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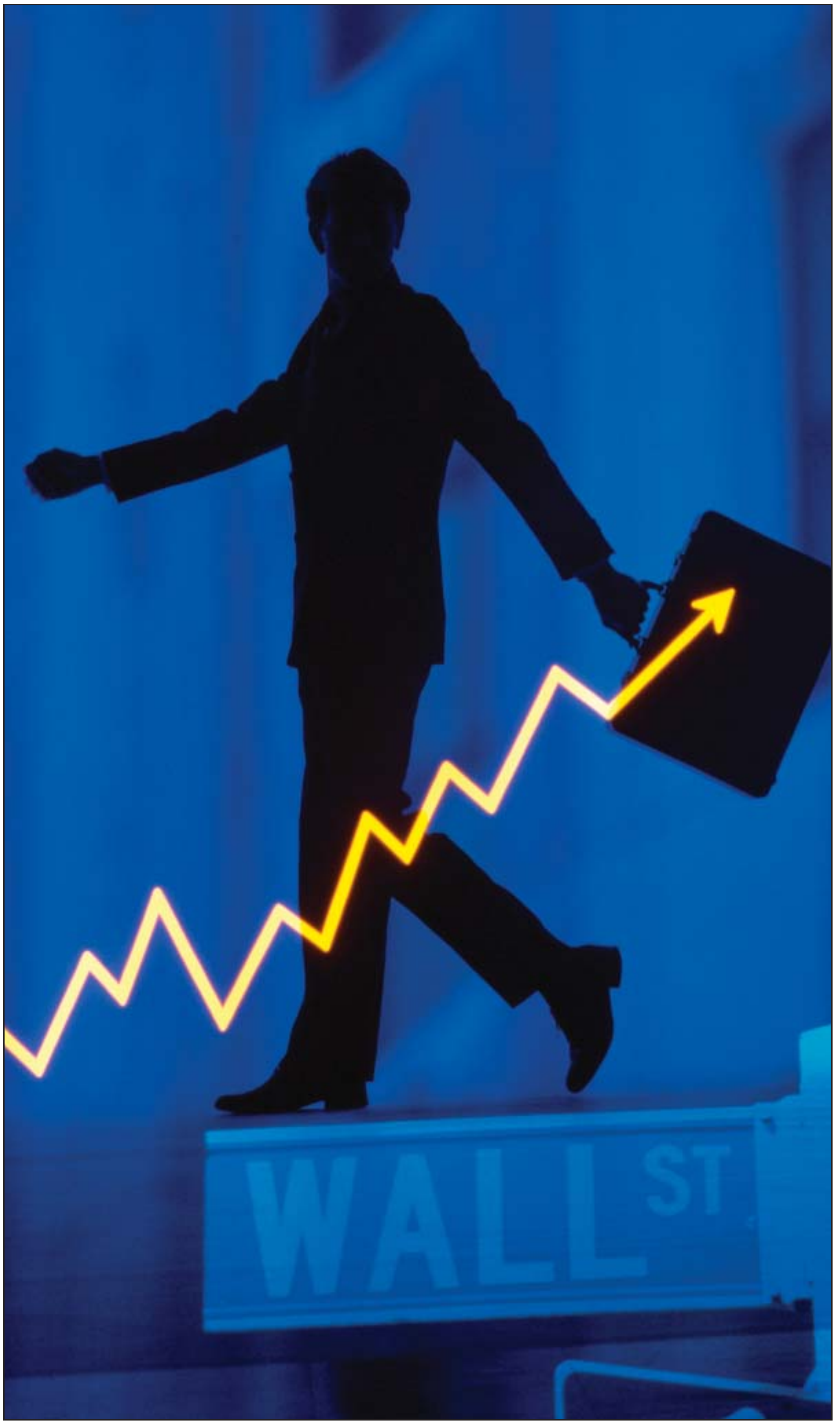

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NY BUSINESS LAW JOURNAL

HeadNotes

The Sarbanes-Oxley Act (SOX) and its many ramifications for business entities and their lawyers continues to hold the spotlight in 2007. Associate Professor David Cassuto of Pace Law School leads off with an analysis of the prosecution of the Arthur Andersen accounting firm, which was brought down by its involvement in the Enron failure. Professor Cassuto highlights the implications of the notion that an entity can be prosecuted for a crime, separate and apart from the acts of its individual officers and employees. The author argues that serious procedural errors in the prosecution—while not directly affecting the outcome—nonetheless hold troubling implications for future prosecutions of business crime, and for civil liberties generally.

C. Evan Stewart, a prolific contributor to the *Journal* (and a regular speaker at Section programs), contributes another provocative and insightful inquiry into the troubled state of the legal profession in relation to its constituencies. Starting from the premise that the attorney-client privilege is under significant attack and "has never been weaker," Mr. Stewart explores various proposals to save the privilege by providing that it can be preserved under certain circumstances, even if confidential information is disclosed. In particular, he focuses on proposals that would save the privilege in cases of 1) inadvertent disclosure, as in massive document discovery during litigation, and 2) selective disclosure, in the context of a government investigation.

Next up is James Grasso, a partner of Phillips Lytle LLP in Buffalo, taking a close look at the "whistleblower" provisions of SOX. While most covered companies by now have adapted to SOX's requirements for financial reporting and certification, the author notes that Section 806 of SOX, which protects whistleblowers, has not received adequate attention. Section 806 applies to publicly traded companies, and imposes personal as well as corporate liability on company officers who take adverse action against employees who engage in protected whistleblowing activities. But the section also reaches non-public companies, such as accounting firms, that contract with the public company, and thus has broad significance for New York business lawyers and their clients. The author notes that policies to protect anonymous complaints may not be sufficient to protect against whistleblower suits, and offers practical guidance for covered employers.

Another potential pitfall of the employer-employee relationship is explored by James M. Thurman, a member of the New York State Bar Association, who is currently conducting research in law and digital communications at the University of St. Gallen in Switzerland. Mr. Thurman discusses two recent cases involving that most ubiquitous tool of the modern corporation—the laptop computer—and the implications for personal privacy, as well as prosecution for computer fraud, when employees undertake to alter, destroy or misappropriate digital information stored on their laptops.

The next two articles look at different aspects of the merger and acquisition boom. Simeon Gold, a partner at Weil, Gotshal & Manges (and a former Chair of the Business Law Section) and his colleague Daniel Holzman give a practical overview of the relative merits of acquiring distressed assets directly from troubled companies or through the bankruptcy process. They start from the premise that low interest rates in recent years have induced troubled companies to try to borrow their way out of difficulty. As a result, private equity funds and funds set up to specialize in distressed acquisitions may have an opportunity to bargain-hunt. But the downside is that the transaction can be unwound after the fact, if the bankruptcy court finds that it involved a fraudulent transfer. Acquiring distressed assets through the bankruptcy process may be safer in some ways, but presents its own issues.

In "The Importance of Due Diligence Investigations in Mergers and Acquisitions," Wendy B. Davis, an associate professor at Albany Law School, contributes practical and thoughtful guidance for attorneys representing buyers in a business combination transaction. Her article is a handy checklist of the areas to be covered in a due diligence investigation, ranging from corporate form through tax and accounting issues; to labor and employment issues, including whether to retain key personnel; through intellectual property, valuation of the business, litigation and environmental liability. At the same time, she warns against simple reliance on checklists, noting the need to customize the investigation to fit the situation. Bottom line: less-than-diligent review will find little sympathy in the courts, if the acquisition turns out to be a lemon.

Concluding this issue is a practical article on a topic not often fully considered by attorneys drafting contracts on behalf of businesses—namely, when revenue from the contract will be recognized. Andrew Vitrano, a New York business practitioner, shows how to effectuate the client's concern with optimizing revenue recognition in conjunction with its business strategy, as well as internal controls to assure that the company's employees are following the revenue recognition policy. Through a series of practical examples, the author illustrates the four elements of revenue recognition: 1) persuasive evidence of an arrangement, 2) delivery of products or performance of services, 3) fixed or determinable price, and 4) reasonable assurance of collection.

David L. Glass
Editor-in-Chief

Guilty by Legal Fiction: The Arthur Andersen Trial and the Remaking of Entity Guilt

By David N. Cassuto

In 2002, Arthur Andersen, LLP stood trial for obstruction of justice stemming from its role in the collapse of Enron and its aftermath. The prosecution offered several theories as to who at the firm had committed the crime but no one theory satisfied all twelve jurors. In an attempt to break its deadlock, the jury asked whether it could convict if some of them thought Person A at Andersen had done it and some of them thought it was Person B. Following argument, the judge ruled that it could convict.

This article argues that the court's response to the jury's query was wrong as a matter of law and policy. The ruling misconstrues the nature of corporate criminal intent and effectively treats a domestic corporate entity as if it were a rogue nation facing trial for war crimes. The conclusion offers some thoughts on the dangers—both present and future—of our national obsession with war.

I. Introduction

The War on Crime has wrought considerable collateral damage. However, Arthur Andersen, LLP ("Andersen"), scandal-rocked auditor of scandal-rocked corporations, hardly qualifies as an innocent victim. A storied member of the "Big Five,"[1] Andersen was Enron's auditor, providing both auditing and consulting services to the giant energy company. When Enron collapsed amidst massive accounting fraud, Andersen faced investigation and public excoriation. When it was later revealed that a group of people at Andersen had engaged in a colossal shredding operation, and that millions of Enron-related documents had been destroyed, the firm faced criminal charges. This hardly seems like a resume for victimhood.

Yet, the firm's 2002 trial for criminal obstruction of justice was marred by serious procedural errors. The jury instructions contained crucial flaws, only one of which was addressed on appeal.[2] It is the other major procedural error that forms the focus of this article. Though it did not ultimately affect the verdict, the error nevertheless has far-reaching implications for future criminal prosecutions of corporations.

A. The Trial

In 2002, the firm stood trial on charges of criminal obstruction of justice under 18 U.S.C. § 1512, specifically section (b)(2), the witness tampering provision, which states in relevant part:

> (b) Whoever knowingly uses intimidation [or physical force], threatens, or corruptly persuades another person, or attempts to do so, or engages in misleading conduct toward another person, with intent to—
>
> (2) cause or induce any person to—
>
> (A) withhold testimony, or withhold a record, document, or other object, from an official proceeding;
>
> (B) alter, destroy, mutilate, or conceal an object with intent to impair the object's integrity or availability for use in an official proceeding . . . shall be [guilty of a crime].[3]

In order to convict, prosecutors had to show that someone at Andersen had either attempted or actually had "corruptly persuaded" another person to tamper with material relevant to an official proceeding. The narrowness of the charge presented significant challenges. Prosecutors had to prove more than just corporate malfeasance; they had to show that a specific Andersen agent had committed a specific act—corruptly persuading—and that said act caused or was intended to cause another person to impede official access to material relevant to the investigation.

1. The Government's Case

The government's case against Andersen featured, as its star witness, David Duncan, former lead partner on the Enron engagement. Duncan had previously pled guilty to felony obstruction of justice charges.[4] In his plea, he admitted knowing that the SEC might have been interested in the documents that he had ordered destroyed. He also acknowledged personally destroying some of those same documents.[5] Prosecutors believed that Duncan's guilty plea and subsequent admissions demonstrated the firm's intent to thwart the SEC investigation and thereby obstruct justice. [6]

The government offered several other theories of Andersen's guilt as well. It suggested that Andersen General Counsel Nancy Temple's emails instructing Duncan to remind the engagement team of the firm's document retention policy was a covert order to destroy incriminating documents and had corruptly persuaded Andersen employees to shred.[7] Prosecutors pointed as well to a videotape of Andersen partner Michael Odom giving instructions to firm employees about destroying documents and noting that (hypothetically speaking) it would be "great" if records were shredded up to the day the firm learned of a lawsuit.[8]

2. Andersen's Defense

In its defense, Andersen maintained that the government's case collapsed under the weight of its internal contradictions. As Rusty Hardin, Andersen's lead trial attorney, argued, "This is a document-destruction charge by the government based on evidence and documents that we [Andersen] preserved and gave them. Is there some irony in that?"[9] He compared the government's case to the children's book, *Where's Waldo*, recommending that the jurors continually ask themselves, "Who are the corrupt persuaders?"[10]

In the defense's view, Nancy Temple's instructions were little more than standard legal advice on document retention for audit clients. Andersen gave even less credence to the argument that Michael Odom's narrative on the training video amounted to criminal behavior. Hardin told the jury to start by asking themselves "if he is on this videotape telling people to do something wrong, why is he doing it on a videotape?"[11]

Duncan's testimony emerged as problematic as well. Unfamiliar with the firm's document retention policy and ignorant of the legalities relating to document destruction, Duncan admitted that at the time he ordered the documents shredded and participated in the shredding himself, he did not believe he was committing a crime.[12] Thus, Duncan appeared to admit that he lacked the requisite intent for the crime to which he had pled guilty.

Given this apparent absence of intent, portraying Duncan as the "corrupt persuader" that the statute requires became increasingly difficult. Nevertheless, Duncan's testimony was not an unalloyed positive for the defense. Both sides found themselves in uncomfortable positions. Andersen had to argue that, irrespective of his guilty plea, Duncan had not committed any crime. For its part, the prosecution found itself reassuring the jury that, despite new evidence to the contrary, their star witness was in fact a criminal.[13]

3. The Jury Instructions

After both sides rested, Judge Melinda Harmon instructed the jury that to convict under 18 U.S.C. § 1512(b)(2), it must unanimously find that Andersen, *through an agent or employee*:

- acted knowingly with corrupt intent
- to cause or persuade one of Andersen's employees
- to withhold a document from an official proceeding,
- or alter, destroy or conceal an object
- with intent to impair its availability in an official proceeding[14]

After seven days of deliberation, the jury reported that it was deadlocked. The judge gave an *Allen* charge[15] and instructed jurors to continue deliberating. Shortly thereafter, the jury sent out Note #9, which asked:

> If each of us believes that one Andersen agent acted knowingly and with corrupt intent, is it [necessary] for all of us to believe it was the same agent.
>
> Can one believe it was agent A, another believe it was agent B, and another believe it agent C.[16]

This query presented an issue of first impression for the court. In fact, as subsequently became clear, no court anywhere had ever addressed a question even similar to it. Unsurprisingly, the two sides took opposite positions. Andersen argued that the jurors must unanimously agree on the actor/agent of the corporation who committed the crime while the government maintained that the law did not require jury unanimity on this point.

The judge ruled in favor of the prosecution. She informed the jury that "[t]o find Andersen guilty as charged you must find beyond a reasonable doubt that at least one agent of Andersen acted with the required knowledge and intent, but you need not all agree unanimously that it was the same agent of Andersen who acted with the required knowledge and intent."[17]

Eventually, the jury broke its deadlock and returned a verdict of guilty. It did not have to rely on the court's answer to Note #9 because it reached consensus that Nancy Temple was the responsible Andersen agent.

B. A Closer Look at the Ruling on Note #9

1. The Ruling Violates Precedent and Makes Bad Policy

Though mooted for purposes of Andersen's trial, the ruling on Jury Note #9 remains important as the sole judicial pronouncement within an unsettled area of law. A finding that juries need not unanimously agree on the identity of the bad actor within a corporation gives wide latitude to prosecutors. Under this rationale, prosecutors can present multiple theories involving any number of potential bad actors. All they need to do is convince the jury that someone did something rather than that a particular person did a particular thing.

Allowing jurors this leeway violates the foundational principle of federal law that juries must unanimously convict in criminal trials. It also allows prosecutors to offer multiple theories of guilt, not in the hopes that the jury will settle on one, but rather that it will settle on *some* of them. This scattershot jurisprudence will markedly shift the dynamics of criminal trials and will almost certainly spur challenges by the defense bar.[18]

The ruling erred on a more subtle, rhetorical level as well. By validating the government's position, the court adopted a stance that strips agents of agency while attributing consciousness to a legal fiction.

2. Identity Is Not an Element but It's Also Not the Issue

The government sought to cast the issue solely as one of identity, which it argued was not an element of the crime and therefore did not require jury unanimity. In its view, "the identity of a specific corporate actor is *not* an element of the offense, but rather a method and means by which a corporation can be found guilty of a crime."[19] To find otherwise would hamstring corporate criminal prosecutions and shield corporations from liability.[20]

According to this view, corporate actors are merely the method and means through which entities commit crimes.[21] The act and intent lie within the corporation itself. Agents are tools, nothing more. As the prosecution argued, the Andersen agents were analogous to guns used in a robbery: "All [the jury has] to agree on is that a gun was used, not the same gun. . . . Just think of (Andersen partners) as guns."[22] Similarly, the jury did not have to agree which Andersen agent obstructed justice, just that the firm itself committed the crime.

Though the prosecution's reasoning has a surface allure, it does not withstand close scrutiny. According to the prosecution's logic, the issue resolves as follows:

- The jury is uncertain as to the identity of the corrupt persuader within Andersen;
- Identity is not an element of 18 U.S.C. § 1512;
- Therefore the jury need not agree on the identity of the corrupt persuader within Andersen.

The flaw in this reasoning lies with the conflation of means and mens rea. Contending that the question hinges on whether identity is a means or an element of the statute steers the inquiry into an area of unsettled law—distinguishing between means and elements—rather than toward the uncontroversial and long-settled principle that jury unanimity is required on the issue of mens rea itself.[23] In addition, even if identity is not an element of the crime (which it likely is not) the court still erred in its ruling.

Consider the following fictional example:

> A memo from the Legal Department of Beelzebub, Inc. dated January 9, 2005 orders the shredding of all records relating to the last three quarterly earnings statements. A day after the accounting department complies, the SEC subpoenas the now destroyed records as part of an ongoing fraud investigation. Based on these facts, it seems likely that one or more people at Beelzebub violated 18 U.S.C. § 1512 (b)(2) by corruptly persuading other employees to destroy evidence.[24] However, it is not clear precisely who did it. Beelzebub's Legal Department has over 200 members. Even assuming the offender actually belonged to that department, locating him or her remains nearly impossible.

Diligent investigation fails to conclusively identify the responsible parties, but the government indicts anyway and the case goes to trial. The defense moves for a directed verdict, arguing that the jury could not reasonably convict because it cannot identify the bad actor within the corporation. The judge denies the motion and the case goes to the jury. Can the jury convict on these facts?

Yes, it likely could. Because the entity, Beelzebub, Inc., is on trial and not an individual, a jury could reasonably conclude that an agent of Beelzebub obstructed justice while never knowing the actual identity of the agent.[25] Knowing the agent's name is not necessary to believing that he or she was an agent of the corporation who knowingly and corruptly persuaded other employees to tamper with evidence. Convicting Beelzebub on this basis would not sound any of the procedural alarms raised by the judge's response to Jury Note #9. To understand why this is so, we must recognize the distinctions between the Beelzebub example and the Andersen case.

C. There Was No Unanimity Regarding Either the *Mens Rea* or *Actus Reus*

In the above example, the jury unanimously concluded that a particular unnamed agent (whom we'll call "Lucifer") at Beelzebub did a particular thing (sent a memo directing that relevant documents be destroyed) at a particular time (January 9, 2005). The jury further concluded that Lucifer knew an investigation was imminent and intended to (and did) corruptly persuade other employees to tamper with evidence. All of the elements of the crime are therefore satisfied. The jury unanimously agreed on the nature of the bad act and the intent of the actor. Though the specific identity of the actor/agent remains unknown, the jury is satisfied that she exists, that she is an agent of Beelzebub, and that her actions and intent violated the law.

Contrast the Beelzebub scenario with the Andersen case. In *Andersen*, the prosecution presented competing theories of the corrupt persuasion that occurred. It suggested that it could have been Duncan's directing subordinates to shred, Temple's emails regarding the document retention policy or the wording of a memo, or Odom's video presentation encouraging the destruction of audit workpapers up to the day the firm learns of a lawsuit.

These actions were carried out by different people on different days. For any of them to be criminal, the responsible individual must have had guilty intent.[26] The *act* of knowing corrupt persuasion is inseparable from the *intent* to do so. One cannot innocently yet corruptly persuade[27] nor can the intent to corruptly persuade reside with someone other than the person doing the persuading.

If the jury were to conclude (as it ultimately did) that Temple corruptly persuaded other employees to obstruct justice, then the jury also had to believe that she intended to do so. The same would hold true for Duncan or Odom. It follows that when the jury deadlocked, the disagreement involved more than just the identity of the corrupt persuader. The deadlock arose because some jurors believed that Person X committed Crime A and some believed that Person Y committed Crime B. This amounts to a disagreement not just over identity but over the nature of the crime itself.

By way of further illustration, consider the following two analogous hypotheticals.

> Jane Smith is standing trial for armed robbery. Prosecutors offer two different scenarios for her guilt: 1) that she robbed a convenience store on July 4 and, 2) that she robbed a bank on July 14.[28] When the case goes to the jury, half of the jury believes that she robbed the convenience store but not the bank while the other half believe that she robbed the bank but not the convenience store. Though all the jurors agree that she committed armed robbery, they do not agree as to when, where or how.

Under these circumstances, it would be manifestly unconstitutional to convict her because the jury has not unanimously concluded that she committed any crime.[29]

Now change the defendant from Jane Smith to Beelzebub, Inc.

> Beelzebub faces trial for dumping hazardous waste into waterways in violation of the Clean Water Act.[30] The prosecution presents evidence that Mephisto, Beelzebub's senior vice president, dumped dry cleaning solvent into the Hudson River in 2004. The prosecution also argues that Sammael, Beelzebub's CFO, dumped biowaste into the Gulf of Mexico in 2003, also in violation of the Clean Water Act.[31]
>
> When the case goes to the jury, half of the jurors believe beyond a reasonable doubt that Mephisto dumped into the Hudson. The other half is dubious about Mephisto but fervently believes that Sammael dumped into the Gulf. Even though everyone on the jury believes that someone at Beelzebub did something illegal, they disagree about what actually happened.

Here again, the jury should not convict for either crime. There is no agreement as to act, actor, or intent. The jury does not agree on anything other than that at some time in the past, someone committed a crime of some sort and that that person worked at Beelzebub, Inc. That is a flimsy hook on which to hang a conviction.

Yet, in *United States v. Andersen*, the judge allowed the jury to hang its verdict on this very hook. The jury did not agree on the actor (Temple, Duncan or Odom), or the action (directing subordinates to shred, sending an email suggesting shredding, or making a videotape encouraging employees to destroy evidence). It follows that the jury similarly lacked consensus on the presence of intent. If it could not agree on the nature of the crime or the person who committed it, the jury could not possibly have agreed on whether whoever committed the crime intended to do so.

To convict amidst all this uncertainty would be manifestly wrong. A shared belief that someone did something illegal is not the same as a shared belief that a particular person committed a particular crime. Only the latter enables conviction.[32]

D. The Government's Position Is Self-Undermining

The government's position founders on other bases as well. In arguing that the jury could convict without knowing the identity of the corrupt persuader, prosecutors maintained that the identity of the guilty corporate agent was immaterial. The agent formed merely the method and means through which the entity, Andersen, committed the crime.[33] The actual person or people who perpetrated the act were comparable to the weapon(s) used in a robbery; they were mere tools acting at the behest and under the control of the entity.[34]

This position directly contradicts the jury instructions, which required the jury to determine which *agent* at Andersen acted knowingly with corrupt intent to cause or persuade another employee to alter or destroy evidence.[35] Maintaining that the agent is fungible and that her identity is irrelevant to the entity's guilt negates the requirement that the jury decide who within the company acted as the corrupt persuader. On that basis alone, the government's argument should have failed.

The government's position is also inconsistent as a matter of statutory exegesis and common sense. One cannot logically contend that agents of a corporation have no intent while simultaneously maintaining that those same agents were knowing corrupt persuaders. The two propositions are mutually exclusive.

On the one hand, prosecutors contended that the guilty agent at Andersen knowingly and corruptly persuaded other employees to obstruct justice. On the other hand, prosecutors argued that agents at Andersen either had no *mens rea* of their own or that their *mens rea* was immaterial because they were mere pawns of the entity. According to the latter thesis, the guilty intent resides with the corporation and the identity of the agent/actor is therefore irrelevant.

These two positions cannot coexist. Either the agent had the intent to corruptly persuade and did corruptly persuade or she did not. If the former, then under these facts, the jury must agree as to the agent's identity. If the latter, then per the judge's instructions, the jury must acquit.

Not only does the prosecution's argument strip the people making up the corporation of any will or intent of their own, it transposes that will or intention onto the corporate entity—a legal fiction created by the law as a matter of social convenience. To attribute intent to such a creation is to bring an incorporeal entity to life, a feat surpassing even that of Dr. Frankenstein. Frankenstein at least worked with a body that was once alive.[36] The government, on the other hand, wished to enliven something that never actually existed outside the printed page.

Furthermore, maintaining that the firm's agents were merely tools in the nefarious grip of a malevolent corporate entity expands the notion of corporate criminal liability to an unprecedented and unsustainable extreme. The bankruptcy of this reasoning becomes clear if we apply it to the crime of homicide. If a corporate employee kills someone on the orders of his employer, one can scarcely imagine a prosecutor arguing that the employee bears no responsibility, that she was merely an extension of the gun, and that the corporation pulled the trigger. Yet, the government made almost precisely this argument in the Andersen trial, explicitly comparing corrupt persuaders within the firm to guns.

By the government's lights, Arthur Andersen, LLP—rather than any person at the firm—intended to (and did) corruptly persuade an employee to obstruct justice. As is now clear, this premise is incoherent for purposes of corporate criminal prosecution. However, there are circumstances where attributing a singular will to a collective is appropriate. The practice has roots in longstanding principles of international law, particularly the laws of war and measuring the guilt of nations.[37]

The fact that prosecutors successfully injected this international vision of entity guilt into a domestic case is cause for alarm. International laws of war do not safeguard civil liberties in the ways that our Constitution requires. Adjudicating a peacetime criminal prosecution in this manner bodes ill for due process.

II. Andersen's Entity Guilt and Its Right to Due Process

The issue posed in Note #9 dealt with the nature of corporate criminality and entity due process. Faced with jury skepticism as to the responsible Andersen agent, the court retooled corporate criminal law to enable conviction without consensus. As a result of the judge's ruling, the jury was permitted to consider convicting without having agreed on the crime, much less the responsible agent. Even if each member of the jury had believed that a different person did a different thing, they still could have convicted Andersen of obstruction of justice.

The judge apparently accepted the prosecution's argument that Andersen's entity responsibility should be expanded and its agents' agency contracted. The ruling effectively treated Andersen as a rogue nation facing an international tribunal rather than as a corporate citizen in a United States court. As such, it violated Andersen's due process rights and set a disturbing precedent for future trials.

It is worth considering why, when faced with such formidable legal barriers, Andersen prosecutors employed the strategy they did as well as why the judge embraced it. The ruling epitomizes a willingness to sacrifice basic liberties for the perceived greater good of public safety. This mindset normally occurs during national emergencies, especially during wartime. However, despite all rhetoric to the contrary, the nation is not at war with crime, at least not in the traditional sense. Nor for that matter is it at war with an array of other incorporeal forms and notions, including terrorism, drugs, illiteracy, and poverty.

Nevertheless, the national obsession with war[38] has assumed enormous political and legal importance in the wake of the September 11, 2001 attacks. The nation has entified and made enemies of sociological phenomena.[39] Amidst this revisioning of war and peace, it should not surprise that a tactic of war crime prosecutions has found its way into a domestic criminal trial. However, the American legal system is a delicate equipoise of rights and obligations. Importing rhetoric that deprivileges rights threatens the system's core function.

War is quintessentially a political act whose goal is to effectuate systemic political change through force of arms. It presupposes a foe dedicated to opposing that change. Crime is both a creation of law and combated by the forces of law. Those who would make war on crime do not wish fundamental change but rather to strengthen the status quo.

Criminals similarly seek only to improve their situation within the social system; they do not seek wholesale systemic change. If recourse to the laws of society is possible, then the conflict involves law enforcement rather than war. The rules of engagement that govern during an armed conflict are therefore neither necessary nor relevant. A war on crime is therefore incoherent by definition.

Conclusion

The conclusions of this article are twofold. First, the Andersen prosecution and the trial judge erred when they respectively accepted the idea that the jury could treat the firm as an entity capable of its own intent, separate and apart from the intentions and actions of its agents. One can prosecute nations or individuals for national crimes in times where typical civil liberties and constitutional protections are suspended. That was not, nor should it have been, the case here.

Second, the Andersen trial occurred during a time of unprecedented erosion of civil liberties and the placement of the country on a permanent war footing. The events of the trial are serious in their own right as an issue of due process. But they also form part of a larger, far more serious issue.

Endnotes

1. The "Big Eight" global accounting firms had compressed to five following a string of mergers. When Andersen imploded, the remaining firms became known as "The Final Four."
2. Though Andersen's conviction was overturned by the Supreme Court in May 2005, the reversible error differs from the issue treated herein. *Arthur Andersen, LLP v. U.S.*, 544 U.S. 696 (2005). According to the instructions, jurors did not have to believe that the guilty agent consciously knew that her corrupt persuasion amounted to an act of wrongdoing. The Court held that this instruction fundamentally misinterpreted the statute. This article focuses on the related but discrete issue of whether the jury was properly instructed that it did not need to unanimously agree on the identity of the guilty corporate agent.
3. 18 U.S.C. § 1512(b)(2) (2005). Following the raft of accounting scandals of the last several years, Congress revised § 1512 as part of the Sarbanes Oxley Act. 18 U.S.C. § 1512(c) now includes a provision prohibiting individuals from corruptly altering, destroying, or concealing a document with the intent to impede its use in an official proceeding. *See* 18 U.S.C. § 1512(c)(1). Section 1512(c)(2) is even more sweeping. It prohibits individuals from corruptly obstructing, influencing or impeding any official proceeding or attempting to do so. 18 U.S.C. § 1512(c)(2).
4. *See* Cooperation Agreement, *United States v. David Duncan* (S.D.TX 2002), http://news.findlaw.com/hdocs/docs/enron/usduncan040602agr.pdf (last checked Aug. 9, 2005).
5. *See id. See also,* Tom Fowler, *Duncan owns up to crime /'Pivotal moment' in Enron action*, HOUSTON CHRON., Apr. 10, 2002, *available at*: http://www.chron.com/CDA/archives/archive.mpl?id=2002_3535179.
6. Kurt Eichenwald, *Early Inquiry Fear Seen at Andersen*, N.Y. TIMES, Apr. 22, 2002, at A1.
7. Transcript of Proceedings at *21, *United States v. Arthur Andersen, LLP*, 2002 Extra LEXIS 454 (S.D. TX May 8, 2002) (No. CR.A. H-02-0121) [hereinafter Trial Transcript].
8. Specifically, Odom stated that "if [documents are] destroyed in the course of normal policy and litigation is filed the next day, that's great . . . we've followed our own policy and whatever there was that might have been of interest to somebody is gone and irretrievable." *United States v. Arthur Andersen, LLP* 374 F.3d 281, 286 (5th Cir. 2004).
9. Trial Transcript, *supra* note 7, at *68.
10. *See id.* at *78.
11. *See id.* at *84.
12. Kurt Eichenwald, *Andersen Auditors Knew About Federal Inquiry, Records at Trial Show*, N.Y. TIMES, May 15, 2002 at C10.
13. *See* W. Amon Burton, Jr. & John S. Dzienkowski, *Reexamining the Role of In-House Lawyers After the Conviction of Arthur Andersen* in ENRON: CORPORATE FIASCOS & THEIR IMPLICATIONS 689, 701 (Nancy B. Rapoport & Bala G. Dharan, eds. Foundation Press 2004).
14. *See* Trial Transcript, *supra* note 7, at *7-33.
15. *See Allen v. United States*, 164 U.S. 492, 501 (1896). An *Allen* charge urges jurors to put aside their differences and come to a verdict.
16. Jonathan Weil et al., *Dramatic Question From Jury Could Shape Andersen's Fate*, WALL ST. J., June 14, 2002, at A1.
17. *See* Transcript of Proceedings at 6343, *reprinted in* Brief for the Petitioner, Jury Instructions 2005 WL 474013 at * 212 [hereinafter Transcript of Proceedings].
18. *See* David M. Zornow & Christopher J. Gunther, *After Andersen, Can Companies Get a Meaningful Jury Trial?* N.Y. L.J., Jul. 8, 2002, at 9.
19. Brief of Gov't at 5, *United States v. Arthur Andersen*, No. CP.A. H-02-0212 (S.D. TX June 14, 2002).
20. *See generally, id*. at 4.
21. *Id*. at 5.
22. Greg Farrell, *Andersen Jury May Be Leaning Toward Guilty*, USA TODAY, June 13, 2002, *available at* http://www.usatoday.com/money/energy/enron/2002-06-13-andersen-jury-deliberations.htm.
23. *See United States v. United States Gypsum Co.*, 438 U.S. 422, 436 (1978) ("[E]xistence of a *mens rea* is the rule of, rather than the exception to, the principles of Anglo-American criminal jurisprudence. . . . [I]ntent generally remains an indispensable element of a criminal offense.") (internal citations omitted).
24. Under the revised statute, the actions would violate 18 U.S.C. § 1512(c) (2002) as well since the agent corruptly obstructed an official proceeding.
25. While no case law speaks definitively to this issue, there are cases suggesting that knowledge of the culpable agent's identity is not a prerequisite to a corporation's conviction. *See, e.g., United States v. Gen. Motors Corp.*, 121 F.2d 376, 411 (7th Cir. 1941) (detailing how a corporation was convicted of conspiracy though all defendant officers and agents were acquitted; court concluded that unnamed co-conspirators could have been responsible for the company's actions); *President Coolidge (Dollar S.S. Co.) v. United States*, 101 F.2d 638 (9th Cir. 1939) (involving steamship company convicted of discharging waste—a strict liability offense—though responsible crewmember was not known.
26. For purposes of 18 U.S.C. § 1512 (2002), the requisite guilty intent is knowledge.
27. The Supreme Court faulted Judge Harmon's failure to adequately explain that knowing corrupt persuasion necessarily involves knowing of the wrongfulness of the act. *See Arthur Anderson LLP v. United States,* 544 U.S. 696, 706 (2005) ("Only persons conscious of wrongdoing can be said to 'knowingly . . . corruptly persuade.'") (*citing United States v. Aguilar*, 515 U.S. 593, 602 (1995)). I am making a different point. I submit that regardless of one's knowledge of the legality of the act, it is self-evident that one

cannot knowingly corruptly persuade without knowing one is doing so in the statutory scheme.

28. Though useful as an illustration, this scenario could not actually take place. Indictments must clearly specify the nature of the crime alleged. *See* Fed. R. Crim. P. 7(c)(1).

29. *See McKoy v. North Carolina*, 494 U.S. 433, 450 (1990) ("Th[e] rule does not require that each bit of evidence be unanimously credited or entirely discarded, but it does require unanimous agreement as to the nature of the defendant's violation, not simply the fact that a violation has occurred.").

30. *See, e.g.*, 33 U.S.C. §§ 1319 (c)(1)-(2).

31. *See id.*

32. As Justice Scalia observes in *Schad v. Arizona*, "We would not permit . . . an indictment charging that defendant assaulted either X on Tuesday or Y on Wednesday, despite the 'moral equivalence' of the two acts." 501 U.S. 624, 651 (1991) (Scalia, J., concurring).

33. *See* Brief of Gov't, *supra* note 19, at 5.

34. *See id.* at 6.

35. Transcript of Proceedings, *supra* note 17, at *212.

36. *See* Mary Shelley, Frankenstein (Henry Colburn & Richard Bentley eds., London 1831).

37. For an in-depth discussion of the distinction between national and corporate entity guilt (as well as all the issues raised in this article, see David N. Cassuto, *Crime, War & Romanticism: Arthur Andersen and the Nature of Entity Guilt*, 13 Va. J. Soc. Pol'y & L. 179 (Winter 2006).

38. *See generally*, Andrew J. Bacevich, The New American Militarism: How Americans are Seduced by War (2005). As Tony Judt observes in his review essay of Bacevich's book, the United States spends more on defense than the entire rest of the world combined, it is the only country where soldiers are omnipresent in political photo ops, movies and television, and civilians queue up to buy expensive faux military vehicles. Tony Judt, *The New World Order*, 52 N.Y. Rev. of Books 12, 16 (2005) (reviewing Andrew J. Bacevich, The New American Militarism: How Americans are Seduced by War (2005)).

39. None of the "enemies" in these "wars" shows any sign of conceding. David Frum wryly observed that the late Daniel Patrick Moynihan "was an officer in the War on Poverty, the War on Drugs, the War on Crime [and] the War on Cancer . . . a series of debacles beside which the military history of Italy begins to look impressive." David Frum, *The Tory From New York*, Am. Spectator, Nov. 1996, at 74.

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Will Waiving the Privilege Save It?

By C. Evan Stewart

During the Vietnam War, we had the spectacle of an army unit deciding to destroy a town in order to "save" it. Fast forward to a different era and a very different subject matter, when there seems little dispute that the attorney-client privilege in the United States is under significant attack from a wide variety of sources: prosecutors, regulators, an often hostile judiciary, skeptical legal academics, etc.[1]

The organized bar's response, at first, was a fairly tepid set of bromides; the ABA, for example, adopted a series of resolutions in support of the privilege.[2] More recently, there have been two more significant initiatives. This article will look at these recent initiatives and consider whether the medicine will cure, kill, or merely sedate the patient.

I. Inadvertent Waiver

Lawyers who litigate complex commercial disputes are frequently concerned that massive discovery production will lead to privileged materials being handed over to adversaries. This concern first led to "non-waiver agreements" being entered into by litigants, then to a number of federal districts adopting such agreements as a matter of local protocol, and most recently to the Federal Rules Advisory Committee issuing proposed revisions to the Federal Rules of Civil Procedure (hereinafter FRCP). Under proposed Rule 26(b)(5), a federal district judge would be empowered to enter an order whereby any inadvertent waiver of privileged (and work product) materials would not be deemed a waiver.

This new rule (and analogs to it in Rules 16, 33, 34, and 37) became effective on December 1, 2006. Thus, there is little point in debating now whether all this fuss was necessary. That being said, however, it seems evident that having no inadvertent waiver as part of the formal rules of procedure will have some consequences. There are at least two of some moment.

A. Problem One

The first is a practical problem: such agreements do not address the *substantive* issue of whether privileged or work product protections have been waived.[3] Courts facing this issue in the past have traditionally taken three routes:

- the "strict" approach—inadvertent waiver equals waiver (i.e., "once confidentiality is lost, it can never be restored");[4]
- the "forgiveness" approach—inadvertent waiver which is unintentional does not equal waiver (i.e., "to err is human");[5]
- the "balancing test" approach—a case-by-case analysis to determine whether the conduct is "excusable."[6]

An Article III judge applying the foregoing standards to Rule 26(b)(5) could reach very different results. Under the first approach, there would be a waiver; under the second there would not; and under the third there could well be a waiver (especially if all that had been done to ensure confidentiality was to have followed the dictates of the non-waiver order).[7]

Recognizing that those inconsistent results might prove a not-insignificant roadblock to the likely success of this proposed "reform" to the FRCP, the U.S. Judicial Conference Advisory Committee on Evidence Rules stepped into the fray with a proposed amendment to Federal Rules of Evidence (FRE) 502:

> [A] voluntary disclosure does not operate as a waiver if—the disclosure is inadvertent and is made during discovery in federal or state litigation or administrative proceedings—and if the holder of the privilege or work product protection took reasonably prompt measures, once the holder knew or should have known of the disclosure to rectify the error. . . .

By this proposal, the substantive legal issue would be addressed by adopting the "balancing test" approach.

B. Problem Two

The second problem raised by the "non waiver" rule is whether such agreements—regardless of whether they are voluntary or ordered by a court—can be binding on third parties.[8] To deal with this matter, the Advisory Committee on Evidence Rules again rode to the rescue, and again proposed amending Rule 502. The proposed rule sets forth that a court order as to such an arrangement would be binding on "all persons or entities, whether or not they were parties to the matter before the court."

C. Problems Solved?

Heaven on Earth may not have been achieved by the interventions of the Advisory Committee on Evidence Rules, unfortunately. Why not? Well, first off is the small matter that there are serious constitutional questions (under the Commerce and Due Process Clauses) as to the breadth of pre-empting the states' substantive laws on privilege and whether non-parties can be deprived of rights without notice.[9] Equally important, at least from a practical perspective, is that (unlike changes to the Federal Rules of Civil Procedure) any change to the Federal Rules of Evidence must be part of a law enacted by Congress.[10] And as will be discussed below, the likelihood of Rule 502 amendments getting through Congress any time soon seems highly doubtful. We are therefore likely to have Rule 26(b)(5) with us sooner than soon (i.e., December 1, 2006), without the "safeguards" of Rule 502. Caveat counselor.

II. Selective Waiver

Not content with "fixing" inadvertent waiver, the U.S. Judicial Conference's Advisory Committee on Evidence Rules also tackled the issue of selective waiver. On April 26, 2006, the Advisory Committee unveiled another amendment to FRE 502. Designed to address the highly problematic cooperation mantra with which governmental targets must now deal,[11] proposed Rule 502(b)(3) would provide for selective waiver of materials covered by the attorney-client privilege or the work product doctrine. If this provision were to be enacted by Congress, companies would be able to employ both a sword (providing the government said materials) and a shield (refusing to produce said materials to private litigants) strategy.[12]

As justification for Rule 502(b)(3), the Advisory Committee wrote that selective waiver "further[s] the important policy of cooperation with government agencies, and maximizes the effectiveness and efficiency of government investigations." If that sounds too good to be true, it is probably because that is the case. And that is true for at least three reasons.

The first is a practical one: it is highly doubtful that this proposed reform will ever get through Congress. Because the people who would be impacted most negatively by Rule 502(b)(3) are the private plaintiff's bar, it seems unlikely that they will take this lying down; indeed, given that group's proven political muscle, it seems highly probable that they will be able to convince their congressional allies to block Rule 502(b)(3).

A second reason is the proposed justification for it—i.e., companies will not "cooperate" with the government unless there is selective waiver; this rationale is not supported by any evidence. Every circuit court—save one, the U.S. Court of Appeals for the Eighth Circuit about 30 years ago—has concluded that there is no evidence whatever to support the notion that companies will not cooperate with the government, but for selective waiver.[13] And this state of affairs (i.e., no evidence) was just recently reaffirmed by the U.S. Court of Appeals for the Tenth Circuit in *In re Qwest Communications International Inc. Securities Litigation*.[14]

The last, and perhaps most compelling reason to oppose the selective waiver, is that it is directly at odds with one of the principal foundations of the attorney-client privilege—for a confidential communication to be protected it *must* be kept confidential. Moreover, and as the *Qwest* court correctly noted, rather than promoting the purposes served by the privilege and work product doctrine, selective waiver could well have the effect of making corporate officials reluctant to speak to company lawyers—a result directly antithetical to why the U.S. Supreme Court extended the corporate attorney-client privilege to all employees in *Upjohn v. U.S.*[15]

III. Conclusion

While it seems indisputable that the attorney-client privilege has never been weaker, finding ways to further breach confidentiality seems like a counterintuitive strategy to reverse that trend. The best way to protect client confidences is to keep them confidential. And that, to be repetitive, has been a basic principle undergirding the privilege dating back to jolly old England. Perhaps a return to the tried and true is worth a try?

Endnotes

1. I have been writing about this state of affairs for over 15 years. *See, e.g.*, Whither the Attorney-Client Privilege?, N.Y.L.J., October 11, 1990; *The Corporate Attorney-Client Privilege: Is Nothing Sacred?* The Corp. Crim. & Constit. L. R. Vol. 1 No. 17 (April 5, 1991); *Corporate Counsel and Privileges: Going, Going . . .*, N.Y.L.J., July 11, 1996; *The Attorney-Client Privilege: The Best of Times, the Worst of Times*, The Prof'l Lawyer (1999). During most of that time, however, many observers (mostly non-practicing lawyers and academics) believed that all was hunky dory. *See, e.g.*, F. Zacharias, *The Fallacy that Attorney-Client Privilege has been Eroded: Ramifications and Lessons for the Bar*, The Prof'l Lawyer (1999).
2. *See ABA is Urged to Express Opposition to Government Incursion on Privilege*, BNA Lawyers' Manual on Prof'l Conduct 303 (2005).
3. U.S. Magistrate Judge Paul Grimm was the first to be alert to this issue. *See Hopson v. Baltimore*, 232 F.R.D. 228 (D. Md. 2005).
4. *See* 8 J. Wigmore, Wigmore on Evidence § 2325 (McNaugton rev. 1961).
5. *See, e.g.*, *Mendelhall v. Barber-Greene Co.*, 531 F. Supp. 931 (N.D. Ill. 1982).
6. *See, e.g.*, *Lois Sportswear U.S.A., Inc. v. Levi Strauss & Co.*, 104 F.R.D. 103 (S.D.N.Y. 1985).
7. As a matter of legal ethics, see ABA Formal Ethics Op. 92-368 (1992) (lawyer who receives privileged material when it was unintended (1) should not review the material, (2) should notify the other side regarding its receipt, and (3) should abide by the other side's instructions vis-à-vis the material).
8. *See* C. Wright & K. Graham, Federal Rules of Evidence, Ch. 6 § 5507, 579 (1986).
9. *See* J. Solovy & R. Byman, *Grant Us Serenity*, Nat'l L.J. 12 (April 24, 2006).
10. 28 U.S.C. § 2074 (b) (the Rules Enabling Act).
11. *See* C.E. Stewart, *When the Government Comes Knocking*, N.Y.L.J., (March 15, 2005). Interestingly, there now appears to be some swinging back of the pendulum, if a recent (9/21/06) speech by SEC Commissioner Paul Atkins is representative of the Commission's current enforcement attitude.
12. The use of a "sword" and "shield" strategy has usually been a controversial one. *See In re von Bulow*, 828 F. 2d 94 (2d Cir. 1987); *In re Kidder Peabody Securities Litigation*, 168 F.R.D. 459 (S.D.N.Y. 1996).
13. *See Diversified Industries, Inc. v. Meredith*, 572 F.2d 596 (8th Cir. 1977). *But see In re Subpoena Duces Tecum*, 738 F.2d 1367 (D.C. Cir. 1984); *Westinghouse Electric Corp. v. Republic of the Philippines*, 951 F.2d 1414 (3d Cir. 1991); *In re Steinhardt Partners, LP*, 9 F.3d 230 (2d Cir. 1993).
14. 450 F.3d 1179 (6th Cir. 2006).
15. 449 U.S. 383 (1981).

What Employers Need to Know About Sarbanes-Oxley's Whistleblower Protections

By James R. Grasso

Most publicly traded corporations are now well versed in the financial reporting and verification provisions of the Sarbanes-Oxley Act (SOX) (Pub. L. No. 107-204 (2002)) and have policies and procedures in place to comply with those requirements. Less well known, however, are SOX's whistleblower protections, which provide for civil and criminal penalties against employers who retaliate against employees for engaging in protected conduct. Contrary to common perception, SOX's whistleblower protections apply not only to publicly traded companies, but also extend to private companies. As a result, all employers need to be aware of SOX's whistleblower provisions.

Covered Employers and Prohibited Conduct Under Section 806

The whistleblower protections applicable to publicly traded companies are contained in section 806 of SOX (18 U.S.C. § 1514(A)). Section 806 applies to employers that are required to file reports under section 15(d) of the Securities Exchange Act of 1934, and foreign employers that have a class of securities registered under section 12 of the Securities Exchange Act of 1934. Section 806 prohibits covered companies, including any of their officers, employees, contractors, subcontractors and agents, from discharging, demoting, suspending, threatening, harassing or in any other manner discriminating against an employee in the employee's terms and conditions of employment for engaging in any conduct protected by section 806.

Thus, section 806 imposes not only corporate liability, but also personal liability on corporate officials and employees for retaliating against whistleblowers. The inclusion in section 806 of contractors, subcontractors and agents of publicly traded companies also means that private companies that do business with a publicly traded company, as well as the corporate officials and employees of the private company, can be subject to liability. For example, if a private auditing firm that has a contract with a publicly held company takes adverse action against an accountant who reports possible improper accounting methods at the publicly traded company, the accountant may have a claim under section 806 against the auditing firm. Likewise, publicly traded companies can also face liability for retaliation against employees of non-publicly traded companies. In one case, an administrative law judge found the publicly traded parent of a second-tier wholly owned subsidiary liable for retaliation against an employee of the subsidiary for reporting possible fraud at the subsidiary, where the evidence showed that the publicly traded company exercised control over the whistleblower's employment and directed the retaliatory actions of the subsidiary.

Protected Whistleblower Conduct Under Section 806

Section 806 protects any employee who provides information, causes information to be provided, or otherwise assists in an investigation regarding any conduct which the employee reasonably believes to be a violation of SOX, any rule or regulation of the Securities and Exchange Commission (SEC), or any federal law relating to fraud against shareholders. It is important to note that since the employee is required only to have a reasonable belief that a violation has occurred, the fact that no violation actually occurred is not a defense to a section 806 whistleblower claim. An employee is also protected for filing, testifying or participating in any proceeding related to a violation of the securities laws. To be protected, the information or assistance must be provided to: (1) a federal regulatory or law enforcement agency; (2) any member or committee of Congress; or (3) a person with supervisory authority over the employee to investigate, discover, or terminate misconduct. Thus, an employee who only makes an internal report of suspected misconduct to an officer, supervisor, manager or human resources representative will likely be protected from retaliation under section 806.

Enforcement of Section 806

Section 806 is enforced by the Occupational Safety and Health Administration (OSHA). An employee who believes that he or she has suffered retaliation must exhaust his or her administrative remedies by first filing a complaint with OSHA within 90 days of learning that he or she is or will be subject to an unfavorable employment action. According to the express language of section 806, suspensions and terminations constitute unfavorable employment actions. In deciding what other actions qualify as unfavorable employment actions, some SOX decisions have required that the employee have suffered a tangible adverse job consequence, such as a transfer or demotion. However, other decisions have adopted a lower standard, finding that an action that has a reasonable likelihood of deterring an employee from making a disclosure is an unfavorable employment action. The Supreme Court recently adopted this lower standard for retaliation claims under Title VII, so it is likely that its application to SOX cases will grow.

The employee may commence suit in federal court only if OSHA has not issued a final decision within 180 days of the complaint being filed and the failure of OSHA to do so is not the result of the employee's bad faith. To establish a claim under section 806, an employee need only show that: (1) he or she engaged in protected activity; (2) the employer knew of the protected activity; (3) the employee experienced an unfavorable employment action; and (4) the circumstances suggest that the protected activity was a contributing factor to the unfavorable action. Proximity in time between an employee's protected conduct and the unfavorable action is sufficient to raise an inference of causation. If the employee establishes a claim, the burden of persuasion then falls upon the employer to refute the claim with clear and convincing evidence that it would have taken the same unfavorable action in the absence of the protected activity. This framework imposes a significantly higher burden on the employer than the burden the employer faces under other employment discrimination laws, such as Title VII. (Under Title VII, once the employee establishes a claim, the employer need only articulate a legitimate, nondiscriminatory reason for its conduct, and the burden of proof does not shift to the employer but remains with the employee to prove that the employer's explanation is a pretext for discrimination.)

Remedies Under Section 806

Employees who suffer retaliation in violation of section 806 are entitled to reinstatement and to all relief necessary to make them whole, including compensatory damages, back pay with interest, compensation for special damages, including expert witness fees and attorney's fees, and all other relief necessary to make the employee whole.

Criminal Penalties Under Section 1107

In addition to the civil liability imposed under section 806, section 1107 of SOX also imposes new criminal liability for "whoever knowingly, with the intent to retaliate, takes any action harmful to any person, including interference with the lawful employment or livelihood of any person, for providing to a law enforcement officer any truthful information relating to the commission or possible commission of any Federal offense."[1] This provision prohibits retaliation against whistleblowers who raise concerns to any "law enforcement officer" about the violation of *any* federal criminal statute, not merely those related to financial fraud. These criminal penalties also apply to *any* employer, regardless of whether the employer is publicly traded or privately held, and to managers, officers and other employees individually. Violation of this provision is a felony punishable by a fine of up to $250,000 and/or up to 10 years imprisonment for individuals. Organizations are subject to a fine of up to $500,000.

Conclusion

SOX requires that the audit committee of all publicly traded companies establish procedures for receiving anonymous complaints about questionable auditing and accounting matters. However, a policy limited to such matters is insufficient to protect against whistleblower suits. To adequately protect against whistleblower suits, covered employers should also have policies and procedures that allow employees to report not only questionable auditing and accounting matters, but also suspected instances of any violation of SOX, any rule or regulation of the SEC, any federal law relating to fraud against shareholders, or any federal offense, and which prohibit retaliation against employees for doing so. Such policies and procedures would encourage the reporting of illegal activity, give companies an opportunity to correct it, and also help prevent a whistleblower suit from arising. Most employers already have similar policies and procedures in place for workplace harassment and have found them to be very successful in preventing harassment suits. Preventing the filing of a whistleblower claim under SOX is particularly important as all complaints filed with OSHA are reported to the SEC.

Endnote

1. 18 U.S.C. § 1513(e).

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Digital Case Notes: *International Airport Centers, L.L.C., et al. v. Citrin* and *Krumwiede v. Brighton Associates, L.L.C.*

By James M. Thurman

I. Introduction

The emergence of "e-Discovery" has proven a costly challenge for contemporary corporations, and ideas concerning the best practices for handling the challenge both on the part of corporations as well as the attorneys who defend them continue to evolve. When, however, corporations have disputes with their employees, the corporations themselves may want to reap the benefits of e-discovery but may also encounter the problems associated with the recovery of digital evidence. Within the Seventh Circuit, two noteworthy cases involving employee handling of company data have recently emerged. These cases highlight the perhaps increasingly serious repercussions for the destruction of digitally based evidence in the current, post-Enron climate as well as for "cleaning up" too meticulously upon leaving the company. Additionally, these cases touch upon the issue of the increasing erosion of personal privacy in the digital environment—a problem to which employee privacy is not immune.

II. Case Summaries

A. *International Airport Centers, L.L.C., et al. v. Citrin*

The first case, *International Airport Centers, L.L.C., et al. v. Citrin*,[1] ostensibly concerned the use of a secure erase program on a company laptop. Citrin was employed by International Airport Centers (IAC), the plaintiffs, which were affiliated companies involved in the real estate business. IAC provided Citrin with a laptop to conduct his work in identifying potential real estate acquisitions. Citrin later decided to quit his employment with IAC and go into business for himself.

Before returning his laptop to IAC, Citrin presumably used a secure erase program to delete files stored on the laptop. The plaintiffs brought suit, inter alia, under the Computer Fraud and Abuse Act[2] (the "Act") for the destruction of the data. The lower court dismissed this claim and IAC appealed.

Under section 1030(a)(5)(A)(i) of the Act, criminal liability is imposed upon anyone who "knowingly causes the transmission of a program, information, code, or command, and as a result of such conduct, intentionally causes damage without authorization, to a protected computer." Judge Posner ruled that the installation of the secure delete program would constitute a "transmission of a program" within the meaning of the provision.[3] Then, the question remained whether the deletion of data constituted "damage." Posner pointed out that the term "damage" as defined under section 1030(e)(8) includes "any impairment to the integrity or availability of data, a program, a system, or information."[4] Under this definition, the deletion of data may certainly be viewed as an impairment to that data's availability. Thus, Citrin's intentional installation of the secure erase program and subsequent use to delete the data incurred liability under the statute.[5]

Additionally, Posner found culpability under section 1030(a)(5)(A)(ii), which makes it a crime to intentionally access a protected computer without authorization where such conduct results in the reckless incurrence of damage.[6] He reasoned that Citrin's authorization to access the computer was derived from his status as an agent of IAC. Once Citrin breached his duty of loyalty to IAC, by resolving to quit his position in violation of his employment contract and by subsequently deleting files that incriminated him and were moreover the property of his employer, the privilege of authorization which he derived as an agent terminated.[7]

Interestingly, Posner dismissed the argument that Citrin's actions were authorized under his terms of employment. A provision within Citrin's contract stated that he might "return or destroy" data on the laptop upon termination of his employment. Posner contended that the clause could not have referred to data of which IAC did not otherwise have a copy; moreover, Posner eviscerated the content of the provision by stating that its likely purpose was merely to "remind Citrin that he was not to disseminate confidential data after he left the company's employ" and was thus limited to "confidential" information.[8] Whether the files that Citrin deleted were all "confidential" was a question which Judge Posner left for the trial court to consider.[9]

B. *Krumwiede v. Brighton Associates, L.L.C.*

The second case also dealt with an employee's use of a company laptop. Krumwiede was Director of Business Development for Brighton Associates from October 2002 to March 2005. In 2005, Krumwiede left Brighton to begin work as Director of Business Development with Strategic Technologies, Inc. (STI).[10]

Krumwiede filed suit against Brighton for breach of his Employee Agreement, reimbursement of back pay, intentional infliction of emotional distress, and reformation of the Employee Agreement. Brighton filed a counterclaim against Krumwiede alleging (1) breach of the non-compete provision, (2) breach of the confidentiality provision of the Employee Agreement, (3) tortious interference with prospective economic advantage, (4) violation of the Illinois Trade Secrets Act, and (5) breach of duty. Included in Brighton's counterclaims were the allegations that Krumwiede went to work with a competitor, STI, and misappropriated a business opportunity with a prospective Brighton client, LifeScan Scotland, Ltd.[11]

Krumwiede had purchased a laptop computer which he used in his work, and he was reimbursed by Brighton for the purchase price of the laptop. As part of his employee agreement, Krumwiede was to return all company equipment. Krumwiede, however, did not return the laptop, claiming that he believed employees had never had to return laptops in the past.[12] Brighton sought discovery of this laptop upon the belief that it might contain evidence relevant to its suit. Upon filing its counterclaims on August 25, 2005, Brighton also demanded return of the laptop and specifically requested that no subsequent changes be made to the laptop's contents. Brighton's notice declared that any such changes would be regarded as spoliation of evidence.[13]

Krumwiede, nonetheless, declined to turn over the laptop, arguing that he believed (1) Brighton's notice was an attempt to harass him; (2) the laptop rightly belonged to him; and (3) Brighton's claims were without merit. Additionally, Krumwiede claimed he had sent his own personal computer in for repairs on August 22, 2005 and needed the laptop for his personal use in the meantime.[14] He also indicated that he transferred files from his personal computer to the laptop before sending the personal computer in for repairs. The computer was sent from the repair shop on September 6, 2005 and arrived at Krumwiede's residence on approximately the 9th.[15]

Brighton filed a motion for an order to compel Krumwiede's surrender of the laptop on the 9th and was granted this motion on September 15. Krumwiede claimed that he was not informed of the September 15 order until September 16.[16] When Brighton did not receive the laptop following the issuance of the order, it filed an Emergency Petition for Rule to Show Cause on September 16. At the hearing on the emergency petition, the parties agreed that the laptop would be submitted into the custody of a neutral computer forensics firm, Forensicon.[17]

1. Computer Forensics—Forensicon's Findings

Forensicon carried out an analysis of the laptop's contents and made the following findings:

> (1) 1,586 files were "Last Accessed" on August 25, 2005, and 1,486 additionally report an "Is Deleted" value of "Yes," (2) 14,074 files were "Last Accessed" in between August 26 and September 14, 2005, and 7,820 additionally report an "Is Deleted" value of "Yes," and (3) 13,317 files were "Last Accessed" on September 15, 2005, of which 8,988 files were created on or before April 14, 2005, and eight report an "Is Deleted" value of "Yes." (JX # 14, Ex. J, pp. 1-2.) "Is Deleted" does not necessarily mean that an entire file was deleted but rather that the original file entry was deleted. Thus, if a file is moved or read or deleted, the original file entry will be changed and it will report as "Is Deleted." (Tr. at 68-69, 144-45.) Any alteration of an original file entry may be significant, however, because the metadata contained in the entry changes, making it impossible to verify that the file is identical to the original, even if the file's content appears unchanged.[18]

Forensicon also found 21 entries which indicated the use of an external device or devices via the USB port as well as entries indicating the use of a defragmentation utility on September 6 and 12, which at least partially overwrote deleted files. Forensicon also reported that on September 15, the day that Krumwiede had been ordered to surrender the laptop, the evidence indicated that Krumwiede had worked on the laptop until 7 p.m. and that for that day there were 8 deleted entries, multiple USB-related entries and 13,000 entries of file access including files named SALES.ZIP and STI.ZIP.[19] The ZIP files also showed evidence of multiple nested files, which Forensicon indicated was often a sign that a user was deliberately trying to conceal data.[20] Additionally, a term search revealed that 180 files containing the term "Lifescan" and 70 files containing the word "Inverness" (the location of LifeScan Scotland) had had changes to their metadata on the 15th and there was evidence that a large number of files had been deliberately deleted.[21]

Based on its findings regarding activity on the laptop between August 25 and September 16, Forensicon issued the opinion that: "The combination of a court order violation, deliberate movement of file data, admitted deletion activities, multiple use of defrag, use of ZIP file to conceal or transport Brighton Associates data, [and use of] multiple USB devices . . . [establishes that] Krumwiede did intend to destroy evidence and did intend to conceal the existence and/or movement of data in violation of defense's preservation letter dated August 25, 2005, as well as defy the Court's order dated 9/15/2005 to surrender the laptop."[22]

2. The Court's Decision

The court found clear and convincing evidence that Krumwiede had acted wilfully and in bad faith in continuing to alter, modify, and destroy data on the laptop following the August 25 notice from Brighton. Krumwiede's actions breached his duty to preserve evidence after August 25 and the activities taking place into the evening of September 15 suggest that Krumwiede lied to the court about not receiving the September 15th order. It was also evident that Krumwiede altered or destroyed evidence which was directly relevant to Brighton's claims regarding Lifescan. Further evidence of Krumwiede's wilfulness and bad faith is revealed by Krumwiede's flat denial that he destroyed any evidence, stating that all files are available either on the Brighton laptop or his own personal computer. Upon Brighton's request for sanctions for spoliation of evidence, however, Krumwiede sent his personal computer to STI for safeguarding, preventing any corroboration of his claims to his preservation of files.[23]

Brighton suffered prejudice from the spoliation of evidence since it had been denied evidence essential to its claims.[24] For this reason and in light of the wilfulness and bad faith on the part of Krumwiede, motion for default judgment was granted on Brighton's claims for (1) breach of the non-compete provision of Krumwiede's Employee Agreement, (2) breach of the confidentiality provision of Krumwiede's Employee Agreement, (3) tortious interference with prospective economic advantage, and (4) violation of the Illinois Trade Secrets Act. Furthermore, Brighton was awarded reasonable costs and fees, including attorneys' fees and the fees billed by Forensicon.[25]

III. Comments

Both *Krumwiede* and *Citrin* concern employees who attempted or did indeed compete with former employers. Naturally, businesses will want to insure that inside information is not used to their disadvantage on the market. Such is probably one of the primary motivations for covenant-not-to-compete clauses in employment contracts. Today, the digital nature of business means that the information which businesses wish to safeguard is both highly portable—facilitating effortless disclosure and transference outside of the business premises—and easier to keep track of since actions executed on computers leave a potentially long-lived record and metadata hold the promise of revealing significant information with regard to electronic files. Yet, such ephemeral digital evidence may also be tampered with just as its physical, often paper-based counterpart. In this regard, *Krumwiede* and *Citrin* also reveal the potential consequences for the destruction of electronic evidence. Additionally, these cases are reminders of the fact that company laptops and other computers are company property, including all the data that is stored on them.[26]

A. Destruction of Evidence

The *Citrin* case raised eyebrows due to the suggestion that Citrin could be held liable for doing something as mundane as deleting files from his company laptop. The significant aspect of the act was the fact that Citrin used a "secure delete" program which prevented the subsequent recovery of the deleted files. Under some circumstances, the use of such a secure program could be construed as the responsible act of a savvy employee to provide the best security possible for corporate information. The opinion, however, suggests that the holding should not be regarded as so controversial as some have seemed to view it. Judge Posner's words suggest that there is some evidence that Citrin engaged in conduct which either constituted competing against his employer or using his employer's resources to advance his planned activities in competition with his employer following his departure. His use of the secure deletion program, therefore, was aimed at covering up his illicit activities. Yet, perhaps another controversial aspect of the case was the court's finding that the deletion of files constituted "damage." Yet, as Judge Posner explained, "damage" under the Act is defined as "any impairment to the integrity or availability of data, a program, system, or information."[27] Deletion could certainly be construed as an impairment to the availability of data. And certainly viruses and the like which cause the deletion of computer files were one of the ills which Congress intended to address with the legislation.[28] Therefore, the issue of deletion as damage is not a stretch of the statutory language. Perhaps more genuinely controversial was Posner's complete dismissal of Citrin's contract defense.

Indeed both *Krumwiede* and *Citrin* may reflect a certain judicial effort to justify desired punishment for the perceived crime. The contractual issue in *Citrin* was ignored in order to impose criminal liability for Citrin's seemingly underhanded actions, whereas *Krumwiede* concerned a particularly egregious instance of flouting the judicial system which called for the imposition of particularly stern consequences on the part of the court. *Krumwiede* is evidence of how far a court will go in the face of evidence suggesting that a party has deleted files or otherwise secreted files away from the other party. The default judgement in favor of Brighton means that Brighton has won its case with regard to the 4 claims mentioned in the opinion without having to go to trial on those claims. Krumwiede will still have an opportunity to advance his claims against Brighton and the other defendant but it is unclear without looking at Krumwiede's claims and corresponding petitions for damages to what extent the added costs of continued litigation will be to Krumwiede's advantage. Naturally, Krumwiede also has the possibility to appeal the default judgment decision on the part of the court. The default judgment is nonetheless a major setback for Krumwiede and an extreme measure on the part of the court. It is interesting to note, however, that the court cites a case in one other jurisdiction (South Carolina) which had also rendered default judgment in light of electronic spoliation of evidence.[29] Additional references worth noting are the *Danis*[30] case of the Northern District of Illinois for the principle that a formal discovery request is not required to trigger the duty to preserve evidence and the reference to the seminal *Zubulake*[31] case for the principle that document retention and destruction policies must be put on hold upon the reasonable anticipation of litigation. Businesses and employees within Illinois as well as those who may anticipate being called into federal court there should take heed of these principles.

A possible distinction between the *Citrin* and *Krumwiede* cases is that in *Krumwiede*, the destruction/tampering in question clearly took place after the onset of litigation and, more significantly, after Brighton had demanded return of the laptop. It is possible that IAC turned to the Computer Fraud and Abuse Act due to this distinction: Citrin had perhaps already destroyed the data before the duty to preserve evidence had arisen; thus, there was no possibility of bringing sanctions for discovery violations. Nonetheless, the effect of Citrin's actions was the same with regard to prejudicing the opposing party's claims—the secure deletion of the files thwarted IAC's ability to discover evidence relevant to its lawsuit.

Due to the fact that Krumwiede's actions did take place subsequent to the initiation of litigation, his proposed justifications (transfer of files due to the repairs made to his personal laptop) for accessing the computer were insufficient to exculpate him from a finding of wrongdoing (not to mention that his actions seemed to go well beyond merely transferring files before and after repairs). If Krumwiede had deemed it necessary to access the computer during this time, the best tactic would have been to petition the court for permission to do so. Such a petition would have given the opposing party the opportunity to supervise Krumwiede's activities—or even to have a third party, such as Forensicon, transfer the files on Krumwiede's behalf—so that the occurrence of potential improprieties could be precluded.

B. Business Is Business

The cases are additionally reminders of the importance of separating business activities and personal activities with regard to the use of company equipment. As the *Citrin* opinion states, the company laptop and everything stored on it rightly belonged to IAC. Likewise, in *Krumwiede*, although Krumwiede originally purchased the laptop himself, he was later reimbursed by the company for this purchase. Thus, what might have arguably started out as a personal computer became a company one upon Krumwiede's acceptance of the reimbursement.

This aspect of these cases may be the most troubling for observers. Although many of us know better, as work becomes more mobile and portable thanks to developments in communications technology, the temptation to utilize these technologies for personal use becomes greater. Moreover, as the amount of hours spent at work increases, the use of even non-portable technologies for personal matters becomes almost unavoidable. Probably many of us have, for instance, used our internet connection at our place of business to order gifts for friends or family, make personal travel arrangements, do personal research, or check personal e-mail. Perhaps most notably, sole proprietorships—particularly where run out of a home office—will generally not have much distinction between business and personal equipment.

The use of office facilities for such personal matters is certainly not new. What is new is the medium. Before, such personal business was carried out over the office telephone. If anything, the number dialed and duration of the call could be traced. Yet, the use of computer-based communications leaves a digital record of all activities. The ramifications of this fact have also revolutionized the nature of discovery in the context of litigation. The *Citrin* case, however, attests to the tension between the desire to safeguard our private lives which are recorded by the devices we use and the desire (or need?) to take advantage of the convenience those devices provide. The *Citrin* opinion suggests that Citrin used the secure delete program to cover his tracks, but he could just have easily been trying to prevent the recovery of personal files.

IV. Conclusion

Krumwiede and *Citrin* are part of the growing body of cases concerning law and computing within the Seventh Circuit. At the same time, they are testimony to issues relating to the increasing reliance on digital information both in law and business and the problems associated with this phenomenon. Just as business organizations will want to ensure that company information is not misused or misappropriated, they will also want to make certain that evidence of such misuse is preserved so that they may obtain appropriate legal relief. How organizations may achieve this goal may depend on a constellation of data management policies, company policies governing employee use of company equipment, and employment agreements. The terms of these instruments would have to be carefully coordinated in order to accomplish the desired results. Yet, draconian policies and the implementation of rigorous employee monitoring may prove undesirable if not untenable. In a world where the ever-accessible, ever-"connected" employee is a desirable enhancement of productivity, personal use of company equipment may be unavoidable. Whether and how the law reacts to protect the personal realm of the employee within the ubiquitous digital work environment remains to be seen. Nonetheless, any response will have to balance the interests of both the employee and the employer—it will have to safeguard privacy concerns while not permitting less scrupulous employees to cover up liable acts of bad faith or disloyalty to the company.

Endnotes

1. 440 F.3d 418 (7th Cir. 2006).
2. 18 U.S.C. § 1030.
3. *Citrin*, at 419. The manner of transmission was deemed to be irrelevant so long as it was obvious that the program had been transferred onto the computer in some manner. *See id*.
4. *Id*.
5. *See id*. at 419-20.
6. *Id*. at 420.
7. *Id*.
8. *Citrin*, at 421.
9. *Id*.
10. *Krumwiede v. Brighton Associates, L.L.C.*, 2006 WL 1308629 at *1 (N.D. Ill. 2006).
11. *Id*.
12. *Id*. at *2.
13. *Id*. at *2-3.
14. *Id*. at *3.
15. *Id*. at *2.
16. *Id*. at *3.
17. *Id*.
18. *Id*. at *4.
19. *Id*. at *4-5.
20. *Id*. at *6.
21. *Id*.
22. *Id*.
23. *Id*. at *9-10.
24. *Id*. at *10.
25. *Id*. at *11.
26. For an exception, see the recently decided case from the Eastern District of New York, *Curto v. Medical World Communications, Inc.*, No. 03CV6327 (E.D.N.Y. 2006). In that case, personal e-mail messages addressed to the employee's personal attorney, which were sent from and saved on a company computer, were still held to be protected by the attorney-client privilege despite the fact that there was a company policy against personal use of company computers. The court's reasoning was that since the company failed to enforce the policy, employees were lulled into the belief that the policy was not truly in force. Therefore, employees could have a reasonable expectation of privacy with regard to communications with their private attorneys which were intended to be confidential.
27. 440 F.3d at 419.
28. *See Citrin*, 440 F.3d at 420.
29. *QZO, Inc. v. Moyer*, 594 S.E.2d 541 (S.C. Ct. App. 2004) (*cited in Krumwiede*, at *11).
30. *Danis v. USN Comm., Inc.*, No. 98 C 7482, 2000 WL 1694325 (N.D. Ill. Oct. 23, 2000).
31. *Zubulake v. UBS Warburg, L.L.C.*, 220 F.R.D. 212 (S.D.N.Y. 2003).

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Private Equity Purchasers of Distressed Assets

By Simeon Gold and Daniel Holzman

Over the past few years, numerous financially distressed companies have attempted to solve their liquidity problems by incurring additional indebtedness as a result of the low interest rates that have been available. Many experts view this as a short-term band-aid that will not provide the type of long-term solution that a comprehensive restructuring would.

Consequently, distressed mergers and acquisitions (M&A) funds are being formed to take advantage of the large number of defaults that are expected to occur over the coming years on many of these companies' debt obligations. In addition, well-positioned private equity firms should be able to capitalize on opportunities to acquire the assets (including the stock of significant subsidiaries) of financially troubled companies at potentially bargain prices. The purchase of a distressed company's assets, however, raises issues and concerns for a private equity firm that are not encountered in a typical M&A transaction with a healthy, solvent seller.

This article addresses the special considerations that arise in the context of distressed M&A transactions.

I. Out-of-Court Acquisitions

An acquisition from a financially troubled company in an out-of-court transaction poses several obstacles. One of the major concerns is whether a court would determine that a transaction with a distressed company is a "fraudulent transfer." A fraudulent transfer occurs when both:

- the seller is insolvent at the time of, or is rendered insolvent by, a transfer of property and
- the consideration paid for the property is less than its fair market value.

This issue typically arises when the seller is in the "vicinity of insolvency" (a term that has not been defined by the courts, but connotes a time period prior to the actual advent of insolvency). If the seller subsequently files for chapter 11, the bankruptcy court will look at the M&A transaction with 20-20 hindsight, and if the court finds that such transaction is a fraudulent transfer, then the transaction could be unwound, even years after the acquired business has already been integrated into the purchaser's business. In that situation, the buyer would lose the benefit of its bargain and be left with a general unsecured claim against the bankrupt seller (often worth only cents on the dollar). While the use of fairness and solvency opinions can reduce the fraudulent transfer risk in a distressed M&A transaction, it cannot eliminate it.

Corporate law which requires stockholder approval of a sale of all or substantially all of a company's assets typically presents another significant hurdle. In a distressed situation, it is unlikely that stockholders would approve an M&A transaction providing little or no value to the stockholders. In addition, difficulties often arise in dealing with the board of directors of a distressed company. The board of directors is often instructed to take into account the interests of creditors when a seller is in vicinity of insolvency. The board, however, may be in denial of the extent of the seller's financial difficulties and fail to adequately consider a sale strategy that enhances value for the creditors of the seller. Due to the fraudulent transfer risk and the obstacles that the stockholders and the board may present, the safest and possibly the only practical way to purchase a distressed company's assets may be under chapter 11 of the Bankruptcy Code.[1]

II. Acquisitions in Chapter 11

A purchase of the assets of a chapter 11 debtor can be accomplished either as part of the consummation of a chapter 11 plan of reorganization or during the pendency of a chapter 11 case under section 363 of the Bankruptcy Code. A section 363 sale is often the preferred method because, among other things, it tends to be quicker while still offering the protections of the Bankruptcy Code. An asset purchase from a chapter 11 debtor, however, can be a complicated affair. Chapter 11 sales require the involvement throughout the M&A transaction of the bankruptcy court, as well as the need to deal with the seller's various constituencies as part of the chapter 11 process. In order for a seller to conduct a sale under section 363, the seller must demonstrate to the bankruptcy court a "good business reason" for the sale, which can often be evidenced by showing a diminution of the value of the distressed assets if a sale was delayed until the chapter 11 plan of reorganization is consummated.

A purchaser of distressed assets in chapter 11 must also be mindful of the seller's creditors and other stakeholders. In addition to negotiating the transaction with the seller, the purchaser should seek to prevent the creditors from taking a "second bite at the apple" and renegotiating the deal that was already negotiated with the seller. Therefore, it is important that the purchaser make sure that the seller keeps its creditors informed and "on board" with the negotiations. Impaired creditors and even stockholders can potentially oppose the asset sale at the bankruptcy court approval hearing by arguing that only senior creditors would be made whole by the sale and that the sale diverts value to the purchaser that under a "stand-alone" plan of reorganization would benefit the seller's other stakeholders.

Another key element of a section 363 sale is the requirement that the sale be subject to "higher or better" offers in an auction process. This presents a risk that other bidders may make a topping offer at the last minute if the bankruptcy court has not yet approved the sale. The initial "stalking horse" purchaser, however, typically gets the benefit of certain protections. Because the sale is exposed to an auction and in light of the value the stalking horse creates in enhancing the ability of the seller to get the highest or best offer, it is customary for the stalking horse to receive a break-up fee or, at a minimum, some expense reimbursement in the event a different purchaser wins the auction. The bankruptcy court must approve the amount of the break-up fee and expense reimbursement, as well as the other auction bidding procedures. Once the bankruptcy court approves the bidding procedures, a full auction is normally conducted and "no-shop" restrictions generally are not permitted. In certain situations, the stalking horse may be able to negotiate the right to match the highest final offer at the auction, but a bankruptcy court may strike this matching right due to concerns that it will chill the bidding.

Typically, the seller's representations and warranties in a section 363 sale have a short post-closing survival period or no survival period and the amount of indemnification is often capped. Sellers argue that in order to satisfy their constituencies, they need a "net-net" deal with no potential to refund any portion of the purchase price to the purchaser. To the extent that the seller has post-closing indemnification obligations, purchasers usually negotiate to have a portion of the sale proceeds either placed into escrow or held back for a limited period of time to address concerns that the seller will not be around or have the wherewithal to pay its indemnification obligations that may arise.

Purchasing distressed assets in a section 363 sale also provides benefits that are not available in acquisitions outside of chapter 11. The purchaser receives the assets sold pursuant to section 363 free and clear of liens, claims and encumbrances. Upon completion of the sale, creditors of the seller cease to have a lien on the assets and instead have a lien on the sale proceeds and are not permitted to pursue the purchaser to satisfy any claims they have against the seller.

Another advantage of a chapter 11 sale is that except for certain contracts, such as contracts pertaining to personal services and certain intellectual property licenses, the seller's contracts are "cleansed" of nonassignability or change-of-control provisions. Subject to certain requirements (including the curing of certain defaults), this facilitates the assignment of contracts to the purchaser without the need for any consents of third parties which would otherwise be required in a sale outside of chapter 11. In addition, "successor" liability generally remains with the seller, except for certain product liability claims, environmental liability, tax liability and employment liability.

If a purchaser desires to strengthen its position in the acquisition of an entire company under a plan of reorganization, there are steps it can take. The purchaser can acquire a stake in the "fulcrum" securities of the bankrupt seller (i.e., those obligations of the seller that, based on the likely valuation of the seller's business by the bankruptcy court, are likely to receive equity in the reorganized business). Acquisition of at least one-third of the fulcrum securities, subject to certain exceptions, may provide the buyer with a blocking position in the approval of a chapter 11 plan of reorganization. Even if less than one-third is acquired, this still gives the purchaser a seat at the table in the event that the transaction is contested.

The acquisition of the seller's fulcrum or other securities is less effective in pursuing an asset purchase under section 363, since there is no stakeholder vote on a section 363 sale. However, the purchaser (even without owning securities of the seller) can still join forces or enlist the support of key creditors of the seller, such as bank lenders or other senior creditors (who will typically favor an asset sale in order to be repaid in full), to help push the sale to the purchaser. Ultimately, however, the bankruptcy court needs to find that the purchaser has presented the highest price or best offer in order for it to approve a section 363 sale.

III. Conclusion

In summary, while the assets of financially troubled companies often provide opportunities for private equity firms to make acquisitions at an attractive price, such firms must be aware of the special considerations attendant to distressed M&A assets. The impediments to acquiring distressed assets outside of the chapter 11 process may be too great due to the fraudulent transfer risk as well as the corporate law requirements, which may include stockholder approval if a substantial portion of the seller's assets is being sold. A purchase of distressed assets under section 363 of the Bankruptcy Code eliminates these concerns and provides certain other protections of the Bankruptcy Code, but can be a tricky process, particularly in dealing with the seller's creditors and other constituencies. For these reasons, a private equity firm that possesses a sound understanding of the bankruptcy process and is advised by experienced legal counsel will be in the best position to effectively take advantage of opportunities in distressed M&A assets.

Endnote

1. 11 U.S.C. § 1101 *et seq.*

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The Importance of Due Diligence Investigations in Mergers and Acquisitions

By Wendy B. Davis

We are currently experiencing a merger frenzy, with businesses competing for the opportunity to acquire or merge with other businesses. This frenzy of activity is not exclusively in the multi-billion dollar transactions, like AOL and Time Warner or HCA, but also encompasses the smaller mid-market acquisitions. In this highly competitive market, it is easy to overlook the careful investigation that should preclude any acquisition decision. In a world designed by lawyers, acquiring corporations would carefully investigate all information pertaining to the business to be acquired before either party discussed the possibility of an acquisition. In the real world, many deals are struck, with signed letters of intent or term sheets, with buyers having only limited knowledge of the seller, often based on public information. In these cases, the buyer expects the lawyers, accountants, and other investigators to gather information to confirm the buyer's expectations of value and potential synergies as quickly as possible so the deal can be finalized.

Whether the investigation occurs before the preliminary handshake, or after the offering price and significant terms have already been agreed to, the buyer should use due diligence to investigate the company to be acquired before the deal is finalized and documented.[1] This investigatory process is similar regardless of whether the structure chosen is an asset purchase, stock acquisition, or merger, and the term 'seller,' is intended to indicate any target of such a transaction. Buyers who neglect this process, or who are less than diligent in their investigations, may hope to rely on the seller's representations and warranties. Courts have found such reliance to be unreasonable, and therefore denied a buyer's claim of harm as a result of a breach of those representations and warranties, where the buyer did not sufficiently investigate to discover the seller's problems.

I. The Purposes of a Due Diligence Investigation

The purposes of a due diligence investigation in an acquisition setting include:

1. To learn details that may be relevant to the drafting of the acquisition agreement, including the substance, extent, and limitations of representations and warranties and any relevant escrow or hold-back agreement for a breach of the same;
2. To evaluate the legal and financial risks of the transaction;
3. To confirm or evaluate the appropriate purchase price and the method of payment, including earn-outs;
4. To evaluate the condition of the physical plant and equipment;
5. To analyze any potential antitrust issues that may prohibit the proposed merger or acquisition; and
6. To discover liabilities or risks that may be deal-breakers.

II. The Scope of a Due Diligence Investigation

Many experienced buyers, and the attorneys who represent them, will use checklists to remind them of issues to review in their due diligence investigation. Sample checklists are available on-line, in most M&A treatises, and in the archives of law firms; however, the value of such forms is suspect. It is critical to customize any checklist to reflect the specific issues of each deal, and to think creatively rather than rely on a form. For example, one transaction was rolling along smoothly with the buyer in the final stages of a due diligence review, when a representative of the buyer did an Internet search of a key employee of the seller and learned the employee had changed his name several years ago. Although there was no evidence that the name change was for fraudulent purposes, there was sufficient suspicion that the venture capitalists financing the deal immediately backed out and the deal fell apart. Checklists should be only a starting point to your investigation. The following are some of the broad topics that should be reviewed.

A. Organizational Status

The buyer will need to confirm that the seller has filed all necessary documents of incorporation, as well as current annual reports, to ensure it is duly organized. Corporations that do business in more than one state will need to register to do business as a foreign corporation in each state in which they operate. The failure to register in each state may result in invalidity of contracts or penalties. The determination of what actions of the corporation will qualify as doing business in each state depends on the laws of each state, but owning real estate, maintaining an office, and employing local employees will require registration in most states.

The buyer will also want to confirm the identity of the officers and directors as well as their authority to ensure that all transaction documents are properly executed and authorized. Minutes, notices, and votes of shareholder and director meetings should be reviewed to ensure appropriate approval of the intended transaction.

Any defensive measures adopted by the seller, such as shareholders' rights to purchase additional shares, or limitations on directors' terms or authority, should be investigated and evaluated for their impact on the intended transaction.

B. Contractual Obligations

The buyer should review all contractual obligations of the seller, including supplier agreements, joint venture agreements, leases, employment agreements, and financial obligations. The buyer will need to determine which contractual obligations it will assume, and whether the proposed sale to the buyer will result in a default or other consequences under any contract, based on change-in-control provisions. Exclusive dealing arrangements will need to be analyzed to disclose any conflicts with the buyer's existing contracts. Accounts payable to vendors, as well as debts owed to banks and others, should be confirmed and considered in any calculations of value of the acquisition.

C. Labor

The buyer may want to retain key employees of the seller, either temporarily to facilitate the change in control or to continue as long-term employees. Employment contracts with such employees should be reviewed to determine obligations for salary, bonuses, and benefits, and whether the sale will trigger any additional compensation, as well as covenants not to compete, should the employees decide to leave. Union contracts should also be reviewed, as well as grievance logs or complaints.

The status of any non-citizen employees should be reviewed. Visas and other immigration permits are often dependent on an employer/sponsor, and if the name or identity of the employer will be different after the merger, this may have significant consequences for the employee. If the U.S. Citizenship and Immigration Services (USCIS) determine that a visa has become invalid as the result of a merger, a key employee may be prohibited from re-entering the country. Even more damaging, if an employee whose visa has been invalidated has traveled outside the U.S. and returned without informing the USCIS of the change in status, she may be deemed to have committed entry fraud, which is a lifetime bar from ever entering the U.S.[2]

Criminal background checks and employment histories of the key employees, founders, and officers should be considered. An Internet search may also be revealing.

D. Insurance

Insurance contracts should be reviewed for sufficiency of coverage, conflicts with buyer's insurance agreements, and compliance by seller. Insurers should be notified of the change of ownership.

E. Tax

Tax returns for several prior years should be reviewed, and the IRS and local taxing authorities should confirm payment of all taxes owed, including payroll, excise, real estate, and income.

F. Accounting

In 2002, Congress enacted the Sarbanes-Oxley Act, Pub. L. No. 107-204, 116 Stat. 745 (2002), 15 U.S.C. § 78 *et seq*. (2000). This act requires the managers of publicly owned corporations to certify that the financial statements of the corporation fairly represent the financial affairs of the corporation. As soon as the acquisition is completed, the managers of the buyer must make these representations as to the seller. The buyer must be certain that the seller, who may be a non-publicly traded corporation and therefore exempt from compliance with Sarbanes-Oxley, has used proper accounting standards in preparing accurate and complete financial statements. Many sellers are hesitant to represent such compliance to the buyer, because their accounting practices may not be as detailed or rigorous as required, and in fact this may be one reason the seller has chosen to sell rather than go through the process of an initial public offering to become publicly traded.

G. Employee Benefits

Employee benefits such as retirement and disability plans should be reviewed to determine compliance with IRS regulations. Funding of such benefits should be reviewed by experts. The buyer will want to know if any benefits or compensation will be triggered by the proposed sale. The impact of the transaction on any employee stock option plan (ESOP) should be evaluated.

H. Litigation

Outstanding lawsuits should be reviewed to determine potential liability that may be assumed by the buyer, as well as threatened litigation. Consider the case of Bristol-Myers acquiring Medical Engineering Corporation (MEC) in 1982. MEC manufactured silicone breast implants which had not been FDA approved. Such approval was not required, because the U.S. Food and Drug Administration (FDA) provided that implants could be sold without approval, but safety and effectiveness data could be required at some unspecified future date.[3] When the FDA demanded the data in 1988, the FDA deemed the data submitted by Bristol-Myers and other implant manufacturers to be inadequate and called for a voluntary moratorium on the sale of the implants. Even though the FDA never stated that the implants were not safe, but merely that the information relating to their safety was inadequate, a panic was caused by the announcement, resulting in a flood of lawsuits. The cases against Bristol-Myers, Dow Corning, 3M, and other manufacturers of breast implants resulted in a $4.25 billion settlement.[4] Predicting potential liability can be challenging. Although Bristol-Myers may have conducted an extensive due diligence review, and MEC was not lacking any required approvals, the results were devastating. A more thorough review should have revealed the potential for a future demand by the FDA for statistics, as well as MEC's lack of preparedness for such a demand.

I. Environmental Liability

Hazardous waste site assessments may be appropriate for all real estate owned or occupied by the seller. Because the contaminator may be liable for clean-up costs even after the property is sold, buyers may also need to assess properties that have been sold by the seller. Buyers may be liable for clean-up costs as operators or owners of the acquired real estate.

J. Valuation of Acquisition

Financial projections, which are the only reasonable indicator of the worth of the acquisition to the buyer, are merely an educated guess as to future performance. The buyer will need to study the market and customer base of the seller and predict the influence of the transaction on those customers. Customers of the seller should be contacted to determine any quality control issues or other product inadequacies, as well as to verify accounts receivable. Competitors should also be considered, to determine how the seller performs relative to the competition and the competitors' future predictions regarding the market.

K. Antitrust

If either the buyer or seller has a significant market share or few competitors, the Hart Scott Rodino Act, 15 U.S.C. § 18a, may require an advance notice of the merger to be sent to the Federal Trade Commission. If the industry is heavily regulated, then the regulating authority may require notification or approval, for example the Federal Communications Commission, Federal Aviation Administration, or Food and Drug Administration.

L. Foreign Regulations

Many U.S. companies are acquiring businesses in China, Brazil, and other emerging economies. Foreign laws will need to be analyzed early in the process to determine the permissibility of the transaction, and in more depth to determine any additional consequences of the transaction.

M. Intellectual Property

All patents, copyrights, trademarks and trade secrets owned by the seller will need to be identified and cataloged. The level of review will of course depend on the value assigned by the buyer to such assets. If the buyer's primary purpose in making this acquisition is to acquire a key product to enhance its product line, then the patent or copyright protecting rights in that product will become much more important. The buyer will need to ensure that the patent is owned by the seller corporation, and that the employee who invented or created the product is not claiming individual rights. Any licensing of the patent will need to be reviewed. The claims of the patent will determine exactly what rights the company has to exclude others from manufacturing or marketing similar products. If the patent was not artfully drafted in the first place, a buyer may find that his most valuable asset is worthless because competitors can reverse-engineer or work around it.

N. Document Retention

The buyer will need to learn the location of all documents, including financial and tax records, human resources records, and government compliance evidence. The buyer will need to be satisfied that the seller has retained adequate records for an appropriate period of time to meet the standards set forth in relevant federal and state regulations, as well as to comply with the buyer's internal policies.

III. Problems Encountered with Less-Than-Diligent Review

If the purchaser decides to abbreviate the due diligence process, or to consummate the deal notwithstanding a lack of information, courts are not likely to come to its rescue when problems are discovered after the closing. In a recent District of Maryland case,[5] the court denied recovery to a buyer who alleged fraud and misrepresentation by a seller. The buyer paid $2 million for the stock of a candy cane manufacturer, following a 21-day due diligence review. The buyer did not receive all of the information it requested in its due diligence checklist, but decided to close notwithstanding this lack. The buyer alleged reliance on projections of future income prepared by the seller. After the closing, the buyer discovered that the seller was not as valuable as the buyer had hoped, in part because numerous liabilities were not disclosed, including a failure to fully fund employees' 401Ks and unpaid unemployment taxes. The court found that the buyer could have discovered these liabilities and did not have a right to rely on income predictions made by the seller, as such were mere puffery. The buyer assessed the risk associated with the deal and made a calculated decision about the level of due diligence it wanted to conduct prior to closing the merger transaction.

Courts are not sympathetic to buyers who complete acquisitions without adequate due diligence, denying recovery to "sophisticated businessmen" who make "errors in judgment."[6] In a 1995 Southern District of New York case, the court denied recovery for fraud[7] alleged by the purchaser in a $400 million deal, where the purchaser had agreed to a due diligence period limited to 17 days, even though the seller's key personnel made themselves unavailable for much of the 17-day period.[8] The court found that the buyer had waived its right to terminate the agreement based on the results of its investigation, and therefore could not complain that it reasonably relied on the seller's representations as to projected future income which did not materialize. The court did not make a determination as to recklessness, instead analyzing the buyer's actions as lacking reasonable reliance.

Although most courts now agree that the buyer's reckless conduct, rather than simple negligence, will preclude a buyer's recovery for a seller's fraudulent failure to disclose, recent decisions have denied recovery based on a finding that the buyer's reliance on the seller's statements or projections was not reasonable, because the buyer was given the opportunity to discover the accurate information.

Sellers should exercise caution where puffery is concerned. A District of Kansas court found that statements could amount to fraud where the statements were made by an insider and related to actual past or present facts and not merely predictions, and where such statements resulted in an increase in the market price of the security purchased.[9] The court was considering the 1999 proposed acquisition of Sprint by WorldCom for $129 billion. The merger eventually was blocked by the Department of Justice because of anti-trust concerns. Buyers considering an acquisition should be skeptical and tenacious in their investigations of the seller and the seller's business. Sellers should avoid making unrealistic predictions as to future profits, and exercise caution in their promises to potential buyers. Careful drafting of the agreement, including disclaimers, representations, warranties, and remedies, will benefit both parties.

IV. Conclusion

Companies that are planning an acquisition or merger should plan to devote sufficient time and resources to discover potential problems with the seller. A failure to carefully review may result in a determination that the buyer is not reasonable in relying on the statements of the seller, and the buyer may be precluded from bringing an action against the seller if fraud is discovered after the sale is consummated.

Endnotes

1. The term "due diligence" originated in the Securities Act of 1933, 15 U.S.C. § 77k, in reference to the duties of a director to make disclosures in public offerings.
2. *See* Mark Ivener, *Stopped at the Border*, HR MAGAZINE, Vol. 51, No. 6, June 2006.
3. 21 U.S.C. § 360(c); *see also* William M. Brown, "Grandfathering Can Seriously Damage Your Wealth: Due Diligence in Mergers and Acquisitions of Medical Device Companies," 36 Gonz. L. Rev. 315 (2000-2001).
4. William M. Brown, *supra* note 3, at 324.
5. *Sherwood Brands, Inc. v. Levie*, 2006 WL 827371 (D. Md. 2006).
6. *Manufacturers Hanover Trust Co. v. Drysdale Sec. Corp.*, 801 F.2d 13 (2d Cir. 1986); *Harsco Corp. v. Bowden*, 1995 WL 152523 at *7 (S.D.N.Y. 1995); *Silva Run Worldwide Ltd. v. Gaming Lottery Corp.*, 1998 WL 167330 (S.D.N.Y. 1998) ("Having agreed in writing that it had only relied on publicly available information . . . , and its own investigation of these companies, in deciding to participate in these offerings, plaintiff, run by sophisticated investors involved in a multimillion deal, cannot now, faced with an investment gone bad, claim that it relied on material misrepresentations and omissions as to material facts by [the seller].").
7. Based on the antifraud provisions of the Securities Exchange Act of 1934, § 10(b), as amended, 15 U.S.C.A. § 78j(b).
8. *Harsco*, 1995 WL 152523 at *7.
9. *In re Sprint Corporation Securities Litigation*, 232 F. Supp. 2d 1193, 1216-1217 (D. Kan. 2002).

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How Your Fine Print Affects the Top Line

By Andrew Vitrano

I. Preface

Revenue is the "top line" of the income statement, and it is the most highly scrutinized indicator of financial performance. It is also the most difficult number to report accurately.[1] The reasons for this have as much to do with the lack of accounting guidance as they do with the gap that exists between the lawyer's view of the world and the accountant's view. Indeed, lawyers often do not consider the effects of their fine print on revenue recognition, and accountants sometimes appear to ignore well-settled legal doctrines in their assessment of risk. Nonetheless, both sides could benefit from a view of the world from the other's perch. As a business lawyer, I try to appreciate that, at the end of the day, my clients' auditors, the accountants, must sign off on my clients' financial statements. Moreover, I often remind myself that business lawyers should consider not only the law, but also their clients' business strategies. Therefore, the best business lawyers draft contracts with revenue recognition effects in mind. Although this article is geared primarily toward public companies with service contracts and not contracts for goods, the discussion should allow you to draw sufficient parallels to serve as starting points for further research.

II. Introduction

The next time you review a draft of your client's Statement of Work (SOW) or negotiate a Master Services Agreement (MSA) covering future work engagements, make sure to "account" for the accounting literature. In particular, pay attention to the Financial Accounting Standards Board (FASB) Statement of Financial Accounting Concepts (CON), American Institute of Certified Public Accountants (AICPA) Statements of Position (SOP), and SEC Staff Accounting Bulletins (SAB) according to the generally accepted accounting principles (GAAP) hierarchy set forth in AICPA Statement of Auditing Standards (SAS) No. 69.[2] These accounting standards and guidance provisions push contract terms into the spotlight. If you normally do account for revenue recognition effects, you may have another problem on your hands. Chances are, your client's employees record the revenue associated with them. If this is the case, your client could have an internal controls issue, because those employees probably do not understand the revenue recognition implications of the contract terms. The message here is twofold—you should draft and negotiate contract terms that optimize revenue recognition according to your client's business strategy within GAAP, and your client should have controls in place to ensure employees are reporting revenue accordingly.

Proper revenue recognition is not always a straightforward matter of compliance with bright-line rules. There is no one piece of authoritative literature on the subject. In fact, the rules for proper revenue recognition may appear like ephemeral lines drawn in the sand. FASB CON-5, *Recognition and Measurement in Financial Statements of Business Enterprises*, provides general guidance. And the AICPA has set forth basic revenue recognition standards for certain categories of transactions related to the construction, production, or modification of tangible assets including software under SOP 81-1 and other transactions such as software licensing under SOP 97-2.[3] However, for those transactions that do not fit into predefined categories or otherwise fall under the ambit of the foregoing literature, you should consult SAB Topic 13 as amended by SAB 104.[4] Nevertheless, even with SAB Topic 13's guidance, properly recognizing revenue can depend more on a well-argued position with legal doctrines such as quantum meruit filling the gaps than reliance on guidelines alone. Indeed, SAB 104 explicitly states, "*The statements in staff accounting bulletins are not rules* or interpretations of the Commission. . . . They represent interpretations and practices followed by the Division of Corporation Finance . . . in administering the disclosure requirements of the Federal securities laws."[5]

A. Topic 13 as Amended by SAB 104

The basic premise behind all revenue recognition is that revenue should not be recorded as earned, i.e., recognized, until "the [seller] has substantially accomplished what it must do [under the contract] to be entitled to the benefits represented by the revenues."[6] That seems simple enough. If your client does not do the work, it may not acknowledge the benefit received in exchange for promising to do the work (even if your client believes that it benefited from the exchange when it spent its customer's initial deposit on a night of fun in Las Vegas). But, what about those provisions in the contract related to acceptance of deliverables, termination for cause, and fee structure? SAB Topic 13 provides examples of transactions for which revenue should be deferred until a prerequisite event has occurred.[7] Nonetheless, a general understanding of the premise of revenue recognition standards should inspire your common sense to dictate how these contractual provisions might affect your approach to your unique transaction. For those of you who, like the author of this article, are occasionally afflicted with a lack of common sense, we highlight a few practical things to consider under each of Topic 13's sections.

According to Topic 13, in order to recognize revenue as earned, there must be (1) Persuasive evidence of an arrangement, (2) Delivery of products or performance of services, (3) Fixed or determinable price, and (4) Reasonable assurance of collection.[8] The best way to illustrate the issues is through example.

1. Persuasive Evidence of an Arrangement

Let us assume there is an agreement between your client, Smarty Pants Consulting Company ("Smarty Pants"), and its customer, Meriwether Milk Co. ("Meriwether"), to assess current operational issues and make strategic recommendations for new systems and processes. The agreement is embodied in a written memorandum signed by your client and Meriwether's Technology Officer, Milk Me Mike. The agreement includes all prerequisites to contract formation.[9] Specifically, the contract states that:

> **Background**
>
> Smarty Pants will work with Meriwether's internal project management office on a staff augmentation basis to assist in its effort to conduct a current-state assessment of Meriwether's accounting systems and related operations and make strategic recommendations to senior management as to what changes should be made to accommodate the integration of a cheese production division.
>
> **Deliverables**
>
> Smarty Pants is responsible for the delivery of:
>
> a) Status reports,
>
> b) Gap analysis report,
>
> c) Future-state architectural design document, and
>
> d) Project plan for execution of recommendations.
>
> **Price**
>
> Smarty Pants shall perform the work on a time and materials basis with billings to occur every thirty (30) days. The work is expected to last from January 2006 through September 2006. Total costs including expenses shall not exceed $450,000.
>
> **Acceptance**
>
> Meriwether shall have a right to review all deliverables. If deliverables meet Meriwether's acceptance criteria, Meriwether shall notify Smarty Pants of acceptance in writing within seven (7) days of delivery.
>
> **Termination for Cause**
>
> If Meriwether discovers a defect in the deliverable, Smarty Pants shall promptly correct such deficiency. If Smarty Pants is unable to correct such deficiency, Smarty Pants shall be considered in breach and Meriwether shall be entitled to a full refund.
>
> **Termination Not for Cause**
>
> Meriwether may terminate this contract with thirty (30) days written notice. In this case, Meriwether shall compensate Smarty Pants for all undisputed amounts due up to termination.[10]

Smarty Pants is well into the second quarter of performing its obligations under the contract and has been recognizing the revenue associated with the billed hours as it performed the services.[11] Meriwether undergoes a change in management and wants to have its new Technology Officer, Milk Me Again, re-sign the contract with his name on it. Meriwether does not want to change any of the terms of the original agreement. Should Smarty Pants accommodate Meriwether and sign a new contract out of courtesy? The answer is, "No," unless you are prepared to go to battle with the accountants, who might argue that the signing of a new contract indicates the original contract was not "final" according to the definition of "arrangement"[12] and revenue recognition not appropriate under the accounting rules despite your superior contract law argument. While this scenario seems unlikely, it has happened. But the basic message here is, be careful to not do anything to a contract that could alter its effective dates unless absolutely necessary. At the very least, you could cause your client to suffer a deferral of revenue. At worst, your client could suffer a refiling of financial statements with the SEC, a government investigation, and a drop in stock price. If you do need to re-sign a previously executed contract, it would be prudent to have the client agree in writing that the original agreement was never, at any time, in jeopardy of rescission.

For those of you who have been working in this area, you probably are familiar with the age-old conflict between accounting rules and the law. The conflict is never more apparent than it is under this prerequisite. What may be sufficient evidence to establish a contract according to contract law may not be sufficient evidence of an "arrangement" under accounting literature. With our example above, the accountant viewed the re-signed contract as an indication that the original agreement was not final and, therefore, questioned whether the previously recorded revenue should have been recognized. Your unquestionable legal argument based on the doctrine of quantum meruit and other impenetrable contract and agency law principles is useless under the accounting literature. Indeed, accountants strive to determine the likelihood of a customer making a payment under an "arrangement" without regard to whose legal argument is stronger. In fact, the accountant may view a subsequent court judgment as a separate accounting event. But the conflict may not be as paralyzing as it may appear if you recognize that accountants and lawyers have different objectives driven by different principles. Both can coexist peacefully if each would appreciate the other's perspective and not take into account too many "what ifs"—something more difficult for the lawyer to do considering his or her training.

2. Delivery of Products or Performance of Services

This prerequisite raises even more pertinent real-life issues and illustrates the vastness of grey matter that SAB 104's amendments create. SAB 104 amends Topic 13 to include "customer acceptance" as a condition precedent to revenue recognition.[13] Topic 13 states, "After delivery of a product or performance of a service, if uncertainty exists about customer acceptance [or, if an arrangement expressly requires customer acceptance], revenue should not be recognized until acceptance occurs, [especially if acceptance is express and the seller is obligated to perform additional steps]."[14] The provision raises questions as to (1) when a customer acceptance requirement is express, (2) when certain services are not considered meaningful enough to render acceptance provisions applicable, (3) the effect customer payment has under contract law principles, (4) the effect of a termination clause, and (5) how to allocate revenue among service workstreams or deliverables.[15]

a. Express Acceptance

A contract might explicitly state that acceptance of a deliverable is required and shall be communicated to the client in writing. However, Topic 13 provides that, "Formal customer sign-off is not necessary to recognize revenue [if] . . . the seller [can] . . . demonstrate[ ] that the *criteria specified in the acceptance provisions* are satisfied.[16] One problem here is that this provision does not address acceptance provisions that specifically require acceptance to be communicated to the seller in writing. Another problem is that most acceptance provisions do not spell out what the acceptance criteria are. Some might be so vague as to state that both the seller and the buyer shall establish the criteria jointly at some future point in time. A third problem has to do with evaluating the characteristics of the deliverables to determine whether any portion of an unfinished performance obligation is so inconsequential that it renders acceptance criteria inapplicable. Topic 13 states that "A remaining performance is not inconsequential or perfunctory if it is essential to the functionality of the delivered products or services."[17] It is perfectly foreseeable that what may seem inconsequential to Smarty Pants could be a valuable missing link for Meriwether to move forward with its plans. Evaluating performance obligations under an express acceptance provision is especially difficult to do where the deliverables are somewhat ephemeral. For example, is Smarty Pants' failure to include a particular analysis in the Gap Analysis Report inconsequential to the report's "functionality"? What about deliverables for which Smarty Pants is not responsible? These deliverables may not be meaningful enough for acceptance criteria to be practically applied. We cover this issue next, but the basic message here is, make sure acceptance criteria are spelled out clearly or intentionally left out of the contract altogether if your client is the seller.

b. Meaningful Deliverables

Accounting rules look to the substance of a transaction, not the form. Therefore, acceptance might not be a prerequisite to revenue recognition despite an express acceptance provision if the performance obligation is such that acceptance is not practical. Although Topic 13 does not expressly provide for this exception, common sense and a well-documented argument may be required to recognize revenue. For example, service-oriented work such as that of a consultant may be provided on a strictly staff augmentation basis with no tangible deliverable. Alternatively, the contract might expressly state that the buyer is solely responsible for the final deliverables. In our example, Meriwether has hired Smarty Pants to "work with Meriwether's internal project management office on a staff augmentation basis to assist in its effort" to perform certain work. This language would indicate that Meriwether's internal staff is responsible for the delivery of any deliverables associated with the effort. Smarty Pants would only be responsible for "assisting" on a "staff augmentation basis." If the contract ended there and did not later state that "Smarty Pants is responsible for the delivery of" certain tangibles such as the gap analysis report, it could easily be argued that Smarty Pants was not providing deliverables for which sign-off would be practical. As long as the designated Smarty Pants consultants showed up for work and were not dismissed, revenue recognition would appear reasonably recognizable on an as-performed basis over the course of the engagement without having to defer.

Acceptance provisions often appear as boilerplate in both seller and buyer contracts even though they might not be suitable for the transaction. However, if the other provisions of the contract do not clearly establish a staff augmentation basis or some other basis for characterizing a deliverable as non-meaningful, acceptance provisions could be a barrier to optimal revenue recognition, a bone of contention for your client's auditors, and a confusing issue for your client's accounting department.

c. Effect of Customer Payment

What if Meriwether does not provide a written notice of acceptance or rejection according to the contract but has taken possession of the deliverables and paid all invoices in full? Did Meriwether accept the work? Topic 13 does not address this occurrence, which is often typical of service-oriented performance obligations. Be careful to realize that just because a busy accounts payable department cuts a check, this does not necessarily mean that the buyer has implicitly accepted the deliverables. Nevertheless, in this scenario, a legal argument under contract law principles could permit recognition. Topic 13's best answer resides in the section pertaining to persuasive evidence of an arrangement. Under the analysis for determining the existence of an arrangement, a gap in formalities might be filled with prior course-of-dealings and past conduct between the parties.[18] In our example, if Smarty Pants had done work for Meriwether in the past under contracts containing acceptance provisions and Meriwether has not previously provided written notice of acceptance, it could be argued that the acceptance provision does not apply, especially where Meriwether has paid all invoices in full. However, it could be difficult to argue that payment constitutes acceptance if the contract contains both an acceptance provision and a termination clause that provides for payment of 'undisputed amounts,' which we discuss next. In the meantime, if your client is the seller, make sure it collects payments in a timely manner. If your client is the buyer, make sure it does not make payments blindly.

d. Effect of Termination Language

Contracts for services often contain boilerplate provisions that allow for termination of the contract. Normally, there is a clause for termination for cause and a clause for termination not for cause. Generally, a termination for cause clause provides that the customer may terminate the contract if the seller has failed to perform its obligations under the contract or is otherwise in breach, in which case the customer is entitled to a refund. A termination not for cause clause usually allows the customer to cancel the contract prior to full performance by the seller only if the customer compensates the seller for the amount of work completed. For obvious reasons, these clauses take a back seat to acceptance provisions. For example, even if a termination for cause clause does not provide for a refund, it defies common sense to allow recognition of revenue for a performance obligation that is subject to acceptance if no acceptance is likely to occur.[19] However, with contracts that do not contain acceptance provisions, the absence of a termination not for cause clause will most likely result in deferral of revenue until work is fully performed. Nevertheless, even with its inclusion, a termination not for cause clause could result in deferral of revenue if the customer has not been paying bills and the clause provides for payment of only "undisputed amounts." A lack of payment beyond the payments' due dates raises questions as to whether payment is at risk, in which case revenue should be deferred until the amounts are no longer at risk. The lesson here is watch out for termination clauses. They can be like a double-edged sword.

e. Allocation of Revenue Among Deliverables

The effect of an acceptance provision on revenue recognition can be severe when the seller is to perform services on a time and materials basis and no values are attached to deliverables or phases of work. Do not be fooled into thinking that just because work is to be performed on a time and materials basis that the contract automatically allows for as-performed revenue recognition despite acceptance criteria. In our example, Smarty Pants is explicitly responsible for delivery of four tangibles. We have already explained that, despite the description of the work as "staff augmentation," the deliverables are considered meaningful because of the deliverables' tangible nature and the consultant's sole delivery responsibility.[20] This conclusion, together with the acceptance clause, requires deferral of revenue until acceptance. However, what if Smarty Pants receives sign-off on each of the four deliverables as they are completed? How much revenue can Smarty Pants recognize at each acceptance date? The answer is "none" unless the contract value can be allocated across deliverables according to Meriwether's valuation of each deliverable. Because work on deliverables often occurs simultaneously, valuing the deliverables based on time sheets is not practicable. The consequences of failing to allocate values among deliverables could be magnified if the parties enter into an extension contract. This would prolong the deferral. The lesson here is to attach values to each deliverable set forth in the contract regardless of whether your client is to complete the work on a time and materials or fixed fee basis.

3. Fixed or Determinable Price

In order to recognize revenue, a fee must be "fixed or determinable" at the outset of the arrangement.[21] Although the terms sound similar, "fixed or determinable" does not have the same meaning as it does in a contract for which work is to be rendered on a "fixed fee" basis. "Fixed or determinable" is a term of art and includes time and materials-based contracts. The question is whether the total expected revenue could be calculated from the terms of the agreement. Looking back to the contract in our example, the provisions state that the work is to be performed on a time and materials basis but they do not state the rates for the individual consultants working on the project. In this case, how does the client know how much an hour of work costs or how many hours will be required to finish the work? Despite the stated cap of $450,000, the client cannot determine the cost of the services. Thus, the fee is not fixed or determinable at the outset of the arrangement. Therefore, Smarty Pants may not recognize revenue until Meriwether formally accepts the deliverables.

4. Reasonable Assurance of Collection

Topic 13 does not expand the definition of this prerequisite beyond its title, but it cites ARB 43 and FASB CON-5. According to CON-5, if collectibility is doubtful, revenue may be recognized on the basis of cash received.[22] This provision sounds simple, but it must be reconciled with the guidance pertaining to acceptance provisions and termination provisions as they pertain to disputed amounts. With those issues in mind, this provision appears to presume that any acceptance or termination provisions are generally controlling but do not control the transaction in question. Interpreting CON-5 in this way, the true reading of the provision would be, "If collectibility of assets [ ] for product[s], services or [ ] assets [*for which the buyer has accepted delivery*] . . . revenues and gains may be recognized on the basis of cash received."[23] Otherwise, for attorneys, the "reasonableness" requirement comes to mind in many forms. However, be prepared to meet the accountant who will argue that when there is a doubt as to whether revenue should be recognized, one should err on the side of deferral.

B. Internal Controls

The last discussion concerned the effect of contract terms on revenue recognition before any revenue hits the books. Now, assuming the terms of the contracts were drafted to account for revenue recognition effects, we turn to the practical issues that arise in recording the revenue according to those terms.

Most companies in the services industry use web-based systems to record the time and materials spent on client work. Many of these systems are either home grown or too generic to rise to the level of sophistication required for accurate reporting. In addition, weaknesses in the time and expense recording and other parts of the reporting process chain pose a challenge to internal controls. As an attorney responsible for highlighting issues with your client's controls, you should at least know what the limitations of your client's systems and processes are so that management can put new controls in place.

1. Reporting Systems

Web-based time and expense reporting systems typically allow employees to enter the hours they are working on specific engagements together with the expenses that their employer might pass along to the customer. These systems feed into the accounting systems that record the revenue associated with those hours and expenses. The accounting systems typically book the revenue according to a profile that administrators set up in the accounting system at the outset of a work engagement. The ability to establish a revenue recognition profile that properly reflects both the characteristics of the work being performed and the contract terms prior to the first hour entered lies at the heart of proper revenue recognition. In addition to setting up a contract as either time and materials-based or fixed fee-based, it is critical that the system allow the administrator to set up a contract on an as-performed or milestone revenue recognition basis.

The shortcomings of your client's systems are difficult to predict, but one example might be the inability to break out milestone-based projects by milestones or workstreams. As we discussed above, this inability makes it very difficult to track revenue for time and materials-billed projects that require deferral of revenue until acceptance occurs. Another example of a shortcoming might be an inability to establish contingencies or rebates and discounts that your client may have to provide its customers. Your client will likely have to defer recognition of revenue that your client may have to give back to the customer at a later date. It is critical to establish this amount at the outset of the engagement.

You might want to conduct an audit of your accounting systems to determine what shortcomings might exist. If your client cannot afford to upgrade its systems, it will be up to you to implement manual control procedures to ensure revenue is booked according to your recognition policy, which is a topic we consider next.

2. Reporting Processes

Every company should have a clearly outlined revenue recognition policy that is both well documented and well communicated to not only legal and sales, but to the entire engagement field as well. The downstream education of employees should include background in the accounting guidance and examples to drive home the implications of failing to follow the policy. The biggest challenge will be the elimination of bad habits.

The elimination of bad habits is critical to enforcement of your policy. Employees need to understand the implications of acceptance provisions, customer discounts, and side agreements, but it is important to drive home the consequences of failing to carry out the terms of the contract and other risks, such as parking hours in another project, failing to receive sign-off from legal, and failing to properly establish the administrative contours of the work engagement. Your client's revenue recognition policy should be established in conjunction with the internal audit committee and updated at least annually.

III. Conclusion

This article has outlined the effects of both shortsighted contract negotiation and ineffectual internal controls on your client's financial reporting. The issues presented here are only a sample of the concerns that face your client as they relate to revenue recognition. It is critical to your client's compliance status and business interests that revenue recognition be a consideration at the outset of work engagements. Moreover, strict adherence to your revenue recognition policy should be an integral part of your client's normal operating procedure. Hopefully, this article has highlighted an issue that is important to you in your practice and put you on the right track to become an even more effective business lawyer.

Endnotes

1. Ashwinpaul C. Sondhi & Scott A. Taub, Miller Revenue Recognition Guide, § 3.02 (2006 ed.).
2. The hierarchy of GAAP to which we should refer in descending order is: (1) FASB Statements and Interpretations, APB Opinions, AICPA Accounting Research Bulletins, and, for SEC registrants, SEC Staff Accounting Bulletins; (2) FASB Technical Bulletins, AICPA Industry Audit and Accounting Guides cleared by the FASB, and AICPA Statements of Position cleared by the FASB; (3) Consensus positions of the FASB Emerging Issues Task Force and AICPA AcSEC Practice Bulletins cleared by the FASB; (4) AICPA Accounting Interpretations, FASB Implementation Guides, and widely recognized and prevalent industry practices; and (5) other. On April 28, 2005, FASB issued a Proposed Statement of Financial Accounting Standards to propose a recategorization of the hierarchy in response to the SEC's criticism that the hierarchy (1) is directed toward the auditor rather than the enterprise; (2) is complex; and (3) ranks FASB Concepts Statements below industry practices that are not subject to due process. *See* FASB Financial Accounting Series No. 1300-001, Appendix A, A3-4, April 28, 2005.
3. SOPs fall under Category B of the GAAP hierarchy.
4. SAB 104, issued December 13, 2003, amended SAB Topic 13 *codified at* 17 C.F.R. pt. 211.
5. *See* SAB 104 at Summary, emphasis added. Although SABs fall into Category A of the GAAP hierarchy, SAB Topic 13, *Revenue Recognition*, states that Topic 13 takes precedence over other authoritative literature only if there is no other industry-specific guidance covering the transaction in question. *See* SAB Topic 13 A(1).
6. *See* FASB Concepts Statement 5 at ¶ 83(b).
7. For example, SAB 104 amended Topic 13 to include guidance where products or services are subject to various forms of customer acceptance. *See* SAB 104 2(c) and (j).
8. Topic 13 explains these requirements and provides guidance in Q&A format. For purposes of the issues presented here, we address only some of those issues that are likely to arise in practice, the guidance for which must be gleaned from between the lines.
9. Despite the existence of a signed contract including a merger clause, side agreements may indicate that the executed contract was not final and revenue recognition not appropriate. *See* SAB Topic 13 at A(2) Question 1. On the other hand, past course-of-dealing with the client where customary practices between the seller and buyer do not include signed contracts may be persuasive evidence of an arrangement. *Id.*
10. We will use these facts to illustrate issues that may arise under the remainder of Topic 13's four prerequisites.
11. Whether the revenue should have been recognized in light of Topic 13's other prerequisites will be addressed in those sections.
12. SAB 101 states, "The use of the term 'arrangement' in this Staff Accounting Bulletin is meant to identify the final understanding between the parties as to the specific nature and terms of the agreed-upon transaction." *See* SAB 101 at footnote 3.
13. *See supra* note 6.
14. *See* Topic 13.A.3(b) and Note 22 thereto.
15. Topic 13 addresses other issues pertaining to delivery and performance that are not addressed here. These issues include client discounts, nonrefundable fees, and deliveries with other arrangements.
16. *See* Topic 13.A.3(b) Question 1 at "Interpretive Response" (emphasis added).
17. *See* SAB Topic 13.A.3(c) Question 2 at "Interpretive Response." This section lists other factors to consider in determining whether performance is perfunctory and provides that registrants' determinations "should be consistently applied [across contracts]."
18. *See* SAB Topic 13 at A(2) Question 1. Accounting literature borrows from The Uniform Commercial Code (UCC) when it refers to the past conduct of the parties. Under the UCC, this is called "course-of-dealing," but a legal argument based on course-of-dealing could be a doubled-edged sword, because the UCC applies only to contracts for goods.
19. The accounting literature does not provide guidance as to how much time must pass before cash received for an unaccepted deliverable may be recognized as revenue.
20. It is arguable that "status reports" amount to meaningful deliverables.
21. *See* CON-5 at ¶ 83(b); *See also* Statement 48 at ¶ 6(a); *See also* SOP 97-2 at ¶ 8. SOP 97-2 defines "fixed fee" as a "fee required to be paid at a set amount that is not subject to refund or adjustment."
22. *See* FASB Concepts Statement 5 at ¶ 84(g).
23. *Id.* (insert added).

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Banking Committee

The Banking Committee focused on emerging developments in bank regulation and loan documentation in its meetings in 2006.

At the January meeting, held in conjunction with the Annual Meeting, Roberta Kotkin, Esq., General Counsel and Chief Operating Officer of the New York Bankers Association, presented an overview of legislative and regulatory developments anticipated for the 2006 session as well as a review of 2005 enactments. Randy Henrick, Esq., Associate General Counsel of Dealer Track, Inc. gave a presentation on identity theft and the evolving state and federal regulatory framework that deals with this growing problem.

At the Spring Meeting in May, Paul Lee, Esq., of Debevoise & Plimpton presented on Bank Secrecy Act and Anti-Money Laundering Developments. Raymond Seitz, Esq., and Deborah Doxey, Esq., of Phillips Lytle LLP reviewed Commercial Law Developments and the Model Deposit Account Control Agreement.

The Fall Meeting, held at the Cranwell resort in Lenox, Massachusetts, featured a presentation by Sara Kelsey, Esq., Deputy Superintendent and General Counsel of the New York State Banking Department, on the Banking Department's current enforcement initiatives in the anti-money laundering area. David Billet, the Banking Department's Director of Government Relations, also provided an outline summarizing banking law changes/enactments during the current legislative session. Norman Nelson, Esq., General Counsel of the Clearing House Association L.L.C., summarized the amicus brief that the Clearing House Association L.L.C. submitted in the *Watters v. Wachovia* case, recently argued before the U.S. Supreme Court.

—Bruce J. Baker, Chair

Bankruptcy Committee

The Bankruptcy Committee is studying the effect on the practice by the BAPCA Act enacted in October 2005. Thus far the effects are focused on Chapter 13 and the Court clerical staff is abiding by and enforcing the standards set in the Act for consumer bankruptcy filings. The Chapter 11 reorganization effects will likely be felt in the coming year when the time constraints of concluding acts under the code and concluding the case itself will be upon those cases commenced after the Act became effective.

The Committee members periodically receive new and interesting case summaries through web blasts.

It is anticipated that in the coming months there will be a selection of persons desirous of being on a panel or being an author of a part of the course book for the CLE bankruptcy law program, which will include a discussion of the effects of the BAPCA Act.

—Paul Silverman, Chair

Consumer Financial Services

The hottest themes for the Consumer Financial Services (CFS) Committee meetings in 2006 were privacy, identity theft and data security. In fact, discussion of these topics went well beyond the confines of CFS Committee meetings. The CFS Committee met jointly with the Banking Law Committee during the NYSBA Annual Meeting on January 25, 2006. At the joint meeting, Randy Henrick, a member of the CFS Committee, provided an excellent report on developments in the areas of privacy, data security breaches and identity theft. At the May 10th Spring Meeting, Randy provided an update to the CFS Committee. At the Fall Meeting, he gave an informative and fascinating presentation to the entire Section that inspired a lively series of comments, questions and answers. At the Fall Meeting of the CFS Committee, Randy reported on five recently enacted New York laws in the same subject areas. As Randy made abundantly clear throughout 2006, privacy, identity theft and data security are, and will continue to be, important issues not only to each of us individually, but also to the companies we counsel.

Stalwarts of the CFS Committee continued to contribute at the committee and section level in 2006. At the Business Law Section CLE Program in January, Barbara Kent and Warren Traiger participated in a spirited discussion in a segment entitled, "Redlining Revisited: Are the Fair Lending Laws Doing Their Job?" At the May CFS Committee meeting, Phil Veltre gave an outstanding review of the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 in the context of delivery of retail financial services, and Vince Amato led a discussion of the potential impact of SEC Regulation AB on originators and servicers of consumer loan products. At the Fall CFS Committee meeting, Grace Sterrett reviewed the highlights of recent New York legal developments affecting consumer financial services, and provided an excellent written summary of those developments to attendees. Also at the Fall CFS Committee meeting, Barbara Kent discussed the changing role of the Banking Department in light of recent substantial federal preemption developments.

In 2007, as in 2006, prospective attendees will determine the topics for discussion at meetings. In 2006, the CFS Committee sought to expand its numbers and to encourage participation by a more diverse group of attorneys. The committee will continue to encourage new and diverse membership in 2007. As Chair, I will look to current members to continue their active participation in the CFS Committee and the Business Law Section. Please contact me, Geoff Rogers, at grogers@hudco.com or (518) 383-9591 if you are interested in attending a meeting or in joining our committee.

—Geoffrey C. Rogers, Chair

Corporations Law and Securities Law

The Committees on Corporation Law and Securities Law met jointly at the Section's Fall Meeting, held at the Cranwell Resort in Lenox, Massachusetts. The joint meeting has been the custom for the Fall Meeting.

Present were: Janet Geldzahler, Robert Fine, Joseph Hansen, Glenn Witecki, Gary Trechel, Robert Yellen, Jeffrey Rubin, Richard Gutman, Edward Cohen and Frederick Attea.

Mr. Attea noted that the primary items covered by the Corporation Law Committee during 2006 dealt with the continued work on a proposed revision to the New York Not-For-Profit Corporation Law, efforts to deal with consequences of the "Publication Bill" and providing "educational" opportunities to members with CLE credit.

The revised NFPCL draft was presented to the Executive Committee of the House of Delegates of the NYSBA earlier in June of this year. The New York City Bar Association requested time to review the proposed legislation and, accordingly, the Executive Committee of the NYSBA Executive Committee suggested that the matter be deferred for this reason. At press time the Corporation Law Committee anticipated resubmitting the proposed revision for action by the House of Delegates at the January 2007 meeting.

The other subject that occupied substantial Committee time was proposed amendments to the Publication Bill which finally became law. There was a general discussion regarding the "negotiations" between the Committee and the Governor's Office and other interested parties. As finally adopted, the law did not contain many of the most onerous provisions of the early version of the bill but there is still a substantial desire to repeal the law entirely. Mr. Attea noted that a bill was introduced or about to be introduced that would repeal the publication law; however, the NYSBA legislative experts did not believe that this bill would have any material support.

There was a discussion regarding the feasibility of joint projects with the Corporation Law and Securities Law Committees. This would be explored further. One example of such a project was the "director majority vote" controversy that was being studied by a Subcommittee chaired by Janet Geldzahler. She generally described the background giving rise to the issue and the status of "majority voting" under current Delaware and New York statutes.

Mr. Attea noted that the Securities Law Committee provided CLE credit on a regular basis at its monthly meetings. The Corporation Law Committee was trying to follow that practice. There was a broad-ranging discussion regarding a need to establish closer ties between the Committees of the Business Law Section and legislative subcommittees that deal with legislation affecting matters covered by the Section's committees. The Business Law Section's Legislative Affairs Committee has been formed recently to make progress on this front.

—Frederick G. Attea, Chair

Franchise, Distribution and Licensing Committee

The year 2007 will mark the start of a new direction for the Franchise, Distribution and Licensing Committee. In the past, the committee has focused on franchising, although the name of the committee was changed some time ago with the addition of the words "distribution" and "licensing." This year, we will look at broader legal issues surrounding the ways in which products and services are delivered. This includes not just those arrangements described in franchise, distribution and license agreements. It can also include direct marketing, multilevel marketing and sales representative arrangements, and specific industry sectors such as auto dealerships, gas stations, liquor stores and cigarette stores.

This broader look at the delivery of products and services should be of interest to more members of the Business Law Section. It might also attract new section members. Lawyers with related practices include those in the fields of intellectual property, litigation, antitrust, real estate and international.

Of course, the committee will continue to channel much of its work in the field of franchising and franchise regulation. We welcome all comments and participation.

—Thomas M. Pitegoff, Committee Chair

Securities Law

(See above under Corporations Law and Securities Law.)

Publication Policy and Manuscript Guidelines for Authors

All proposed articles should be submitted to the *Journal*'s Editor-in-Chief. Each author must submit a 3½" disk, double density or high density, plus two printed copies of the manuscript. The disk should be labeled indicating the type of computer software used in the creation of the material. Preferred document formats are: Microsoft Word for Macintosh, Microsoft Word for Windows and Microsoft Word for DOS. WordPerfect is also acceptable if formatted using v.5.1 or 6.0. Most laser-printed copy is acceptable. Dot matrix copy is not. There should be no pencil or pen markings made on either of the printed copies submitted. Authors are responsible for the correctness of all citations and quotations; footnotes should be double spaced and segregated at the end of the article. A short author's biography should also be included.

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The Section's Committees are also encouraged to submit for publication in the *Journal* notices of committee events, Annual Meeting notices, information regarding programs and seminars and other news items of topical interest to the members of the Business Law Section.

Deadlines

Manuscripts intended for publication in the fall and spring issues must be received by the preceding July 31 and February 15, respectively. Manuscripts are to be submitted to:

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