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Inside

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NY BUSINESS LAW JOURNAL

HeadNotes

I am pleased to announce the winners of our Law Student Writing Competition. Both of our winners have contributed articles that are especially timely in light of the current turmoil in the financial markets.

First Prize, a check for $1,500 and the lead position in this issue, goes to Anthony Altamuro, a student at Pace University School of Law, for "Internet Banking and the Community Reinvestment Act: An Examination of the Proposals to Establish Compliance." The Community Reinvestment Act (CRA), enacted in 1977, was designed to assure that banks and other FDIC-insured institutions reinvest, primarily by making home mortgage and other credit available, in the communities from which they derive their deposits. Although it applies to all FDIC-insured depositories, over time the focus of CRA compliance increasingly has been on inner city communities, and some have alleged that CRA and its advocates contributed to the subprime mortgage crisis by compelling banks to make unsound loans in order to meet their CRA obligations. Mr. Altamuro's article addresses a different, but no less timely question: how can a law that defines "community" in its most narrow geographic sense be applied in the Internet age? The article provides a succinct synopsis of CRA and a concise and thoughtful analysis of the approaches that have been advocated to resolve the problem of compliance in a world where a bank can exist only in cyberspace.

Second Prize and a check for $1,000 is awarded to Sachin Raval, a joint JD-MBA candidate at New York Law School and the Zicklin School of Business at Baruch College, for "Auction Rate Securities: Mechanics and Turmoil." Auction rate securities (ARS) essentially are long-term debt instruments, primarily issued by municipalities, with variable interest rates that reset weekly, monthly or according to offering documents. The ARS market allows issuers with long-term financing needs to tap investors who want to hold short-term investments. At each reset date, the securities are sold in a Dutch auction. In theory, the investor gets the advantage of liquidity, without the interest rate risk that attaches to longer term securities, while the issuer gets the benefit of lower rates. But like other forms of financial engineering, the TANSTAAFL principle (there ain't no such thing as a free lunch) reared its head when the current credit crisis started. Mr. Raval explains the mechanics of the market and discusses the legal issues that have arisen in the current turmoil.

On behalf of the Section, congratulations to Messrs. Altamuro and Raval. Their awards will be formally presented by the Section at the NYSBA Annual Meeting in January.

Yet another ramification of the current credit crisis is explored by Thomas Baxter, Executive Vice President and General Counsel, and Michael Campbell, Assistant Vice President and Counsel, of the Federal Reserve Bank of New York. In "The Lawyers' Foreclosure Intervention Network: Addressing Mortgage Foreclosure in New York City," Messrs. Baxter and Campbell discuss an initiative undertaken earlier this year by their Bank and the City Bar Justice Center, and supported by the Business Law Section of the NYSBA, to assist distressed homeowners facing possible mortgage foreclosure in the five boroughs. The Lawyers' Foreclosure Intervention Network (LFIN) is a pro bono initiative in which attorneys work with homeowners to find a solution that will allow them to remain in their homes. Among other matters, the sponsors of LFIN had to resolve issues related to conflict of interest, since many of the participating attorneys work for New York City law firms that represent one or more financial institutions. In addition to highlighting the good work of LFIN itself, the authors offer some thoughtful observations regarding considerations for successful pro bono programs generally and resolution of conflict issues in the pro bono context.

In "Tugboats, Glaucoma and the Check Collection Process," Jay Hack, a member of the Section and its Banking Law Committee, flags a recent banking case that may have broader ramifications. While the Uniform Commercial Code (UCC) imposes liability on the depositary bank when a forged or altered check is paid, the court held that liability may devolve back to the drawer, if it failed to use available technology that might have prevented the loss. The author links this holding to earlier cases where whole industries were, in effect, held liable for not adopting new technology.

With the growing concern over climate change and its possible effects on the environment, both federal and state legislatures have increasingly focused on legislative initiatives to address the issue in ways that have significant implications for businesses and their attorneys. In "Wrestling the Fire: Climate Change Law in New York State," attorney Nathan Whitehouse briefly and cogently explains the background of the problem, and discusses New York's participation in a regional "cap-and-trade" initiative—essentially, a means to explicitly price the cost of greenhouse gas emissions—beginning in 2009. He notes that, in addition to providing price incentives to industries that directly produce carbon emissions, other businesses may have incentives to trade in allowances and credits under the system.

Continuing a regular feature begun in our last issue, James Grasso of Philips Lytle provides an update on employment law developments relevant to New York business practitioners. Among other topics, Mr. Grasso discusses the Supreme Court's recent holding allowing employees to sue for retaliation under the federal civil rights law (Section 1981); the federal Genetic Information Nondisclosure Act signed by the President last spring and its counterpart under New York law; and proposed amendments to the Department of Labor's regulations under the Family and Medical Leave Act.

Our Ethics guru, Evan Stewart, weighs in next with his latest contribution. In "Documents and Lawyers: Oil and Water," Mr. Stewart provides several cautionary tales regarding the consequences for attorneys who, cavalierly or carelessly, neglect to produce responsive documents in a litigation. He notes that "the line between clever lawyering and irresponsible (or worse) lawyering in the document discovery process seems for some lawyers not to be a very clear one."

The next two articles deal with various aspects of intellectual property that are relevant to attorneys counseling business clients in various types of transactions. Ralph Scola, a solo practitioner based in Cleveland, Ohio, leads off with "Intellectual Property in Various Types of Business Transactions." Mr. Scola discusses the various types of intellectual property, some obvious and some not, and how they can be used, protected, and properly valued in a merger or acquisition. He provides useful checklists for counsel to work against in various types of transactions.

Victoria Cundiff, a partner at Paul Hastings in New York City and past Chair of NYSBA's Intellectual Property Law Section, hones in on a particular problem area for business, with a thorough and insightful analysis of the so-called "inevitable discovery" doctrine in the area of trade secrets. In "Preventing the Inevitable: How Thinking About What Might Happen Can Help Ensure That It Won't," Ms. Cundiff prescribes some preventive medicine for employers concerned about protecting trade secrets when an employee goes to work for a competitor. She analyzes the consequences in situations where there is, or is not, a non-compete agreement in place, and highlights the numerous issues to consider in planning strategy.

Attorney Miriam Gold provides some practical advice for small businesses and their attorneys in "Getting Ready to Sell a Small Business: A Conversation with a Client." Among her sound recommendations is that the client be advised to conduct "reverse due diligence"—the process of fully understanding all the aspects of the business that may add to or detract from its value to the buyer. Otherwise, the buyer may, through the due diligence process, be able to put the seller at a disadvantage in negotiations. She also urges practitioners to discuss with their clients issues related to how the transaction is structured for tax and other purposes; preserving intellectual property; and myriad other considerations.

Our Fall issue concludes with "The Role of the Corporate Secretary in Corporate Governance: The View from a U.S. Subsidiary of a Japanese Insurance Company," by Yoshikazu Koike, General Manager, Business Development Department, Mitsui Sumitomo Insurance Group Holdings, Inc. Mr. Koike, a member of the New York bar who formerly was Executive Vice President and Corporate Secretary for a U.S. subsidiary of Mitsui Sumitomo, offers his perspective on the increasing importance of the corporate secretary role for sound corporate governance in the post Sarbanes-Oxley environment. In addition to comparing and contrasting the Japanese and American views of the corporate secretary's role, the article is a useful summary and checklist for practitioners regarding the corporate secretary's function more generally.

David L. Glass
Editor-in-Chief

Internet Banking and the Community Reinvestment Act: An Examination of the Proposals to Establish Compliance

By Anthony D. Altamuro

Introduction: A Brief Overview of the Community Reinvestment Act

In 1977, in an effort to eliminate the effects of mortgage discrimination, redlining and community disinvestment, Congress passed the Community Reinvestment Act (CRA).[1] Congress stated that the general purpose of the CRA was "to encourage" banks and other financial institutions "to help meet the credit needs of the local communities in which they are chartered," in a way "consistent with" their "safe and sound operation."[2]

The authors of the CRA felt obliged to address the belief that banks and other financial institutions were "arbitrarily excluding certain segments of the population from receiving credit services based on factors that were unrelated to credit risk."[3] Specifically, Congress was targeting discrimination against "racially and ethnically disenfranchised people" in the communities in which they lived.[4] In addition, Congress sought to preclude banks from using the deposits of the struggling communities that they served to provide credit products for more prosperous communities, without reinvesting in those struggling communities.[5] The latter practice ultimately had a negative effect on the net worth of the neglected community.[6] In short, the CRA required banks "to serve the credit and deposit needs of their surrounding communities, including low- to moderate-income individuals in those areas."[7]

Although banks are privately owned entities, Congress had no trouble justifying any of the burdens that this Act placed on the financial institutions it covered. The logic was simple. Banks had an obligation to the public because they received federal government protections, most notably federal deposit insurance and the Federal Reserve System's backing as "lender of last resort."[8] In addition, Congress considered banking to be a local industry, and therefore concluded that the banks had a duty to reinvest in their local communities.[9]

While the CRA has become a burden of sorts on the financial institutions it covers, its authors and the regulatory agencies charged with its enforcement have managed to specify its requirements in a way that leaves little mystery as to what constitutes compliance. However, this is not the case when the CRA is applied to Internet banks. By their very nature, Internet banks are faced with many issues (e.g., defining what constitutes their communities) that can directly affect their status as CRA compliant institutions. Because Congress has failed to specifically address the CRA's application to Internet banks, the banks have been left in a virtual limbo. The result is particularly relevant, albeit problematic, especially when we consider the recent and continuous growth of the Internet banking industry.

In addition to reviewing the CRA and its general components and requirements as related to traditional financial institutions, this article will assess the implications of the CRA on the Internet banking industry. It also will examine some existing theories of Internet bank/CRA compliance, as well as offer some new approaches to dealing with the issues that await Congress and the entire Internet banking industry.

The CRA: Coverage, Compliance and Enforcement

The CRA covers any "insured depository institution," which, as defined by the statute, includes all banks that are insured by the Federal Deposit Insurance Corporation (FDIC).[10] Included are "foreign-owned banks, wholesale banks that do not have branches, Internet banks, and other banks with a narrow purpose or limited business."[11] Lenders who do not take deposits, such as mortgage and finance companies, are not covered.[12] Perhaps one of the reasons Congress made this distinction was to ensure that those institutions that enjoyed the benefit of FDIC insurance would promote the agenda of the CRA in return.

Four distinct federal agencies are charged with enforcing the CRA. National banks are regulated by the Office of the Comptroller of the Currency; state-chartered banks (that are members of the Federal Reserve System) are regulated by the Board of Governors of the Federal Reserve System; state-chartered banks and savings banks (that are not members of the Federal Reserve System) are regulated by the FDIC; and savings associations and savings-and-loan holding companies are regulated by the Office of Thrift Supervision.[13]

The CRA has always had mechanisms in place to ensure the compliance of its covered institutions. The original testing standards focused on the processes that an institution had in place to determine the needs of its community. This system utilized 12 assessment factors, which primarily focused on operations and products offered, and did not require that any specific products be offered, nor did it mandate any lending requirements. The results of an institution's CRA regulations test were published in a confidential report which was not available to the public.[14]

In 1989, CRA testing standards were revised under the Financial Institutions Reform, Recovery, and Enforcement Act (FIRREA). It was under this Act that the current four-tiered system for evaluating CRA compliance was adopted.[15] In addition, the Act eliminated the confidential reporting method, and instead mandated that all testing results be made available to the public. Because the CRA contained no statutory authority for enforcement, this public disclosure was used to inform consumers of the practices of their banks with the hope that any negative testing results would have an effect on the bank's volume until those negative issues were resolved.[16]

Finally, in 1995, the Clinton Administration directed the CRA governing agencies to "review and revise the CRA regulations to make them more . . . consistent, clarify performance standards, and reduce cost and compliance burden." This overhaul addressed the concerns of critics who felt the examination processes that were in place at the time "were too process-oriented, burdensome, and not sufficiently focused on actual results."[17] The testing system that is used today is the result of the 1995 revisions.

Under the current CRA testing model, banks must fulfill requirements in three distinct areas. The first area, community delineation, requires a bank to independently define the community it serves.[18] Traditional brick-and-mortar banks consistently have defined their community using "commonly recognized metropolitan areas, political subdivisions, or the physical area surrounding main offices, branches, and automatic teller machines (ATMs) where customers come to transact banking services."[19]

The second requirement under the CRA is disclosure. Under this provision, all banks must issue a CRA statement that is readily available to the public, which defines its community and describes the types of credit offered in that community.[20]

Finally, every bank must fulfill the compliance requirement under the CRA. To measure compliance, the appropriate governing agency issues a composite rating based on test results.[21] The way a bank is tested depends on its size and classification. For example, a bank with $250 million or more in assets is evaluated under the "lending, investments, and banking services" tests.[22] The lending test primarily evaluates whether a bank lends equitably to individuals and businesses.[23] The investment test considers the volume of investments made within the bank's community. Finally, "the service test analyzes the availability of services, the distribution of branches, and the methodology for creating accessible banking services for low and moderate-income communities."[24]

In contrast to the aforementioned testing standard, banks with less than $250 million in assets are evaluated based on their lending to borrowers of different incomes and the geographic distribution of their lending.[25] In addition, a bank may also choose to opt out of the testing process and develop its own strategic plan by which it will be evaluated. This permits a bank to establish its own criteria for CRA compliance.[26]

However, no matter what mechanism is used to test a bank, a rating is assigned at the conclusion of the testing period to indicate just how compliant the institution is with the provisions of the CRA. These ratings categories include "outstanding," "satisfactory," "needs to improve," and "substantial noncompliance."[27] In 2003, rating results reflected that 81% of banks were satisfactory, 16% were outstanding, and 4% needed improvement or were substantially noncompliant.[28]

It is important to note that several states have their own statutes that mandate CRA compliance as a prerequisite for allowing state chartered financial institutions to accept deposits. In New York, for example, in order for a financial institution "to be eligible to receive deposits," that institution must have a "current CRA rating of satisfactory or better."[29]

The Influence of Consumer Groups on CRA Regulation

In addition to CRA-mandated agency review, community groups can have a substantial impact on a bank's compliance. Through their efforts, community groups hold banks accountable to the communities they serve.[30] "The CRA has enhanced the bargaining position of community groups because concern over CRA lending has brought these groups off the street and into the conference rooms of regulated institutions and regulatory agencies."[31]

Two options exist by which a community group may raise issues regarding a financial organization's CRA performance and challenge its application to expand. The first option is filing a negative comment or criticism with the appropriate regulatory agency.[32] This document is a thorough description of a bank's failure to comply with CRA lending provisions which becomes part of the banking institution's public file. At some point, these documents will reach the attention of regulators and may even prompt a special inquiry.

In addition, a community group may stage a protest, which almost certainly leads to an agency response.[33] "The effectiveness of a community group's protest depends on the level of expertise they develop in documenting alleged CRA violations and their persistence in negotiating for loan commitments within their community."[34] A regulatory agency places little emphasis on documented complaints that contain inadequate information. However, regulatory agencies strongly support the idea of community groups negotiating with financial institutions for the outcomes they desire, rather than seeking agency relief. A financial organization is often "convinced" to accept a community lending agreement or other provision in order to put an end to a "costly" protest.[35]

The Nature of Internet Banking

In 1995, Security First Network Bank (SFNB) was granted approval by the Office of Thrift Supervision to operate as the first online provider of banking services in the United States.[36] The bank was open to any person who was able to access its Web site and offered 24/7 customer service and technical support.[37] In addition, the bank offered a "no-risk guarantee against computer fraud losses" in which it agreed "to reimburse customers for money lost from their accounts as a result of system errors and unauthorized access by criminals."[38]

Since 1995, several banks have followed in SFNB's footsteps by offering Web sites and online services. Some of these Web sites were born out of existing brick-and-mortar banks, while others obtained new charters and operated as Internet-only banks.[39] In today's market, no matter what type of Internet bank an entity maintains, that entity will be rewarded by cost savings. First, Internet banks incur fewer personnel costs, and require no branch maintenance.[40] In addition, at one cent per transaction, "banking via the internet is markedly less expensive than using all other channels of delivering services." Ultimately, an Internet bank offers its customers reduced fees and better interest rates on loans and deposits.[41]

It has been argued that because Internet banking requires the use of a personal computer and an Internet connection, it is inherently discriminatory against low- to moderate-income individuals. The basis of this argument has always been that those individuals are not as likely to own a personal computer based on their economic status.[42] This electronic gap between those with Internet service and those without is often referred to as the "digital divide."[43]

Based on the evidence, it is clear that the "digital divide" leads to at least some disparate impact. However, because of the way Internet banks conduct business, they are in a position to exploit the competitive advantage that comes with the inherent exclusion of certain customer groups. Since those persons who can afford a computer and Internet service are essentially "well-to-do," Internet banks are predisposed to a customer base that is very attractive financially.[44] One author has said that "a purely Internet bank is basically a form of redlining in and of itself—but income-based rather than geographic-based."[45]

Internet Banking and the CRA

When the CRA was enacted in 1977, Congress could not have anticipated the Internet banking explosion that would begin less than two decades later. Data collected in 2003 showed that online banking services were being used by 33 million households, representing approximately 31% of the consumer banking market.[46] That number will undoubtedly grow as banks continue to increase and improve the services they offer online.

Internet banking presents obvious challenges to the CRA and its application. Because Congress has failed to directly address the issue, the regulatory agencies that enforce the CRA are faced with a serious dilemma: "appease Congress by confining cyberbanks to the vague language of the CRA while encountering increased criticism by community groups, or adopt an alternative method of compliance potentially overstepping the bounds of the CRA."[47]

Defining an Internet Bank's "Community" Under the CRA

The question of how Internet banks should define their communities under existing CRA regulations is difficult to answer. Traditional brick-and-mortar banks have always defined their communities based on a physical location. However, by its very nature, an Internet bank's community is "nowhere and everywhere at the same time."[48] It is feasible that an Internet bank could accept deposits from all corners of the United States, and define its CRA community by a small home office in an affluent community, thus defeating the intended purpose of the CRA.[49]

Congress' failure to specifically address Internet banks per se in the CRA does not exempt those banks from fulfilling the purpose of the legislation. Many approaches have been used by Internet banks in an effort to define their communities as mandated by the CRA. Below are three approaches that were reported in a 1999 article by Miho Kubota for determining an Internet bank's "community."

1. **Brick and Mortar (The Traditional Approach):** Some Internet banks have defined their community based on the location of their home office. However, critics have argued that this method is not demonstrative of a bank's actual customer base. While this approach allows a bank to meet the policy goals of the CRA, it also distorts the actual reinvestment obligations of the bank because of the disparity between the massive size of the customer base and the defined CRA assessment area.[50]

2. **Women and Racial Minorities:** This approach explores the possibility of Internet banks "defining the community they serve under the CRA as women and minorities throughout the United States."[51] This is seemingly permissible, as the CRA allows regulatory agencies to consider activities directed at institutions owned by women and minorities in determining a bank's compliance with the CRA.[52] However, this approach is probably invalid for multiple reasons. First, the expansion of gender and racial classifications may not pass Constitutional muster as it may be considered too broad and "not narrowly tailored to the goal of

increasing bank reinvestment in the community."[53] Additionally, Internet customers may be untruthful about their race and gender when filing online applications. Finally, women and minorities constitute a group that seems to be much broader than what Congress envisioned at the time the CRA was passed, as members of these groups may not be considered low- to moderate-income individuals.[54]

It is important to note that the CRA is not a *per se* anti-discrimination statute, and therefore, Congress probably did not intend for it to be construed as applying only to women and minorities. Congress has already addressed discrimination based on race and gender in the Equal Credit Opportunity Act (ECOA), which prohibits discrimination "on the basis of race, color, religion, national origin, sex or marital status, or age."[55]

3. **Low- to Moderate-Income Individuals Across the U.S.:** This method suggests that regulators eliminate the geographic approach to defining communities and instead "require banks to service and lend to low- to moderate-income individuals and small businesses across the United States." The approach allows regulators to determine who would be eligible for these services, and additionally would satisfy CRA objectives "because the recipients of Internet bank CRA benefits would originate from the same pool, or 'community,' as close to take advantage of Internet bank services." Finally, this would make a client's place of residence irrelevant in the identification of "communities," as this approach would require Internet banks to serve one national community.[56]

Suggested Approaches of Internet Banks in Establishing CRA Compliance

Several scholars have addressed the issue of CRA compliance for Internet banks. While some approaches are more feasible than others, each of them possesses unique ideas and suggestions that would enable these non-traditional institutions to meet the requirements of the CRA.

From an industry standpoint, it has been suggested that Internet banks establish a "working definition of [the term] 'community' for purposes of CRA compliance."[57] This approach suggests that the definition could consider "the region of the country where most depositors live, the region where the bank physically receives mail deposits, or even the region where the bank would like for its customer base to grow."[58] The idea behind this approach is that by defining their community, Internet banks could establish means to accommodate low- to moderate-income individuals, as required by the Act, as well as the affluent members of their client base.[59] Overall, this approach could allow Internet banks to comply with the CRA and meet the credit needs of every member of their community.

Another proposal similarly suggests that the regulatory definition of a bank's assessment area be expanded to areas "where they gather a sizeable amount of their deposits and make a substantial portion of their loans," in addition to the areas where they maintain branches and ATMs.[60] This approach would allow an Internet bank to define itself by where its clients reside as opposed to the location of its offices. It should be noted that in order to carry out this proposal, the CRA regulations would have to be amended to define the "assessment area" of Internet banks as separate and distinct from any other bank.[61]

Internet banks may also achieve CRA compliance through innovative classification filings. For example, an Internet bank may apply for and obtain classification as a limited purpose bank to establish compliance with CRA requirements. A "limited purpose bank" is outlined in the definition section of the CRA regulations as "a bank that offers only a narrow product line (such as credit card or motor vehicle loans) to a regional or broader market and for which a designation as a limited purpose bank is in effect."[62] The CRA "permits limited purpose banks to establish means of fulfilling CRA lending requirements outside of direct consumer lending practices."[63] An example of one of the criteria for compliance that a regulatory agency would evaluate when assessing a "limited purpose bank" is "the use of innovative or complex qualified investments, community development loans, or community development services and the extent to which the investments are not routinely provided by private investors."[64] As an example, an Internet bank making technology available to "low- and moderate-income" individuals would be deemed to have satisfied the aforementioned criteria.[65]

Perhaps one of the most practical and effective methods of Internet bank compliance with the CRA would be the use of a strategic plan. This approach offers a bank the opportunity to formulate a CRA compliance plan in conjunction with representatives from the community it serves.[66] Upon completing the plan, the developing bank is obligated under CRA regulations "to formally solicit public comment by publishing notice of the plan in a newspaper of general circulation in each of its assessment areas for a period of at least 30 days."[67] After this process is complete, the plan must then be approved by the bank's federal regulator.[68]

One of the best examples of a successful strategic plan under the CRA was that of Netbank, which was approved in 2001. This Internet bank had one brick-and-mortar branch, but was operating nationally. Therefore, it initiated a strategic plan to help define its community and ensure CRA compliance. Through the strategic planning process, Netbank identified California, Florida and Georgia as its primary banking markets.[69] Based on its market assessment, Netbank developed a strategic plan to meet the needs of low-and moderate-income individuals in these areas.[70] Although Netbank's assessment area is the Atlanta, Georgia Metropolitan statistical area, this strategic plan allowed it to reinvest in locales outside that area, where they were receiving "over ten percent of their total deposits and where they originate or purchase over ten percent of their loans," all while meeting the requirements of the CRA.[71] An approach similar to this was proposed by Office of Thrift Supervision Director Ellen Seidman in 1999. In her proposal, she suggested that "in order to keep pace with technology, it may be time to revise the traditional notion of 'community' as defined by the CRA, expanding the definition of 'assessment area' to allow an institution to include areas where they make 'a substantial portion of their loans.'"[72]

Another example of a successful strategic plan would be that of Wells Fargo. Using an innovative approach, Wells Fargo developed the "eBus." These buses brought computers and instructors into low-income neighborhoods to teach both computer and basic Internet skills to the residents. The idea behind this program was for Wells Fargo to comply with the CRA while helping to reduce the "digital divide." It is suggested that compliance could be measured by looking at the financial and time investment involved in programs such as this. Ultimately, this type of strategy will encourage participation in online banking and may constitute reinvestment in a particular community.[73]

While strategic planning may seem like a tedious process for some organizations, it is believed by some that "a streamlined application and approval procedure would allow internet banks to meet their CRA requirements and would not oblige regulators to embark on the arduous process of amending existing regulations."[74] In addition, it allows an institution to adopt strategies that focus less on its assessment area and more on its national programs.[75]

Conclusion

While the purpose of the CRA reflects a desire by Congress to ensure equality in the banking market, there are serious questions about the practical effectiveness of this Act. Statistics have not necessarily shown any economic improvement to low- and moderate-income individuals that could be attributed directly to the CRA.[76] However, whether direct or indirect, it is likely that when Congress passed the CRA, the banking industry as a whole was put on notice as to the new duties it had to the communities that it served.[77]

Overall, the CRA has probably contributed to making the banking industry more socially responsible. Internet banking, perhaps, offers even greater potential for assisting the poor and disadvantaged because it allows a lender to communicate "relevant information with precision and accuracy at low costs."[78] In addition, since 2004, the nine largest banks in America have had community service components on their Web sites. Many of these Web sites actually show the particular bank's CRA activities, community partners, and how its programs exceed minimum CRA requirements.[79] It is reasonable to conclude that this type of exposure may lead to a positive community response and increased profitability for participating banks.[80] However, at this point, the question still remains: "to what extent will banks recognize and use the internet as a vehicle to exercise their corporate responsibilities?"[81]

Conversely, we must also consider the fact that there are those who consider the CRA to be an inappropriate burden on the banking industry. For example, Texas Senator Phil Gramm described the CRA as "legalized extortion" during a debate over the proposed Financial Services Modernization Act (FMA).[82] Perhaps Gramm's point is best summarized by the following excerpt from a 1999 article by David C. John of the Heritage Foundation:

> The CRA was established to "encourage" banks to lend more money in minority communities. But it's turned into a license to commit extortion. "Community groups" and other agitators can contest mergers and block applications to launch new services by claiming that a particular bank is not lending enough money to minorities or low-income neighborhoods. These protests cause delays that can cost banks millions of dollars in legal fees and lost business opportunities. To get the protests dropped, banks agree to make millions or even billions worth of loans to low-income areas. These agreements are always made public and trumpeted by the community groups as victories for social justice.[83]

Critics have argued that because of the activities that are required to be performed under the CRA (i.e., loans to low-income individuals with poor credit), all consumers pay more for banking services. The argument is that the majority must make up for the increased credit risk that the bank must absorb when offering CRA-mandated services. In addition, CRA-covered banks argue that they are at a competitive disadvantage to those lenders who are not covered by the CRA because they are "forced" to make loans that they would normally not make.[84]

Another argument against the CRA proposes that covered banks tend to stay away from "underdeveloped and minority areas because if an institution locates near such an area, those areas will become part of the institution's assessment area."[85] Ironically, if this is in fact true, the CRA is actually influencing financial institutions to behave in a manner that is counterproductive to its intended purpose.

Overall, it seems evident that the CRA requires at least some reform. The burden on the covered banks must be balanced with the need for socially responsible lending and general banking services. The government's involvement seems to be forcing the hand of covered institutions into making business decisions they would otherwise not make.

Some Food for Thought

Perhaps the best way to deal with the uncertainty surrounding Internet banks and CRA compliance would be for Congress to amend the Community Reinvestment Act. Obviously, any amendment would have to be in line with the original purpose of the CRA, which, in short, was to address those financial institutions that were "arbitrarily excluding certain segments of the population from receiving credit services based on factors unrelated to credit risk."[86] However, I propose that this amendment take a creative approach to meeting the needs of the low- to moderate-income citizens it aims to protect.

The Internet, due to its vastness, creates an almost unworkable and indefinable "community" under the present CRA provisions. Perhaps the idea of defining a banking "community" has no place in Internet banking. I believe the goals of the CRA would be better served, and the Internet banks themselves better stabilized, by a mechanism that would somewhat resemble a cap-and-trade system.

Most often seen in environmental law, a cap-and-trade system achieves its goals by creating a financial incentive directly related to compliance for industry participants.[87] The programs generally work by limiting, or "capping," the amount of pollutants a company is allowed to emit.[88] Every company and industry is provided a certain amount of credits, which allows them a certain level of emissions. If a company exceeds that limit, it must pay a large financial penalty. However, because the burden of reducing, or "capping," emissions presents a greater challenge for some companies than others, these programs allow for emissions credits to be traded and/or sold among participants. In other words, if a company is able to reduce its emissions in a cost-effective manner, it may elect to do so and then sell its credits (at a profit) to a company unable to reduce emissions without incurring great costs.[89] A system such as this creates a desired outcome, while taking into consideration that certain participants in an industry are in a better position than others to adjust their operations to achieve the desired outcome.

I propose that Congress modify the CRA to create a sort of modified cap-and-trade system for Internet banks. This will enable the market to play a major role in achieving the purpose of the CRA. Congress can simply create a system in which Internet banks would be required to contribute, through financial or service-based contributions, to CRA-approved programs that would focus on helping low- to moderate-income individuals. This system would provide a minimum contribution for all Internet-based banks. However, any Internet bank that exceeded its minimum requirements would be issued credits, which it could then sell to those banks that were falling short of their requirements. This system, like the environmental "cap-and-trade system," considers that some banks may have an easier time meeting CRA requirements than others, and allows those banks to "buy" their compliance, as opposed to making major, and perhaps cost inhibitive, revisions to their business models.

While the above proposal would require much research and development before implementation, I believe it would provide the Internet banking industry with a much-needed benchmark for compliance, and perhaps more importantly, provide a means for achieving the original goals and objectives of the CRA.

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Auction Rate Securities: Mechanics and Turmoil

By Sachin Raval

I. Introduction

One crunch, two crunch, three crunch, four . . .

"I was in a state of shock,"[1] says Naveen Ahuja of Miami Beach, Florida. You would be too if $665,000 of your hard earned money was stuck in an investment you were repeatedly told was as "liquid as cash."[2] If an investment were as liquid as cash, you're probably thinking, "Shouldn't I be able to take *my* money out when I want?" Exactly. Until recently, banks and investment advisers have pitched Auction Rate Securities (ARS) as cash equivalent investments. ARS have variable interest rates that are set through an auction process. When Mr. Ahuja could not close his $665,000 position in the ARS market, this meant that there were no bidders or buyers ready to take ownership of his position. A bond investor's main question or concern is whether or not the issuer will default. Should Mr. Ahuja be worried that the issuers of ARS will default? What is the future of the ARS market? Is Mr. Ahuja stuck forever?

Many banks, brokers, and financial planners around the country told ARS investors not to panic, as these investments are issued by high quality issuers so the chances of default are low.[3] However, the situation is not that simple. Whether investors can close their current positions is not the only issue for investors. Since ARS were marketed as short-term liquid investments, investors may have relied on these statements and made financial decisions requiring quick liquidity.

Another party that suffered in the early-2008 turmoil was the ARS issuer. If an auction does not have enough buyers, the auction is said to have failed and, as a result, the issuer must pay the highest interest permissible by contract, as stipulated in the ARS offering documents or the law. Imagine the state of shock municipal cash managers feel when, as a penalty for failed auctions, the interest rate on their debt goes from 4% to 20%![4] (The Port Authority of New York and New Jersey faced higher interest expenses that have gone as high as 20%.[5])

Some readers of this article may be students who are thinking they do not have to worry about this mess. Unless you are receiving federal aid, the credit crunch may affect you as well.[6] Student loan providers often issue auction rate securities to raise money for loans. If these loan providers cannot raise cash, students will have fewer funds available to finance higher education.[7] The credit crisis is far reaching. Issuers are attempting to find ways to restructure the ARS portion of their variable-rate debt portfolio into fixed-rate debt. The SEC has come to their rescue and issued a no-action letter permitting issuers to bid on their own auctions.

In order to fully assess the future of the ARS market, I will provide a brief background of these securities, followed by the mechanics whereby the interest rate for the period is reset. Following the mechanics of the auction process, I trace the origins of the ARS turmoil. Finally, I assess some of the legal implications attached to the ARS fallout. I have tracked investor sentiment through *Wall Street Journal* articles, Bloomberg.com articles, Dow Jones media outlets, and various other publications. While I recognize that newspaper authors may express views that may be less objective than certain primary sources, these articles provide a good scale by which we can measure investor consensus.

II. Background

Auction Rate Securities (ARS) are long-term debt instruments with variable interest rates that reset weekly, monthly or according to offering documents. The ARS market allows issuers with long-term financing needs to tap investors who want to hold short-term investments that were believed to be easily liquid.[8] Auction Rate Securities are sophisticated debt vehicles. The ARS market has expanded significantly over the years. Issuance of ARS grew from $100 billion in the first quarter of 2002 to $200 billion by the end of 2003.[9] As of February 2008 the ARS market has $325 billion to $360 billion, with state and local governments accounting for about $166 billion of the outstanding auction-rate debt.[10]

The ARS market includes a diverse range of players. Market participants include large, investment grade companies, non-profit issuers and state agency guarantors. ARS issuers may be closed-end municipal bond or equity funds, student loan entities, and/or municipalities. Issuers of municipal ARS typically include traditional issuers of tax-exempt debt, for example, non-profit hospitals, utilities, housing finance agencies, student loan finance authorities and universities.[11] Municipal ARS issues are often rated with high credit quality. Historically, more than 75% of such issues have received the highest credit rating available from the major credit agencies, typically because of the bond insurer.[12] ARS issued by closed-end funds are typically referred to as auction rate preferred shares. ARS investors may also consist of institutional investors (for taxable issues), high net worth individuals (for tax-exempt issues), or cash managers.

Auction Rate Securities are alternatives to variable-rate demand obligations (VRDO).[13] For the issuer, ARS have lower set up costs than VRDO have; however, ARS usually yield higher interest rates than VRDO.[14] ARS, as opposed to VRDO, do not have put options. A put option is a demand feature, when exercised, requiring the issuer to purchase the securities from the holder. Since no put option exists in ARS, the credit quality of the ARS must be higher than VRDO in order to attract investors. Also, the lack of a put option affects the liquidity of ARS.

ARS issuers may be more attracted to variable-rate debt securities than to fixed-rate debt securities because in normal times, issuers pay lower interest rates than they would on long-term debt.[15] Data show that the spread between long-term fixed-rate debt and short-term variable debt is substantial, with fixed-rate debt being higher.[16] On the other hand, ARS have higher risks for the issuer than fixed-rate debt because in times of volatility, the interest expense will rise. If interest expense rises, an issuer's debt-to-equity ratio may rise. If the debt-to-equity ratio rises significantly, the issuer's credit rating may be adversely affected. If an issuer's credit rating is adversely affected, the investment's marketability is lessened. If the investment's marketability is lessened, fewer buyers are attracted to the investment. If fewer buyers are attracted to the investment, sellers are stuck. If sellers are stuck . . . well, you'll see.

III. Mechanics of the ARS System

A. Parties to the ARS System

There are six groups of participants in the auction rate system:

1. **Issuer.** The issuer selects an underwriter or syndicate of underwriters to market the securities.

2. **Auction Rate Agent.** The agent acts as an agent for the issuer for purposes of the auction. The agent lists the bids and determines which bids are accepted. The agent confirms purchases and sales from the auctions.

3. **Existing Holders and Potential Buyers.** These two types of investors are current holders and potential investors in the ARS. Current holders and potential owners submit orders to broker/dealers.[17]

4. **Broker/dealers.** The issuer of each security selects one or more broker/dealers to underwrite the offering and/or manage the auction process.[18] The issuer pays an annualized fee to each broker/dealer engaged to manage an auction.[19] The auction agent enters into a broker/dealer agreement with the issuer. Some auction rate securities have a single broker/dealer, while others have multiple broker/dealers.[20] Broker/dealers may also place orders for their own accounts.[21]

5. **Municipal Securities Rulemaking Board.** Municipal auction rate securities represent a substantial portion of the auction rate market. The MSRB makes rules regulating dealers who deal in municipal bonds, municipal notes and other municipal securities.[22]

6. **Securities and Exchange Commission and Its Staff.** The SEC is the agency that has the principal responsibility for enforcement and administration of federal securities law.[23]

B. Dutch Auction Mechanics

Auction rate securities permit issuers to finance a longer-term portion of their debt portfolio with a short-term variable rate. The interest rate on auction rate securities is set through a Dutch auction.[24] Generally, interest rates are reset every seven, 28, or 35 days. ARS trade at par and are callable at par on any interest payment date at the option of the issuer.[25] The number of shares available to auction at any given period is determined by the number of existing holders who place, sell or hold orders.[26] Usually, ARS are not puttable by the holder. The lack of a put option affects the liquidity of the security. Interest is paid at each reset date in arrears. The frequent reset dates on the notes provided significant liquidity to sellers, as buyers were historically attracted to the fluctuating rate.

C. Procedures

i. Holders of existing ARS may submit the following instructions:

1. **Hold at Rate:** In these orders, existing owners wish to retain their holdings or a portion of their holdings.[27] The existing owners specify the minimum interest rate they are willing to accept to continue holding the securities for the upcoming auction period.

2. **Hold at Market:** In these orders, existing owners wish to retain their existing positions regardless of the new interest rate.[28] "Hold at market" orders are not included in the auction. If an existing owner fails to submit an order, most auction procedures provide that the owner will have elected to continue to hold the securities regardless of the clearing rate.[29]

3. **Sell:** In these orders, existing owners wish to close their position in whole or in part regardless of the interest rate set at the auction.[30]

ii. Potential Buyers of ARS may submit the following instructions:

Buy: In these orders, potential owners submit a bid to buy the securities at a specified minimum interest rate.[31] Existing owners may also wish to add to their current position and are considered buyers for purposes of this article.

D. Clearing Rate

Investors submit orders to the broker/dealers with specifications on the par amount of securities they want and what they are willing to pay. The broker/dealer(s) convey(s) the bids to the auction agent. The auction agent assembles all the bids in ascending rate order and determines the clearing rate accordingly. In other words, the "rank" of the bid is determined by the interest rate.

E. Auction Example

The following example illustrates how the auction procedures determine the clearing rate on the auction notes (assuming 500 outstanding units with an auction period of 28 days). Let us assume the following orders are submitted to the auction agent:

Figure 1: Bid Submission		
Bid/Hold Orders	**Potential Bid Orders**	**Sell Orders**
10 units at 2.90% 30 units at 3.00% 60 units at 4.00% 100 units at 2.33% 100 units at 3.40% **Total: 300 units**	40 units at 2.33% 10 units at 3.40% 30 units at 2.95% 40 units at 3.00% 100 units at 2.98% 40 units at 2.99% 10 units at 2.90% 50 units at 2.85% **Total: 320 units**	100 units sell 100 units sell **Total: 200 units**

The auction agent will organize the orders in ascending order with preference to existing holders.

Figure 2: Auction Agent's Ascending Order				
Number	**Interest Rate**	**Number of Units**	**Cumulative Units**	**Filled**
1	2.33	100	100	Yes
2	2.33	40	140	Yes
3	2.85	50	190	Yes
4	2.90	10	200	Yes
5	2.90	10	210	Yes
6	2.95	30	240	Yes
7	2.98	100	340	Yes
8	2.99	40	380	Yes
9	3.00	30	410	Yes
10	3.00	40	450	Yes
11	3.40	100	500 (50 filled)	Yes (Partial)
12	3.40	10	N/A	No
13	4.0	60	N/A	No

In the above example, 3.40% was the lowest bid where all available notes sold at par. Therefore, the clearing rate for this auction is set at 3.40%. Note that the existing owners receive preference over new bidders at the same rate. For example, Bidder 1, as a holder, receives the shares before Bidder 2 while both bids are 3.40%. Bidders at or lower than the clearing rate will receive the securities. If there are multiple bids at the clearing rate, the auction agent will allocate securities using a pro-rata calculation. The auction agent will notify the broker/dealer(s) of the auction results. The broker/dealers can proceed to record and settle the trades for the next business day settlement.

F. Failed Auctions

An auction can fail due to a lack of demand. A lack of demand will result in no clearing bid. A lack of demand in this auction process means that there are insufficient bids to purchase all the shares available for sale. In a failed auction, the existing owners are required to hold the shares (an "all-hold auction") in return for the maximum rate specified in the offering documents. The maximum rate in the offering documents may be very high or very low, possibly depending upon the creditworthiness of the issuer. If the rate is very high, the issuer suffers the burden of additional interest expense. If the rate is very low, the investor suffers the burden of reduced return for the additional risk.

IV. 2006 SEC Probe of ARS

In May 2006, the Securities and Exchange Commission instituted an administrative cease-and-desist proceeding against 14 respondent-banks.[32] The SEC imposed remedial sanctions against the banks for practices that were in violation of Section 17(a)(2) of the Securities Exchange Act.

The 1934 Act Rule 17a-2 requires that the prospectus set forth the possibility that underwriters will make market purchases that have the effect of stabilizing the market. The rule also requires underwriters to file detailed reports with the SEC when they in fact do stabilize.

Upon the SEC staff's request for information, respondents voluntarily disclosed the practices they engaged in.[33] The probe revealed that each of the respondents engaged in one or more of the following practices in connection with certain auctions:

1. **Completion of Open or Market Bids.**[34] Some ARS investors submitted open bids and/or market bids in auctions with parameters left open to be filled by Respondents. When an investor placed such a bid, certain respondents supplied bid parameters after viewing other orders in the auction. Respondents would then set parameters that were advantageous or disadvantageous to certain investors. This practice may have displaced investors who did not submit open or market bids.
2. **Intervention.**[35] Certain respondents bid in the auction for their own proprietary accounts and affected the clearing rate. However, the SEC order does not prohibit this practice if proper disclosure is given to the investors.[36] The order states that certain respondents, without proper disclosure, (1) bid to prevent failed auctions, (2) bid or asked investors to change their bids in order to set a clearing rate, (3) and/or bid to prevent all-hold auctions.

3. **Prioritization of Bids.**[37] Certain respondents changed or "prioritized" investors' bids to increase the likelihood that bids would be filled. For example, if a respondent received a sell order from one investor and a buy order from another investor, rather than submitting both orders to the auction agent, respondent would cross-trade the transactions. This sounds harmless at first; however, because existing holders have preference over potential owners, respondent prioritized a potential buy order, violating typical auction procedures.

4. **Submission or Revision of Bids after Deadlines.**[38] Certain respondents allowed certain investors to submit or revise bids after internal deadlines (set by the broker/dealer) or formal deadlines (set by the offering documents) that were set for investors to submit bids to the broker/dealers. Additionally, the probe showed that certain respondents submitted or revised bids after these deadlines. The effect of these practices, "except when solely done to correct clerical errors,"[39] disadvantaged certain investors while advantaging others. While the order does not explicitly state the following, I believe it can be safely inferred that certain respondents could have manipulated the clearing rate after judging investor bids by submitting or revising bids for their proprietary account.

5. **Allocation of Securities.**[40] Certain respondents allocated securities to investors who bid at the clearing rate instead of allocating securities *pro rata*.

6. **Partial Orders.**[41] When there are more bids than outstanding shares, investors may receive a *pro rata* allocation of the securities rather than receiving the full amount of the securities for which they bid.[42] Certain respondents did not require certain investors to stick to their bids. Bids are supposed to be irrevocable; however, if the investor knew that only a portion of the order was to be filled, the bid would be revoked or resubmitted at a higher rate, thereby affecting the clearing rate.

7. **Express or Tacit Understanding to Provide Higher Returns**.[43] Certain respondents provided returns higher than the clearing rate to certain investors. For example, certain respondents advised certain investors to submit a bid lower than the investor actually wanted to receive and allowed the auction to clear at a lower rate. Respondents would then purchase the securities at par value from the investor and then sell the security back to the investor below par. (That is, if a security with par value $100 is sold to an investor at $99, the investor can expect a $1 profit in addition to any interest payments when the security is resold at par.)

8. **Price Talk.**[44] Certain respondents gave different advice to certain investors regarding the clearing rate. Certain respondents told certain investors to bid at a particular rate, thereby displacing other investors who did not receive any of these recommendations.

These practices affected the clearing rate and did not conform to disclosed procedures. When respondents do not notify investors, parties to the auction, or the general public, of these practices, the ARS market becomes random for displaced investors. By requiring respondents to disclose their practices, the information becomes public and investors can make portfolio decisions accordingly. Regardless, respondents were ordered to cease and desist from committing or causing any violations and any future violations of Section 17(a)(2) of the Securities Exchange Act. On one hand the SEC forbids engaging in these prohibited practices, but on the other hand, the SEC explicitly states that this order does not prohibit broker/dealers from bidding for their proprietary accounts when properly disclosed. The SEC also did not create a legal requirement for respondents to prevent failed auctions. However, the SEC did require each respondent to provide all ARS holders, issuers and first-time purchasers with a written description of the respondent's material auction practices and procedures. The order outlines some options available to respondents, such as e-mail for existing holders and trade confirmation for first-time purchases.

V. ARS Turmoil: Investors Try to Escape if Possible

From 1984 through 2006, only 13 auctions failed as brokers stepped in to buy the bonds when demand was weak.[45] However, almost 70 percent of the periodic auctions in the $330 billion market failed in the last week of February 2008 as brokers stopped buying the securities.[46] Investors want more liquidity, and the mentality towards these securities has unfortunately gone sour.[47] J.P Morgan stated that the average interest rate for municipal issuers after failed auctions between February 12, 2008 and February 15, 2008 was 7.3%, up from 4.25%.[48] A big problem with most ARS stems from the threat of bond insurer downgrades. Bond insurers guarantee that ARS issuers will make their interest payments. Bond insurers' credit ratings are critical to their ability to do business. The housing slowdown means investments tied to mortgages could threaten insurer defaults.[49] As a result, these insurers may have to pay out billions. Unfortunately, insurers like MBIA, Inc. have sold guarantees on securities tied to "ill-fated subprime mortgages."[50] Credit-rating downgrades would raise the insurer's cost of funds and hurt the value of the bonds they insure.[51] The risk of being downgraded has dissuaded investors from investing in securities backed by these insurers. Investors are worried that if insurers have to pay guarantees on mortgage-backed securities, the insurer may not have the financial capacity to guarantee ARS issuers' interest payments.[52]

These downgrades, and the potential for many more, present a tremendous problem for the ARS market and have led to many failed auctions. While there are many ARS that are self-insured, insurer-backed ARS make up a significant portion of the market and therefore draw the most attention. Regulators believe that if more information is disclosed regarding the auction, such as the number of bidders and the clearing rates, the market would become more efficient and failures could be prevented.[53]

Not all investors were attempting to bail out of the ARS market. Sophisticated investors who had cash reserves could benefit significantly from the higher interest rates in the ARS market.[54] These investors saw the penalty rate, generally very high, as attractive. Analysts thought the market would be redeemed by sophisticated buyers and could provide sellers liquidity. However, when an auction fails, the securities may also reset to a very low rate, therefore driving away sophisticated investors. If sophisticated investors only look to high-rate penalty rates, a large portion of the ARS market will fail repeatedly.[55]

In the past, when an auction was about to fail, broker/dealers would step in and purchase enough shares to prevent failure.[56] The SEC noted that these firms would participate in the auction to prevent failure, which would have reset at a very high interest rate, adversely affecting issuers or at a very low interest rate, adversely affecting investors who must hold the securities.[57]

VI. Preventing Failure and the Future of the ARS Market

A. Allowing Municipal Money-Market Funds to Purchase ARS to Prevent Failure

Municipal money-market funds may bail out ARS issuers and investors. Municipal money-market funds have felt the brunt of the credit crisis. These funds typically invest in short-term tax-free municipal securities. However, short-term tax-free investments such as municipal bonds have been suffering in their valuations and price forecast as credit ratings for bond insurers are downgraded. Municipal money-market funds are worried about price declines on bonds backed by downgraded insurers.[58] While win-win situations may be rare, ARS and municipal money-market funds may be the perfect match. Municipal money-market funds are readily looking for tax-exempt investments for their portfolios. Since much of the municipal auction-rate market is self-insured, bond insurer worries are mitigated. The primary concern is that municipal money-market funds are heavily regulated and are generally not permitted to invest in long-term debt. What is the solution? Issuers are refinancing their auction-rate debt into money-fund eligible investments.[59] Only time will tell how many auction-rate issuers convert their offerings. Because the crisis is having a detrimental effect on ARS issuers, conversion is likely. Simple economics: money-funds are spurring demand that must be fulfilled. The Georgia Power unit of Southern Co. had $700 million in ARS and is now in the process of converting roughly $500 million of that into money-fund eligible investments.[60] As more issuers recognize this option, the incentive to remain in the ARS market decreases tremendously.

B. Using a Centralized MSRB System to Prevent Failure

In February 2008, an article on Bloomberg.com highlighted ARS regulators' call for more, well . . . regulation![61] Apparently, in the mechanics of the Dutch auction, a lot of information is kept available to a chosen few. The article states that regulators want more disclosure in the wake of a 2006 SEC insider-trading probe. The 2006 SEC probe resulted in 14 banks, including Citigroup and Goldman Sachs Group, being fined a total of $13 million after alleging the banks gave clients information about rival bids in the supposedly blind auctions (see Section IV).

The Municipal Securities Rulemaking Board (MSRB) has released MSRB Notice 2008-15. The notice serves as guidance for enforcement agencies and market participants. The MSRB notice highlights the lack of a comprehensive same-day source for information about Auction Rate Securities available to non-market professionals. "To increase the amount of information available to market participants, the MSRB is requesting comment on a plan to create a centralized system for the collection and dissemination of critical market information about Auction Rate Securities."[62] The plan would require ARS broker/dealers to report auction information to a central system operated by the MSRB. As of March 21, 2008, this was a recommendation and a call for open discussion.

C. Permitting Self-Bidding by Municipal Issuers to Prevent Failure

Municipal issuers, including 14 hospitals in California and Massachusetts, asked the Securities and Exchange Commission in January 2008 to let them bid on their own securities to prevent failures until they could refinance the debt.[63] Bond lawyers were concerned the issuers would violate securities laws by bidding at their own auctions. Self-bidding may be another manner by which the ARS market shrinks. If you were the finance manager of a municipality, wouldn't you bid on much of the auction-rate portion of the debt portfolio and restructure it from short-term variable rate to long-term fixed rate debt?

Lawyers working for the municipal issuers who intended to self-bid were concerned that self-bids may violate disclosure requirements set forth in the 2006 probe of the market. According to Anne Phillips Ogilby, an attorney at Ropes & Gray in Boston, market participants are looking for SEC assurance that allowing issuer self-bids does not violate the terms of the 2006 settlement.[64] Mr. Erik Sirri, director of the SEC's Division of Trading and Markets, has stated that "to bid in an auction, an issuer would have to disclose 'certain facts related to price and quantity.'"[65] Some ways in which disclosure may be deemed adequate are set forth in SEC Rel. No. 33-8684.

On March 14, 2008, an SEC staff letter specified that as long as there is proper disclosure, an issuer of municipal auction rate securities will be permitted to submit a bid in an auction for its own securities.[66] The letter also said conduit borrowers may bid ARS, and brokers, dealers or auction agents may accept and process such bids.[67] The SEC's no-action letter set forth the following guidelines for issuers who wish to bid:

> Appropriate disclosure about the submission, acceptance and processing of a bid consist of the following:
>
> (i) Disclosure should occur at a meaningful time (such as two business days) prior to an auction of the Municipal Issuer's or Conduit Borrower's intention to bid in a particular auction; the disclosure should describe the intention of participating dealers to bid on the Municipal Issuer's or Conduit Borrower's behalf and the interest rate(s) and amount(s) of municipal auction rate securities that will be bid for.
>
> (ii) If a Municipal Issuer or Conduit Borrower intends to bid, directly or through participating dealers, for nearly all (for example, 90% or more) of the outstanding principal amount of an issue of municipal auction rate securities, disclosure should be made of any steps the Municipal Issuer or Conduit Borrower intends to take to allow remaining holders of the issue to sell their securities to the Municipal Issuer or Conduit Borrower following the auction, such as whether the securities will promptly be purchased at par plus accrued interest, if any, from any and all holders who request such a purchase following the auction.
>
> (iii) Disclosure should be made of appropriately detailed information regarding bidding in the immediately preceding auction, such as the amount of securities for sale in the auction; the number and aggregate dollar amount of bids made; the number of bidders other than the participating dealers, Municipal Issuer or Conduit Borrower; the number, interest rate(s) and amount of bids, if any, made by the participating dealers; the number, interest rate(s) and amount(s) of bids, if any, made by the Municipal Issuer or Conduit Borrower; the clearing rate; and the high, low, and median bids received.
>
> (iv) Disclosure should be made of any steps to avoid an auction leading to a below market clearing interest rate, such as whether the rate(s) bid would not be less than an appropriate benchmark (for example, the relevant SIFMA municipal swap index).
>
> (v) Prompt disclosure should be made following the auction of appropriately detailed information concerning the bidding that occurred, such as that described in clause (iii) above.
>
> (vi) Timely dissemination of the foregoing disclosures to the public, should occur, and these disclosures should be provided to nationally recognized municipal securities information repositories and the financial press, coupled with posting on publicly accessible portions of the participating dealers' web sites and the Municipal Issuer's or Conduit Borrower's web site.[68]

The staff letter gives a lot of breathing room for issuers. However, in case an issuer thought there was a blanket rule permitting the issuer to bid, the letter included the following statement: "Appropriate disclosure in any particular case will, of course, depend on all the relevant facts and circumstances."[69] One may assume this statement is to protect contractual duties for the issuer not to bid or other contractual obligations possibly set forth in the offering documents.

If an issuer meets all the disclosure requirements and is permitted to place a bid at the lowest possible rate, only a few investors will remain in the ARS market if such a market still exists. The remaining investors may be high net-worth individuals who are attracted to tax-exempt investments. However, if municipalities are refinancing ARS debt into money-fund eligible securities, the money fund may be more appealing to the high net-worth investor because of diversified risk. Investors looking for tax-exempt securities can look for high-quality tax-exempt municipal bonds or invest in tax-exempt municipal money-market funds. If the issuer uses the SIFMA municipal swap index as its bid, this becomes a clearing rate maximum. Eventually, few buyers *other than* the issuers may be attracted to this market because of the risk. The number of issuers seeking bids indicates that the issuers themselves are pulling away from this debt vehicle. ARS issuers may resort to VRDO, even though the set-up cost is higher. Municipal borrowers from throughout the United States have set out plans to take at least $21 billion of bonds out of the auction-rate market by May 1, 2008 to escape soaring costs, according to data compiled by Bloomberg.[70] This means that within a few months, 6% of the $330 billion market will convert into fixed rate debt.

VII. Pitched as Cash, Treated as Investments: Legal Implications

Plaintiff attorneys have alleged that investment banks and broker/dealers have violated Section 10(b) of the Securities Exchange Act of 1934 by employing manipulative and deceptive devices in the ARS market or in deceiving ARS investors.[71] As of this writing, a handful of ARS-related cases have been filed in U.S District Courts. The story may differ slightly; however, the gist of the matter is the same. [72]

ARS have been considered successful debt portfolio strategies for 20-plus years. However, plaintiffs' lawyers allege that ARS were not successful by themselves; rather, the 20-plus-year history is tainted with insider trading and broker/dealer-intervention. Furthermore, plaintiffs' lawyers are claiming that broker/dealers never disclosed to their clients that auctions would have a much higher failure rate had it not been for the intervention. Did broker/dealers have an obligation to disclose the details of their bidding before the 2006 SEC probe? If not, they certainly should have a duty to disclose after the probe. Technically, how can disclosure in a seven-day auction be possible? Considering that mail takes on average three to four days to deliver, the broker/dealer must send notices at least five days before the auction. However, is that possible? What if market conditions change? Should they give investors updated notice? If so, how will they give notice within one day of a seven-day auction? These intricacies may be resolved if the proposed MSRB system is put into place.

Let us revisit the reason why broker/dealers stopped bidding in auctions. The supposed reasons were 1) credit risk, and 2) market conditions requiring broker/dealers to maintain larger cash reserves. If that were the case, why did Morgan Stanley and UBS offer their clients loans against their clients' ARS holding?[73] Arnold Goldner of Fort Lauderdale, Florida, says Morgan Stanley offered him a loan against his auction-rate securities, but he declined, asking, "They'd charge me a rate to borrow my own money?"[74] After all, if these loans are backed by ARS holdings, Morgan Stanley and UBS believe that ARS positions can eventually be liquidated; stated otherwise, clients will eventually close their ARS positions, obtain cash and pay off the loan. If Morgan Stanley and UBS believe that the ARS market can be liquid, why don't they bid on them again? If broker/dealers do not want to get involved in the ARS market anymore, why did they offer loans to clients whose cash is in the ARS market? If ARS auctions keep failing, their clients cannot pay their loans back in a timely fashion.

In a complaint against UBS, plaintiffs allege that UBS misrepresented the liquidity and risks associated with ARS and omitted material facts about its own role in the auctions market. The complaint stated that UBS, as the second largest underwriter of ARS, received significant underwriting fees from the issuance of these securities. UBS entered into broker/dealer agreements with the issuers and was paid an annualized fee for operating the auction process. At the same time, UBS "acted as a principal for its own account," utilizing inside information to make profitable decisions for itself. UBS failed to disclose its involvement in the market and the risks associated with the market to investors when it pitched ARS as cash equivalent investments.[75] The complaint alleged that UBS was in violation of Section 10(b) of the Exchange Act and Section 20(a) of the Exchange Act.

Wall Street brokerage firms are also actively looking at creating a secondary market that will allow investors to sell their auction rate securities to other investors.[76] The catch is that participating investors would most likely have to sell at a discount (below par). If there are no buyers in the primary ARS market, which buyers will come to the secondary market? Institutional investors will flood this market. Why wouldn't Wall Street firms want securities issued by high-quality municipalities? These firms have led investors to believe that ARS are cash-equivalent; firms have then offered loans at .25 points above LIBOR against "cash-equivalents"; finally, these firms have asked for a secondary market to sell ARS.[77] Joe Morgan, head of portfolio management at SVB Asset Management, says that the only place to convert ARS into cash is through the investment bank that sold them in the first place.[78] Investment banks are concerned about the cash they have on hand, so they have no incentive to convert, unless at a discount. It sounds as though Wall Street is trying to douse an oil fire with water. However, I do believe that a secondary market also has the benefit of attracting investors who have the cash to take hold of ARS until they become money-fund eligible paper. Of course, the current holders will have to sell at a discount; however, this solution may be better than holding onto an illiquid position. I believe this may be the strongest solution to the ARS freeze.

VIII. Re-Evaluating Our Investments

As litigation continues, more important questions are likely to arise, such as whether ARS issuers acknowledged or relied on broker/dealer bids.[79] Furthermore, a very important issue is how shareholders can effectively evaluate companies that fail to state their ARS positions. Because ARS were believed by market participants to be cash equivalents, companies generally did not distinguish between ARS and capital-on-hand in their prospectuses. The tricky issue becomes how an investor can evaluate such a company, when, for example, the company's stated "cash-reserves" are no longer cash reserves![80] According to JetBlue's Form 10-K, as of December 31, 2007, the company's ARS position accounted for approximately 72%, or $611 million, of the $834 million in cash and investment securities. While the company reduced the $611 million ARS holding to $330 million, roughly 45% of the $330 million was not successful at auctions. The company went on to state that it has enough accessible working capital for

12 months. JetBlue has not stated whether its reset rate on the failed auctions is above or below market. How does the intelligent investor use ratios to compare one company with ARS holdings against another company without such holdings or the industry as a whole? JetBlue may be one of many companies that have significant investments in ARS. In light of the 2008 turmoil, does the investor view ARS holdings as short-term liabilities or as a long-term investment? Certainly we can no longer consider them short-term cash equivalents!

IX. Conclusion

During my research, I have found only one individual who warned investors about the ARS storm, Mr. Joe Morgan. However, Mr. Morgan is not a regulatory authority whose sole purpose is to protect the general public from fraudulent or manipulative practices. The MSRB, on the other hand, has such a purpose (for municipal ARS anyway). The MSRB, in 2003, claimed to have proposed an electronic system whereby the auction reset rate along with other information would be disseminated automatically. However, broker/dealers were not interested in the system because of the highly specialized nature of the Dutch auction. While the MSRB has re-launched the electronic information dissemination idea,[81] some may question whether it is too late. The ARS problem can be summarized as the lack of proper disclosure leading to investments valued by manipulative practices. Did the MSRB realize that the 20-year-old municipal ARS market was tainted? If yes, why was that information not disclosed? If no, why didn't the MSRB know? However, the ARS collapse does not seem to have been caused by issuer involvement. If there is one lesson, it is that you should be wary of where your money is positioned and who is advising you about your positions. Take an active role in understanding your investments from angles other than the one provided by your investment adviser!

Endnotes

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71. "It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce, or of the mails or of any facility of any national securities exchange, (a) To employ any device, scheme, or artifice to defraud, (b) To make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or (c) To engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person, in connection with the purchase or sale of any security." 17 CFR 240.10b-5.

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80. Megan Johnston, *Exchange helps ease ARS woes (somewhat)*, Financial Week, May 19, 2008, http://www.financialweek.com/apps/pbcs.dll/article?AID=/20080519/REG/904246648 (JetBlue Airways previously did not mention its ARS positions since ARS holdings were generally thought to be cash-equivalents and capital-on-hand. JetBlue said nothing about whether the reset rate of its $313 million ARS holdings was at 0% or above market. My question is how can investors properly assess the financials of such a company? JetBlue did, however, reveal in its annual Form 10-K filing that it had 72% of its cash and investments in ARS!).

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The Lawyers' Foreclosure Intervention Network: Addressing Mortgage Foreclosure in New York City

By Thomas C. Baxter, Jr. and Michael V. Campbell

A husband and wife are walking along the shore just after high tide. A large number of starfish are stranded at the high water mark. The wife begins to pick up the starfish and toss them back into the water.

Husband: Why bother? There must be millions. You're never going to be able to get them all back in.

Wife: I know. But for the ones that get back home, it really makes a difference.

This story illustrates the nature and, unfortunately, the limits imposed on all legal pro bono endeavors—the desire to accomplish what is possible, while ultimately coming to terms with the impossibility of assisting all those in need. It captures the promise and limitations of the Lawyers' Foreclosure Intervention Network (LFIN), a pro bono program launched earlier this year by the Federal Reserve Bank of New York[1] and the City Bar Justice Center.[2] Unlike so much of the Federal Reserve System's work, which deals with events at the macroeconomic level, LFIN is a much more modest "pilot" program, aimed at improving the lives of individuals, one at a time. Its primary mission is to marshal the resources of New York City's legal community to represent subprime borrowers in New York City so that they might avoid unnecessary foreclosure. The Federal Reserve is monitoring the LFIN pilot program to determine whether similar efforts might be helpful in other areas of the country. The LFIN framework includes lawyer recruitment, mentoring and training, intake and screening of cases, program administration through the City Bar Justice Center and Federal Reserve Bank of New York, and metrics to evaluate the success of the program.

I. LFIN's Design

LFIN was officially launched on May 27, 2008. For more than six months prior to that, lawyers at the Federal Reserve Bank of New York and staff at the City Bar Justice Center worked to design and implement LFIN, keeping in mind the following characteristics, observed in other successful in-house pro bono programs:

- Partnering with an experienced pro bono services provider;
- Training on pro bono representation and applicable law;
- Selecting a knowledgeable pro bono activities coordinator;
- Establishing a policy that encourages volunteers and provides a variety of opportunities; and
- Providing volunteers with mentors who have subject matter expertise.[3]

A. Partnering with the City Bar Justice Center

The City Bar Justice Center was chosen by the Federal Reserve Bank of New York as a co-sponsor to help administer the program because of its extensive experience in operating a number of pro bono initiatives, including the Immigrant Women and Children Project, the Pro Bono Consumer Bankruptcy Project, the Elder Law Project and the Legal Clinic for the Homeless. The City Bar Justice Center was able to provide the expertise necessary to help tailor the program that was envisioned and has been able to provide appropriate resources for its implementation.

B. Selecting LFIN Management

LFIN is administered through an attorney Director and a Project Coordinator. The Director was selected in view of her experience with predatory lending cases and consumer and commercial litigation. The Director's responsibilities include recruiting volunteer lawyers; interviewing clients and screening for suitability for pro bono representation; coordinating the activities of and mentoring volunteer lawyers who will represent homeowners at risk of losing their homes; creating model pleadings; handling a docket of cases; troubleshooting with regard to the conduct of the project, such as rematching cases in the event of conflicts or other issues; ensuring client confidentiality, and supervising the reporting of project results.

The Project Coordinator is not an attorney, and works under the Director's supervision. His responsibilities include handling enrollment of lawyer volunteers and clients, assignment of lawyers to clients, client inquiries, continuing legal education administration, reporting results and other administrative activities related to the project.

C. Training Volunteers

In early May 2008, pro bono coordinators and other contacts at more than 300 law firms and corporations with a presence in New York City received a save-the-date flier describing LFIN and the opportunity to volunteer for pro bono service. The Federal Reserve Bank of New York hosted a reception in early June 2008 to provide encouragement and thank volunteers for agreeing to participate in LFIN.

On June 18 and 19, 2008, volunteer lawyers received 1.5 days of training and training materials, some of which were specifically created for LFIN with the assistance of the Federal Reserve Bank of New York's legal staff. Training was provided by an affiliate of a large New York-based financial institution and a non-profit corporation well known for consumer training and consumer advocacy. Topics included loan workout options, bankruptcy, the New York foreclosure process, home "rescue" scams, major federal and New York claims and defenses, and a case study. Volunteers agreeing to assist at least one client in LFIN were given Continuing Legal Education credit for attending.

Although the training was regarded by attendees as valuable,[4] it should be recognized that there are limits to what can be learned over such a short period of time. Therefore, training will be provided in the future as a refresher, to address new developments and to narrow the focus to cover issues reflected by the clients of LFIN. Since June, several additional training opportunities have been offered. Based on the situations of many pro bono clients and the needs of LFIN's current volunteer pool, a training session on basic litigation skills was provided to volunteers on September 10. In addition, the New York City Bar Association hosted two half days of training on October 21 and 22 based on revisions to the agenda that was used to train volunteers in June. Nearly 250 new volunteer lawyers entered the program as a result of the October training sessions.[5]

D. Encouraging Volunteers and Providing Opportunities

LFIN provides attorneys numerous incentives to encourage participation and the opportunity to meet their professional obligation to render pro bono legal service.[6] Aside from the obvious incentive of helping to sustain the viability of neighborhoods by preventing unnecessary foreclosures and thereby keeping homeowners in their homes, it also gives lawyers an opportunity to learn consumer law, sharpen negotiating skills, gain valuable advocacy experience and earn Continuing Legal Education credit.

LFIN periodically sends volunteers e-mail "blasts," which briefly describe a client's case and request volunteers. The response of volunteers has been exemplary. Due to ethical conflicts, "positional" conflicts and other considerations, however, some lawyers will not be able to represent these clients. Alternative opportunities have been or will be provided for these lawyers, such as performing basic research to assist the lawyer representing an LFIN client, preparing guides on consumer rights, providing legal memoranda, and drafting LFIN blasts on how various laws such as the HOPE for Homeowners Act of 2008[7] and New York's new mortgage lending reform law[8] can be used by volunteers to enhance client service. Volunteers may also have an opportunity to be seconded to Legal Aid programs that help homeowners avoid foreclosure.

Finally, because it is important to recognize laudable work, on each anniversary of the project, LFIN will acknowledge superior performance of volunteers at an awards ceremony at the Federal Reserve Bank of New York.

E. Mentors

Volunteers in LFIN have very different expertise and skill levels in consumer law, negotiating and litigating. The LFIN Director has mentored some volunteers by taking them on as co-counsel. More recently, efforts have been made to pair experienced consumer lawyers with lawyers whose expertise lies elsewhere. Additional mentoring assistance may be provided through LFIN's association with some of the Legal Aid offices in New York City that provide foreclosure prevention assistance and elder care services. However, it is painfully clear that even in a place like New York City, where the supply of lawyers is bountiful, there is a far more limited number of lawyers skilled in mortgage foreclosure prevention who are available to provide the optimal level of mentoring.

F. Monitoring Results

In addition to the five characteristics that appear to be present in successful pro bono programs, LFIN incorporates a sixth element: monitoring of results and making program adjustments based on them. Numerous statistics will be compiled and analyzed on cases that flow through LFIN. Aside from providing evidence on how well the program is doing, the feedback will be used to determine where the program is not performing adequately so that changes can be made. The statistics reported will include information on the volunteers (e.g., name of lawyer, name of law firm); borrower characteristics (e.g., FICO score, ratio of debt to gross family income); loan characteristics (e.g., type of residence, loan features such as fixed rate, "low doc," ARM product, negative amortization); reasons for default (e.g., job loss, health problems, fraud); type of assistance rendered (e.g., loan modification, bankruptcy, litigation, sale of property), and the number of borrowers remaining in their homes 6 to 24 months after receiving assistance.

Several adjustments have already been made to LFIN based on initial observations of the program's operation. As mentioned above, efforts are being made to assign to cases two attorneys with different experience levels. Also, as a practical matter, utilizing protections afforded by certain consumer laws requires in-depth understanding of highly technical requirements that many volunteers do not have and may take considerable time to acquire. The Federal Reserve Bank of New York is assisting volunteers to make the determination as to whether the client may have rescission rights under the federal Truth in Lending Act by assisting in the review of operative loan documents.[9] This right to rescind[10] the home loan may also provide significant leverage in negotiating a loan modification.

II. Addressing Conflicts of Interest

With respect to a client's mortgage, LFIN recruits lawyers to: (1) counsel homeowners and negotiate with financial institutions; (2) represent clients, where appropriate, in bankruptcy proceedings, and (3) represent clients in litigation. An assumption made in designing LFIN was that most volunteer lawyers would come from large New York law firms that already represent myriad financial institutions. LFIN would have to confront the problem of how these potential volunteers would be able to reconcile their responsibilities to potential pro bono clients with the duty to avoid conflicts of interest that arise from representing clients whose interests diverge (i.e., borrowers and lenders). This problem will not arise in cases where the volunteer lawyer's law firm does not represent a financial institution. In fact, this is the case for many of the small law firms and solo practitioners who have volunteered for LFIN. Nevertheless, the prospect of attracting a financial institution client in the future may also work as a disincentive assuming the law firm believes participation in LFIN will deter the prospects of such business developing.

New York's Disciplinary Rule 5-105 instructs a lawyer to decline employment and discontinue multiple employment "if the exercise of independent professional judgment in behalf of a client will be or is likely to be adversely affected by the lawyer's representation of another client, or if it would be likely to involve the lawyer in representing differing interests. . . ."[11] Subsection C of DR 5-105, however, permits a lawyer to accept or continue to represent multiple clients "if a disinterested lawyer would believe that the lawyer can competently represent the interest of each and if each consents to the representation after full disclosure of the implications of the simultaneous representation and the advantages and risks involved."[12]

After consulting with the Federal Reserve Bank of New York, the General Counsel of the New York City Bar Association requested an informal opinion from its Committee on Professional and Judicial Ethics on the ethical considerations concerning multiple representation relevant to LFIN. The Committee issued an informal ethics opinion on June 12, 2008,[13] which analyzed several scenarios under which clients of a participating law firm—financial institutions and pro bono clients—could provide consents that satisfy the two tests under DR 5-105(C). The opinion notes that, under the various scenarios described below, the validity of the consent "is determined largely by whether the law firm's representation of the financial institution substantially relates to the mortgage taken out by the pro bono client."[14] The purpose of applying a substantial relationship test is to ensure that the financial institution's secrets and confidences are not used against it and that the law firm is not placed in a position where it will have to attack work it performed for the financial institution.[15]

A. Scenario 1: The Law Firm's Representation of the Financial Institution Does Not Substantially Relate to the Mortgage Taken Out by the Pro Bono Client

The Committee concluded that "the financial institution can readily consent to having lawyers at a law firm that represents the institution also negotiate adversely to the institution."[16] With respect to litigation, the opinion states that "it is commonplace for financial institutions to consent to having law firms that represent them also act adversely to those institutions, including suing them, regarding matters not substantially related to the scope of the representation."[17] Under the LFIN framework, pro bono representation by lawyers from such law firms is limited to "(1) counseling the pro bono client and negotiating with the relevant financial institution(s) regarding the client's mortgage, and (2) representing the pro bono client, when appropriate, in bankruptcy proceedings."[18] In addition to these limitations, a lawyer providing pro bono representation may not, at the same time, personally represent the financial institution.[19]

The opinion provides no examples of, or methods to determine whether, a law firm's representation of a financial institution is substantially related to the mortgage taken out by the pro bono client. But it should not be difficult to envision such situations. Where a financial institution's law firm has not represented it with respect to the origination of the pro bono client's mortgage, ostensibly the law firm's representation is not substantially related to the mortgage taken out by the pro bono client. Likewise, when a financial institution purchases a mortgage loan and its law firm has not represented the financial institution with respect to the purchase and has not provided representation with respect to the origination and sale of that mortgage, the law firm's representation would not appear to be substantially related to the mortgage taken out by the pro bono client.

A determination of whether any particular situation gives rise to a Scenario 1 type situation is highly dependent on the facts. Whether the representations are substantially related may, in some cases, be a close call. Where this happens, the Committee advises the law firm to consider erecting an ethical screen between lawyers representing the financial institution and those representing the pro bono client.[20]

B. Scenario 2: The Law Firm's Representation of the Financial Institution Substantially Relates to the Mortgage Taken Out by the Pro Bono Client

In a case where a law firm's representation of a financial institution is substantially related to the mortgage taken out by the pro bono client, the Committee's informal opinion states that the clients cannot consent to multiple representation as litigants.[21] Under these same circumstances, if the law firm is asked to negotiate on behalf of the pro bono client and the financial institution, the Committee reaches the same result because the degree of adversity between both parties "would still be too great for the conflict to be consentable."[22]

C. Consent from the Perspective of the Pro Bono Client and the Financial Institution

When a law firm has a lender as a client with conflicts described under DR 5-105, and can ethically take on a borrower as a client, there is an additional factor. The lender's consent to the firm's representation of the borrower is limited to counseling and negotiation with financial institutions, and to representing the borrower only in non-adversarial bankruptcy proceedings. The Committee's opinion notes that such limited representation in pro bono matters is commonplace.[23] Limited representation is impermissible, however, when it is so limited as to render counsel inadequate.[24]

In cases where the pro bono client is determining, with the advice of the LFIN Director, whether to agree to limited representation, the potential client will receive a letter from the law firm that describes, among other things, the scope of the representation, conflicts that the pro bono client will waive and that the lawyer may have to withdraw from representing the client in certain cases. The pro bono client is told that, because the volunteer lawyer may be ethically prohibited from litigating a matter, he or she would have to withdraw representation, and the client would have to engage another lawyer. If this occurs and another volunteer lawyer comes to represent the borrower, the pro bono client will receive a letter describing the nature of the proposed relationship.

Another concern is that even where a conflict may be waived, as in Scenario 1, the law firm providing the limited representation will have, as a client, a financial institution that it is negotiating against and, as significant clients, financial institutions with similar "lender" interests. The Committee concludes that, under these circumstances, the pro bono client cannot consent without the advice of a disinterested lawyer. The lawyer supplied by a law firm representing a financial institution does not qualify for this purpose. The LFIN Director, however, who is committed to representing pro bono clients, should qualify as a disinterested lawyer and be qualified to advise the pro bono client on whether to agree to limited representation or seek representation from another lawyer in LFIN who does not have such restraints.[25]

In the case of the financial institution that must decide whether to consent to having its law firm lawyers negotiate adversely to it, the financial institution should not rely exclusively on the advice of that law firm. That financial institution's inside counsel can be relied upon as independent counsel for this purpose.[26]

D. When the Pro Bono Client Decides to Litigate

Although the Committee's informal opinion states that the financial institution may consent to being sued under Scenario 1, it was understood from initial feedback from various financial institutions that there would be discomfort in waiving the law firm's conflict in cases that could not come to resolution through negotiation. It was also noted that the law firms might not be comfortable permitting their lawyers to litigate against a significant financial institution client. Therefore, with the exception of non-adversarial bankruptcy proceedings,[27] as a practical matter, pro bono client representation by a lawyer whose firm represents a financial institution is limited to trying to achieve a negotiated settlement with the lending institution, most probably some kind of loan modification.

If the lawyer in Scenario 1, after discussing various options with the borrower, learns that the borrower wishes to litigate with the lender, then the lawyer will recommend or assist in securing other counsel to litigate the case. When this situation arises, it is anticipated that the LFIN Director will reassign the case to a volunteer lawyer who does not have a conflict under DR 5-105.

When litigation is necessary, the efficient operation of LFIN depends on the transfer of all background information and the case history from the attorney with the conflict to the attorney without the conflict. Under the Committee's informal opinion, it is a waivable conflict for the first attorney to outline in a memorandum the client's claims and defenses to avoid foreclosure and provide this memorandum to the client. In addition, under New York law, with narrow exceptions, the former pro bono client is entitled to the attorney's entire file concerning the representation.[28] Thus, LFIN has two lawyer populations—one with conflicts and potential conflicts under DR 5-105, and one without conflicts—which can be utilized to ensure that, when a conflict arises, the pro bono client "hand off" can be made seamlessly in a way that benefits the client and promotes the operation of the program.

III. Letters from Financial Institutions to Law Firms Encouraging Participation in LFIN

Lawyers from the Federal Reserve Bank of New York met with general counsels and other legal representatives from various financial institutions to discuss plans for LFIN and how their financial institutions and the law firms that represent them could be helpful. The financial institutions were provided with template letters, consistent with the Committee's informal opinion, that could be used by the financial institutions to waive certain conflicts of interest that might arise as a result of a law firm's representation of a pro bono client. A template cover letter from a financial institution's general counsel requests that the law firm participate in LFIN and includes, as an attachment, a template "advance waiver" letter[29] that may be used by the law firm to request a waiver of certain conflicts of interest. The purpose of the cover letter was to give comfort to law firms that their participation would be encouraged.

Although some financial institutions have made requests of their law firms to participate, the extent to which these letters have been sent out and the number of law firms that have made the request for, and were granted, the limited waiver is not known at this time.

IV. Preliminary Results

A. Client Sources

Clients have been referred to LFIN through the City Bar Justice Center's hotline, Google searches, the Federal Bureau of Investigation, lawyers, city agencies such as the Department of Housing Preservation and Development and the New York City Comptroller's Office, and the state Supreme Courts in the Bronx, Queens and Manhattan. At the time of this article, there were 62 pro bono clients accepted into the program, 47 of whom were placed with a volunteer lawyer.

B. Client Cases

In many of our early cases, the pro bono client has refinanced a mortgage loan and taken equity out of the transaction to pay for home repairs. In other cases, the home equity was used to finance a child's education, start a business or purchase a second home. Many clients appear to be unable to make payments on their mortgages simply because they did not appreciate the increased payments that would be needed to support the larger debt on the refinanced loan. This was often the result of a failure to understand the loan terms, especially with regard to adjustable rate features, and an overly optimistic sales pitch (and possibly fraud) by an aggressive loan broker. Some of the more prevalent factors leading to default were life events such as the loss of a job, divorce, a failed business, nonpayment of rent by tenants, and health-care and home-repair costs. In addition, several clients were victims of a type of fraud known as "deed theft."

The following LFIN blasts are examples of cases that have been accepted:

- Mr. and Mrs. F bought their house in the Bronx in 1994 with a $245,000 fixed-rate mortgage. They refinanced in 2006 for $356,000 in order to start a day care business. They invested funds in the business, which never got off the ground. Then, Mr. F lost his job, and the tenants renting an apartment from them destroyed and then abandoned the unit. Mr. and Mrs. F are now about four months behind in payments and were served with a summons and complaint on May 27.
- Mr. and Mrs. M have owned their home in the Bronx since 1987. They never refinanced their original loan but fell behind because Mr. M has been injured and out of work since 2001. They learned from a local real estate agent that their house is scheduled to be sold at auction. They say they were never served with a summons and complaint in the foreclosure action, though they were aware something was pending. They would like to sell the house and move; they just need some time. They have equity in the house; it would be helpful if they could get the default fees and interest reduced or eliminated.
- Mr. C was the victim of a crime known as deed theft. His home is a brownstone in Bedford-Stuyvesant, Brooklyn, that has been in his family for generations. He inherited it free and clear but then got caught up in successive refinancings, starting with a loan taken out to renovate the kitchen for his mother. Each refinancing ended up digging a deeper hole, compounded by various business and health setbacks. Finally, in 2005, facing foreclosure, Mr. C contacted a company that had been canvassing the neighborhood and advertising in the local newspaper as providing foreclosure rescue. The plan was to "put the house in someone else's name" for 12 months while Mr. C straightened out his financial problems and then transfer it back to him. He did not receive any documents at the closing, and, when he went to the company's office a short time later to pick them up, the business was closed down. The new "owner" then proceeded to refinance the mortgage and take out more money against the property. The mortgage has been foreclosed, and in May, the property was sold at auction. The con artists have been arrested and are being prosecuted in federal court; one has pleaded guilty. Both the Justice Department and the FBI have confirmed that Mr. C was the victim of a crime. The house, however, is no longer in his name. The utilities have been disconnected because the companies will not take his payments (as a non-owner), and a local real estate company has been asserting ownership as an agent of the bank that purchased the property at auction.

C. Client Representation

Although it was anticipated that LFIN would rely primarily on lawyers from large law firms, at this time most of the lawyer volunteers come from small law firms or are sole practitioners. It is too early in the life of the program to determine if this is a long-run trend.

There are several possible explanations for the lack of participation by large law firm lawyers. Financial institutions may not be as supportive of LFIN as expected. If the financial institution's senior officers do not promote LFIN and some palpable harm comes to the institution through a case supported by LFIN, particularly in the form of reputational damage, the general counsel who sent letters to law firms requesting support might reasonably anticipate some audible grumbling.

Another explanation may be concern over "positional" or business conflicts, which have been defined as conflicts that "may occur when a lawyer or law firm's presentation of a legal argument on behalf of one client is directly contrary to or has a detrimental impact upon the position advanced on behalf of a second client *in a different case or matter*" (emphasis added).[30] It has been noted that "an overly broad concern about how positional conflicts might alienate paying corporate clients will inevitably trump the lawyer's obligation to undertake pro bono work, particularly in complex and controversial matters."[31] Of course, any failure to actively embrace LFIN by financial institutions will only magnify law firm concerns over positional conflicts.

V. Conclusion

LFIN was designed as a response to the rising tide of foreclosures in New York City. It was built on certain untested assumptions about legal representation and upon expectations that have yet to be realized. LFIN has already undergone several adjustments and will continue to be modified, as we learn from experience. At present, it is too early to evaluate results or speculate about success. However, LFIN has provided a few hints about situations that will need to be addressed and some encouraging signs.

LFIN's promise—to provide legal representation with respect to a legal process that can be life-altering, namely foreclosure—can be realized if certain matters receive close attention. It is clear that the program will have to promote itself continuously if it is to generate a sufficient and continuing supply of lawyer volunteers. Because of the scarcity of lawyers skilled in mortgage foreclosure prevention, training and mentoring are essential for effective client representation. Positional conflicts appear to have surfaced, limiting the availability of legal resources. Efforts will have to be made by the sponsors of LFIN and the legal community to overcome concerns over positional conflicts, to the extent possible. Beyond moral suasion, there is a strong case to be made to financial institutions that facilitating borrower representation will be more likely to avoid unnecessary foreclosure and instead lead to loan modification, which will be in the overall economic interest of both borrower and lender. Furthermore, the goodwill generated by supporting efforts such as LFIN greatly outweighs the speculative fear of economic loss and damage to the lender's reputation. LFIN's design and the types of cases it has taken on mitigate such fear.

On the positive side, the number of lawyers who have volunteered for LFIN and their enthusiasm is encouraging. The framework adopted for the project is one that has been widely used in other successful pro bono programs. The timing of the project coincides with state and federal legislative changes that volunteers will use to further LFIN's purpose. In this respect, the recent New York law requiring mandatory settlement conferences between the parties to a foreclosure action should be particularly helpful, especially where this process leads to the replacement of unaffordable subprime loans with conventional mortgage loans that the borrower can afford to repay.

Endnotes

1. The Federal Reserve Bank of New York is one of 12 Federal Reserve Banks which, together with the Board of Governors in Washington, D.C., make up the Federal Reserve System. The "Fed," as the system is commonly called, is an independent governmental entity created by Congress in 1913 to serve as the central bank of the United States. The Federal Reserve Bank of New York is the largest Reserve Bank in terms of assets and volume of activity. It supervises and regulates bank holding companies, as well as state member banks, and provides services to depository institutions in the Second Federal Reserve District. Consistent with the Federal Reserve System's mission to promote community development in historically underserved markets, the Community Affairs Office of the Federal Reserve Bank of New York assesses credit needs, engages in applied research and develops programs and products to address local community needs. Information gathered on local economic conditions and community needs helps inform policies that contribute to the financial stability of the region.
2. The City Bar Justice Center is the 501(c)(3) public service affiliate of the New York City Bar Association. Founded in 1946 to "facilitate and improve the administration of justice," its mission is to increase access to justice by leveraging the resources of the New York City legal community. By working in tandem with the legal community, the City Bar Justice Center annually provides direct legal representation, information and advocacy to more than 25,000 indigent and low-income New Yorkers.
3. John C. Cruden, *Promoting Pro Bono Service by Government Attorneys*, 53 Fed. Law. 30, 33 (2006).
4. There were 113 attendees at the LFIN training sessions on June 18 and 19 who were given evaluation response forms to fill out. On a scale of 1 to 5, with scores of 1(excellent) and 2 (very good), faculty, program content and written materials received scores of 1 or 2, 93, 95 and 95 percent of the time, respectively, with a score of 1, 68, 76 and 81 percent of the time, respectively.
5. It has been noted by Esther F. Lardent, president and chief executive officer of the Pro Bono Institute at Georgetown University Law Center, that in the vast majority of cases, pro bono opportunities are litigation-based. Elisabeth Frater, *The Rise of Corporate Law Departments and Pro Bono Service: Strategies and Innovations That Lead to Success*, Diversity and the Bar, March-April 2008, at 44. This observation is currently reflected in the LFIN caseload.
6. The American Bar Association's Model Rule 6.1 begins by stating, "[e]very lawyer has a professional responsibility to provide legal services to those unable to pay." Model Rules of Prof'l Conduct R. 6.1, *available at* http://www.abanet.org/legalservices/probono/rule61.html. New York State's ethical considerations state that a

lawyer "should aspire to provide at least 20 hours of pro bono services annually . . . to (1) persons of limited financial means, or (2) not for profit, governmental or public service organizations, where legal services are designed primarily to address the legal and other basic needs of persons of limited financial means, or (3) organizations specifically designed to increase the availability of legal services to persons of limited financial means." N.Y. Law. Code of Prof'l Responsibility, EC 2-34, *available at* http://www.nysba.org/Content/NavigationMenu/ForAttorneys/ProBonoInformation/EC234ETHICSCODE.pdf.

7. This bill, signed into law in July, will create a Federal Housing Administration (FHA) program, available to mortgagors and mortgagees on a voluntary basis, that would insure refinanced affordable loans for economically distressed borrowers to support long-term, sustainable homeownership. The FHA-run program will insure up to $300 billion in refinanced 30-year, fixed-rate mortgage loans. Pub. L. No. 110-289, 122 Stat. 2654.

8. The New York bill was signed into law in August. It provides, among other things, for the court to schedule a mandatory settlement conference between parties to a foreclosure action within 60 days of when the plaintiff files a proof of service of the complaint. The purpose of the settlement conference is to discuss the "rights and obligations of the parties under the mortgage loan documents, including, but not limited to, determining whether the parties can reach a mutually agreeable resolution to help the defendant/borrower avoid losing his or her home, and evaluating the potential for a resolution in which payment schedules or amounts may be modified or other workout options may be agreed to, and for whatever other purposes the court deems appropriate." N.Y. Real Prop. Acts § 1304.

9. The right of rescission under the Truth in Lending Act may be available for most home loans secured by the home, other than loans for the purchase of a home. The right of rescission may last up to three years if certain disclosures were not made to the borrower at the time the loan was consummated. 15 U.S.C. § 1635.

10. *See In re West*, 46 Clearinghouse 795 (E.D. Pa. 1992), *available at* http://www.povertylaw.org/clearinghouse-review (holding that failure to advise a client of his or her rescission rights may be malpractice). This unreported decision may also be obtained through the Sargent Shriver National Center on Poverty Law by mail at: 50 East Washington Street, Suite 500, Chicago, Illinois 60602; by telephone: (312) 263-3830; or by facsimile: (312) 263-3846.

11. N.Y. Law. Code of Prof'l Responsibility, DR 5-105 (A) and (B).

12. DR 5-105 (C).

13. Informal Ethics Op. *available at* http://www.nycbar.org/pdf/report/June_12_Mortgage_Foreclosure_Op.pdf.

14. *Id.* at 2.

15. *Id.* at 1.

16. *Id.* at 2.

17. *Id.*

18. *Id*. at 1.

19. *Id.* at 2.

20. *Id.* at 2-3.

21. *Id.* at 3.

22. *Id.*

23. *Id.* at 4-5.

24. *See* ABA Comm. on Prof'l and Judicial Ethics, Formal Op. 2001-3, cited at note 6 of the Informal Op. at 4.

25. Informal Op. at 4-5.

26. *Id.* at 3.

27. *See* ABA Comm. on Prof'l and Judicial Ethics, Formal Op. 2005-01 (adversity between debtor and creditor insufficient to trigger DR 5-105 restrictions "unless and until a creditor objects to the discharge of a debt or otherwise takes action that is directly adverse to the debtor").

28. New York courts follow the majority position, as adopted in the American Law Institute Restatement (Third) of the Law Governing Lawyers, Section 46(2). Adopting the position in the Restatement, the New York State Court of Appeals in *Sage Realty Corp. v. Proskauer Rose Goetz & Mendelsohn L.L.P.*, 91 N.Y.2d 30, 666 N.Y.S.2d 985 (1997) reached several conclusions: (1) The former client is "presumptive[ly]" entitled to the attorney's "entire file on the represented matter," with "narrow exceptions;" and (2) "Even without a request, an attorney is obligated to deliver to the client, not later than promptly after representation ends, such originals and copies of other documents possessed by the lawyer relating to the representation as the former client reasonably needs." With respect to narrow exceptions to the general rule, the court held that "nonaccess would be permissible as to firm documents intended for internal law office review and use." Under this exception, the court clearly recognized that lawyers must have the ability "to set down their thoughts privately," by, for example, recording "tentative preliminary impressions . . . for the purpose of giving internal direction to facilitate performance of ... legal services." Examples might include documents "containing a firm attorney's general or other assessment of the client, or tentative preliminary impressions of the legal or factual issues." The court noted that such documents "presumably are unlikely to be of any significant usefulness to the client or to a successor attorney." *See Lippe v. Bairnco Corp.*, No. 96 CIV. 7600 DC, 1998 WL 901741 (S.D.N.Y. 1998) (applying *Sage's* exception for internal law office review and use).

29. *See* C. Evan Stewart, *The Legal Profession and Conflicts: Ain't No Mountain High Enough?*, 11 N.Y. Bus. L. J., 7, 7-11 (2007). The author discusses the requirements advance waiver letters must meet, under ABA Model Rule 1.7, for a law firm to satisfy its duty to disclose multiple representations and obtain client consent to those representations.

30. Esther F. Lardent, *Positional Conflicts in the Pro Bono Context: Ethical Considerations and Market Forces*, Challenge Signatories Update, Fall 1998-Spring 1999, at 1.

31. *Id.*

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Tugboats, Glaucoma and the Check Collection Process

By Jay L. Hack

In law school, we all studied *The TJ Hooper*,[1] in which the Second Circuit, in an opinion by Judge Learned Hand, held that a tugboat operator was negligent for failing to maintain a radio, even though the industry generally did not use radios. Those new-fangled radios were inexpensive and easily available, so the negligent behavior of an entire industry was no defense. As technology marched forward, industry was required to march along with it.

Years later, the Washington Supreme Court, in *Helling v. Carey*,[2] similarly held that the practice of ophthalmologists not to give glaucoma tests to patients under age 40 was no defense to a claim that a doctor was negligent in not testing a young patient. The availability of a simple, low cost, harmless procedure allowed the court to define the failure to implement that procedure as negligence, even if the probability of damage was very small. As a result, we now all get puffs of air in our eyes every time we go to LensCrafters to get a new pair of glasses.

UCC cases on check clearing are uncommon, but when the payee's name is altered on a $382,210.15 check, litigation soon follows. Thus, the Second Circuit, in *J. Walter Thompson USA, Inc. v. Bank of America Corporation*[3] (*JWT*), touched upon the issue it had addressed 76 years earlier in *TJ Hooper* when it considered whether the maker of a check "substantially contributed to the alteration" by not adopting a procedure to verify payee names on checks before its bank paid those checks.

The plaintiff had written a check payable to Outdoor Life Network, drawn on its account at Bank of America. By the time the check was deposited, the name of the payee had mysteriously changed to Diversified Business Enterprises, Inc. The ultimate responsibility for an altered item rests with the person who altered it, but since that person has usually absconded, liability normally lands in the lap of the depositary bank that took the check for deposit, in this case First BankAmericano.[4] The UCC provides that the depositary bank warrants to anyone who pays the check that the check has not been altered.[5] If the check has been altered, then that warranty fails. Thus, the depositary bank suffers the loss because it was most able to stop the wrongdoer—either it dealt directly with the wrongdoer as its depositor, or indirectly when it accepted a double-endorsed check for deposit.[6]

UCC § 3-406 provides an exception to the general rule of depositary bank liability and shifts liability to the drawer when the drawer "substantially contributes" to the alteration. In *JWT*, the depositary bank, facing a loss, argued that the drawer should have adopted procedures to verify that the payee whose name appeared on the check when it was presented for payment was the same payee that was named when the check was originally written. The depositary based this argument on the fact that the drawer had previously experienced altered checks, and its failure to take these steps was negligent.

The *JWT* court pointed out that the drawer had participated in a program offered by Bank of America that allowed B of A to verify that when a check was presented for payment, the amount of the check had not been altered. Apparently, JWT could upload a list of checks it had written by check number, thus advising B of A of the amount of each check on the day it was written. If a check was later presented to B of A for payment and the amount of the check did not match the amount previously reported for that check number, then B of A knew that the check had been altered, and could bounce the check. However, the court pointed out that B of A did not have the technology to match payee names on presented checks with names previously provided by the drawer. Therefore, the failure of the drawer to use a technology that was unavailable could not be considered a "failure to exercise ordinary care" under UCC § 3-406. The *JWT* court put a second stake into the heart of the depositary bank's argument by pointing out that liability may shift when negligence substantially contributes to an alteration, but the failure to detect an alteration does not contribute to making it in the first place.[7]

This brings us back to tugboats and glaucoma. Computer data moves back and forth over the Internet with ease, and even my 86-year-old mother has Internet banking. Every Tom, Inc., Dick, P.C. and Harry, LLC has at least Quicken to write its checks and track them by computer. This forces us to ask some very difficult questions. Is every bank required to implement the technology that Bank of America had which allows it to match check amounts with reports from its customer? If a bank offers that technology, must its checking account customers avail themselves of it? If either such obligation exists, then it flies in the face of the UCC warranties by the depositary bank. We must then take the analysis one step further. Is Bank of America required to implement optical character-reading technology that allows it to read the payee's name on each check it pays? Is its customer required to upload a list of all payees, in order to protect against an alteration of the name of the payee? The court in *JWT* never addressed these issues directly, but if we go back 76 years and listen to Learned Hand, we may have to tell our clients that they are obligated to make investments in technology to protect against not only the thieves, but also against depositary banks that blithely deal with thieves and claim that they should benefit from the prophylactic measures taken by others.[8]

Endnotes

1. 60 F.2d 737 (2d Cir.), *cert. denied*, 287 U.S. 662 (1932).
2. 83 Wash. 2d 514, 519 P.2d 981 (1974).
3. 518 F.3d 128 (2d Cir. 2008).
4. The *JWT* court outlined the collection process in a graphic appendix. The dirty little secret that deserves to be buried in this footnote (of which the court was apparently unaware) is that the depositary bank gets the money for the check the night that it sends the check out for collection, and does not have to wait until the check goes all the way through the chain for the money to come all the way back. The only notification is if the check bounces. The bounced check is sent back through the system, and each bank in the chain refunds the money to the bank before it, until the depositary ultimately pays the money back and hopefully collects it from the depositor.
5. *JWT* was decided under New Jersey and Georgia law, which so provides in UCC § 4-208 (a)(2) (1990 ver.). New York law differs slightly because it provides that the warranty is that the check has not been "materially" altered, UCC § 4-207 (1)(c) (McKinney's). In this case, that is an irrelevant distinction because the complete change in the name of the payee is unquestionably material. Note also that since the name of the payee has changed, and thus the endorsement is ineffective, the depositary also breached its warranty of title to the instrument, although the Second Circuit curiously ignored this much simpler issue.
6. There is a judicial inefficiency in these cases that is outside the scope of this article. The maker of the check can't sue the depositary bank directly because the drawee bank was not authorized to pay the check, and thus the courts hold that the payment was made with the drawee's own money, not the maker's money. Thus, the maker sues the drawee to recredit his account, and the drawee must then sue the depositary on the breach of warranty.
7. What level of negligence is necessary to substantially contribute to a material alteration is a question of fact, and a question that the New York courts have addressed sparingly, at best. Perhaps writing a check in pencil, or in erasable ink, would qualify.
8. The Second Circuit paraphrased *The TJ Hooper* decision only a few months before deciding *JWT* when it explained, "a party may be deemed negligent in failing to adopt new and available safety measures because their adoption is 'so imperative that even their universal disregard [by the industry] will not excuse their omission.'" *Beretta v. Tug Vivian Roehrig*, LLC, 259 Fed.Appx. 343 (C.A.2 N.Y.2007) (quoting Judge Hand) (not selected for publication).

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Wrestling the Fire: Climate Change Law in New York State

By Nathan Whitehouse

I. Introduction

The change in global climate, ongoing for decades, has become a recent focus in business, law and public policy. In New York, the emergence of the Regional Greenhouse Gas Initiative cap-and-trade scheme, comprising seven states, has become an important focus of energy and environmental law. In the U.S. Congress, members have introduced a rising stream of bills, culminating in the recent Lieberman-Warner-Boxer bill.[1] To underscore the growing acceptance of climate change law, that bill failed its filibuster by only eight votes, compared with earlier bills that failed to be reported out of committee.[2]

These legislative mandates have a weighty effect on New York businesses.[3] Certain enterprises will expect increased regulatory and compliance costs; however, new business opportunities, with widely ranging risk profiles, are also emerging. Also, because most high-output greenhouse gas processes are energy intensive, additional regulatory costs in electricity or transportation are upstream of almost all downstream businesses. We all drive cars and turn on the lights.

II. Background

The physical laws that undergird modern energy production involve the transformation of hydrocarbons into energy and carbon dioxide.[4] The energy, created by steam and other means, moves turbines, which transform it into electricity that moves onto the transmission grid. Downstream users, such as businesses, contract to purchase electricity from the producers.

The carbon dioxide produced by plants was, up until now, emitted into the atmosphere. Over the past 150 years, the gradual increase in atmospheric concentration has increased the greenhouse effect, which, according to the best available scientific data, has increased global average temperature. According to statistical measurements, New York State is, in aggregate, one of the larger emissions-producing states in the U.S.[5] Communities have noted anecdotal changes in their environments traceable to temperature warming, including potentially increased numbers of tropical cyclones.[6] For example, "annual average Arctic sea ice has shunk by 2.7% per decade [since 1978]."[7] Underscoring this point, the Intergovernmental Panel on Climate Change determined that there is "high confidence" that many natural systems have been affected, including snow and ice, water quality, changes in fish stocks, and terrestrial systems like bird migration, egg laying, and others.[8] In New York State,[9] these effects could include shoreline changes in Long Island Sound, for example, with potential effects on the fishing industry,[10] as well as a potentially reduced water supply, and thus higher water prices, affecting all businesses that use water.[11]

The law-making bodies, and the advisory policy community, have identified numerous tactics to maintain our electricity-dependent standard of living while reducing greenhouse gas output.[12] The tactics fall into two broad categories. The first is a goal of shifting our energy portfolio to contain more processes that do not create carbon dioxide, commonly known as "renewable energy." These techniques include power created by the natural course of rivers, captured directly from sunlight, wind, and various other natural processes. In the transportation sector, the process is mitigated by creating fuels, such as hydrogen, that have reduced the global warming effect and can be created from increased efficiency power plants. The second is to increase the efficiency of power plants. This is achieved, in part, by establishing a cap-and-trade system.[13] The carbon price, if sufficiently high, encourages the construction of efficient plants or capital expenditures to retrofit existing plants.

III. Cap-and-Trade Systems

New York businesses are implicated by cap-and-trade in several ways. First, cap-and-trade adds a *carbon price signal* to energy production.[14] This price signal will be added onto electricity costs, which will be borne by the producer, out of its margins, or by the consumer, depending on the incidence of the cost burden. Second, opportunities will arise for trading and speculating in allowances, as well as assisting in the creation of *credits*.

Cap-and-trade requires producers of carbon dioxide,[15] within certain sectors, to tender "allowances" to a regulatory authority equal to the producer's level of carbon dioxide emissions each year.[16] Utilities obtain allowances by, depending upon the policy choice, a grant of a number of allowances by a formula dependent on their historical emissions or an auction system. After the grant or the auction, the utilities can trade allowances among themselves depending on their projected allowance needs.

Utilities' needs will reflect their own consumers' demand. For example, if summer temperatures are high, electricity demand will be high, and thus coal-fired power plants will combust more coal, producing more carbon dioxide. In that case, utilities will require more allowances, and can purchase those allowances off the market.

A prudent utility, expecting high summer demand at the beginning of the year, can purchase[17] allowances off other utilities. The amount of trading, or market liquidity, necessarily implicates the frequency of auctions and differences in utilities' expectations.

Cap-and-trade systems for greenhouse gases also permit *credits* or *offsets*.[18] Because the effect of adding greenhouse gases to the atmosphere is global, unlike many other pollutants, *any reduction* adds carbon value.[19] Secondary participants can fund projects that create *additional* reductions and apply to a regulator for credit creation. Once the regulator decides the project validly reduces emissions that would otherwise occur,[20] the project is given credits. These credits are fungible with allowances. Thus, if a utility decides its credit cost is lower than the cost to either buy allowances or reduce its own emissions, the utility can then purchase the credit and tender it to the regulator, in combination with its regular allowances.

Carbon is already a significant market, valued at $64 billion globally in 2007.[21] Over time, Commissioner Bart Chilton at the Commodities Futures Trading Commission (CFTC) estimates that the futures market in carbon emissions could be as high as $2 trillion in the U.S. alone.[22] This trade in carbon will have a significant downstream impact on many sectors of the economy, adding a price signal that incentivizes technological innovation and patents, and business formation, with implications for litigation, tax law, securities disclosures[23] and other legal practices.

A. Regional Greenhouse Gas Initiative

New York will place in effect a cap-and-trade system starting in 2009. In 2003, Governor Pataki challenged the Northeastern states to implement a regional cap-and-trade system,[24] in the face of reluctance by the federal government to implement a nationwide scheme. In late 2005, the interstate umbrella organization, the Regional Greenhouse Gas Initiative (RGGI), first released a model rule for an interstate trading system.[25] In total, the RGGI states set a cap of approximately 64 million metric tons of carbon dioxide per year.[26]

New York implemented the RGGI system[27] by issuing regulations enacting the model rule developed by the RGGI organization, referring to the system as a "CO_2 Budget Trading Program." These regulations set up an accounts system, where a tracking system shall have accounts which contain the list of serial numbers of allowances owned by the account holder. Two types of accounts will exist: a compliance account,[28] used by emitters to tender their allowances, or "true-up," with the regulator, and a general account, used by traders. When two parties deliver contract rights under a contract, they must then register with the RGGI allowance tracking system.[29] Many of the allowances will be auctioned; however, a few will be granted to utilities.[30]

The direct effect of this regulation will be on New York utilities. Under the terms of the regulations, a *CO_2 budget unit* is any electricity generator with a capacity of greater than 25 megawatts,[31] a relatively small generation facility. The budget unit will be expected to tender a compliance certificate with data that indicates the amount of carbon dioxide emitted by the plant by March 1 of the year following the compliance year,[32] and contains within its *compliance account*[33] a number of allowances equal to its emissions. The utilities, in their capacity as CO_2 budget units, can either purchase allowances at auctions offered by RGGI,[34] or from other allowance holders. In addition, parties can take futures positions through one of two exchanges, Chicago Climate Futures Exchange or the Green Exchange, owned and cleared by NYMEX. An entity that takes a futures position in these contracts would, as a condition of delivery, register the transfer of title with the RGGI allowance tracking system.

B. Trading Other Regulatory Credits: European Union Emissions Trading Systems, Kyoto Certified Emission Reductions, California Allowances, and Other Emerging Compliance Markets

Certain business opportunities exist for New York asset traders for out-of-New York regulatory assets. In particular, the areas being currently traded by New York firms include European Union Allowances (EUAs) and Kyoto Protocol Clean Development Mechanism Credits, or CERs.[35] These assets are being traded both on European and American exchanges, including the New York Mercantile Exchange-owned Green Exchange[36] in America. In Europe, a number of exchanges trade these assets, including Nordpool in Norway, the European Climate Exchange (ECX) in London, trading futures options and swaps, and Bluenext in Paris, trading only spot contracts.[37]

The European Union began trading compliance assets in 2005 under its trading system, known as the EU-ETS.[38] These assets are traded pursuant to EU member countries' obligations under the Kyoto Protocol to the United Nations Framework Convention on Climate Change (UNFCCC). The European Union set, in concert, a three-phase and progressively more stringent cap on greenhouse gas emissions.[39] Under the EU system, electricity-producing utilities were granted allowances based on a set of formulas.

European Union Allowance owners hold title to an asset that has value to avoid punitive fines. Although New York businesses have no compliance duties, many are acting as speculators in these assets. Numerous arbitrage opportunities exist between European energy commodity prices, electricity, and carbon allowances and credits.[40] A number of asset management funds have traded in these areas, and certain asset management funds are specializing in these areas. Whether there is sufficient value added by firms specializing only in carbon to ward off competitors is unclear.

The Clean Development Mechanism is a credit method under the Kyoto Protocol. The mechanism allows countries to obtain credits, fungible with allowances, from projects in the developing world.[41] A project that would reduce the amount of greenhouse gases emitted can apply to a UNFCCC-based agency, the CDM board,[42] to receive credits. To establish creditworthiness, the applicant must generally demonstrate three prongs: host government approval, "real" climate change benefits and *additionality*, defined as the fact that the project would not otherwise have been funded without the expectancy of credits.[43] Generally, the monitoring and verification can be established by third-party "validator" and "verifier" firms.[44] These firms, which must be designated by the CDM board as "Designated Operational Entities," or DOEs, can then act as trusted agents to help decide which credits are valid.

Several business opportunities have arisen from the Clean Development Mechanism. Because of the CDM's worldwide scope, U.S. firms have leveraged financing expertise to *originate* credits by latching onto project financings.[45] A credit originator contacts a project sponsor,[46] offers to invest funds to reduce carbon emissions,[47] shepherds the credits through the CDM board, frequently with the help of its attorneys, and purchases and resells the credit in the markets.[48] Several labeling standards or certifying organizations exist that reduce the risk that the CDM board rejects the credit application, such as the Gold Standard.[49] Part of the emerging discussion in the area involves the refining of issues for what involves valid credits and the addition of valid projects.

Other emerging compliance markets are slowly appearing. California will implement a cap-and-trade system pursuant to its Global Warming Solutions Act of 2006.[50] Australia, in 2007, made a dramatic policy change and announced plans for a cap-and-trade system, recently releasing a Green Paper delineating this potential system.[51] Several Canadian provinces have discussed setting forth a cap-and-trade system; however, a federal system seems unlikely at this time.[52] The short-term business opportunities for speculators here are unlikely. Finally, the government of Japan has announced plans for an experimental cap-and-trade system beginning in October 2008.[53] In sum, opportunities for New York businesses acting as speculators in markets other than the EU and RGGI are unlikely in the near term.

C. Voluntary Emissions Reductions

Large multinationals have, over the past 10 years, begun purchasing non-mandated reductions, otherwise known as non-compliance assets. These assets, known as *V*oluntary *E*missions *R*eductions (VERs), have no intrinsic value. The Voluntary Carbon Standard[54] and the Gold Standard[55] both provide ways to certify reductions. Many large companies have begun to invest in these assets in order both to prepare for federal and state compliance regulation, and potentially to gain insight into market opportunities. As such, they represent a hedged bet on the emergence of a compliance market.

One early experiment in voluntary targets was the Chicago Climate Exchange. This exchange was developed in part by Richard Sandor, who is credited with the cap-and-trade idea and started the Clean Air Act SOx trading program. The exchange involved a consortium of industrial companies that each contractually bound themselves to a greenhouse gas emissions reduction target. The exchange functioned to permit the trading of spot contracts on these voluntary emissions. The CCX has leveraged its experience to begin trading European Allowances, as well as recently RGGI futures contracts, on a U.S. exchange.

IV. Energy from Renewable Sources

A. Renewable Energy Portfolio Standards

Renewable Energy Portfolio Standards (REPS) are one legal way of addressing the climate impacts of the electricity production industry.[56] New York State is an early proponent of this method,[57] which involves mandating utilities to have a certain percentage of their electricity from renewable sources. In the alternative, utilities can choose to purchase credits, labeled Renewable Energy Credits, or RECs, from other parties. In theory, the system encourages innovation by giving an additional revenue stream to renewable energy producers. Because renewable producers' costs are higher than those of fossil fuel-based producers, this is a subsidy for renewables, encouraging innovation.

There is at present no federal portfolio standard requirement. In the 2007 session, however, Congress was very close to passing a measure that would have established such a standard.[58] However, conceivably in the near future a federal policy may be enacted.

Renewable energy portfolio standards affect two classes of New York businesses. The first is, clearly, the utilities regulated by the Public Service Commission that are required to have renewables in the portfolio or to purchase RECs. The second general class includes opportunities for creating REC projects and trading REC credits. The first is subject to the portfolio requirement standards, and also implicates other areas, such as the financing of renewable projects, obtaining credits, securing intellectual property for technological innovation, and contracting risk among utilities, renewables producers and others. The second class implicates the tradable nature of RECs. These certificates can be traded using forward and spot contracts, as well as be derivatized using futures and options.[59] Speculators in these fields, including funds and banks, also can and do trade in this area.

B. Intellectual Property

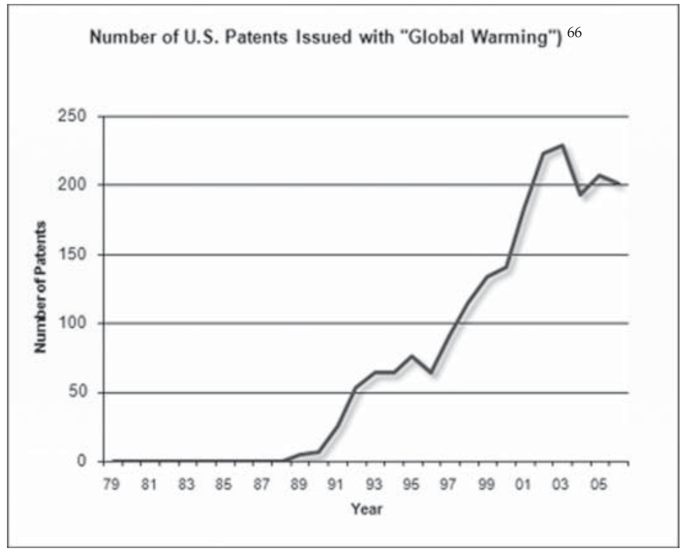
A carbon price will drive a number of technological opportunities. Enterprises require stringent patent protection to exploit ideas protected from competition. As much of the carbon world is rapidly evolving on parallel tracks, it is often difficult to determine whether an idea has received patent protection, whether the appropriate licenses have been purchased, and whether a business without downstream patent litigation risk has been created.[60] For example, just in the renewables sector there exist companies working in wind power, in solar power, in hydropower and elsewhere. The downstream legal risk is relatively high, requiring diligent counsel to avoid litigation, and, when litigation arises, to pursue clients' cases vigorously.

The technological opportunities appear mostly if a carbon price exists under a cap-and-trade regime. At present, the prime financial incentive to implement "cleantech" is either a bet on future market conditions, or pursuant to a tax subsidy.[61] For example, the best estimated market price of solar-based electricity ranges from $148 to $492/megawatt-hour in California, a relatively solar-friendly state. To compare, the coal-based price, in equivalent areas of the country, is 11.83 cents/KwH, or $118.30/megawatt-hour.[62]

The number of patents involving global warming and low-carbon technology has grown in the past 10 years.[63] The major growth areas have been in renewable energy, as measured by the Clean Energy Patent Growth Index.[64] The graph below illustrates the emerging business and entrepreneurial interest in developing technologies to fit in this area. Of course, these patents have a reduced value in the absence of a carbon price. The graph does reflect, however, a significant swell of long-term financial bets on protecting intellectual property associated with the field. Capitalization on an idea requires protection from competitors. Because patent costs are arguably relatively low compared with funding from venture capital, patent information provides an "early-warning" system for innovation interest.[65]

The patent growth for the global warming area is already becoming a growing sector of certain patent practices. Whether there is added value by specializing in cleantech patents is unclear; however, the multi-disciplinary nature of securing an idea's rights, creating the business, and helping the entrepreneur shepherd it to the company's sale or commercialization will require an understanding of how all the different fields interlock.

Other areas of intellectual property law have grown dramatically. Green trademarks have been an exploding area, reflecting an early and inexpensive bet on the market, as well as the understanding that branding was a prime competitive advantage in the early days of the Internet. Securing legal protection for "green" brands is an indication of an early strategy to lock in consumers' attention before there is any real money to be made off of the area. Regardless, the flurry of activity represents, at the least, a short-term opportunity for intellectual property lawyers. Copyright law will continue to be an important sector in software, as software applications will need to be modified or developed to cope with the enormous quantity of data carbon-footprint information will require. In sum, other areas of intellectual property law are, at the least, short term growth areas with potential synergies for business formation, litigation and other fields as a carbon price becomes a reality.



V. Geological Carbon Storage

Geological carbon storage is a technique for injecting carbon dioxide into geological formations such as deep undrinkable aquifers.[67] Although the technique is not now in common usage, if driven by a carbon price, it could account for a vast proportion of carbon mitigation prior to 2050. The technique works if there is a "caprock" formation over the geological formation holding the CO_2. The carbon dioxide is injected via a "plume" that is forced through the permeable rock. Over the course of many years, the carbon dioxide begins to react with the rock, forming a solid that locks the carbon in place.[68] The carbon dioxide itself is captured from the flue gas, or exhaust, of coal-fired electricity plants. The carbon dioxide could be stored in the subsurface close to the plant, or sold as a commodity through pipelines like natural gas pipelines.[69]

The financial driver for the technique comes from a cap-and-trade system or from using carbon dioxide to enhance oil recovery.[70] Either the plant, by storing its own carbon dioxide, avoids having to purchase allowances, or it sells the carbon dioxide to a storage operator, who then applies for credits and sells them elsewhere. There are several proposed projects in New York, including the Praxair–sponsored project in Levittown.[71] The technique itself has been used to enhance oil recovery for roughly 20 years in West Texas and in Alberta.

Geological storage has several risks, which regulatory authorities will attempt to control.[72] Public health and safety risks include a low risk of leakage into ground water, potentially decreasing water pH and leaching out metals in the rock.[73] Other low-probability risks include small seismic events and rapid emergence of the carbon dioxide.[74] There is a risk to the integrity of the regulatory scheme if, when carbon dioxide escapes, the sequestered emissions fail to happen. The costs of that risk will likely be passed on to the storing party, or shared among government, insurance and the storing party. The form in which the likelihood of the risk is determined will be set by the permitting procedures. At present, no permitting procedures exist, as there is no mandated reduction of greenhouse gases on the federal level. That said, EPA has given itself a "foothold" in its recent advanced proposal for rulemaking under the Safe Drinking Water Act.

The legal framework for carbon storage regulation is the federal Underwater Storage Drinking Water Act (USDWA),[75] regulated by the U.S. Environmental Protection Agency. The legislative purpose of the USDWA is to protect the drinking water supply. Under this act, the EPA administers a framework known as the Underground Injection and Control (UIC), which divides underground injection into six classes of wells.[76] Although for several years most commentators have understood the USDWA to regulate geological storage wells, project sponsors have needed specific guidance on the regulatory requirements. Therefore, the EPA prepared regulations, releasing an Advanced Notice of Proposed Regulation on July 17, 2008, laying out guidelines for carbon dioxide storage.[77]

This ANPR required that storage in wells mitigate the risk of both drinking water contamination, as well as laying the groundwork for requirements to mitigate the risk of greenhouse gas escape. The proposal fleshes out planning requirements; however, it does not yet set forth certain requirements for areas of liability risk sounding in two areas of law, tort and contract.[78]

There is currently no standard for determining the credit availability of geological storage. This is an important political risk[79] that will not be mitigatible until a carbon price is added into the economy. Moreover, even under the international CDM regime, credits will not presently be issued for geological storage projects. Once this issue is resolved, financing for geological storage may prove to be a business opportunity for New York businesses and project finance attorneys.

An additional legal risk facing geological storage is the ownership of the "pore space" in the geological formations.[80] Within formations amenable to geologic storage, the rock is permeated with "empty" small tunnels within the rock, which are filled with various substances, including saline water, crude oil and others. Historically, ownership rights of subsurface space belonged to the surface owner. As the mineral economy developed, many jurisdictions allowed the surface land rights to be alienated from the underlying mineral rights, which were the oil held within the pore space. The mineral rights could then be bought and sold. Because underground oil reservoirs often spread across wide areas underneath a patchwork of surface rights, this permitted the efficient extraction of minerals from the ground. In addition, government often granted eminent domain rights to regulatory agencies, allowing them to avoid the holdout problem for the "greater good" of society.[81]

The pore space now has value as a place to hold carbon dioxide. Under present regulatory regimes, the pore space belongs to the landowner, which can be deeded to other persons.[82] This poses numerous difficulties for project developers, who face essentially the same problem that earlier oil wildcatters did. The "holdout problem," where a single surface landowner can refuse to sell her pore space, or sell at a price greatly above market value, can end the viability of any large-scale storage project. Several Western states, including Wyoming, New Mexico, Washington and Montana, have enacted or have proposals to codify these rules.[83]

VI. Conclusion

The emerging law of climate change is a shift in attitude for environmental policy. It is the awareness, long overdue, that decency towards the environment and the vigorous creation of wealth are only partially at odds.[84] It is perhaps a return to the social philosophy of an earlier New York attorney, Alexander Hamilton, who declared that government, and the economy, must harness the ambitious energies of humans to achieve a greater social good.[85] Law represents the orderly reconciliation of competing interests. This experiment that society is currently attempting, an experiment in "the laboratory [that is] the State[] [of New York],"[86] will prove to be one of the more dramatic ones of our modern age. In a way, it represents the reconciliation of man's tactics with natural law, the old tradition versus the new, Schuyler and the Iroquois chieftain, or going back even further in Western civilization, Zeus *contra* Prometheus.

Endnotes

1. S. 2191; S. 3036 (replaced by the Boxer substitute amendment). Notably, this was the first "comprehensive greenhouse gas reduction bill ever to be reported out of a committee . . . from the Senate Environment and Public Works Committee," Eileen Claussen, President, Pew Center on Global Climate Change, *forward to* A. Daniel Ellerman & Paul L. Joskow, *The European Union's Emissions Trading System in Perspective*, Pew Center on Global Climate Change ii (May 2008).
2. *Id*.
3. Each U.S. consumer has a net carbon footprint of between 10 to 20 metric tons of carbon dioxide per year. Lionel Fretz, *quoted in* Susana Twidale, *Lionel Fretz*, TRADING CARBON, 2:6 Point Carbon 21 (Jul./Aug. 2008).
4. Among other "greenhouse gases." After sunlight enters the atmosphere, it hits the earth, and its energy is absorbed by the soil and rock. After its absorption, infrared radiation releases from the ground back up through the atmosphere. A certain percentage of this infrared radiation is re-absorbed by "greenhouse gases" because of their physical properties. The remainder escapes to space. The heated greenhouse gases move the radiation back into the earth, increasing global temperature. On a geologic time-frame,

this has maintained the Earth's temperature at a level favorable for human flourishing. But with greenhouse gases added by human energy processes, the temperature has, arguably, risen faster than much of the natural world's ability to adapt itself, causing problems with ramifications over many human interests, including business interests and political interests, such as the desire to act as a "steward" for the continued stability of the earth. Importantly, nature is in a constant state of flux—the problem is not change, but the rapid rate of change. *See* Intergovernmental Panel on Climate Change, Climate Change 2007: Synthesis Report, *hereinafter* IPCC.

5. Per capita, New York lags behind other states. As estimated according to EPA guidelines, New York's total 1990 emissions were 75.7 million metric tons of carbon dioxide equivalent, and 4.2 metric tons of carbon dioxide equivalent per capita. To give perspective, California emitted approximately 428.8 MMCFE. EPA, *Greenhouse Gas Emissions Inventory for New York State, 1990* 1 (summary), *available at* http://www.epa.gov/climatechange/emissions/downloads/NYSummary.PDF; California Energy Commission, *Revisions to the 1990 to 2004 [GHG] Inventory Report* 3 (summary) (Dec. 2006), *available at* http://www.energy.ca.gov/2006publications/CEC-600-2006-013/2007-01-23_GHG_INVENTORY_REVISIONS.PDF.

6. IPCC at 30.

7. *Id.*

8. *Id.* at 31, 33.

9. *See, e.g.*, Peter Frumhoff et al., *Climate Change in the U.S. Northeast*, Union of Concerned Scientists (Oct. 2006); *see also* New York Academy of Sciences & New York Energy Research and Development Authority, "Climate Change in New York: Developing a Research Strategy" (May 2007); Columbia University, "Climate Change Information Resources [for the] New York Metropolitan Region" (2005).

10. *See* Joseph E. Blumberg, U.S. Environmental Protection Agency, *Long Island Sound Study* (noting that the fisheries industry in Long Island has approximated effects of $148 million. This is admittedly small in relation to New York's contribution to the nationwide GPA of approximately $1 trillion, but underscores the climate risk to certain stakeholders in this geographical area.).

11. *See*, *e.g.*, *New York City Depends on Natural Water Filtration*, Rand Corporation (2007), *last visited* on Sept. 4, 2008.

12. *See*, *e.g.*, Pacala & Socolow, *Stabilization Wedges: Solving the Climate Problem for the Next 50 Years with Current Technologies*, 2004 Science 968 (2004).

13. There are numerous sources explaining the theory of cap-and-trade, its development, and how it has worked in earlier cap-and-trade systems. Those include the SO2 system implemented federally pursuant to the Clean Air Act, the NOx trading system, and the European Emissions Trading System for greenhouse gas allowances instituted in 2005. The general theory of cap-and-trade involves the folding-in of an external cost, or externality, into the economy, paralleling numerous historical internalizations of costs across cultures. *See* Harold Demsetz, *The Exchange and Enforcement of Property Rights*, 7 J.L. & Econ. 11 (1964).

14. This can include only electricity production, as in the European scheme, or a larger group, including car and truck pollution, as in the proposed Australian scheme. *See*, *e.g.*, Christian de Perthuis, *Carbon Trading History and Stakes Mission Climate*, Caisse des Depots, BlueNext Conference (Jan. 22, 2008), *last visited* Sept. 4, 2008.

15. As well as other greenhouse gases.

16. For a quick and easy primer with a graphic, see *Cap and Trade Programs Explained*, Brave New Leaf (Feb. 20, 2008), *available at* http://www.bravenewleaf.com/environment/2008/02/cap-and-trade-p.html.

17. Either going long via a forward contract or with futures. The advantage of using futures to hedge these risks derives from margins purchasing, and thus the lower quantity of working capital necessary.

18. The two terms are frequently used interchangeably.

19. Where carbon value can be thought of as the avoidance of a risky addition to the concentration of carbon dioxide in the atmosphere, and particularly the potential legal consequences for a given business. *See* Mark Goddard, *Carbon Value: Robust Carbon Management: a Framework to Protect and Enhance Shareholder Value in Response to Climate Change*, PriceWaterhouseCoopers Australia (2008), *available at* http://www.pwc.com/extweb/pwcpublications.nsf/dfeb71994ed9bd4d802571490030862f/0c8e60f5f928faa7ca25734700022840/$FILE/ATT8L0N1/CarbonValueReport_2008.pdf.

20. The so-called "additionality" requirement under the Kyoto Protocol UNFCCC mechanism.

21. World Bank Institute, State and Trends of the Carbon Market 2008, 5.

22. *CFTC's Chilton says Carbon Futures Will Soar to $2 trillion,* Reuters News (June 25, 2008).

23. California Public Employees Retirement System et al., *Petition for Interpretive Guidance on Climate Risk Disclosure*, Petition to the Securities and Exchange Commission (Sept. 18, 2007) (requesting guidance on whether climate risk disclosure is mandated for public companies on their 10-K filings). Currently, the SEC has indicated that it will not take action to require carbon disclosures, as it is not bound to recognize petitions.

24. *About RGGI*, Regional Greenhouse Gas Initiative, *available at* http://www.rggi.org/about.htm.

25. *See* Regional Greenhouse Gas Initiative Final Model Rule (Jan. 2007), *available at* http://www.rggi.org/docs/model_rule_corrected_1_5_07.pdf (RGGI Model Rule).

26. RGGI Model Rule, Subpart 242-5.1(a) (allocating 64,310,805 tons per year for the states in total for the period from 2009-2014).

27. 6 N.Y.C.R.R. Part 242; *see also* Northeast Regional Greenhouse Gas Coalition, *Comments on Proposed RGGI Regulation*.

28. 6 N.Y.C.R.R. Part 242-6.2(a). These accounts will correspond to CO_2 budget units. At the end of the compliance period, currently March 1 of the following year, the compliance account will be deducted by the number of CO_2 allowances emitted according to the February 1 report tendered to NYSERDA by the CO_2 unit.

29. *See* Press Release, Chicago Climate Exchange (Aug. 15, 2008) (marking the first transaction in RGGI futures, 60,000 allowances by Shell Energy North America, as well as options contracts on RGGI allowances).

30. 21 N.Y.C.R.R. Part 507 (direction to NYSERDA to administer the energy efficiency and clean energy account); Charles Holt et al., *Auction Design for Selling CO_2 Emission Allowances under the Regional Greenhouse Gas Initiative*, RGGI (2007).

31. 6 N.Y.C.R.R. Part 242-1.4(a).

32. 6 N.Y.C.R.R. Part 242-2.1.

33. 6 N.Y.C.R.R. Part 242-1.5(c).

34. *See* 6 NYCRR Part 242-5.3(a)(3) ("NYSERDA will administer the . . . account . . . so that allowances will be sold in a transparent allowance auction or auctions.").

35. Kyoto Protocol to the United Nations Framework Convention on Climate Change, UNFCCC, Art. 12.

36. Green Exchange will act as an exchange for EUAs, CERs, state renewable energy certificates (RECs), as well as voluntary reductions Although it is not currently a designated contract market (DCM) under the CFTC, NYMEX plans to submit an application to CFTC to have it regulated as a DCM, while maintaining NYMEX as the clearinghouse. *The Green Exchange Initiative, New York Mercantile Exchange*, *available at* http://nymex.greenfutures.com/overview/. This exchange is not regulated as

a futures and options market by the Commodity Futures Trading Commission (CFTC), as a Designated Contract Market (DCM). However, NYMEX is planning to submit an application in 2009 to have it act as a separate exchange, with NYMEX acting as the clearinghouse. *The Green Exchange Initiative—Overview*, New York Mercantile Exchange, *available at* http://nymex.greenfutures.com/overview." *See* 7 U.S.C. §§ 7 *et seq.*; 17 C.F.R. § 38.3.

37. A. Denny Ellerman & Paul L. Joskow, *The European Union's Emissions Trading System in Perspective*, Pew Center on Global Climate Change 17 (May 2008), *hereinafter* EU-ETS.

38. *See*, *e.g.*, EU-ETS.

39. The phases include phase I, from 2005-2007, phase II, from 2008-2012, and phase III, from 2013-2020. In phase III, the EU-ETS cap is set at 80%, or a 20% reduction, of the emissions for the year 1990, as measured by the UNFCCC. European Commission; *Commission Decision for the monitoring and reporting of greenhouse gas emissions pursuant to Directive 2003/87/EC of the European Parliament and of the Council*, 2004/156/EC (Jan. 2004); European Commission, *Commission regulation for a standardised and secured system of registries pursuant to Directive 2003/87/EC of the European Parliament and of the Council and Decision no. 280/2004/EC of the European Parliament and of the Council*, 2216/2004/EC (Dec. 2004).

40. A minor example of this is the oft-noted correlation between German electricity prices and European Union Allowances.

41. What constitutes the "developing world," for the purposes of Kyoto, is what is known as a non-Annex I signatory to Kyoto. These countries have no binding obligations under the Protocol, but observe at the meetings and are able to vote on amendments to the protocol. *Kyoto Procol*, Annex B; *compare with* signatory list.

42. Established pursuant to *Kyoto Protocol*, Art. 12(4) ("The [CDM] shall be subject to the authority and guidance of the Conference of the Parties . . . and be supervised by an executive board of the clean development mechanism.").

43. *Kyoto Protocol*, Art. 12(5), ("(a) Voluntary participation approved by each Party involved [reflecting the need for Designated National Authority approval], (b) Real, measurable, and long-term benefits related to the mitigation of climate change, (c) Reductions in emissions that are additional to any that would occur in the absence of the certified project activity [additionality]").

44. *Kyoto Protocol*, Art. 12(7), (9); International Emissions Trading Association Secretariat, "Manual for CDM and JI Projects," *available at* http://www.ieta.org/ieta/www/pages/getfile.php?docID=370. These organizations include the World Bank Prototype Carbon Fund, TÜv Nord, Det Norske Veritas (DNV), KPMG and others.

45. *E.g.* Natsource LLC, RNK Capital, etc.

46. The organizing person or company that arranges the project itself.

47. Fulfilling additionality. The "certified project activity" must occur as a but-for-cause of the investment of money.

48. *See* Christopher Carr & Flavia Rosembuj, *World Bank Experiences in Contracting for Emissions Reductions*, 2 ENV. LIABILITY 114 (2007).

49. *The Gold Standard: About Us—in Brief*, The Gold Standard, Basel Agency for Sustainable Energy (2005), *available at* http://www.cdmgoldstandard.org/about_goldstandard.php?id=11., *hereinafter* Gold Standard.

50. Global Warming Solutions Act, AB 32 part 5 (Aug. 31, 2006) (delineating the possibility for CARB to implement "Market-Based Compliance Mechanisms"); *see* Market Advisory Committee to the California Air Resources Board, *Recommendations for Designing a Greenhouse Gas Cap-and-Trade System for California* (June 30, 2007), *available at* http://www.climatechange.ca.gov/publications/market_advisory_committee/2007-06-29_MAC_FINAL_REPORT.PDF.

51. Australian Department of Climate Change, *Carbon Pollution Reduction Scheme* (July 2008) (containing many sectors, including downstream carbon emissions from petroleum products, where liability is placed on the original seller of the crude oil).

52. Government of Alberta, *Alberta's 2008 Climate Change Strategy* (Jan. 2008); British Columbia Ministry of Small Business and Revenue, *British Columbia Carbon Tax*, (Feb. 2008); Government of Ontario, *Go Green: Ontario's Action Plan on Climate Change*, (Aug. 2007); Lee Greenberg, *Ontario to Sign Cap-and Trade Climate Plan*, OTTAWA CITIZEN, Jul. 18, 2008.

53. *Japan to Launch Cap-and-trade Trial in October*, BusinessGreen.com (Jul. 30, 2008).

54. *Voluntary Carbon Standard 2007*, *available at* http://www.v-c-s.org/docs/VCS%202007.pdf.

55. *About Us – in Brief*, The Gold Standard, *available at* http://www.cdmgoldstandard.org/ about_goldstandard.php.

56. The use of renewables has a triple goal—to lower greenhouse emissions, as many classes of renewables have low emissions; to reduce dependence on foreign energy markets, particularly volatile oil, and to avoid the risk of being affected by the depletion of the world's fossil fuel resources. As oil becomes tapped, supply will decrease, increasing price. As price increases, harder-to-find oil will come online, because it is more expensive to find and drill. The lag time for oil production to come online assures a certain volatility in price, which affects large parts of the American and New York downstream markets, particularly any sector involving transportation. *See* Neil King, Jr., *Global Oil-Supply Worries Fuel Debate in Saudi Arabia*, WALL ST. J., June 27, 2008; Nansen Saleri, *The World Has Plenty of Oil*, WALL ST. J, Mar. 4, 2008.

57. State of New York Public Service Commission, Order Approving Implementation Plan, Adopting Clarifications, and Modifying Environmental Disclosure Program, Case 03-E-0188 (Apr. 14, 2005); *see* Joshua P. Fershee, *Changing Resources, Changing Market: The Impact of a National Renewable Portfolio Standard on the U.S. Energy Industry*, 29 ENERGY BAR J. 52 (2008).

58. Renewable Energy and Energy Conservation Tax Act of 2007, H.R. 3221, 110th Cong. (as passed by the House, Aug. 4, 2007).

59. Jeremy D. Weinstein, *On the Path to Renewable Energy Certificate Derivatives*, 27 FUTURES & DERIVATIVES LAW REPORT 3 (2007).

60. Thanks for many of these insights to Eric Lane, Esq. of Luce, in San Diego, as well as Brian Higgins of Blank Rome in Washington, D.C.

61. 26 U.S.C. § 45 (2008) (renewable tax credit); *See*, *e.g.*, Ryan Wiser et al., *Analyzing the Interaction Between State Tax Incentives and the Federal Production Tax Credit for Wind Power*, Lawrence Berkeley National Laboratory (Sept. 2002).

62. *See* Severin Borenstein, *The Market Value and Cost of Solar Photovoltaic Electricity Production*, UNIVERSITY OF CALIFORNIA ENERGY INSTITUTE WORKING PAPER SERIES (Jan. 2008); Energy Information Administration, *Average Retail Price of Electricity to Ultimate Customers by End-Use Sector*, *available at* http://www.eia.doe.gov/cneaf/electricity/epm/table5_6_b.html.

63. This includes business method patents. *See* U.S. Patent No. 7,343,341 (Mar. 11, 2008); U.S. Patent Appl. No. 11/840,482 (Aug. 17, 2007); U.S. Patent Appl. No. 10/623,134 (Jul. 18, 2003) (applying for protection of emissions trading systems methods by Richard Sandor, with the Chicago Climate Exchange as assignee).

64. *See*, *e.g.*, Jeff Rothenberg et al., *Heslin, Rothenberg, Farley, & Mesiti P.C. announces Clean Energy Patent Growth Index Results through 1st Quarter 2008 Including Leading Countries, States, and Companies*, Press Release, Heslin, Rothenberg, Farley & Mesiti P.C., Albany, N.Y. (June 11, 2008).

65. *U.S. Cleantech Investment Climbs 41% in 2d Quarter of 2008 to Nearly $1 Billion, the Highest Quarter on Record*, Press Release, Ernst & Young (Aug. 4, 2008).

66. Graphic copyright Brian Higgins, *at* http://www.marylandiplaw.com.

67. Mark Anthony de Figueirido, *The Liability of Carbon Dioxide Storage*, PhD. Dissertation, Massachusetts Institute of Technology 33, 36 (2007).

68. Travis McLing, *CO_2 Storage in Reactive Rock Formations: Fundamental Physical and Chemical Phenomena and a Basalt Case Study*, Research Experience in Carbon Sequestration, Albuquerque, NM (July 22, 2008).

69. Mike Moore, Bluesource, *CO_2 Commodity Markets*, Research Experience in Carbon Sequestration (Jul. 28, 2008).

70. Oil is stored in a network of "holes" in formations under pressure. As the subsurface pressure lowers, the oil will no longer rise to the surface. In order to increase the amount of oil available from the reservoir, operators in the Permian Basin of West Texas and elsewhere pump carbon dioxide into the ground, increasing the pressure and thus the amount of recoverable oil.

71. Mark Holtz, Praxair, Inc., *Subsurface Reservoir Characterization*, Research Experience in Carbon Sequestration, Albuquerque, N.M. (July 21, 2008).

72. *See* Jeffrey W. Moore, *The Potential Law of On-shore Carbon Geologic Sequestration of CO_2 Captured from Coal-Fired Power Plants*, 28 ENERGY L. J. 443 (2007).

73. *See* Christopher D. Laughrey et al., *Origin of Carbon Dioxide Gas Contamination in Groundwater and Building Spaces in Western Pennsylvania: Implications for Subsurface Carbon Sequestration*, Geological Survey of America North-Central and Southeast Meeting (Apr. 4, 2002), *available at* http://www.midcarb.org/Documents/NC-SE-GSA-April-2002/Laughrey.shtml.

74. *See* George W. Kling et al., *Degassing Lake Nyos and Monoun: Defusing Certain Disaster*, 102 Proc. Nat'l Acad. of Sci. 14185 (2005) (describing the eruption of volcanic CO_2 from Lake Nyos in Cameroon, killing approximately 1,800 people by asphyxiation).

75. 42 U.S.C. §§ 300f *et seq.*

76. *See*, *e.g.*, Figueiredo; Sally Benson *et al.*, *Underground Geological Storage*, IPCC SPECIAL REPORT ON CARBON CAPTURE AND STORAGE 255 (2005).

77. *Federal Requirements Under the Underground Injection Control (UIC) Program for Carbon Dioxide (CO_2) Geologic Sequestration (GS) Wells*, 144 Fed. Reg. 43492 (July 25, 2008), *to be codified as* 40 C.F.R. p. 144, 146.

78. *See* Figueirido at 154, 202.

79. John D. Finnerty, *Project Finance: Asset-Based Financial Engineering* (1996).

80. Nathan Whitehouse, Lacunae: The Evolving Land Law of Pore Space, forthcoming (2009); John G. Sprankling, *Owning the Center of the Earth*, 55 UCLA L. Rev. 979 (2008); Elizabeth J. Wilson & Mark A. de Figueiredo, *Geologic Carbon Dioxide Sequestration: An Analysis of Subsurface Property Law,* 36 ENVTL. L. REP. 10114, 10115 (2006).

81. FERC eminent domain/DOT eminent domain pipeline rights.

82. At least this is the "majority rule," Sonja Nowakowsi, Research Assistant, Legislature of Montana, *personal communication* (Aug. 19, 2008).

83. Sonja Nowakowski, *personal communication*, Aug. 25, 2008.

84. Deirdre McCloskey, *The Bourgeois Virtues: Ethics in the Age of Capitalism* (2006).

85. THE FEDERALIST No. 1 (Alexander Hamilton) ("Ambition, avarice, personal animosity, party opposition, and many other motives . . . are apt to operate as well upon those who support as those who oppose the right side of a question"); Forrest MacDonald, *Novus Ordo Seclorum: The Intellectual Origins of the Constitution* (1986).

86. *Cruzan v. Director*, 497 U.S. 261 (1990) (O'Connor, J., concurring), *citing New State Ice Co. v. Liebmann*, 285 U.S. 262 (1932) (Brandeis, J., dissenting) ("It is one of the happy incidents of the federal system that a single courageous state may, if its citizens choose, serve as a laboratory; and try novel social and political experiments without risk to the rest of the country.").

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New York Employment Law Update

By James R. Grasso

Supreme Court Allows Retaliation Suits Under Section 1981

On May 27, 2008, the Supreme Court expanded the ability of employees to sue employers for employment-related retaliation by ruling in *CBOCS West, Inc. v. Humphries* (No. 06-1431) that 42 U.S.C. § 1981 (commonly referred to as "Section 1981") encompasses retaliation claims. Enacted after the Civil War, Section 1981 grants all citizens the right to enter into and enforce contracts, including the formation of the employment relationship and the terms and conditions of employment, without regard to race.

In *Humphries*, Hedrick Humphries, an African-American assistant manager at Cracker Barrel, alleged that he was terminated because of his race and because he complained that an African-American co-worker had been fired because of the co-worker's race. Humphries also sued under Title VII. The district court dismissed all of Humphries' claims. However, on appeal the Seventh Circuit Court of Appeals reinstated Humphries' Section 1981 retaliation claim. Cracker Barrel then appealed to the Supreme Court, arguing that Section 1981 does not prohibit retaliation because the statute does not mention retaliation.

While the plain language of the statute appeared to favor Cracker Barrel's argument, in a 7-2 ruling the Supreme Court rejected Cracker Barrel's argument and held that Section 1981 does prohibit retaliation. In reaching its decision, the Supreme Court relied on several factors, including the legislative history of amendments made to Section 1981 in 1991 that indicates Congress intended to amend Section 1981 to prohibit retaliation. The Court also relied on the fact that it had previously held that another Civil War-era law, Section 1982, which prohibits discrimination in the purchase of real property, prohibited retaliation and that the federal courts have interpreted Section 1981 and Section 1982 similarly. Lastly, the Court noted that lower federal courts have consistently held that Section 1981 prohibits retaliation.

The consequences of the *Humphries* decision for employers will be significant. Plaintiffs' attorneys will likely now bring more race discrimination and race-based retaliation claims under Section 1981, rather than Title VII. Section 1981 has several advantages for plaintiffs. First, the statute of limitations under Section 1981 is four years, rather than the 180 or 300 days that plaintiffs have to file an administrative charge, depending on the state in which they reside. Second, unlike Title VII, a plaintiff suing under Section 1981 does not have to first file an administrative charge with the EEOC or the equivalent state agency. Lastly, unlike Title VII, Section 1981 has no cap on compensatory and punitive damages.

Penalties for Day of Rest and Meal Time Violations

As of January 14, 2008, employers who fail to provide eligible employees with at least one day (24 consecutive hours) of rest every calendar week or to provide the required minimum amount of time for meal breaks face higher monetary penalties. Under the New York Labor Law, employers are required to provide certain employees, including those working in factories, mercantile establishments, hotels and restaurants, with at least one day of rest every calendar week. With limited exceptions, employers must also provide all employees with at least a 30 minute unpaid meal period. Previously, the fine for a first time violation of either of these provisions was $100. As a result of an amendment to the Labor Law, employers are now subject to a fine of up to $1,000 for the first offense, $2,000 for the second offense and $3,000 for the third offense. These higher fines are part of a program to increase enforcement by the New York State Department of Labor. As a result of these changes, employers should ensure that their scheduling and meal break policies and practices comply with the law.

Department of Labor Proposes Revisions to FMLA Regulations

The U.S. Department of Labor (DOL) recently proposed changes to the Family Medical Leave Act (FMLA) regulations. If enacted, the proposed regulations would be the first changes to the FMLA regulations since the FMLA was passed in 1993. Many of the changes are cosmetic, such as restructuring and reorganizing several sections of the regulations and rewording the titles of the sections so that they are statements rather than questions. The major substantive proposals are discussed below.

Serious Health Condition

The proposed regulations modify the definition of "continuing treatment" of a serious health condition that includes a period of incapacity of more than three consecutive days and two or more treatments. The DOL proposes that the two treatment visits must occur within 30 days of the beginning of the period of incapacity unless extenuating circumstances exist. The time period is now undefined. Where the serious health condition involves a period of incapacity due to chronic condition, the proposed regulations clarify that the employee must see a physician at least two times per year for that condition. The existing regulations simply call for "periodic visits." Also, employees seeking leave for their own serious health condition would have to provide sufficient information indicating that a condition prevents them from performing the functions of their jobs. Merely "calling in sick" would not trigger an employer's obligations under the FMLA.

Intermittent Leave

Despite employers' protests, the proposed regulations do not change the minimum increment in which intermittent leave can be taken. The existing regulations allow an employer to limit intermittent leave increments to the smallest increment of time permitted under an employer's payroll timekeeping system, as long as it is one hour or less. However, the proposed regulations would allow employers to require employees using FMLA leave to comply with an employer's call-in procedures before taking unscheduled, intermittent leave, except in defined "emergency" situations.

Medical Certification

The most significant change to the medical certification process is that the proposed regulations would allow employers to contact an employee's medical providers directly to obtain clarification or authentication of documentation, provided that the employee is first given a chance to cure any deficiency. However, when contacting an employee's medical providers, an employer would not be able to request more medical information than requested in the certification form. An employer seeking "clarification," or further information about the substance of information in the certification form, would have to comply with the Health Insurance Portability and Accountability Act (HIPAA) and obtain the employee's HIPAA consent. An employee who refused to provide such consent would put his or her FMLA rights at risk if the medical certification is insufficient. The employee's consent would not be required to authenticate a certification form.

The DOL is also proposing changes to its optional certification forms. One such revision is that a health-care provider would have to list the symptoms, diagnosis, medications or other information that relates to the leave request. Also, the revised medical certification form will expressly require health-care providers to designate intermittent leave as "medically necessary," which is omitted from the current form. Another proposal is that an employer must inform an employee why a medical certification is incomplete or insufficient and afford the employee seven days to cure it. Recertification could also be requested every six months when the leave period is listed as "indefinite" or "unknown."

Employer Policies and Bonus Plans

Proposed changes include a requirement that employees comply with the terms and conditions of an employer's paid-leave policy when substituting a paid accrued leave, such as paid vacation or paid time-off, for unpaid FMLA leave. In addition, the proposed regulations clarify that for FMLA purposes, "substitution" means that the unpaid FMLA leave and the paid leave provided by an employer run concurrently.

Similarly, under the proposed regulations an employer could disqualify an employee from a bonus or award based upon achieving a goal if the employee fails to meet that goal due to a FMLA absence and employees on non-FMLA leave were treated the same. For example, an employer could disqualify an employee from receiving a perfect attendance bonus if the employee has been absent on FMLA leave.

Employer Notification Processes

Employers must continue to post a notice providing general information about the FMLA. However, an electronic posting would be sufficient under the proposed regulations if the posting is accessible to applicants and employees. The DOL suggests online posting of the notice would be acceptable if it were on the company's Internet site, where applicants applied for jobs, or if an employer provided a computer kiosk on which an applicant could view the policy. Employers also would have to provide to each employee annually the same general notice posted in the workplace by including it in an employee handbook or distributing it annually to each employee in paper or electronic form. Additional changes would allow employers five days, instead of the current two days, to provide an employee notice of eligibility for FMLA leave and FMLA leave designation notice.

Conclusion

The proposed regulations are not yet effective, and employers need not make changes to their current policies or practices until they are finalized and adopted by the DOL. However, the DOL expects to issue the final regulations before the end of the Bush administration. Employers should be prepared to make significant changes to their FMLA policies and practices when the proposed regulations take effect.

Genetic Information Nondiscrimination Act (GINA) Becomes Law

On May 21, 2008, President Bush signed into law the Genetic Information Nondiscrimination Act (GINA), which prohibits covered employers from discriminating against applicants and employees based on genetic tests or genetic information. Many states already have laws prohibiting employment discrimination based on genetic information. The New York Human Rights Law (HRL), for example, has had a similar prohibition since 1996.

Who Does GINA Cover and When Is It Effective?

GINA incorporates Title VII's definition of employer, meaning that GINA covers all employers who have 15 or more employees for each working day in each of 20 or more calendar weeks in the current or preceding calendar year. GINA will become effective 18 months after its enactment (November 21, 2009). The Equal Employment Opportunity Commission (EEOC) is required to issue final regulations within one year of GINA's enactment (May 21, 2009).

What Is Genetic Information?

GINA defines genetic information as information about: (i) an individual's genetic tests; (ii) the genetic tests of family members, or (iii) the manifestation of a disease or disorder in family members. Family members include dependents and any relative up to the fourth degree of separation. Information about sex and age is specifically excluded from the definition of genetic information.

What Employment Practices Does GINA Prohibit?

GINA prohibits employers from refusing to hire, terminating or otherwise discriminating against a person regarding terms and conditions of employment based on genetic information and from segregating or classifying an employee in any way that deprives the employee of any employment opportunity because of genetic information.

GINA also prohibits employers from acquiring or collecting genetic information, unless the acquisition or collection of the information falls within a specific exception. For example, the law does not prohibit the acquisition of genetic information that is inadvertently disclosed (such as during a personal conversation), or where health or genetic services are offered as part of a wellness program, or where genetic information and family medical information are "commercially and publicly available" (e.g., newspapers and magazines). An employer can also receive genetic information if the employee provides a voluntary written consent, or where it is received as part of a medical certification under the Family and Medical Leave Act (FMLA) or similar state laws, or in several other identified circumstances.

How Must Employers Protect Genetic Information?

Genetic information must be maintained on separate forms and in separate medical files and treated as confidential medical information. Maintenance of genetic information in compliance with the requirements for confidential medical information under the Americans with Disabilities Act also will be considered to meet GINA's requirements. Employers may not disclose genetic information, except: (i) at the employee's written request, (ii) to an occupational or other health researcher, (iii) pursuant to a court order, (iv) to a government official investigating compliance with the law, (v) in connection with the employee's compliance with the FMLA or state family and medical leave laws, and (vi) to a public health agency.

Enforcement Procedures and Remedies

The enforcement procedures and remedies under GINA are identical to those under Title VII. As a result, individuals asserting a genetic discrimination claim will have to first file an EEOC charge and receive a right-to-sue letter before filing a lawsuit. As under Title VII, a plaintiff will have a right to a jury trial and be able to recover back and front pay, compensatory and punitive damages and attorneys' fees. Compensatory and punitive damages would be capped at $300,000, pursuant to the Civil Rights Act of 1991, depending on the employer's size. However, unlike Title VII, GINA specifically provides that disparate impact claims cannot be brought for discrimination resulting from neutral employment practices that have the effect of discriminating based on genetics. GINA also prohibits retaliation against any individual for opposing any illegal practice or participating in any investigations, proceeding or hearing under the law. GINA does not pre-empt other federal or state laws that may provide equal or greater protection.

Recommendations

GINA will compound the compliance requirements employers face and undoubtedly lead to new litigation. Employers will face a particular challenge in complying with the law's prohibitions on acquiring and disclosing genetic information. All employers should review their existing policies and procedures and begin working on necessary changes so they will be ready when GINA becomes effective.

New Regulations Issued on Federal Contractors' Duty to Report on Veterans

On May 19, 2008, the United States Department of Labor (DOL) issued new regulations on the duty of federal contractors, including subcontractors, to report on veterans in the workforce to implement the Jobs for Veterans Act (JVA) that was signed into law in 2002. The JVA made several significant changes to the reporting requirements of federal contractors regarding veterans.

First, it raised the threshold for covered federal contracts from $25,000 to $100,000. It also revised the reporting categories by, among other things, eliminating the coverage category of Vietnam-era veterans and adding the new categories of armed service medal veterans. (Vietnam veterans remain covered if they fall into another covered category.) The JVA also expanded the coverage of recently separated veterans from one year after discharge or release from active duty to three years. It also removed the threshold disability rating, thereby covering all veterans discharged or released from active duty because of a service-connected disability regardless of the severity of the disability. Under the new regulations, which took effect on June 18, 2008, employers with federal contracts worth $100,000 or more entered into or modified on or after December 1, 2003, will be required to file a new form, VETS-100A, with the DOL's Veterans' Employment and Training Service (VETS). Federal contractors covered by the JVA must begin collecting the information required by the new regulations this summer and file their first annual reports on the VETS-100A form by September 30, 2009. Employers working on federal contracts of $25,000 or more that predate December 2003 must continue to file VETS-100, the annual reporting form under the Vietnam Era Veterans' Readjustment Assistance Act of 1974. According to the DOL, employers who have contracts that fall into both categories will have to file both the VETS-100 and VETS-100A forms.

New York State Law for Social Security Number Protection

As of January 1, 2008, New York private employers are now required to comply with General Business Law § 399-dd that requires employers, among other entities, to protect Social Security numbers from disclosure.

Under the law, employers are prohibited from the following:

(i) intentionally communicating or otherwise making available to the general public an employee's Social Security number;

(ii) printing an employee's Social Security number on any card or tag required to access any service or benefit provided by the employer;

(iii) requiring an employee to transmit his or her Social Security number over the Internet, unless the connection is secured or the number is encrypted;

(iv) requiring an employee to use his or her Social Security number to access an Internet Web site, unless a password or other authentication device is also required for access; and

(v) printing an employee's Social Security number on any materials, except for applications or forms, mailed to an employee, unless required by state or federal law. A Social Security number permitted to be sent by mail may not be printed, in whole or in part, on a postcard or other mailer not requiring an envelope or be visible on the envelope or without the envelope having been opened.

The new law does not prevent the collection, use or release of a Social Security number as required by state or federal law or the use of Social Security numbers for internal verification, fraud investigation or administrative purposes. Employers must also take "reasonable measures" to ensure that no person has access to employees' Social Security numbers, except for legitimate or necessary business purposes, and provide safeguards to prevent unauthorized access to them and protect their confidentiality.

Violation of the new law is punishable by a civil penalty of up to $1,000 per violation and up to $100,000 for multiple violations for first-time offenders. Repeat offenders face a penalty of up to $5,000 for a single violation and up to $250,000 for multiple violations. The Attorney General is also authorized to seek injunctive relief. As a result of this new law, employers should take the necessary steps to comply with the law and protect employees' Social Security numbers from disclosure, including training human resources employees about its requirements. Employers with questions about the law should contact their labor and employment attorney.

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Ethical Issues for Business Lawyers

Documents and Lawyers: Oil and Water?

By C. Evan Stewart

George Eliot once observed that "[h]istory, we know, is apt to repeat itself."[1] One area where it seems to repeat itself with a fair amount of frequency is in document discovery; not only are lawyer memories demonstrably short, but the rules governing that process (e.g., certification as to completeness) have made it more and more dangerous.[2]

The Fairly Recent Past

It does not seem so long ago that Arthur Andersen got into a whole lot of trouble for destroying Enron-related documents, just as Enron was publicly imploding.[3] Part and parcel of that brouhaha (at least based upon publicly available materials) was that internal Andersen lawyers, most notably, Nancy Temple, appear to have either: (i) encouraged the destruction of materials by not very subtle hints, or (ii) recklessly turned a blind eye to the wholesale destruction of documents.[4] Of course, neither option was a really happy one, especially given the then applicable federal statutes governing obstruction of justice.[5] Ms. Temple, facing potential criminal liability on a number of fronts, publicly took the Fifth Amendment on these matters. For better or worse, Ms. Temple was able to dodge a criminal bullet (as well as exposure to sanction by the Illinois Bar),[6] and (as of April 1, 2008) she is now working for a small law firm she co-founded in Chicago.

In 1998, a deal was brokered by Morgan Stanley between its client, Sunbeam, and Ronald Perelman, whereby Perelman merged his majority interest in Coleman into Sunbeam for $1.5 billion ($680 million of which was conveyed in Sunbeam stock). Shortly after the deal closed (Morgan Stanley's fees were $33 million), Sunbeam went into the tank and later filed for bankruptcy. The value of Perelman's Sunbeam stock went to zero.

In 2003, Perelman approached Morgan Stanley to see if a lawsuit charging the investment bank with fraud could be avoided. Settlement discussions were unsuccessful, so Perelman sued Morgan Stanley in Florida state court. As is usually the case, there was a fair amount of taffy-pulling over discovery issues (on both sides), but the main battleground focus soon shifted to Morgan Stanley's e-mails. Ultimately, it was determined that Morgan Stanley had not only failed to comply with SEC retention rules *vis-à-vis* e-mails, but more importantly, it was determined that the bank had tendered a false certification of completeness; 1,423 e-mails, back-up tapes and other materials—8,000 pages in all—were discovered after the certification had been submitted to the court.

This caused a very angry judge to find that Morgan Stanley had "contumaciously" engaged in a "willful and gross abuse of discovery obligations," and that finding led her to issue three rulings: (i) an adverse inference instruction would be given to the jury; (ii) the burden of proof would be shifted at trial—Morgan Stanley would have to prove that it was not guilty of conspiring with Sunbeam to defraud Perelman, and (iii) the jury would be allowed to hear about Morgan Stanley's discovery abuses as part of Perelman's request for punitive damages.[7]

At trial, the jury not surprisingly found against Morgan Stanley. Compensatory damages of $604 million were awarded to Perelman. Later, $850 million in punitive damages were added, to which the judge thereafter piled on another $120 million in interest.[8]

Happily for Morgan Stanley, the verdict and damages award were vacated on appeal in 2007.[9] Unhappily for the Morgan Stanley lawyers involved in the case, they took a huge hit—the bank's distinguished outside law firm was fired and publicly threatened with a malpractice suit (it is unclear whether this ever proceeded any further than the threat stage), and the bank's distinguished general counsel left the company (as did a number of his protégées).[10]

The Really Recent Past

You might think lawyers pondering just the foregoing examples would be very careful about how they handle documents. You might, but you would be wrong.

The case of *Qualcomm Inc. v. Broadcam Corp*.[11] is a prime example. In that patent-infringement dispute, 21 e-mails on a key Qualcomm witness's laptop were revealed for the very first time in front of the jury at trial (counsel had decided that the e-mails were not responsive to the other side's discovery requests). The jury ultimately ruled against Qualcomm; thereafter, the trial judge ordered Qualcomm to pay Broadcam approximately $8 million in attorneys' fees and costs.

If that were not bad enough, Qualcomm's lawyers (trial counsel and the company's general counsel) then wrote to the trial judge, informing the court that the 21 e-mails had only been the tip of the iceberg. In fact, the company had failed to produce more than 46,000 e-mails that had been called for by Broadcam's discovery requests, and many of those materials turned out to be "inconsistent" with positions proffered at trial.

Nineteen Qualcomm lawyers were subsequently cited by the trial judge for discovery non-compliance, referred to the California Bar authorities, and ordered to participate in a sanctions hearing before a magistrate judge. Ultimately, the magistrate dismissed 13 of the lawyers without sanction. As to the remaining six lawyers, the magistrate found that Qualcomm had intentionally withheld the discovery materials and that those lawyers—skilled and experienced litigators all—must have known about Qualcomm's duplicity. This latter finding was important insofar as (i) there was no record evidence that the six Qualcomm lawyers did in fact know about the additional 46,000 e-mails, and (ii) the lawyers could not defend themselves under governing California professional responsibility rules—i.e., California lawyers are not allowed to divulge client confidences under any circumstances.[12]

The affected lawyers objected to the Article III judge, who vacated the magistrate judge's order and remanded the matter back for a hearing in which the lawyers would "not be prevented from defending their conduct by the attorney-client privilege of Qualcomm." This decision was based upon (i) the attorneys' "due process right to defend themselves," and (ii) other states' rules (like New York's) and the ABA Model Rules, which allow lawyers to divulge client confidences in order to defend themselves against specific charges of wrongdoing."[13] The second prong of the trial court's decision is not built on a strong foundation (i.e., the lawyers are California lawyers, not governed by New York's rules or the aspirational ABA Model Rules). As for the first prong, that is a closer question—the due process issue might well be counterbalanced by the notion that California lawyers knowingly gave up that right when they agreed to practice law under the rules of the State of California.[14]

The ultimate outcome—both before the magistrate judge and the California Bar authorities—is yet unknown. But we do not need to wait for that outcome to have learned (again) some important, and seemingly obvious, lessons.

The first lesson is that electronically stored information is a trap for the unwary.[15] And this is not only for retrieving e-mails, but sometimes with respect to trading desk telephones and voice messages as well.[16] Even innocent mistakes can prove to be enormously costly, as seen above—both to clients and their lawyers.

Perhaps less obvious is the fact that the current nature of law practice has produced inverse (and perhaps perverse) incentives and results. The ever-escalating cost structure of the legal profession (most notably, associate salaries and technology)[17] has led to document discovery being carried out exclusively by the most junior lawyers, or by outside/contract lawyers, or by paralegals, or by clerical staff at the client—all in the name of saving money. Recognizing that this is likely to be a less precise process, with greater errors, the profession cut itself a bit of slack by encrafting a new provision onto Rule 26(b)(5)—whereby inadvertent waivers of privileged materials will (at least in principle) not constitute actual waivers and the materials will not be usable by litigation opponents.[18] All of the foregoing has meant that senior lawyers (both inside the client and outside) have become farther and farther removed from the discovery process.

This loosening of standards and the absence of grey hair have coincided precisely at the same time regulators have been requiring certifications that "everything" has been turned over, with the courts on that same wavelength. In light of the *Qualcomm* and *Morgan Stanley* rulings, clients, as well as their grey-haired lawyers, need to re-jigger how they staff and monitor the retrieval of materials for the litigation process. As is quite clear, delegating completeness certifications to the "low man on the totem pole" will not save senior lawyers or their clients in case of material screw-ups.

What Was She Thinking?

Every once in a while there is something that comes up that is now, always has been, and always will be, indefensible. *In re Kristian Peters*,[19] surely qualifies on that score.

In that case, Ms. Peters, a seasoned litigator and a (then) partner at a well-known law firm, had received deposition transcripts covered by a protective order in a case before Judge Harold Baer in the Southern District of New York. On the eve of Ms. Peters' voluntarily dismissing the New York action before Judge Baer and seeking to file an identical suit in Boston, Judge Baer ordered the return of all documents covered by the protective order. To forestall part of that return, Ms. Peters instructed a first-year associate at her firm to "scribble all over" unmarked deposition transcripts; she believed (wrongly) that by so "scribbling" on the transcripts they would be turned into attorney work product and thus not be subject to being returned.[20] The associate promptly reported the incident to senior members of the law firm, which then launched an investigation.

After this was brought to Judge Baer's attention, the matter was fully vetted in an evidentiary hearing. Ms. Peters did not deny the incident; she testified instead that it was merely a "joke" or that she was being "facetious" or "sarcastic." Judge Baer himself asked the associate: "What is your view about whether she was saying it in jest?" The associate's under-oath response was: "It was absolutely not in jest." Based upon the record before him, Judge Baer concluded that Ms. Peters had engaged in "a blatant disregard for court orders, and a willingness to take any action necessary towards the desired end, including ordering subordinates to commit misdeeds that, apparently, she felt uncomfortable committing herself."[21] He accordingly imposed more than 24 separate reprimands or sanctions on Ms. Peters; he also referred the matter over to the Committee on Grievances for the Southern District of New York.

Headed by Judge Jed Rakoff, the Committee on Grievances issued its own decision on April 10, 2008, fully in accord with Judge Baer's analysis and critique of Ms. Peters' behavior and ordering her suspended from law practice in the Southern District, pending her appeal of Judge Baer's order to the Second Circuit.[22]

Conclusion

Regardless of what the Second Circuit does in its review of Judge Baer's order, emulating Ms. Peters' conduct would clearly not be a good career move. Beyond that obvious point, however, lies the fact that the line between clever lawyering and irresponsible (or worse) lawyering in the document-discovery process seems for some lawyers not to be a very clear one.[23] Is it really worth it to be too cute in parsing the depth and breadth of discovery boundaries, especially with respect to electronic materials—which can turn up in any number of unexpected places? It is undoubtedly better in the short and long term—for lawyers and clients both—to do your best to find and then dump all relevant materials on your opponent; then, you can start being a clever lawyer and advocate.

Endnotes

1. George Eliot a/k/a Mary Ann Evans, SCENES OF CLERICAL LIFE (1858). Yogi Berra, of course, also once said: "It's déjà vu all over again." Berra was not musing on history, however; he made his famous comment "after Mickey Mantle and Roger Maris hit back-to-back home runs for the umpteenth time." Yogi Berra, THE YOGI BOOK (Workman Publishing, 1998).
2. Not that document discovery screw-ups did not always have significant risks. *See* S. Brill, *When a Lawyer Lies*, ESQUIRE, Dec. 19, 1979.
3. The firm itself was criminally prosecuted by the Department of Justice. After it was found guilty at trial, Arthur Andersen (which at its peak had 90,000 employees) went out of business. The Supreme Court later overturned the verdict, a result that did not resuscitate the firm. *See* C. E. Stewart, *The Post-Enron Pendulum: Is It Swinging Back (And in What Direction)?* AMERICAN BANKER, June 25, 2005.
4. *See* C. E. Stewart, *Andersen Agonistes: The Ethics of Document Destruction*, N.Y.L.J., April 15, 2002. One e-mail from Ms. Temple played a particularly key role in the government's decision to prosecute Arthur Andersen (and the jury cited this e-mail as a pivotal piece of evidence that led to Andersen's criminal conviction). It reads in whole:

   To: David B. Duncan
   Cc: Michael C. Odum@ANDERSEN WO:
   Richard Corgci@ANDERSEN WO
   BCC:
   Date: 10/16/2001 08:39 PM
   From: Nancy A. Temple
   Subject: Re: Press Release draft
   Attachments: ATT&ICIQ; 3rd qtr press release memo.doc

   Dave—Here are a few suggested comments for consideration.

   —I recommended deleting reference to consultation with legal group and deleting my name on the memo. Reference to the legal group consultation arguably is a waiver of attorney-client privilege advice and if my name is mentioned it increases the chances that I might be a witness, which I prefer to avoid.

   —I suggested deleting some language that might suggest we concluded the release is misleading.

   —In light of the "non-recurring" characterization, the lack of any suggestion that this characterization is not in accordance with GAAP, and the lack of income statements in accordance with GAAP.[sic] I will consult further within the legal group as to whether we should do anything more to protect ourselves from potential Section 10A issues.

   Nancy

   This document, at least on its face, has always seemed relatively innocuous to me. Ms. Temple's e-mail of Oct. 12 ("It might be useful to consider reminding the engagement team of our documentation and retention policy."), on the other hand, I have always thought to be much more problematic—coming, as it did, after Andersen (and Temple) were aware of how dire a predicament Enron really faced.
5. *See* 18 U.S.C. §§ 1503 and 1505. In passing Sarbanes-Oxley, Congress added two more weapons to attack document destruction. *See* 18 U.S.C. §§ 1512(c) and 1519. In New York State, it is a class E felony for a person to tamper with physical evidence "believing that [the] evidence is about to be produced or used in an official proceeding or a prospective official proceeding . . ." N.Y. Penal Law § 215.40(2) (McKinney 1999).
6. Ms. Temple was not only identified as a target of the Justice Department's grand jury investigation, but the House Energy and Commerce Committee separately asked the Justice Department to look into whether she had lied to the Committee in sworn testimony (which pre-dated her Fifth Amendment invocation at a civil deposition). Notwithstanding, no criminal charges were ever brought against Ms. Temple. She also faced potential exposure to Illinois Rules of Professional Conduct 3.4(a), which states:

   > [A lawyer shall not] unlawfully obstruct another party's access to evidence or unlawfully alter, destroy or conceal a document or other material having potential evidentiary value.
7. *See Coleman (Parent) Holding, Inc. v. Morgan Stanley & Co.*, 2005 WL 674885 (Fla. 15th Cir. Ct. 2005).
8. In *Treppel v. Biovail*, 249 F.R.D. 111 (S.D.N.Y. 2008), a similar adverse inference instruction (and other sanctions) were sought in light of the defendant's "clearly inadequate"/ "clearly deficient" efforts to preserve electronically stored information when litigation was obviously imminent. Luckily for the defendant, the judge rejected the requested instruction for two reasons: (i) the discovery failures did not appear to be willful, and (ii) the plaintiff could not demonstrate that any missing materials were relevant to his claims.

   More recently, in shareholder litigation against Oracle Corp. and its CEO, Larry Ellison, the judge ruled that he would issue an adverse inference instruction against Mr. Ellison for his failure to preserve more than 1,500 e-mails, as well as a number of recorded interviews with a biographer. *See* B. Worthen, *Judge Rules Oracle CEO Withheld Emails*, WALL ST. J., Sept. 5, 2008, at B6.
9. The issue that swayed the Florida appeals court was that the compensatory damages calculation was wholly speculative. And without a compensatory damages award, the punitive damages award (punitive damages being a purely derivative claim) could not stand alone.
10. The trial judge said in open court that she had seen "no evidence of malpractice" by Morgan Stanley's outside counsel, adding that the only evidence before her was that the law firm had merely "follow[ed] the directions" of their client. *See generally* S. Beck, *Morgan Stanley's Recipe for Disaster*, THE AMERICAN LAWYER (June 5, 2006).

11. 2008 U.S. Dist. LEXIS 16897 (S.D. Cal. March 5, 2008), *reversing in part and remanding* 2008 WL 66832 (S.D. Cal. Jan. 7, 2008).

12. In New York, lawyers do have the ability to divulge client confidences to defend themselves against specific charges of wrongdoing. *See* DR 4-101(C)(4).

13. *See* DR 4-101(C)(4); ABA Model Rule 1.6 (b)(5) and comment 10.

14. *See*, *e.g.*, Balla v. Gambro, 584 N.E. 2d 104 (Ill. 1991). *See also* C. E. Stewart, *In-House Counsel as Whistleblower: a Rat with a Remedy?* N.Y.L.J., Aug. 21, 2008.

15. Judge Shira Scheindlin comprehensively defined the landscape of this subject matter in Zubulake v. UBS Warburg, 217 F.R.D. 309 (S.D.N.Y. 2003).

16. Most companies have systems that automatically recycle or delete telephone taping systems after a set period (e.g., 30 or 60 days). Unlike emails, which are subject to legislated document retention requirements, such voice messages are not subject to those same requirements. If litigation is expected or imminent, however, such tapes would have to be preserved.

17. *See* G. Fields, *Digital Data Drive Up Legal Costs*, WALL ST. J., Sept. 6, 2008, at A3.

18. *See* C. E. Stewart, *Will Waiving the Privilege Save It?* N.Y. BUS. L.J., Vol. 11, No. 1, at 13 (Spring 2007); C. E. Stewart, *The Internet, Litigation, and the 'Oops' Factor*, N.Y.L.J., May 15, 2006. This was recently (September 2008) codified by Congress in Rule 502 of the Federal Rules of Evidence. Fed. R. Evid. 502.

19. M-2-238 (S.D.N.Y. April 10, 2008, per Judge Jed S. Rakoff), N.Y.L.J., April 17, 2008.

20. It never ceases to amaze me how many lawyers do not understand attorney-client and work product issues. *See* C.E. Stewart, *The Attorney-Client Privilege: The Best of Times, the Worst of Times*, THE PROFESSIONAL LAWYER, March 2000. This lack of understanding is most frequently displayed to the judiciary in privilege logs, often compiled by junior lawyers or paralegals who are instructed to withhold any document with a lawyer's name on it.

21. *See Wolters Kluwer Financial Services, Inc. v. Scivantage*, 525 F. Supp. 2d 448, 549-50 (S.D.N.Y. 2007).

22. *See* M-2-238 (S.D.N.Y. April 10, 2008, per Judge Jed S. Rakoff), N.Y.L.J., April 17, 2008. Besides Judge Rakoff, the Committee consisted of Judges Wood, Castel, Haight, Keenan, Lynch, McMahon, Stanton, and Magistrate Judge Freeman. The Committee determined that Ms. Peters violated at least DR 1-102(a)(5), DR 1-102(A)(4), and DR 7-106(A).

23. Incredibly, there has been some encouragement by the organized Bar, as well as the courts, for attorneys playing fast and loose with ethical obligations in discovery. *See* New York County Lawyers' Association's Committee on Professional Ethics Formal Opinion 737 (May 23, 2007) (endorsing an ethical safe harbor for lawyers who employ "dissemblance" in the evidence gathering process); *Gidatex v. Campaniello Imports, Ltd.*, 82 F. Supp. 2d 119 (S.D.N.Y. 1999) (counsel held to be "technically" violative of ethics obligations in discovery but not sanctioned and materials procured thereby admitted into evidence). This approach to law practice is obviously not one that aspires to the highest level. *See* C. E. Stewart, *When Exceptions Swallow the Rule: the Growing Demise of the 'No-Contact' Rule*, N.Y. BUS. L.J., Vol. 12, No. 1, at 34 (Spring 2008).

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Intellectual Property in Various Types of Business Transactions

By Ralph J. Scola

A. Introduction

Intellectual property (IP) is often overlooked in the business context. Even though it can be the most important asset group owned by a company, because it is intangible, and thus essentially invisible, it does not receive the same sort of attention in the planning process and in the manner in which it is protected that financial or tangible assets receive. The purpose of this article is to demonstrate the ways in which IP can be exploited to benefit a company.

IP takes many different forms. The client is generally unaware of its importance to a transaction. In addition, most companies do not realize how easily IP can be lost to the competition.

"Even though [IP] can be the most important asset group owned by a company, because it is intangible, and thus essentially invisible, it does not receive the same sort of attention in the planning process and in the manner in which it is protected that financial or tangible assets receive."

Voluntary disclosure of IP to a competitor is the stuff of antitrust violations.

In a merger or acquisition situation, each party must take care if it is dealing with a competitor to be certain that the party does not violate the antitrust laws by disclosure of sensitive competitive information which, should the deal not go forward, could be used, among other things, to fix prices and divide markets. Consideration should be given to securing a business letter approving the discussions from the Department of Justice beforehand, or alternatively, to using third parties as intermediaries in evaluating the respective IP and reporting on the results of their evaluation without disclosing the specifics of the information disclosed to them. Another approach is to employ secrecy and non-use letter agreements with a commitment to hold the information close within the respective organizations, not disclose it to operating and sales personnel, and to return it and all copies to the other party at the end of the evaluation. Someone else's IP, especially that of the competition, acquired in such a voluntary manner, can present significant problems for the client organization, if not carefully handled.

B. Types of Intellectual Property

There are many types of IP. To better understand the discussion which follows, set out immediately below are several IP types typically found in a company.

Obvious

Patents and Patent Applications
- U.S. and Foreign

Trademarks
Trade names
Trade dress
Copyrights
Internally generated software

Less Obvious

Secret Know-how
- Technical
- Non-technical

Chemical formulas
Bid proposal response process and procedure
Customer lists
Customer preferences
Customers' internal organizations
Customer contracts
Strategic Plans
Accounting practices
Contacts in venture capital firms
Cooperative arrangements with suppliers
Legal methods of discovering competitive information

C. Use, Protection and Value

1. Use

IP can be important currency in any of the seven transaction types described below. This applies not only to so-called "high tech" companies, but also to any successful operating entity. IP is what makes a company successful, whether it is a list of patents, a highly regarded trademark, or the essence of "how" the company does business—e.g., its operating know-how, strategic plans, internally generated software, or plan for R&D. Other examples include the obvious—patents, trademarks, copyrights—and the less obvious or "hidden" IP—customer lists, bidding formulas, marketing information sources, and manufacturing processes.

If the client is a publicly traded company or a financial institution, its IP as currency for a merger or acquisition, for example, is less important. Its publicly traded stock or financial assets will be the currency. However, if not, the client's assets will be the basis for the deal, and its IP can be some of the most valuable of these, even though its value may not appear on the client's balance sheet. Accordingly, IP can be an untapped source of value for any of the seven transactions considered below. Before this can happen, however, the client's IP must be specifically identified, catalogued and, most importantly, valued. Thereafter, it can be used as identified and valuable currency.

2. Protection

Not all M&A and joint venture deals go forward. In fact, in this author's experience, most do not close. There are, of course, good reasons for this, the two most common being that management could not decide who was to be in charge and that one of the two companies turned out not to be worth what it was thought to be. This latter development is often the result of an engaged third party's evaluation of the worth of the company, in particular, its future earning power, which is usually a function of its IP—e.g., its goodwill with its customer base. Accordingly, a company must take care to protect its IP, which, in the case of negotiations for an M&A or a JV, is often disclosed to some other company in the same business, and just as importantly, the same company must be certain to protect itself from the other company's IP. Guilty knowledge can be a dangerous thing, especially if, after a deal does not close, the recipient company begins to increase its market share at the expense of the one-time future M&A or JV partner.

Protection of IP from unauthorized use or disclosure is absolutely essential because the would-be partner, lender or licensee will need to examine the other party's operations very carefully, and may end up knowing as much about the disclosing company as that company does about itself. IP may be the most valuable asset a company possesses, so it must take extraordinary care in protecting it. Its value to a company will be lost forever if it is disclosed in an unauthorized manner, or, worse still, appropriated by the competition. Furthermore, a company must insulate itself from the impact of disloyal or misguided employees. It should be certain that its employees and representatives are obligated personally not to disclose the other party's IP. A signed secrecy and non-use agreement at the outset, applicable only to a third party's IP disclosed as part of negotiations and due diligence by each member of the negotiation and due diligence team, will provide the maximum legal protection to the client company and the would-be partner, and the same should be expected by the client from the client's prospective partner's people. This will also protect the client company from claims that it did not do all that was needed to protect competition from the effects of unauthorized use by elements within the client company, which use could result in an antitrust violation, or a violation of the Economic Espionage Act of 1996. Beyond the legalities, it is recommended that the client's internal audit group perform a follow-up examination of company records and the personal records of those of its employees and outside representatives who worked on the transaction to be certain that all information has been returned and no copies, in any form, have been retained.

The Economic Espionage Act of 1996 has the capacity to criminalize behavior previously considered only civilly actionable. It provides companies whose IP, in the form of trade secrets, has been appropriated in ways that are not permitted under the statute to now complain to U.S. governmental agencies to cause them to seek criminal penalties against recipients of such trade secret information and their employees. The client company should consider the somewhat broadly worded statute when planning, for example, to hire away an employee from the competition or seeking to exploit recently discovered competitive information secured from a consultant previously employed or engaged by the competition.

18 U.S.C. § 1832 states:

> **Theft of Trade Secrets**
>
> (a) Whoever, with intent to convert a trade secret, that is related to or included in a product that is produced for or placed in interstate or foreign commerce, to the economic benefit of anyone other than the owner thereof, and intending or knowing that the offense will, injure any owner of that trade secret, knowingly—
>
> (1) steals, or without authorization appropriates, takes, carries away, or conceals, or by fraud, artifice, or deception obtains such information;
>
> (2) without authorization copies, duplicates, sketches, draws, photographs, downloads, uploads, alters, destroys, photocopies, replicates, transmits, delivers, sends, mails, communicates, or conveys such information;
>
> (3) receives, buys, or possesses such information, knowing the same to have been stolen or appropriated, obtained, or converted without authorization;
>
> (4) attempts to commit any offense described in paragraphs (1) through (3); or
>
> (5) conspires with one or more other persons to commit any offense described in paragraphs (1) through (3), and one or more of such persons do any act to effect the object of the conspiracy, shall, except as provided in subsection (b), be fined under this title or imprisoned not more than 10 years or both.

(b) Any organization that commits any offense described in subsection (a) shall be fined not more than $5,000,000.

As noted, most M&A, JV or licensee partners are the client company's competition. Certain companies that want to garner sensitive, competitive information from the client company may express interest in a merger, acquisition, joint venture or license simply to gain access to the client company's technology during the due diligence process, only to decide later, before closing the deal, that they are not, after all, interested. Meanwhile, they have the client's sensitive information, and while they may have returned it, there can be no assurance that they have not kept a copy. This is why selection of the prospective partner is the first and most important step in the client's program of protection of its IP.

Common-sense approaches to protecting IP in the seven types of transactions discussed below are the best means to this end:

1. Do select the prospective partner well. Use of firms that specialize in evaluating partners is perhaps the most effective way to proceed, especially if the prospect is located offshore.
2. Do not disclose sensitive, detailed IP at the outset. Move from the more general to the more specific.
3. Do negotiate at least the outline of the deal, if not the specifics, before disclosing the truly important parts of the IP that is the basis for the transaction.
4. Do not proceed with any discussions except the most preliminary ones necessary to indicate sufficient interest without mutual execution of secrecy and non-use agreements that obligate not only the companies, but also the individuals involved.
5. Do not have any discussions leading to a merger or acquisition, or a major license, with a significant competitor, especially if the two companies together own a significant share of the market, without a compelling reason to do so, and, if so, without a business letter from the Department of Justice (and, as needed, the appropriate state attorney general) approving the discussions and laying out the ground rules for conducting same.

If the client can overcome these hurdles, or, alternatively, if the client cannot or will not go to the Department of Justice and the state attorney general before beginning discussions with a competitor, there are other or additional means of protecting itself:

A. After "tight" secrecy and non-use agreements are signed between the prospective "partners," the use of a third-party professional to evaluate the other side's IP is recommended; the client must be certain that it contracts with such a firm to require it to refrain from disclosing to the client the specifics of the information it has learned, and to disclose to the client only the results of its evaluation, sometimes tied to specific benchmarks the client needs to be evaluated. This is especially helpful if the deal does not go forward.

   Or:

B. Less attractive, but perhaps required because of cost considerations, is the use of people within the client organization who do not work in the areas being evaluated and thus have no business need for the information to be evaluated; the building of a "Chinese wall" around these employees at the client company; keeping the data they receive separate (and, preferably, offsite) from the client's other business information; not placing such information in electronic data form on the client's data system; making no copies of what is received; and returning all information and all copies in any form to the other side.

3. Valuation

In mergers and acquisitions (asset-based), licenses, loan transactions, and performance bond arrangements, knowing the value of the client company's IP, especially its technology (after it has been carefully and completely catalogued and properly protected) is essential if the client wishes to use it to generate income or support a significant loan amount or performance bond. Its value can generate more income if known, can secure a more favorable exchange rate in a merger or acquisition, or can secure a more favorable loan rate, because the estimation of future income (which is generally the way in which the value of IP is expressed) will be higher.

There are several methods of valuation that are generally employed and accepted. In any of the transactions addressed below, valuation by a third party will be the preferred method in an arm's-length negotiation and transaction. This is usually the only way in which the owner of IP will have a credible method to convince a third party of the value of its IP. Professional assistance in this regard is almost always required.

Protection is the key to credible value. Unless the IP constitutes already protected elements, such as patents, trademarks and registered copyrights, an effective IP management program is essential to preserving value (even in the case of registered IP, an effective IP management program may be essential). When considering disclosure of the client's expensively developed and carefully catalogued and protected IP, remember that, unless the client proceeds carefully with its prospective partner, it could, by its own hand, disclose important IP that could be used against it in the marketplace. The above advice must be followed in any such discussions and negotiations.

D. IP Protection Around the World

Much of the licensing and joint venturing, and certain of the M&A transactions that occur, do so outside of the U.S., or at least involve a non-U.S.-based company. In considering whether and how to proceed with such a prospective partner, there are several issues which the client must keep in the forefront of its analysis.

The legal regime for the protection of IP differs greatly from country to country. Consequently, whether a U.S.-based client is seeking to establish an operation in a non-U.S. jurisdiction, or merely seeking to do business with a company based there, it is essential that the client be aware of the manner in which its IP will be treated in that jurisdiction because the client may be required to seek legal redress in that country's court system. For example, in certain jurisdictions, secrecy agreements are difficult, if not impossible, to enforce, regardless of the terms and conditions of same. Also, U.S. patent protection has no extra-territorial reach (in the sense of providing the basis for a patent infringement action in the courts of the non-U.S. jurisdiction), so that the patented technology is not worth much in a foreign jurisdiction unless it is also patented there. Because the secrecy and non-use agreement will be the most important vehicle by which the client will seek protection of its IP, the U.S.-based client must pay particular attention to how such documents are treated in that country's court system.

If a U.S.-based client is entering into a joint venture with a company in a non-U.S. country, consideration should be given to combining secrecy and non-use provisions into the JV agreement, since the latter document may receive more respect in the court system than a bare-bones secrecy and non-use agreement supported only by mutual promises.

In many foreign countries, IP, especially technology, can be the subject of public disclosures, most particularly in those countries where patent applications are published for opposition prior to issuance. Knowing the prospective partner's technological base by examining the patent literature can make the client a more effective negotiator, and can enable it to make a more informed choice of partners based upon its own analysis of their technology rather than accepting at face value that which the prospective partner gives the client to analyze. The same is true for the U.S.-based client with respect to its foreign-filed patent applications.

E. Quick Lists for Typical Transactions

1. Mergers & Acquisitions

In an asset-based transaction, counsel must be certain that the client knows its technology and other trade secret information and its value, as well as how it will benefit the combined organization. In a stock deal, particular assets are less important, although, if the client's stock is undervalued by the market, directing attention to asset groups and their value may provide a way by which to secure a better exchange ratio.

2. Joint Ventures

Often, joint ventures are technology-based. One or both of the parties may have technology that will enable the combined organization to make a significant market impact. It is essential that the parties know precisely their technology, its worth as currency, and its contribution to achieving the goals of the JV. It is also essential that the U.S.-based company knows how well its technology, especially its non-patented technology, will be protected in the country in which it is to be employed and protected by the JV, as well as in surrounding countries.

3. Creditor/Lender

Asset-based borrowing should include IP, as well as financial and hard assets. Since IP is usually not well reflected on the balance sheet, it is essential, if the client wishes to maximize its borrowing power, to identify, catalogue and objectively value it through a third party. Additionally, an IP management program will enhance its value by demonstrating the IP's continuing worth because it is protected and updated.

4. Licensing

A license usually involves technology or other forms of protected IP, such as trademarks and copyrights. Comparative, arm's-length valuations are usually essential in order to establish the license fee. A third-party evaluator, familiar with market worth, as well as other forms of valuation, can enable a licensor and licensee to arrive at a mutually agreeable license fee. An IP management program can enable a prospective licensor to know how best to maximize the exploitation of its IP assets without damaging its home markets from unwanted competition from its licensees.

Various types of licenses include: exclusive; non-exclusive; sole; geographically limited; product limited; bare patents vs. design package vs. turnkey plant; all improvements. Depending upon the prospective licensor's strategic plan for its IP, one or more of these types of licenses may be the approach it will need to take.

5. Performance Bond Collateral

IP can be an untapped source of collateral. The same requirements apply: it must be identified, catalogued, valued, protected and updated.

6. Pledge of Licensing Revenues to Secure Loans

The better the technology or other form of IP, the greater and more secure is the licensing revenue. Licensing income is usually measured by a running royalty as a percentage of sales. The more carefully catalogued and protected the IP, the greater the revenue, and, thus, the greater its value as loan security. IP can be a substitute for other assets, freeing them up for income generation of a different sort. An IP management program can generate even more revenue. This revenue can be discounted through borrowing, and with IP, such as outdated domestic technology (which may be considered up-to-date foreign technology), that might not otherwise be productive, a company can greatly exploit its technological position, and thus enhance its cash flow for borrowing against IP income based upon future revenues. For certain highly leveraged industries, this can amount to cash management by way of IP management.

7. Grant and Licensing Back by Creditor

This somewhat arcane area can be very useful if the client company has a significant creditor or equity holder. For a high tech or purely licensing entity, this approach to future cash generation can unlock the future value of IP by exchanging with a creditor or investor its money for the client company's IP, and then licensing back from the lender or investor the recently transferred IP in order to operate. This enables certain companies, in particular start-up entities, to realize the cash they need to begin large scale operations, and enables the lender or investor to have an even greater measure of protection, free of bankruptcy set asides and the claims of other, later creditors, when done properly.

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Preventing the Inevitable: How Thinking About What Might Happen Can Help Ensure That It Won't

By Victoria A. Cundiff

The so-called "inevitable disclosure" doctrine recognizes that in some cases, if an employee performs particular activities for a new employer, the former employer's trade secrets are at virtually certain risk of disclosure. The doctrine has been around for nearly 100 years.[1] It first gained widespread attention in the business community, however, in 1995 when the Seventh Circuit affirmed an injunction preventing Bill Redmond, a former PepsiCo senior marketing executive, from continuing his planned employment to integrate the Snapple and Gatorade soft drink businesses, then owned by Quaker Oats. Redmond had never signed a non-compete agreement.[2] Since then, hundreds of articles in the popular press have announced that it is now possible to prevent an employee from working for a competitor without first requiring him to agree to a non-compete agreement.

The decision affirming the grant of the injunction said that the former employer "finds itself in the position of a coach, one of whose players has left, playbook in hand, to join the opposing team, before the big game." That phrase has made its way into untold court filings seeking injunctive relief under the inevitable disclosure doctrine, and resonates with business people in a variety of industries concerned that the loss of a key employee will necessarily lead to the loss of their valuable trade secrets.

The general awareness of the *PepsiCo v. Redmond* case has led many companies facing the loss of employees steeped in their trade secrets to anxiously ask their counsel, "Does this particular jurisdiction 'have' the inevitable disclosure doctrine?" as they plan their legal strategy. While it is always important to know what the jurisdictions of interest have said the law "is" when they have looked at similar disputes, today's answer to that particular question will tell only a very small portion of what the client needs to know. Far more important is the answer to the question, "Do we have the *facts* we need to show the court that disclosure is virtually certain in these circumstances, and to win an injunction to prevent it?"

While terminology and specific tests applied do vary considerably among, and even within, different jurisdictions in the United States, no jurisdiction is insensitive to the concerns underlying claims of "inevitable disclosure": namely, that if an employee armed with a former employer's trade secrets engages in certain activities, those trade secrets are at serious risk of disclosure. Even California, which has unequivocally rejected the inevitable disclosure doctrine,[3] recognizes that "threatened" disclosure of trade secrets can be enjoined,[4] as do the 46 other U.S. jurisdictions that have adopted the Uniform Trade Secrets Act.[5] Further, every state will award damages, and frequently permanent injunctive relief, where a new employer obtains information that it knew or should have known included trade secrets of the prior employer.

Similarly, while some jurisdictions have expressly applied the inevitable disclosure doctrine in granting injunctions in specific cases, the "doctrine" has been refined over time, and no jurisdiction embraces the doctrine in all cases in which an employee who knows valuable secrets goes to work for a competitor.[6] Obtaining an injunction to restrain particular *activities* likely to lead to the use or disclosure of trade secrets (as opposed to simply an injunction against the actual use or disclosure of trade secrets) is difficult in virtually every jurisdiction. That is true even with a non-compete agreement. Indeed, some courts are requiring employers seeking an injunction to enforce a non-compete agreement to show that without the injunction, disclosure of trade secrets is virtually inevitable.

Determining whether relief is available to address specific concerns is thus not simply a question of analyzing inevitable disclosure "doctrine" as articulated in the relevant jurisdictions, or of shepardizing the *PepsiCo-Redmond* decision.[7] Case law in this area is not likely to yield reliable bright-line legal "answers,"[8] although it does sometimes lead to strident "pronouncements."[9] Rather, the case law is particularly useful in showing what terminology the specific jurisdiction uses in addressing inevitable disclosure concerns and, critically, what facts are likely to lead a particular court to conclude that an injunction restraining particular kinds of activity is necessary.

Accordingly, rather than providing a jurisdiction-by-jurisdiction analysis of the current status of the case law on the inevitable disclosure doctrine,[10] what follows is a consideration of some of the key issues the case law suggests that employers who have lost employees, the employees themselves, and the companies that hire them need to consider in evaluating and reducing the risk that trade secrets will be lost in a particular change of employment, regardless of whether there is a non-compete agreement.

1. Trade secrets owners who have not entered into a non-compete agreement need to be concerned about the inevitable disclosure doctrine.

The chief ill in the inevitable disclosure doctrine is its "after the fact" imposition of a non-compete agreement.[11] If the potential disclosure of trade secrets was so inevitable, courts have asked, why didn't the employer enter into a contract to protect against it?[12] The question becomes particularly pointed where the *employee* requested an employment agreement and the company refused to enter into one,[13] or where the employee was asked to sign a restrictive covenant but refused to do so.[14] For these reasons, and more fundamentally because courts throughout the United States recognize important public policies in favor of employee mobility, "in its purest form the inevitable disclosure doctrine treads an exceedingly narrow path through judicially disfavored territory."[15]

That said, the answer to the question of why the trade secrets owner didn't negotiate or impose a non-compete agreement may be, in a particular situation, because such an agreement would have been overly broad or even unnecessary. In most cases, at most times, most of the company's employees would be able to embark on most types of competitive employment with no significant risk of using or disclosing trade secrets, the plaintiff might concede. In most cases, plaintiff might admit, a non-disclosure agreement would provide adequate protection. But this particular move at this particular time will create a "perfect storm." The employee has detailed and current knowledge of trade secrets; the new employer desperately needs and is in a position to use them; the new employer has tried but failed to develop them internally, and, perhaps there is even evidence that the employee has brought some of the trade secrets with him to his new job and has actually begun to use them. In this particular case, the plaintiff would argue, the very nature of this specific move inevitably threatens trade secrets. The former employer should not have to be "precariously poised" waiting for actual disclosure to occur, but should instead be permitted to gain relief "earlier in the sequence of likely inevitable events."[16]

As discussed below, the case law makes it clear that if that is plaintiff's argument, plaintiff must present evidence and specific facts showing why that argument is correct. Saying that disclosure is "inevitable" doesn't make it so.

2. Trade secrets owners who *have* entered into a non-compete agreement *still* need to be concerned about inevitable disclosure.

Since a major criticism of the inevitable disclosure doctrine is its "after the fact" imposition of restrictions on competition, employers who chose to enter into "before the fact" non-compete agreements might assume that they do not need to be concerned with presenting evidence of inevitable disclosure. That assumption is wrong.

Increasingly, courts evaluating whether to grant injunctive relief to enforce a non-compete agreement designed to protect trade secrets focus on whether, without the injunction, disclosure of trade secrets is "imminent."[17] While courts applying this standard do not require a showing that actual misappropriation has already occurred before enforcing a non-compete agreement,[18] they will treat a showing of inevitable disclosure as a surrogate for showing that the plaintiff will suffer imminent irreparable harm without an injunction.[19]

Other courts have gone further and demanded that an employer seeking an injunction to enforce a non-compete agreement show that unless the non-compete is enforced, trade secrets will inevitably be disclosed. For these courts, the inevitable disclosure "doctrine," which can lead a court to impose post-employment restraints without a non-compete agreement, becomes the inevitable disclosure "standard" former employers must meet to win an injunction enforcing their non-competes. These courts have *required* employers attempting to enforce non-compete agreements to establish the same facts they would need in order to win an inevitable disclosure case: after first establishing that the employee in fact knew valuable trade secrets, properly protected as such, the employer must show:

> (1) the extent to which the new employer is a direct competitor of the former employer; (2) whether the employee's new position is nearly identical to his old one, such that he could not reasonably be expected to fulfill his new job responsibilities without utilizing the trade secrets of his former employer; (3) the extent to which the trade secrets at issue would be valuable to the new employer, and (4) the nature of the industry and its trade secrets.[20]

If plaintiff is not able to demonstrate that these factors establish the need to enforce the non-compete agreement to prevent the otherwise inevitable disclosure of trade secrets, courts following this approach may decline to grant an injunction enforcing the non-compete agreement or may opt instead for narrower relief, such as enforcing or modifying a non-solicitation agreement.[21]

Since any jurisdiction being asked to enforce a non-compete agreement will assess whether the agreement is no broader than necessary to protect legitimate interests, inevitable disclosure evidence "checklists" can provide a useful way to analyze presentations in support of any request to enforce a restrictive covenant.

3. A party asserting that disclosure of trade secrets is "inevitable" must clearly identify what specific secrets are at risk.

The case law is uniform that, when seeking an inevitable or threatened disclosure injunction, "a party must establish more than the existence of generalized trade secrets and a competitor's employment of the party's former employee who has knowledge of the secrets."[22] Rather, the plaintiff bears the burden of establishing what *specific* trade secrets are necessarily at risk. A plaintiff "must identify a trade secret with sufficient particularity so as to enable a defendant to delineate that which he is accused of misappropriating and a court to determine whether misappropriation has or is threatened to occur."[23]

Courts are increasingly requiring that plaintiff make a clear specification of its own trade secrets before being permitted to view the defendants' alleged trade secrets. "[P]laintiff will normally be required first to identify with reasonable particularity the matter which it claims constitutes a trade secret, before it will be allowed (given a proper showing of need) to compel discovery of its adversary's trade secrets."[24] Failing to make a precise identification of the trade secrets allegedly at risk may result not only in the denial of the requested injunction,[25] but has even resulted in the imposition of attorney's fees.[26]

A good example of how to identify trade secrets can be found, *inter alia,* in *Aetna, Inc. v. Fluegel*[27]:

> The hearing testimony and documentary evidence demonstrate that Aetna possesses many trade secrets of which Fluegel has extensive knowledge. Fluegel not only had access to, but also helped create many of Aetna's confidential documents. Aetna's strategic plan goes to the heart of its economic value. The strategic plan is the who, what, where, when and why of Aetna's business. The plan describes such things as where Aetna plans to invest its time and resources, how it will implement its strategies and what companies and markets it plans to target. The specific strategies and execution steps developed and employed by Aetna are not known publicly and are economically valuable to Aetna. Bertolini testified about the importance of "first mover advantage," a strategy to be the first to a particular market with a particular product, service or initiative. Bertolini described *several examples* of these first mover advantage strategies that Aetna is currently pursuing, such as, generally, network fortification efforts, the pursuit of new technologies, market segmentation strategies and execution pathways.

The complete sealed testimony and the use of specific examples clearly brought the significance of the endangered secrets to life.[28]

By contrast, in *Boston Laser, Inc. v. Zu*,[29] the court noted that

> BLI has failed to articulate with any degree of specificity the confidential, proprietary trade secret information to which Zu purportedly was exposed during his employment other than in purely conclusory terms. . . . Conspicuously lacking in the record now before the court are any specifics concerning BLI information which could truly be considered as proprietary and highly confidential and which, the evidence discloses, was treated as such by the Company.

Providing generalized lists of "subjects about which [plaintiff] may have developed trade secrets (e.g., 'competitive strategy against chemical companies,' 'competitive strategy against non-electric non-chemical treatment companies,' 'strategy for pricing and bringing the [product] to market,' 'strategy for achieving alliances with OEMs')"[30] or simply presenting stacks of documents marked "confidential" without explanation does not adequately identify trade secrets.[31] Plaintiff must clearly state what specific information it protected as a trade secret it now claims to be at certain risk. The defendant, and the court, should not be forced to guess.

4. A party seeking an injunction cannot simply rely on "changing teams at halftime" rhetoric or other conclusory assertions, whether there is a non-compete or not. It must establish why this particular job assignment for this particular employee threatens the use or disclosure of trade secrets at this particular time.

Many anxious former employers simply quote the factual findings of *PepsiCo v. Redmond* or keep reiterating the phrase "he cannot help but inevitably use this information" in an effort to persuade the court to grant an injunction. But the *PepsiCo* decision itself recognized that the mere fact that an employee has assumed a job with a competitor does not, without more, make disclosure inevitable.[32] The courts reject conclusory speculations that are not backed by evidence and have developed countervailing "anti-inevitable disclosure" rhetoric of their own. For example, in denying injunctive relief, they frequently point out that "[a]n injunction should not issue merely to allay fears and apprehensions or to soothe the anxieties of a party."[33] And if the basis for seeking an activity injunction would apply equally well to all employees who have been exposed to the secret, courts are likely to reject the request for an injunction because, "[i]f the doctrine is applied as urged . . . then no employee could ever work for its former employer's competitor on the theory that disclosure of confidential information is inevitable."[34]

To win this battle of conflicting maxims, a trade secrets owner seeking an activity restraint must offer evidence, not simply speculation.[35] While no single factor is dispositive, and not all of the factors listed below are essential to win injunctive relief in any given case, courts have found that the trade secrets owner has made a showing of inevitable disclosure where

- the employee was personally heavily involved in learning and developing the trade secrets;[36]

- the employee knew enough about the secrets to be able to communicate them to third parties;[37]
- the trade secrets are readily recalled and implemented;[38]
- the employee has become employed by a key direct competitor (or by a company actively working to become one);[39]
- the new employer has great need for the information claimed to be at risk (such as where the new employer is a relatively new or smaller entrant to a business in which the former employer is already an established leader);[40]
- the employee will be in a position to, or was specifically hired to, guide and direct or manage decision-making in an area of the direct competitor's business that places the trade secrets at risk;[41] and
- there is a particular time sensitivity to this secret, as where the two employers are each rushing to be first to market.[42]

Where the plaintiff has not been able to show that the new employer needs or would benefit from the identified trade secrets, however, courts have not granted injunctions. For example, in *Aetna, Inc. v. Fluegel*, a pure inevitable disclosure case in which the employee was not bound by a non-compete agreement, while the court found that Aetna established that it had, and that it had carefully protected, valuable trade secrets and that Fluegel knew and had indeed developed many of them, it also concluded that Fluegel's intended work as an executive for the new employer, WellPoint, would not inevitably place those trade secrets at risk. The court found that despite some overlap, Aetna and WellPoint were not direct competitors, and the particular trade secrets Fluegel knew were not highly valuable to WellPoint. WellPoint was the largest of the four major competitors in the health insurance industry, whereas Aetna was the third largest and only half WellPoint's size. The core of Aetna's business, and the area with which Fluegel had the greatest familiarity, national accounts, accounted for only three percent of WellPoint's revenue. Further, both Fluegel and WellPoint admitted that the information at issue constituted trade secrets and committed to respect its secrecy. After an evidentiary hearing, the court found credible Fluegel's testimony that his first priority would be to honor his commitments to both Aetna and WellPoint to maintain the confidentiality of Aetna's trade secrets. Accordingly, the court found that Aetna's trade secrets would not be placed at serious risk in the new position.[43]

In an interesting play on the "changing teams at half time" language from *PepsiCo*, the court concluded that Fluegel, who had been temporarily restrained from engaging in certain activities for his new employer pending the decision on longer term injunctive relief, "has already sat out half the season, and it is unfair to keep him on the bench any longer."[44]

Similarly, in *Analog Devices v. Michalski*[45] the court denied an inevitable disclosure injunction where, while the new employee clearly knew trade secrets, the new employer was shown to use different device geometry and device compositions and the trade secrets were thus non-transferable to the new business. The trade secrets were unlikely even to be useful in the new job, let alone likely to be disclosed.[46]

Likewise, in the marketing context an inevitable disclosure activity restriction has been denied where the employee's knowledge from his work at the prior employer related to different sales channels than those for which he would be responsible at the new company.[47]

Courts have also denied inevitable disclosure injunctions where the new employer is already far advanced beyond the prior employer, and thus presumably does not need its competitor's trade secrets;[48] where trade secrets are likely to quickly become stale,[49] and where the trade secrets are highly complex but there is no evidence that they have been removed or are likely to be recalled.[50]

Moreover, where the employee will not be in a position to guide or influence the direction of the new company, courts have rejected the claim that absent an injunction the disclosure is threatened or "inevitable."[51]

5. Evidence that the employee has been less than forthright or has removed confidential information is useful in seeking an activity injunction, but is not always dispositive.

A number of decisions have granted pure inevitable disclosure activity restraints even in the absence of a non-compete agreement because the nature of the new job places trade secrets at risk even if the employee acts in the utmost good faith.[52] There is no question, however, that evidence that the employee has been dishonest can help establish that trade secrets may be in serious jeopardy in a particular new job. In fact, as many of the commentators on the *PepsiCo* decision have tended to ignore, in *PepsiCo v. Redmond* itself the court concluded that Redmond's "lack of forthrightness on some occasions and out and out lies on others . . . leads the court to conclude that [the] defendant . . . could not be trusted to act with the necessary sensitivity and good faith."[53] Similarly, evidence that the employee has removed confidential information from the prior employer can also establish a very real threat of imminent use and disclosure and lead to an injunction restraining particular employment activities.[54]

Where there is no non-compete agreement, some decisions have held evidence of bad faith or misappropriation of trade secrets to be essential in order to grant injunctive relief.[55] But not all dishonest acts or omissions establish a need for injunctive relief. Some courts have cautioned that the dishonesty must specifically relate to the potential for disclosure before it should give rise to a broad restraint on future activity.[56] Courts also note that not all pre-departure activity is necessarily dishonest simply because the employee has kept it a secret. It is not unusual, for example, for an employee not to notify the current employer that he or she is considering a new job. That omission, without more, is not necessarily evidence that trade secrets are at risk.[57]

Further, even evidence that an employee has removed confidential information from the prior employer is not necessarily dispositive on the question of whether disclosure is threatened or inevitable. An increasing number of recent cases considering whether to impose activity injunctions have concluded that recent access to, or even removal of, confidential information is not, by itself, a sufficient basis to grant relief absent evidence that the information has been or is at imminent risk of being used.[58]

Where there is a non-compete agreement, courts typically do not require evidence that misappropriation has already take place before they will grant injunctive relief,[59] although such evidence is clearly helpful in establishing a need for injunctive relief. As described throughout this article, however, plaintiff should still be prepared to offer evidence of *why* disclosure is likely to occur absent an injunction; otherwise, the requested contractual restraint may be seen as unnecessary overkill.

6. A party seeking an activity injunction must conduct internal discovery before moving for injunctive relief, and will likely need to conduct formal discovery to win.

An injunction is an extraordinary remedy. It should not be grounded in conclusory recitals of alarmist fears. Before bringing a case seeking an injunction, the trade secrets owner needs to conduct a sober assessment of the evidence it has to support its claims. While the plaintiff generally cannot know everything about the magnitude of the potential risk without reviewing information it does not control, plaintiff must begin, as the defendant will, by conducting internal "discovery" of its own records and employees. If it cannot marshal the evidence to make even a *prima facie* showing that its valuable secrets are at serious risk in the new position, it should spare itself the substantial expense typically involved in seeking an injunction to restrain particular activities. It will not be able to win.

In preparing a case seeking injunctive relief, the former employer must be clear on whether and why such relief is necessary. If the former employer cannot identify a specific risk, it cannot expect the court to do so. Thus, courts have refused to impose activity restraints where "[plaintiff's President and CEO] was unable to articulate a reason for requiring [its] employees to sign a restrictive covenant and the need to extend it for a period of one year"[60] or where, when plaintiff's Chief Financial Officer was asked "[w]hat trade secrets were misappropriated by [defendant]?" he testified "I don't know" and admitted that defendant "could engage in [a competing business] without having to appropriate trade secrets from [plaintiff]."[61] An employer who loses an employee needs to focus on answering such questions *before* bringing suit.

In considering whether to bring suit, plaintiff should conduct careful internal fact-finding to develop *evidence* to show what trade secrets *this particular employee* had access to, how valuable they are, and how time-sensitive. Provided the company has developed and followed reasonable measures to preserve the secrecy of the information at suit, it should be a relatively easy matter to assemble evidence of what those precautions are.[62] If such measures have not been followed, however, the would-be plaintiff needs to focus particularly carefully on whether it has a valid claim.

In assessing the risk of use and disclosure, the trade secrets owner should consider what it already knows, and also what it has publicly said, such as in securities filings, about the importance of its information and of the specific competitors the employee intends to join. The company's competitive intelligence team may have developed useful benchmarking information bearing on the issue of whether a specific competitor has a significant need for the information the employee knows or is technologically married to an alternative platform. If the competitor is a public company, its securities filings may reveal the recent success or failure of its own research and development efforts. So can its press releases.

This background fact-finding can be time-consuming, particularly if begun only in response to a specific departure. Companies operating in industries where employee mobility is common or can be particularly dangerous should regularly discuss the state of the industry and evaluate their internal safeguards with their counsel on an ongoing basis. Discussions should focus on preventing the loss of employees and on evaluating what information is particularly sensitive and likely to be most at risk if transferred to particular competitors. This institutional knowledge can be hard to develop on the fly in the face of a specific threat. Without it, ill-prepared trade secrets owners could wind up presenting "boiler plate" conclusory affidavits making off-point requests for relief—and thereby lose their request for injunctive relief.

Once a key employee has announced a move that appears to place trade secrets at risk, pre-litigation investigation increasingly includes conducting forensic exploration. Forensic investigation of company computers and other digital storage devices may reveal actions the employee has taken to access, copy, download, transfer or destroy company information prior to leaving. Further, assuming the company has established an e-mail policy permitting it to examine e-mails, a thorough forensic examination may also reveal how long the employee has been in discussions with the new employer, the nature of the new position, and efforts to recruit other employees or customers to the new employer.

Internal fact-finding will often yield enough evidence to file a solid motion seeking to obtain appropriately tailored injunctive relief. In many cases, however, it will not be likely to yield enough evidence, standing alone, to win more than temporary relief. Where there is no non-compete agreement, the court's focus will be on the details of why *this particular job* poses such a grave risk to the trade secrets at issue. Frequently that information can be learned only through formal discovery. After taking early steps to ensure that the defendant's or defendants' relevant evidence is properly preserved, the trade secrets owner will want to focus on learning:

- What is the employee's specific job? What specific kinds of decisions will the employee make or participate in making? What kinds of decisions will the employee be consulted on?
- What is the reporting structure?
- Are other former company employees part of the reporting structure (potentially increasing the risk)?
- How long has the interviewing process been going on?
- What information was exchanged as part of the interviews?[63]
- Did the employee download or transfer trade secrets during the period he or she was interviewing for the new job? Why? Has the employee used them? Where are they now? Is the new employer aware of—and did it direct—the data transfer?
- How has the job description evolved over the course of the interviews? Has it become more, or less, likely to jeopardize the trade secrets?
- What safeguards has the new employer installed to guard against disclosure of trade secrets?
- What financial incentives exist for the employee to use trade secrets?
- To what extent does the new employer need the trade secrets at issue?
- Does the new employer have a history of misappropriating competitors' trade secrets?
- If technical secrets are at issue, to what extent can the secrets be incorporated into the existing technology?
- Has the new employer tried, and failed, to achieve the results the employee knows how to achieve?
- If the secrets are customer-focused secrets, to what extent do the two companies already share customers? Are there in-process bids? Do they use the same channels of distribution?
- If the employee has already started work, what work has he or she already done?

7. A party seeking an activity injunction should tailor the requested relief to the provable threat.

A trade secrets owner seeking to enforce a non-compete agreement is typically required to show that the restraint is no broader than necessary to protect its legitimate interests.[64] *A fortiori*, one seeking an injunction in the absence of a restrictive covenant needs to tailor the relief sought so that it simply eliminates the threat of inevitable disclosure—not all competition.

While trade secrets owners frequently express the fear that if the employee is permitted to do "anything" for a competitor, trade secrets "could" be compromised, even, for example, during friendly conversations in the Company cafeteria, the inevitable disclosure doctrine is not a tool to prevent employees from having lunch with competitors. It is a scalpel-like device for preventing the employee from engaging in specific activities that will place the former employer's trade secrets at serious risk. Particularly where there is no non-compete agreement, an inevitable disclosure restraint may well leave the employee free to work for a diversified competitor, just not to perform particular activities for that competitor.[65] Thus, in *PepsiCo*, the court did not bar Redmond from performing all work for Quaker Oats, simply from "assuming any duties with Quaker relating to beverage pricing, marketing, and distribution" for one selling season (six months).[66]

Similarly, in *National Starch*, where 95% of the employee's intended work for the new employer did not involve the search for an adhesives formula which the employee had helped to develop and the new company was trying to replicate, the court enjoined the employee only from working on developing that particular type of adhesive formula, not from working for the competitor.[67]

However, in framing the request for relief, the trade secrets owner is not required to ignore the structure of the new organization or the potential value of the trade secret to multiple product applications.[68] If, for example, discovery reveals that a particular company conducts its business using a "team" approach, so that the head of the adhesives group, for example, typically engages in resource allocation meetings with the heads of other research projects, the head of human resources, and the head of finance, the requested relief would appropriately include a ban prohibiting the employee from participating in any meetings at which the off-limits project is discussed, not simply from performing the project itself. And if the trade secret is transferable across product lines, it may be appropriate to seek to restrict the employee from engaging in specified activities relating to any of the products for which the trade secrets fill a pressing need of the new employer.[69] But the courts are clear that injunctive relief should not be punitive, and that it should not usually prevent the employee from pursuing employment in the areas in which he or she has developed experience or general expertise that is not proprietary to the former employer.

In imposing activity restrictions, particularly where there is no restrictive covenant in place, some courts have conditioned the injunction on plaintiff's promise to compensate the employee during the period of the restriction.[70] Further, courts enforcing an activity restriction contained in a non-compete agreement have noted that the trade secrets owner's commitment to compensate the employee during the period of restraint reduces the harm that would otherwise be suffered by the employee.[71] While courts do not uniformly require such payment, in balancing the hardships they will likely consider whether the employee had been well-compensated by the former employer and whether the proposed restraint is sufficiently narrow that the employee will be able to secure alternate employment during the period of the restraint.[72]

8. New employers should not assume that they don't have to think about inevitable disclosure issues unless they are sued.

Inevitable disclosure issues should not be of interest only to employers who lose employees. Companies hiring a competitor's employees need to identify "high risk" hires during the interview phase. At that point they can still decide whether to hire the individual or not, and they can conveniently tailor the job to reduce the risk of actually misappropriating the former employers' trade secrets. Thinking about potential hazards only in the throes of a lawsuit (whether for injunctive relief or damages) is too late.

Two recent cases granting preliminary injunctions under an inevitable disclosure theory drive this point home. In *Verizon Communications v. Pizzirani*,[73] Comcast had already extended an offer to Pizzirani, a very senior Verizon executive, to serve as Vice President, Product Management, High-Speed Data, before it learned that he had a non-compete agreement. Pizzirani was highly knowledgeable about, and had even developed, many of the confidential marketing and product plans relating to Verizon's competing products. He was responsible for the pricing and deployment strategy for Verizon's products under development and had overseen Verizon's design and marketing of a new service and product that would expand the competition with Comcast. The two companies were each other's most significant competitors in the geographic market for which Pizzirani would have responsibility and were vying to become first in that market with new high-speed data product offerings.

While Comcast did not learn the full details of the activities in which Pizzirani had been involved for Verizon before hiring him, it did know in general terms the range of areas for which he had been responsible. In fact, based on prior discussions with him, Comcast had directly sought out Pizzirani for the proposed job in part because of this specific background.[74]

Once Comcast learned of Pizzirani's non-compete agreement, it restructured the proposed job to offer him a position as Vice President in an executive training program it created specifically for him. In that position, as in the position he had initially been offered, he was to report to Comcast's Senior Vice President having responsibility for high-speed data products, a Mr. Bowling. In the "restructured position," Bowling was to serve as Pizzirani's supervisor, "mentor," and "point of contact" for an "independent research project" that is not fully described in the decision and that may not have been fully detailed before the court. Pizzirani's compensation for participating in this training program would be the same as that proposed for the position as Vice President, Project Management.

The court found Comcast's efforts to circumvent the non-compete agreement unavailing because they would not sufficiently "insulate" Pizzirani from the very areas in which he was most likely to disclose trade secrets. The court determined:

> It would strain credulity to the breaking point to conclude that in his extensive contact with Mr. Bowling, Mr. Bowling's responsibilities for broadband will not come into discussion, and that Defendant will not consciously or unconsciously share or draw on insights gained from his work as a senior executive at Verizon.[75]

The court discounted Comcast's statements that it did not want Pizzirani to disclose trade secrets, in part precisely *because* Comcast had made the choice to assign Mr. Bowling the role of mentor. That decision indicated to the court that Comcast was placing Pizzirani in harm's way, not removing him from a risk of use or disclosure. The court therefore enforced Pizzirani's non-competition agreement, which prohibited him from engaging in activities relating to products or services for which he had had responsibility in the prior two years at Verizon.

Would the outcome on the request for an injunction have been different if Pizzirani had not had a non-compete agreement? Perhaps, depending on the jurisdiction and on the details of the disclosures that Pizzirani was found to have already made.

But from the new employer's standpoint, warning bells should have gone off—and measures to protect against receiving Verizon's trade secrets should have been established—regardless of whether Pizzirani had a non-compete agreement. In either case, he had intimate knowledge of the very information about Verizon that would have helped Comcast best anticipate its major competitor's moves. To protect not only Verizon but itself, the new employer would have been well-advised to install *and document* specific guidelines *before* hiring Pizzirani to ensure that Pizzirani would be removed from activities that would place that information at serious risk. And if the thrust of the proposed job was, in fact, to determine how best to defeat plans Pizzirani had helped to formulate for Verizon, the new employer might appropriately have considered whether placing Pizzirani in that specific job at that particular time did not in fact place Comcast at an unacceptable risk of learning Verizon's trade secrets. It may be that regardless of whether or not Pizzirani had a non-compete agreement, the job presented was simply a job that he could not do at that particular time. Other positions might well have been available to take advantage of Pizzirani's skills and industry knowledge but not Verizon's trade secrets.

Certainly, the new employer's *ad hoc*, after-the-fact attention to the potential risk contributed to the court's conclusion that Verizon's trade secrets would not be safe in the specific job. Similarly, in *Quaker Chemical Corp. v. Varga*,[76] the court derided the new employer's post-litigation restructuring of the employee's job to avoid claims that Varga, global technical manager for steel at his prior employer, was in violation of his non-compete agreement. Noting that the modified job description was almost a "tacit admission" that the first job offer violated the agreement, the court went on to say that: "There may be *some* job for Varga at Stuart that would not violate the non-compete covenant but Varga and Stuart are entitled to only one bite at the apple. They cannot keep offering different positions until they stumble upon one that falls outside the covenant."[77]

The court further noted that under the proposed "work-around" (in which Varga would direct market development for the aluminium division as opposed to the metals division, which included both steel and aluminium), it was unclear whether there would be a director of market development for the steel division, the job for which Varga had initially been hired. This raised the spectre that Varga would wind up filling that void. Finding that Varga had extensive knowledge of his former employer's trade secrets and customers, and finding that at least some of this information and goodwill would be directly applicable to the aluminium business as well as to the steel business, the court rejected the "after thought" solution as an inadequate safeguard.

These decisions show that the hiring company should consider how to build in and clearly document safeguards against trade secrets use and disclosure before employment begins—or determine, before offering the employee a position, that work-arounds do not make business sense. Thinking too late about protecting trade secrets is one way to encourage the court to impose its own restructuring in the form of an injunction order.[78]

9. Employers involved in national businesses may need to think beyond state lines. In particular, California employers should not assume that they do not have to think about non-compete agreements or inevitable disclosure issues.

"Act local, but think global" is increasingly good advice for employers evaluating "mobile trade secrets" issues.

Those dealing with departing employee issues in California, for example, sometimes too quickly find bright-line conclusions in California Business and Professions Code 16600, which states that, except as otherwise provided in the chapter, "every contract by which anyone is restrained from engaging in a lawful profession, trade, or business of any kind is to that extent void." This provision is routinely used by California courts to strike most non-compete agreements in the employment context (as opposed to the sale-of-business context).

However, 16600 does not mean that those involved in job changes involving California employees can set aside all concerns about the potential risk particular jobs can pose to trade secrets. First, California, like all other states, prohibits the misappropriation of trade secrets. If a particular job in fact leads to the misappropriation of trade secrets, the employee, and potentially the new employer as well, will be liable in damages for misappropriation.[79] Regardless of any concerns over whether an injunction will be entered preventing particular employment, prudence thus dictates analyzing sensitive job changes to make an honest assessment of how to reduce the risk that trade secrets will actually be disclosed.

Second, the California Supreme Court has recently left undisturbed prior decisions finding a "trade secrets" exception to 16600 and holding that contractual restraints on trade may be enforceable where they are necessary to protect against the misappropriation of trade secrets.[80]

Further, in an increasingly national and international economy, the fact that an employee resides in California—or in any other state, for that matter—does not mean that he or she may not also be closely connected through employment with other jurisdictions that do enforce non-compete agreements and that do use inevitable disclosure concerns as a basis for enforcing them. Thus, in *Estée Lauder Companies, Inc. v. Batra*,[81] a New York federal court considered a non-compete agreement between a New York employer and a California employee who had worked for the prior employer while residing in California and who intended to work for a competitor in California. The court enforced the agreement's New York choice-of-law provision because, while the policies of California and New York regarding employee mobility were undeniably different, the employee had reported to New York in his work for Estée Lauder, a significant portion of his responsibilities were centered in New York, he had supervised New York employees, he had learned trade secrets in New York that belonged to a New York company, and his use or disclosure of those trade secrets in California or elsewhere would injure plaintiff in New York. In a conclusion that should be carefully reviewed by all employers relying on a multi-jurisdictional workforce, the court stated, "The fact that Batra literally carried out many of his duties from California does not overcome the fact that the work itself was the management of a New York-based brand with predominantly New York-based employees."[82]

The court then assessed the risk of use or disclosure, noting that while Estée Lauder had not demonstrated that to date there had been actual misappropriation of its trade secrets, it need not do so to enforce the covenant under New York law. Rather, because the employee was bound to a non-compete agreement, "Estée Lauder simply need establish that there is a risk of inevitable disclosure."[83] The court found that Estée Lauder had made this showing by demonstrating that Batra had been responsible for, or intimately involved in, developing the brand strategies for two brands that competed with his new employer's products. He knew marketing plans and was knowledgeable about confidential products under development and scheduled innovations.

While Batra contended that he "really doesn't care" about his former employer's trade secrets and his new employer said it did not want them, the court found that Batra "no longer feels allegiance to his former employer" and that even while still employed by Estée Lauder he had engaged in activities for his new employer in breach of his duty of loyalty. Further, upon his departure from Estée Lauder, Batra had misled his former employer into thinking he was interested in remaining with that company so that he could buy time to file a declaratory judgment action in California seeking to hold the agreement unenforceable. The court concluded that under the circumstances Estée Lauder should not be required to rely on Batra's characterization of the usefulness of the information he obtained while employed there. Batra's prior lack of trustworthiness also gave reason for the court to discount Batra's stipulation that he would have no involvement in product development for a short period of time at his new employer. Accordingly, the court entered an injunction enforcing the agreement, while reducing its duration to be consistent with agreements Estée Lauder had reached with other departing employees who had held similar positions while at Estée Lauder.

The *Batra* litigation illustrates that in evaluating the risks surrounding a particular hire and the likelihood of injunctive relief, one may need to consider the approaches of several jurisdictions in arriving at an accurate assessment of the legal risk.[84] Framing a litigation strategy when multiple jurisdictions may have an interest in reviewing the risk a particular job poses to trade secrets is a complex issue going beyond the scope of this article. It is vital to note, however, that parties considering potential "dueling courthouse" litigation should have a strategic plan well in mind from the outset in order to move swiftly toward securing an early ruling in the preferred jurisdiction. One procedural misstep can doom the overall strategy. Where the choice of forum may have a major impact on the outcome of any litigation, it makes sense to explore these issues with national counsel before extending an employment offer.

Finally, as discussed below, while those contemplating employee moves in California may take some comfort in California's resounding rejection of the "inevitable disclosure doctrine,"[85] California, like the other 46 U.S. jurisdictions that have adopted the Uniform Trade Secrets Act, prohibits the "threatened" misappropriation of trade secrets and will enter injunctive relief to prevent it.

10. Regardless of where the employee will work and whether there is a non-compete agreement, new employers and mobile employees must detect and guard against the "threatened misappropriation" of trade secrets.

Hiring an employee who is steeped in a competitor's trade secrets always poses some threat that the employee will wind up using or disclosing trade secrets. As described throughout this article, one question the employee and the new employer should consider early on is how large that threat is, and what can be done to reduce it.

The employee, the new employer, and the trade secrets owner will also want to consider whether the particular "threat" of disclosure is so great that a court is likely to grant an activity injunction to reduce the threat.

While all states will grant injunctions to prevent "threatened" disclosure of trade secrets, they do not agree on how significant the threat must be before an injunction will be granted. Commentators[86] and some courts have discussed at length the differences between "inevitable" disclosure and "threatened" disclosure, reaching inconsistent conclusions.

California has emphasized that "the inevitable disclosure doctrine cannot be used as a substitute for proving actual or threatened misappropriation of trade secrets."[87] Conversely, while observing that "the inevitable disclosure doctrine appears to be aimed at preventing disclosures despite the employee's best intentions, and the threatened disclosure doctrine appears to be aimed at preventing disclosures based on the employee's intentions," Iowa courts have concluded, consistent with the *PepsiCo* decision, that, actually, "the inevitable disclosure doctrine . . . is just one way of showing a threatened disclosure."[88]

Florida has held that "threatened disclosure" requires proof of "inevitability-plus."[89] North Carolina has arguably gone further, stating that to win a broad activity injunction, "threatened disclosure" probably requires a showing of "bad faith or underhanded dealing, and may require employment with a competitor that lacked comparable levels of knowledge and achievement."[90]

Still other courts have not discussed the nuances of "threatened" vs. "inevitable" disclosure but have found "threatened misappropriation" where the employee had a detailed and comprehensive knowledge of specific and valuable trade secrets and began employment with a competitor in a position substantially similar to the position held during the prior employment[91]—the same findings that have led to "inevitable disclosure" injunctions in other jurisdictions.

Jurisdictional differences in approaching the issue are something that trade secrets owners will want to assess carefully if they consider bringing suit. Despite the differences, however, there is also considerable uniformity on two critical points: First, virtually no court will issue a significant activity restraint based on conclusory speculation and no proof. But, second, virtually no court will require a former employer to simply stand by and wait for its trade secrets to be misappropriated if that court finds solid evidence that, without an injunction, disclosure will in fact occur.

In *Central Valley General Hospital v. Smith*,[92] one of California's Courts of Appeal found that under California law, "winning an injunction based on a claim of threatened misappropriation requires a greater showing than mere possession by a defendant of trade secrets where the defendant acquired the trade secret by proper means."[93] After finding that plaintiff had failed to make this showing in the case before it, the court then suggested *in dicta* a number of ways that a former employer might establish a claim of threatened disclosure sufficient to warrant an activity restriction. These suggestions have already found and are likely to find future acceptance in other jurisdictions:

1. trade secrets remain in the possession of a defendant who has actually misused or disclosed some of those trade secrets in the past;[94]
2. trade secrets are held by a defendant who intends to improperly use or disclose some of the trade secrets, as evidenced by defendant's testimony about how he intends to go about doing his new job;[95] or
3. defendant possesses trade secrets and wrongfully refuses to return them after a demand for their return has been made.

The list might be expanded to include situations in which a disgruntled former employee has literally threatened to use the former employer's secrets and situations in which the evidence shows that the new employer hired the employee specifically to obtain the prior employer's trade secrets.[96]

Whether this latter showing could be made by asking the court to make reasonable inferences based upon evidence depends on how strong the evidence is, how reasonable the requested inference, and, ultimately, how willing that specific court is to make the needed inference. Case law from the specific forum (or judge) considering the issue can provide valuable clues to answering that question, and may suggest appropriate ways to present the evidence.

But the hiring employer is not generally principally concerned with debating legal theory, except as a short-term matter. It has a business to run. As a business matter, it needs to focus on evaluating the realistic extent of any threat a particular hire genuinely poses to the former employer's trade secrets—whether or not an injunction is granted. Hiring employers should take clear note that, regardless of whether an injunction is entered to restrain particular employment activities, "an employer may be liable for misappropriation of trade secrets for hiring a competitor's employee and placing him in a position where inevitable disclosure occurs."[97] Further, if an employee begins work for a new employer and actually uses the former employer's trade secrets, that "contribution" may well taint the new employer's work product and cause the work to have to be redone at the loss of substantial time and at considerable expense.[98]

Conclusion

Winning an activity-based injunction to protect trade secrets under the inevitable disclosure theory, the threatened disclosure statutes, or non-compete agreements is difficult. It requires a clear showing that without injunctive relief, specific trade secrets are at serious risk of use and disclosure. But inevitable disclosure issues should not be the concern only of employers seeking injunctions. By carefully thinking through sensitive employee moves to focus on what "could" happen to put secrets at risk, former employers, new employers, and mobile employees can help ensure that it won't.

Endnotes

1. *See, e.g., Harrison v. Glucose Sugar Refining Co.*, 116 F. 304 (7th Cir. 1902); *Eastman Kodak Co. v. Powers Film Prods., Inc.*, 189 A.D. 556, 561-62, 179 N.Y.S. 325, 330 (4th Dep't 1919).
2. *PepsiCo v. Redmond*, 54 F.3d 1262 (7th Cir. 1995).
3. *See, e.g., Whyte v. Schlage Lock Co.*, 125 Cal. Rptr. 2d 277 (4th Dist. 2002).
4. *Id.* (stating that "the inevitable disclosure doctrine cannot be used as a substitute for proving actual or threatened misappropriation"); *Cent. Valley Hosp. v. Smith*, 75 Cal. Rptr.3d 771, 791-792 (2008) (outlining how a trade secrets owner might go about establishing a claim of "threatened misappropriation").
5. The states that have not adopted the Uniform Trade Secrets Act, New York, New Jersey, Massachusetts and Texas, have each recognized, although not uniformly applied, the inevitable disclosure doctrine.

6. *Compare, e.g., Doubleclick Inc. v. Henderson*, No. 116914/97, 1997 WL 731413 (N.Y. Sup. Nov. 7, 1997) (granting inevitable disclosure injunction) *with U.S. Re Cos., Inc. v. Scheerer*, 41 A.D.3d 152, 155, 838 N.Y.S.2d 37, 39-40 (1st Dep't 2007) (denying inevitable disclosure injunction absent concrete evidence that employee had actually breached a confidentiality agreement) *and Marietta Corp. v. Fairhurst*, 301 A.D.2d 734, 736, 754 N.Y.S.2d 62, 65 (3d Dep't 2003) (denying inevitable disclosure injunction where there was "absolutely no evidence" of actual use or disclosure of trade secrets and agreement had contemplated that employee might compete); *Nat'l Starch and Chemical Corp. v. Parker Chemical Corp.*, 530 A.2d 31, 219 N.J. Super. 158 (N.J. Super.Ct. 1987) (granting inevitable disclosure injunction), *with Fluoramics, Inc. v. Trueba*, No. BER-C-408-05, 2005 WL 3455185 (N.J. Super. Ct. Dec. 16, 2005) (denying inevitable disclosure injunction where plaintiff had not sufficiently established that its information constituted a trade secret and thus had not demonstrated a threat of immediate and irreparable harm); *Dexxon Digital Storage, Inc. v. Haenszel*, 161 Ohio App. 3d 747, 832 N.E. 2d 62 (Ohio Ct. App. 2005), *app. not accepted*, 107 Ohio St. 3d 1682, 839 N.E. 2d 403 (2005) (granting inevitable disclosure activity injunction to enforce non-compete agreement) *with Aero Fulfillment Servs. Inc. v. Tartar*, No. C-060071, 2007 WL 120695 (Ohio App. 1 Dist. Jan. 19, 2007) (denying injunction to enforce non-compete where plaintiff "did nothing more than make unsubstantiated allegations that it would suffer incalculable or irreparable harm absent injunctive relief") *and Jacono v. Invacare Corp.*, No. 86605, 2006 WL 832451, *7 (Ohio Ct. App Mar. 30, 2006) (unpublished decision) (denying activity injunction to enforce non-compete where employee was not shown to know trade secrets); *and Pepsico v. Redmond* (granting inevitable disclosure injunction) *with Dulisse v. Park Int'l Corp.*, No. 97C8018, 1998 WL 25158 (N.D. Ill. Jan. 9, 1998) (enjoining sale of products incorporating trade secrets but denying injunction against ongoing employment of employee who may already have disclosed trade secrets).

7. Some cases have granted activity injunctions under inevitable disclosure doctrine reasoning without mentioning the phrase or citing the *Redmond* decision. *See, e.g., Essex Group, Inc. v. Southwire Co.*, 269 Ga. 553, 501 S.E.2d 501 (1998) (enjoining employee who had no non-compete agreement from developing software to perform similar functions or from working in new employer's logistics development for the lesser of five years or the time it took new employer to independently develop its own system, as confirmed by an independent monitor; court found that otherwise, new employer would, through the simple act of hiring employee, acquire information it had taken prior employer millions of dollars and years to develop); *Global Telesystems, Inc. v. KPNQWEST*, 151 F. Supp. 2d 478, 482 (S.D.N.Y. 2001) (granting injunction requiring employee who had been hired in violation of business-to-business non-hire provision not to work for competitor; employee did not have non-competition agreement, but court found that if employee took the job, "it is unclear to me how disclosures, even inadvertent, can be prevented"). *See also Avery Dennison Corp. v. Finkle*, No. CV010757706, 2002 WL 241284 (Conn. Super. Feb. 1, 2002) (unpublished decision) (granting injunction restraining employee from continuing employment with a specific competitor in any capacity dealing with the manufacture, product development, or engineering of writing instruments where "however well intentioned the defendants may be, it seems virtually impossible for [plaintiff's trade secrets] to not affect the employment relationship of Donald Finkle while in the employ of Bic"; decision relied on threatened misappropriation theory and did not mention either inevitable disclosure or the *PepsiCo* decision).

8. For example, in *Degussa Admixtures, Inc. v. Burnett*, Nos. 07-1302, 07-1498, 2008 WL 1960861 (6th Cir. May 5, 2008), the court imposed sanctions on a plaintiff that persisted in asserting a pure inevitable disclosure claim without identifying any specific secrets it claimed to be at inevitable risk. The court observed that "Michigan has not endorsed that theory," while recognizing that in other circumstances Michigan may recognize the doctrine. *Degussa*, *4. *Cf., Allis-Chalmers Mfg. Co. v. Cont'l Aviation & Eng. Corp.*, 255 F. Supp. 645 (E.D. Mich. 1966) (an early case granting an inevitable disclosure activity injunction in the absence of a non-compete agreement where an engineer who had been intimately involved in developing a fuel injection pump for his former employer went to work in a similar position for a new employer that had been unable to develop a similar pump despite extensive experimentation and effort to do so; court granted an activity restraint because "[t]he virtual impossibility of [the employee's] performing all of his prospective duties . . . to the best of his ability, without in effect giving [new employer] the benefit of Allis-Chalmer's confidential information, makes a simple injunction against disclosure and use of this information inadequate").

9. *Cf., e.g., Whyte v. Schlage Lock*, stating "[l]est there be any doubt about our holding, our rejection of the inevitable disclosure doctrine is absolute" *and ElectroOptical Industries, Inc. v. White*, 90 Cal. Rptr. 2d 680, 684 (Cal. App. 1999) (depublished), which had previously pronounced that the inevitable disclosure doctrine "is rooted in common sense and calls for a fact specific inquiry. We adopt the rule here." (Note, however, that in *Electro Optical* the Court found that inevitable disclosure had not been proved.) The disparity underscores both courts' recognition of the fact that particular activities can place trade secrets at grave risk and both courts' grappling with how that risk should be best assessed and remedied.

10. A useful state-by-state guide may be found in Randall Kahnke, Kerry Bundy, Kenneth Liebman, Doctrine of Inevitable Disclosure White Paper, *available at* http://www.ipo.org, Committee on Trade Secrets, *and at* http://www.faegre.com; Brandy L. Treadway, *An Overview of Individual States' Application of Inevitable Disclosure: Concrete Doctrine or Equitable Tool?*, 55 SMU L. Rev. 621, 635 (Spring 2002); *Whyte v. Schlage Lock*, 101 Cal. App. at 1460-1463.

11. *See, e.g., Del Monte Fresh Produce Co. v. Dole Food Co., Inc.*, 148 F. Supp. 2d 1326, 1337 (S.D. Fla. 2001) ("[A] court should not allow a plaintiff to use inevitable disclosure as an after-the-fact non-compete agreement to enjoin an employee from working for the employer of his or her choice"); *Whyte v. Schlage Lock*, 101 Cal. App. at 1462 (noting that "the covenant is imposed *after* the employment contract is made and therefore alters the employment relationship without the employee's consent"); *LeJeune v. Coin Acceptors, Inc.*, 849 A.2d 451, 381 Md. 288 (Md. 2004); *Merck & Co., Inc. v. Lyon*, 941 F. Supp. 1443, 1462 (M.D.N.C. 1996) ("a long-standing public policy against noncompete agreements exists in the law, which favors rejection of the [inevitable disclosure] doctrine because it creates an after-the-fact covenant not to compete.").

12. *See, e.g., Analog Devices, Inc. v. Michalski*, 157 N.C. App. 462, 471, 579 S.E.2d 449 (2003) (denying injunction under inevitable disclosure theory and noting, "[w]hile Analog might have prevented Michalski and Karnik from working in the field of HSHR ADC design and development in the event they ceased working for Analog by making a non-compete clause part of their employment contract, no such clause has been presented"); *Interbake Foods L.L.C. v. Tomasiello*, 461 F. Supp. 2d 943, 977 (N.D. Iowa 2006) (stating that plaintiff, the industry leader, "is asking the court to overlook its total failure to have in . . . place a reasonable, narrowly-tailored covenant not to compete. . . . Due to this rather large oversight on the part of Interbake, any harm that stands to be suffered by the plaintiff in this aspect is self-inflicted"); *Merck v. Lyon*, 941 F. Supp. at 1461 ("This failure on [the] plaintiffs' part may also serve as an indication that the type of confidential information which Lyon possesses has a limited . . . value.").

13. *See, e.g., Aetna, Inc. v. Fluegel*, No. CV074033345S, 2008 WL 544504 (Conn. Super. Feb. 7, 2008) (unpublished), *motion to continue temporary injunction denied*, 2008 WL 803168 (Conn. Super. March 5, 2008) (unpublished).

14. *See, e.g., Dorel Juvenile Group, Inc. v. DiMartinis*, 495 F.3d 500 (7th Cir. 2007).

15. *Earthweb v. Schlack*, 71 F. Supp. 2d 299, 310 (S.D.N.Y. 1999), *remanded by* 205 F. 3d 1322, *appeal after remand* at No. 99-9302, 2000 U.S. App. LEXIS 11446, 2000 WL 1093320 (2d Cir. May 18, 2000).

16. *Orthovita, Inc. v. Erbe*, No. 07-2395, 2008 WL 423446 (E.D.Pa. Feb. 14, 2008) (denying motion to dismiss inevitable disclosure claim where plaintiff alleged that while employed by plaintiff, employee had copied company files onto 13 flash drives, deleted more than 5,500 files from his company laptop, and revealed confidential information to potential investors and to a direct competitor).

17. In many jurisdictions, non-compete agreements may be enforceable to protect customer goodwill, as well as or instead of trade secrets. This article does not address arguments that activity restrictions are necessary to protect customer goodwill as distinguished from trade secrets used in serving the customers.

18. *See, e.g., Payment Alliance Int'l. v. Ferreira*, 530 F. Supp.2d 477, 480 (S.D.N.Y. 2007) ("[w]hile irreparable harm is presumed where a trade secret has been misappropriated, evidence of misappropriation is not a prerequisite to a finding of irreparable harm"); *Estée Lauder Cos. Inc. v. Batra*, 430 F. Supp.2d 158, 179 (S.D.N.Y. 2006); *LaCalhène, Inc. v. Spolyar*, 938 F. Supp. 523, 530-31 (W.D. Wisc. 1996).

19. *See, e.g., Payment Alliance v. Ferreira*, 530 F. Supp. 2d. at 481 ("a number of recent decisions, principally applying . . . New York law, have used proof of inevitable disclosure as a basis for enforcing restrictive covenants"); *G&K Services, Inc. v. Ambler*, No. 07-601, 2007 WL 712290 (E.D. Pa. March 6, 2007) (granting injunction to enforce restrictive covenant under Minnesota law where "the nature and character of his job as General Manager [of the plant] will inevitably require him to draw upon his experience and knowledge gained while a high level employee" with plaintiff); *Verizon Communications, Inc., v. Pizzirani*, 462 F. Supp. 2d 648, 658 (E.D. Pa. 2006) ("plaintiff may . . . [establish] irreparable harm by establishing that trade secrets will be inevitably disclosed"); *Estée Lauder v. Batra*, 430 F. Supp. 2d at 179 (plaintiff "simply need establish that there is a risk of inevitable disclosure"); *Lumex, Inc. v. Highsmith*, 919 F. Supp. 624, 628 (E.D.N.Y. 1996) (same); *LaCalhène v. Spolyar*, 938 F. Supp. at 531 (enforcing non-compete agreement to protect engineering, strategic and marketing plans where "it is all but inevitable that he will utilize that knowledge" during his work with a competitor); *Marcam Corp. v. Orchard*, 885 F. Supp. 294, 297 (D. Mass. 1995) (enforcing non-compete agreement where "[i]t is difficult to conceive how all of the information stored in Orchard's memory can be set aside . . . On the contrary, what Orchard knows about Marcam is bound to influence what he does for [his new employer]"); *Bard v. Intoccia*, No. 94-11568-Z, 1994 WL 601944 (D. Mass. Oct. 13, 1994) (enforcing non-compete agreement where "in serving his new employer [employee] will inevitably draw upon" his detailed knowledge of all phases of prior employer's development and marketing strategy). *Cf., CertainTeed Corp. v. Williams*, 481 F.3d 528 (7th Cir. 2007) (reversing denial of preliminary injunction to enforce non-compete agreement where new position is one in which employee would be "tempted" to use former employer's information and remanding for determination of whether any transgression could be detected if the employee yielded to temptation).

20. *See, e.g., Spinal Dimensions, Inc. v. Chepenuk*, 16 Misc. 3d 1121 (A), 847 N.Y.S.2d 905 (Sup. Ct., Albany Co. 2007); *Cf. Superior Consultant Co., Inc. v. Bailey*, No. 00-CV-73439, 2000 WL 1279161 (E.D. Mich. Aug. 22, 2000) (assessing question of whether to grant an injunction enforcing non-compete and non-solicitation provisions by determining whether plaintiff had established a substantial likelihood of "threatened disclosure" in the absence of an injunction).

21. *See, e.g. Spinal Dimensions* (enforcing a customer non-solicitation agreement but refusing to enforce a non-compete agreement where plaintiff had not established that a non-compete restriction was needed to prevent the inevitable disclosure of trade secrets); *Superior Consultant Company v. Bailey*,*12 (enforcing customer non-solicitation provisions and equitably extending period of restraint but refusing to enforce non-compete, as there had not been a showing that without an injunction Bailey would inevitably rely on Superior's trade secrets).

22. *Degussa Admixtures, Inc. v. Burnett*, Nos. 07-1302, 07-1498, 2008 WL 1960861 (6th Cir. May 5, 2008) at *1, awarding attorneys fees to defendant where Degussa "failed to allege with any specificity the confidential information that Burnett possesses" because "general allegations of impropriety do not demonstrate that, absent an injunction, Degussa will suffer irreparable harm." *See also, Dura Global Technologies, Inc. v. Magna Donnelly, Corp.*, No. 07-cv-10945, 2007 WL 4303294 (E.D. Mich. Dec. 6, 2007); *Aero Fulfillment Servs. v. Tartar*, No. C-060071, 2007 WL 120695 (Ohio App. 1 Dist. Jan. 19, 2007) (denying injunction to enforce non-compete where plaintiff "failed to identify any specific trade secrets or confidential information that [employee] had misappropriated or could have even used to [plaintiff's] detriment").

23. *Analog Devices, Inc. v. Michalski*, 157 N.C. App. 462, 468 579 S.E. 2d 449, 454 (2003) (citing case).

24. *Dura Global Technologies* at *2, *quoting Automated Techs., Inc. v. Eller*, 160 F. Supp. 2d 915, 925 (N.D. Ill. 2001). This requirement is imposed by statute in California, Cal. Code. Civ. Proc. 2019.210, and is increasingly recognized to be the law throughout the United States. *See, e.g., L-3 Comm. Corp. v. Reveal Imaging Tech. Inc.*, No. 0358100 BLS, 2004 WL 2915743 at *13 (Mass. Sup. Ct. Dec. 2, 2004) (unpublished order); *Engelhard Corp. v. Savin Corp.*, 505 A.2d 30, 33, 12 Del. J. Corp. L. 249, 254 (Del. Ch. 1986); *Zila Swab Techs., Inc. v. Van Dyke*, No. OI C 8729, 2002 WL 31028720 (N.D. Ill. Aug. 7, 2002); *Porous Media Corp. v. Midland Brake Inc.*, 187 F.R.D. 598, 600 (D. Minn. 1999). *See* V. A. Cundiff, "*How to Identify Your Trade Secrets in Litigation*," 574 PLI/Pat 557 (1999).

25. *See, e.g., Boston Laser, Inc. v. Zu*, No. 3:07-CV-0791 (TJM/DEP), 2007 WL 2973663 (N.D.N.Y. Sept. 21, 2007) (denying injunction to enforce non-compete agreement where BLI "has failed to articulate with any degree of specificity the confidential, proprietary trade secret information to which Zu purportedly was exposed during his employment there, other than in purely conclusory terms"); *Fluoramics, Inc. v. Trueba*, No. BER-C-408-05, 2005 WL 3455185 (N.J. Ch. Div. Dec. 16, 2005) (denying inevitable disclosure injunction where plaintiff did not "sufficiently establish that its product formulas and manufacturing processes constitute trade secrets").

26. *Degussa*, *5.

27. No. CVO 74033345S, 2008 WL 544504 *5 (Conn. Super. Feb. 7, 2008) (unpublished) (emphasis added), *motion to continue temporary injunction denied*, 2008 WL 803168 (Conn. Super. March 5, 2008) (unpublished).

28. Note, however, that as discussed below, Aetna nonetheless did not prevail on its inevitable disclosure claim because it did not establish that the new employer had a need for these secrets. Properly identifying trade secrets is always necessary to win, but is not always sufficient.

29. *Boston Laser*, *10.

30. *Clearwater Systems Corp. v. Evapco, Inc.*, No. Civ. A. 305CV507SRU, 2006 WL 726684 (D. Conn. Mar. 20, 2006) (denying request for inevitable disclosure injunction). *See also FSI Int'l Inc. v. Shumway*, No. 02-402, U.S. Dist. LEXIS 33 88 at *29 (D. Minn. Feb. 26, 2002) (denying injunction because plaintiff's description of categories of information alleged to be at risk was too broad).

31. *Dura Global Technologies* at *4 (stating that "it is not Defendant's burden to review over 8500 sheets of paper, among the other information provided, to discern which material constitutes Plaintiffs' trade secrets").

32. 54 F.2d at 1269.

33. *See, e.g., Analog Devices v. Michalski*, 157 N.C. App. at 472; *Travenol Labs., Inc. v. Turner*, 30 N.C. App. 686, 696, 288 S.E.2d 478, 485-86 (1975); *Continental Group, Inc. v. Amoco Chem. Corp.*, 614 F.2d 351, 359 (3d. Cir. 1980); *United Products Corp. v. Cederstrom*, No. A05-1688, 2006 WL 1529478, *4 (Minn. App. June 6, 2006); *Standard Brands, Inc. v. Zumpe*, 264 F. Supp. at 267–68, all denying injunctive relief under inevitable disclosure theory.

34. *Id.; see also, Dearborn v. Everett Prescott, Inc.*, 486 F. Supp. 2d 802 (S.D. Ind. 2007) (denying injunction where the "theory here is that Dearborn must surely remember valuable information . . . [but] under plaintiff's theory . . . no sales representative would ever be able to leave one competitor to join another because he would inevitably use valuable proprietary information to compete for business" and finding that while employee had learned a great deal of *general* knowledge about the industry, he was not shown to have acted in bad faith or to have intended to misappropriate trade secrets); *Aero Fulfillment Servs. v. Tartar*, *4 (denying injunction to enforce non-compete where plaintiff offered only unsubstantiated allegations that otherwise disclosure would be inevitable); *CSC Consulting, Inc. v. Arnold*, No. 001800, 2001 WL 1174183, *3 (Mass. Super. July 12, 2001) (denying injunction where former employer did not "set forth sufficient facts to show that Arnold has gone beyond her right to use her general knowledge, skill, experience, and memory"); *FMC Corp. v. Cyprus Foote Mineral Co.*, 899 F. Supp. 1477, 1482-83 (W.D. N.C. 1995). *See also Extracorporeal Alliance*, 285 F. Supp. 2d 1028, 1042 ("it is not enough [for the trade secrets owner] to simply state that [defendant's] use of this information is inevitable. [Plaintiff] has the burden to establish misappropriation has actually occurred or is threatened"). It should be noted that some courts have been willing to find that where there is a non-compete agreement, a showing that the two companies compete directly and that the employee has in-depth knowledge of highly confidential information may establish that disclosure of trade secrets is "likely, if not inevitable and inadvertent." S*ee, e.g., Bus. Intelligence Servs., Inc. v. Hudson*, 580 F. Supp. 1068, 1073 (S.D.N.Y 1984); *Estée Lauder v. Batra*, 430 F. Supp. 2d at 174; *Lumex v. Highsmith*, 919 F. Supp. at 634; *Verizon v. Pizzirani*, 462 F. Supp. 2d at 658; *see also* cases cited at n. 91. Significantly, however, in each of the cited cases, the trade secrets owner went beyond bare-bones allegations and presented evidence that the trade secrets at issue were particularly valuable to the specific competitor at that specific point in time.

35. While prevailing on an inevitable disclosure claim has always required detailed proof, a number of recent decisions have also discussed the need to come forward with specific factual allegations in light of the United States Supreme Court's holding in *Bell Atlantic Corp. v. Twombly*, __U.S.__, 127 S.Ct. 1955, 1965, 167 L.E.2d 929 (2007) (holding that to withstand a motion to dismiss, "[f]actual allegations must be enough to raise a right to relief above the speculative level, . . . on the assumption that all the allegations in the complaint are true (even if doubtful in fact)." *See Osteotech, Inc. v. Biologic, LLC*, No. 07-1296 (JAP), 2008 WL 686318, at *5 (D.N.J. Mar. 7, 2008) (denying motion to dismiss where in addition to alleging that defendants had placed "themselves in positions in which they inevitably must use and disclose such trade secrets," plaintiffs alleged facts "supporting an indication" that defendants had actually used misappropriated trade secrets); *Orthovita v. Erbe,* at *9-10 (expressing uncertainty as to whether *Twombly* applies to trade secrets cases but finding that complaint adequately alleged that some disclosure of trade secrets had already occurred).

36. *See, e.g., Verizon v. Pizzirani*, 462 F. Supp. 2d at 658-659; *Payment Alliance*, 530 F. Supp.2d at 481-482; *Avery Dennison v. Finkle*, at *2 (note that the court used the term "threatened disclosure" in describing the risk).

37. *See*, *e.g.*, *Payment Alliance v. Ferreira* (employee was knowledgeable about the development and overall design of the secret software application even though he had not designed it at the technical level); *Estée Lauder v. Batra*, 430 F. Supp. 2d at 175 ("The fact that Batra was not the scientist behind the formulas . . . bears not on whether or not Estée Lauder has carried its burden" given the pervasive nature of his knowledge of marketing and product plans.).

38. *See, e.g., National Starch*, 530 A.2d at 161; *Business Intelligence*, 580 F. Supp. at 1072; *Barilla America, Inc. v. Wright*, No. 4-02-CV-90267, 2002 U.S. Dist. LEXIS 12773 (S.D. Iowa July 5, 2002) ("The way this Court interprets the inevitable disclosure doctrine, an employer must prove . . . that [the employee] would be able to remember the trade secret information in a usable form"; note, however, that the court entered an injunction based primarily on the employee's removal of trade secrets in physical form and his credibility and intent). B*ut see Emery Industries, Inc. v. Cottier*, No. C-1-78-474, 1978 WL 21419, at *1, 202 U.S.P.Q. 829.833 (S.D. Ohio Aug. 18, 1978) (granting inevitable disclosure injunction where finding "[i]t could not be claimed that the detail of the proprietary material could be or is carried around by the defendant in his head. It is not. The generality of it is, and the generality is usable for conclusory purposes").

39. *See, e.g., Verizon Commc'ns, Inc. v. Pizzirani*, 402 F. Supp. 2d at 650 (granting injunction enforcing non-compete agreement where former and new employer were each other's most significant competitors in the region); *Procter & Gamble Co. v. Stoneham*, 140 Ohio App. 3d 260, 747 N.E.2d 268 (2000), *app. dism'd*, 91 Ohio St.3d 1478, 744 N.E.2d 775 (2001) (reversing denial of injunction to enforce non-compete agreement where Stoneham set a goal to make new employer one of the top three global hair care brands largely by targeting former employer's products); *Allis-Chalmers v. Continental*, 255 F. Supp. at 651-652 (former and new employers were in head-to-head competition to develop a new fuel injection system for the armed services).

40. *See, e.g., Prosonic Corp. v. Stratford*, 539 F. Supp. 2d 999 (S.D. Ohio 2008) (granting injunction to enforce non-compete covenant where former employer was North American market leader in sonic drilling and new employer was a recent entrant to the business and had hired employee specifically to grow its sonic drilling business in the Gulf Coast); *Xantrex Tech., Inc. v. Advanced Energy Indus., Inc*., No. 07-cv-02324-WYD-MEH, 2008 WL 2185882 (D. Colo. May 23, 2008) (enforcing covenant where former employer was the oldest North American manufacturer of solar inverters, there were only two significant North American competitors, and the new employer was just entering the market).

41. *Id.*; *PepsiCo v. Redmond*, 54 F.3d at 1266; *see also generally Avery Dennison v. Finkle; Estée Lauder v. Batra; Proctor & Gamble v. Stoneham; Aetna Retirement Servs., Inc. v. Hug*, No. CV 970479974S, 1997 WL 396212 (Conn. Super. June 18, 1997) (unpublished) (all enforcing restrictive covenants).

42. *Verizon v. Pizzirani*, 462 F. Supp. 2d at 651 (granting injunction to enforce non-compete agreement where former and new employer were each developing new broadband offering and sought to be "first to market" with those offerings); *Cf. Dorel* ("because the industry worked on a cyclical calendar, [the] new employer would be able to do little with the information before it became public"); *Sprint Corp. v. DeAngelo*, 12 F. Supp. 2d 1188 (D. Ks. 1998) (denying injunction to enforce non-compete where court found that the former and new employers were not yet competitors and, were in fact, "both late entries in the market and . . . it is not clear that either one of them is sufficiently advanced in its marketing efforts to exploit confidential marketing information from the other").

43. *Cf. Aetna Retirement Servs., Inc. v. Hug* at *11 (enforcing non-compete agreement with high level executive where former and new employer were "substantial and direct competitors" for the sale of variable annuities, approximately 80% of the new employer's total variable annuity sales came from products competitive with those overseen by employee for former employer, the two companies' annuity products were "clearly in substantial and direct competition with one another " and were sold through the same channels to the same target clientele, and employee would have "full profit and loss general management" responsibility for these annuity products. While court found that "it is unquestionable that Hug is a person of unimpeachable integrity whose honesty is widely respected and admired," nevertheless, his "decisions, contributions and strategic insights cannot help but be informed by the framework and knowledge he gained in employment at Aetna in making and participating in strategic business, sales, product and marketing plans.").

44. *Aetna v. Fluegel*, *8.

45. 157 N.C. App. 462.

46. *See also Interbake Foods, LLC v. Tomasiello*, 461 F. Supp. 2d 943, 973-74 (N.D. Iowa 2006) (denying inevitable disclosure injunction where the equipment, processes, and recipes independently developed by the two employers were significantly different and the trade secrets would thus be of little value to the new employer without substantial modification); *Hoskins Mfg. Co. v. PMC Corp.*, 47 F. Supp. 2d 852 (E.D. Mich. 1999) (granting summary judgment for defendant on inevitable disclosure claim where there were significant differences between the two manufacturing processes). Note, however, that in some situations even if the *technologies* may not be directly transferable to a new employer, intimate non-public knowledge of the strengths and weaknesses of a competitor's product and of future strategies can be put at substantial risk in particular new employment activities. *Marcam v. Orchard*, 885 F. Supp. 294, 297 (granting injunction to enforce non-compete agreement).

47. *See Pella Windows & Doors v. Buscarnera*, No. 07-CV-82 (SLT) (JMA), 2007 WL 2089298 (E.D.N.Y. July 18, 2007) (refusing to grant inevitable disclosure injunction where court found that sales employee lacked sufficient knowledge of or experience with trade secrets that would be relevant in his new position to impart them to new employer; employee had previously focused on direct sales to consumers and in new job would sell to commercial and trade customers; court rejected both plaintiff's "speculative allegations about how business really works" and its conclusory dismissal of defendant's evidence as "hogwash").

48. *PSC Inc. v. Reiss*, 111 F. Supp. 2d 252 (W.D.N.Y. 2000) (denying inevitable disclosure injunction where new company was market leader and had no particular need for the trade secrets); *Standard Brands v. Zumpe*, 264 F. Supp. 254 (E.D. La. 1967).

49. *See, e.g., Dorel Juvenile Group v. DiMartinis*, 495 F.3d at 502-03 (denying injunction where the information "was fairly general, subject to change and evolution, and had a very short shelf life").

50. *See, e.g., Extra Corporeal Alliance*, 285 F. Supp. 2d at 1042 (noting that where the employee did not have a copy of the secret computer program, recreating it would be difficult if at all possible, making disclosure unlikely, rather than inevitable); *Pella Windows*, at *10 (denying injunction where PPQ computer program at issue could generate approximately four million different list prices and employee thus could not possibly recall an exact list price to undercut his former employer even if the information were a trade secret).

51. *Kelly Services, Inc. v. Greene*, 535 F. Supp. 2d 180, 187-188 (D.Me. 2008) (applying Michigan law) (refusing to enforce non-compete agreement against junior employee not personally engaged in direct competition where there were no allegations of specific acts of actual or threatened misappropriation); *Degussa Admixtures, Inc. v. Burnett (trial court decision)*, 471 F. Supp. 2d 848, 856 (W.D. Mich. 2007) (noting that inevitable disclosure doctrine "is only suggested to be applicable to high executives and key designers of the company's strategic plans and operations"); *Campbell Soup Co. v. Giles*, 47 F.3d 467 (1st Cir. 1995) (denying inevitable disclosure injunction where mid-level executive was hired to execute existing plans); *Travenol Laboratories v. Turner*, 30 N.C. App. at 688 (denying inevitable disclosure injunction where employee was hired for manufacturing, not to work in research and development; and manufacturing process was widely known).

52. *See, e.g., Nat'l Starch*, 530 A.2d 31; *Emery Indus. v. Cottier*, 202 U.S.P.Q. 829.

53. 54 F.3d at 1270.

54. *See Creative Collections of New York, Inc. v. DiBlasi*, 15 Misc.3d 1130(A), 841 N.Y.S.2d 218 (N.Y. Sup. 2007) ("It is appropriate to issue a preliminary injunction against former employees *even without a restrictive covenant* where they have breached trust or stolen the employer's proprietary information," enjoining employee defendants from soliciting plaintiff's customers for one year and from using misappropriated documents [citing cases, emphasis added]). *See also Henkel Corp. v. Cox*, 386 F. Supp. 2d 898 (E.D. Mich. 2005) (granting activity restraint in absence of non-compete where employee removed and apparently used confidential information and made contradictory statements regarding his retention of additional confidential information); *Liebert Corp. v. Mazur*, 357 Ill.App.3d 265, 827 N.E.2d 909 (2005) (reversing denial of inevitable disclosure injunction in face of employee's removal of documents, spoliation of evidence regarding its use or disclosure, and other indicia of bad faith); *Barilla America v. Wright*, No. 4-02-CV-90267, 2002 U.S. Dist. LEXIS 12773 (S.D. Iowa July 5, 2002) at *16, 32-34 (enjoining competitive employment in absence of non-compete where evidence showed that employee removed and did not return CDs and notebook containing plaintiff's trade secrets and at best "handled Barilla's trade secrets in a haphazard way"); *Novell, Inc. v. Timpangos Research Group, Inc.*, No. 97040037, 1998 WL 177721 (Utah Dist. Ct. Jan. 30, 1998) (granting inevitable disclosure injunction against employee who lacked non-compete covenant but was found to have "willfully used and disclosed former employer's trade secrets"); *Doubleclick v. Henderson* at *5-6 (need for relief was bolstered by showing of actual disclosure, which showed "a high probability of 'inevitable disclosure' of trade secrets"). Similarly, where an employee has a non-compete agreement, the removal of confidential information has been a factor leading to the grant of injunctive relief. *See, e.g., Verizon v. Pizzirani*, 462 F. Supp. 2d at 660 (court granted injunction to enforce non-compete agreement where it was given "additional pause" by employee's disclosures of some trade secrets to the new employer during the interview process and by his removal and transfer of Verizon confidential documents, even though he claimed he later erased them; such acts gave the court "reason to question [employee's] credibility in regards to his claim that he would fastidiously guard Verizon's trade secrets if he worked at Comcast").

55. *See, e.g., Dearborn v. Everett Prescott*, 486 F. Supp. 2d at 820 (holding that the inevitable disclosure theory "should remain limited to a rare and narrow set of circumstances in which the departing employee has acted in bad faith in taking or threatening to take valuable confidential information"); *FMC Corp. v. Cyprus Foote*, 899 F. Supp. at 1483 ("North Carolina's case-law to date indicates that its courts would refuse to enjoin an employee from working for . . . [a] competitor under the 'inevitable discovery' [theory] absent some showing of bad faith, underhanded dealing, or employment by an entity so lacking comparable technology that misappropriation can be inferred").

56. *See, e.g., Merck v. Lyon*, 941 F. Supp. at 1461 (observing that while Lyon had not been "entirely forthright" in his representations concerning his future employment, "it does not appear that he was attempting to hide the truth in order to spirit off trade secrets." Thus, there was no basis to impose broad injunction barring him from working for a competitor, but there was "a basis for questioning his ability to keep his word with respect to the confidentiality agreement." Accordingly the court imposed a restriction prohibiting employee from discussing certain topics with new employer.).

57. *Aetna v. Fluegel*, at *7.

58. *See, e.g., Interbake*, 461 F. Supp. 2d at 974 (fact that employee accessed numerous computer files before resigning did not establish that he took any of these documents with him or warrant activity restraint; court did, however, require that all forensic evidence be preserved). For examples of cases where copying of computer data alone did not lead to a finding of misappropriation, or to injunctive relief, *see Kelly Services, Inc. v. Greene*, 535 F. Supp. 2d 180 (D. Me. 2008) (finding that the fact that defendant transferred files to a USB drive prior to resignation did not establish misappropriation in face of sworn statements that she did not retain protected information and in absence of proof that she had used any of the information); *Spinal Dimensions, Inc. v. Chepenuk* (finding defendant's actions in

e-mailing employer's documents to a personal e-mail account not sufficient to establish a likelihood of success on a claim of "actual misappropriation" absent showing documents had been used and granting limited injunction to enforce customer non-solicitation agreement); *Sovereign Business Forms, Inc. v. Stenrite Indus., Inc.*, 2000 WL 1772599 at *7 (S.D.N.Y. Nov. 28, 2000) (testimony established individual often worked at home on his computer so presence of customer files on computer without more was not misappropriation).

59. *See* n. 18.

60. *Boston Laser, Inc. v. Zu*, No. 3: 07-CV-0791 (TJM/DEP), 2007 WL 2973663 (N.D.N.Y. 2007), at *8.

61. *Meritage Homes Corp. v. Hancock*, 522 F. Supp. 2d 1203, 1220 (D. Ariz. 2007) (granting summary judgment for defendant on misappropriation claim based on inevitable disclosure theory).

62. For suggestions on reasonable measures to maintain secrecy, *see, e.g.*, V.A. Cundiff, "*Digital Defense: Protecting Trade Secrets Against New Threats*," PLI Intellectual Property Law Institute Course Handbook, 2008.

63. *See, e.g., Xantrex Technology v. Advanced Energy Industries* (granting injunction to enforce non-compete where, among other things, during interviews the employee learned that the new employer intended to enter current employer's market but did not tell the current employer and employee conveyed detailed comments to new employer about new product and directed employees of current employer to assemble information that would be useful to new employer); *Verizon v. Pizzirani* (granting injunction where employee made some disclosures of confidential information during interviews).

64. *See, e.g., Spinal Dimensions* (narrowing covenant where "plaintiffs have demonstrated a likelihood of success in establishing a legitimate interest in protecting their existing customer relationships from unfair competition by defendants but have not, at least on the present record, established that such relief must be extended to other customers in New York and through [plaintiffs'] geographic territory").

65. *Cf. Emery Industries v. Cottier*, where new employer was engaged solely in the field which court found would necessarily place trade secrets at risk. The court found that "[i]t would be useless to attempt to draft an injunction which would permit any employment" by the specific competitor and therefore required plaintiff to compensate the employee during the period of the injunction; *Barilla America v. Wright*, at *33, 35, which enjoined employee from working for any competitors of the plaintiff in the pasta industry for one year following his departure from plaintiff; court noted, however, that only five of Wright's 26 years of food processing experience had been in the pasta business and that other jobs in the food industry were available to Wright.

66. 54 F.3d at 1271.

67. *Nat'l Starch*, 219 N.J. Super. at 158. *See also, Prosonic Corp. v. Stratford*, 539 F. Supp. 2d at 1008 (finding that plaintiff had established threatened disclosure as to sonic drilling and thus enforcing the non-compete to the extent of prohibiting employee from engaging in activity relating to sonic drilling, but leaving the employee free to engage in other types of drilling for the same competitor).

68. *See Victaulic Co. v. Tieman*, 499 F.3d 227, 235 (3d Cir. 2007), holding that the question of whether an employee bound by a non-compete could work for a competitor selling similar products to those he had sold for the prior employer but to different industries is a fact-specific inquiry that may need to focus on how transferable the trade secrets are across industries and customers. *See also Quaker Chem. Corp. v. Varga*, 509 F. Supp. 2d at 482 (emphasizing the fact-intensive nature of this inquiry).

69. *Id.*, noting that trade secrets at issue could be valuable both to employer's aluminum and steel businesses and issuing an injunction enforcing the non-compete agreement.

70. *See, e.g., Emery Indus. v. Cottier*, 202 U.S.P.Q. at 836.

71. *See Avery Dennison Corp. v. Finkle*, at *3, n. 13 ("Implicit in the decision of the court is the order that Donald Finkle be so compensated. Noncompliance by the plaintiff with this contractual provision [to pay two-thirds of Finkle's base monthly salary] will be grounds for an immediate review by the court of the continued propriety of the temporary injunction as well as possible sanctions by the court"); *Estée Lauder v. Batra*, 430 F. Supp. 2d at 182 ("Here the risk of Batra's loss of livelihood is entirely mitigated by the fact that Estée Lauder will continue to pay Batra his salary of $375,000 per year for the duration of the 'sitting out' period"); *Aetna Retirement Services, Inc. v. Hug*, at *11 (conditioning grant of injunction on former employer's representation in court that it would pay Hug the *pro rata* portion of his $210,000 base salary during the period of restraint); *Marcam v. Orchard* (finding that potential harm to former employer if injunction was not granted was greater than harm to employee if it was since former employer had agreed to pay employee 110% of the salary offered by the new employer).

72. *See, e.g., Verizon v. Pizzirani*, 462 F. Supp. 2d at 661-62 (noting that defendant acknowledged in the agreements and during his deposition that he possessed broad-based, marketable skills so that enforcement of the covenant would not prevent him from earning a livelihood); *Payment Alliance Int'l, Inc. v. Ferreira*, 530 F. Supp. 2d 477 (observing that Ferreira was not barred from all gainful employment within an industry); *Henkel Corp. v. Cox* (observing that injunction would leave defendant free to work for his new employer in other areas without reduction in compensation).

73. 462 F. Supp. 2d 648 (E.D. Pa. 2006).

74. *Id.* at 653.

75. *Id.* at 659.

76. 509 F. Supp. 2d 469 (E.D. Pa. 2007).

77. *Id.* at 482 (emphasis in original).

78. For examples of cases in which the hiring employer's early sensitivity to trade secrets issues helped to avoid injunctive relief, *see United Prods. Corp. of Am., Inc. v. Cederstrom*, No. A05-1688, 2006 WL 1529478 (Minn. App. June 6, 2006) (denying injunction to enforce non-compete agreement where new employer had specifically structured the terms of employment to avoid violating the contract and there was no evidence that employee had breached confidentiality and non-solicitation provisions; court would not presume irreparable harm simply because a non-technical employee with access to confidential information took a position with a competitor or because a former employer presumes that disclosure and solicitation are inevitable); *Del Monte Fresh Produce v. Dole*, 148 F. Supp. 2d at 1339 (denying injunction and finding no showing of threatened disclosure, noting that when Dole and employee worked out employment arrangements "they were very aware" of employee's confidentiality obligations; Dole instructed employee and others at the company that he was not to reveal confidential information and structured his job to keep him away from areas that would be most likely to place Del Monte's trade secrets even at inadvertent risk; and both employee and new employer testified that they did not want him to disclose trade secrets); *Bridgestone/Firestone, Inc. v. Lockhart*, 5 F. Supp. 2d 667, 682 (S.D. Ind. 1998) (denying injunction to enforce non-compete agreement where new employer and employee "worked hard to develop an arrangement that would not violate the terms of the noncompetition agreement," removed employee from any direct competition with his former employer's products, and advised senior management of the extent of employee's obligations to former employer; such precautions made it appear that misappropriation was not inevitable or even seriously threatened). *Cf. Glenn v. Dow AgroSciences, LLC*, 861 N.E.2d 1 (Ind. Ct. App. 2007) (reversing injunction and refusing to enforce overly broad restrictive covenant which could not be reformed under Indiana law, observing that employee had, prior to litigation, provided a letter to former employer detailing differences between the

businesses of the two employers which he asserted would prevent the inevitable disclosure of trade secrets and outlining his specific commitments not to use or disclose former employer's trade secrets).

79. *See, e.g., Cadence Design Sys., Inc. v. AvantA Corp.*, 29 Cal. 4th 215, 57 P.3d 647 (2002).

80. *Edwards v. Arthur Andersen*, 81 Cal. Rptr. 3d 282, No. S147190, 2008 WL 3083156 (Aug. 7, 2008).

81. 430 F. Supp. 2d 158 (S.D.N.Y. 2006).

82. *Id.* at 172.

83. *Id.* at 179.

84. *See also Sprint Corp. v. DeAngelo*, 12 F. Supp. 2d 1184 (D. Ks. 1998) (enforcing contract's Kansas choice of law provision even though employee had worked for company in Virginia since employee traveled frequently to company headquarters in Kansas on business). In evaluating mobile employee issues, employers are increasingly needing to look across national borders as well. *See, e.g.*, *Xantrex Tech. v. Advanced Energy*, where employee's British Columbia non-compete agreement was assessed under both the law of Colorado, where employee intended to work, and of British Columbia, where he had previously worked.

85. 101 Cal. App. 4th at 1464.

86. *See, e.g.*, Elizabeth A. Rowe, *When Trade Secrets Become Shackles: Fairness and the Inevitable Disclosure Doctrine*, 7 Tul. J. Tech. & Intell. Prop. 167, 181 (Spring, 2005).

87. *Whyte v. Schlage Lock Co.*, 101 Cal. App. 4th at 1464.

88. *Barilla Am., Inc. v. Wright*, No. 4-02-CV-90267, 2002 U.S. Dist. LEXIS 12773 (S.D. Iowa July 5, 2002), at *25. ("[T]he approach this Court takes will be to simply enforce a stricter standard on inevitable disclosure and then treat it and the threatened disclosure standard as variations of the same standard."). *Id*. *See also Interbake Foods v. Tomasiello*, 461 F. Supp. 2d at 973 ("the inevitable disclosure doctrine is just one way of showing threatened disclosure . . . where additional evidence showing the existence of substantial threat of impending injury is unavailable to the movant"). To the same effect, *see La Calhène v. Spolyar*, 938 F. Supp. at 531.

89. *Del Monte Fresh Produce v. Dole*, 148 F. Supp. 2d at 1338-39, relying upon *Int'l Bus. Mach. Corp. v. Seagate Tech, Inc.*, 941 F. Supp. 98, 101 (D. Minn. 1992).

90. *Merck v. Lyon*, 941 F. Supp. at 1462, *FMC Corp. v. Cyprus Foote*, 899 F. Supp. at 1483; *Analog Devices v. Michalski*, 157 N.C. App. at 471.

91. *See, e.g., Procter & Gamble v. Stoneham*, 140 Ohio App. 3d 260, 278 and *Dexxon Digital Storage v. Haenszel*, 832 N.E. 2d at 68 (both finding threatened disclosure and reversing trial court's denial of injuction to enforce non-compete agreement); *Avery Dennison v. Finkle*, at *3.

92. 162 Cal. App. 4th 501, 527-529, 75 Cal. Rptr. 3d 771 (2008) (denying injunction because plaintiff did not establish threatened misappropriation but outlining factual showings that could support an injunction).

93. *Id.*, 162 Cal. App. 4th at 528-529.

94. *See, e.g., Ready Link Healthcare v. Cotton*, 126 Cal. App. 4th 1006, 1011, 1017, 24 Cal. Rptr. 3d 720, 722-23, 727 (2005); *see also Henkel Corp. v. Cox*, 386 F. Supp. 2d 898 (E.D. Mich. 2005) (finding threatened misappropriation and granting activity restraint in absence of non-compete agreement where plaintiff showed that employee had removed trade secrets from prior employer, transferred some confidential information to new employer's computer, was using the trade secrets in creating a product for new employer, and had made contrary statements about whether he had returned all confidential information to prior employer before litigation began).

95. *See, e.g., Technical Indus., Inc. v. Banks*, 419 F. Supp. 2d 903, 913 (W.D. La. 2006) (employee testified that he intended to use a different computer code but the same secret data collection process as his prior employer); *Allis-Chalmers v. Cont'l Aviation*, 255 F. Supp. 645 ("there is simply no other way to execute the necessary tasks").

96. *Cf. Liebert v. Mazur*, 357 Ill. App. 3d 265, 827 N.E.2d 909 (2005) (finding that trial court erred in finding that plaintiff had not established inevitable disclosure where employee downloaded documents, destroyed evidence that would have revealed whether the documents had been copied and used, told a client of his former employer before he resigned that he intended to approach it with a competing sales proposal from his new employer, and plaintiff presented evidence that the new employer wanted to "cripple Liebert in Chicago for at least six months" through hiring its sales team).

97. *PRG-Schultz Int'l, Inc. v. Kirix Corp.*, No. 03 C 1867, 2003 WL 22232771 at *7 (N.D. Ill. Sept. 22, 2003); *RKI Inc. v. Grimes*, 200 F. Supp. 2d 916 (N.D. Ill. 2002) (imposing award of actual and punitive damages, attorneys' fees, and permanent injunction where company hired employee who knew trade secrets, placed him in an identical job, and actual disclosure occurred); *C&F Packing Co., Inc. v. IBP, Inc.*, No. 93 C 1601, 1998 WL 1147139 (N.D. Ill. Mar. 16, 1998) (denying new employer's motion to dismiss misappropriation claim which asserted that new employer had placed the employee in a position resulting in the inevitable disclosure or use of the trade secret). In *C&F Packing Co.*, the jury ultimately found that disclosure actually did occur and returned a verdict of $11 million: *Jury Delivers $11 Million Verdict in Pizza-Sausage Battle,* Nat'l L.J., Feb. 1, 1999.

98. *See, e.g., General Reinsurance Corp. v. Arch Capital Group, LTD*, No. X05CV074011668S, 2007 WL 3121766 (Conn. Super. Oct. 17, 2007) (unpublished) (enjoining defendants, including new employer, from using confidential information of prior employer, including information regarding loss costs that had already been incorporated into computer tools developed by a group of plaintiff's former employees through studied recreation of a "tribal memory" of former employer's information. New employer's stated goal had been to enter a new line of reinsurance business quickly and to target the clients of plaintiff, the largest such reinsurer in North America; injunction would require much of the finished work toward that goal to be set aside as unusable).

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Getting Ready to Sell a Small Business: A Conversation with a Client

By Miriam V. Gold

Once a client has decided to sell a small business, he typically wants to move directly to the mechanics of the sale—from his perspective, soliciting potential buyers with marketing-like materials, having the lawyer prepare the documentation and closing the deal. Often, the client comes to a lawyer to consummate the transaction with a buyer already in hand, without having prepared the groundwork for the sale. This article presents a hypothetical conversation between a potential client who has decided to sell his business and has approached a lawyer seeking advice on how to best proceed.

I. The Conversation

Congratulations! You have decided to sell your business. Before you go out and find a buyer, you need to do your homework. Doing so will not only make the sales process go more quickly and more smoothly, it might well result in more profit for you. Selling a business is often more difficult for an owner than operating one. The first step in this process is sometimes called "reverse due diligence" or "buyer side due diligence."

II. What Is Reverse Due Diligence? Isn't the Buyer Going to Conduct Due Diligence? Why Should I?

The buyer will certainly conduct Due Diligence. He will want to know as much as possible about what he is buying. Sometimes buyers end up knowing more about the business than the seller, putting the seller at a disadvantage during negotiations. Simply put, Reverse Due Diligence is the process of understanding all of the elements of the business that either provide—or may provide—value to the business or subtract—or may subtract—value from it. Identification of the value enhancing, or value destroying, aspects of your business will help you to (a) price your business optimally, (b) target the types of buyers who will best meet your objectives for the sale, (c) fix problems or manage issues before involvement of a buyer, (d) eliminate a buyer's ability to renegotiate the price late in the process, when you are already committed, because he has discovered an "issue," (d) structure the deal with your tax adviser to maximize your profitability, and (e) create a level of trust between you and the buyer that will facilitate the sale.

Reverse due diligence, like the due diligence that will be undertaken by the buyer, is a team activity. The particular nature of your business will determine the members of the team. For example, a business whose value is predominately intellectual property will need intellectual property experts as team members. Any chemical deal will need environmental expertise. Any transaction will need tax advice. The earlier a team is formed, the more likely the issues that arise will be addressed in a timely way. For important areas, make sure to use experts. In the long run, they will be cost effective because they will quickly cull the wheat from the chaff.

III. Why Are You Selling the Business? Are You the Only "Seller"? How About Interested Parties? Does Everyone on the Selling Side Have the Same Vision of the Outcome?

Any agreements (shareholders agreement, operating agreement, partnership agreement and the like) that might deal with a sale of the business need to be consulted. Who needs to agree? What are each seller's rights and obligations to the other sellers? What will be the ultimate disposition of the proceeds? Even in the absence of such an agreement, relationship issues need to be considered. Ensuring that everyone on the selling side has the same vision of what selling the business means is sometimes especially challenging in a family owned business, even when it appears that only one member of the family is actively involved in the operations. Had grown children intended to join the business? Does Uncle Joe need to continue to work? Are you intending to retire, or do you want to maintain some ongoing relationship with the company? Is timing important? Are you going to want a buyer who will display loyalty to your employees and the community, and will be a good steward for the business into the future? Often, entrepreneurs who have built a business do not want to sell to someone who will not continue to treat employees in the same fashion. Understand where you are willing to compromise and where you will not. Ensure that everyone on the selling side who can impact the transaction, whether with legal rights or not, has a shared vision of the end state of the deal.

Once you fully understand all of the objectives of your transaction, and have prioritized those objectives, you should affirmatively try to attract the type of buyer that best meets your goals for the sale. Strategic buyers and financial buyers have very different motivations, and often buy and operate businesses quite differently. Small buyers may also have different plans and needs than bigger buyers. Private buyers are of course different from public buyers. Knowing exactly what you are selling, and the relative value of each of the components in the transaction, will ensure you are positioning your business optimally for the type of buyers you want to attract.

IV. How Will You Structure Your Transaction? Stock Deal? Asset Deal?

How your deal is structured can impact the proceeds you receive from the transaction. Tax and liability issues are often, but not always, the driving considerations in structuring a transaction. Assignability provisions and change-in-control provisions for significant contracts will also have to be considered. Most deals can be structured as either a stock or an asset deal, but the form will impact the benefits to each of the parties. In a stock transaction, the business entity itself is transferred, with all of its assets and liabilities, whereas in an asset deal, the buyer is able to select only those assets and liabilities it wants to assume, subject to some exceptions. In the sale of a closely held business, the ability of the buyer to select out assets and liabilities may be more theoretical than real, as the seller likely will want to transfer the entire enterprise, however that is accomplished. Reverse due diligence will help your advisors determine the best arrangement for the transaction. The final determination of the structure will likely be negotiated between the seller and the buyer, who will have different perspectives. The parties will have to determine which structure provides the most benefit in the aggregate, and then, based on the structure, calculate or adjust the purchase price.

V. What Exactly Are You Selling? What Is the Condition of Each of those Assets? Will Some Be of More Value to Some Buyers Than to Others? Do They All Belong to the Business? Do You Want to, or Are You Willing to, Retain Ownership of Any of Those Assets?

Not all assets of a business are of equal value to all buyers. Some buyers may see more value in some of the assets than the seller does. You might also find that some buyers don't want certain assets (for example, a headquarters building or a contract for payroll administration) and might even value the business higher without them. While in a stock deal, as opposed to an asset deal, the whole entity is being sold, this analysis is still important.

A. Intellectual Property

Intellectual property generally consists of patents, trade secrets, copyrights, trademarks and trade names. For trade secrets, one of the most important considerations is ensuring that the trade secret is in fact "secret." Verify that you have confidentiality agreements, and with respect to IP developed by third parties under contract to you, verify that you have agreements that demonstrate the IP was made as a "Work for Hire" and has been assigned to the business. This is especially important for companies that have used independent contractors to develop IP, such as software. Make sure you own what you think you own. Sometimes owners discover that some of the IP used in the business is licensed from third parties. In those cases, for important technology, you need to be sure that you have the right to transfer the license to a buyer of the assets, and, with respect to stock deals, that there are no issues with change-of-control provisions. To the extent you are selling only part of your business, think about how some of the technology that relates to several different product lines may be divided in the transaction. Understand whether or not some of your technology may be infringed by third parties, or whether or not you may be infringing the IP of third parties. This type of information may have found its way into call reports, correspondence files or lab files. For patents, make sure your maintenance fees are paid.

B. Real Estate

The same issues exist about ownership and liens with respect to real estate as with respect to other assets. Make sure you have good and transferable title to your real estate. Any issues with title and any liens should be addressed before the business is marketed. Recognize that buyers may be more particular these days about real estate, both because of concerns with environmental issues, and to keep hard assets off of their balance sheets. Generally, manufacturing plants raise the highest level of environmental concern, then warehouses, laboratories and office space. Newer facilities are generally less of an issue than older facilities. Cleanliness is important. Just like showing a home for sale, a clean plant makes a far better impression than a dirty, run-down one. Dirty facilities invite more inspection.

Is the real estate in question just suited to the current use? Should the buyer not be interested, are there other buyers for this particular asset? Is the asset worth more as part of the contemplated transaction than apart from the transaction? If the real estate is leased, can the lease be assigned to the buyer, or are there opportunities to terminate the lease early, at what fee, or to sublet the property?

C. Inventories

The quality and quantity of the inventories are both important. What is your percentage of obsolete or nonconforming inventory? Does it make sense to rework or discard such inventories before sale, or is it better to expect the buyer to take this on? Having too much defective inventory on hand could suggest to the buyer either a problem with the manufacturing process, suppliers or internal controls. How much inventory do you have? As a percent of sales? You should look at this not only in the aggregate, but also on a product level, to ensure that the business can meet its order flow without tying up too much money in working capital. Some buyers might even want extra inventories to carry them through any change in manufacturing sites. Is more capital than is necessary tied up in inventories?

D. Accounts Receivable

Are your credit terms customary for your industry and your geography? Do you collect receivables in a timely fashion? What percentage of your receivables is aged, and how aged? Is more money than is necessary tied up in accounts receivable? In an economic downturn, such as now, will your customers be likely to go into bankruptcy? Have you thought about managing potential preferences in such a case? Consider whether making the effort to tighten up your collections will be worth it in the greater scheme of things.

E. Employees

Employees are always impacted by a sale, and employees have a disproportionate ability to impact the sale. There will be some employees of the seller whose continued employment will be significant to the ongoing vitality of the business, a small portion of whom where perhaps retention might even be a condition precedent to the closing of the transaction. There will be some who will be essential to operate the business during the transition and help integrate the business after the sale. There will be some whose jobs will be terminated as a result of consolidation after the sale. Financial buyers will likely have fewer of the latter than strategic buyers. While the complete classification of employees into one of the foregoing categories cannot be made until later in the process, you should think about what you can do to ensure that the employees you need to retain stay committed to the business during what can be an unsettling time for many. Do you have severance policies in place? Would you consider retention bonuses for significant players? While those issues will be worked out with the buyer, the costs should be considered by the seller when valuing the business. Consider also the shifting of loyalties that inevitably occurs in a sale, from the seller to the buyer, who will be the new employer.

Some employees may have contracts. Review those carefully. You may have a union at one or more facilities. You will need to determine your obligations with respect to labor contracts in a sale transaction. Notice provisions? Bargaining over effects? And so on. Don't forget that there can also be federal (such as the WARN Act) or state laws that need to be consulted. Not only will employees be concerned with whether or not they will retain their positions, but they will want to know about their benefits. The mechanics of how that will be handled will need to be addressed.

F. Contracts and Third Party Relationships

All contracts need to be reviewed to ensure they are current and to determine whether they are assignable in connection with the contemplated transaction, and for stock deals, whether there are any change-of-control provisions. During a diligence exercise we find that some contracts have long expired or that the written terms of the contract no longer reflect the practice between the parties. To the extent a contract is critical to the business, you might want to consider negotiating an update or extension. What is a critical contract depends on the business itself. It could be a contract with important customers, large suppliers or suppliers of unique products. It could be a supply contract that provides a price advantage not available on the open market. It could be a license for technology essential for the seller's processes or products. If there are critical contracts that are nonassignable by their terms, you have the time to consider how best to address the situation. Sometimes your buyer might be able to persuade the third party to deal with it. Sometimes there might be an alternative you can identify. Remember also that the software you use to run your business might be subject to restrictions on the number and locations of users, among other things.

Important relationships might not be subject to a contract. How will you be able to persuade your buyer that those relationships will be transferred with the business? This is especially important where the third party is a considerable portion of the customer or supplier base of the seller. Understand the motivations those parties have to conduct business on the same basis they have historically.

VI. What Liabilities Does the Business Have? Do You Intend to Transfer Those to the Buyer? Can You? How Might Those Liabilities Impact the Purchase Price?

You can think of liabilities in several different ways: (a) known versus unknown, (b) historic versus continuing, or (c) quantifiable versus unquantifiable. As the seller, especially of a small wholly contained business, you want to dispose of all of the liabilities. After all, you will likely have neither the apparatus nor the desire to manage liabilities after you are out of the business. The buyer, on the other hand, wants to limit the liabilities for which it will be responsible and to quantify every liability it will assume so that it can factor the cost into the purchase price. It also wants to be assured that the business is currently in full compliance with the law, so it doesn't buy a business that might expose it to criminal and civil penalties or burden it with additional costs to come into compliance.

A. Loans and Other Indebtedness

Every business has creditors. Among others, there are suppliers, whose debts may be reflected in accounts payable; banks and other financial institutions, whose obligations will typically be secured and fully documented; and contingent creditors, such as potential plaintiffs (see litigation and claims below).

How carefully are accounts payable being managed? Does the company pay its bills on time? Does the company pay its bills too early? Remember that the trade creditors the company now uses might be considered an asset to the buyer.

Institutional credit arrangements typically have prohibitions on assignments and on changes in control. Does it make more sense to the transaction to pay these obligations off or to transfer them, assuming that can be done? A determination needs to be made as to when and how to approach these lenders.

B. Environmental Issues

Environmental due diligence is of varying importance, depending on the nature of your business. For a chemical business, it is of utmost importance. For a real estate business, it is very important. Software developers don't typically have much to be concerned about. Developing a conceptual framework of environmental due diligence that is meaningful to company management is probably a helpful way to consider diligence. How do the operations of the business create potential environmental impacts? What exactly does the business do? How do those activities present potential environmental challenges?

What is the nature of the business? Does it distribute chemical products manufactured by others, or does it manufacture its own products? Is it a user of chemicals? Or, does it (such as a real estate business or the owner of any real estate) sit on land that might be contaminated? In what jurisdictions are your facilities located? Are there any particular state or local requirements that will impact the deal? What will the value of the transaction be to the buyer? How knowledgeable is the buyer about the likely issues? Is the buyer public or private? A public buyer will have to consider materiality thresholds for SEC-related disclosures after the deal closes. What is the history of the seller and its facilities? Has the seller sold off other facilities or business lines, and in so doing, what obligations did the seller retain or assume? A review of prior transaction closing documents would be appropriate. You will need to assemble documentation demonstrating that you have all of the required permits and other governmental approvals needed to operate the business as you have been operating it.

C. Litigation and Claims

Buyers will want to know about your current and historic litigation track record. What litigation is current? Is it mostly in one area (product liability or employee issues) or is it spread across different facets of your business? Some businesses have inherent litigation risks, such as pharmaceutical companies for product liability, or high tech companies with intellectual property. Think about whether your litigation history is consistent with a business in your industry, and if not, why not, whether for better or for worse. Consider, if your litigation profile has changed recently, why that would be. Have you improved your manufacturing processes? Have you moved into slightly different products with a different litigation risk?

D. Compliance

Is there any reason to think that the company might be operating in material non-compliance with any laws and regulations that govern its conduct? Are there systems in place to manage compliance obligations? Is there any history of noncompliance? Before starting any system or compliance review, careful consideration should be given to how deep and how broad it should be.

What happens if you become aware of some noncompliance during the course of your reverse due diligence? While not part of the due diligence process, there is always the possibility that you might become aware of some non-compliance with law as you go through this process. You should give some thought at the outset as to how you might handle such a discovery. Many regulatory agencies have published policies allowing companies that self-report violations of law to mitigate gravity-based penalties, in some cases up to 100 percent. To be eligible for mitigation, you need to ensure that your diligence is set up to meet the requirements of the various agencies with which you deal, all of which require disclosures to be made within a specific (and short) time frame. Remember also that while some disclosures are voluntary and are rewarded with penalty mitigation, other disclosures are mandatory and the failure to disclose is itself another non-compliance. Given the pressures of the transaction, waiting for a problem to surface during the process is not the best approach. Balancing the timetable for closing the transaction with the timetable for resolving any non-compliances is not easy. As an aside, buyers likely will want to see as part of diligence copies of any prior audit reports and self-disclosures.

VII. Conclusion

The work you do up front preparing for the sale of your business will no doubt help you facilitate the transaction and obtain the most attractive after-tax net profit. Good luck!

Miriam V. Gold does general business counseling and corporate legal work, including mergers and acquisitions. Prior to opening her private practice last year, she was Deputy General Counsel and Vice President of Legal & Regulatory Affairs for a multinational chemical company. She also teaches business law at the University of Phoenix.

The Role of the Corporate Secretary in Corporate Governance: The View from a U.S. Subsidiary of a Japanese Insurance Company

By Yoshikazu Koike

I. Preface

Since the Sarbanes-Oxley (SOX) Act[1] was enacted in 2002 as a result of a series of "corporate scandals" such as Enron and WorldCom, there has been increasing attention to achieving better corporate governance, enhancing compliance and risk management, and strengthening corporate internal controls. In Japan, there has also been an increasing emphasis on these areas, as evidenced by significant amendments to the Japanese Corporation Law in 2006[2] and the strengthening of corporate internal control requirements through enactment of "the Financial Products and Trading Act."[3] Thus, like their United States counterparts, senior managers in Japanese corporations are now expected to meet these higher standards.

While it can be observed that the recent amendment of the Japanese Corporation Law has introduced into the Japanese business environment elements of U.S. corporate law, there are still certain differences between the two legal systems. In particular, some business customs and practices accepted as quite traditional under one of the countries' legal system are not widely accepted under the other country's legal system. For example, the standing corporate auditor in the corporation has been widely accepted in Japanese corporations, but there is nothing comparable in the United States. In the United States, the auditing function generally is divided between external accounting firms, which conduct accounting audits, and the internal audit function, which conducts operating and compliance audits. With the enactment of the SOX Act, the board Audit Committee has assumed paramount importance in the oversight function, particularly for public companies.

Another fundamental difference is seen in the role of the corporate secretary. In the United States, the secretary has long been recognized as one of the cornerstones of the corporate structure, along with the president and treasurer. By contrast, under Japan's Corporation Law, the corporate secretary does not have the same significance as a key officer of the corporation.

Since 2003, when I assumed the role of the corporate secretary for the U.S. subsidiary of a Japanese property and casualty insurance company, with cooperation and advice from the general counsel of the subsidiary, I have focused many of my efforts on improving its corporate governance structure and enhancing overall compliance. Based upon that experience, this article shares some conclusions that I have gleaned about the role of the corporate secretary in enhancing corporate governance, especially from the vantage point of a U.S. subsidiary of a Japanese corporation.

The article begins by reviewing the basic responsibilities of the corporate secretary under U.S. law. It then describes the desirable qualifications for a corporate secretary from the vantage point of a U.S. subsidiary of a Japanese corporation. Third, it focuses upon the advanced roles of the corporate secretary in the current business and legal environment, in particular (1) enhancing compliance activities, (2) communications with outside directors, (3) document retention, (4) liaison with the parent corporation, (5) contributing to corporate risk management activities and (6) enhancing corporate social responsibility. Finally, the article discusses the importance of the coordinating functions of the corporate secretary.

In the current business and legal environment, the enhancement of enterprise risk management and overall compliance is key. It is the author's opinion that corporate secretaries are in a unique position to contribute to this goal through close communication with the corporation's general counsel, internal auditors, and those exercising other professional functions in corporations. These points are elaborated below.

II. Responsibilities of the Corporate Secretary under U.S. Corporate Law

In the United States, basic corporate law is the province of individual states. In most states corporate law contains provisions relating to powers, authorities and responsibilities of directors and officers,[4] and corporations typically provide in their bylaws details about the scope of authority and responsibilities of key corporate officers, including the corporate secretary.

The corporate secretary is generally defined as "a corporate officer in charge of official correspondence, minutes of board meetings, and records of stock ownership and transfer."[5] The fundamental responsibilities of the corporate secretary therefore include maintaining corporate documents, conducting official correspondence on the corporation's behalf, and overseeing basic governance procedures. In the course of fulfilling these responsibilities, a corporate secretary is expected to conduct timely corporate managerial meetings, such as shareholders' meetings and board of directors meetings, lawfully and appropriately in order to fulfill the fundamental requirements of the corporate governance function. The corporate secretary also maintains official corporate documents in order to ensure that the history of the corporate legal entity is preserved. Therefore, the corporate secretary's fundamental responsibility is comprised of securing the legal and lawful existence of the corporate entity and contributing to fundamentals of corporate governance. The following discusses these functions in more detail.

A. Official Correspondence

The first fundamental role of a corporate secretary is to supervise the official correspondence of the corporation. This typically will include the following activities:

1. Filing the corporate registration with the Secretary of State under corporate seal;
2. Providing the Secretary's Certificate on board or shareholder resolutions in response to any regulatory or non-regulatory requests for certified copies of resolutions (such as to establish a bank account);
3. Sending notices of various managerial meetings, such as official notice of shareholders' meetings or boards of directors meetings.

When the corporate secretary conducts this kind of activity, he or she must confirm that all the documents that he or she is handling are in good order and have been prepared by appropriate officers as required by law and sound practice. Also, there may be certain legal requirements for meeting notices. The fulfillment of these requirements is essential to ensure that meetings are conducted lawfully. The corporation's bylaws or state corporate law (if bylaws are absent) typically stipulate the notice required for various kinds of managerial meetings. The corporate secretary is expected to make sure that the agendas of such meetings are lawfully and properly in accordance with state corporate law as well as the company's articles of incorporation and bylaws. The corporate secretary is not only responsible for sending notices properly for managerial meetings—he or she is also expected to contribute to preparing proper agenda items for such meetings. Some corporate decisions may require the approval of the board of directors, while others may require a vote of the shareholders under state corporate law, relevant regulatory laws or the corporate bylaws. Other corporate decisions may require a report to the board of directors. The corporate secretary is expected to follow these legal and regulatory requirements, as well as the bylaws, when he or she prepares the notices of such meetings.

B. Keeping Official Corporate Documents

Another role of a corporate secretary is to keep various official corporate documents. Official corporate documents may include those that designate corporate decision-making, such as minutes of shareholders' meetings or board of directors meetings, records of stock ownership and transfer, and administrative or procedural documents, such as copies of corporate registrations and licenses issued by regulatory authorities. Keeping such documents ensures that the corporation takes necessary and appropriate action to achieve corporate decisions, such as securing resolutions of the board of directors when appropriate. When the corporate secretary records these meeting activities, he or she has to ensure that such meetings are properly and legally held from the vantage point of both corporate law and the company's bylaws. Whether the meeting notice was properly given, whether a quorum was present, and whether voting actions were made in accordance with legal or bylaw requirements are all fundamental points which the corporate secretary must verify.

III. Qualifications for Corporate Secretary

A. Observations about U.S. Companies

In view of the fundamental responsibilities discussed above, certain conclusions can be drawn about the characteristics and qualifications that should be prerequisites for a corporate secretary in the U.S. business community. While state corporation laws typically identify the corporate secretary as one of the officers of a corporation, there are many instances where the corporate secretary holds another title concurrently—for example, treasurer or general counsel. These concurrent roles are appropriate in the context of the secretary's fundamental responsibility to promote the best practices in good corporate governance.

For example, as discussed above, one of the fundamental duties of the corporate secretary is to keep records of stock ownership and transfer, as well as administrative procedural documents with regulatory agencies. Such activities are closely related to those of the financial function in a corporation. Therefore, financial expertise, background or experience will help the corporate secretary conduct this area of business effectively. The need for financial expertise helps explain why in many corporations the corporate secretary holds the office of treasurer, co-treasurer, or assistant treasurer concurrently.

Another important area of the corporate secretary's responsibility is to maintain records of various corporate meetings, such as board of directors or shareholders meetings. Because these meetings must be held in compliance with legal formalities as well as corporate protocols contained in the by-laws, legal expertise and experience can greatly enhance the corporate secretary's ability to execute his or her duties in this area. Furthermore, the secretary is responsible for maintaining minutes of these meetings, which need to be carefully drafted to accurately document corporate decisions and actions taken. These factors help explain why in some corporations the general counsel also serves concurrently as the corporate secretary.

However, a corporate secretary does not necessarily require a financial or legal background in all instances. The modern corporation typically will have the requisite financial expertise, as represented by the chief financial officer (CFO) or treasurer, who may be supported by a finance department. Similarly, corporations typically will have in-house (as well as outside) attorneys, including a general counsel. Through effective and close communication with these professionals, the corporate secretary can utilize their expertise even if he or she does not have a financial or legal background. Therefore, the most fundamental qualification for the corporate secretary can be identified as the ability to communicate effectively with various professional groups of people in the corporation or outside of the corporation who are expected to render necessary information and support the corporate secretary in the execution of his or her corporate governance duties.

B. Liaison with the Japanese Parent Company

In the case of a corporation that is a subsidiary of a Japanese corporation, there is an additional element for corporate governance: namely, the viewpoint of group governance. Generally, while a Japanese parent corporation is expected to behave only as a shareholder, it may request that the subsidiary establish procedures so that the parent corporation can obtain necessary managerial information in a timely fashion. For example, a Japanese parent corporation will indirectly give advice on the items to be discussed by the board of directors of the subsidiary so that the parent can make certain that important items are duly discussed at the subsidiary's board meetings. When the Japanese parent corporation is in the financial sector, it should further take into account the fact that the regulatory authority of the Financial Services Agency of Japan will be expanded to cover the parent's international subsidiaries.

For these reasons, it is important that the corporate secretary of a U.S. subsidiary be able to communicate effectively with relevant constituencies in the Japanese parent corporation. Effective communication will not only contribute to the parent corporation's managerial oversight, but also will enhance the parent corporation's accountability to the regulatory agencies to which it is accountable. Therefore, with respect to the subsidiaries of a Japanese parent corporation, it may be beneficial if a staff member expatriated by the parent takes the office of corporate secretary. Based upon the observation that in U.S. corporations there are several cases in which a corporate secretary takes the title of treasurer or general counsel[6] concurrently, it also may be beneficial for both the subsidiary and parent corporation if such expatriated staff possesses financial or legal background or experience. It is also important that the corporate secretary of a subsidiary corporation of a Japanese parent fully communicate with all professional groups of people in the subsidiary to achieve better corporate governance.

IV. Enhanced Role of the Corporate Secretary to Achieve Sound Corporate Governance

Given the increased importance of sound corporate governance practices in the current business environment, the role of the corporate secretary should be enhanced in several areas.

- First, compliance and related areas are becoming pivotal, so corporations must ensure that their activities are legal and appropriate as minimum prerequisites.
- Second, as corporations will generally have one or more outside corporate directors, it is becoming more important to closely communicate with such outside directors through the channel of the corporate secretary.
- Third, in the case of a U.S. subsidiary of a Japanese parent corporation, when the corporate secretary fulfills his or her role of liaison with the parent corporation, corporate governance of the entire corporate group will be enhanced.
- Fourth, especially since enactment of the SOX Act, the coordinating role of the secretary in document retention is increasingly paramount.
- Fifth, a key component of enterprise risk management is to conduct company-wide risk mitigation activities through the processes of risk analysis, planning, implementing and monitoring. The communications function of the corporate secretary will increase the effectiveness and transparency of this process.
- Finally, corporate social responsibility increasingly is emerging as an area of management focus. Corporations are expected not only to fulfill their responsibility to make lawful profits, but also to contribute to the local and global society as good corporate citizens. The corporate secretary's communication and coordination role can be valuable in planning, organizing and implementing corporate social responsibility activities.

The following discussion expands upon these points.

A. Enhancing Compliance Activities

Under the current legal climate in the United States since the SOX Act, there is an increased interest and emphasis on enhancing compliance with any and all relevant laws and regulations so that a U.S. corporation can make certain that its existence and business activities are lawful, legal and compliant. It goes without saying that lawyers such as the general counsel should have a primary role in enhancing the compliance activity of the corporation. Some corporations will have in-house general counsels while other corporations will appoint outside lawyers as general counsels. In any event, since enactment of the

SOX Act, the expectations surrounding the role of general counsel have been significantly increased and expanded. Until a few years ago, the central responsibilities of general counsels may have been to prepare drafts of the contracts which the corporation might enter, to conduct all necessary actions in any lawsuits in which the corporation could become a plaintiff or defendant, and to be consulted about the legal activities of the corporation in general. Post-SOX, the general counsel is expected to act more widely and actively as a champion of compliance and related activities. The general counsel is supposed to advise the corporate management team of the current legal framework and of possible future trends in the legal climate in order to assist with the process of informed decision-making by corporate management. In such matters, the corporate secretary is expected to closely communicate with the general counsel in order to support the general counsel's activities in advising corporate management.

For example, it is desirable that general counsel and the corporate secretary cooperate in organizing various managerial meetings, such as the board of directors meetings. Because a board of directors meeting is one of the fundamental decision-making mechanisms for a corporation, it is important to establish agenda items properly and timely to reflect the current legal, financial and business circumstances of the corporation, to fulfill legal requirements of the meeting and to encourage meaningful and material discussion of issues at the meetings. While state corporate law and often applicable regulatory laws such as state insurance laws stipulate some of the items that a corporate board of directors must address, other items may be up to corporate discretion thorough corporate bylaws and internal rules. The corporate secretary is expected to prepare the draft of items of the agenda and closely communicate with the general counsel for his or her advice so he or she may assure that the items on the agenda for the board meeting are timely and appropriate. Such a discussion will enable the corporate secretary to prepare adequately for these meetings, including preparing the meeting materials for members of the board in a timely fashion.

There is another example. In the current legal environment, many corporations are preparing compliance manuals and compliance programs. The input of the general counsel is essential in order to prepare and authorize the implementation of these documents. The corporate secretary can assist this process by effecting intracompany communication with relevant constituencies. Finally, the finished compliance manuals or compliance programs should be duly approved by the board of directors so that the corporate management team becomes clearly committed to achieving the goals stipulated in such compliance manuals and compliance programs. Throughout this process the corporate secretary is expected to communicate with the relevant constituencies of the corporation so that corporate management can make informed decisions.

Therefore, close communication with general counsel toward improvement of the compliance function is one of the enhanced areas in which the corporate secretary will be expected to engage for better corporate governance.

B. Communication with Outside Directors and Other Stakeholders of Corporations

Recently, and especially post-SOX, there is increasing pressure on corporations to have outside directors as their board members. These outside directors are expected to conduct an important oversight function of corporate governance through active participation in the board of directors meetings. In order to secure and maximize this oversight function, outside directors must have a full opportunity to evaluate the corporation's business activities and financial situation and to make informed decisions at the board of directors meetings. Because these outside directors are not engaged in the corporation's daily operations, it is important to properly communicate with them so that they will have sufficient information to understand corporate activities and the corporation's financial situation. The corporate secretary is expected to properly communicate with such outside directors through not only notice of board meetings, but also ongoing communication about the corporation's business activities and environment.

In the case of a U.S. subsidiary of a Japanese corporation, outside directors may not be familiar with Japanese corporate law and the changing business environment in Japan as well as current Japanese economic trends. It is sometimes useful for the management team to have opportunities to provide information to outside directors regarding the legal and business environment in Japan. If the corporate secretary has expertise and background in this area, he or she can facilitate such opportunities and sometimes can help explain these matters to the outside directors. Also, it may be convenient to provide the outside directors with a digest of the annual shareholders' meeting of the Japanese parent corporation.

There may be other stakeholders with whom corporations should communicate about corporate governance. From the standpoint of a U.S. subsidiary of a Japanese corporation, usually the parent corporation is the sole shareholder of the subsidiary. Communication with the parent corporation is important, not only from the viewpoint of parent-subsidiary relations but also for investor relations. The U.S. subsidiary is expected to fulfill its mission and is accountable for its business results as well as its future strategy. The relationship with local regulatory agencies is also important. In the case of property and casualty insurance corporations in the United States, proper communications with State insurance regulators are important. While this function is mainly carried out by the general counsel or legal or governmental affairs department, the corporate secretary is expected to recognize the latest information and to advise its Japanese parent corporation of legal developments in a timely fashion.

C. Document Retention

The SOX Act was intended to enhance corporate governance practices through, among other measures, strengthening the internal control structure of the corporation. Section 404 of this Act[7] encourages the strengthening of internal financial controls through proper documentation, among other requirements. While the SOX Act is currently applicable only to public corporations in the United States and their international parent corporations, some international corporations may consider adopting similar internal controls as a matter of best practice. Furthermore, Japan recently enacted the "Financial Products and Trading Act," which can be regarded as a Japanese version of the SOX Act, similar to the U.S. SOX Act in substance.

In order to cope with the more stringent internal control practices of current law, it is critical to secure proper document retention—historically one of the fundamental responsibilities of the corporate secretary. Although the primary players responsible for document retention enhancement activities in the corporation will be internal auditors, general counsel, financial department managers and information technology managers, the corporate secretary also can promote effective document retention in these areas based on his or her experience. Also, because the corporate secretary typically participates in regular managerial meetings, he or she tends to have a good sense of what is necessary in setting a retention schedule. If the corporate secretary can share information regarding document retention or schedule setting, it will enhance the corporation's ability to comply with SOX Act requirements.

In the insurance industry in the United States, the National Association of Insurance Commissioners is studying the introduction of a model law that requires an internal control mechanism similar to that required in Section 404 of SOX for insurance companies whose annual gross premiums are greater than certain threshold amounts, regardless of whether they are publicly held. A corporate secretary of an insurance company will have to take these elements into account.

D. Liaison with the Parent Company

As mentioned before, in the case of a U.S. subsidiary of a Japanese corporation, the management team of that subsidiary is expected to take into consideration the prospect that the Japanese legal structure may be applied to the subsidiary. This is particularly true in the financial sector, including property and casualty insurance companies. For example, the Insurance Business Law of Japan stipulates that the Financial Services Agency of Japan has regulatory authority over the subsidiaries of insurance companies to the extent that the Financial Services Agency considers it necessary to properly supervise the parent insurance company in Japan.[8] If the subsidiary corporations of Japanese insurance companies are located outside of Japan, such as in the United States, the Japanese Financial Services Agency will communicate with relevant local insurance regulators. While the individual state insurance regulators continue to be the primary regulatory bodies for insurance subsidiaries in the United States, they nonetheless must recognize that their activities have to comply with the Insurance Business Law of Japan. To ensure such compliance, if the subsidiary has the corporate secretary seconded from the Japanese parent corporation, and if such seconded corporate secretary has proper legal experience, he or she can serve as a proper liaison between the U.S. subsidiary and the parent corporation to enhance the subsidiary's compliance activities, both in the United States and in Japan.

Also, in the current globally interdependent society, the enhancement of group governance structure will be important. If a Japanese insurance corporation has insurance subsidiaries in different countries, it may seek to attain, to the extent possible, a common governance structure in its various subsidiaries. For example, it is true that different countries have their own corporation laws and criteria for determining items to be discussed and approved at board of directors meetings. However, it may be useful for the Japanese parent corporation to set some fundamental rules as to which issues should be discussed by the board of directors. Financial regulators worldwide are increasingly expecting multinational financial corporations to have global governance and compliance structures.

As part of effective group governance, the U.S. subsidiary of a Japanese parent corporation is expected to strengthen its internal audit structure in cooperation with the parent corporation. Specifically, the Japanese parent corporation will establish the rules on the internal audit standards applicable to global subsidiaries, including appointing the internal auditors for its global subsidiaries. The Japanese parent corporation may further request these subsidiaries to report on internal audit activities. Furthermore, the parent corporation will dispatch its internal audit team to the U.S. subsidiary from time to time to make sure that the subsidiary's business operations are in good order and to identify any issues and potential problems in their early stages. Although the subsidiary's internal audit activities are primarily overseen by its internal auditor, its secretary is expected to communicate with its internal auditor so that audit activities are reported to the Japanese parent corporation as well as to the management team and outside directors of the subsidiary.

Also, it may be useful if the corporate secretary of the subsidiary can coordinate the parent corporation's internal audit activity with the subsidiary's. Various recommendations and fact-findings by the parent corporation's internal audit team should be properly communicated to the subsidiary so that the subsidiary may undertake the requisite corrective actions through its internal auditors and management team. In this role, the corporate secretary must maintain an objective viewpoint and respect the internal auditor's independent status and neutrality.

E. Contributing to Corporate Risk Management Activities

A corporate secretary also can contribute to corporate risk management, increasingly becoming a primary managerial focus, through exercising his or her coordinating function. The growing concern about uncertainty in the nature of business and the increasing interdependency within the global economy encourage management to pay more attention to managing potential risks in various aspects of business operations. In this regard, since the framework of "Enterprise Risk Management (ERM)" was proposed in 2004,[9] more and more corporations recognize the importance of corporate risk management activities, including the enhanced ERM concept. This concept helps the management team to establish effective and sufficient risk management processes such as analyzing, planning, organizing, implementing and monitoring. In the insurance industry, the areas of corporate risk management to be addressed may include, among others, managerial risks, financial risks, underwriting risks, claims handling risks, operational risks, marketing risks, and legal and compliance risks.

As part of the risk management cycle, the corporation should identify, analyze and evaluate various risk elements in each risk area. Next, it should identify the proper measures to mitigate such risks, and the relevant functions or departments that will implement these measures with periodic monitoring. Because these activities will require intensive analysis and painstaking monitoring activity, some corporations may have a risk management department to plan, organize and monitor proper risk management. Other corporations may have a risk management committee whose members are composed of relevant departmental managers and legal professionals. In any case, corporate risk management activities are related to almost all the functions or departments of the corporation. Resolution of the essential issues requires strong commitment by top management of the corporation, a widely held understanding of the importance of risk management to the entire enterprise, and periodic monitoring of mitigating activity by the appropriate department or committee in the corporation.

In the course of this risk management cycle, the corporate secretary is expected to communicate the significance of corporate risk management to the top management team, to promote managerial decisions towards enhancing risk management through the approval of the board of directors, and so on, with cooperation from the general counsel, and to monitor risk-mitigating activities through proper cooperation and communication with the risk management department or risk management committee. While the corporate secretary is not able to implement risk management initiatives, he or she can promote effective risk management through these coordination and communication efforts.

F. Enhancing Corporate Social Responsibility

As corporations pay more attention to their overall responsibility to entire groups of stakeholders, they are expected not only to make lawful profits but also to contribute to local communities and the global economy. As more and more corporations commit themselves to corporate social responsibility (CSR) initiatives, they have come to consider constituencies such as customers, vendors, producers, employees, the local community and the environment as stakeholders, along with shareholders. Some corporations have established charters for CSR to underscore their managerial commitment to such stakeholders. Establishing the CSR concept within the corporation, preparing the charter for CSR and implementing CSR activity by the corporation will require input and execution from around the corporation. The corporate secretary can contribute to such activity through timely planning and proper communication with relevant functions. The coordinating function of the corporate secretary will enhance CSR activity efficiently and effectively.

In the case of a U.S. subsidiary of a Japanese parent corporation, the CSR charter and activity of the subsidiary should be harmonized with those of the parent corporation. The subsidiary's secretary is expected to make a plan for overall CSR activity, including a draft of the charter, to communicate with relevant areas of the subsidiary, and to promote the concept of CSR at the managerial level. Therefore, the role of the coordinating function of the corporate secretary takes on great importance in planning and implementing desirable, well-extended CSR activities in the U.S. subsidiary.

V. The Coordinating Function of the Corporate Secretary Will Be Enhanced

As discussed above, in the current business and legal environment, various corporate activities and decision-making processes are becoming increasingly complicated and interdependent. Especially as business and economic activity becomes increasingly globalized, multinational corporate groups are increasingly focused on enhancing group governance, to include a group-based risk management structure. Given this reality, harmonization and coordination of the corporate risk management strategies, CSR activities and comprehensive compliance enhancement are necessary and useful, and ultimately should enhance value to shareholders and other stakeholders. The corporate secretary of a U.S. subsidiary of a Japanese corporation is increasingly expected to contribute to this process through effective communication within the subsidiary corporation and with its parent, as well as with outside stakeholders.

However, even if the corporate secretary has knowledge and experience in financial and legal areas, ultimately the achievement of these challenging goals will primarily fall to other relevant functions or departments, such as the general counsel, the risk management team, or the internal auditors. The secretary's role is, therefore, one of identifying the relevant functions and departments, and bringing together their expertise in pursuit of the goals of the corporation as a whole. In other words, the most fundamental qualifications of the corporate secretary will include the ability to communicate, harmonize and coordinate. These abilities will stand the secretary in good stead through the planning, organizing and implementing phases.

In the planning cycle, the corporate secretary can prepare practical plans through efficient communication with the relevant departments and proper coordination throughout the organization. In the organizing cycle, the secretary can promote ongoing discussions and present plans for approval by the board of directors or shareholders, assuring that the decision makers have adequate information to make informed decisions. In the implementing cycle, the corporate secretary maximizes the effect of each strategy by maintaining close communication with relevant corporate functions or departments. To the extent that he or she can bring these different abilities to bear, the secretary will be able to fulfill his or her expanded role as a key figure in effective corporate governance.

Thus, to meet the advanced responsibilities imposed by today's demanding global climate, the corporate secretary may play the role of catalyst or assume the role of communicating, coordinating and harmonizing within the organization. In the case of a U.S. subsidiary of a Japanese corporation, this role is especially important because of the need to coordinate and harmonize the daily management of the corporation by the local management team with the group strategy established in the Japanese headquarters, through effective communication between parent and subsidiary.

VI. Conclusion

As corporate governance and related concerns will remain pivotal areas in the future business and legal environment, the role of the corporate secretary will also continue to be important. It is desirable that the corporate secretary take on these additional responsibilities by developing close relationships with the various areas of the corporation to enhance corporate value and to contribute to the corporation's responsibility to its multiple stakeholders. In the current globally interdependent society, it is useful for Japanese corporations to focus on the enhanced roles of the corporate secretary of their subsidiary corporations to achieve better group governance and corporate risk management. Ultimately, the corporate secretary of such a subsidiary can undertake and fulfill responsibilities well beyond the traditional role of mere liaison with the parent corporation.

Endnotes

1. 15 U.S.C.A. §§ 7201, *et seq.*
2. Corporation Law of July 26, 2005. Legislation Number 86.
3. Law No. 25 of 1948. Complete amendment to the Securities Exchange Act. In Japan, the Internal Control requirement in this Act is sometimes referred to as the "Japanese Type of Sarbanes-Oxley Act."
4. For example, Delaware General Corporation Law §§ 141, 142, and New York Business Corporation Law §§ 715, 717.
5. Black's Law Dictionary (Seventh Ed.) 1355 (1999).
6. The ability of Japanese staff to serve in the general counsel's post at a U.S. subsidiary would, of course, be subject to local licensing requirements for the practice of law in the U.S. jurisdictions where the subsidiary operates.
7. 15 U.S.C.A. § 7262.
8. For example, Paragraph 2 of Article 128 of the Insurance Business Law of Japan establishes document submission requirements for any subsidiary of insurance companies licensed in Japan. Paragraph 2 of Article 129 of that Law authorizes the Financial Services Agency of Japan to conduct an on-site examination of any subsidiary of an insurance company to the extent that the Agency deems necessary to effectively supervise the parent.
9. The Committee of Sponsoring Organizations of the Treadway Commission (COSO) introduced the concept of "Enterprise Risk Management," or ERM, in 2004. *See* Committee of Sponsoring Organizations of the Treadway Commission, Enterprise Risk Management—Integrated Framework-Executive Summary (2004).

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Banking Law Committee

The Banking Law Committee met four times in 2008. The Committee has heard presentations on judicial, regulatory, legislative, litigation and transactional developments, including those involving the subprime mortgage crisis. Speakers have included the General Counsel of the New York Banking Department and the Regional Counsel of the OCC. We continue to seek to build attendance at our meetings by providing quality presentations, CLE credit and a forum for idea exchange.

—Clifford Weber, Chair

Bankruptcy Law Committee

Jeffrey Reich on behalf of the Bankruptcy Law Committee made a presentation on sanctions and damages awarded by bankruptcy courts against mortgage lenders and on assumption of executor contracts and Chapter 13 issues at the Section's annual meeting in September. The Committee presented a statewide CLE program on Basic Bankruptcy Skills at the end of October. Finally, a special subcommittee has been looking at alternatives to allow a partial "cram-down" of consumer home mortgages in Chapter 13 cases that would be acceptable to lending institutions (at press time, this issue was pending before the Congress).

—Mark Tulis, Chair

Corporations Law Committee

The Corporations Law Committee was particularly active last spring in commenting on proposed legislation in New York. The two bills which the Committee supported were approved by both houses and signed into law. The first bill amends Section 614 of the BCL to provide that the plurality default for the election of directors of New York corporations can be overridden by a bylaw provision as well as an amendment to the certificate of incorporation. In recent years, many corporations have shifted from a standard that directors are elected by a plurality vote to a majority vote standard, except in the case of contested elections. Because this shift previously required an amendment to the certificate of incorporation, which required board and shareholder approval, it was more difficult for New York corporations to make this change and more difficult for shareholders of New York corporations to force this change, unlike in Delaware, where the change could be made with a bylaw amendment that shareholders can adopt without board approval. While disagreeing with the much stated rationalization for majority voting—"where a single 'for' vote could elect a director" because directors in companies with plurality voting have almost always also received a majority of the votes cast—the Committee acknowledged that majority election of directors was being adopted increasingly by New York as well as Delaware corporations, and the bill would facilitate that change. The bill would not eliminate the need to amend the certificate of incorporation where the corporation's certificate of incorporation explicitly provided for plurality voting.

The second bill supported by the Committee amended paragraph (b) of Section 510 of the BCL to permit New York corporations to pay dividends out of net profits (either in the year the dividend is paid or in the prior year) in addition to paying dividends out of surplus. Under the BCL, "surplus" is the excess of the net assets of the company over the stated capital. The Committee acknowledged that in the era of no-par and low-par shares, it has been long recognized that stated capital provides no protection to creditors, and that the Model Act and most other states have eliminated the concepts of capital and surplus and adopted tests of financial condition in determining whether a corporation may pay dividends. New York's amendment would follow Delaware law, in permitting dividends to be paid out of net profits, where surplus was insufficient.

The four bills with respect to which the Committee submitted memoranda in opposition did not become law. Two of them were consecutive versions of a bill mandating New York corporations (in the first instance with 100 or more shareholders, and in the second instance publicly traded corporations) to make the annual shareholder meeting available by remote access and to permit shareholders to vote electronically throughout the meeting (the first version also would have required the corporation to consider those shareholders attending electronically to be present for quorum purposes). While the Committee supported the concept of having permissive provisions, it explained in its memoranda that mandating these requirements was not appropriate because they were either technologically or economically not feasible at present. Very few corporations as of yet Webcast their annual meetings;

the Committee could not find any example where a corporation whose shareholders remotely accessed the meeting were considered present for quorum purposes, and the voting during the meeting requirement was contrary to the practices of most issuers (where the mechanics of compiling the vote require an earlier cutoff for proxies, as opposed to ballots submitted at the meeting). Moreover, the Committee noted that because most shares are held in nominee name, and these provisions applied only to record holders, the legislation would not have the intended effect.

The Committee also opposed a bill that would have amended subdivision (3) of the limited liability company law to require, among other things, New York LLCs to include in their articles of organization the names and addresses (which must be an actual location, rather than a post office box) and a description of the duties and responsibilities of all members, the actual addresses of all offices of the LLC wherever located, and the amendment of the articles of organization whenever any changes in the foregoing occurred. While the stated purpose of the bill was to assist cities in enforcing local codes and ordinances and the collection of taxes and judgments, the Committee noted that imposing these onerous requirements would simply cause entities seeking to avoid such obligations to gravitate to another form of entity, and force most of the hundreds of thousands of New York LLCs that were not shunning these obligations to also change to another form of entity to avoid continual amendments of the articles of organization, resulting in considerable transaction costs and the likely abandonment of the LLC as a business entity in New York.

Finally, the Committee opposed an Assembly bill that would have amended the limited liability company law and the general construction law with respect to the definition of newspaper to eliminate the requirement that a "newspaper" has a paid circulation. The Committee noted that the Assembly Memorandum in Support provided no data or analysis as to the difference in publication costs, public availability and archival retrieval between newspapers with or without paid circulations, and that given the number and significance of legal notices that must be published in a "newspaper," such an analysis should be undertaken before making the change.

—Janet Geldzahler, Chair

Franchise, Distribution and Licensing Law Committee

The Franchise, Distribution and Licensing Law Committee held a meeting in May 2008 with a presentation by Craig R. Tractenberg on the subject of "Bankruptcy Issues and Strategies in Franchising."

Attendees also discussed New York State Assembly Bill A10963, introduced by Assemblyman Adam Bradley on May 8, 2008, shortly before the legislative session ended. The Legislature did not act on the bill in its 2008 session, but Mr. Bradley's staff has indicated that he intends to reintroduce the bill in the next legislative session, which begins in January 2009. Thomas Pitegoff, the Chair of this Committee and a resident in Mr. Bradley's election district, assisted Mr. Bradley's staff in preparing this bill.

The bill would conform the definition of a "franchise" in New York more closely to the definitions used by the Federal Trade Commission (FTC) and other states. It would add the concept of a "business opportunity," consistent with the FTC approach. It would exempt franchise sales by New York franchisors to franchisees outside of the state, bringing New York law in line with the approach taken by other states. Finally, the bill would exempt the grant of master franchise rights to a single company in New York.

The coverage of the current franchise law in New York is so broad that it is often a trap for the unwary. The broad scope of the law discourages companies from doing business in New York and creates uncertainties that make compliance difficult.

These changes would improve the environment for business in the state. They would also remove barriers to international business in New York and enhance New York's reputation as an international center of business. At the same time, the changes would not eliminate the private right of action by aggrieved franchisees, and they would preserve the authority of the Attorney General's Office to prosecute franchise fraud.

The Committee welcomes comments on this bill. The Committee also welcomes suggestions for future presentations and programs. Contact the Committee Chair at pitegoff@pitlaw.com.

—Thomas M. Pitegoff, Chair

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All proposed articles should be submitted to the *Journal*'s Editor-in-Chief. Submissions should be e-mailed or sent on a disk or CD in electronic format, preferably Microsoft Word (pdfs are not acceptable). A short author's biography should also be included.

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