acid-base interaction is a salt. When this interaction occurs all along the interface of the acidic coat and the alkaline core, a salt layer forms. That this layer resulted from precisely the acid-base interaction that a separating layer was supposed to prevent did not matter to the court's claim construction and infringement analysis—a separating layer is a separating layer. Thus, all the generics except KUDCo were found to infringe the formulation patents and were prevented from marketing their generic drugs until the formulation patents had expired.

The Takeaway from the Zolpidem and Omeprazole Decisions

For the patent challenger, the zolpidem and omeprazole cases teach the following:

- **Keep your obviousness argument simple and based on common sense.** In the zolpidem case, the generics' case for obviousness was simple and commonsensical: half a pill for half a night's sleep, under the tongue to provide immediate absorption. In contrast, the patent holder's case seemed counterintuitive: more of the drug is needed for less sleep.
- **Retain an expert with drug formulation experience.** Formulation patents are often susceptible to obviousness challenges, because standard, tried-and-true, and common-sense solutions are generally used and can be well-documented in the prior art. But you need an expert with formulation experience to explain how the formulation choices were well-known, standard options and that—confronted with the problem at hand—a formulator with an ordinary level of skill would have chosen the patented formulation.
- **Carefully consider the chemistry and claim construction for your non-infringement theory.** Formulation patents, as we've seen, can be designed around. KUDCo in the omeprazole case successfully did so. But the other generics were caught off-guard by simple but unanticipated chemistry taking place right under their noses. Thus, even where all seems to be straightforward, it is imperative that all possibilities, under all realistic (or maybe even unrealistic) claim constructions and possible chemical interactions, have to be considered.

As counsel for the patent holder, you should keep in mind the following:

- Formulation patents have a high invalidation rate—at times 70% or so.
- You need an expert who can clearly and credibly explain why a formulation choice that appears simple and obvious is not. Avoid a convoluted or counterintuitive explanation.
- Your testifying expert may need to rely on testing or experiments to establish chemical interactions that may help to establish infringement. But if there is any doubt as to the outcome of the testing or experiments, they should be performed by a separate non-testifying expert before being shared with your testifying expert.

Related Content

For information on common patent law terminology and other foundational information, see

> **PATENT LAW FUNDAMENTALS RESOURCE KIT**

RESEARCH PATH: *Intellectual Property & Technology > Patents > Patent Litigation > Practice Notes*

For an explanation of the unique patent litigation scheme under the Hatch-Waxman Act, see

> **HATCH-WAXMAN ACT FUNDAMENTALS**

RESEARCH PATH: *Intellectual Property & Technology > Patents > Patent Litigation > Practice Notes*

For a sample complaint that is applicable to Hatch-Waxman litigation, see

> **PATENT INFRINGEMENT COMPLAINT (HATCH WAXMAN ACT)**

RESEARCH PATH: *Intellectual Property & Technology > Patents > Patent Litigation > Forms*

For a form that is designed for use as a starting point in preparing interrogatories in litigation under the Hatch-Waxman Act, see

> **PLAINTIFF'S INTERROGATORIES IN HATCH-WAXMAN PATENT LITIGATION (INNOVATOR TO GENERIC CHALLENGER)**

RESEARCH PATH: *Intellectual Property & Technology > Patents > Patent Litigation > Forms*

For additional information on obviousness as a ground for patent invalidity, see

> **OBVIOUSNESS IN PATENT LITIGATION**

RESEARCH PATH: *Intellectual Property & Technology > Patents > Patent Litigation > Practice Notes*

The Treatment Patent

Treatment patents are directed to methods of using a drug. A drug label sets forth how the drug is to be used. For example, it indicates the particular conditions to be treated by the drug and the dosing regimen. Thus, a patent on a method of using a drug to treat the disease that is indicated in the label could be infringed by a person (e.g., a doctor) who uses the drug to treat that disease. In this scenario, the person who uses the drug is the direct infringer. But a drug manufacturer may be held liable for inducing the infringement under 35 U.S.C. § 271(b) if its label for the drug directs that it be used in an infringing manner. The elements of inducement of infringement include proof of direct infringement by a third party and specific intent to encourage a third-party's infringement.[5]

But in Hatch-Waxman litigation, typically, the generic drug has not yet been marketed, so there is no actual direct infringement by a third party, and the inducement analysis focuses on the scope of approval sought by the generic company as described in the proposed label for the generic drug. A generic company can avoid a finding of inducement by seeking FDA approval only for a method of use that is not covered by an Orange Book-listed treatment patent (a so-called Section viii carve-out or skinny label).[6] This strategy may effectively immunize the generic company from a finding of inducement. This is so notwithstanding the reality that once the generic drug is sold, doctors are free to prescribe it for a use other than that specified in the approved generic drug label (so-called off-label use) and such off-label use may infringe an Orange Book-listed patent.

A generic uses a Section viii carve-out when the brand holds patents on only some of the approved methods of using the drug.

Infringement: Comparing the Rosuvastatin and Budesonide Cases

If a generic label properly carves out (i.e., omits) a treatment covered by a treatment patent, there is generally no inducement of infringement. Such was the case for rosuvastatin (sold under the brand-name Crestor®).[7]

A patented and approved use of rosuvastatin was to treat heterozygous familial hypercholesterolemia (HeFH). An unpatented, but also approved use, was to treat homozygous familial hypercholesterolemia (HoFH). Because the generic had created a skinny label by carving out the treatment-patented HeFH indication, leaving in the unpatented HoFH indication, the court held that the generic was not inducing third parties to use its generic product to treat HeFH. This was so even though it is understood that doctors will prescribe the generic drug for all indications that are on the brand's labeling.

A contrasting case is AstraZeneca LP v. Apotex, Inc., 633 F.3d 1042 (Fed. Cir. 2010). A generic tried to avoid a treatment patent directed to a method of treating respiratory diseases by administering a budesonide dose not more than once per day. The brand's label described both once-per-day and twice-per-day dosing. The generic carved out the once-per-day dosing, but kept recommendations for starting doses of "0.5 mg total daily dose administered twice daily in divided doses" and was required to keep the FDA-mandated recommendation to titrate down to the lowest effective dose. The court found infringement of the treatment patent, concluding that:

- Starting with a 0.5 mg total daily dose administered twice daily, downward titration would necessarily lead to once-per-day use of the generic's 0.25 mg vial of budesonide.
- The generic's label would inevitably lead some users to practice the claimed treatment of once daily administration of the drug.

Invalidating Treatment Patents: The Omeprazole Case

A patent claim is invalid for lack of novelty (i.e., anticipation) if a single prior art reference discloses each claim limitation, either expressly or inherently. One way in which treatment patents have been successfully invalidated is by showing that the use of the API in the prior art inherently treated patients according to the treatment patent, even though at the time this wasn't recognized. A patent directed to a previously unknown mechanism of action for an API is vulnerable to such a finding of anticipation. For an example, we return to the omeprazole case, Astra Aktiebolag v. Andrx Pharms., Inc., 222 F. Supp. 2d 423 (S.D.N.Y. 2002).

Treatment of ulcers by omeprazole was disclosed in the prior art. Subsequently, it was found that ulcers were associated with *H. pylori* infection, not burns in the stomach lining from spicy food, as had been the conventional wisdom. Treatment of ulcerative *H. pylori* infection by omeprazole was then patented. But the *H. pylori* treatment patent claims were found invalid for anticipation, because the prior art showed treatment of ulcers by omeprazole, and because those ulcers had harbored *H. pylori* infections, then—though unrecognized at the time—omeprazole had inherently treated the *H. pylori* infections.

The Takeaway from the Rosuvastatin, Budesonide, and Omeprazole Decisions

As counsel for a generic company, keep the following in mind when litigating treatment patents:

- A Section viii carve-out is an effective shield against a finding of infringement of a treatment patent, notwithstanding the fact that once the generic drug is on the market, doctors will prescribe it for all indications that are on the brand's labeling, including a patented treatment.

- But courts will look past mere labeling verbiage to see if the generic's label indication really would lead third parties to infringe the treatment patent.
- For a Section viii carve-out to be effective, you must ensure that the generic's labeling does not either expressly or inherently point the way for third parties to practice the treatment claims.
- You should scrutinize the prior art for old uses of the drug because if the patented treatment is inherent in the prior art use, the treatment claims may be invalidated for anticipation.

As counsel for the patent holder, you should do the following:

- Try to ensure that the patent claims are drafted so as to avoid reference to an old mechanism of use (i.e., a mechanism of action for the drug disclosed either expressly or inherently (e.g., *H. pylori* infection) in a prior art reference).
- Notwithstanding a Section viii carve-out, carefully examine the generic's label for any argument that the labeling statements would inherently induce third parties to practice the treatment claims.[8] L

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RESEARCH PATH: *Intellectual Property & Technology > Patents > Patent Litigation > Practice Notes*

5. *See* R+L Carriers, Inc. v. DriverTech LLC (In re Bill of Lading Transmission & Processing Sys. Patent Litig.), 681 F.3d 1323 (Fed. Cir. 2012). 6. *See* 21 U.S.C. § 355(j)(2)(A)(viii). 7. *See* AstraZeneca Pharms. LP v. Apotex Corp., 669 F.3d 1370 (Fed. Cir. 2012).

8. *See, e.g.*, GlaxoSmithKline LLC v. Teva Pharms. USA, Inc., 2016 U.S. Dist. LEXIS 94438 (D. Del. Jul. 20, 2016), where summary judgment for the defendant was denied because the carved-out use, decreased mortality due to congestive heart failure, may overlap with the use left in the generic label, treatment of post-myocardial infarction left ventricular dissynchrony.

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THE GDPR COMPLIANCE DEADLINE HAS ARRIVED— Are You Prepared?

The deadline for organizations to comply with the European Union (EU) General Data Protection Regulation (GDPR) is upon us.[1] As of May 25, 2018, all entities covered under the GDPR must be able to demonstrate their compliance to EU regulators. The expanded territorial reach of the GDPR means organizations in the United States must comply if they either offer goods or services to individuals in EU member states and select other countries or monitor individuals' behavior in those nations.

THE FAILURE TO COMPLY WITH THE GDPR MAY NOW trigger steep administrative fines of up to €20 million or 4% of the organization's global annual revenue, whichever is greater. Notably, the GDPR does not apply solely to commercial businesses—not-for-profit organizations, charities, and educational institutions may all fall within the regulation's purview.

What Is the GDPR?

Put simply, the GDPR is a regulation requiring organizations that process the personal data of individuals in the European Economic Area (EEA)[2] to institute strong data protection mechanisms, incorporate privacy principles into the design of business processes, and allow EEA individuals to exercise certain rights over their personal data. The GDPR replaced the EU Data Protection Directive[3] and creates more robust requirements for protecting EEA personal data.

The GDPR also significantly expands the territorial scope of European data protection law. Even organizations in the United States will need to comply with the GDPR if they either offer goods or services to EEA individuals or monitor EEA individuals' behavior. Accordingly, your organization may be required to comply with the GDPR even if it does not have a physical presence in Europe.

Who Needs to Comply?

Consider the following examples of scenarios in which your organization may need to comply with the GDPR:

- Your company operates a website or mobile app that targets EEA users.
- You track and monitor the online behavior of EEA users of your company's website or mobile app.
- Your multinational company performs human resources activities for its employees and job applicants residing in the EEA.
- Your company's customer base includes businesses located in the EEA.
- Your organization receives charitable donations from EEA individuals.
- Your educational institution processes admissions applications submitted by prospective students currently residing in the EEA.

10 Key Compliance Areas

Because of the wide-reaching application of the GDPR, every organization should evaluate whether it has any GDPR compliance obligations. If you determine your organization is subject to the GDPR, we suggest focusing your initial compliance efforts in the following 10 key areas:

1. **Create a Data Map for Personal Data.** A deep understanding of how your organization creates, receives, maintains, or transmits personal data about EEA individuals is foundational to a GDPR compliance program. Additionally, it is important to ascertain whether your organization processes special categories of personal data, such as information about racial or ethnic origin, political opinions, religious beliefs, trade union membership, sex life or sexual orientation, medical or genetic information, or biometric data.
2. **Inventory Processing Activities.** The GDPR requires an organization to create detailed records of all of its processing activities. This step is not only necessary for demonstrating your organization's GDPR compliance to a regulator, but it is also helpful in identifying which of your practices and operations will need to be scrutinized for consistency with the GDPR's requirements.
3. **Assess the Scope of Your GDPR Compliance Obligations**. The extent of your GDPR obligations depends on whether your organization is best characterized as a "data controller" that determines the purposes for which processing activities are carried out or a "data processor" that handles personal data on behalf of a data controller. Sometimes an organization may be both a controller and a processor. For instance, it may be a data controller to the extent it performs human resources functions for its EEA employees and a data processor with respect to personal data received from EEA customers.

1. General Data Protection Regulation (EU) 2016/679, http://eur-lex.europa.eu/legal-content/EN/TXT/HTML/?uri=CELEX:32016R0679&from=EN. 2. The European Economic Area consists of EU member states and Iceland, Liechtenstein, and Norway. 3. EU Data Protection Directive 95/46/EC. Unlike the GDPR, the EU Data Protection Directive was not a regulation that was immediately legally binding on EU member states. Instead, the directive required each EU member state to interpret the directive's standards and pass national legislation to implement them.

Related Content

To learn more about the European Union General Data Protection Regulation (GDPR), see

> **GENERAL DATA PROTECTION REGULATION (GDPR)**

RESEARCH PATH: *Data Security & Privacy > International Compliance > General Data Protection Regulation (GDPR) > Practice Notes*

For a sample GDPR privacy policy, see

> **PRIVACY POLICY (GDPR COMPLIANT, GENERAL)**

RESEARCH PATH: *Data Security & Privacy > International Compliance > General Data Protection Regulation (GDPR) > Expert Forms*

For a discussion on GDPR protection principles, see

> **PROTECTION PRINCIPLES UNDER THE GENERAL DATA PROTECTION REGULATION (GDPR)**

RESEARCH PATH: *Data Security & Privacy > International Compliance > General Data Protection Regulation (GDPR) > Practice Notes*

For an explanation of the consent requirements under the GDPR, see

> **CONSENT UNDER THE GENERAL DATA PROTECTION REGULATION (GDPR)**

RESEARCH PATH: *Data Security & Privacy > International Compliance > General Data Protection Regulation (GDPR) > Practice Notes*

4. **Identify Legal Bases for Processing Activities.** The GDPR enumerates several bases for the lawfulness of a processing activity. For example, a processing activity may be lawful if consent has been obtained from the individual data subject, the processing is necessary for the performance of a contract entered into with the data subject, the processing is necessary to comply with applicable legal requirements, or the processing is necessary for the organization's legitimate interests. Your organization should be prepared to articulate a legal basis under the GDPR for each category of processing activities in which it engages.

5. **Implement Valid Consent Mechanisms.** The GDPR includes stringent requirements for obtaining an individual's consent to the processing of personal data. Your organization should carefully implement valid mechanisms to obtain individuals' consent to those processing activities involving special categories of personal data and for which you have identified consent as the legal basis. Along with consent mechanisms, your organization should ensure it provides meaningful notices to individuals of the purposes of its processing activities that satisfy GDPR requirements.

6. **Evaluate Processes for Protecting Individuals' Rights.** Under the GDPR, individuals have enhanced rights with respect to their personal data, including the rights to transparency, access, rectification and erasure, restrict processing, object to certain types of processing, and data portability. Your organization should decide how it will operationalize the GDPR's requirements for protecting individuals' rights over each category of personal data you process.

Related Content

To explore the data portability rights and requirements pursuant to the GDPR, see

> **DATA PORTABILITY UNDER THE GENERAL DATA PROTECTION REGULATION (GDPR)**

RESEARCH PATH: *Data Security & Privacy > International Compliance > General Data Protection Regulation (GDPR) > Practice Notes*

For more information on GDPR enforcement and sanctions, see

> **SANCTIONS AND ENFORCEMENT UNDER THE GENERAL DATA PROTECTION REGULATION (GDPR)**

RESEARCH PATH: *Data Security & Privacy > International Compliance > General Data Protection Regulation (GDPR) > Practice Notes*

To examine pro-controller data processing clauses, see

> **DATA PROCESSING CLAUSES (DPA 1998 AND GDPR COMPLIANT, PRO-CONTROLLER)**

RESEARCH PATH: *Data Security & Privacy > International Compliance > General Data Protection Regulation (GDPR) > Expert Forms*

To examine pro-processor data processing clauses, see

> **DATA PROCESSING CLAUSES (DPA 1998 AND GDPR COMPLIANT, PRO-PROCESSOR)**

RESEARCH PATH: *Data Security & Privacy > International Compliance > General Data Protection Regulation (GDPR) > Expert Forms*

7. **Examine Vendor Relationships.** Whether your organization is functioning as a data controller or a data processor, the GDPR requires you to update relevant vendor contracts to impose specific data protection obligations on them. Further, data processors are required to obtain general or specific consent from the data controller to whom it is providing services before outsourcing any processing activities to vendors.

8. **Assess Data Security Practices.** Your organization should have a documented plan for complying with the GDPR's requirements for protecting the confidentiality, availability, and integrity of EEA personal data and the resilience of systems processing such data.

9. **Appoint a Data Protection Officer (DPO) and/or a Europe-Based GDPR Representative.** Under some circumstances, the GDPR requires an organization to appoint a DPO. A DPO must have expertise in data protection laws and can be either an external service provider or an employee of the organization, as long as the DPO does not experience a conflict of interests when performing his or her duties. The DPO would serve as the organization's point of contact for regulators and be responsible for various GDPR compliance efforts, including training staff, conducting audits, and advising on data protection impact assessments of proposed or existing processing activities. Moreover, the GDPR requires organizations without a European establishment to appoint a GDPR representative based in the EEA.

10. **Develop an Internal GDPR Policy Manual.** Although not explicitly required by the GDPR, we recommend creating an internal GDPR Policy Manual that your organization can not only use as a foundation for employee training, but also produce to regulators to showcase your compliance. The manual may contain policies and procedures that address topics such as consent mechanisms, individuals' rights, vendor management, meeting the GDPR's strict breach notification requirements, when to perform data protection impact assessments, receiving and investigating privacy complaints, handling special categories of data, international transfers of personal data, data retention requirements, and the concepts of privacy by design and privacy by default. L

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RESEARCH PATH: *Data Security & Privacy > International Compliance > General Data Protection Regulation (GDPR) > Practice Notes*

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Climate Change Considerations in M&A TRANSACTIONS

Introduction

CLIMATE CHANGE IS ARGUABLY THE MOST HIGH-PROFILE and rapidly evolving environmental issue facing the global business community today. Governments of nearly every nation have acknowledged the risks posed by a warming climate and taken some action either to combat those risks, to mitigate the physical effects of climate change, or both. In addition, many corporations have publicly announced efforts to reduce emissions of greenhouse gasses (GHGs) associated with their operations and to otherwise take steps to combat climate change. Companies involved in certain mergers and acquisitions need to be aware of the risks related to climate change that may arise in the transactional context. While not every deal will involve climate change-related diligence, more and more industries are becoming subject to regulations and legal actions aimed at combatting climate change. Others have found that a changing climate may present direct risks to property and supply chains. In addition, many companies have taken to marketing themselves as climate-friendly organizations in an effort to attract businesses and investment, therefore creating a risk that failure to live up to those claims may prove off-putting to customers and investors and possibly result in legal liability. In order to properly assess and value corporate assets in M&A transactions, buyers and sellers of regulated assets need to understand the potential impact of climate change on business and successfully anticipate developments in this rapidly evolving area of law and policy.

There is no set formula for assessing climate risk in the transactional context. Due diligence will need to be tailored to the target and will vary substantially depending on the industry and the location of the target's operations. That said, risks associated with climate change generally fall into one of four categories: physical risks, customer and investor considerations, compliance risks, and litigation risks, each of which is discussed in more detail below. Given the potential enormity of the issues presented by climate change, and the wide-ranging efforts taken in response, climate change diligence is no longer limited to deals involving power plants and heavy industry. At a minimum, parties in nearly every M&A transaction should conduct a preliminary assessment to determine whether any or all of these categories of risk are present with respect to a target.

Physical Risks

While perhaps the most difficult to assess, climate change's most obvious risks relate to disruptions to a company's business or damage to a company's assets (e.g., facilities, infrastructure, land, or resources) due to physical impacts, such as rising sea levels, more extreme storms, floods, fires, and drought. The 2017 hurricane season and the forest fires that blazed across the western United States serve as a reminder of the devastation that can be caused by natural disasters, the prevalence and intensity of which some are attributing to climate change. Although it can be argued that virtually every sector of the U.S. economy faces risks for the short- and long-term physical effects of climate change, it appears likely that certain sectors will be disproportionately impacted. For example, the agriculture sector faces greater risks associated with water scarcity and droughts, as well as increased exposure to new pests and diseases.

Likewise, due to climate change, the tourism industry is vulnerable to increased weather extremes, rising temperatures, coastal erosion, droughts, and changes in precipitation patterns and snow reliability. The insurance industry, perhaps more than any other, faces increased risks from virtually all physical impacts of climate change. At meetings at the United Nations in 2015, top insurers called on governments to step up global efforts to build resilience against natural disasters exacerbated by climate change and highlighted that average economic losses from disasters in the last decade amounted

Related Content

For a general discussion on the environmental risks that arise in corporate transactions and defenses that may be obtained through due diligence, see

> ENVIRONMENTAL DUE DILIGENCE IN M&A TRANSACTIONS

RESEARCH PATH: *Corporate and M&A > Specialist Issues in M&A > Environmental > Practice Notes*

For an explanation about the most important contractual provisions for allocating environmental liabilities in an M&A agreement, see

> ALLOCATING ENVIRONMENTAL RISKS IN THE TRANSACTION AGREEMENT

RESEARCH PATH: *Corporate and M&A > Specialist Issues in M&A > Environmental > Practice Notes*

For information on environmental concerns that must be considered during and after closing an M&A transaction, see

> CLOSING AND POST-CLOSING ENVIRONMENTAL LAW CONSIDERATIONS

RESEARCH PATH: *Corporate and M&A > Specialist Issues in M&A > Environmental > Practice Notes*

To explore the role that environmental insurance can play in M&A transactions by allowing the parties to transfer environmental risks to an insurer, see

> ENVIRONMENTAL INSURANCE AS M&A RISK MANAGEMENT TOOL

RESEARCH PATH: *Corporate and M&A > Specialist Issues in M&A > Environmental > Practice Notes* to around $190 billion annually, while average insured losses were about $60 billion.

Assessing the physical risks posed by climate change can be extraordinarily difficult, given the randomness of natural disasters and the vicissitudes in weather. Droughts, hurricanes, floods, and fires are nearly impossible to predict with any certainty. That said, it is becoming easier in certain circumstances to observe trends, particularly with respect to rising sea levels. For example, a recent study by the University of Miami found that Miami Beach flooding events have increased significantly over the last decade due to an acceleration of sea-level rise in South Florida. Thus, should a target company hold significant assets in South Florida, or in any other coastal area experiencing increased flooding, a potential buyer would be wise to assess what impacts such flooding could have on the target's operations and assets. Likewise, tourism-based assets such as ski or beach resorts may have a limited carbon footprint yet face substantial physical risks due to warmer long-term temperatures or rising sea levels. A recent study by the European Geosciences Union found that European ski resorts may lose up to 70% of their snow cover by 2100 due to climate change.

In addition, there may be significant physical risks associated with a target's supply chain potentially affecting the target's ability to reliably produce its products and deliver services. For example, at first glance, a clothing manufacturer targeted in an acquisition may seem unlikely to be subject to material risks associated with climate change. However, if the clothing manufacturer sources its products from a low-lying area like Bangladesh, an essential source for many clothing retailers globally, risks associated with climate may be far greater than originally anticipated, as Bangladesh is frequently cited as a country most likely to be impacted by the anticipated sea-level rise associated with climate change. While supply chain due diligence is now a common element of any M&A transaction, it is becoming increasingly important to assess how climate change could impact a target's suppliers as well as raw materials used in the target's operations.

Shareholder Activism Considerations

Carbon-intensive businesses, such as oil and gas exploration and production, electric utilities, and chemical manufacturers, also face risks related to a growing cadre of institutional and other investors who have pledged to reduce or eliminate the carbon-intensity of their investments and portfolios. Known as fossil fuel divestment or portfolio decarbonization, these socially motivated campaigns seek to achieve reductions in GHG emissions by shifting investment capital from particularly carbon-intensive companies, projects, and technologies in each sector and by reinvesting that capital into carbon-efficient companies, projects, and technologies of the same sector. If a sufficient number of institutional investors start to engage and/or reallocate capital on the basis of companies' GHG emissions, it can provide a strong incentive for those companies to rechannel their own investments from carbon-intensive to low-carbon activities, assets, and technologies. According to an October 2013 University of Oxford study, the divestment campaign to persuade investors to take their money out of the fossil fuel sector is growing faster than any previous divestment campaign and could cause significant damage to carbon-intensive companies. Although the direct financial impact on share prices related to such campaigns is likely to be small in the short term, the report concluded that the reputational damage, or stigmatization, can still have major financial consequences. In particular, significant reputational damage to carbon-intensive businesses could reduce the availability or increase the cost of debt, both short-term working capital and long-dated securities.

Many jurisdictions have passed laws or promulgated rules and regulations aimed at combatting climate change. Some of these legal requirements may directly affect a target company, while others may have indirect effects on supply chains, the price of raw materials, or otherwise impact operating costs.

In the wake of the agreement reached at the 2015 United Nations Framework Convention on Climate Change (UNFCCC) meeting in Paris, known widely as the Paris Agreement, there were 89 shareholder resolutions filed on climate change in 2016. Many institutional investors are now considering climate-related factors in their investment decisions. In fact, Blackrock, the world's largest asset manager with $5.4 trillion in assets under management, has identified climate risk disclosure as one of five top engagement priorities.

In a similar vein, another concept potentially relevant to carbon-intensive businesses is that of stranded assets, a financial term that describes corporate assets that become subject to unanticipated or premature write-downs, devaluations, or conversion to liabilities. With respect to climate change, the term has become more prevalent in recent years as economists and scientists study the potential ramifications of regulatory policies, technological advances, consumer behaviors, or other market actions that could dramatically decrease the use of fossil fuels. Investors are also beginning to take notice, expressing concern that action needed to curtail the increase in global temperatures ultimately will result in a regulatory mandate to leave proven reserves of fossil fuels in the ground or will otherwise make it uneconomical to produce or use fossil fuels. Certain institutional investors have gone on record to state that stranded asset-related concerns have led them to divest, while others are pressuring companies to disclose their strategies to deal with the potential for stranded assets.

When assessing carbon-intensive targets in an M&A transaction, it is important to understand how that target, and its industry, is perceived by investors and financial institutions. Coal companies, for example, may have a much more difficult time attracting investment given perceptions about the negative environmental attributes of the industry. This could result in depressed pricing for the target's assets, and it could also make it more difficult to obtain debt financing, if needed. Certainly, financial investors should understand the risks of reputational damage to carbon-intensive businesses, and any trends in those risks, as such concerns may increase during the hold period and jeopardize a successful exit.

Compliance Risks

Despite a varied and rapidly shifting regulatory landscape on climate, parties to an M&A transaction should identify and assess compliance risks. Many jurisdictions have passed laws or promulgated rules and regulations aimed at combatting climate change. Some of these legal requirements may directly affect a target company, while others may have indirect effects on supply chains, the price of raw materials, or otherwise impact operating costs. Buyers and lenders in M&A deals, therefore, need to understand the current state of climate change regulation to determine whether a target's business is directly or indirectly affected by such regulation. Given the rapid developments in climate change regulation, this is not always an easy task.

Federal Climate Change Regulation

The U.S. government's effort to regulate climate change serves as a vivid example of the unsettled state of domestic climate change law. In 2007, the U.S. Supreme Court ruled in Massachusetts v. EPA, 549 U.S. 497 (2007), that GHGs must be regulated under the federal Clean Air Act, a law first passed in 1970 (long before climate change entered the lexicon), provided that the Environmental Protection Agency (EPA) issues a finding that GHGs endangered the public health and welfare, which EPA has since done. Around this time, Congress made several attempts to amend the Clean Air Act to impose restrictions on GHG emissions; however, these efforts never met with success. Frustrated with Congress' inability to pass what it saw as important restrictions on GHG emissions, the Obama administration attempted to bypass Congress by promulgating several regulations under the existing Clean Air Act aimed at reducing GHG emissions from the power sector, the largest emitter of GHGs in the U.S. These rules, promulgated by the EPA, imposed

standards on both new and existing power plants[1]. These rules were immediately challenged in court by plaintiffs who argued that the EPA overstepped its authority under the Clean Air Act, and many of these challenges remain pending. As such, it remains unclear to what extent the EPA can regulate GHGs, notwithstanding the Supreme Court's finding that it must.

The state of federal climate change regulation was further disrupted by the 2016 election of Donald Trump to the presidency. Since taking office in January, President Trump has made it clear that his administration has no interest in taking any legislative or regulatory action to mitigate or adapt to the effects of climate change. Rather, he has suggested that climate change is a hoax and withdrew the United States from the Paris Agreement. In furtherance of these views, EPA Administrator Scott Pruitt (who led several of the legal challenges against the Obama administration climate change rules) issued a public notice that the EPA will repeal the rules imposing GHG emission standards on existing power plants. This action is certain to spur a new round of legal challenges, where plaintiffs will almost certainly argue that, given the Supreme Court's ruling in *Massachusetts v. EPA*, the federal government is required to regulate GHG emissions. If the past is predictive, legal disputes over federal regulation of GHG emissions likely will remain unresolved well into the next presidency.

The unsettled state of federal law concerning climate change makes it very difficult to assess what impact, if any, federal regulation will have on a particular business operating in the United States. Certainly, those in the power generation industry remain subject to a shifting legal regime that could have profound impacts on their operations. For companies assessing potential M&A transactions with targets in the traditional or renewable energy industries, including any of their suppliers or major customers (which now include many Fortune 500 companies that have directly contracted for energy from solar and wind farms), assessing possible impacts from federal climate regulation will be key to any due diligence exercise.

State Regulation of Climate Change

In the absence of stable federal policy concerning climate change, many states have taken action to reduce GHG emissions or otherwise respond to climate change. For example, a block of nine states in the Northeast and Mid-Atlantic have joined together to establish a cap-and-trade program, known as the Regional Greenhouse Gas Initiative (RGGI), regulating GHG emissions from power plants located within the member states (as of the date of this writing, Connecticut, Delaware, Maine, Maryland, Massachusetts, New Hampshire, New York, Rhode Island, and Vermont). Under a cap-and-trade program, GHG emitters either are granted or must purchase credits equal to the amount of GHGs emitted over a certain period of time. The number of available credits is capped, ensuring that total GHGs emitted from all regulated sources do not exceed a preset amount, which often lowers over time. Under the RGGI program, for example, the cap is reduced by 2.5% each year until 2020. It is up to the source either to reduce emissions or obtain sufficient credits to match its emissions. In general, market forces set the price of a credit on an open market.

While RGGI is focused exclusively on the power generation sector, California (the world's sixth-largest economy) has enacted, under the California Global Warming Solutions Act of 2006, 2006 Cal ALS 488, a more expansive cap-and-trade program that applies to utilities, large industrial facilities, and certain fuel distribution companies, regulating 85% of all of California's GHG emissions. One interesting aspect of the California program is that it allows for what are known as offset credits, whereby businesses that voluntarily reduce GHG emissions can generate credits equal to their GHG reduction, which credits can then be sold to regulated entities to meet their compliance obligations under the cap-and-trade program. California recently renewed its commitment to its cap-and-trade law, extending the program until 2030 and requiring that it reduce GHG emissions by 40% below 1990 levels over the next 13 years.

In addition to cap-and-trade programs, a majority of states have taken action to promote the use of renewable energy technologies. Twenty-nine states and the District of Columbia currently have adopted binding renewable portfolio standards, which require that a certain percentage of the retail electricity power consumed or generated come from renewable energy sources, typically wind, geothermal, solar, hydro, landfill gas, or biomass (and nine additional states have renewable or alternate energy goals, which generally are not legally binding).

In short, many states have acted to fill the void left by the federal government in the area of climate change regulation. Parties to M&A transactions need to be aware of state-level requirements, both those on the books and those pending in the state legislatures and regulatory agencies. Much like the federal government, the status of climate change regulation at the state level remains in flux, though unlike at the federal level, the trend appears to be towards greater regulation. Depending on the state and the industry, the operating costs associated with these regulations could be substantial.

International Climate Change Regulation

Parties to M&A transactions that involve overseas operations also need to be aware that many foreign jurisdictions have enacted laws aimed at combatting climate change, and it is likely that many more will in the next decade. This is because 176 nations have ratified the Paris Agreement, which requires signatories to take steps to keep global temperature rise below 2 degrees Celsius above pre-industrial temperatures while pursuing efforts to limit it to 1.5 degrees Celsius. The Paris Agreement seeks to increase the ability of the global community to adapt to, and directs funds towards, low-emission and climate-resilient development. Paris Agreement parties generally are permitted to adopt whatever means they choose for achieving those goals, though countries are to submit plans to the UNFCCC by 2020 detailing those efforts, and are required to update those plans every five years.

Of course, the Paris Agreement is not the first international undertaking to combat climate change. Businesses operating in the European Union likely are familiar with its GHG cap-and-trade program, known as the EU Emissions Trading System (EU ETS), which is the world's first international emissions trading system to address GHG emissions from companies and is by far the biggest carbon market today. It covers more than 11,000 power plants and manufacturing facilities in the 28 EU member states as well as Iceland, Liechtenstein, and Norway. In addition, airline operators flying within and between most of these countries are also regulated under the programs such that, in total, around 45% of total EU emissions are limited by the EU ETS.

China, the world's largest emitter of GHGs, is also taking steps to combat climate change. A Paris Agreement signatory, China has committed to reducing GHG emissions by up to 45% from 2005 levels by 2020 and increasing renewable energy production so that it will meet 20% of national electricity needs by 2030. In addition, since 2011, China has implemented a number of cap-and-trade pilot programs in cities and provinces around the country, testing market-based mechanisms for reducing GHG emissions.

Outside the United States, it is largely accepted that climate change poses a significant threat to human health, the environment, and many industries. Almost without exception, the trend internationally has been towards greater regulation, and given the commitments embodied in the Paris Agreement, there is little reason to believe this trend will not continue. Therefore, parties to M&A deals involving foreign operations will need to assess what steps the foreign jurisdiction is taking to combat climate change, and because there is no overarching international agreement as to what those steps should be, a country-by-country analysis will be required.

Litigation Risks

It also is increasingly important in M&A transactions to assess potential litigation risks arising out of climate change. Over the past few years, climate change litigation against private parties has arisen in numerous contexts, though the largest GHG emitters, particularly those in the oil and gas industry, appear to be the most likely targets.

Government Investigations into Climate-Related Disclosures

One litigation risk concerns government investigations into disclosure practices surrounding the existence or potential impacts of climate change. These investigations seek to determine whether certain energy companies have participated in a long-standing

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1. 82 Fed. Reg. 48035 (October 16, 2017).

disinformation campaign to create doubt about the existence of climate change and to undermine scientific findings regarding climate change. In November 2015, the New York Attorney General announced that a two-year investigation found that Peabody Energy Corporation, the largest publicly traded coal company in the world, had violated New York laws prohibiting false and misleading conduct in the company's statements to the public and investors regarding financial risks associated with climate change and potential regulatory responses. As part of the agreement concluding the investigation, Peabody agreed to file revised shareholder disclosures with the U.S. Securities and Exchange Commission that are to "accurately and objectively represent these risks to investors and the public." That same month, the New York Attorney General issued ExxonMobil a subpoena ordering the company to turn over four decades worth of research findings and communications into the causes and effects of climate change. Massachusetts and California have since commenced similar investigation into ExxonMobil's conduct with respect to climate change disclosures. In addition, members of Congress have called on the Department of Justice to investigate whether Shell Oil deceived the public on climate change at the same time it was preparing its business operations for rising sea levels. The ultimate impact of such investigations into fossil fuel company conduct regarding climate change is unclear. To date, lawsuits generally have not been filed, and it is uncertain whether the investigations of the attorneys general will identify information that would allow a lawsuit to proceed against the companies under investigation. Nevertheless, governmental investigations can be costly, both in terms of legal fees and reputationally. As such, parties to M&A transactions involving energy companies and other large sources of GHGs should assess a target's disclosures concerning climate change to determine whether they present any issues.

Tort Litigation

Large emitters of GHGs also face litigation risks associated with tort claims alleging various injuries related to climate change. Several cases have been brought in courts across the country alleging damages related to climate change under tort theories such as nuisance, trespass, and negligence. For example, in Conn. v. Am. Elec. Power Co., 406 F. Supp. 2d 265 (S.D.N.Y. 2005), eight states, the City of New York, and three environmental groups filed suit against five energy companies, alleging that the carbon dioxide emissions from the companies' power plants contribute to the public nuisance of global warming. Plaintiffs asked the district court to cap carbon dioxide emissions and mandate annual emissions reductions. The court granted defendants' motions to dismiss on the grounds that the case raised non-justiciable political questions; however, on appeal the U.S. Court of Appeals for the Second Circuit reversed the decision, holding that the plaintiffs had standing to bring their claims.[2] The U.S. Supreme Court later reversed the Second Circuit, holding that the plaintiffs' claims were preempted by the Clean Air Act, which the Court found delegated authority to regulate harms associated with GHG emissions to the EPA.[3]

Another example of climate change tort litigation can be found in the case of *Comer v. Murphy Oil*. In the district court case, Mississippi property owners had brought suit against numerous insurers, chemical companies, oil companies, and coal companies, alleging that the defendants' carbon dioxide emissions contributed to global warming, which warmed the waters in the Gulf of Mexico and increased the frequency and severity of hurricanes, including Hurricane Katrina.[4] Under theories of private nuisance, trespass, and negligence, the plaintiffs sought damages for loss of property, loss of income, cleanup expenses, loss of loved ones, and emotional distress. The suit was dismissed on standing and political question grounds and plaintiffs appealed to the U.S. Court of Appeals for the Fifth Circuit, which initially overturned the district court ruling for the same reasons cited by the Second Circuit in the Connecticut v. American Electric Power Co. case.[5] However, after a protracted legal battle over procedural rules, the district court's decision ultimately was allowed to stand.[6]

Although courts have held that climate-related tort litigation claims are preempted by the Clean Air Act, some are beginning to question whether the United States may soon experience a renewed round of climate-related tort litigation prompted, in part, by the Trump administration's actions aimed at rolling back existing GHG regulations. In fact, in July of 2017, three local governments in California (San Mateo County, Marin County, and the City of Imperial Beach) each sued 20 fossil fuel companies, including Chevron, ExxonMobil, Peabody Energy, and Arch Coal, under various state common law tort theories alleging that each defendant is responsible for contributing to climate change, which has resulted in sea level rise and increased flooding that resulted in the local governments' incurring damages. Whether these three cases are a sign of things to come remains to be seen, but it is noteworthy that the plaintiffs' claims were brought under state common law, which is not preempted by the federal Clean Air Act.

To date, climate-related litigation has been limited largely to parties or projects involved in oil and gas and other major GHG-emitting industries. There also has been something of a recent lull in the number of climate-related cases filed in the courts; however, many attribute this to the fact that the Obama administration was seen as taking a proactive role in addressing climate change. Given the change in approach adopted by the Trump administration, it would not be surprising to see a surge in climate change litigation in the near future. As such, parties to M&A transactions involving major GHG emitters would be wise to assess the risk that the target may be named in such litigation.

2. Conn. v. Am. Elec. Power Co., 582 F.3d 309 (2d Cir. 2009). 3. Am. Elec. Power Co. v. Conn., 564 U.S. 410 (2011). 4. Comer v. Nationwide Mut. Ins. Co., 2006 U.S. Dist. LEXIS 33123 (S.D. Miss. Feb. 23, 2006). 5. Comer v. Murphy Oil USA, 585 F.3d 855 (5th Cir. 2009). 6. Comer v. Murphy Oil USA, 718 F.3d 460 (5th Cir. 2013).

Conclusion

Assessing climate change risks in M&A transactions can be difficult, at times subjective, and in many cases speculative. Any diligence exercise in this area must be tailored to the particular target, the location and operations of its assets, the nature of its supply chain, and the target's own experience managing climate-related risk. There simply is no standard procedure for conducting this type of due diligence. That said, every climate change diligence exercise in an M&A transaction will require the parties to consider the totality of a target's operations and anticipate infrequent occurrences that may present catastrophic risks.

When assessing companies that emit significant quantities of GHGs, the parties and their counsel must examine issues concerning the target's current and future compliance obligations with climate change-related regulations. Some questions to ask in M&A due diligence include:

- Does the target operate in jurisdictions where GHG emissions are regulated or where there are current or recent historic efforts to impose such regulation?
- If currently regulated, will the target be required to make significant capital expenditures to obtain or maintain compliance?
- Is the target part of an industry that has been subject to governmental investigations or litigating relating to climate change?
- Has the target made public statements or disclosures concerning climate change risk that may in any way be considered misleading?

While it is perhaps obvious that climate change-related diligence of major GHG emitters is important, it is becoming clear that such diligence is just as important in M&A deals involving companies with little or no GHG emissions. These types of questions need to be asked regardless of whether the target operates in a carbon-intensive industry:

- Does the target operate, or are its raw materials sourced, in areas prone to flooding or at risk of rising sea levels?
- Is a warming climate likely to affect business operations or a target's supply chain?
- Is the company developing, or dependent upon, a project that may require a National Environmental Policy Act assessment?
- Is the target procuring renewable energy from projects dependent on governmental subsidies or similar support programs?

Certainly not all of these risks will be present in every M&A deal; however, where they do materialize, they can be material to the transaction. As such, it is key for those involved in M&A deals to understand the risks and think creatively about how they can be assessed and, if possible, managed in the transactional context.

See the complete practice note in Lexis Practice Advisor at *Corporate and M&A > Specialist Issues in M&A > Environmental > Practice Notes.*

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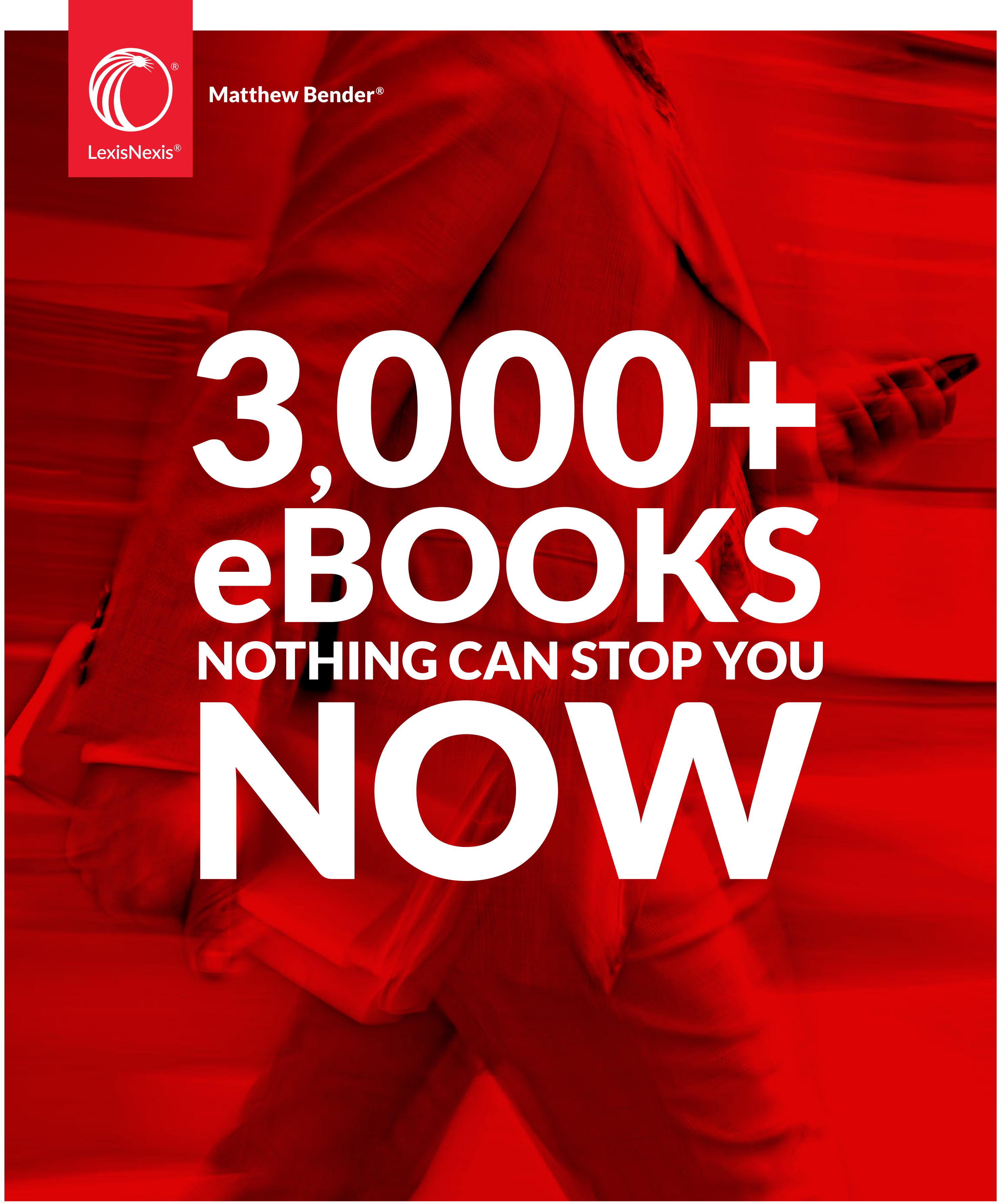

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Stored Communications Act: Practical Considerations

The Stored Communications Act (SCA), 18 U.S.C. § 2701 et seq., governs the disclosure of electronic communications stored with technology providers. Passed in 1986 as part of the Electronic Communications Privacy Act (ECPA), the SCA remains relevant to address issues regarding the privacy and disclosure of emails and other electronic communications.

AS THE USE OF TECHNOLOGY CONTINUES TO GROW, SO does the importance of the SCA's protections—and limits—on the disclosure of stored electronic communications. The SCA's age, however, makes it difficult to apply in modern times. This article provides guidance on how to apply the SCA to today's fast-growing technology.

Understanding How SCA Issues Arise

As a privacy statute, diverse circumstances can give rise to SCA issues:

- **Direct liability.** As discussed below, the SCA limits the ability of certain technology providers to disclose information. It also limits third parties' ability to access electronic communications without sufficient authorization. Litigation alleging violations of the SCA's substantive provisions therefore directly presents SCA issues.
- **Civil subpoena limitations.** Because of the SCA's restrictions on disclosure, technology providers and litigants often invoke the SCA when seeking to quash civil subpoenas to technology providers for electronic communications.[1]
- **Government investigations.** The SCA provides a detailed framework governing law enforcement requests for electronic communications. SCA issues often arise in motions to suppress and related criminal litigation. For example, a growing number of courts have found that the SCA is unconstitutional to the extent that it allows the government to obtain emails from an internet service provider without a warrant in violation of the Fourth Amendment. See U.S. v. Warshak, 631 F.3d 266 (6th Cir. 2010).

1. *See* Viacom Int'l Inc. v. YouTube Inc., 253 F.R.D. 256, 264 (S.D.N.Y. 2008) (quashing subpoena), aff'd in part on other grounds, vacated in part on other grounds, 676 F.3d 19 (2d Cir. 2012); In re Subpoena Duces Tecum to AOL, LLC, 550 F. Supp. 2d 606, 611 (E.D. Va. 2008); O'Grady v. Superior Court, 139 Cal. App. 4th 1423, 44 Cal. Rptr. 3d 72 (2006).

Additionally, the circuit conflict about whether technology providers and litigants can invoke the SCA when quashing criminal subpoenas or search warrants requesting data from extraterritorial servers, was resolved by the passage of the CLOUD Act as part of the Consolidated Appropriations Act, 2018, H.R. 1625, Div. V, 115th Cong., 2d Sess. (2018). The Act provides that a service provider must produce information within its "possession, custody, or control, regardless of whether such . . . information is located within or outside of the United States." CLOUD Act § 103(a). The passage of the CLOUD Act also rendered moot the *U.S. v. Microsoft* case pending before the Supreme Court on this issue. See U.S. v. Microsoft Corp., No. 17-2, slip op. at 3 (April 17, 2018) (dismissing the appeal as moot). The government has subsequently obtained a new warrant against Microsoft for the information requested in the original warrant at issue in the case.

Categorizing the Technology Involved in an SCA Claim

The technology behind an SCA claim matters. In many instances, the applicable SCA rules hinge on the particular technology involved. Specifically, different SCA rules apply depending on whether technology is classified as electronic communication services (ECS), remote computing services (RCS), both, or neither.

The following sections discuss the definitions of ECS and RCS, the rules applicable to each, and certain applications of these definitions. While you should familiarize yourself with these concepts, you must exercise caution in applying them. Courts have reached disparate results, and this area continually evolves with each new technological development.

Electronic Communication Services

The SCA defines an ECS as "any service which provides to users thereof the ability to send or receive wire or electronic communications."[2] With certain exceptions, ECS providers may not "knowingly divulge to any person or entity the contents of a communication while in electronic storage by that service."[3]

Clear examples of an ECS include an email provider's computer systems, a bulletin board system, or an internet service provider (ISP).[4] In addition, courts have classified text message service providers as ECS providers.[5] Even if providing a messaging service or internet service is not the entity's primary business, the entity can qualify as an ECS provider.[6]

As a practical matter, the definition of ECS often plays an important role in e-discovery matters. Because the SCA prohibits ECS providers from disclosing the contents of communications stored with them, do not expect to succeed in obtaining these communications by subpoenaing an ECS provider, such as a social media website or email vendor. Instead, you should request these records from the creator or recipient of such content.

Remote Computing Services

In contrast, the SCA defines an RCS as providing to the public "computer storage or processing services by means of an electronic communications system."[7] Again with certain exceptions, the SCA prohibits RCS providers from knowingly divulging to any person or entity the contents of any communication that the service carries or maintains:

- On behalf of, and received by means of electronic transmission from (or created by means of computer processing of communications received by means of electronic transmission from), a subscriber or customer of such service
- Solely for the purpose of providing storage or computer processing services to such subscriber or customer, if the provider is not authorized to access the contents of any such communications for purposes of providing any services other than storage or computer processing[8]

For example, a U.S. District Court in Illinois found that Microsoft's Hotmail's email service was an RCS because it found that "Microsoft [was] maintaining the messages 'solely for the purpose of providing storage or computer processing services to such subscriber or customer.'"[9]

Both ECS and RCS

In some instances, courts have concluded that modern technology providers act as both ECS and RCS providers with the different services they offer.[10] In Crispin v. Christian Audigier, Inc., 717 F. Supp. 2d 965 (C.D. Cal. 2010), the court concluded that social media websites were ECS providers, but alternatively held that they were RCS providers.

Where a provider acts as both an ECS and RCS, the SCA's applicable rules will apply to those aspects of the service that fit within the respective definitions.

Neither ECS nor RCS

In some instances, neither an ECS nor an RCS provider holds electronic communications. "[A] person who does not provide an electronic communication service [or a remote communication service] can disclose or use with impunity the

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For a discussion on the key issues involving the Electronic Communications Privacy Act, see

> ELECTRONIC COMMUNICATIONS PRIVACY ACT: KEY ISSUES

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For additional information on the Electronic Communications Privacy Act, see

> ELECTRONIC COMMUNICATION PRIVACY ACT ISSUES CHECKLIST

RESEARCH PATH: *Labor & Employment > Employment Policies > Company Property and Electronic Information > Checklists*

2. 18 U.S.C. § 2510(15). **3.** 18 U.S.C. § 2702(a)(1). **4.** *See* In re iPhone Application Litig., 844 F. Supp. 2d 1040, 1057 (N.D. Cal. 2012). **5.** *See* Quon v. Arch Wireless Operating Co., Inc., 529 F.3d 892 (9th Cir. 2008), rev'd on other grounds, City of Ontario v. Quon, 560 U.S. 746 (2010). Courts have ruled as well for social media sites. *See* Ehling v. Monmouth-Ocean Hosp. Service Corp., 961 F. Supp. 2d 659 (D.N.J. 2013); Crispin v. Christian Audigier, Inc., 717 F. Supp. 2d 965 (C.D. Cal. 2010). **6.** *See* In re Application of the United States for an Order Pursuant to 18 U.S.C. § 2705(b), 2018 U.S. Dist. LEXIS 19556 (D.D.C. Jan. 30, 2018) (Airbnb was an ECS provider as it provided a messaging service for its users to communicate with each other); In re United States for an Order Pursuant to 18 U.S.C. § 2703(d), 2018 U.S. Dist. LEXIS 52183 (D.D.C. Mar. 8, 2018) (Royal Caribbean Cruises provided internet service to its customers and thus qualified as an ECS provider). **7.** 18 U.S.C. § 2711(2). **8.** 18 U.S.C. § 2702(a)(2). **9.** United States v. Weaver, 636 F. Supp. 2d 769, 772 (C.D. Ill. 2009) (quoting 18 U.S.C. § 2703(b)(2)). **10.** *See* United States v. Weaver, 636 F. Supp. 2d 769, 770 (C.D. Ill. 2009) (email service provider was both ECS and RCS provider); *see also* In re United States, 665 F. Supp. 2d 1210, 1214 (D. Or. 2009) ("Today, most ISPs provide both ECS and RCS.").

> Terminated employees may retain access credentials or otherwise seek to obtain electronic records from the company. While the SCA may provide an employer with a remedy against such actions, a successful claim usually necessitates clear evidence that the employer had revoked the employee's authorization before the employee accessed the information.

contents of an electronic communication unlawfully obtained from electronic storage."[11]

In general, courts have concluded that personal devices, such as laptop computers and smartphones, do not provide electronic communications services for purposes of the SCA, even though they allow users to access such services.[12] Thus, individual computer users generally do not count as ECS or RCS providers.

However, while the SCA's disclosure limits would not apply, even entities that do not qualify as ECS or RCS providers can fall afoul of the SCA's limits on unauthorized access.[13] Importantly, the SCA provides for criminal and civil penalties for anyone who:

- Intentionally and without sufficient authorization
- Accesses "a facility through which an electronic communication service is provided"
- And in doing so, "obtains, alters, or prevents authorized access to a wire or electronic communication while it is in electronic storage in such system"[14]

Because the SCA does not prohibit the disclosure of information by non-ECS or RCS providers, you should not rely on it to protect against all possible disclosures of sensitive electronic communications.[15] Instead, you should counsel employers to maintain close control over individual devices, such as company laptops and cell phones.

Determining What Is in Electronic Storage

The SCA's ECS restrictions, 18 U.S.C. § 2702(a)(1), and access restrictions, 18 U.S.C. § 2701, only apply to communications that are in electronic storage. Electronic storage means:

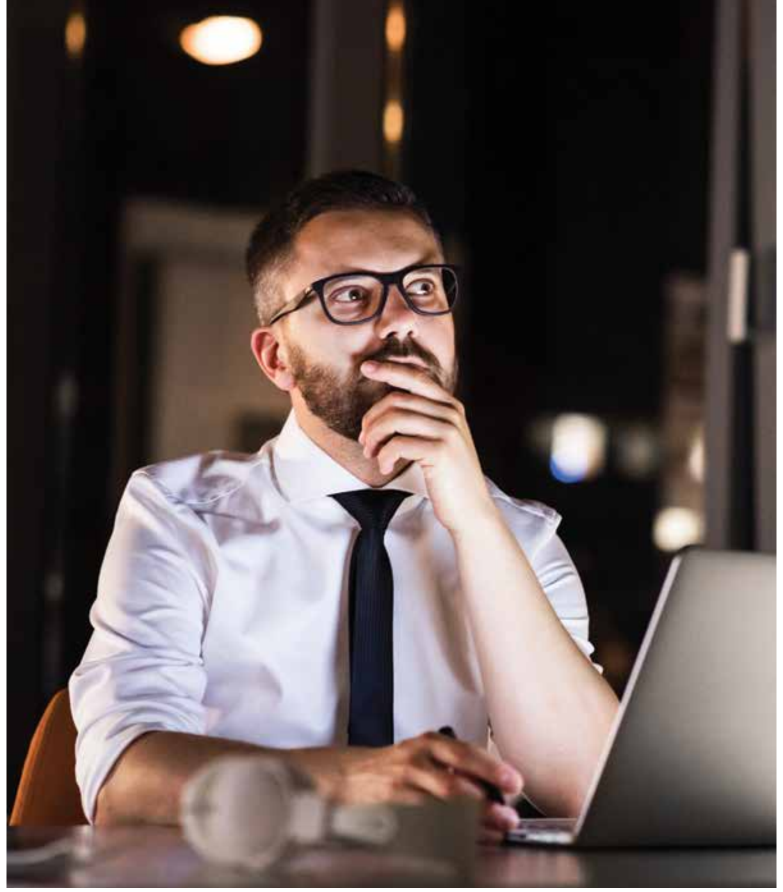
- Any temporary, intermediate storage of a wire or electronic communication incidental to the electronic transmission thereof
- Any storage of such communication by an ECS for purposes of backup protection of such communication[16]

In today's world of cloud computing and remote hosting, applying this definition can prove difficult. In particular, courts continue to struggle with whether documents stored remotely, such as web-based email, are stored "for purposes of backup protection" or for some other purpose that would render them outside the scope of the SCA's definition.[17] Nonetheless, certain general principles can help you analyze this portion of a potential SCA claim:

- Messages (such as emails, bulletin board postings, or pager messages) being stored pending delivery are generally deemed to be in electronic storage for purposes of the SCA.[18]
- Items stored on personal devices, such as cookies (small pieces of data stored on an internet user's computer) and text messages are generally not deemed to be in electronic storage for purposes of the SCA.[19]
- Messages that have already been delivered and read, but that a user chooses to leave on the server, have produced divergent results. Courts disagree on whether such emails are stored "for purposes of backup protection."[20]

Because technology continues to change, and in light of the disagreement among the courts in applying the SCA's definitions to today's technology, you should exercise caution in coming to fixed conclusions about the SCA's implications to particular facts.

11. Wesley College v. Pitts, 974 F. Supp. 375, 389 (D. Del. 1997). 12. *See* Garcia v. City of Laredo, 702 F.3d 788 (5th Cir. 2012); United States v. Steiger, 318 F.3d 1039, 1049 (11th Cir. 2003); In re iPhone Application Litig., 844 F. Supp. 2d at 1057–58; In re DoubleClick, Inc. Privacy Litig., 154 F. Supp. 2d 497, 512 (S.D.N.Y. 2001); Crowley v. CyberSource Corp., 166 F. Supp. 2d 1263, 1270–71 (N.D. Cal. 2001). 13. *See* Penrose Computer Marketgroup, Inc. v. Camin, 682 F. Supp. 2d 202, 211 (N.D.N.Y. 2010) ("[S]ection 2701 outlaws illegal entry, not larceny.") 14. 18 U.S.C. § 2701. 15. *See* K.F. Jacobsen & Co. v. Gaylor, 947 F. Supp. 2d 1120 (D. Or. 2013) (rejecting SCA claim because employers' individual computers were not ECS facilities). 16. 18 U.S.C. § 2510(17). 17. *See* Lazette v. Kulmatycki, 949 F.Supp.2d 748, 758-59 (N.D. Ohio 2013) (discussing the divergence in opinions). 18. *See* Theofel v. Farey-Jones, 359 F.3d 1066, 1075 (9th Cir. 2003) (collecting cases); Quon, 529 F.3d 892. 19. *See* In re DoubleClick, Inc. Privacy Litig., 154 F. Supp. 2d 511–12; Garcia, 702 F.3d 788. 20. Compare Theofel, 359 F.3d 1076-77, (holding delivered messages were in electronic storage for purposes of the SCA); Bailey v. Bailey, 2008 U.S. Dist. LEXIS 8565, at *16–18 (E.D. Mich. Feb. 6, 2008) (same); Ehling v. Monmouth-Ocean Hosp. Service Corp., 961 F. Supp. 2d 667 (D.N.J. 2013) (holding that Facebook wall postings were in electronic storage) with United States v. Weaver, 636 F. Supp. 2d 771–73 (C.D. Ill. 2009) (holding previously opened messages not in electronic storage for purposes of the SCA); Jennings v. Jennings, 736 S.E.2d 242, 245 (S.C. 2012).



Analyzing "Authorization"

Proper analysis of an SCA claim under 18 U.S.C. § 2701 also requires you to examine the factual question of whether the defendant acted "without authorization" or "exceed[ed] an authorization" in accessing the facility involved. In general, "[p]ermission to access a stored communication does not constitute valid authorization if it would not defeat a trespass claim in analogous circumstances."[21]

However, where an individual was "entitled to see" the information, courts do not generally find liability.[22] This result holds even where an individual puts the electronic communications to unauthorized use.[23] Relatedly, joint use of a computer will often preclude an SCA claim by one user against another.[24]

This issue often arises in the context of post-termination employment disputes. Terminated employees may retain access credentials or otherwise seek to obtain electronic records from the company. While the SCA may provide an employer with a remedy against such actions, a successful claim usually necessitates clear evidence that the employer had revoked the employee's authorization before the employee accessed the information.[25] You should therefore counsel clients to develop policies that will facilitate such proof.

Exceptions to SCA Prohibitions

The SCA includes many exceptions to its prohibitions, which the following sections discuss.

Certain Authorized Conduct

The SCA[26] does not apply with respect to conduct authorized:

- By the person or entity providing a wire or electronic communications service
- By a user of that service with respect to a communication of or intended for that user
- In Section 2703 (government access, 18 U.S.C. § 2703), 2704 (backup preservation, 18 U.S.C. § 2704), or 2518 (court-ordered electronic eavesdropping or wiretaps, 18 U.S.C. § 2518)

Allowable Disclosures of Communication Contents

The SCA allows providers of an RCS or ECS to disclose the contents of a communication:

- To an addressee or intended recipient of such communication or an agent of such addressee or intended recipient
- As otherwise authorized in Sections 2517, 2511(2)(a), or 2703 of the SCA
- With the lawful consent of the originator or an addressee or intended recipient of such communication or the subscriber in the case of an RCS
- To a person employed or authorized or whose facilities are used to forward such communication to its destination
- As may be necessarily incident to the rendition of the service or to the protection of the rights or property of the provider of that service
- To the National Center for Missing and Exploited Children, in connection with a report submitted thereto under Section 2258A
- To a law enforcement agency if the contents (1) were inadvertently obtained by the service provider and (2) appear to pertain to the commission of a crime
- To a governmental entity, if the provider, in good faith, believes that an emergency involving danger of death or serious physical injury to any person requires disclosure without delay of communications relating to the emergency[27]

21. Theofel v. Farey-Jones, 359 F.3d 1073. 22. *See* Int'l Ass'n of Machinists & Aero. Workers v. Werner–Masuda, 390 F. Supp. 2d 479, 495 (D. Md. 2005). 23. *See* Educational Testing Serv. v. Stanley H. Kaplan Educ. Ctr., 965 F. Supp. 731, 740 (D. Md. 1997). 24. *See* White v. White, 781 A.2d 85, 90–91 (N.J. 2001); State v. Poling, 938 N.E.2d 1118, 1123 (Ohio 2010). 25. *See* Sherman & Co. v. Salton Maxim Housewares, Inc., 94 F. Supp. 2d 817, 821 (E.D. Mich. 2000) (rejecting SCA claim because individuals had authorization at the time of access); Lasco Foods, Inc. v. Hall & Shaw Sales, Mktg., & Consulting, LLC, 600 F. Supp. 2d 1045, 1050 (E.D. Mo. 2009) (similar). 26. 18 U.S.C. § 2701(c).

Consent Exception

The consent exception (18 U.S.C. § 2702(b)(3)) is one of the more common exceptions to arise under the SCA. In addition to allowing disclosures with the sender's consent, this exception also allows the disclosure of communications directed to the service provider.[28]

Allowable Disclosures of Information Concerning a Subscriber or Customer

The SCA allows providers of an RCS or ECS to disclose information concerning a subscriber to, or customer of, such service (not including contents of communications covered by 18 U.S.C. § 2702 (a)(1) or (a)(2)):

- As otherwise authorized in 18 U.S.C. § 2703
- With the lawful consent of the customer or subscriber
- As may be necessarily incident to the rendition of the service or to the protection of the rights or property of the provider of that service
- To a governmental entity, if the provider, in good faith, believes that an emergency involving danger of death or serious physical injury to any person requires disclosure without delay of information relating to the emergency
- To the National Center for Missing and Exploited Children, in connection with a report submitted thereto under 18 U.S.C. § 2258A
- To any person other than a governmental entity[29]

Court Orders, Warrants, Subpoenas, Statutory Authorization, or Certifications

The SCA has an exception for ECS providers who provide information in response to a legal mandate. Specifically:

> No cause of action shall lie in any court against any provider of wire or electronic communication service, its officers, employees, agents, or other specified persons for providing information, facilities, or assistance in accordance with the terms of a court order, warrant, subpoena, statutory authorization, or certification under this chapter.[30]

Through this exception, service providers can disclose information not only in response to court orders and law enforcement requests, but also in cases of crisis. Specifically "if the provider, in good faith, believes that an emergency involving danger of death or serious physical injury to any person requires disclosure without delay of information relating to the emergency."[31]

Good Faith Defense

The SCA allows a complete defense when a defendant can show good faith reliance on:

- A court warrant or order, a grand jury subpoena, a legislative authorization, or a statutory authorization (including a request of a governmental entity under Section 2703(f))
- A request of an investigative or law enforcement officer under 18 U.S.C. § 2518(7)
- A good faith determination that 18 U.S.C. § 2511(3) permitted the complained-of conduct[32]

If a recipient of an SCA request complies with the request in good faith, it will enjoy immunity from suit even if the request is later determined to be invalid.[33] While courts differ slightly in their tests for determining whether a recipient has acted in good faith, the question generally boils down to reasonableness.[34] This exception lowers the burden on recipients to scrutinize requests under the SCA for all potential flaws.

Statutory, Actual, and Punitive Damages

With respect to direct liability, you should take note that a plaintiff suing under 18 U.S.C. § 2707 for violations of the SCA can pursue either (1) their actual damages and any profits the violator obtained or (2) $1,000. The statute also provides for punitive damages.

Courts disagree, however, about whether a plaintiff must show some amount of actual damages in order to trigger the statutory damages provision.[35] Thus, you should take careful note of the jurisdiction in which an SCA claim is brought, as this disagreement may have significant implications for how a case is litigated. But note that even *Van Alstyne* holds that punitive damages may be available in the absence of proof of actual damages.

Secondary Liability

Courts generally agree that, although the SCA creates civil liability for violations of its prohibitions, it does not create secondary civil liability, such as for aiding and abetting or conspiracy.[36]

Other Potentially Relevant Law

The SCA is not the only statute governing the disclosure of electronic communications. Many cases involving electronic communications also involve potential liability under the Wiretap Act, 18 U.S.C. § 2510 et seq., which was also passed as part of the Electronic Communication Privacy Act. In addition, depending on the facts involved, the Computer Fraud and Abuse Act, 18 U.S.C. § 1030, the Pen Register Act, 18 U.S.C. § 3121 et seq., or the Cybersecurity Act of 2015, 6 U.S.C. § 1501 et seq., may apply, as well as traditional common-law doctrines such as trespass and intrusion upon seclusion. L

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RESEARCH PATH: *Labor & Employment > Employment Policies > Company Property and Electronic Information > Practice Notes*

Related Content

For guidance on how to counsel employers to manage the risks that accompany employee social media use, see

> SOCIAL MEDIA ISSUES IN EMPLOYMENT: COUNSELING EMPLOYERS ON KEY SOCIAL MEDIA ISSUES

RESEARCH PATH: *Labor & Employment > Employment Policies > Company Property and Electronic Information > Practice Notes*

For a discussion on the key issues involving the Electronic Communications Privacy Act, see

> ELECTRONIC COMMUNICATIONS PRIVACY ACT: KEY ISSUES

RESEARCH PATH: *Labor & Employment > Employment Policies > Company Property and Electronic Information > Practice Notes*

For guidance on protecting confidential information, see

> CYBERSECURITY MEASURES TO PROTECT EMPLOYERS' CONFIDENTIAL INFORMATION AND TRADE SECRETS

RESEARCH PATH: *Labor & Employment > Non-competes and Trade Secret Protection > Protecting Trade Secrets > Practice Notes*

27. 18 U.S.C. § 2702(b). 28. In re Facebook Privacy Litig., 791 F. Supp. 2d 705, 714 (N.D. Cal. 2011), rev'd on other grounds, 572 Fed. Appx. 494 (9th Cir. 2014); In re Am. Airlines, Inc., Privacy Litig., 370 F. Supp. 2d 552, 560–61 (N.D. Tex. 2005). 29. 18 U.S.C. § 2702(c). 30. 18 U.S.C. § 2703(e). 31. 18 U.S.C. § 2702(c)(4). 32. 18 U.S.C. § 2707(e). 33. *See* Sams v. Yahoo! Inc. 713 F.3d 1175, 1179–1181 (9th Cir. 2013). 34. *See* Sams v. Yahoo! Inc. 713 F.3d 1181; McCready v. eBay, Inc., 453 F.3d 882, 892 (7th Cir. 2006).

35. Compare Van Alstyne v. Elec. Scriptorium, Ltd., 560 F.3d 199, 206 (4th Cir. 2009) (actual damages are a prerequisite to recover statutory damages) with Shefts v. Petrakis, 931 F. Supp. 2d 916, 918 (C.D. Ill. 2013) no actual damages necessary to recover statutory damages). 36. *See* Council on American–Islamic Rels. Action Network, Inc. v. Gaubatz, 891 F. Supp. 2d 13, 26–27 (D.D.C. 2012); Garback v. Lossing, 2010 U.S. Dist. LEXIS 99059, at *19 n. 6 (E.D. Mich. Sept. 20, 2010); Jones v. Global Info. Grp., Inc., 2009 U.S. Dist. LEXIS 23879, at *5–7 (W.D. Ky. Mar. 25, 2009).

Stored Communications Act Issues Checklist

This is a high-level checklist for examining issues involving the Stored Communications Act (SCA), 18 U.S.C. § 2701 et seq., which comprises one of the major components of the Electronic Communication Privacy Act (ECPA). The other major component of the ECPA is the Wiretap Act, 18 U.S.C. § 2510 et seq. The Wiretap Act generally governs when communications (whether electronic, oral, or wire) are "intercept[ed]," while the Stored Communications Act governs access to electronic communications that are "in electronic storage."

Consider How SCA Issues May Arise

Keep in mind the variety of ways in which SCA issues may arise:

- ✓ **SCA compliance.** Consider direct liability for violations of the SCA's provisions.
- ✓ **Subpoenas.** Keep in mind the limitations on civil subpoena responses due to the SCA.
- ✓ **Government investigations.** Consider access to stored communications by government investigators.

Is the Technology an Electronic Communication Service or a Remote Computing Service?

Determine the relevant SCA rules for the particular technology involved. Different SCA rules apply depending on whether technology is classified as "electronic communication services" (ECS), "remote computing services" (RCS), both, or neither.

- ✓ **Consider whether the technology is an electronic communication service or a remote computing service.** In doing so, think about the following issues:
  - **Legislation outdated.** Recognize that Congress passed the SCA in 1986—before the development of most modern technology. Thus, applying the SCA to today's technology may be difficult/uncertain.
  - **Issues with categorization.** Note that some technologies may provide both an electronic communication service and a remote computing service. Some technologies may be neither.

Determine Whether Communications Were Stored Electronically

If the technology is an electronic communications service, consider whether the communications involved were in electronic storage.

- ✓ **Messages pending delivery.** Messages pending delivery are generally held to be in electronic storage. See, e.g., Quon v. Arch Wireless Operating Co., Inc., 529 F.3d 892 (9th Cir. 2008), rev'd on other grounds, 560 U.S. 746 (2010).
- ✓ **Delivered messages.** Courts have reached varying results regarding delivered messages. Compare, e.g., Theofel v. Farey-Jones, 359 F.3d 1066, 1076–77 (9th Cir. 2003) (holding delivered messages were in electronic storage for purposes of the SCA) with United States v. Weaver, 636 F. Supp. 2d 769, 771–73 (C.D. Ill. 2009) (holding previously opened messages not in electronic storage for purposes of the SCA).
- ✓ **Items stored on personal devices.** Courts generally conclude that items stored on personal devices are not in electronic storage. See, e.g., In re DoubleClick, Inc. Privacy Litig., 154 F. Supp. 2d 497, 511–12 (S.D.N.Y. 2001); Garcia v. City of Laredo, 702 F.3d 788 (5th Cir. 2012).

Consider Potential Defenses or Exceptions to Liability

- ✓ **Authorization not exceeded.** If the policy or procedures in place entitled the accessing individual to see the information, courts will generally not find SCA liability. See 18 U.S.C. § 2701(c); Sherman & Co. v. Salton Maxim Housewares, Inc., 94 F. Supp. 2d 817, 821 (E.D. Mich. 2000) (rejecting SCA claim because individuals had authorization at the time of access).
- ✓ **Permissible disclosures of communication contents.** The SCA allows remote computing services or electronic communication services to disclose the contents of a communication in circumstances specifically addressed in 18 U.S.C. § 2702(b).
- ✓ **Permissible disclosures of information concerning a subscriber or customer.** The SCA allows providers of a remote computing service or electronic communication service to disclose information concerning a subscriber to, or customer of, such service in circumstances specifically addressed in 18 U.S.C. § 2702(c).
- ✓ **Court orders, warrants, subpoenas, statutory authorization, or certifications.** The SCA has an exception for electronic communication service providers who provide information in response to a legal mandate pursuant to 18 U.S.C. § 2703(e) or 18 U.S.C. § 2702(c)(4).
- ✓ **Good faith reliance on legal requests.** There is generally no SCA liability for individuals or entities relying in good faith on a court order or law enforcement request for access to stored communications. See 18 U.S.C. § 2707(e).

Consider Potential Liability

Consider the following types of potential liability under the SCA:

✓ **Civil remedies.** A civil plaintiff can recover:

- **Actual/statutory damages.** A civil plaintiff can recover either actual or statutory damages. See 18 U.S.C. § 2707.
  - Note that some courts hold that plaintiffs must prove at least some actual damage to recover statutory damages. See, e.g., Van Alstyne v. Elec. Scriptorium, Ltd., 560 F.3d 199, 206 (4th Cir. 2009).
- **Punitive damages.** The SCA provides for punitive damages. See 18 U.S.C. § 2707.

✓ **Aiding/abetting liability.** Courts have held that the SCA does not impose civil liability under an aiding and abetting theory. See, e.g., Council on American-Islamic Rels. Action Network, Inc. v. Gaubatz, 891 F. Supp. 2d 13, 26–27 (D.D.C. 2012).

✓ **Criminal liability.** The SCA also includes potential criminal liability for violations of its provisions. See 18 U.S.C. § 2707.

Research Other Potentially Applicable Laws

The following laws may also be applicable:

✓ The Wiretap Act, 18 U.S.C. § 2510 et seq.

✓ The Computer Fraud and Abuse Act (CFAA), 18 U.S.C. § 1030. For information on the CFAA, see Cybersecurity Measures to Protect Employers' Confidential Information and Trade Secrets and Counterclaims or Separate Lawsuits against Plaintiff Employees.

✓ The Pen Register Act, 18 U.S.C. § 3121 et seq.

✓ The Cybersecurity Act of 2015, 6 U.S.C. § 1501 et seq.

✓ State tort laws concerning privacy

Related Content

For more information on the Wiretap Act and the SCA, see

ELECTRONIC COMMUNICATIONS PRIVACY ACT: KEY ISSUES

RESEARCH PATH: *Labor & Employment > Employment Policies > Company Property and Electronic Information > Practice Notes*

For more information on the ECPA, see

ELECTRONIC COMMUNICATION PRIVACY ACT ISSUES CHECKLIST

RESEARCH PATH: *Labor & Employment > Employment Policies > Company Property and Electronic Information > Checklists*

Checklist provided by ***Michael E. Lackey and Oral D. Pottinger*** *at Mayer Brown LLP.*

RESEARCH PATH: *Labor & Employment > Employment Policies > Company Property and Electronic Information > Checklists*


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Issues Related to Human Resources Outsourcing

This article discusses special issues that may arise in the context of Human Resources Outsourcing (HRO). HRO is a form of business process outsourcing (BPO) focused on the functions that have typically been performed or managed through a company's human resources (HR) or personnel department. The accepted industry definition of an HRO transaction is that it includes a minimum of three HR functions and service to more than 3,000 employees.

CONTRACTING WITH A MANAGEMENT SERVICES COMPANY to process the company's payroll is not considered outsourcing, even though some of the concepts discussed may be relevant to a customer's hiring of such a company. The issues that customers should address in connection with the outsourcing of HR functions can be broadly grouped into three types: compliance, contractual, and operational. This article explores these issues and provides best practices for how to address them so that the HRO deal is successful.

An HRO deal involves the management and processing of people, so the issues likely to be encountered in such a transaction, and the solutions designed to address them, are specific to this type of deal. Contractual issues are typically addressed in the agreement itself, or the legal front end of the statement of work (i.e., not the business-specific schedules thereto). Operational issues are often addressed in the back end of the statement of work and certainly in the schedules thereto. Compliance issues are a subset of each of the foregoing two issue types and are focused on the heavily regulated nature of the subject matter.

The key to the success of any type of outsourcing deal is establishing a review process for gaining an in-depth understanding of the tasks or functions that are within the scope for outsourcing. This is particularly the case in an HRO transaction where the tasks and functions were previously a part of a worker's job description. Sometimes the review will lead to an expansion or contraction of the scope as more is learned, but such an in-depth review will always allow the customer to include in its requirements (e.g., in a request for proposal) precisely what the customer is seeking to procure and the desired standards to be achieved. This in-depth understanding will allow the customer to discuss such requirements with the prospective service provider(s) to ensure that a meeting of the minds is achieved at the outset. The customer will also be able to document such requirements, and the methodology by which the requirements will evolve, in a definitive contract.

Functional Area and Compliance Issues

Compliance issues are identified through a detailed understanding of the subject matter of the proposed outsourcing. The purpose of this section is to describe select subject matter types (often called functional areas) that might be encountered in a particular HRO deal in order to facilitate spotting compliance issues. The next section, on contractual issues, identifies the general approach to the compliance-with-law topics in the main agreement. In general, the customer looks to the service provider to propose industry best practices for the customer's review and approval, based upon the service provider's domain expertise.

Staffing/Recruiting

Staffing or recruiting is defined by developing candidate pools, assessing and selecting candidates, managing the administration of the staffing process, and developing related strategies. Staffing services include the administration of third-party service providers, management of logistics, and assessment of sourcing strategies. The process involves staffing activities in accordance with organizational policies, government regulations, and equal employment opportunity (EEO) compliance, and includes electronic sourcing of applicants, electronic data capture of applicant information, applicant screening, interviewing, and related activities. If the service provider uses algorithms to process large amounts of data from applicant pools, then best practice dictates that the parties work together to develop inputs that focus on job descriptions, rather than personal characteristics, in order to minimize the risk that human biases will continue to be embedded in the algorithm's outputs and result in disparate impact. If the service provider alone determines the inputs, then any liability stemming from the same should be allocated appropriately. This is a point of negotiation between the parties that must be considered.

New Hire/Onboarding

New hire/onboarding is the assimilation of a new employee, a rehire, reinstatement, or a transfer. A variety of tasks are involved, including HR, payroll data, and benefits enrollment. This process includes IT access, facilities, equipment assignment, ID badges, etc., which the service provider will often facilitate through tools, programs, and materials that it will design and implement on the customer's behalf. The responsibilities may include the integration of the process with related processes (e.g., strategic staffing), together with technical integration among various tools that support recruiting, new hire, and computer system security (e.g., implementation of access controls and security credentials). Many onboarding documents, such as job applications, offer letters, and job descriptions (among others) must comply with various federal, state, and local laws and regulations.

Employee and Manager Self-Service (HR Portal)

Employee and manager self-service generally encompasses those activities that employees/managers can perform directly through online system capabilities or services and information that employees/managers can access through online vehicles. Within many organizations, these vehicles are spread among numerous (often not connected) systems and applications, and an HRO service provider may be engaged to create an integrated HR portal to deliver access to HR information and services via direct access vehicles (e.g., interactive voice response, web, direct access). To accomplish the integration, the service provider will leverage web technology to enable customer employees to view and maintain their personal HR information, including pay stubs, open enrollment, life change events, benefit enrollment data, etc. The service provider will also leverage web technology to enable managers to view and manage information on their employees, such as salary planning, approving pay increases, submitting open position requests, approving time worked and paid time off (PTO), etc.

HR Service Center

HR Service Center refers to all activities associated with the processes that deliver query and issue-resolution services to customer employees, whether such services are delivered via a call center or through other business HR functions. The primary reason that an external service provider is engaged is to establish an integrated one point-of-contact for all functions and processes, robust case management technology and processes, and increased service center technology capability.

Payroll

Payroll includes:

- The management of employee earnings, deductions, and taxes
- Determination and set-up of applicable employee tax withholdings
- Calculation of gross and net pay
- Processing of base, exception, and miscellaneous employee payments
- All aspects of direct deposit and garnishment administration
- Production of all live checks
- Processing of employee payroll issues and inquiries

Payroll services include computing, reconciling, and filing all payroll-related taxes, withholdings, and employer-paid tax liabilities; online access to tax forms and W-2s; managing compulsory deductions; and performing accounting transactions related to labor distribution at a detailed level, including general ledger interfaces. Payroll services also include responsibility for interfaces to and from the payroll process (relating to payroll-required or derived data). From a payroll perspective, the service provider is generally replicating all of the payroll services that the customer is currently performing internally or through an existing payroll-services vendor. Enhanced tools to capture and track time and attendance data are often part of the mix. The goal is to have one repository to track information on PTO, sick pay, Family and Medical Leave Act leaves, jury duty, bereavement, emergency leaves, etc., allowing employees to request days off and managers to approve those requests and track what has been earned and taken. By having this data available, PTO pay-outs upon termination can be automated and management reporting and trend analysis can be performed.

When it comes to compliance, of all the functional areas, this one is fraught with problems. Employers must comply with a plethora of wage-and-hour laws and regulations at the federal, state, and local level across all 50 states. For example, pay stubs must contain certain information. Each state's laws on this are different, and the costs of getting pay practices wrong can be very high. One strategy is to comply with the most comprehensive state's laws and be overinclusive as opposed to underinclusive. Another strategy is for the customer to provide a pay practices chart containing all requirements in each jurisdiction where the customer operates. The chart should be updated regularly. The agreement should include this pay practices chart in a schedule, requiring the service provider to comply. If no such chart is contemplated, then the liability for compliance should be negotiated between the parties and outlined in the agreement.

Benefits

Benefits includes a benefits strategy definition, benefit plan design, benefits administration, and the communication of benefits plans/programs to the employees, as well as administering, managing, and monitoring internal and external delivery of benefits administration services. The customer generally retains responsibility for defining its benefits, strategies, and policies and will maintain responsibility for designing and developing plans in support of such strategies and policies. The customer will also determine the appropriate competitive level and mix of benefits that will be offered and retain responsibility for establishing the fiduciary and business requirements to govern the plans and/or providers. The service provider, on the other hand, is often looked to for automating the process as much as possible, including via the HR portal, where employees/managers can process all self-service transactions and find benefits-related information.

Compensation

Compensation includes the development of global compensation strategies, philosophies, and programs, and the effective communication and administration of those issues. In essence, the service provider becomes a consultant to the customer, applying its expertise and experience (across its broad customer base) to advise the customer on industry practices. It also includes the management and administration of the customer's:

- Annual cash programs including base salaries, spot bonuses, annual cash incentives, and sales incentives
- Long-term incentive awards, including restricted stock, restricted stock units, stock options, and performance-based equity awards
- Job analysis, evaluation, competencies, pay structure, and officer titling
- Review of competitive positioning based on participation in market pricing surveys
- Linkage to performance management to enforce a pay-for-performance environment
- Executive pay programs, including deferred compensation, market pricing, and communications with external board of directors members
- Directors' total compensation program
- Deployment of comprehensive reporting tools customized to users' needs and authorized access
- Analysis tools for compensation budgeting and forecasting
- Access to market pricing data and modeling tools
- Collection and analysis of global compensation

To the extent that the service provider uses algorithms to process large amounts of data for any of the above areas, best practice dictates that the parties develop inputs that minimize the risk that human biases will continue to be embedded in the algorithm's outputs and result in unequal pay practices in violation of the law.

Data Administration

Employee data administration/employee records management, or data administration, is defined as the performance of all activities necessary to capture, track, modify, and report employee-related electronic and physical data. Employee data includes data on active employees and inactive employees and limited electronic data on a segment of retired employees. This

aspect of the deal will typically trigger an extensive privacy and data protection discussion. The service provider will typically have (or will design and deliver) tools, programs, and materials to assist in the deployment or change of processes, systems, or tools, often resulting in an information technology (IT) component added to the deal.

As part of the pre-deal review process, the customer should review the types of data being outsourced and set time frames around retention and destruction of same with the assistance of legal counsel. Not all data should be retained indefinitely. Additionally, the customer should establish a detailed litigation-hold process.

Learning/Training

Learning is a popular addition to the scope of many HRO deals. It involves building out and/or deploying the customer's learning management system to the relevant employee population and ensuring consistency for the company's technical and non-technical training offerings. Enhanced portal functionality is often a goal of this aspect of the deal, including personal learning plans, choice of language, targeted messages based on business unit, and various search capabilities and security access controls applied to output reports. Program logistics (from travel to production of training materials) will be managed by the service provider, along with employee enrollments. The employee enrollments may be by invitation only, with passive managerial approval, or they may be open, with the service provider managing employee transcripts per the customer's directions.

There are many federal, state, and local laws and regulations that require specific types of employee training. Such training is typically required on a yearly basis. All such training should be administered in accordance with the applicable laws and regulations.

Employee Relations

The customer's employee relations department is responsible for developing, disseminating, managing, and interpreting the customer's employment policies and for ensuring the appropriate resolution of employee-related issues. Customer employees are provided several avenues through which to raise concerns, including the HR service center established by the service provider, which must ensure that the service center is trained and prepared to receive and document employee calls or emails raising concerns and refer the issues appropriately. The service provider is often in a position to provide tools to improve the customer's ability to document and monitor such issues. To the extent a customer has subsidiaries, affiliates, and other operations outside the United States, it should ensure that the service provider's HR service center is compliant with local laws and is culturally appropriate. This will be especially important in the area of data protection and data retention.

Employee Engagement/Retention

Many large companies conduct employee engagement surveys periodically, seeking input on all or a significant cross section of its employees. If this function is part of the HRO deal, the service provider will take over the management, development, and administration of the survey, even though most (if not all) of the components of the design and communication of the survey will generally be maintained by the customer. The tracking of the survey and compilation of the results will be managed by the service provider. A key customer expectation is the possibility for greater data manipulation and analysis—broken out by any of a wide range of categories—than might currently exist (prior to the HRO). Discuss whether and how to keep such survey results anonymous. The administration of the survey will be integrated within the HR portal, discussed above.

Talent Management

Performance management and succession management have been identified as problem areas in many companies. Performance management includes appraisals, reviews, goal setting, competency assessment, and development planning. Succession management includes assessment of potential and leadership competencies, talent reviews, and development. Often, companies turn to external resources, including HRO service providers, to transform the process, providing greater portal functionality, such as cascading of goals from organizational to business to individual, linkage of development plans from business goals/review results to the learning management system, and utilization of integrated system technology and processes to create user-ready talent profiles to eliminate the need for manual paperwork during talent reviews.

Relocation

Relocation refers to all functions associated with relocating existing employees or new hires from one geographical location to another, including policy development, employee education and communication, third-party service provider administration, transferee expense processing, third-party service provider bill paying, cost tracking, and issue resolution. The service provider is generally expected to provide expanded systemic support to manage the workflows involved in initiating and tracking relocation activity for both the manager and employee.

Expat Services

Expatriate relocation and administration includes the design, processing, and monitoring of expatriate employee policies, management of the special needs of the expatriate employee population, tax preparation services, and administration of expatriate employee relocation programs. This includes:

- Updating, processing, and reconciling compensation, allowances, and tax withholdings during the assignment; responding to assignee inquiries; and obtaining required legal documentation for the assignee and family
- Providing relocation assistance and support for expatriation and repatriation
- Performing tax activities, such as:
  - Management of expatriate tax programs
  - Annual reporting of expatriate worldwide statement of earnings (W-2 or comparable foreign tax form)
  - Annual tax gross-ups on applicable compensation
  - Annual tax equalization, tax notices, tax filings (actual returns for home and host locations and the home country theoretical return)
  - Customer service and resolution
  - Spouse and dependent programs
  - Relocation assistance
  - Salary equalization
- Managing the repatriation process or providing assistance as needed for localizations and terminations
- Maintaining a database for all assignment activity and payments

To avoid the usual expat assignment problems, such as accidentally creating a permanent establishment in the foreign jurisdiction, legal counsel should evaluate all expat assignments.

Termination

Termination is the administration and execution of employee terminations. This process includes the preparation of termination documents; establishing eligibility for benefits, pension, and Consolidated Omnibus Budget Reconciliation Act issues; partnering with third-party service providers for data feeds and processing final payment in conformance with all applicable laws, etc.; and customer guidelines. Unfortunately, final pay practices are often areas where compliance is difficult, and even the best service providers can get this wrong. The costs of getting it wrong can be high. Best practice dictates that the customer should provide a final pay chart containing all requirements in each jurisdiction where the customer operates, and the chart should be updated regularly. The agreement should include this chart in a schedule, requiring the service provider to comply. If no such chart is contemplated, then the liability for compliance should be negotiated between the parties and outlined in the agreement.

Contractual Issues

Compliance with Laws

It is essential that a service provider commits to complying with all laws applicable to its performance of the designated services. However, one of the most contentious points in many negotiations on this topic surrounds the service provider's responsibility for complying with all laws specifically applicable to the portion of the customer's operations that are performed by the service provider as part of the services, just as if the customer had performed the services itself (customer compliance requirements). Furthermore, the customer will want to ensure its own ability to interpret and augment compliance with this body of laws.

In perhaps no other outsourcing type is this issue more important or more relevant than in an HRO deal. This is because the employees managed through the in-scope processes are the customer's employees, so the law places the legal obligation on the customer. There are a wide range of laws on the state, local, national, and international levels that are applicable to the employer-employee relationship. Therefore, the shifting of this responsibility should be made very clear in any agreement governing an HRO transaction.

Changes in Laws

The service provider is generally obligated, with the customer's approval (where there is a potential impact to the customer) and at the service provider's expense, to conform the

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> **THE OUTSOURCING PROCUREMENT SOLICITATION PROCESS**

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To learn more about drafting an outsourcing agreement, see

> **DRAFTING AN OUTSOURCING MASTER SERVICES AGREEMENT**

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For a discussion of tracking performance in an outsourcing agreement, see

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> **GOVERNANCE IN OUTSOURCING**

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For a detailed discussion on privacy concerns and data safeguards for outsourcing projects, see

> **PRIVACY AND DATA SECURITY IN OUTSOURCING**

RESEARCH PATH: *Commercial Transactions > Outsourcing > Risk, Disputes and Termination in Outsourcing > Practice Notes*

services in a timely manner to any changes in the compliance matters applicable to the service provider's performance of the designated services. The service provider should also be obligated, with the customer's approval, to conform the services in a timely manner to any change in customer compliance requirements. Conformance of the services under this latter requirement may also be at the service provider's expense with respect to changes in customer compliance requirements that are applicable to the service provider's other customers for services that are the same as or similar to the services or relevant components or modules of the services (e.g., changes in withholding percentages, etc.). With respect to new or revised customer compliance requirements that are unique to the customer (which is generally not the case in HRO deals) and require sustained, substantive changes in the services or increases in the resources required to perform the services, a mechanism can be established to adjust the charges. The mechanism is subject to a requirement that such changes and adjustments can be integrated in a cost-effective manner and without disruption of the customer's ongoing operations, as modified by such changes.

Procedures Manual

A common requirement under most outsourcing agreements involves the service provider's maintenance of a procedures manual. Like compliance with laws, this requirement is uniquely important in HRO deals to ensure that the customer has an adequate understanding of the support it is receiving at any given point in time, especially upon termination. The initial procedures manual is typically developed during transition and is subject to review and written approval of the customer. Note that this review and approval is generally not contentious, as the purpose of the document is not to expand or alter the scope of the services or the parties' respective responsibilities, but to capture how the support will actually be provided. The service provider is responsible for the preparation, accuracy, maintenance, and currency of the procedures manual and should be required to propose updates as necessary to reflect any substantive changes within a reasonable time prior to the implementation of such changes. The processes and procedures contained in the procedures manual should be of such quality as to reasonably ensure that the services are performed accurately and in a timely manner. The procedures manual, and any derivatives thereof, should be deemed work product to be owned by the customer and to enable the customer's use of the materials, including following the termination of the relationship.

Employee Data and Information

Employee information generally refers to records, files, reports, and other data relating to the customer's past, present, or prospective employees that are provided to the service provider by or on behalf of the customer, or otherwise collected or obtained by the service provider, in connection with the services, as well as any information derived therefrom. Depending on the services, employee information may also include such records, files, reports, and other data relating to the customer's retirees and, as applicable, to their respective applicants for employment. This information is extremely sensitive, both to the customer and to the individual persons to which the information relates; therefore, great care must be taken to protect this information contractually, including:

- The contract should be clear that employee information (and other customer data) is the exclusive property of the customer. The service provider should be prohibited from asserting a lien over the information or from seeking to use access to the information as leverage in a dispute situation.
- The service provider should commit to use the employee information only in connection with providing the services in accordance with the service provider's obligations under the agreement.
- While it should be obvious that employee information should be subject to the agreement's confidentiality provisions, it should also be made clear that the standard exclusions from confidential information do not apply to employee information, as it is the compilation of this information that the customer is seeking to protect, even if individual pieces of information may be available from other sources.
- The contract should clarify/confirm that employee information must not be aggregated or commingled with service provider or third-party data; disclosed, sold, assigned, leased, or otherwise provided to third parties; or commercially exploited by or on behalf of the service provider. In this age of big data, the customer should not assume that the foregoing restrictions need not be specified, as there is often great value in this information to the service provider and others in the HR industry for trend analysis and other purposes.

Data Protection

As an adjunct to the sensitivity of any employee information from a contractual perspective, the service provider should also commit to complying in all respects with all relevant laws (domestic and international) relating to the holding, processing, and protection of data. In the event that any transfer of personal information is subject to the EU Data Directive or any implementing legislation, then the parties may need to enter into a processor agreement, as mandated by such laws. The customer and service provider should agree to endeavor in good faith to determine whether execution of the processor agreement is necessary with respect to any given data flow into the United States, both at inception and over the duration of the contract, as the laws in this area tend to shift frequently. The customer and service provider should enter into such agreement, to the extent necessary and required pursuant to the contract's terms, within specific time frames specified in the contract. The scope of the processor agreement should be limited to the subject matter required under the applicable laws and not necessarily to other unregulated data, to ensure that it will not have any unintended impact on any transfers of other data.

> The reporting requirements associated with an HRO deal are extensive, just as they likely were imposed on the internal HR department prior to the outsourcing.

Operational Issues

Service Levels and Customer Satisfaction Surveys

As in most large outsourcing deals, the service levels to be measured in an HRO transaction will likely be extensive, ranging from IT system-type measurements (like uptime/availability for the HR portal) to BPO-type measurements (such as the accuracy and timeliness of the service provider's performance of various tasks), and measurements tied to the customer's objectives in entering into the HRO deal in the first place (like shortening the cycle time for filling vacant positions). These latter two categories are often measured by percentage of success over the course of a month for the service provider to have a population to measure against and to ensure that a single blip (as might be used with event-based measurements) does not detract from the service provider's overall performance. An example in the payroll context might be the percentage of payroll checks issued within the lesser of the customer-defined timeframes or legislation-required timeframes. Hopefully, the answer to this measurement is 100%.

One of the other key service level measurements in an HRO deal, which by definition is focused on the customer's personnel, is whether the service provider is achieving the desired benefits, both from an employee perspective and from a management perspective. To measure this somewhat subjective element, the service provider is often required to administer employee- and manager-satisfaction surveys tailored to each of the functional areas to which the customer is providing support. The surveys should cover, at a minimum, a representative sampling of employees and senior management of the customer, as applicable, and in each case as specified by the customer. The timing, content, scope, and method of the surveys should be as directed by the customer, with the customer having the right to audit the service provider's administration of the surveys and all data associated with the administration of such surveys, including the raw data comprising the survey results.

Access to Facilities

Because of the high-touch nature of many of the HRO services, such services may be performed from the customer's location. Accordingly, the HRO contract needs to provide for such access, ensuring that the service provider follows any applicable regulations, lease restrictions, rules of conduct, and security procedures of the customer's facility. The customer will generally agree to supply water, sewer, heat, lights, air conditioning, electricity, janitorial services, mail services, office equipment, and furniture for any contemplated supplier employees, although the service provider will generally be required to supply cell phones, personal computers, and other materials for its personnel. Office space should be in accordance with the customer's space standards, which the customer should reserve the right to revise from time to time in its sole discretion.

The service provider should be solely responsible for the conduct, welfare, and safety of its employees, subcontractors, and agents while in customer facilities. Additionally, the service provider should undertake all necessary precautions to prevent the occurrence of any injury to persons or property or any interference with the customer's operations while occupying such space. The service provider should contractually commit on behalf of its employees, agents, and representatives to submit to any security requirements of the customer and to comply with all rules and regulations established by the customer, including physical security requirements like badging and respect for restricted access areas.

Furthermore, the service provider should be prohibited from providing or marketing services to any third party from any customer facility or location.

Governance

Governance is important in any outsourcing deal because the corporate objectives, management objectives, competitive challenges of the marketplace, and the technologies and value propositions available for the duration of a long-term deal are all subject to change. This is particularly the case in an HRO deal. Thus, it is important that a well-considered governance structure and operational governance principles be established at the outset in order to be responsive to the changes occurring over time to meet the customer's objectives, which may include some of the following:

- Providing access to continuously reviewed and improved HR services incorporating industry best practices
- Supporting by appropriate information management technology the management of a high value-added, global workforce
- Facilitating fact-based organizational development and change
- Providing operational efficiencies
- Reducing operating expenses to increase competitiveness
- Providing high-quality HR administrative support, technical support, and case management activities to the customer's employees for all HR functions
- Providing direct access to current HR data management technology to support strategic decision making on a global basis
- Enhancing access to skills and capabilities that are scalable to meet the customer's changing business needs
- Consolidating, rationalizing, and standardizing the customer's HR systems, tools, processes, and procedures to support the customer's strategic vision and improve managerial effectiveness
- Leveraging and sharing existing service provider technologies, economies of scale, capital investment, and scope
- Removing the high and low points of capital expenditures for the in-scope HR functions by financing and leveling out the expense in a predictable and scalable pay-as-you-go arrangement with no up-front implementation fees
- Mitigating risk by improving financial, payroll, and HR controls
- Releasing internal customer HR resources to be more strategic and focused on its core business
- Expanding self-service capabilities that will enable managers and employees to perform HR-related activities at any time and place, including during non-working hours

Reports

The reporting requirements associated with an HRO deal are extensive, just as they likely were imposed on the internal HR department prior to the outsourcing. These requirements often lead to one of the more detailed schedules to the agreement, defining each report the service provider is required to produce and when it is to be produced (periodically or on demand). The type of reporting may generally fall into the following categories:

- **Service level reports.** These measure the service provider's performance against agreed-upon service level agreements (SLAs).
- **Management reports.** These provide metrics like number of new employees, number of transfers, etc.

- **Operational reports.** These include information collected or maintained by the service provider, such as emergency contact information or service anniversaries.
- **Systems reports.** These account for system resources and access details like user IDs issued to employees.
- **Audit reports.** These are defined by the customer's internal or external auditors.
- **Statistical reports.** These provide demographic data, such as headcount by gender for diversity purposes.
- **Organizational charts.** These outline the organizational structure, with names or positions.
- **Contact center reports.** These include standard telephone metrics, such as call volume metrics, arrival patterns, speed to answer metrics, abandon metrics, and average handle time.
- **Payroll operational reports.** These are generally issued per pay period.
- **Compliance reports.** These include updates on affirmative action programs for diversity/EEO purposes.
- **Recruiting reports.** These are generally tied to SLAs used to measure the service provider's performance.
- **Compensation planning reports.** These are used to set compensation/bonus arrangements and ensure consistency across the organization.
- **Benefits reports.** These often revolve around enrollment and census information tied to employee participation in the customer's benefit plans, including medical, disability, retirement, and other programs.

Use of Algorithms in HRO Functional Areas in General

If a service provider will be using algorithms to handle any of the functional areas where it is providing services, the details surrounding the use of algorithms must be a high-priority item during negotiations. The parties must consult legal counsel to determine how much, if any, control each wants or should have with respect to the algorithm inputs. Additionally, because the algorithms can potentially yield outputs that have an adverse impact, carefully review the liability surrounding the same. L

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Devika Kewalramani MOSES & SINGER

CONFIDENTIALITY AND WHISTLEBLOWING: Where In-House Counsel's Competing Interests Collide

With a changing legal landscape, increasing regulatory compliance, and global economic uncertainties, corporations—foreign and domestic—are under greater pressure to meet their business objectives in a more cost-effective way. In this evolving corporate environment, in-house counsel shoulder additional responsibilities—wearing many hats as business advisor to the corporate employer, salaried corporate employee, and legal counsel to the corporate client.

WHILE PLAYING THESE ROLES, IN-HOUSE COUNSEL ARE mandated to act ethically under the rules of professional conduct, ensure that the corporate employer complies with applicable laws and regulations, and follow the direction of company management on corporate policies and practices.

This rather complex assortment of functions can occasionally lead to conflicting—and often competing—loyalties. Are in-house counsel to act as officers of the court, upholding principles of professionalism and ethics while enforcing compliance with applicable laws, or are they to blindly protect the confidences and further the interests and objectives of their corporate employers without regard for legal and ethical compliance? These issues can give rise to unique ethical, moral, economic, and business dilemmas. This is because in-house counsel are ordinarily exposed to sensitive internal matters that could increase the potential for situations where it may be appropriate to blow the whistle on clients. Suppose an in-house counsel detects corporate wrongdoing. Would reporting such conduct violate the ethical duty of confidentiality and loyalty owed to the client and breach the attorney-client privilege? Or would the failure to disclose and report such unlawful activity constitute a violation of law and related ethics rules on reporting company wrongdoing? Can a fine balance be struck?

Aside from federal and state laws and regulations containing reporting and disclosure requirements related to improper corporate activity, guidance is available under the American Bar Association Model Rules of Professional Conduct (Model Rules)[1] that govern a lawyer's professional conduct. Most U.S. jurisdictions have adopted professional conduct rules that are largely based on the Model Rules, but there can be wide discrepancies in how closely the states' ethics rules resemble the Model Rules. Moreover, many of the states that have amended their ethics rules to follow the professional conduct standards and whistleblower protections provided by federal or state law have adopted amendments that are not identical to the statutory and regulatory standards, nor consistent with other states or the Model Rules. Thus, there is potential for conflict between the application of the statutes and regulations and the state ethics rules.

In addition, the interaction of the ethics rules themselves displays how complex and nuanced these rules are. Take for example, the fundamental duty of confidentiality owed to the corporate client (Model Rule 1.6) and the obligation to report an organizational client's wrongdoing (Model Rule 1.13). These two ethics rules are complex and nuanced, vary state-to-state, and require careful analysis. Notably, in-house counsel, who are regulated by these ethics rules (and existing laws and regulations), need to pay very close attention to how broadly or narrowly these rules and laws are written in the jurisdictions where they are licensed or admitted to practice, so that their conduct does not fall below the lines of permissible ethical and lawful conduct.

The Model Rules highlight a delicate interplay between the duty of confidentiality to the corporate client and the limited disclosure exception that permits in-house counsel to reveal confidential client information. Model Rule 1.6 prohibits an attorney from divulging confidential information related to the representation of a client, unless the client consents or if permitted by one of the express exceptions under the Model Rules, including, for example, to prevent a client's crime or fraud, to establish a claim or defense in a dispute with a client, or to comply with other law, etc.. However, buried in Model Rule 1.13—the rule that regulates representation of organizational clients—is a narrow exception to the confidentiality obligation. That exception permits in-house (and outside) counsel to disclose confidential client information without client consent and to externally report illegal corporate activity whether or not Model Rule 1.6 permits such disclosure, but only if, and to the extent that, counsel reasonably believes it is necessary to prevent substantial injury to the organization. Model Rule 1.13 provides an ethical roadmap for the course of action in-house counsel whistleblowers must follow. This process begins with raising concerns with the highest authority inside the organization itself, and then, if dissatisfied with the response, in-house counsel may reveal confidential information outside the organization in an effort to prevent substantial injury to the organization.

1. American Bar Association Model Rules of Professional Conduct, https://www.americanbar.org/groups/professional_responsibility/publications/model_rules_of_professional_conduct/model_rules_of_professional_conduct_table_of_contents.html

> [I]n-house counsel . . . were often afraid to disclose illegal conduct of their corporate employers for fear of violating their ethical obligations to their clients and risking loss of employment, and, if actually terminated, being left with little or limited recourse.

In several instances in which in-house counsel reported illegal corporate activity, they faced termination by their corporate employers for blowing the whistle. In response, in-house counsel typically filed retaliatory-discharge suits alleging dismissal for refusing to violate their ethical duties, reporting their employer's wrongdoing, or urging their employers to comply with the law. Courts around the country have taken varied positions on the degree of protection afforded to whistleblowing in-house lawyers. This lack of consistency is problematic for both corporations and their in-house counsel who advise them in matters spanning multiple jurisdictions. In any event, where courts address in-house counsel whistleblower cases, they tend to focus attention on the client-lawyer relationship between the corporation and its in-house counsel and the rules of professional conduct.

Recently, in Trzaska v. L'Oreal USA, Inc., 865 F.3d 155 (3d Cir. 2017), the U.S. Court of Appeals for the Third Circuit analyzed whether refusing to violate professional conduct rules constituted protected activity under a New Jersey anti-retaliation law. *Trzaska* illustrates that in-house counsel's commitment to upholding professional conduct rules will be rewarded, despite contrary direction from the corporate employer. There, the corporate employer established a patent application quota for its in-house patent attorneys that encouraged them to submit patent applications for products, even if they had a good faith belief such products were not patentable. The state's rules of professional conduct and those of the U.S. Patent

Related Content

For further discussion of ethical considerations for in-house counsel, see

> **IN-HOUSE COUNSEL'S ROLE AS WHISTLEBLOWER**

RESEARCH PATH: *Corporate Counsel > Ethics for In-House Counsel > In-House Counsel as Whistleblower > Practice Notes*

To learn more about conflicts of interest for in-house counsel, see

> **CONFLICTS OF INTEREST**

RESEARCH PATH: *Corporate Counsel > Ethics for In-House Counsel > Conflicts of Interest > Practice Notes*

For more information on an in-house counsel's duties under the ABA Model Rules, see

> **IN-HOUSE APPLICABILITY OF ABA MODEL RULES AND MISCELLANEOUS PROVISIONS**

RESEARCH PATH: *Corporate Counsel > Ethics for In-House Counsel > Applicability of ABA Model Rules and Miscellaneous Provisions > Practice Notes*

and Trademark Office (USPTO) prohibited attorneys from filing frivolous or bad-faith patent applications or from knowingly making false statements before a tribunal. Due to a deficit in patentable products, in-house counsel informed company management that the legal team was unwilling to file patent applications that they did not reasonably believe were patentable and that doing so would violate the ethical rules. In response, the corporate employer made it clear that the failure to file such applications would negatively impact their careers.

Consequently, in-house counsel was offered a severance package and discharged for protesting company directives. Counsel sued his former employer, asserting violation of a state statute prohibiting retaliatory termination of employees who disclose illegal company conduct. That statute protected employees who could identify a law, rule, regulation, or clear mandate of public policy that supported a retaliation claim, as well as unacceptable practices in the corporate employer's business that contravened the identified authority. The U.S. District Court for the District of New Jersey dismissed the complaint. On appeal, the Third Circuit ruled that the corporate employer's coercive instruction to file frivolous, meritless, and bad-faith patent applications, notwithstanding in-house counsel's express recommendation against doing so, contravened the state's and the USPTO's professional conduct rules and was a clear violation of public policy. The Third Circuit determined that the ethics rules provided a source of authority enabling in-house counsel to pursue claims of whistleblower retaliation against his corporate employer and remanded the case.

Trzaska falls in line with another major decision from 2017, Wadler v. Bio-Rad Labs., Inc. 2017 U.S. Dist. LEXIS 16522 (N.D. Cal. Feb. 6, 2017), that provides similar whistleblowing safeguards for in-house counsel from a slightly different perspective. In February 2017, a California federal jury found that a corporate employer breached whistleblower protections under 15 U.S.C. § 7245 of the Sarbanes-Oxley Act (SOX) when it fired its general counsel for reporting alleged Foreign Corrupt Practices Act (15 U.S.C. §§ 78dd-1, et seq.) violations. The jury awarded the general counsel nearly $8 million in back wages and punitive damages. A magistrate judge in the U.S. District Court for the Northern District of California held that SOX whistleblower protections preempt the attorney-client privilege, thus allowing general counsel to use otherwise privileged and confidential information as evidence in the lawsuit. This case is significant as it creates protection for in-house counsel who, until this ruling, were often afraid to disclose illegal conduct of their corporate employers for fear of violating their ethical obligations to their clients and risking loss of employment and, if actually terminated, being left with little or limited recourse. Both *Trzaska* and *Wadler* highlight a possible trend towards expanding whistleblower protections for in-house counsel, while offering guidance on when in-house counsel may disclose client confidences and privileged information without violating their ethical duties.

In-house counsel's relationship with its corporate client can be complicated. As the rights, responsibilities, limits, and protections underlying this unique relationship are tried and tested in courtrooms and boardrooms, ultimately it is the rules of professional conduct that define and shape the client-lawyer relationship. L

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RESEARCH PATH: *Corporate Counsel > Ethics for In-House Counsel > In-House Counsel as Whistleblower > Articles*



Michael B. Bernstein, Matthew A. Tabas, and Matthew H. Fine ARNOLD & PORTER

Due Diligence: Antitrust Issues

Even in the very earliest stages of planning a merger or an acquisition, it is never too soon to begin considering the antitrust issues. In fact, it is critical to provide parties with guidance about ensuring compliance with the antitrust laws during due diligence, including guidance on avoiding inappropriate information sharing (i.e., complying with Section 1 of the Sherman Act), creating documents related to the transaction and the potential impact of those documents in a government investigation, and joint defense/common interest privilege arrangements. This article addresses these issues.

Avoiding Inappropriate Information Sharing (Complying with Section 1 of the Sherman Act)

Section 1 of the Sherman Act and Information Sharing

Transactions among competitors—or potential competitors—raise antitrust concerns regarding the type of information that can and should be shared to evaluate the transaction. To properly evaluate a transaction, the parties to the transaction typically need to share sensitive information—potentially non-public and competitively sensitive information. When sharing such information, the parties need to be careful not to violate the antitrust laws, as discussed below.

Sherman Act Elements

It is critical to ensure that competitively sensitive information is not improperly shared during due diligence. Section 1 of the Sherman Act, 15 U.S.C. § 1 et seq., prohibits "[e]very contract, combination in the form of trust or otherwise, or conspiracy, in restraint of trade or commerce." The basic elements of a Section 1 violation are:

1. The existence of a contract, combination, or conspiracy between or among at least two separate entities
2. That unreasonably restrains trade
3. That affects interstate or foreign commerce

If an improper information exchange is discovered during a government antitrust review of a proposed transaction, the government may challenge the conduct. Moreover, a private plaintiff may also attempt to use such improper information sharing as evidence in alleging a conspiracy.

Individuals involved in the due diligence process need to understand that shared information must be limited to information that is required to evaluate the transaction and that they must take care when sharing what is commonly referred to as competitively sensitive information.

Information Exchange under the Rule of Reason

Because there is some other legitimate business purpose for the conduct—negotiating the transaction—improper information exchange typically is evaluated under the rule of reason. That is, the government must show that the improper information exchange harmed competition.

Because the rule of reason is a balancing test, not every exchange of sensitive information is inherently unlawful. However, certain types of information are more likely to have such an impact and may be found to constitute a violation of Section 1 of the Sherman Act. Also, the ability to establish a harm to competition can be easier in more highly concentrated industries involving fewer competitors, as price changes by any one competitor can have a greater impact on the overall market.

Since a violation of Section 1 of the Sherman Act is subject to treble damages, your client should take special care to avoid sharing such sensitive information with a competitor in the context of a transaction. Moreover, if the antitrust authority reviews documents during its investigation and has concerns that improper information sharing has occurred, the reviewing authority may become distracted from the transaction's substance and ultimately delay clearance of the transaction.

Caution: There does not need to be a prolonged or systematic exchange for potential liability to attach. Rather, a single improper exchange of information could potentially result in a violation.

Limitations on Sharing Competitively Sensitive Information (CSI)

Individuals involved in the due diligence process need to understand that shared information must be limited to information that is required to evaluate the transaction and that they must take care when sharing what is commonly referred to as competitively sensitive information (CSI).

What Is Considered CSI?

You will need to consider what is considered CSI in your client's particular situation, as CSI can take many forms depending on the nature of the parties to the transaction, the industry, and nature of competition between the parties, if any. The types of information often considered CSI include:

- Current or future prices, pricing policies, or formulas
- Current or future marketing strategies
- Current or future profit margins or profitability targets
- Product development plans, including plans to reduce or expand output
- Customer lists, prospective bidding plans, detailed information about pending bids, or customer-specific information
- Detailed cost information about individual products, services, or technology
- Current or future strategic plans
- Intentions to bid or not bid for specific customers or projects

Mitigating Antitrust Risk of Sharing CSI

When it is necessary to share CSI, your client should consider ways to mitigate the associated antitrust risk.

Exchange Historical Rather Than Current Data

Generally, parties should avoid exchanging information that would help competitors coordinate current and future pricing, output, and business operations. One way to prevent this is to exchange only historical data, rather than current, specific data. Exchanging historical data that is at least a few months old helps to decrease the likelihood that such an exchange will be seen as a means to anticompetitive collusion, particularly if the CSI is the type of information that frequently fluctuates. Historical information that is less meaningful in the current marketplace is less likely to be viewed as helpful to a competitor than current or future information, potentially reducing the risk. There is no set time period for when information becomes dated. Parties will need to evaluate that for themselves, based on the competitive dynamics of the relevant industries and the potential that information might be competitively sensitive, including when information becomes sufficiently stale. As one example, the antitrust agencies have issued a formal enforcement policy for health care in which they deemed exchanges of information in third-party surveys sufficiently stale when the surveys are based on data that is over three months old. These guidelines also require information to be anonymized; however, this does not ordinarily occur in a due diligence setting.

Use Aggregated Data Rather Than Specific Data

Similarly, using aggregated data (such as total sales or purchases or combined figures across products or businesses, rather than sales to individual customers or purchases from individual suppliers) enables a party to provide information relevant to due diligence while masking specifics that could be utilized for unlawful coordination. For instance, if your client has different prices or contract terms or arrangements with various customers or suppliers, cost and pricing information can be aggregated to obscure the details of the individual arrangements.

Assemble a Clean Team to Handle CSI

Another method to reduce antitrust risk during the due diligence process is to utilize what is commonly referred to as a clean team, consisting of individuals whose normal job functions do not include responsibilities relating to competitive decision-making for a competing business. Limiting CSI to a clean team helps ensure that the individuals privy to the CSI will not be in a position to utilize or take advantage of it. An agreement to utilize a clean team should set out the contours of clean team composition and procedure and be signed by both parties. When drafting a clean team agreement, some items parties should consider are:

- The definition of CSI
- The identities of clean team members
- The process for approving clean team members
- Any post-clean team restrictions on clean team members' roles and responsibilities
- Whether the clean team will include in-house counsel
- Whether the clean team will include third-party advisors or outside counsel who routinely advise the party
- Permitted uses of CSI, including whether clean team members may use CSI to prepare summary reports to share with non-clean team members (and relatedly, whether the party to whom the CSI belongs has a right to review and approve those reports)

While clean teams can assist in ensuring compliance with the antitrust laws, successful implementation depends on proper training and safeguards. Clean team members should receive training regarding the clean team restrictions and their individual compliance obligations.

As part of a clean team process, it can be useful to take additional steps to prevent the inadvertent disclosure of CSI during the due diligence process. The additional preventive steps include enlisting antitrust counsel review of any information in advance of it being shared, creating a segregated portion of an online data room limited to the access to exchanged CSI (or otherwise identifying, separating, and labeling sensitive materials), and establishing a process to carefully vet additional members of the clean team that may be proposed after a team is initially established. To the extent that there are ever questions regarding whether improper information was exchanged during due diligence, having a clearly documented process may help to assuage any concerns.

Creating Documents Related to the Transaction and the Potential Impact of Those Documents on a Government Investigation

Parties to a potential transaction should be aware at the outset of the substantive antitrust considerations when creating documents. The antitrust authorities typically receive certain documents and/or request all contemporaneous business documents related to even the earlier stages of a transaction. The government can request these documents either formally pursuant to the Hart-Scott-Rodino Antitrust Improvements (HSR) Act, 15 U.S.C. § 1311, or through an informal voluntary document request. The government will be interested in internal contemporaneous documents analyzing the potential transaction, as well as those that speak to competitive dynamics within a relevant market—and how the transaction may impact those competitive dynamics—which may be pivotal to a government investigation or challenge. These document creation considerations start at the early stages of transaction evaluation and become even more critical as a potential transaction moves forward.

Businesses today create a multitude of documents and other written information discussing and analyzing any potential transaction—often before one side even approaches the other, including:

- Formal confidential information memoranda
- Emails between executives or other employees discussing the merits of a transaction
- Handwritten notes discussing the impact of a transaction on the company's business lines
- Formal presentations to company leadership describing the post-transaction competitive landscape in a given market

While many of these documents are intended to be confidential or contain preliminary thoughts, it is important to remember that the antitrust authorities will not necessarily know the context in which the documents were created and may require the parties to provide explanations about the documents. The government typically defines documents broadly and requires the production of formal written documents, as well as emails, messaging chats, handwritten notes, and informal written documents.

To further shape its understanding, the reviewing authority may rely on documents created in the ordinary course of business as another source of information regarding existing levels of competition, identities of competitors, and the transaction's impact on that competition and the competitive landscape. To the extent the Department of Justice (DOJ) and/or Federal Trade Commission (FTC) decide to challenge a transaction in court as a violation of Section 7 of the Clayton Act, 15 U.S.C. § 12, which prohibits combinations whose effect may be to substantially "lessen competition, or to tend to create a monopoly," the DOJ and FTC will likely rely on ordinary course documents in building their case.

Government Requests for Documents

There are several opportunities during a potential transaction for the competition authorities to receive documents from the parties. For instance, if the transaction is reportable under the HSR Act, the parties will be required to produce certain materials pursuant to Items 4(c) and (d) of the premerger notification form. Item 4 documents are certain documents provided to officers or directors evaluating the transaction with respect to competition and synergies. Specifically, Item 4(c) of the form requests all studies, surveys, analyses, and reports which were prepared by or for any officer or director of the company or any entity controlled by the company involved in the transaction, if those documents analyze or evaluate the transaction with respect to market shares, competition, competitors, markets, potential for sales growth, or expansion into product or geographic markets. Item 4(d) of the form requests such documents as confidential information memoranda, certain documents prepared by outside advisers, and transaction synergies analyses. It is important to remember that the government's definition of documents for the purposes of Items 4(c) and (d) is broad, including everything from handwritten notes to formal presentations and board minutes.

Even if the transaction is not reportable under the HSR Act, the DOJ, FTC, or a state attorney general may investigate a proposed transaction's impact on competition. If the proposed transaction is reviewed, it is almost certain that some documents will be requested by the reviewing authority. In cases where the request is voluntary, it is typically advisable for your client to comply with the request to the extent possible, in hopes of resolving any concerns quickly.

The scope of this voluntary request typically is focused on developing a better understanding of the impact of the transaction on competition. Therefore, these voluntary requests include requests for business and strategic planning materials, marketing materials, and other documents that analyze competition in the ordinary course of the parties' business.

In the event the government has concerns that it cannot resolve during its preliminary investigation, it will issue a "Request for Additional Information & Documentary Material" (known as a Second Request). The Second Request is typically a significant request for data, documents, and narrative responses. To substantially comply with a Second Request, a party often must produce documents going back several years on a wide variety of subjects related to the acquisition, competition, its business and strategic planning, the products where the parties compete, and its dealings with customers, suppliers, and competitors.

Mitigating the Antitrust Risks of Document Creation

Given the likelihood that the parties will produce a significant number of written materials relating to the transaction to the reviewing authority, parties should consider the steps they can take to protect any particularly sensitive materials from disclosure and, at the same time, limit the creation of written materials that may be harmful to their strategy. It is important that the documents created in the ordinary course of business are consistent with the parties' strategy for explaining to the antitrust authorities why the deal does not create competitive concerns. In particular, it is common for certain selling documents, such as a confidential information memorandum, to include language minimizing competitive threats to the target. Investment bankers, consultants, and the business should work with counsel to ensure that these documents do not create antitrust issues. To do so, it is often useful to involve antitrust counsel in the drafting of the most sensitive materials. For example, the flow chart below describes a common process for preparing potentially sensitive documents.

DOCUMENT CREATION PROCESS

Document is drafted by business department

↓

Document is reviewed by counsel and edits and comments are provided

↓

Document is finalized by business department

↓

Document is reviewed by counsel for information that may be competitively sensitive

↓

Document is circulated to intended audience

There are several common types of language that may be more likely to attract the government's attention. You and your client should consider the following practical steps to mitigate risk and how to communicate this to your employees:

- **Inflammatory language.** Inflammatory or otherwise unprofessional language, even in casual email conversations, can be misinterpreted during an antitrust investigation, particularly with respect to a transaction's competitive effects. The key is to consider carefully the language used to ensure market realities are not overstated and instead reflect a realistic view of the competitive dynamics of the marketplace.
- **Discussion of particular markets.** The company should carefully consider how it describes its product, competitors, and the particular competitive substitutes for its products. It may unnecessarily suggest a narrow market that does not reflect the actual competitive significance of alternatives. Because the antitrust authorities commonly seek to define an antitrust product/service market or geographic market in which it will analyze the effect of a transaction, the business needs to ensure that its documents accurately reflect the marketplace. If not, it is possible that the reviewing authority develops a different view of the relevant product/service and/or relevant geography such that it creates issues for the transaction.
- **Predicting competition.** Your client should carefully consider how it discusses future competitive effects of the merger, including such topics as future prices or potential ability to compete in the marketplace. For example, statements such as "this deal will give us a monopoly," "high barriers to entry will prevent anyone from competing with us after this deal," or "if we acquire [X company], we can charge whatever we want!" would have serious ramifications during an antitrust review of a transaction.

Joint Defense/Common Interest Privilege

Once the parties begin transaction negotiations, it sometimes is helpful to begin discussions regarding potential legal strategies to achieve antitrust clearance. For a transaction that raises substantive antitrust concerns, parties typically face strategic and legal challenges, from the evaluation of a potential transaction to the review of that transaction by the government and, potentially, a court. These communications commonly include decisions about strategy with respect to engaging with the antitrust authorities, including what arguments and submissions to make to the government or court, how to structure a transaction to limit antitrust risk, or what remedies to consider in the event the government has concerns about the transaction's impact on competition.

Because these are critical strategy documents, the parties typically do not want to divulge these types of documents to the reviewing authority. Each party's communications regarding strategy with its respective attorneys is ordinarily subject to the attorney-client privilege and/or attorney work-product protection. The attorney-client privilege protects communications from disclosure when they involve a confidential request for, or conveyance of, legal advice between an attorney and a client. Attorney work-product protections are implicated when documents and other materials are prepared by an attorney, or at the attorney's direction, in anticipation of litigation. These protections, however, may be waived when documents and communications are no longer confidential and are shared with third parties, in this case the other party to a transaction or its counsel.

But, in a transactions context, there is a common law joint defense exception to such a waiver. This exception was developed to maintain the attorney-client and attorney work-product privileges where parties' interests are aligned in order to facilitate legal representation. This joint defense exception may also be referred to as a common interest, community of interest, or allied litigant exception, among others. In certain jurisdictions, these various titles implicate differing legal standards and are applicable in different circumstances, while other courts use the terms interchangeably.

The applicability of the common interest or joint defense doctrine can vary by state. Notably, some jurisdictions now recognize that this exception to waiver extends outside of the litigation context, while others require that litigation at least be anticipated for the privilege to be maintained. In the more permissive jurisdictions, the parties only must have a common interest in the matter under discussion, such as a potential merger. Most jurisdictions, however, require that the common interest be of a legal nature and that the communications be in furtherance of that interest. For instance, while communications discussing antitrust implications or other legal compliance may be considered to be in furtherance of a common legal interest, most jurisdictions will not confer the privilege to more general communications about merger details. Similarly, as communications are typically required to be in furtherance of the common interest, any situation where the parties have adverse interests may result in there being a waiver of privilege. For instance, even if two parties share the goal of consummating a successful merger, their negotiations with each other would likely not be covered under the common interest doctrine, even in the most permissive jurisdictions. (Tip: Entering into a formal joint defense agreement in writing can help clarify the existence and extent of common interest.)

While the applicability of the common interest doctrine to a specific transaction will depend on the specific circumstances, the parties should consider potential actions to increase the likelihood that a common interest will be recognized in the event of a subsequent challenge. In particular, a written joint defense agreement is likely the best evidence of an express intention to jointly pursue a common purpose. Similarly, explicitly laying out, within the agreement and communications, the legal purpose of communications can make for an effective, unambiguous indication. Although this is especially important for parties that actually enter into a transaction agreement with one another, to the extent such joint defense materials are shared with counsel or a firm itself that is not ultimately part of the transaction, a joint defense agreement can help to preserve that privilege in the face of a challenge.

Finally, it is important to note that the common interest doctrine does not create an independent privilege, but rather can merely prevent waiver of documents or communications that are already privileged. Thus, even if the parties share a common interest, discussions between businesspeople will likely not be protected, unless they are conveying legal advice pursuant to independently privileged conversations. If your client wishes to demonstrate a common legal purpose, it would generally be prudent to involve legal counsel in the relevant communications. L

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RESEARCH PATH: *Antitrust > Mergers & Acquisitions > Pre-signing and Integration Planning > Practice Notes*

Related Content

For a list of guidelines to distribute to employees involved in due diligence for a potential transaction, see

> INFORMATION SHARING GUIDELINES

RESEARCH PATH: *Antitrust > Mergers and Acquisitions > Pre-signing and Integration Planning > Forms*

For an example of a Clean Team Agreement, see

> CLEAN TEAM AGREEMENT

RESEARCH PATH: *Antitrust > Mergers and Acquisitions > Pre-signing and Integration Planning > Forms*

For guidance on how to fashion a joint defense agreement, see

> JOINT DEFENSE AGREEMENT

RESEARCH PATH: *Antitrust > Mergers and Acquisitions > Pre-signing and Integration Planning > Forms*

For best practices for identifying and collecting documents required under the Hart-Scott-Rodino (HSR) Act, see

> ITEM 4(C) AND 4(D) DOCUMENTS FOR THE HART-SCOTT-RODINO (HSR) ACT FILING

RESEARCH PATH: *Antitrust > Mergers and Acquisitions > Premerger Notification > Practice Notes*

For a discussion of how to determine whether a merger or acquisition must be reported to the antitrust authorities, see

> REPORTABILITY OF A MERGER OR ACQUISITION UNDER THE HART-SCOTT-RODINO (HSR) ACT

RESEARCH PATH: *Antitrust > Mergers and Acquisitions > Premerger Notification > Practice Notes*

To learn about preparing and submitting an HSR filing, see

> HART-SCOTT-RODINO (HSR) ACT FILINGS

RESEARCH PATH: *Antitrust > Mergers and Acquisitions > Premerger Notification > Practice Notes*

For a review of federal merger investigation methods, see

> DOJ/FTC MERGER INVESTIGATION PROCESS

RESEARCH PATH: *Antitrust > Mergers and Acquisitions > Antitrust Investigations (US) > Practice Notes*

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Insuring Construction Risks Through Commercial General Liability Policies

In most construction projects, the general contractor traditionally takes control of the site and is responsible for its means and methods of construction, and, therefore, should bear primary liability for damage arising from construction operations.

MOST CONSTRUCTION CONTRACTS REQUIRE THE GENERAL contractor to purchase commercial general liability (CGL) coverage to assure that the contractor has a means to pay for liability arising out of its construction operations. Owners and subcontractors, however, may be liable for their own negligence, as well as jointly and severally liable for some or all of the damages resulting from the general contractor's construction operations. CGL insurance provides a way to manage the risks for all participants in a project. Insurance is not one-size-fits-all, and the variations in policy terms may leave gaps in coverage. This article describes the risks covered by the CGL policy and how to specify in a construction contract the insurance to be obtained so that coverage for construction risks is maximized.

Risks Covered by Standard CGL Policies

Understanding CGL coverage is easy, except when it is not. Coverage A, "Bodily Injury or Property Damage," under the standard Insurance Services Office, Inc. (ISO) CGL policy can easily be understood to cover the insured's liability to third parties for bodily injury and property damage arising out of an occurrence within the policy period and up to coverage limits. It is not as easy to define the exceptions to that coverage. For example, the CGL policy does not cover an insured's liability for bodily injury to the insured's own employees (which is insured through workers' compensation insurance), but in some states the CGL policy covers the insured's indemnification obligation for liability arising out of injury to its own employees. It usually covers the insured's liability for bodily injury to the employees of other contractors, subcontractors, and third parties, but state court interpretations of the CGL policy may preclude that coverage. The CGL policy also covers damage to property of third parties, but has exclusions limiting coverage for damage to the contractor's own work (although the exceptions to that rule are the subject of significant litigation).

Risks Excluded from Standard CGL Policies

While a CGL policy generally indemnifies the insured for its liability to third parties for bodily injury and property damage, various exclusions limit that coverage. The standard ISO CGL form CG 00 01 includes standard exclusions, including the following described below.

Contractual Liability

Many older forms of insurance specifications in construction contracts require contractual liability coverage to ensure the contractor's financial ability to pay the contractor's indemnity obligations undertaken in the construction contract. Although contractual liability is a standard exclusion, its exceptions swallow the rule, making coverage for indemnification agreements a standard part of ISO form CGL policies. The contractual liability exclusion does not apply to liability assumed by the insured in an insured contract, usually defined to include the agreement to assume liability that the insured would have in the absence of the indemnity agreement. In other words, if the indemnity is limited to the vicarious liability imposed on the indemnitee as a result of the contractor's actions (which is exactly how the standard indemnity in AIA® Document A201™—2017 (Construction Contract General Conditions, Sample Form), Section 3.18 is written), then the CGL policy will cover the contractor's indemnity obligation. For this reason, it is not necessary to specify that the general liability policy include coverage for contractual liability. It is better practice to specify that the insured must purchase a standard ISO form CG 00 01 policy.

If the indemnity in the construction contract extends beyond vicarious liability arising from a contractor's negligence, then the CGL policy will not cover all of the liability assumed through the indemnity clause. If, for example, the indemnity requires the contractor to indemnify the owner for liability resulting from the owner's negligence (which requirement would render the indemnity clause unenforceable under the anti-indemnity statutes in many states), the CGL policy would not extend coverage to the contractor for that liability. A better way to provide coverage for the owner's own negligence is through the additional insured endorsements, as discussed below in Coverage for Owners under Contractor's CGL Policy.

Other liability often assumed in the indemnity clause includes liability for infringement of intellectual property rights, fines and penalties for violations of law, and mechanics liens. CGL carriers generally do not cover these risks.

It is important to note that the definition of an insured contract does not cover indemnification of a railroad for bodily injury or property damage arising out of construction or demolition activities within 50 feet of any railroad property. That is why some insurance requirements will state that an exclusion for "50' railroad" will not be allowed. The carve-out from the definition of insured contract for indemnification of a railroad may be removed by endorsement. If construction work is within 50 feet of a railroad, consider not only requiring the exclusion to be removed, but also whether Railroad Protective Liability Insurance is advisable or required by the railroad as a condition for access.

Employer's Liability

The standard CGL policy excludes the insured's liability for injury to its employees as well as damages payable to an employee's family members due to injury to an employee. Obviously, those risks are generally covered under a workers' compensation or employer's liability policy. State workers' compensation laws often limit an employer's liability for injuries to its employees to statutorily mandated coverage limits.

However, it is standard for a construction contractor to indemnify the owner of a project for liability imposed on the owner because of injuries to the contractor's employees. In other words, by agreeing to indemnify the owner, the contractor waives the statutory workers' compensation cap on its liability for injuries to its employees. However, state court interpretation of an insured contract in CGL policies along with state workers' compensation, contribution, and anti-indemnity statutes may limit the CGL policy's coverage of this risk in some jurisdictions, leaving the contractor potentially exposed to uncovered liability. Additionally, the definition of an employee may be interpreted expansively to include employees of downstream subcontractors, extending the impact of the exclusion beyond injuries to the contractor's own employees. In states where there is doubt about whether the CGL policy will cover liability for injuries to the contractor's employees or the employees of downstream parties, it is best to specify that the coverage will be obtained by the contractor and to consult with a qualified broker about products available in the jurisdiction to adequately address the risk.

Pollution

An exclusion for pollution is standard in CGL policies. Determining what is a pollutant and the application of the exclusion is fact-intensive and varies from jurisdiction to jurisdiction. The pollution exclusion may be the most litigated portion of the CGL policy. Coverage for liability arising out of many common construction activities may be barred by this exclusion, depending on the jurisdiction (e.g., some jurisdictions hold that damages from Chinese drywall are covered, while others hold that they are not). It is particularly important to evaluate coverage for these risks if the contractor will bring pollutants to the site (e.g., chemicals) and if the

contractor risks disturbing pollutants already on the site (e.g., asbestos-containing materials and lead-based paint are often implicated in remodeling projects).

It should be noted that contractor's pollution liability policies are becoming more commercially available to cover at least some of the risk, but even these policies may need to be modified by endorsement to address specific risks (e.g., asbestos, lead-based paint, mold, fungi, and bacteria such as legionella).

Owner-purchased policies may also be available to address the pollution risks for all participants in the construction project. Each policy should be reviewed carefully to determine the scope of its coverage.

Automobiles, Aircraft, and Watercraft

CGL policies generally do not extend coverage to damages from automobiles, aircraft, or watercraft. Thus, loading and unloading a truck may fall within the auto coverage rather than the CGL policy. Moreover, the CGL policy will not cover the use of a lift on a bucket truck or a barge brought to the site to assist in operations. Those risks are better addressed through auto and marine insurance.

Mobile Equipment

Generally, the use of mobile equipment, such as a forklift or bulldozer, on the construction site is covered by the CGL policy, but its transportation to the site is not. That transportation risk should be covered by an auto policy.

Contractor's Work or Product Exclusions

The extent to which a CGL policy will cover damage to the contractor's own work is another of the most litigated issues relating to CGL coverage for construction activities. CGL carriers generally will not modify or remove these exclusions by endorsement. However, in some cases, the exclusions may be removed from the policy when an owner purchases an owner-controlled insurance program.

Electronic Data

The loss of use or corruption of electronic data is excluded from CGL coverage. Projects using building information modeling may have special risks that will not be covered by a CGL policy.

Risks That Can Be Excluded by Endorsement

Caution may be required to assure that particular risks are not excluded from the CGL policy by endorsement, particularly by non-admitted or surplus lines insurers. Some exclusions that raise concerns and may inappropriately limit coverage include those discussed below.

Insured vs. Insured

The standard CGL policy allows for suits by one insured against another (e.g., an additional insured owner against a named insured contractor). Some insurers may modify that provision by endorsement. It is best practice to specifically disallow any such endorsement.

Prior Work

Although a standard CGL policy covers personal injury and property damage that occur during the policy period, some insurers modify coverage to provide that there is no coverage for work that was done prior to the current policy period. The construction contract should not allow this endorsement as it completely undermines the completed operations coverage.

Particular Types of Work Excluded

Some insurers in certain markets eliminate coverage for particular types of work by adding an endorsement to their policies. Any endorsement that excludes coverage for residential or multi-family projects should not be allowed if the work involved falls into those categories. Likewise, there should be no exclusion allowed for roofing work or an exterior insulation and finish system if the work involved includes either of these risks.

Earth Subsidence or Movement

Some insurers endorse the CGL policy to eliminate coverage for property damage caused by earth subsidence or movement. When a contractor is performing work that might be implicated, especially when performing foundation work, it is particularly important to specify that this exclusion will not be allowed.

Explosion, Collapse, or Underground

Some insurers modify the CGL by endorsement to eliminate coverage for explosion, collapse, or underground (known as XCU) risks. Specifically, it excludes property damage arising out of blasting or explosion (but not burst pipes, machinery, or power transmitting equipment), collapse of a structure or structural damage, and damage to underground property (e.g., pipes, sewers, wires). If those risks are implicated in a project, it is good practice to specify that the XCU endorsement will not be allowed.

Specifying Contractor's Coverage under CGL Policies

Specifying general liability insurance to be carried by the general contractor requires more than simply specifying limits of insurance to be maintained. The following are important points to address:

- **Occurrence policies.** CGL policies are generally written on an occurrence basis rather than a claims-made basis. Occurrence policies cover all liability imposed for occurrences during the policy period, regardless of when a claim is made. Claims-made policies only cover claims actually made within the policy period for events that occurred after a date certain, which leaves potential gaps in coverage. Although claims-made CGL policies are rare, it is a good practice to specify that the policy will be an occurrence policy. It is helpful to specify the ISO form as there may be manuscript forms sold by insurers in certain markets, particularly to smaller or higher risk contractors.
- **Size and rating of carrier.** It is common to require that the contractor obtain coverage from a carrier properly licensed in the jurisdiction where the project is located and to specify the size and rating of an acceptable carrier. The size and rating to be specified depends upon the project and marketplace where the project is located.
- **Products and completed operations coverage.** Products and completed operations covers bodily injury and property damage arising out of the contractor's work after it is put to its intended use. Occasionally, an insurer will sell a policy that does not cover this risk. It is best practice to specify that the contractor obtain this coverage and to specify the limits to be purchased. The period of time for which the coverage should be maintained after completion should correspond to the construction statute of repose in the jurisdiction where the project is located.
- **Per project limits.** Coverage limits should be on a per project basis. This ensures that the amount of insurance available for losses relating to the project are not eroded by losses relating to other projects.
- **Excess and umbrella coverage.** It is often helpful to specify that the limits may be achieved through a combination of CGL and excess or umbrella coverage. This allows the contractor greater flexibility in structuring its insurance program. In that event, it is important to specify that the excess and umbrella coverage shall follow the form of the underlying coverage.
- **Allowable deductibles and self-insured retentions.** A self-insured retention (SIR) is an amount that must be paid by the insured before the insurance policy will apply to a covered loss. A deductible, however, is an amount the insured is required to pay after the insurance policy pays. Consider stating that self-insured retentions will not be allowed and setting limits on the amount of deductible allowed so that a contractor's inability to fund the SIR or deductible will not prevent coverage by the insurer.
- **Notice of cancellation.** It is common to specify that the policies shall not be cancelled or modified without notice from the carrier to the owner. In most cases, the policy will need to be endorsed to provide for direct notice to the owner. Generally, 30 days' notice of cancellation, and 10 days' notice for cancellation for non-payment, can be obtained through an endorsement. In some cases, insurers will not offer that notice or have not obtained regulatory approval to provide such notice.
- **Subcontractor coverage.** It is a good idea to require the contractor to extend the construction contract's insurance requirements to its subcontractors. However, subcontractors do not generally carry limits as high as general contractors unless they are engaged in a high-risk trade. For this reason, many insurance contracts include limits that vary according to the risk associated with various trades.
- **Certificates of insurance.** Most construction contracts require contractors to supply a certificate of insurance on an Association for Cooperative Operations Research and Development form evidencing that coverage is in place in compliance with the contract's requirements. Certificates of insurance do not create any obligation on the part of the insurer to actually extend the coverage reflected therein, but rather only provide evidence of the existence of coverage at a particular point in time. Nevertheless, they are commonly accepted to substantiate coverage. Periodic updates of those certificates should be required on or before the expiration of any required policies. It is a good practice to require the contractor to supply copies of all relevant endorsements and to reserve a right to request copies of any policies required by the construction contract to confirm coverage, if necessary.

> It is important to note that the trend is for additional insured endorsements to provide coverage to additional insureds only up to the limits specified in the construction contract even if the contractor purchases higher limits for itself.

Coverage for Owners under Contractor's CGL Policy

Additional Insured Endorsement Forms

Contracts often require the general contractor and its subcontractors to name the project owner as an additional insured on the CGL policy, the general contractor requires its subcontractors to name the general contractor and owner as additional insureds on the CGL policy, and so on down the line. Additional insured endorsements may vary widely in the extent of coverage they provide to upstream parties. Older ISO forms (e.g., CG 20 10 11 85) have been interpreted to provide coverage for liability incurred as a result of the additional insured's own negligence. Later, the forms provided coverage for the additional insured's own negligence, but two endorsements were required to cover both ongoing (CG 20 10 10 01) and completed (CG 20 37 10 01) operations. Subsequent editions of those two forms narrowed the scope of coverage provided to additional insureds.

Some insurance companies sell manuscript endorsements that define the scope of coverage provided to additional insureds based upon the endorsement required by the construction contract. Thus, if the contract specifies the CG 20 10 11 85 endorsement, the insurer will provide the coverage described therein. If, on the other hand, the contract does not specify a particular additional insured endorsement or specifies an endorsement without identifying the endorsement date, then the insurer will provide significantly narrower coverage to the additional insured. It is advisable to specify the older forms, either CG 20 10 11 85 or both CG 20 10 10 01 and CG 20 37 10 01, and to verify the coverage by requesting copies of the endorsement purchased by the contractor. An owner should consider whether to adjust its own general liability coverage based upon the extent to which its status as an additional insured will or will not cover the owner's own liability for its own acts and omissions.

Coverage Limits Applicable to Additional Insureds

It is also important to note that the trend is for additional insured endorsements to provide coverage to additional insureds only up to the limits specified in the construction contract even if the contractor purchases higher limits for itself. Thus, the limits required should be carefully reviewed and specified.

Primary and Non-contributory

CGL policies provide insurers with a right to recovery from other valid and collectible insurance policies. To make a contractor's insurance policy respond first, it is generally accepted practice to require the contractor's insurance to be "primary and not seek contribution from" other insurance available to the additional insured.

It is also a good practice to specify that any umbrella or excess insurance bought by the contractor shall be primary and not seek contribution from other insurance available to the additional insured, as some excess carriers may seek contribution from the additional insured's own policies before they will contribute to the loss.

Waiver of Subrogation

It is accepted practice in construction contracts to require a waiver of subrogation in favor of the additional insureds. The waiver of subrogation prevents the insured's insurance carrier from seeking recovery from the additional insureds for liability for which the additional insureds are deemed at fault. While it may seem repetitive of the additional insured requirement, it particularly comes into play when the additional insured endorsements do not extend coverage to the additional insured for liability arising out of the additional insured's own negligence. In that case, the insurer cannot seek subrogation to recover such damages imposed on the contractor and paid by the insurer even if the contractor has a right to contribution from the additional insured.

Another waiver of subrogation to consider including in the construction contract is the owner's waiver of subrogation rights for losses covered by its own property insurance. This impacts CGL coverage because that waiver of subrogation quarantines the loss with the property insurer and eliminates the possibility for claims that might erode the CGL policy's limits available to respond to liability claims.

Related Content

For complete coverage of commercial general liability policies, see

> COMMERCIAL GENERAL LIABILITY INSURANCE

RESEARCH PATH: *General Practice > Insurance > Insurance Policies > Practice Notes*

For a discussion about the nature of general liability coverage, see

> 3 NEW APPLEMAN ON INSURANCE LAW LIBRARY EDITION § 16.07

RESEARCH PATH: *Real Estate > Commercial Leasing > Bankruptcy, Insurance and Tax Considerations > Secondary Materials*

For more information on umbrella and excess liability insurance policies, see

> UMBRELLA AND EXCESS INSURANCE COVERAGE

RESEARCH PATH: *General Practice > Insurance > Insurance Policies > Practice Notes*

For an explanation of the grounds that an insurer may invoke for denying coverage, see

> UNDERSTANDING WHY INSURANCE COMPANIES DENY COVERAGE

RESEARCH PATH: *General Practice > Insurance > Understanding Business Insurance > Practice Notes*

Owner's CGL Coverage

Most of the risk of loss in a construction contract should fall on the contractor, who manages the site, as well as its subcontractors who are likewise responsible for their own means and methods. However, claims against the owner for its own negligence are not infrequent. The owner does not have a right to indemnity for its liability arising out of its own negligence under the contractor's CGL policy unless it is named as an additional insured using the broadest additional insured endorsement (either CG 20 10 11 85 or both CG 20 10 10 01 and CG 20 37 10 01), although it may be entitled to a defense from the contractor's insurer even under the narrowest additional insured endorsements, depending on how the claim is stated. Despite the possibility of coverage under a broad additional insured endorsement, it is good practice for the owner to purchase its own CGL policy to cover itself in the event of a claim alleging that the owner is negligent.

In some cases, the owner will purchase CGL coverage for the contractor and subcontractors through an Owner-Controlled Insurance Program (OCIP). OCIP coverage, and particularly its exclusions, should be reviewed carefully to make certain that it extends coverage commensurate with the coverage provided by traditional CGL policies purchased separately by the project's participants.

Project participants should be keenly aware of how the CGL policy operates to provide—and disclaim—coverage in the unfortunate event of a claim in order to understand how to mitigate against the risks up front. The construction contract should carefully specify the characteristics of the CGL policy to be procured by contractors and subcontractors in order to protect all of the project participants. L

Ellen M. Chapelle is a partner and co-chair of the Construction Practice at the Chicago-based law firm of Gould & Ratner LLP. She has a wide range of experience that spans both the litigation and corporate sides of representing construction clients. In the corporate arena, Ellen negotiates and drafts contracts, including construction contracts. Ellen advises clients concerning risk avoidance in the contracting process, including the importance of identifying gaps in insurance specifications and indemnity provisions. With respect to insurance coverage matters, Ellen has represented clients in disputes with their insurers for coverage under property, general liability, and builders risk policies. In addition, she has litigated cases seeking insurance coverage for property damaged by construction defects.

RESEARCH PATH: *Real Estate > Construction > Owner and Contractor Agreement > Practice Notes*

LexisNexis Partners with Australian Foundation on Legal Initiative in Myanmar

Government attorneys in Myanmar are better equipped to negotiate contracts with other countries thanks to intensive training provided by LexisNexis and Australia's Colin Biggers & Paisley Foundation.

THE TRAINING, BASED ON LEXISNEXIS RESEARCH materials, is part of The Juris Pilot, an initiative to connect legal professionals with legal bodies in developing countries to create pro bono opportunities that advance the rule of law.

Myanmar was chosen as the venue for launching the initiative because of LexisNexis' ongoing rule of law work in the country. In addition, the lifting of economic sanctions against the country in October 2016 was seen as creating both opportunities and challenges.

Veronica Rios, Executive Manager, Rule of Law, at LexisNexis Asia Pacific, said, "As democracy has been introduced to Myanmar, the legal professionals acting on behalf of the government have been faced with new challenges of negotiating contracts with other countries—an area of law that was previously largely unused."

Among the first participants were more than 50 public prosecutors from the Union Attorney General's Office and other government ministries, including the Department of Energy, Construction, and the Auditor General at the offices of the Attorney General in Naypyidaw, Myanmar.

The Foundation was established in 2015 by Colin Biggers & Paisley, a leading Australian law firm with offices in Sydney, Melbourne, and Brisbane, with the goal of using "an innovative mix of pro bono legal services, volunteering and charitable contributions for the greatest possible impact."

The initiative builds on the LexisNexis Myanmar Law School Programme, through which LexisNexis partnered with the Electronic Information for Libraries to provide online legal research solutions and training for Myanmar's Yangon Law School and Mandalay Law School in 2015. The following year, after the devastation caused by Typhoon Nargis, LexisNexis partnered with the Philippine Group of Law Librarians to assist in restoration of Yangon Law School.

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