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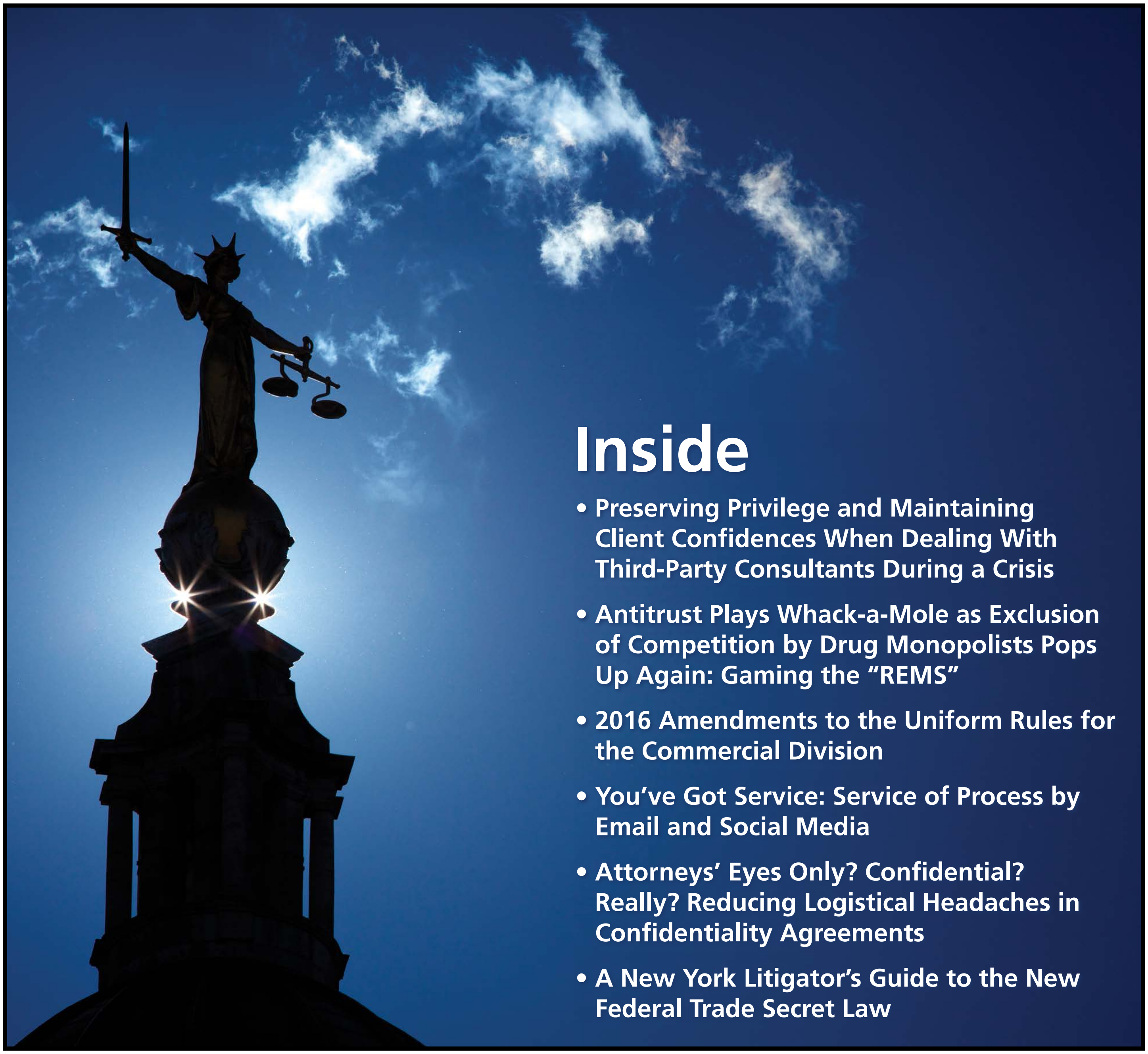
of the New York State Bar Association



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NYSBA

Commercial and Federal Litigation Section

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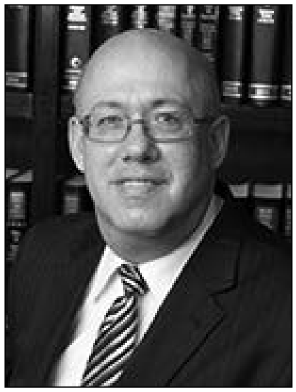
A Message from the Chair



It is a privilege and honor to have been elected Chair of the Commercial and Federal Litigation Section, following in the steps of great icons of the New York State Commercial Bar. The Section's membership has increased over the past year and the Section is a vibrant and robust organization of terrific commercial litigators. We are the bar organization of choice for attorneys who practice business litigation in our State and Federal Courts, and we will continue to add value to our members and offer the best programming available in the State.

The Fuld Award Goes to the Second Circuit

The Section has great plans for the next year. We are excited and proud to announce that the entire Second Circuit Court of Appeals will be presented with the Section's 2017 Stanley H. Fuld Award at our Annual Meeting in January 2017. The award recognizes outstanding contributions to the development of commercial law and jurisprudence in New York. The Second Circuit's accomplishments in advancing commercial law in New York State, throughout this country and the world are well-recognized. With this award, it is only appropriate that the Annual Meeting's CLE programming will include a panel addressing federal appellate issues. In addition to honoring the Second Circuit in this manner, the Section also will be sponsoring an additional event with the Second Circuit associated with the Fuld Award. The Section is honored to be participating in celebrating the Second Circuit's 125th anniversary with the presentation of the Fuld award, and looks forward to the opportunity to strengthen its ties with the Second Circuit and the Federal Judges in each of the Districts in New York.

The Section's Women's Initiative

The Section just established a new award, the first time in over ten years that one has been created. It is called *The Shira A. Scheindlin Award for Excellence in the Courtroom* in honor of the Section's former Chair, who served with distinction as a United States District Judge for the Southern District of New York from September 1994 through April 2016. The Section will present this award annually in November, around the date when women received the right to vote in New York State in 1917, to a woman who has distinguished herself in the courtroom in either the Federal or State Courts in New York and who has shown a commitment to mentoring young attorneys in the legal community.

The awardee will be Carrie Cohen, now of Morrison & Foerster, who this year successfully prosecuted Sheldon Silver as an Assistant United States Attorney and who served as Section Chair in 2007-2008. The award will be presented on November 14th in the ceremonial courtroom in the Southern District of New York's Federal Courthouse.

The November program will also initiate a new Section scholarship funded through the New York Bar Foundation to be awarded to junior female attorneys, which covers the cost of their registration to the Section's 2017 Commercial Litigation Academy. The goal of this new scholarship is to prepare women to serve as first chair in business litigation trials. The awardees will be called Kaye Scholars in honor of the Honorable Judith S. Kaye, the State's former Chief Judge. The program will have, among other components, a CLE trial practice program and its participants will include female former chairs of the Section as well as young rising women attorneys. Additional programming seeking to increase the number of women in the courtroom is also intended this year.

CLEs and Our Cutting Edge Reports

Already scheduled for September 29 is a groundbreaking Section four credit CLE program entitled *Legal Ethics in the Digital Age* that draws upon members of our Electronic Discovery, Ethics and Professionalism and Social Media committees as well a member of the Executive Committee of the New York State Bar. The Section is also working on putting together a joint CLE with the Dispute Resolution Section on eDiscovery and arbitration.

The Section intends to continue to lead the nation in issuing reports concerning our new digital world. The Electronic Discovery Committee will debut its Third Edition of *Best Practices in eDiscovery in New York State and Federal Courts* this fall. The Social Media Committee also intends to issue its Third Version of *Social Media Ethics Guidelines* next spring. The Second Version of the *Social Media Ethics Guidelines* already leads the nation on the issue and is highlighted on the State Bar's homepage.

Meeting Chief Judge DiFiore, and the Section's Executive Meetings Continue to Travel the State

We have always invited State and Federal Judges to speak at our monthly Executive Committee meetings concerning current issues, but this coming year we are extremely proud to kick off the year in September with Chief Judge Janet DiFiore speaking to our Section's Executive Committee.

As for our monthly Executive Committee meetings, continuing the initiative of holding meetings throughout the State, we anticipate travelling out of New York City three times during the next year and will seek to have these meetings held at upstate Federal Courthouses. By having our Executive Committee meetings at Federal Courthouses, we hope to forge closer ties to the Federal District Judges throughout our State, as well as to their law clerks and local practitioners, who will be able to see first-hand the benefits of joining our Section.

Membership Diversity—Seeking to Add Diversity, Youth and Law Students to the Section

As part of our membership initiative, the officers of the Section intend to speak with law students at law schools around the State to encourage them to join our Section. To that end, the Section has created a video promoting the benefits of joining the Section which will be shown to students during our visits. The Section also intends to work with local upstate bar associations to create a diversity program with the goal of increasing the diversity of the Section statewide. The Section is going to work with local bar associations, having already reached out to the Asian American Bar Association to explore symbiotic relationships with the Section. In addition, the Section this year created a formal Kids Club at our Spring Meeting in Cooperstown in order to encourage Section members who have young children to attend our meeting. I will seek to make this a permanent addition to our programing with the goal of extending our reach to our membership who have not typically attended our Spring Meetings.

Conclusion

The Section will continue to focus its efforts on educating the business community of the benefits of litigating in New York by continuing our support of finding new ways to make litigating in our New York State and Federal Courts more efficient and cost effective. We have the best and brightest attorneys as members of our Section, and it is their creative ideas that have assisted the Bench and Bar in seeking to achieve this objective.

This will be an exciting year, and the Section is committed to providing value to its members through CLEs, programming, reports and the mentoring of young attorneys. We are always open to ideas, so please feel free to contact me at mberman@ganfershore.com if you would like to share with me your thoughts regarding how we can continue to grow and improve.

Mark Arthur Berman

Preserving Privilege and Maintaining Client Confidences When Dealing With Third-Party Consultants During a Crisis

By Robert D. Argen, Jason Canales, and Devika Kewalramani

I. Introduction

In times of crisis, corporations often seek urgent legal advice from counsel. In formulating a rapid response, counsel is forced to work under pressure to collect and comprehend volumes of data. These situations may require counsel to utilize the help of third-party consultants. For instance, in response to the increasing number of company data breaches, the retention of a third-party forensic investigator is often necessary because information technology departments commonly lack the expertise or technology required to preserve electronically stored information. Additionally, these departments commonly lack the expertise to conduct a thorough investigation of a breach on their own. Counsel may also rely on third-party consultants in response to a whistleblower action under the Dodd-Frank Act or as part of an internal investigation into violations of the Foreign Corrupt Practices Act, where the services of forensic accountants and technology experts are integral to the comprehension of complicated financial transactions and the use of computer review platforms. Notably, in any high-profile data breach, litigation, or regulatory enforcement action, counsel may also need to immediately bring a large-scale public relations firm into the fold.

In each of these scenarios, the attorney-client privilege guards against disclosure of confidential communications, between attorney and client, made for the purpose of providing legal advice.[1] But what happens when the client or counsel communicates with third-party consultants? Will such communications be privileged?

Generally, the attorney-client privilege is waived when a privileged communication is disclosed to a third party.[2] However, when a third-party consultant "assist[s] the lawyer in the rendition of professional [legal] services,"[3] the "agency exception"[4] to waiver may apply. This exception to the general waiver rule is commonly referred to as the *Kovel* doctrine. In the landmark case *United States v. Kovel*,[5] the Second Circuit ruled that a client's communications with an accountant, hired by the client's attorney, were privileged because the accountant was functionally equivalent to a foreign language translator who helped the attorney understand his "client's story."[6]

But application of the *Kovel* doctrine to communications between counsel and third party consultants is not automatic. For example, in *Fine v. ESPN, Inc.*,[7] the United States District Court for the Northern District of New York recently declined to apply the doctrine to communications between the defendant in a defamation suit, defense counsel, and the defendant's public relations firm. Even though the public relations consultants incorporated the advice of counsel into press releases, the court determined that the work of the third-party consultants did not assist in the provision of legal advice.[8] Similarly, in *Scott v. Chipotle Mexican Grill, Inc.*,[9] the United States District Court for the Southern District of New York held that the *Kovel* doctrine did not apply to communications with a human relations consultant in an employment-related class action lawsuit.[10] Consequently, case law reveals that in times of crisis—no matter how rapid a response is required—client and counsel should remain cognizant of the need to properly preserve privileged communications and client confidential information with third-party consultants and should make sure to take all necessary steps to do so.

II. Attorney-Client Privilege and the "Agency Exception" to Waiver

Upjohn Co. v. United States[11] remains the leading case on attorney-client privilege in the corporate context. Extending the attorney-client privilege to corporate communications, the United States Supreme Court in *Upjohn* ruled that the attorney-client privilege protected interview notes and memoranda (i) prepared and collected by in-house counsel (ii) as part of a factual investigation to determine the nature of alleged illegal activities and to enable in-house counsel "to be in a position to give legal advice to the company" in light of the fact that (iii) the interviewed employees were "sufficiently aware" of the legal purpose and confidentiality surrounding the investigation.[12] In support of its holding, the Court recognized that the purpose of privilege was "to encourage full and frank communication between attorneys and their clients and thereby promote broader public interests in the observance of law and administration of justice."[13]

The current formulation of the *Kovel* doctrine provides that "the inclusion of a third party in attorney-client communications does not destroy the privilege if the purpose of the third party's participation is to improve the comprehension of the communications between attorney and client."[14] Notably, the *Kovel* doctrine is a federal common law doctrine; thus, it applies in federal court, unless such court sits in diversity to decide a state law claim or defense where the state privilege law governs the dispute.[15] According to the more stringent New York formulation of the "agency exception" to the general waiver rule of the attorney-client privilege, the party asserting the privilege must demonstrate the following: "(1) . . . a reasonable expectation of confidentiality under the circumstances, and (2) [that] disclosure to the third party was necessary for the client to obtain informed legal advice."[16] To satisfy the "necessary" prong, the third party's involvement must be "nearly indispensable or serve some specialized purpose in facilitating the attorney-client communications."[17] As a result, it is more difficult to preserve privilege under New York law than under federal common law.[18]

III. The Work Product Doctrine

The work product doctrine is a related privilege that prevents discovery of "1) a document or tangible thing; 2) that was prepared in anticipation of litigation; and 3) was prepared by or for a party or by his representative," unless the party seeking discovery makes a showing of substantial need and a lack of undue hardship.[19] The rationale of the work product doctrine is "to preserve a zone of privacy in which a lawyer can prepare and develop legal theories and strategy 'with an eye toward litigation,' free from unnecessary intrusion by his adversaries."[20] The doctrine protects materials prepared by attorneys and their agents.[21] The party asserting work product protection bears the burden of establishing its applicability.[22]

IV. Extending the Attorney-Client Privilege to Third-Party Consultants

A closer look below at the application of the *Kovel* doctrine and the agency exception to waiver reveals how and where the attorney-client privilege may be extended and what situations would preclude its extension.

A. Accountants

As established in *Kovel*, the attorney-client privilege readily extends to communications with accountants. The Second Circuit continues to rely upon *Kovel*, and it has more recently stated that the attorney-client privilege "is held to cover communications made to certain agents of an attorney, including accountants hired to assist in the rendition of legal services."[23] Still, in *United States v. Adlman*,[24] the court found that communications with an accounting firm were not privileged since there was "virtually no contemporaneous documentation"[25] to support the view that the accountants operated in a legal capacity. *Adlman* illustrates the canon from *Kovel* that "if the advice sought is the accountant's rather than the lawyer's, no privilege exists,"[26] a canon which holds true independent of the type of consultant.

B. Forensic Investigators/Technology Experts

Though lawyers have a professional responsibility to "stay abreast of technological advances,"[27] forensic investigators and technology experts have specialized skills that can help counsel, especially in a crisis situation, provide fully informed legal advice. As a result, courts have extended the attorney-client privilege to communications with such consultants—especially in the context of data breach litigation, a bourgeoning practice area.

In class action litigation arising out of the high-profile data breach of customer payment information at Target, for example, the Minnesota District Court recently held that the attorney-client privilege extended to communications with a "Data Breach Task Force," comprised of outside technology consultants.[28] In this case, Target assembled the Data Breach Task Force after discovering the possibility of a data breach and the consequent exposure to litigation.[29] Target adopted a laudable "two-track investigation" that allowed the court to easily delineate which communications were privileged.[30]

On the (non-privileged) first-track of the overall investigation, Target conducted an "ordinary-course investigation," focused on determining what happened and remediation of the data breach. In addition, a team of consultants hired by credit card companies affected by the breach conducted a similar investigation.[31] These investigations occurred for business purposes, as opposed to a legal purpose, and thus privilege did not attach to the "first-track" of the overall investigation.

On the (privileged) second-track of the overall investigation, Target created the Data Breach Task Force, hiring a separate team of consultants to help its lawyers provide fully informed legal advice: "Target's lawyers needed to be educated about the breach so that they could provide Target with legal advice and protect the company's interests in litigation that commenced almost immediately after the breach became publicly known."[32] The court ultimately applied the agency exception to waiver to the second-track of the overall investigation, holding that email communications between Target, its counsel, and the Data Breach Task Force were privileged.[33]

Similarly, in *Genesco, Inc. v. Visa U.S.A. Inc.*,[34] the court applied the *Kovel* doctrine, holding that privilege extended to communications with a "computer security consultant"[35] retained by outside counsel to assist in an investigation of a cyber attack. Mirroring Target's approach, Genesco similarly used a two-track approach: the company determined that its outside counsel "should conduct an investigation of the [i]ntrusion, separate and apart from the investigation already being conducted [by adverse parties,] . . . for the purpose of providing legal advice . . . and in anticipation of litigation[.] . . . Genesco Counsel identified the need to retain a computer security consultant to assist them in conducting the [p]rivileged [i]nvestigation."[36]

These cases demonstrate that careful planning, such as adopting a two-track approach to the investigation of a data breach, allows for extension of attorney-client privilege to communications with third-party forensic investigators and technology experts.

C. Public Relations ("PR") Consultants

Extension of the attorney-client privilege to communications with public relations consultants who assist in times of crisis is a rare and unlikely exception to the general rule. A well-known 2003 decision concerning the insider trading suit against Martha Stewart[37] marked the broadest application of the *Kovel* doctrine: it extended privilege to the PR firm that Martha Stewart's lawyers hired to help counteract the media blitz that demanded prosecution of Ms. Stewart. The court held "that (1) confidential communications (2) between lawyers and public relations consultants (3) hired by the lawyers to assist them in dealing with the media in cases such as this (4) that are made for the purpose of giving or receiving advice (5) directed at handling the client's legal problems are protected by the attorney-client privilege."[38] Since then, however, later courts have declined to extend privilege to communications with PR consultants: the Martha Stewart case has been deemed an outlier[39] and its holding has been limited to the particular facts of the case.[40]

Courts in the Second Circuit have distanced themselves from the Martha Stewart decision, which applied federal common law, and have emphasized that New York privilege law does not apply the agency exception unless the PR consultant's work is "necessary" to the provision of legal advice. In *Egiazaryan v. Zalmayev*,[41] the court—while sitting in diversity and applying New York State law—held, in a defamation action, that communications with a PR consultant were not privileged because the coordination of a media campaign was not "legal advice."[42] Moreover, the court found no showing that the consultant's involvement was "necessary to facilitate communications" between the client and counsel.[43] The court distinguished the Martha Stewart case and an earlier case that extended privilege to communications with PR consultants because "they were not diversity cases, each applied the principles of federal common law rather than New York State privilege law."[44]

In *Fine v. ESPN, Inc.*,[45] another recent defamation suit, the court similarly held that communications with a PR firm were not privileged.[46] The plaintiff sought discovery of documents related to a university's internal investigation into allegations of sexual abuse by an employee.[47] The university hired a PR firm to write press releases and manage the media during the investigation.[48] The university claimed that communications with the PR firm were privileged; but the court rejected such a premise, holding that, despite incorporating advice of the university's lawyers into press releases and other documents, communications were not disclosed to the PR firm to assist in the provision of legal advice.[49] In the end, the university did not satisfy the strict standard for the agency exception to waiver to apply under New York law.[50]

D. Management Consultants

The extension of privilege to communications with management consultants applies only when the consultant has technical expertise that demonstrably assists counsel in the provision of legal advice. An instructive case is *Scott v. Chipotle Mexican Grill, Inc.*,[51] a class action lawsuit turning on the employment classification of "Apprentices" working at Chipotle restaurants.[52] Chipotle hired a human resources management consultant to conduct a "job function analysis" and argued that the consultant's report was privileged.[53] The court held that *Kovel* did not apply because neither the consultant nor her report provided any "specialized knowledge" that the attorneys could not have gained on their own.[54] Moreover, the court explained that "[i]t strains credulity to imagine that an attorney evaluating wage and hours laws would not be able to speak with employees or interpret those laws on his own."[55] While management consultants can be a valuable addition to a crisis response team, *Scott* reveals that privilege will not be preserved simply because a consultant makes counsel's job easier—the consultant, instead, must provide a unique service or expertise that helps counsel provide fully informed legal advice.

"The extension of privilege to communications with management consultants applies only when the consultant has technical expertise that demonstrably assists counsel in the provision of legal advice."

E. Financial Consultants

Depending upon the nature of a corporate crisis, a financial consultant may be a crucial member of a crisis management team. However, corporate officers and counsel should be mindful of the court's strict approach in determining whether communications with financial consultants, such as valuation experts and investment bankers, fall under the attorney-client privilege umbrella. For example, in *Sieger v. Zak*,[56] the Second Department held that a financial consultant hired by the majority shareholder and CEO of a closely held corporation, in the context of a buyout of the minority shareholders, was not an "agent" of the corporation for the purpose of making communications related to the stock purchase agreement privileged.[57] As a result, the agency exception to the general waiver of privilege rule did not apply—the corporate defendant was required to disclose potentially damaging communications between the CEO, corporate counsel, and the financial consultant, which could reveal that such parties acted in concert to undervalue the corporation at the time of the buyout of the minority shareholders.[58] Similarly, in *United States v. Ackert*,[59] the Second Circuit Court of Appeals held that communications between corporate counsel and an investment banker regarding the tax consequences of a strategic transaction—which the IRS challenged in court—were not privileged because, unlike in *Kovel*, counsel did not rely on the investment banker to help "translate" information or better understand the facts.[60] On the contrary, counsel sought additional information about the transaction from the banker, thus the attorney-client privilege did not apply.[61]

V. Interaction of Privilege and Client Confidentiality

Protecting a client's privileged communications from unauthorized disclosure is inherently tied to a lawyer's fundamental duty to preserve the confidentiality of client communications under Rule 1.6 of the New York Rules of Professional Conduct (the "Rules"). The ethical duty of confidentiality is far broader than the attorney-client privilege: it applies to an attorney in all scenarios and at all times (unless disclosure is permitted or required by law), and applies not only to privileged communications with clients, but also to all information gained during or relating to the client representation, whatever the source of such information.[62]

With the pervasive impact of technology in the practice of law and the increasing use of third-party providers (e.g., cloud services, legal process outsourcing, etc.), the Rules and accompanying Comments have emphasized the need for a lawyer to exercise reasonable care to avoid inadvertent disclosure or unauthorized access to client confidential information. Rule 5.3 similarly imposes a duty on attorneys to adequately supervise and monitor third-party non-lawyer consultants retained to assist the lawyer in rendering legal services to the client.[63] Under Comment 3, attorneys must make reasonable efforts to ensure that the services of a non-lawyer consultant are provided in a manner that is compatible with the professional obligations of the lawyer.[64] This ethical duty to adequately supervise non-lawyer consultants to avoid disclosure of confidential client information is an ongoing obligation of every lawyer, but it is particularly critical in a client crisis scenario. A practical first step for counsel to take to further comply with the duty of confidentiality is to ensure that third-party consultant engagement letters include a carefully drafted confidentiality provision.

VI. Conclusion

Crisis situations underscore the crucial role played by outside counsel to preserve attorney-client privilege and to maintain confidentiality of client information. Where the crisis scenario involves complex litigation facing the client, outside counsel must act quickly and effectively to retain skillful and experienced third-party consultants in highly specialized or technical fields. However, the attorney-client privilege terrain remains to be filled with ambiguous case law. Moreover, the standards for application of the "agency exception" to the general waiver rule for privilege under federal and New York law remain in tension.[65] While it appears that federal law would allow privilege to extend to third-party consultants who assist in providing legal advice or improve the lawyer's understanding of communications between the lawyer and client, New York law is far more restrictive, stretching the privilege doctrine only to where the consultant's involvement is "necessary" (not merely useful or supportive), i.e., nearly indispensable or serving a special or unique purpose in facilitating or aiding the lawyer's rendering of legal advice.[66]

Therefore, when a crisis erupts for a client, it is vitally important for outside counsel to work closely with the client and its in-house attorneys from the outset in any initial communications with third-party consultants. Outside counsel should also carefully structure and document any third-party consulting relationships to ensure client confidential information is protected. Finally, counsel should monitor, control, and analyze the flow of information with consultants to assess whether there is a likelihood that privilege may apply to any consultant relationship and its corresponding communications in order to protect the client in crisis.

Endnotes

1. *See, e.g.*, *In re Cnty. of Erie*, 473 F.3d 413, 419 (2d Cir. 2007) (the attorney-client privilege applies to "(1) a communication between client and counsel that (2) was intended to be and was in fact kept confidential, and (3) was made for the purpose of obtaining or providing legal advice").
2. See, *e.g.*, *In re Horowitz*, 482 F.2d 72, 81 (2d Cir. 1973) ("disclosure to a third party . . . eliminates whatever privilege the communication may have originally possessed, whether because disclosure is viewed as an indication that confidentiality is no longer intended or as a waiver of the privilege").
3. Joseph M. McLaughlin, 3 Weinstein's Federal Evidence § 503.01 (LexisNexis, 2d ed. 2003).
4. *See Egiazaryan v. Zalmayev*, 290 F.R.D. 421, 431 (S.D.N.Y. 2013).
5. 296 F.2d 918, 918 (2d Cir. 1961).
6. *See Kovel*, 296 F.2d 918, 921.
7. *See Fine v. ESPN, Inc.*, No. 5:12-CV-0836 LEK/DEP, 2015 WL 3447690, at *1 (N.D.N.Y. May 28, 2015).
8. *Id.* at *11 (stating that "[i]f public relations is merely helpful but not necessary to the provision of legal advice, the agency exception does not apply").
9. *See Scott v. Chipotle Mexican Grill, Inc.*, 94 F. Supp. 3d 585, 585 (S.D.N.Y. 2015), *motion for relief from judgment denied*, No. 12-CV-08333 ALC/SN, 2015 WL 2182674, at *1 (S.D.N.Y. May 7, 2015).
10. *Id.* at 592.
11. 449 U.S. 383, 383 (1981).
12. *See Upjohn Co.*, 449 U.S. at 394-95.
13. *Id.* at 389.
14. *See Scott*, 94 F. Supp. 3d at 592 (quoting *United States v. Ackert*, 169 F.3d 136, 139 (2d Cir. 1999)).

15. Fed. R. Evid. 501.
16. *See Egiazaryan*, 290 F.R.D. at 431 (quoting *Don v. Singer*, No. 105584-06, 2008 WL 2229743, at *5 (N.Y. Sup. Ct. 2008)).
17. *See Nat'l Educ. Training Grp., Inc. v. Skillsoft Corp.*, No. M8-85 (WHP), 1999 WL 378337, at *4 (S.D.N.Y. June 10, 1999).
18. *See, e.g.*, *McNamee v. Clemens*, No. 09 CV 1647 SJ, 2013 WL 6572899, at *6 (E.D.N.Y. 2013) (declining to extend privilege in a defamation action governed by New York law to communications between Roger Clemens, the baseball player, and his public relations consultants because *in camera* review of the allegedly privileged documents showed that "standard public relations" services provided by the consultants were not "necessary so that [Clemens' counsel] could provide Clemens with legal advice").
19. *Id.* at *7; *see also* Fed. R. Civ. P. 26(b)(3) (stating that Rule 26(b)(3) "provides the general rule that material prepared by or at the request of an attorney in anticipation of litigation is not subject to discovery").
20. *See United States v. Adlman*, 134 F.3d 1194, 1196 (2d Cir. 1998) (quoting *Hickman v. Taylor,* 329 U.S. 495, 510–11 (1947)).
21. *See Costabile v. Westchester, N.Y.,* 254 F.R.D. 160, 164 (S.D.N.Y. 2008).
22. *See In re Grand Jury Subpoenas Dated Mar. 19, 2002 & Aug. 2, 2002,* 318 F.3d 379, 384 (2d Cir. 2003).
23. *See United States v. Schwimmer*, 892 F.2d 237, 243 (2d Cir. 1989).
24. 68 F.3d 1495, 1495 (2d Cir. 1995).
25. *See Adlman*, 68 F.3d at 1500.
26. *See Kovel*, 296 F.2d at 922.
27. Opinion 842, N.Y. St. B., Ass'n Comm. On Prof'l. Ethics (Sept. 10, 2010), http://www.nysba.org/CustomTemplates/Content.aspx?id=1499 (quoting Opinion 782, N.Y. St. B. Ass'n Comm. On Prof'l. Ethics (Dec. 8, 2004), http://www.nysba.org/CustomTemplates/Content.aspx?id=5385); *see also* N.Y. Rules of Prof'l. Conduct R. 1.1 cmt. 8 (McKinney 2015) (as part of a lawyer's duty to provide competent representation "a lawyer should . . . keep abreast of the benefits and risks associated with technology the lawyer uses to provide services to clients or to store or transmit confidential information").
28. *See In re Target Corp. Customer Data Sec. Breach Litig.*, MDL No. 14-2522 (PAM/JJK), 2015 WL 6777384, at *3 (D. Minn. Oct. 23, 2015) [hereinafter *Target*].
29. *See Target*, MDL No. 14-2522 (PAM/JJK), 2015 WL 6777384, at *3.
30. *Id.*, at *2.
31. *See Target*, MDL No. 14-2522 (PAM/JJK), 2015 WL 6777384, at *2.
32. *Id.*
33. *Id.* at *3-4.
34. 302 F.R.D. 168, 168 (M.D. Tenn. 2014).
35. *Id.*at 180.
36. *Id.*
37. *See In re Grand Jury Subpoenas Dated Mar. 24, 2003 Directed to (A) Grand Jury Witness Firm & (B) Grand Jury Witness*, 265 F. Supp. 2d 321, 322 (S.D.N.Y. 2003) [hereinafter *Martha Stewart Litigation*].
38. *See Martha Stewart Litigation*, 265 F. Supp. 2d at 331.
39. *See Comm'r of Revenue v. Comcast Corp.*, 901 N.E.2d 1185, 1198 n. 20 (Mass. 2009), *holding modified in other part by McCarthy v. Slade Associates, Inc.*, 972 N.E.2d 1037, 1037 (Mass. 2012) (the *Martha Stewart Litigation* is "in the minority").
40. *See Ravenell v. Avis Budget Grp., Inc.,* No. 08-CV-2113 (SLT), 2012 WL 1150450, at *3 (E.D.N.Y. Apr. 5, 2012) (the *Martha Stewart Litigation* which "arguably extended the [Kovel doctrine] the furthest" is limited by its specific holding and context).
41. 290 F.R.D. 421, 421 (S.D.N.Y. 2013).
42. *Id.* at 431.
43. *Id.*
44. *Id.*
45. *See Fine v. ESPN, Inc.,* No. 5:12-CV-0836 LEK/DEP, 2015 WL 3447690 at *1 (N.D.N.Y. May 28, 2015).
46. *Id.* at *11.
47. *Id.* at *1.
48. *Id.* at *10.
49. *Id.* at *11.
50. *See Fine*, 2015 WL 3447690 at *11.
51. *See Scott v. Chipotle Mexican Grill, Inc.*, 103 F. Supp. 3d 585, 585 (S.D.N.Y. 2015), *motion for relief from judgment denied*, No. 12-CV-08333 ALC/SN, 2015 WL 2182674, at *1 (S.D.N.Y. May 7, 2015).
52. *See Scott*, 94 F. Supp. 3d at 590.
53. *Id.* at 593.
54. *Id.* at 594-95.
55. *Id.* at 595.
56. *See Sieger v. Zak*, 874 N.Y.S.2d 535, 535 (N.Y. App. Div. 2009).
57. *Id.* at 538.
58. *Id.*
59. *See United States v. Ackert*, 169 F.3d 136, 136 (2d Cir. 1999).
60. *Id.* at 139.
61. *Id.* at 139–40.
62. N.Y. Rules of Prof'l. Conduct R. 1.6 cmt. 3 (McKinney 2015).
63. N.Y. Rules of Prof'l. Conduct R. 5.3 (McKinney 2015).
64. N.Y. Rules of Prof'l. Conduct R. 5.3 cmt. 3 (McKinney 2015).
65. *See supra* note 44.
66. *See supra* note 17.

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Antitrust Plays Whack-a-Mole as Exclusion of Competition by Drug Monopolists Pops Up Again: Gaming the "REMS"

Antitrust Committee

I. Introduction

The pharmaceutical industry is a big business. Top selling drugs, many protected by patents, often sell at prices reflecting the monopoly power that brand-name drug manufacturers may enjoy. Enter the fray, generic competition, offering patients therapeutic equivalents to brand-name drugs at a fraction of the cost—saving consumers hundreds of ***billions*** of dollars each year.[1] The first generic drug to come to market is typically offered at a price discount of 20% to 30% off the brand-name, with entry by additional generic competitors driving the discount to as much as 90%.[2]

Often, brand-name drug manufacturers have hundreds of millions of dollars in yearly sales at risk from generic drug competition. Given the stakes, some brand-name drug manufacturers have used various tactics—some lawful and some arguably unlawful—in an effort to delay generic competition and maintain monopoly profits. As a result, brand-name manufacturers have come under heavy scrutiny from private plaintiffs, the Federal Trade Commission (FTC), and the New York Attorney General's Office for using so-called "reverse payments"[3] and "product hopping"[4] to delay generic entry.

Most recently, several brand-name drug manufacturers have also sought to forestall generic competition by using federally mandated distribution restrictions—known as Risk Evaluation Mitigation Strategies, or REMS—which apply to particular drugs with potentially dangerous side effects. Specifically, some brand-name drug manufacturers selling REMS-restricted drugs have declined to provide to potential generic competitors the brand product samples that the generics need for Food and Drug Administration (FDA) approval in order to bring the generic version to market. Generic companies, supported by the FTC, have challenged this conduct, arguing that where the generic company cannot otherwise obtain samples for bioequivalence testing, the brand-name drug manufacturer has a duty to deal under the antitrust laws. Brand-name manufacturers have defended their approach on the grounds that REMS prevent them from providing samples to generic manufacturers, that selling samples outside of the REMS process would raise safety concerns, that brands would face an enhanced risk of products liability if they were to sell these potentially dangerous drugs to generic manufacturers, and finally, that brands—as patentees—have no duty to deal.

Litigation over REMS-restricted drugs is now emerging, and is unlikely to go away. According to one commentator, nearly 40 percent of new FDA approvals are subject to REMS.[5] Thus far, courts have largely upheld antitrust claims asserting that a brand-name drug manufacturer has a duty to deal with its generic competitor. However, the rulings have come on motions to dismiss, thus leaving the challenging "details" for another day. These include (1) what business or procompetitive justifications (*e.g.*, safety concerns) can justify a branded-drug manufacturer's refusal to deal, (2) what showing of "pretext" must be made to support a monopoly maintenance claim, and (3) can would-be generic competitors demonstrate "antitrust injury," bearing in mind product development, testing and regulatory steps that are prerequisites for market entry?

In this article, we discuss this emerging area of contention between brand-name drug manufacturers and generic competitors. We first consider the framework of brand-generic competition under the Hatch-Waxman Act and REMS legislation. We then discuss and consider the leading Supreme Court refusal-to-deal precedent and review recent REMS antitrust litigation against this doctrinal backdrop. Finally, we consider the potential procompetitive justifications for, and the potential anticompetitive effects of, brand-name manufacturers refusing to provide REMS-restricted samples to generic manufacturers.

II. The Hatch-Waxman Framework

In 1984, Congress passed the Drug Price Competition and Patent Term Restoration Act, commonly referred to as the Hatch-Waxman Act (the "Act"). A primary purpose of the Act is to encourage the development of generic drugs by offering an abbreviated pathway for approval by the FDA, as an alternative to proving that a generic drug is safe and effective through clinical trials. Under the Act, a generic drug company can file an Abbreviated New Drug Application (ANDA) that relies on the safety and efficacy research performed by the brand-name drug manufacturer in connection with the branded product's approval.[6] As a result, generic drugs can receive expedited FDA review and approval so long as the FDA is satisfied that the generic product is bioequivalent to the brand product.[7] A generic drug is considered bioequivalent or "AB-rated" if it contains the same active ingredient, is the same dosage and form (*e.g.*, tablet, capsule, etc.), and is absorbed into the bloodstream at the same rate and to the same extent as the brand-name drug.[8]

III. REMS and the Food and Drug Administration Amendments Act of 2007

The Food and Drug Administration Amendments Act of 2007 (FDAAA) authorizes the FDA to require brand-name drug manufacturers to implement safety measures beyond routine professional labeling where the agency "determines that [such measures are] necessary to ensure that the benefits of the drug outweigh the risks of the drug."[9] These REMS include requiring a medication guide, including a patient packet insert to inform patients of potential risks and side effects,[10] or implementing communication plans to healthcare providers concerning the drug's risks.[11] If a drug's potential risks or side effects are particularly dangerous, the REMS also may include distribution restrictions, known as Elements to Assure Safe Use (ETASU), which restrict the ability of doctors to prescribe the drug, and of wholesalers and pharmacies to distribute it. In addition, an ETASU may require (1) that the drug only be dispensed in certain healthcare settings such as hospitals or infusion centers, and (2) that patients using the drug be monitored or enrolled in a registry.[12]

"The FDAAA explicitly prohibits a brand-name drug manufacturer from using REMS to 'block or delay approval' of a would-be generic competitor's ANDA."

IV. The Hatch-Waxman/REMS Intersection

To file an ANDA under the Hatch-Waxman Act, a generic manufacturer needs to demonstrate the bioequivalency of its product, and that requires the generic to secure a limited amount of the branded product for testing. Thus, branded product samples for testing are essential to the generic manufacturer obtaining FDA approval of its ANDA, a prerequisite to marketing the generic drug. Ordinarily, a would-be generic competitor can purchase necessary quantities of the brand drug from wholesale distributors or specialty pharmacies. But where a drug is subject to REMS, distribution restrictions may make the brand-name drug manufacturer the only available source for product samples. Hence, the opportunity for brand-name drug manufacturers to delay entry of the generic.

The FDAAA explicitly prohibits a brand-name drug manufacturer from using REMS to "block or delay approval" of a would-be generic competitor's ANDA.[13] Moreover, the FDA has assured generic manufacturers that REMS cannot be used as a shield against generic competition.[14] Indeed, the FDA has issued draft guidance procedures by which a generic drug company can obtain an FDA letter stating that (1) the generic's bioequivalence protocol complies with the applicable REMS and (2) the FDA will not consider it a violation of the REMS for the brand-name drug manufacturer to provide the requisite branded samples needed to perform bioequivalence testing in support of the generic's ANDA.[15] Once the generic receives such a letter, it can request the FDA to advise the brand-name drug manufacturer of the agency's conclusions.[16] Despite its tough talk and draft guidance, however, the FDA has disclaimed any ability to enforce REMS abuse, publicly stating that "issues related to ensuring that marketplace actions are fair and do not block competition would be best addressed by the FTC."[17]

Indeed, the FTC and other antitrust enforcers have expressed concerns that brand-name drug manufacturers may use REMS as a pretext to exclude generic competition.[18] Recently, FTC Chair Edith Ramirez testified before Congress that "we continue to be very concerned about potential abuses by branded pharmaceutical companies of safety protocols known as REMS...to impede generic competition" by using "REMS-mandated distribution restrictions to inappropriately limit access to product samples."[19] Similarly, Connecticut's Attorney General described "a disturbing, broader trend by certain branded drug manufacturers" to use the REMS program "as a weapon to blunt the development of generic drugs."[20]

The FTC has twice filed amicus briefs supporting generic manufacturer suits, discussed below, which alleged that brand-name drug manufacturers took advantage of REMS requirements to block generic competition.[21] The agency also has issued at least one civil investigative demand to a brand-name drug manufacturer. [22] However, to date, no government enforcer has initiated litigation against a brand-name drug manufacturer alleging antitrust or any other claim stemming from branded companies' distribution restrictions.

A 2014 analysis concluded that brand-name drug manufacturer abuse of restricted access programs to prevent generic competition costs the health care system $5.4 billion annually, including $1.8 billion to the federal government.[23] To date, legislation to remedy this abuse has stalled in Congress.[24] Therefore, as things now stand, we can expect litigation to increase—and to become increasingly important in addressing claims of REMS abuse.[25]

V. Private Antitrust Litigation: The REMS Overview

Although government enforcers have not sued brand-name drug manufacturers alleging REMS abuse, generic manufacturers and other private plaintiffs have. The common thread of these cases is that the brand-name drug manufacturer violated the antitrust laws by refusing to sell its generic competitor the REMS-restricted drug samples necessary for bioequivalence testing. And while none of the cases has produced a merits ruling based on a factual record, courts have come out both ways on pretrial motions.

Plaintiffs have made several arguments why such conduct is anticompetitive. The most successful one thus far is that REMS restrictions prevent generic companies from purchasing branded product in normal distribution channels of distribution—specifically, wholesale distributors or specialty pharmacies. Therefore, a generic firm's only option is to buy product directly from the brand-name drug manufacturer, which can shut out the generic by simply refusing to sell the required samples. Plaintiffs have thus argued that the brand-name drug manufacturer, as a monopolist, has a duty to sell branded product samples to its generic competitor on commercially reasonable terms.[26]

This approach bumps up against the principle that a business should generally be free to choose to deal with whomever it pleases.[27] As the Supreme Court wrote in its seminal ruling on the point, "[i]n the absence of any purpose to create or maintain a monopoly, the [Sherman] [A]ct does not restrict the long recognized right of trader or manufacturer engaged in an entirely private business, freely to exercise his own independent discretion as to parties with whom he will deal."[28] Nevertheless, that right is not absolute: "[u]nder certain circumstances a refusal to cooperate with rivals can constitute anticompetitive conduct and violate § 2 [of the Sherman Act]."[29] Determining when and under what circumstances a monopolist has a duty to deal with its rivals is "one of the most unsettled and vexatious [questions] in the antitrust field."[30] Thus, this is a primary battleground in REMS cases: in what circumstances must a brand-name drug manufacturer sell to its would-be generic rival to enable the rival to seek FDA approval of the rival's ANDA?

VI. The Antitrust Duty to Deal Framework

As a general matter, an antitrust plaintiff asserting a Sherman Act § 2 refusal-to-deal claim must demonstrate that the defendant (1) has monopoly power in the relevant market and (2) acquired or maintained that monopoly power through exclusionary or predatory conduct—conduct that, broadly speaking, tends to impair the opportunities of rivals or customers, and does so either on a basis other than product price or merit, or in an unnecessarily restrictive way.[31] In addition, in the REMS cases discussed below, the brand-name drug manufacturer defendants have argued that an additional element is essential to state a refusal-to-deal claim under Section 2: the defendant's termination of a prior course of dealing with its rival.

Here, we focus on the second element—whether a brand-name drug manufacturer's company's refusal to provide samples to its generic competitor in the REMS context constitutes exclusionary conduct—and whether the termination of a prior course of dealing is also a necessary feature of such a claim.[32]

Four Supreme Court decisions provide the framework for analyzing refusal-to-deal claims:

Otter Tail: An electric power company, Otter Tail, denied access to its power transmission lines to several towns that sought to offer their own electrical power to consumers in competition with Otter Tail.[33] Without access to Otter Tails lines, the towns could not compete with Otter Tail in the retail power market. Otter Tail did, however, provide its power transmission lines to non-competing customers, and no capacity or technical restrictions prohibited it from selling the same services to the towns.[34] The Supreme Court found that Otter Tail's refusal to deal was motivated "***solely*** to prevent municipal power systems from eroding its monopolistic position," and Otter Tail thus violated Section 2.[35]

Aspen Skiing: In *Aspen Skiing*, defendant Ski Co. owned three of the four ski resorts in Aspen, Colorado, and also sold ski passes to Highlands, which owned the fourth ski resort, so that both resorts could offer a multi-day pass covering all four mountains.[36] Ski Co. stopped doing business with Highland, which responded by trying to offer a four-mountain pass by itself. Ski Co., however, refused to sell Highland's passes to its three mountains, even at retail prices; nor would it honor vouchers from Highland's customers.[37] By eliminating the four-mountain pass, Ski Co. adversely affected consumer choice and had a negative impact on Highland's ability to compete.[38]

The Supreme Court held that Ski Co. violated the Sherman Act because its refusal to deal was motivated by anticompetitive goals. As the Court wrote, "[i]f a firm has been 'attempting to exclude rivals on some basis other than efficiency,' it is fair to characterize its behavior as predatory."[39] Moreover, Ski Co.'s refusal to sell ski tickets to Highland at full retail price "supporte[d] an inference that Ski Co. was not motivated by efficiency concerns and that it was willing to sacrifice short-run benefits...in exchange for a perceived long-run impact on its smaller rival."[40] Although Ski Co. offered business justifications for its conduct, the Supreme Court found them pretextual.[41] It should be noted also that Highland's claim arose after Ski Co. had ended the two companies' prior business relationship—a circumstance that, as we will see, factors into the Supreme Court's subsequent *Trinko* ruling, as well as the more recent REMS-based cases.

Trinko: This more recent case arose from Verizon's failure to share its telephone network with its rivals as required by the Telecommunications Act. [42] Distinguishing *Aspen Skiing*, the Supreme Court held that Verizon's refusal to deal did not constitute monopolization under § 2 of the Sherman Act for several reasons.

First, both the Federal Communications Commission ("FCC") and state public utilities had extensive statutory enforcement authority to ensure that Verizon made its network available to potential competitors.[43] Thus, unlike Ski Co., Verizon's duty to deal was mandated and enforced by legislation separate from the Sherman Act. Indeed, the FCC fined Verizon $3 million for failing to share its network with potential competitors.[44]

Second, Ski Co. unilaterally terminated "a voluntary (*and thus presumably profitable*) course of dealing" with Highland, and refused "to renew the [ski] ticket *even if compensated at retail price*."[45] Ski Co.'s conduct "suggested a willingness to forsake short-term profits to achieve an anticompetitive end," as well as "a distinctly anticompetitive bent."[46] On the other hand, there was no reason to presume that Verizon's dealings with its rivals would have been profitable, because its duty to deal was compelled by statute, not voluntary.

Third, Ski Co., refused to sell to Highland a product (its three-mountain pass) that it sold to others at retail. By contrast, rivals sought services that Verizon had not previously offered to the public.[47]

Linkline: *Trinko* involved a claim that Verizon had refused to make its network available to the plaintiff, a competing telephone company. In a more recent decision, the Supreme Court applied *Trinko*'s duty-to-deal analysis where the competitor challenged the supplier's price terms to do business.[48] In *Linkline*, a competing phone company alleged that the wholesale price terms on which the defendant, AT&T, was prepared to deal were so onerous that they "squeezed" the plaintiff out of the retail market. The Supreme Court rejected the claim:

> *Trinko* . . . makes clear that if a firm has no antitrust duty to deal with its competitors at wholesale, it certainly has no duty to deal under terms and conditions that the rivals find commercially advantageous. . . . If AT&T had simply stopped providing DSL transport service to the plaintiffs, it would not have run afoul of the Sherman Act. Under these circumstances, AT&T was not required to offer this service at the wholesale prices the plaintiffs would have preferred.[49]

VII. The REMS Refusal-to-Deal Cases

As previewed above, brand-name drug manufacturers in REMS cases have cited *Trinko* for the proposition that to plead a Section 2 refusal to deal claim, the plaintiff must plausibly allege that the brand terminated a prior course of dealing without a legitimate business reason for doing so. This argument, if credited, would create a significant hurdle for plaintiffs, however, because in many instances, the brand-name drug manufacturer does not have a pre-existing business relationship with its generic competitor for any drug, let alone for the REMS-restricted drug for which samples are needed to do bioequivalent testing.[50]

In response, plaintiffs have maintained they need allege only that the brand-name drug manufacturer's conduct was economically irrational absent an exclusionary motive. In other words, the brand-name drug manufacturer's refusal to provide samples was predicated on its "willingness to forsake short-term profits to achieve an anticompetitive end."[51] To support this allegation, plaintiffs have pleaded that (1) the brand-name drug manufacturer sold the REMS-restricted drug to wholesaler distributors, specialty pharmacies and independent testing organizations on commercially reasonable terms and (2) the FDA has advised brand-name drug manufacturers in writing that the FDA has approved the generic company's safety protocols and that the sale of the samples to the generic would not violate the applicable REMS.

District courts have directly addressed this question in five cases. In three of those cases, district courts in the Third Circuit held that a prior course of dealing between brand and generic was not required.

The Thalomid & Revlimid Cases. There have been two decisions in the District of New Jersey to address the refusal by a brand-name drug manufacturer (Celgene) to sell REMS-restricted samples to a generic rival. Both decisions—one in a case brought by Mylan, a generic drug company, and the other in a case by a putative class of third-party payors and end-users—involve Thalomid and Revlimid, two drugs that can be used to treat certain forms of blood cancer, among other conditions.[52] The plaintiffs in both cases alleged that Celgene engaged in anticompetitive conduct to perpetuate its Thalomid and Revlimid monopolies, including refusing to sell potential generic competitors samples of the drugs under the pretext of its REMS program.

In the *Mylan* case, the court issued a thorough oral opinion, replete with citation to applicable case law, after full briefing and oral argument of Celgene's motion to dismiss.[53] The court concluded that Mylan was not required to plead a prior course of conduct to state a duty to deal claim. Discussing both *Aspen Skiing*—where there was a prior course of dealing—and *Trinko*—where there was not—the court said: "the *Trinko* Court considered [that] fact[] not for [its] independent significance, but rather for what [it] *suggest[s]*: A willingness to engage in irrational, anticompetitive conduct."[54]

The *Mylan* court also interpreted several prior Third Circuit decisions to "suggest that a 'prior course of dealing' is relevant—but not dispositive—in determining whether such a duty applies."[55] It further observed that "the Supreme Court has 'never held that termination of a preexisting course of dealing is a necessary element of an antitrust claim,' and there remains valid Supreme Court law imposing an affirmative duty to deal when no prior course of dealing was alleged."[56] The court found particular support for its conclusion in *Otter Tail*, noting that the *Trinko* court discussed *Otter Tail* without overruling it. Indeed, although Celgene had not previously dealt with Mylan, Celgene—like Otter Tail—had sold product at retail to non-competitors (here, research organizations).[57]

The court also denied the motion to dismiss the class action brought by customers in *In re Thalomid and Revlimid Litigation*.[58] According to the court, both *Aspen Skiing* and *Trinko* demonstrate that, in a Section 2 refusal-to-deal case, the defendant's "motivation is central."[59] A prior course of dealing, the court noted, was only one means of "circumstantial evidence" demonstrating "anti-competitive motivation, along with [a] lack of legitimate business justifications" for refusing to deal.[60] The court further concluded that the plaintiffs' complaint "raise[d] a plausible inference that Celgene's reliance on its distribution programs [was] pretextual"[61] because (1) Celgene sold drug samples to researchers who were not seeking to enter the market, while denying samples to would-be competitors and (2) potential generic competitors seeking to buy product had provided Celgene with FDA letters stating that Celgene could supply samples without violating REMS.

Tracleer. Unlike the *Thalomid* and *Revlimid* cases, the litigation involving Tracleer's REMS program was initiated by the brand-name drug manufacturer, Actelion Pharmaceuticals. Actelion sought a declaratory judgment in the District of New Jersey that, under its REMS distribution program, it had no duty to sell to its rivals samples of Tracleer, a treatment for pulmonary (lung) artery hypertension that is also linked to severe liver problems.[62] After oral argument on Actelion's motion for judgment on the pleadings and to dismiss antitrust counterclaims by Actelion's generic competitors, the court denied relief in an oral opinion.[63]

The *Actelion* court held that *Trinko* did not require plaintiffs to plead a prior course of dealing to state a refusal-to-deal claim in all circumstances. Like the *Revlimid/Thalomid* opinions, the *Actelion* court considered Actelion's motivation in refusing to sell samples to the generics central to whether the rivals had stated an actionable antitrust claim. Because the generics had pleaded facts demonstrating that the brand-name drug manufacturer was "motivated by the desire to use the REMS . . . to maintain and extend a monopoly,"[64] the court denied Actelion's motion to dismiss the plaintiffs' counterclaims. Issuing the ruling, the court stated that a written opinion would follow, but the case settled first.[65]

Suboxone. The only decision from a court in the Third Circuit dismissing a REMS-based refusal-to-deal claim comes from the Eastern District of Pennsylvania in *In re Suboxone (Buprenorphine Hydrochloride and Naloxone) Antitrust Litigation*.[66] Unlike all other cases to date, the plaintiffs in *Suboxone*—direct and indirect purchasers of the drug—did not allege that the brand-name drug manufacturer failed to sell its generic competitors samples necessary for bioequivalence testing. Instead, they alleged a refusal to deal arising from the defendant's failure to cooperate with its generic competitors to develop and implement a ***shared*** REMS program, as instructed by the FDA.[67] The *Suboxone* court appeared to interpret *Trinko* as requiring a prior course of dealing,[68] although the court recognized that other district courts in the Third Circuit had previously upheld antitrust claims alleging abuse of REMS distribution restrictions even without a prior course of dealing.[69] The *Suboxone* court concluded that these prior decisions were distinguishable, however, because, unlike the generics in those cases, the plaintiffs in *Suboxone* were able to create a REMS program without Reckitt's cooperation—and ultimately did just that.[70]

> *"In the REMS cases to date, brand-name drug manufacturers have offered several justifications for refusing to sell drug samples to their generic competitors, such as safety concerns, enhanced risk of product liability exposure, and patent exclusivity."*

Letairis. In addition to the decisions from district courts in the Third Circuit, one other district court decision, *Natco Pharma Ltd. v. Gilead Sciences, Inc.*,[71] is worthy of mention. Granting the defendants' motion to dismiss, the court held that Natco, the generic company, failed to state a refusal-to-deal claim because Natco could obtain samples of the drug by following the distribution procedures set forth in the brand-name drug manufacturer's FDA-approved REMS program, which included obtaining a prescription from a REMS-certified doctor.[72] The court also held that "complying with FDA requirements . . . constitutes a valid business reason to refuse to dispense Letairis."[73] Although not explicitly referred to in the district court's opinion, Natco, unlike the generics in the other refusal to deal cases, never obtained an FDA letter approving its bioequivalence safety protocol.[74]

VIII. Refusal to Deal: Business Justification or Pretext?

Although some of the plaintiffs in the REMS-related cases have survived motions to dismiss, they have only scratched the litigation surface. A defendant can rebut a refusal to deal case or, indeed, any case alleging facially anticompetitive unilateral conduct, by demonstrating a legitimate procompetitive justification for the restraint.[75] In the REMS cases to date, brand-name drug manufacturers have offered several justifications for refusing to sell drug samples to their generic competitors, such as safety concerns, enhanced risk of product liability exposure, and patent exclusivity. Plaintiffs, in turn, have countered that the justifications are pretextual.[76] We examine these justifications, which—once a motion to dismiss is denied—can be resolved only after discovery on summary judgment or at trial.

A. Safety Concerns

Brand-name drug manufacturers have argued that selling samples to their generic competitors would violate the terms of the REMS program, which, in the interest of safety, can limit drug distribution to REMS-certified pharmacies or distributors. This argument may ultimately gain little traction, however, because FDAAA statutory provisions explicitly provide that no brand-name drug manufacturer of a REMS-restricted drug shall use the program to "block or delay approval" of a generic drug manufacturer's ANDA.[77] Moreover, as discussed above, the FDA has approved generic company safety protocols and so informed brand-name drug manufacturers in writing that their sale of samples would not violate the applicable REMS.[78] While at least one court has recognized that safety concerns may constitute a legitimate reason for a brand-name drug manufacturer to refuse to provide samples to its generic competitors,[79] demonstrating that the justification is not pretextual may prove difficult where (1) there is appropriate FDA approval and (2) the brand-name drug manufacturer has previously sold the drug to third parties, such as research organizations operating under safety protocols comparable to those offered by the generic.

B. Enhanced Risk of Products Liability Exposure

Brand-name drug manufacturers also have argued that it would enhance their exposure to product liability lawsuits to sell potentially dangerous drugs to generic competitors. This is so, they maintain, because some courts have held brand-name drug manufacturers liable for the injuries caused by generic versions of their drugs. At least one court has rejected this justification as a matter of law, however:

> Those states holding brand name manufacturers liable do so on a failure-to-warn theory. These decisions rely on the laws regulating a generic drug's labeling, which require it to use the identical labeling that was approved for the brand name drug. These courts held that a brand name manufacturer owes a duty to a consumer injured by a generic manufacturer's drug when a risk of that drug is not adequately disclosed on its labeling because the generic drug must use the same labeling as the brand name drug. A brand name manufacturer would not be liable for defects in the generic's formulation or manufacture. In fact, a failure-to-warn claim relies on the fact that the brand name and generic drugs are bioequivalents, having the same formulation. The possibility that Celgene could be liable for a generic drug's harm is ***therefore not a legitimate justification*** that would support its refusal to supply generic manufacturers with samples of Thalomid and Revlimid.[80]

Defendants might argue that the cost-benefit analysis of providing product samples to generic manufacturers favors withholding the sample. While the brand-name manufacturer would not profit from generic sales, it could be exposed to damages to patients injured from use of the generic product were they to prevail on a failure-to-warn theory. However, potential generic competitors could eliminate this risk by offering to provide indemnity to the brand-name drug manufacturer for damages arising from any potential liability associated with the generic manufacturer's eventual drug distribution.[81]

c. The Brand Manufacturer's Patent Exclusivity

Finally, brand-name drug manufacturers also have asserted that drug patents justify their refusal to sell product samples. The exclusivity conferred by the patent is said to legitimize refusing to help the would-be generic competitor to gain ANDA approval for the drug, a step that itself often leads to protracted patent validity litigation. Indeed, the brand-name manufacturers assert a central principle of the patent and antitrust laws: that, "[i]n the absence of any indication of illegal tying, fraud on the Patent and Trademark Office, or sham litigation, the patent holder may enforce the statutory right to exclude others from making, using, or selling the claimed invention free from liability under the antitrust laws.'"[82]

But this argument seems contrary to the clear policy underlying the Hatch-Waxman Act, which was adopted to encourage development of generic versions of brand-name drugs and their submission to the FDA for approval, even during the period of patent protection and exclusivity. The ANDA process itself requires the generic manufacturer to perform the bioequivalency tests that will allow the FDA to approve market entry by the generic.[83]

Moreover, the "Bolar Amendment" to the Hatch-Waxman Act provides that it "shall not be an act of infringement to make, use, offer to sell, or sell . . . a patented invention . . . solely for uses reasonably related to the development and submission of information" for FDA approval.[84] The Amendment addresses Congress's concern that if generic companies could not begin the testing necessary to submit an ANDA until after the brand-name drug manufacturer's patents had expired, "the patentee's *de facto* monopoly would continue for an often substantial period until regulatory approval was obtained," amounting to an "effective extension of the patent term."[85]

Accordingly, the brand-name drug manufacturer's interest in avoiding challenges to its drug patents seems unlikely to be a legally cognizable justification for refusing to sell samples of REMS-restricted drugs to potential generic competitors.

IX. Causation and Antitrust Injury

Business justification issues aside, brand-name drug manufacturers also have argued on motions to dismiss that would-be generic competitors and direct and indirect customers cannot satisfy the threshold showing of "but for" causation—that, but for the brand-name drug manufacturer's refusal to sell, the generic company would have brought the generic drug to market by a date certain. This argument posits that, besides obtaining samples necessary for bioequivalence testing, the generic must overcome other hurdles before it can begin marketplace sales. For example, the generic must (1) develop its own version of the drug, (2) perform and successfully complete studies demonstrating that its drug is bioequivalent to the brand-name manufacturer's drug, (3) file an ANDA and obtain FDA approval to market and sell the drug, and (4) establish that the generic drug does not infringe the brand-name drug manufacturer's patent, or that the patent is invalid—often the greatest challenge the generic faces.[86]

The D.C. Circuit addressed a similar argument in upholding Microsoft's Section 2 liability for preventing Netscape from competing against Microsoft's Internet Explorer browser:

> We may infer causation when exclusionary conduct is aimed at producers of nascent competitive technologies as well as when it is aimed at producers of established substitutes. Admittedly, in the former case there is added uncertainty, inasmuch as nascent threats are merely *potential* substitutes. But the underlying proof problem is the same—neither plaintiffs nor the court can confidently reconstruct a product's hypothetical technological development in a world absent the defendant's exclusionary conduct. To some degree, "the defendant is made to suffer the uncertain consequences of its own undesirable conduct."[87]

Here too, a brand-name drug manufacturer might not be heard to complain about causation when its own refusal to sell samples denies nascent competition the opportunity even to germinate. Both the Hatch-Waxman Act—designed to promote generic competition—and the REMS provision—prohibiting REMS abuse—favor the *Microsoft* court's approach.[88]

In a related vein, brand-name drug manufacturers also have argued that "antitrust injury" cannot be alleged in a REMS case. Antirust injury—that is, "injury of the type the antitrust laws were intended to prevent and that flows from that which makes defendants' acts unlawful"[89]—is, of course, a prerequisite in a private antitrust claim. Thus, Celgene—the brand manufacturer—argued that because Mylan failed to plead that its intended generic drug would not infringe Celgene patents—and thus would be a bona fide competitor of Celgene—the absence of a cognizable antitrust injury doomed the complaint. The district court rejected Celgene's argument, reasoning that, with discovery, Mylan could develop facts to demonstrate that Celgene's patents were invalid, or that Mylan could enter the market with a competing, non-infringing product.[90] Moreover, even if Mylan were unsuccessful in proving patent invalidity or non-infringement, it still could satisfy antitrust injury by showing that Celgene's refusal to deal "prevent[ed] it from entering the market immediately upon the expiration of [Celgene's] patents."[91]

In sum, courts that have addressed this issue thus far have held that antitrust injury is not susceptible of resolution on a motion to dismiss, but must, instead, await discovery permitting a factual record to be developed. As more REMS-related cases are litigated, there may be opportunities to explore possible "workable surrogate[s],"[92] such as presumptions and burden shifting, to facilitate resolving patent validity and infringement issues underpinning arguments regarding a potential absence of a cognizable antitrust injury.

X. Conclusion

If brand-name drug manufacturers increasingly attempt to use REMS restrictions to block or delay generic competition, challenges to their conduct are likely to play out in the courtroom. As with the health care industry in general, there are big bucks—and important questions of antitrust doctrine—at stake.

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Endnotes

1. Generic Pharmaceutical Ass'n, Generic Drug Savings in the U.S.1 (6th ed. 2014), <http://www.gphaonline.org/media/cms/GPhA_Savings_Report.9.10.14_FINAL.pdf>.

2. *See generally* FTC, Authorized Generic Drugs Short Term Effects and Long Term Impact (2011); FTC, Pay-For-Delay: How Drug Company Pay-offs Cost Consumers Billions: A Federal Trade Commission Staff Study (2010), <https://www.ftc.gov/reports/pay-delay-how-drug-company-pay-offs-cost-consumers-billions-federal-trade-commission-staff>.

3. A "reverse payment" refers to a brand-name drug manufacturer with a patent paying a potential generic competitor to abandon the generic's patent challenge and to refrain from selling its generic drug for a number of years. *See, e.g., F.T.C. v. Actavis, Inc.*, 133 S. Ct. 2223, 2227 (2013).

4. Product hopping describes a branded drug manufacturer's making minor changes to its drug (e.g., from a tablet to a capsule), while also taking affirmative steps to shift users of the original drug formulation to the newer version, in order to prevent generic substitution at pharmacies, thereby preserving the brand monopoly. *See New York ex rel. Schneiderman v. Actavis PLC*, 787 F.3d 638, 643, 652-59 (2d Cir.), *cert denied*, 136 S. Ct. 581 (2015).

5. Alex Brill, Lost Prescription Drug Savings from Use of REMS Programs to Delay Generic Market Entry 1 (2014).

6. 21 U.S.C. § 355(j).

7. *Id.* at § 355(j)(2)(A)(iv).

8. *Id.* at §§ 355(j)(2)(A)(ii), (iii), (iv).

9. 21 U.S.C. § 355-1(a)(1).

10. *Id.* at § 355-1(e)(2).

11. *Id.* at § 355-1(e)(3).

12. FDA, Standardizing and Evaluating Risk Evaluation and Mitigation Strategies (REMS) 9-10 (2014).

13. 21 U.S.C. § 355-1(f)(8).

14. Jane Axelrad, Associate Director of Policy at the FDA Center for Drug Evaluation and Research (CDER), stated that the FDA "take[s] [the prospective effects on generic competition] into account when we write the REMS, and I don't think that any of the REMS with restricted distribution programs per se would block generic competition." Transcript of Public Meeting, FDA, Center for Drug Evaluation and Research, Risk Evaluation & Mitigation Strategy (REMS), at 270-71 (July 28, 2010); Partial Petition Approval & Denial, Citizen Petition of Dr. Reddy's Laboratories at 6-7, No. FDA-2009-P-0266 (Aug. 7, 2013).

15. FDA, How to Obtain a Letter from FDA Stating that Bioequivalence Study Protocols Contain Safety Protections Comparable to Applicable REMS for RLD—Guidance for Industry 1 (Dec. 2014) ["*REMS Letter Guidance*"],, <http://www.fda.gov/downloads/Drugs/GuidanceComplianceRegulatoryInformation/Guidances/UCM425662.pdf>.

16. *Id*. at 3-4.

17. Partial Petition Approval & Denial, Citizen Petition of Dr. Reddy's Laboratories at 7, No. FDA-2009-P-0266 (Aug. 7, 2013).

18. Henry Butler, *REMS-Restricted Drug Distribution Programs and the Antitrust Economics of Refusals to Deal with Potential General Competitors*, 67 Fla. L. Rev. 977, 991 (2015).

19. *Oversight of the Enforcement of the Antitrust Laws: Hearing Before the Subcomm. on Regulatory Reform, Commercial and Antitrust Law of the H. Comm. on the Judiciary*, 114th Cong 41 (2015) (statement of Edith Ramirez, Chairwoman, FTC), <https://www.gpo.gov/fdsys/pkg/CHRG-114hhrg94604/pdf/CHRG-114hhrg94604.pdf>.

    Other FTC officials have expressed these concerns. Markus Meier, assistant director of the FTC's Healthcare Division, stated that the FTC "definitely see[s] [REMS misuse] as a significant threat to competition." Katie Thomas, *Drug Makers Use Safety Rule to Block Generics*, N.Y. Times (Apr. 15, 2013), <http://www.nytimes.com/2013/04/16/business/drug-makers-use-safety-rule-to-block-generics.html>. Similarly, at the 2012 spring ABA Antitrust Meeting, then-FTC Chairman Jon Leibowitz stated that "the FTC plans to ramp up its efforts in the coming year to stop pioneer drug manufacturers from using REMS as a 'pretext' for denying generic drug manufacturers access to drug samples that would enable them to do bioequivalence testing as a prerequisite to the filing of an Abbreviated New Drug Application." R. Brendan Fee & Jonathan M. Rich, MORGAN, LEWIS & BOCKIUS LLP *Healthcare Tops the Agenda of U.S. Antitrust Enforcers* (Apr. 4, 2012), <https://shar.es/16AZN8>.

20. Butler, 67 Fla. L. Rev. note 18, at 991 (internal citations omitted).

21. *See* Brief for FTC as Amicus Curiae, *Mylan Pharms. Inc. v. Celgene Corp.*, No. 2:14-cv-02094 (ES) (MAH) (D.N.J. June 17, 2014), ECF No. 26-3;Brief for FTC as Amicus Curiae, *Actelion Pharms. Ltd. v. Apotex Inc.*, No. 1:12-cv-05743 (NLH) (AMD) (D.N.J. Mar. 11, 2013), ECF No. 61-2.

22. Celgene Corporation reported publicly that the FTC issued a civil investigative demand requesting information relating to requests by manufacturers of generic drugs to purchase Celgene's patented REVLIMID® and THALOMID® brand drugs. *See* Celgene Corp., Annual Report (Form 10-K) at 113 (Feb. 11, 2016).

23. Alex Brill, Lost Prescription Drug Savings from Use of REMS Programs to Delay Generic Market Entry note 5, at 1 (2014).

24. Fair Access for Safe and Timely Generics Act, H.R. 2841, 114th Cong. (2015).

25. Outside the REMS content, brand-name drug manufacturers have similarly sought to restrict product distribution as a way to impede competition by generic manufacturers. Actavis used distribution restrictions as part of a strategy to switch users of Namenda—a drug for treatment of Alzheimer's disease—from the company's existing twice-a-day dosage to its forthcoming once-a-day dosage. The switch was designed to thwart competition from generics who offered only twice-a-day dosage. *See New York ex rel. Schneiderman v. Actavis PLC*, 787 F.3d 638 (2d Cir. 2015) (affirming a preliminary injunction). More recently, the New York Attorney General began an investigation of Turing Pharmaceuticals, which increased the price of Daraprim—a drug used to treat infectious diseases that attack cancer and AIDS patients—by 5,000 percent, while implementing distribution restrictions that prevented potential generic competitors from obtaining samples necessary for bioequivalence testing. *See* Andrew Pollack, *New York Attorney General Examining Whether Turing Restricted Drug Access*, N.Y. Times (Oct. 12, 2015), <http://www.nytimes.com/2015/10/13/business/new-york-attorney-general-examining-if-turing-restricted-drug-access.html>; DARAPRIM, About, <http://www.daraprimdirect.com/patients> (last visited Feb. 23, 2016).

26. With varying degrees of success, private plaintiffs have also asserted that such conduct violates the antitrust laws under the essential facilities doctrine, as well as § 1 of the Sherman Act, which prohibits unreasonable agreements in restraint of trade. *See, e.g.*, Order Den. Mot. to Dismiss, *Lannett Co. v. Celgene Corp.*, No. 2:08-cv-03920 (TJS) (E.D. Pa. May 13, 2010), ECF No. 27 (denying the brand-name drug manufacturer's motion to dismiss a complaint alleging a § 2 essential facilities claim); Tr. of Mot. Hr'g, *Actelion Ltd. v. Apotex Inc.*, No. 12-cv-05743 (NLH) (AMD) (D.N.J. Oct. 17, 2013), ECF No. 93 ("*Actelion Mot. Hr'g and Oral Decision*") (denying the brand-name drug manufacturer's motion for judgment on the pleadings and to dismiss the generic's counterclaims, pleading both refusal to deal and essential facilities claims); Transcript of Oral Opinion, *Mylan Pharms.*, No. 2:14-cv-02094 (ES) (MAH) (D.N.J. Dec. 22, 2014), ECF No. 56 ("*Mylan Oral Opinion*") (granting the brand-name drug manufacturer's motion to dismiss the generic's § 1 claim because the generic failed to plead non-conclusory allegations of an unlawful agreement between the brand and its distributors, while denying the motion to dismiss the generic's § 2 claim, without addressing the essential

facilities doctrine). In response, defendants have argued, among other things, that plaintiffs are not seeking access to an essential facility, such as a network or pipeline, but are, instead, proposing a one-time transaction. Defendant Celgene Corp.'s Mem. of Law in Supp. of its Mot. to Dismiss or, in the Alternative, for a Stay at 15, *Lannett*, No. 2:08-cv-03920 (TJS) (E.D. Pa. Nov. 4, 2008), ECF No. 12.

27. *Pac. Bell Tel. Co. v. Linkline Commc'ns, Inc.*, 555 U.S. 438, 448 (2009).
28. *United States v. Colgate & Co.*, 250 U.S. 300, 307 (1919).
29. *Verizon Commc'ns, Inc. v. Law Offices of Curtis V. Trinko, LLP*, 540 U.S. 398, 408 (2004). *See also Aspen Skiing Co. v. Aspen Highlands Skiing Corp.*, 472 U.S. 585, 601 (1985) ("The high value . . . placed on the right to refuse to deal with other firms does not mean the right is unqualified."); *Otter Tail Power Co. v. United States*, 410 U.S. 366 (1973).
30. *Byars v. Bluff City News Co.*, 609 F.2d 843, 846 (6th Cir. 1979).
31. *See generally Aspen Skiing*, 472 U.S. at 605 & n.32.
32. In litigation, the monopoly power element can also be hotly contested, as defendants have argued that the absence of generic competition does not, standing alone, prove monopoly power in the "market" relevant for antitrust purposes. *Compare Mylan Pharms., Inc. v. Warner Chilcott Pub. Ltd.*, No. 12-cv-3824, 2015 WL 1736957 (E.D. Pa. Apr. 16, 2015) (granting summary judgment in favor of the brand manufacturer where court concluded that the generic failed to demonstrate that the relevant market was limited to a single drug), *with* George Farah & Laura Alexander, *Prominent Market Definition Issues in Pharmaceutical Antitrust Cases*, 30 ANTITRUST 46 (2015) (citing authorities for the proposition that "in the pharmaceutical context, formal market definition is not necessary to establish market or monopoly power").
33. *Otter Tail*, 410 U.S. 366.
34. *Id.* at 377-79.
35. *Id.* at 378.
36. *Aspen Skiing Co. v. Aspen Highlands Skiing Corp.*, 472 U.S. 585, 610 (1985).
37. *Id.* at 592-94.
38. *Id*. at 606-608.
39. *Id*. at 605 (citation omitted).
40. *Id*. at 610-11.
41. *Id*. at 608-11.
42. *Verizon Commc'ns, Inc. v. Law Offices of Curtis V. Trinko, LLP*, 540 U.S. 398, 411-15 (2004).
43. *Id*. at 403-04.
44. *Id*. at 404.
45. *Id*. at 409.
46. *Id*.
47. *Id*. at 409-10.
48. *Pac. Bell Tel. Co. v. Linkline Commc'ns, Inc.*, 555 U.S. 438 (2009).
49. *Id.* at 450-51.
50. *See generally* Darren S. Tucker et al., *REMS: The Next Pharmaceutical Enforcement Priority?*, 28 ANTITRUST 74, 75 (2014).
51. *Verizon Commc'ns, Inc. v. Law Offices of Curtis V. Trinko, LLP*, 540 U.S. 398, 409 (2004) (citing *Aspen Skiing Co. v. Aspen Highlands Skiing Corp.*, 472 U.S. 585, 610-11 (1985)).
52. *Mylan Pharms. Inc. v. Celgene Corp.*, No. 2:14-cv-02094 (ES) (MAH) (D.N.J. June 17, 2014), ECF No. 26-3. Lannett, a second generic manufacturer, twice sued Celgene under § 2 for refusing to sell samples of Thalomid. *See Lannett Co. v. Celgene Corp.*, No. 2:08-cv-00233 (E.D. Pa., filed Jan. 14, 2008); *Lannett Co. v. Celgene Corp.*, No. 2:08-cv-03920 (TJS) (E.D. Pa., filed Aug. 15, 2008). The cases settled after the court denied Celgene's motion to dismiss. Order Den. Mot. to Dismiss, *Lannett*, No. 2:08-cv-03920 (TJS) (E.D. Pa., Dec. 7, 2011), ECF No. 51.
53. Oral Opinion, *Mylan*, No. 2:14-cv-02094 n. 26, at 12. The Third Circuit subsequently denied Celgene's petition for interlocutory appeal. *See* Order Den. Interlocutory Appeal, *Mylan Pharms., Inc. v. Celgene Corp.*, No. 15-8017 (3d Cir. Mar. 5, 2015).
54. Oral Opinion, *Mylan*, No. 2:14-cv-02094 n. 26, at 12 (emphasis added).
55. *Id.* at 12-13 (citing *Broadcom Corp. v. Qualcomm Inc.*, 501 F.3d 297 (3d Cir. 2007)). Court of Appeals decisions outside the Third Circuit can, however, be read to require a prior course of dealing factor. *See, e.g., Transhorn, Ltd. v. United Tech. Corp.,* 502 F.3d 47, 53 (2d Cir. 2007).
56. Oral Opinion, *Mylan*, No. 2:14-cv-02094 n. 26, at 16-17 (quoting *Helicopter Transp. Servs., Inc. v. Erickson Air-Crane, Inc.*, No. 06-cv-3077-PA, 2008 WL 151833, at *9 (D. Or. Jan. 14, 2008)).
57. Oral Opinion, *Mylan*, No. 2:14-cv-02094 n. 26, at 17-18. Significantly, the Supreme Court in *Otter Tail* did not suggest that there were any prior dealings between the power company and the towns. To the contrary, the Court noted that Section 2 precluded conduct aimed at hindering even "potential entrants." *Otter Tail Power Co. v. United States*, 410 U.S. 366, 337 (1973).
58. *In re Thalomid & Revlimid Antitrust Litig.*, No. 2:14-cv-06997 (KSH) (CLW), 2015 WL 9589217 (D.N.J. Oct. 29, 2015).
59. *Id.* at *15.
60. *Id*.
61. *Id.*
62. Complaint for Declaratory Judgment, *Actelion Pharms. Ltd. v. Apotex Inc.*, No. 1:12-cv-05743 (NLH) (AMD) (D.N.J. Sept. 14, 2012), ECF No. 1.
63. Mot. Hr'g and Oral Decision, *Actelion* , No. 1:12-cv-05743 note 26.
64. *Id. supra* note 26, at 117.
65. *See* Order Den. Mot. for J. on the Pleadings, *Actelion Pharms.*, No. 1:12-cv-05743 (NLH) (AMD) (D.N.J. Oct. 21, 2013), ECF No. 90; Order of Dismissal, *Actelion Pharms.*, No. 1:12-cv-05743 (NLH) (AMD) (D.N.J. Feb. 28, 2014), ECF No. 113.
66. *In re Suboxone (Buprenorphine Hydrochloride & Naloxone) Antitrust Litig.*, 64 F. Supp. 3d 665, 688 (E.D. Pa. 2014).
67. *Id.* at 685-88.
68. *Id.* at 688.
69. *Id.*
70. *Id.*
71. No. 14-cv-3247 (DWF/JSM), 2015 WL 5718398 (D. Minn. Sept. 29, 2015).
72. *Id.* at *5.
73. *Id.*
74. *See id.* at *2.
75. *See, e.g., Eastman Kodak Co. v. Image Technical Servs., Inc.*, 504 U.S. 451, 483 n.32 (1992) ("It is true that as a general matter a firm can refuse to deal with its competitors. But such a right is not absolute; it exists only if there are legitimate competitive reasons for the refusal."); *Morris Commc'ns Corp. v. PGA Tour, Inc.*, 364 F.3d 1288, 1295-98 (11th Cir. 2004) (affirming summary judgment for the defendant where the refusal to deal was justified by its desire to prevent free-riding); *Data Gen. Corp. v. Grumman Sys. Support Corp.*, 36 F.3d 1147, 1183 (1st Cir. 1994) ("A monopolist may nevertheless rebut [a refusal to deal claim] by establishing a valid business justification for its conduct."); *Seagood Trading Corp. v. Jerrico, Inc.*, 924 F.2d 1555, 1569-73 (11th Cir. 1991) (affirming summary judgment where the defendant's refusal to deal with plaintiff was motivated by a desire to prevent free-riding and where the plaintiff was not harmed because there were sources of supply besides the defendant).

76. *See Mot. Hr'g and Oral Decision*, *Actelion Pharms. Ltd. v. Apotex Inc.*, No. 1:12-cv-05743 (NLH) (AMD) (D.N.J. Sept. 14, 2012), ECF No. 1 n. 26, at 117 ("[I]f the [generic manufacturer] can prove that the [brand-name manufacturers are] motivated not so much by safety concerns but instead motivated by the desire to use the REMS or REMS equivalent...to maintain and extend a monopoly, then [the generic manufacturer] may very well make out a [§] 2 claim."); Oral Opinion, *Mylan Pharms. Inc. v. Celgene Corp.*, No. 2:14-cv-02094 (ES) (MAH) n. 26, at 17 (D.N.J. June 17, 2014) (denying the motion to dismiss where "Mylan has pled that there is no legitimate business reason for Celgene's actions, which it argues are solely motivated by its goal to obtain long-term competitive gain."); *In re Thalomid & Revlimid Antitrust Litig.*, No. 2:14-cv-06997 (KSH) (CLW), 2015 WL 9589217 at *16 (D.N.J. Oct. 29, 2015) (denying the motion to dismiss where "[p]laintiffs' allegations plausibly show that Celgene lacked a legitimate business justification for withholding samples of its drugs").

77. 21 U.S.C. § 355-1(f)(8). *But see Natco Pharma Ltd.v. Gilead Sciences, Inc.*, No. 14-cv-3247 (DWF/JSM), 2015 WL 5718398 (D. Minn. Sept. 29, 2015) (holding that the generic manufacturer failed to state a refusal to deal claim where it did not attempt to comply with the REMS by obtaining a REMS-certified physician to write the prescription).

78. In late 2014, the FDA issued draft guidance procedure allowing a generic manufacturer to request the FDA to inform its branded competitor that supplying it with the requisite samples would not be a violation of the applicable REMS program. *See REMS Letter Guidance*, *supra* note 15.

79. Mot. Hr'g and Oral Decision, *Actelion*, No. 1:12-cv-05743 note 26, at 116 (accepting the notion that safety concerns may be a "legitimate business reason" for the brand name company's refusal to deal, but emphasizing that the generic manufacturer "paint[s] a very different scenario . . . that the existence of safety concerns is really just a beard, if you will, to mask the true motivation [of the brand manufacturer] . . . to extract monopolistic profits . . . beyond the patent term").

80. *In re Thalomid & Revlimid Antitrust Litig.*, 2015 WL 9589217, at *16 (emphasis added).

81. *See* Oral Opinion, *Mylan Pharms. Inc. v. Celgene Corp.*, No. 2:14-cv-02094 (ES) (MAH) n. 26, at 6-8 (D.N.J. June 17, 2014).

82. *CSU, L.L.C., v. Xerox Corp.*, 203 F.3d 1322, 1327 (Fed. Cir. 2000); Defendant Celgene Corp.'s Mem. of Law in Supp. of Mot. to Dismiss Class Action Compl. at 13-16, *In re Thalomid & Revlimid Antitrust Litig.*, No. 2:14-cv-06997 (D.N.J. Feb. 3, 2015), ECF No. 20-1.

83. *See* 21 U.S.C. § 355(j).

84. 35 U.S.C. § 271(e)(1).

85. *Eli Lilly & Co. v. Medtronic, Inc.*, 496 U.S. 661, 670 (1990).

86. In addition to patent exclusivities, a brand-name drug may be entitled to regulatory exclusivities for a New Chemical Entity or under the Orphan Drug Act. *See* 21 U.S.C. § 355(j)(5)(F)(ii) (providing for five-year exclusivity for a New Chemical Entity); Orphan Drug Act, Pub. L. 97-414, § 527, 96 Stat. 2049, 2051 (1983) (codified as amended at 21 U.S.C. § 360cc(a) (providing seven-year exclusivity for drugs approved to treat certain rare diseases)).

87. *United States v. Microsoft Corp.*, 253 F. 3d 34, 79 (D.C. Cir. 2001) (quoting 3 Areeda & Hovenkamp, ANTITRUST LAW ¶ 651c, at 78) (emphasis in original) (en banc), *cert denied*, 534 U.S. 952 (2001).

88. As one commentator has written, where the brand-name drug is protected by a patent, "determining whether the generic product candidate at issue in a REMS abuse action (one that has yet to establish it is in fact bioequivalent to the brand's product) will yield a generic product that infringes on the brand's patents is an exercise in predictive speculation." Anna Fabish, *REMS Abuse and Antitrust Injury: Round Peg, Square Hole*, CompLaw360 (Nov. 4, 2015), <https://www.law360.com/competition/articles/723053/rems-abuse-and-antitrust-injury-round-peg-square-hole>.

89. *Brunswick Corp. v. Pueblo Bowl-O-Mat, Inc.*, 429 U.S. 477, 489 (1977).

90. Oral Opinion, *Mylan Pharms. Inc. v. Celgene Corp.*, No. 2:14-cv-02094 (ES) (MAH) n. 26, at 30 (D.N.J. June 17, 2014). *See also In re Thalomid & Revlimid Antitrust Litig.*, No. 2:14-cv-06997 at *27 (D.N.J. Feb. 3, 2015), ECF No. 20-1. (finding that the plaintiffs adequately pleaded causation despite the branded manufacturer's argument that the drug was covered by "almost three dozen patents" because "[t]he law does not demand that plaintiffs allege all alternative theories of causation to survive a motion to dismiss . . . . Plaintiffs are simply required to allege facts showing that they suffered the type of injury or harm the antitrust laws were intended to prevent, and their injury flows from [the brand manufacturer's] anticompetitive conduct") (quotations and citations omitted).

91. Oral Opinion, *Mylan*, No. 2:14-cv-02094 note 26, at 30.

92. *FTC v. Actavis, Inc.*, 133 S. Ct. 2223, 2236-37 (2013) (holding that, in the context of reverse payments, "the size of the unexplained reverse payment can provide a workable surrogate for a patent's weakness, all without forcing a court to conduct a detailed exploration of the validity of the patent itself").

Enforcement of Foreign Country Judgments: Expanded Use Confronts Increasing Questions

By Steven J. Mandelsberg

"The New York real-estate market is now the premier destination for wealthy foreigners with rubles, yuan, and dollars to hide."[1]

I. Introduction

Long recognized as a major hub of international finance and business, New York City has, in the past decade, experienced a surge of capital from wealthy foreigners who have chosen to park their fortunes in what has been dubbed New York's "bank safe deposit boxes in the sky."[2] The source of this capital infusion, wealthy foreigners and government officials, has led to the increased use of New York law and the accessibility and sophistication of New York courts, to enforce as well as to thwart, the enforcement of foreign country money judgments and decrees.

The rules and regulations governing the enforcement of foreign money judgments are set forth in New York's Uniform Foreign Money-Judgments Recognition Act ("UFMJRA" or "the Act"), codified in Article 53 of New York's Civil Practice Law and Rules ("CPLR"). This article provides an overview of New York's version of the UFMJRA; evaluates common jurisdictional challenges to New York's statutory scheme; discusses the lack of judicial guidance concerning what conduct in a foreign forum constitutes a jurisdictional waiver; and the dilemma litigants are confronted with when deciding whether to default or defend in a foreign forum.

II. Overview of New York's UFMJRA

Traditionally, New York has provided a liberal forum to enforce money judgments obtained in foreign countries.[3] Following a history of recognizing foreign money judgments under general principles of comity (absent evidence of fraud or if enforcement would violate strong public policy of the state), New York enacted the UFMJRA in 1970 upon the recommendation of the Judicial Conference of the State of New York to achieve two objectives: (1) to facilitate more favorable reciprocal treatment of New York judgments in foreign countries; and (2) to codify and clarify existing case law applicable to the recognition of foreign money judgments.[4]

The UFMJRA applies only to foreign country money judgments that are "final, conclusive and enforceable where rendered even though an appeal is pending or possible."[5] Once applicable, the statute dichotomizes the circumstances warranting mandatory and discretionary recognition. A foreign money judgment is conclusive "to the extent that it grants or denies recovery of a sum of money," unless (1) the judgment was rendered under a system which does not provide impartial tribunals or procedures compatible with the requirements of due process of law; or (2) the foreign court did not have personal jurisdiction over the defendant.[6] A foreign money judgment is conclusive—that is, a court may refuse to recognize it—upon eight discretionary grounds, including lack of subject matter jurisdiction, failure to receive notice of the proceedings in the foreign forum in a sufficient time to allow for defenses, or if, in the case of jurisdiction based upon personal service, the foreign court was a seriously inconvenient forum.[7]

Under CPLR 5305(a), the foreign money judgment shall not be refused recognition for lack of personal jurisdiction, if, among other things, the defendant was served personally in the foreign state or voluntarily appeared in the foreign court proceedings other than for the purpose of contesting jurisdiction, or if, prior to the commencement of the proceedings, the defendant agreed to submit to the jurisdiction of the foreign court with respect to the subject matter involved.[8] Because the bases of jurisdiction set forth in CPLR 5305(a) are not exhaustive, the court may recognize grounds upon which to enforce the foreign judgment.[9] To streamline enforcement, the UFMJRA provides for three procedural methods by which to enforce the foreign judgment: an action on the judgment, a motion for summary judgment in lieu of complaint, or by counterclaim, cross-claim or affirmative defense in a pending action.[10]

Expressly excluded from the UFMJRA are judgments for taxes, fines, or penalties, or judgments related to matrimonial or family matters.[11] Although inapplicable to foreign judgments related to matrimonial or family matters or non-monetary foreign judgments, the UFMJRA does not preclude their recognition under general principles of comity.[12] Also excluded are foreign arbitral awards, whose enforcement is instead governed by federal law.[13] Once the foreign arbitral award is confirmed and converted into a foreign judgment, however, New York's UFMJRA applies.[14] Similarly, foreign arbitral orders and decrees that are the functional equivalent of a foreign judgment are enforceable under the UFMJRA.[15]

III. Challenges to Recognition

A. The *Harvardsky* Case

Among the most common challenges to New York's recognition of foreign money judgments is that the foreign forum lacked personal jurisdiction over the defendant.[16] A challenge on such grounds is currently being litigated in *Harvardsky Prumyslovy Holding, A.S.,-V Likvidaci v. Kozeny*,[17] pending in New York County Supreme Court. In this case, defendant Viktor Kozeny has contested New York's enforcement of a Czech Republic judgment on the basis that the Czech court lacked personal jurisdiction over him when the judgment was rendered.

The facts of *Harvardsky* illustrate how New York can become a central forum for the adjudication of a global foreign decree recognition dispute: Kozeny solicited Czech investors to invest money in certain investment privatization funds ("IPFs") in the Czech Republic. These IPFs would purchase and manage a portfolio of shares on the investors' behalf. Kozeny allegedly looted the IPFs and diverted funds to shell companies in Cyprus. He then relocated to the Bahamas, where the Bahamian government refused extradition. Kozeny was prosecuted in the Czech Republic in abstentia and found guilty of gross fraud, sentenced to ten years imprisonment, and ordered to pay approximately $410,000,000.[18] Harvardsky Prumyslovy Holding, A.S.,-V Likvidaci ("Harvardsky"), one of the looted investment funds, commenced suit in New York under the UFMJRA to enforce the Czech judgment. Seeking dismissal of Harvardky's complaint on multiple grounds, including the Czech court's lack of personal jurisdiction, Kozeny argued that he was not properly served with notice of the Czech proceedings or the indictment and that an impartial tribunal did not decide the Czech judgment.

Although Kozeny's motion has not yet been decided, *Harvardsky* raises provocative and unresolved issues through which to examine relevant New York case law.

1. Personal Jurisdiction in New York

A New York court need not have personal jurisdiction to enforce a foreign money judgment against a defendant under the UFMJRA.[19] The courts in New York have reasoned that no such requirement is found in either CPLR Article 53 or inherently in the U.S. Constitution Due Process Clause.[20] As explained in *Lenchyshyn v. Pelko Electric Inc.*, in seeking enforcement of a foreign money judgment, a creditor is not requesting new relief, but merely asking the court to perform a ministerial function: "In proceeding under article 53, the judgment creditor does not seek any new relief against the judgment debtor, but instead merely asks the court to perform its ministerial function of recognizing the foreign country money judgment and converting it into a New York judgment."[21] A defendant's due process rights are further protected by CPLR 5304, which precludes recognition of foreign judgments where the foreign forum lacked personal jurisdiction over the defendant. For these reasons, a defendant is not entitled to added protection in a New York judgment enforcement action.[22]

Courts are split as to the extent to which due process requires a creditor to establish that the court has a jurisdictional basis to enforce a foreign money judgment. Although New York does not so require, the District of Columbia might. In *Ahmad Hamad Al Gosaibi & Bros. Co. v. Standard Chartered Bank*, the District of Columbia Court of Appeals refused recognition of a Bahranian judgment that had been registered in New York under New York's UFMJRA.[23] The court, while not determining whether the judgment would be entitled to recognition under the District of Columbia's UFMJRA, noted that the foreign judgment was not entitled to Full Faith and Credit under the U.S. Constitution[24] because New York did not have personal jurisdiction over the defendant. The court noted that New York's UFMJRA provided fewer grounds to withhold recognition than were available to courts in the District of Columbia.

2. Personal Jurisdiction in Foreign Forum

Under CPLR 5304(a)(2), a New York court is precluded from recognizing a foreign money judgment if the foreign court did not have personal jurisdiction over the defendant. CPLR 5305 enumerates six jurisdictional bases upon which a New York court can rely to enforce a foreign judgment. But this list is not exhaustive; courts can look to any other jurisdictional bases New York recognizes.[25]

The legislative history of New York's UFMJRA makes clear that judicial inquiry into the foreign forum's jurisdiction was explicitly intended.[26] It also suggests that a defendant who had an insufficient connection to the foreign forum may have a basis to challenge the enforcement of the judgment based upon the concept of forum non-conveniens.[27] Although doing so would appear to require the New York court to exceed its mere ministerial function and peer behind the judgment to the foreign forum's underlying proceedings, the New York Court of Appeals has held that a "microscopic analysis" is not required.[28] Instead,

> [t]he inquiry turns on whether exercise of jurisdiction by the foreign court comports with New York's concept of personal jurisdiction, and if so, whether that foreign jurisdiction shares our notions of procedure and due process of law. If the above criteria are met, and enforcement of foreign judgment is not otherwise repugnant to our notion of fairness, the foreign judgment should be enforced in New York under well-settled comity principles.[29]

Consistent with the United States Supreme Court's pronouncement in *International Shoe Co. v. Washington*, New York's concept of personal jurisdiction and due process of law requires that a defendant not present in the forum have "certain minimum contacts" with it such that the forum's exercise of personal jurisdiction over him does not offend "traditional notions of fair play and substantial justice."[30] Cases decided prior to the enactment of the UFMJRA involving the enforcement of foreign judgments embraced this concept of personal jurisdiction, requiring a showing that a defendant had minimum contacts with the foreign forum for due process to be satisfied.[31] Following the enactment of the UFMJRA, New York courts will continue to employ a minimum contacts analysis in cases involving foreign default judgments if no other bases of jurisdiction under CPLR 5305 or New York law exist.[32] In such a case, New York courts have refused to enforce a foreign money judgment against defendants who had no contacts with the foreign forum.[33]

3. Proper Service

While CPLR 5304(b)(2) makes lack of proper notice of the foreign proceedings a discretionary ground for non-recognition of a foreign money judgment, New York courts hold that insufficient notice is in fact a mandatory basis for non-recognition.[34] In so holding, courts have determined that notice and an opportunity to be heard is a fundamental requirement of due process.[35] Enforcement of a foreign judgment against a defendant who received no meaningful notice of the foreign proceedings would be a violation of due process and contrary to our notion of fairness.[36] A plaintiff seeking to enforce a foreign money judgment need not establish strict compliance with the service rules of the foreign forum.[37] Instead, the inquiry turns on whether notice was "reasonably calculated, under all the circumstances, to apprise interested parties of the pendency of the action and afford them an opportunity to present their objections."[38]

As long as the defendant is afforded proper notice, under CPLR 5305(a)(3) a foreign money judgment may be enforced in New York against a defendant who agreed to submit to the jurisdiction of the foreign court with respect to the underlying subject matter even if the foreign forum lacked personal jurisdiction over the defendant.[39] A foreign selection clause and/or consent to jurisdiction provision may therefore provide an exception to the requirement that the foreign forum have a basis of personal jurisdiction if meaningful notice was provided.[40] As stated by the Court of Appeals, enforcement of a foreign judgment in that instance would not violate due process because:

> [E]nforcement of a foreign judgment is not repugnant to our notion of fairness if defendant was a party to a contract in which the parties agreed that disputes would be resolved in the courts of a foreign jurisdiction and defendant was aware of the ongoing litigation in that jurisdiction but neglected to appear and defend …. [S]o long as the exercise of jurisdiction by the foreign court does not offend due process, the judgment should be enforced without "microscopic analysis" of the underlying proceedings.[41]

Even if proper notice was not provided, under CPLR 5305(a)(2), a defendant who voluntarily appeared in the foreign court proceedings, other than for the purpose of contesting jurisdiction, may waive the right to challenge the foreign forum's jurisdiction in an enforcement proceeding in New York.[42]

B. Lack of Judicial Guidance: Waiver of Jurisdiction

Pursuant to CPLR 5305(a)(2), a New York court may not refuse recognition of a foreign money judgment for lack of personal jurisdiction if the defendant voluntarily appeared in the foreign court proceedings, other than for the purpose of contesting jurisdiction. As will be discussed below, the case law and legislative history would seem to confirm that a defendant who argues the merits in the foreign forum would waive the right to raise lack of jurisdiction in a New York judgment enforcement proceeding. But what if the defendant raises an issue as to venue or choice of law in the foreign forum? Or what if a procedural challenge to the foreign forum's jurisdiction necessarily requires the defendant to argue some or all of the merits of the action? Would a defendant who engages in this type of conduct waive his or her right to later contest the foreign court's jurisdiction? Given the dearth of case law on this issue, guidance is critical for a litigant faced with the decision of whether to default in the foreign forum (and lose the opportunity to present a defense on the merits) or defend (and risk waiving the right to challenge the foreign court's jurisdiction in the New York courts).

The legislative history of the UFMJRA suggests that CPLR 5305(a)(2) was intended to embody the well-settled U.S. rule that a defendant who makes a special appearance for the sole purpose of contesting jurisdiction does not waive the right to challenge the court's jurisdiction in a later proceeding. While New York no longer recognizes a distinction between a general and special appearance, the New York Court of Appeals has held that such distinction remains in the statute and is applicable to judgment enforcement proceedings.[43] The Restatement (Second) of the Conflict of Laws defines a special appearance as one made solely for the purpose of objecting to the jurisdiction of the court.[44] In contrast, "a general appearance is one where the defendant either enters an appearance in an action without limiting the purposes for which he appears or where he asks for relief which the court may give only if it has jurisdiction over him."[45] Such conduct is deemed a general appearance even if the defendant simultaneously challenges the court's jurisdiction.[46] A defendant who "makes a motion raising a question as to the merits of the plaintiff's claim even though the defendant shows that he does not intend thereby to submit himself to the jurisdiction of the court" will waive the right to later challenge the court's jurisdiction.

The commentary to CPLR 5305(a)(2) provides some useful instruction by explaining that the proper inquiry to determine whether a waiver has occurred is whether the defendant did "more than they had to do to preserve a jurisdictional objection."[47] If so, the defendant will have voluntarily submitted to the court's jurisdiction and forfeited the right to claim an exception. For example, in *CIBC Mellon Trust Co. v. Mora Hotel Corp. N.V.*, the Court of Appeals found that the defendant, upon its application to the High Court of England to set aside an English default judgment, raised an issue as to the merits of the underlying case and thus waived its right to contest the English court's personal jurisdiction in the subsequent judgment enforcement action in New York.

So far, a lack of judicial guidance leaves open a definitive answer to the question of whether raising improper venue or choice-of-law issues in the foreign forum will be deemed a waiver to challenge the foreign court's jurisdiction in a judgment enforcement proceeding in New York. Venue and choice of law do not necessarily require an inquiry into the merits of the action. Since questions as to venue and choice-of-law are jurisdictionally related, a defendant who raises these issues could reasonably contend that it is not doing anything more than it has to to preserve a jurisdictional objection. Under such reasoning, a New York court may not deem as waived an objection to the foreign court's jurisdiction in the case of a defendant who raises improper venue or choice-of-law in the foreign forum.[48]

Courts have also recognized the possibility that a defense on the merits might be required to preserve a jurisdictional objection and not constitute a waiver of jurisdiction. In *Nippon Emo-Trans Co. v. Emo-Trans, Inc.*, the court noted in dicta that in a case where a foreign court refused to hear a jurisdictional appeal unless a defendant presented a defense on the merits, the defendant "had not done 'any more than he had to do' by arguing the merits." On the other hand, the court in *Hamilton Bank, N.A. v. Kookmin Bank* found that a defendant faced with possibility of waiving the right to challenge the foreign court's jurisdiction would not be without recourse; the court suggested that the defendant in that particular circumstance avoid the risk by defaulting and contesting jurisdiction in the subsequent enforcement proceeding.

IV. Guidance for the Practitioners

Given the attendant risks associated with either defaulting or defending in a foreign court proceeding, a defendant with substantial assets in New York would be well-advised to establish a forward-thinking litigation strategy that carefully considers the potential for a subsequent judgment enforcement proceeding in New York courts. Provided proper notice was given, practitioners faced with a forum selection or consent to jurisdiction clause may choose to defend in the foreign forum in light of the inability to challenge the foreign court's jurisdiction in New York. Alternatively, absent such a clause and provided that no grounds of jurisdiction under CPLR 5305(a) exist, a defendant with minimal or no contacts with the foreign forum may be better off defaulting and challenging the foreign court's jurisdiction in the subsequent enforcement proceeding in New York. Until definitive judicial guidance is provided, a defendant who appears in the foreign court solely for the purpose of raising improper venue or choice-of-law issues will have good grounds to stand upon if a creditor seeking enforcement of the judgment in New York asserts that such conduct amounts to a waiver of jurisdiction.

Endnotes

1. Andrew Rice, *Stash Pad*, New York Magazine, Jun. 29, 2014, http://nymag.com/news/features/foreigners-hiding-money-new-york-real-estate-2014-6/.
2. Julie Creswell, *Stratospheric Views, and Prices*, The New York Times, Nov. 3, 2013, http://www.nytimes.com/2013/11/04/business/stratospheric-views-and-prices.html.
3. *See CIBC Mellon Trust Co. v. Mora Hotel Corp. N.V.*, 100 N.Y.2d 215, 762 N.Y.S.2d 5 (2003); *Sung Hwan Co. v. Rite Aid Corp.*, 7 N.Y.3d 78, 817 N.Y.S.2d 600 (2006); *see also Hilton v. Guyot*, 159 U.S. 113, 163-64 (1895) ("Comity, in the legal sense, is [not] a matter of absolute obligation … [I]t is the recognition which one nation allows within its territory to the legislative, executive or judicial acts of another nation.").
4. *Greschler v. Greschler*, 51 N.Y.2d 368, 434 N.Y.S.2d 194 (1980); *Intercontinental Hotels Corp. v. Golden*, 15 N.Y.2d 9, 254 N.Y.S.2d 527 (1964) (To violate public policy judgments must be "inherently vicious, wicked or immoral, and shocking to the prevailing moral sense."); Judicial Conference Mem. in Support, Bill Jacket, L1970, at 4-5.
5. N.Y. Civil Practice Law and Rules 5302 (CPLR).
6. CPLR 5303; CPLR 5304.
7. CPLR 5304(b); CPLR (b)(1); CPLR (b)(2); CPLR (b)(7).
8. CPLR 5305(a)(1); CPLR (a)(2); CPLR (a)(3).
9. CPLR 5305(b).
10. CPLR 5303.
11. CPLR 5301.
12. *See* CPLR 5307; *Downs v. Yuen*, 297 A.D.2d 251, 746 N.Y.S.2d 389 (1st Dep't 2002); *Chevron Corp. v. Salazar*, 807 F. Supp. 2d 189 (S.D.N.Y. 2011).
13. *See* 9 U.S.C.S. §§201–208 (Convention on the Recognition and Enforcement of Foreign Arbitral Awards).
14. *Fotochrome, Inc. v. Copal., Co.* 517 F.2d 512 (2d Cir. 1975); *Shipcraft A/S v. Arms Corp. of the Philippines, Inc.*, 150651/2012 (Sup. Ct., N.Y. Co. Feb. 19, 2013).
15. *See Seetransport Wiking Trader Schiffahrtsgesellschaft MBH & Co., Kommanditgesellschaft v. Navimpex Centrala Navala*, 29 F.3d 79 (2d Cir. 1994); *V. Corp. v. Redi Corp. (USA)*, 04 Civ. 1683 (MBM), (S.D.N.Y. Oct. 7, 2004).
16. Kulzer, *Recognition of Foreign Country Judgments in New York: The Uniform Foreign Money-Judgments Recognition Act*, 18 Buff. L. Rev. 1., 25 (1968-1969) ("The foreign court's lack of personal jurisdiction over the defendant is probably the most frequent defense alleged when a judgment is offered as conclusive in another state.").
17. Index No. 651826/2012 (Sup. Ct., N.Y. Co.).
18. 117 A.D.3d 77, 983 N.Y.S.2d 240 (4th Dep't 2014).
19. *Lenchyshyn v. Pelko Elec., Inc.*, 281 A.D.2d 42, 723 N.Y.S.2d 285 (4th Dep't 2001).
20. *Id.*; *Abu Dhabi Commercial Bank PJSC v. Saad Trading*, 117 A.D.3d 609, 986 N.Y.S.2d 454 (1st Dep't 2014).
21. 281 A.D.2d at 49.

22. *Abu Dhabi Commercial Bank*, 117 A.D.3d 609.

23. 98 A.D.3d 998 (2014); *but see Standard Chartered Bank v. Ahmad Hamad Al Gosaibi*, 99 A.3d 936, 2014 PA Super 179 (Super. Ct. PA 2014) (different result reached between same parties), *appeal denied*, 108 A.3d 36 (Pa. 2015).

24. U.S. Const. art. IV, § 1; *Johnson v. Muelberger*, 340 U.S. 581, 584 (1951) (explaining that the purpose of the Full Faith and Credit Clause is to "help weld the independent states into a nation by giving judgments within the jurisdiction of the rendering state the same faith and credit in sister states as they have in the state of the original forum").

25. *Sung Hwan Co. v. Rite Aid Corp.*, 7 N.Y.3d 78, 817 N.Y.S.2d 600 (2006) (use of New York's long-arm statute).

26. Kulzer, *supra* note 16, at 16, n. 112 (1968-1969) (noting that in the case of a foreign default judgments, the jurisdiction of the foreign court is subject to close scrutiny).

27. *Id*. at 37 ("[I]f neither the cause of action nor the defendant had any connection with France, a good case for nonrecognition on the ground of forum non conveniens is presented.").

28. *Sung Hwan Co.*, 7 N.Y.3d at 83.

29. *Id.*; *see also CIBC Mellon Trust Co. v. Mora Hotel Corp. N.V.*, 296 A.D.2d 81, 96, 743 N.Y.S.2d 408, 420 (1st Dep't 2002), *aff'd* 100 N.Y.2d 215 (2003) (explaining that the question posed "is not whether the foreign court properly exercised jurisdiction under its own laws. The use of the term 'personal jurisdiction' in CPLR 5305 necessarily contemplates the definition of that term as understood in our jurisprudence.").

30. *International Shoe Co. v. Washington*, 326 U.S. 31 (1945); *George Reiner & Co. v. Schwartz*, 41 N.Y.2d 648, 394 N.Y.S.2d 844 (1977) ("When tracing the modern notion of due process as it relates to in personam jurisdiction, it is necessary to go back no further than *International Shoe Co. v Washington*.") (internal citation omitted).

31. *Johnston v. Compagnie Generale Transatlantique*, 242 N.Y. 381, 384 (1926) (A foreign judgment "can be impeached only by proof that the court in which it was rendered had no jurisdiction of the subject matter of the action or of the person of the defendant, or that was procured by means of fraud."); *Martens v. Martens*, 284 N.Y. 363, 365-66 (1940) (" In order to pass upon the question as to whether a judgment of a court of a foreign country is to be recognized, there must be a disclosure of the jurisdiction of the foreign court of the subject-matter and of the parties. The acts of the parties to the foreign litigation in invoking the jurisdiction must also sometimes be scrutinized."); *Falcon Mfg. (Scarborough), Ltd. v. Ames*, 53 Misc. 2d 332, 335, 278 N.Y.S.2d 684, 687 (Civ. Ct., N.Y. Co. 1967) ("[A] court would not be able to determine on a motion for summary judgment whether the foreign judgment sued upon offended traditional notions of fair play and substantial justice or our own sense of justice and equity as embodied in our public policy, or whether it served to deprive the defendant of due process of law in violation of the Fourteenth Amendment.") (internal quotations and citations omitted).

32. *Siedler v. Jacobson*, 86 Misc. 2d 1010, 1011, 383 N.Y.S.2d 833, 834 (1st Dep't 1976) (finding that "the nature of defendant's solitary act in this case was so casual and incidental to the foreign forum that it could not possibly serve as a jurisdictional predicate sufficient to grant conclusive effect to the default judgment sued upon"); *Ackermann v. Levine*, 788 F.2d 830 (2d Cir. 1986) (applying New York law).

33. *Siedler*, 86 Misc. 2d 1010; *Ackermann*, 788 F.2d 830.

34. *Baker & Mckenzie Zurich v. Anna Frisone*, 47 Misc. 3d 1227(A), 18 N.Y.S.3d 577 (Sup. Ct., N.Y. Co. 2015) ("[I]f the defendant in the proceedings in the foreign court did not receive notice of the proceedings in sufficient time to enable him to defend it is fundamental to due process and nonrecognition is mandatory."); *Gondre v. Silberstein*, 744 F. Supp. 429 (E.D.N.Y. 1990) (citing Siegel, McKinney Practice Commentaries, C5304:1 (1978)).

35. *Baker & Mckenzie Zurich*, 47 Misc. 3d 1227(A).

36. *Galliano, S.A. v. Stallion, Inc.*, 15 N.Y.3d 75, 904 N.Y.S.2d 683 (2010).

37. *Id*.

38. *Gondre*, 744 F. Supp. at 431 (citing *Mullane v. Central Hanover Tr. Co.*, 330 U.S. 306, 314 (1950)).

39. *Galliano, S.A.*, 15 N.Y.3d at 80 ("CPLR 5304's grounds for nonrecognition of foreign money judgments must be read together with CPLR 5305, however, which provides that a 'foreign country judgment shall not be refused recognition for lack of personal jurisdiction if … the defendant prior to the commencement of the proceedings had agreed to submit to the jurisdiction of the foreign court with respect to the subject matter involved.'").

40. *See id.*; *see also Landauer Ltd. v. Joe Monani Fish Co.*, 22 N.Y.3d 1129, 985 N.Y.S.2d 463 (2014); *Baker & Mckenzie Zurich v. Anna Frisone*, 47 Misc. 3d 1227(A), 18 N.Y.S.3d 577 (Sup. Ct., N.Y. Co. 2015).

41. *Landauer Ltd*, 22 N.Y.3d 1129.

42. CPLR 5305(a)(2); *Gemstar Can., Inc. v. George A. Fuller Co.*, 127 A.D.3d 689, 6 N.Y.S.3d 552 (2d Dep't 2015).

43. *CIBC Mellon Trust Co. v. Mora Hotel Corp. N.V.*, 100 N.Y.2d 215, 762 N.Y.S.2d 5 (2003).

44. Restatement [Second] of Conflict of Laws, § 81, Comment b.

45. *Id*. at § 33, Comment d.

46. *Id*.

47. Siegel, McKinney Practice Commentaries, C5304:1 (1978); N.Y. Civ. Prac. Law & R. § 5305 (McKinney's 1978) at 496-97. (The jurisdictional exception applies] where the appearance was solely to protest jurisdiction . . . . If the judgment debtor did *any more than he had to do*, however, to preserve his jurisdictional objection in the foreign court, he would thereby have submitted voluntarily to its jurisdiction and forfeited the right to claim an exception [under this section.").

48. *See, e.g. In re. Avon Dairies, Inc.*, 280 A.D. 116, 111 N.Y.S.2d 272 (4th Dep't 1952) (noting the distinction between venue and jurisdiction); *Fla. Dep't of Children & Families v. Sun-Sentinel, Inc.* 865 So. 2d 1278 (Fla. 2004) (holding that a motion to transfer venue made simultaneously with an objection to personal jurisdiction does not waive the jurisdictional objection); *State v. Omega Painting Inc.*, 463 N.E.2d 287 (Ind. Ct. App. 1984) (same).

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The Remarkable Invulnerability of the Unconditional Guaranty

By John D. Rodgers

I. Introduction

While most commercial practitioners have a general, if not intricately refined, awareness of the importance, role, and superior clout enjoyed by creditors holding an absolute, unconditional guaranty in the collection of commercial indebtedness, many who do not regularly find themselves pursuing or defending guarantors are not acquainted with the breadth of judicial protection bestowed upon these agreements, the abundant options conferred and doors opened by the fortuity of holding this "trump card," or the often summarily preclusive effect of these guaranties in defeating potential challenges, defenses and counterclaims relating to the underlying indebtedness.

From humble origins grounded in general notions of freedom of contract, the evolution of the application of the parol evidence rule, and specific statutory constructions, the absolute, unconditional guaranty has become the rarest of commodities in the law, a nearly impenetrable cloak of armor, the scope of which is considerably greater than the underlying obligation which it was designated to secure and safeguard.

This article examines the origins and development of current judicial sentiments and the prevailing construction and enforcement of unconditional guaranties in New York through analysis of critical judicial opinions, including the most recent expressions by the New York State courts and Second Circuit Court of Appeals, and explores, where appropriate: conclusions suggested by recent appellate pronouncements, assessment of the viability of prior expressions in light of recent opinions, questions naturally posed by contemporary judicial trends, and wide-lens suggestions and concerns from the standpoints of both lender and guarantor counsel.

II. The Development and Progression of Rigid Judicial Enforcement of Unconditional Guaranties 1959-2015[1]

A. The Emergence of Strict Enforcement of Broad Defense Waivers

Judicial recognition and the strict enforcement of comprehensive waivers of defenses and counterclaims contained in absolute, unconditional guaranties initially emerged from case law developments involving disclaimers encompassed in contractual merger clauses. Court of Appeals' decisions from the 1970s and 1980s highlighting distinctions in the application of various UCC provisions and protections applicable to "debtors," in contrast to the contractual freedom pervading the relationship between an a obligee and a debtor's surety, further contributed to this development by advancing the principle of independence between the obligations of the primary obligor and those of the guarantor. While earlier appellate opinions had enforced discrete issue specific disclaimers, the movement toward enforcement of wholesale, sweeping waivers was punctuated by the 1985 Court of Appeals opinion in *Citibank, N.A. v. Plapinger*[2] ("*Plapinger*") in which the Court squarely approved and enforced comprehensive defense and counterclaim waivers contained in unconditional guaranties, largely shaping the judicial landscape and its progression for more than a generation, and signaling expansion of guarantor exposure beyond that of the principal obligor.

The *Plapinger* Court relied heavily upon the then-controversial 1959 decision in *Danann Realty Corp. v. Harris* (*"Danann"*),[3] in which the Court strictly enforced express disclaimer language contained in a merger clause, acknowledging that no representations other than as stated in the contract were made and that neither party was relying upon any statement or representation not contained in the contract to preclude a claim of fraudulent inducement. The Court distinguished this "specific" disclaimer from general merger clauses, which had been repeatedly held insufficient to bar such a claim. Observing that the specific disclaimer language "destroys the allegations in plaintiff's complaint that the agreement was executed in reliance upon...contrary oral representations,"[4] the Court reinstated the Supreme Court's dismissal of the complaint. In a reference which foreshadowed the rationale later employed by appellate courts in upholding broad defense waivers contained in unconditional guaranties, the *Danann* Court emphasized that the language of the disclaimer "is inconsistent with the contention that plaintiff relied upon the [alleged] misrepresentation and was led thereby to make the contract."[5]

Danann was followed by two Court of Appeals' decisions in which guarantors claimed they had been discharged from their obligations where their exposure was increased by (1) the lender's release of collateral and (2) the lender's failure to file financing statements perfecting its interests in collateral securing the guaranteed loan.[6] In each case, the Court held that the UCC did not prohibit a surety from consenting to impairment of a lender's collateral in advance, and, where such a waiver had been so consented to, the guarantors were not discharged despite their enhanced exposure.

In *Plapinger*, the Court directly addressed, in the context of another fraudulent inducement defense, the legal effect of comprehensive waivers of defenses and counterclaims contained in the unconditional guaranty, a practice which by then had become commonplace among lenders' counsel. While acknowledging that defendants' submissions in opposition to dismissal otherwise plainly raised issues of fact, the Court nonetheless affirmed the striking of all defenses based solely on the "disclaimer" language contained in the guaranty which the Court found sufficiently specific to foreclose, as a matter of law, defendants' asserted defenses and counterclaims. The Court highlighted the language from the guaranty reciting that the obligations were " 'absolute and unconditional . . .' 'irrespective of (1) [the] lack of validity of' " [underlying loan documentation or any related agreement or instrument]; and (2) "any other circumstance which might otherwise constitute a defense" to the guaranty.[7] The Court also dismissed defendants' contention that plaintiff's asserted inequitable denial of additional credit raised issues of fact relating to the failure of a necessary condition precedent triggering the guarantors' liability by holding that any extrinsic evidence contradicting the express terms of the guaranty's written waivers would be excluded by the parol evidence rule.[8]

In the three decades since *Plapinger* was handed down, absolute and unconditional guaranties containing sweeping defense waivers have been routinely enforced by courts with very limited exceptions.[9] Where a guarantor's obligations are broadly defined as absolute and unconditional regardless of any other circumstances which might otherwise constitute a legal or equitable discharge or defense, such language has been held to preclude all legal or equitable defenses as a matter of law, so as to even deprive a guarantor of standing to assert defenses or counterclaims. Such defenses or counterclaims are deemed "irrelevant," since the guaranty is not dependent upon any condition other than payment.[10] Applying this analysis, some appellate courts have characterized unconditional guaranties containing comprehensive waivers as an "insurmountable obstacle."[11]

Illustrative of some notable bedrock defenses that have been precluded by express guaranty waivers are: fraud in the inducement;[12] bad faith, unclean hands, equitable estoppel, waiver, failure to mitigate damages, and contractual interference and prevention of performance;[13] tortious interference by a lender;[14] breach of the implied covenant of good faith and fair dealing;[15] forgery and duress;[16] and discharge, release and failure of consideration.[17] This rule of preclusion has been held to apply and has been enforced regardless of whether the alleged defense or counterclaim arose after the waiver was executed,[18] and without regard to the manner in which a defense is characterized or labeled. Thus, defenses classified as challenges to the validity of the underlying obligation or the fulfillment of all conditions necessary to trigger a guarantor's liability have also resulted in preclusion.[19]

In a judicial preview of the emerging trend respecting guaranty enforcement, the First Department in *Red Tulip, LLC v. Neiva,*[20] beyond enforcing the express defense waivers, found it significant that the guaranty there at issue also waived everything except "actual payment."

B. Separation of the Obligations and Duties Owed the Primary Obligor From Those of the Unconditional Guarantor

Although the purpose of the guaranty contract has been traditionally thought to consist of assuring payment of valid and enforceable debts agreed to, but not paid in full by the primary obligor, appellate courts have increasingly separated the obligations of the guarantor from those of the primary debtor, independently construing and enforcing the guaranty contract without regard to express or implied limitations, conditions, or the enforceability of the obligations created by the base borrowing documentation and distinguishing the duties owed and the defenses available to each.

> *"In the three decades since* Plapinger *was handed down, absolute and unconditional guaranties containing sweeping defense waivers have been routinely enforced by courts with very limited exceptions."*

Although separation of a surety's undertaking from that of the primary borrower has a long tradition in New York jurisprudence, the prominence of the division has progressively expanded, decidedly increasing the guarantor's exposure well beyond that of the primary obligor while simultaneously vastly reducing the guarantor's universe of available defenses.[21] While this augmented exposure has earlier roots, the guarantor's present day expanded liability can be loosely traced to language contained in the Court of Appeals' decision *American Trading Company, Inc. v. Fish*[22] in which the Court determined that the statute of limitations applicable to a defendant's guaranty was not limited to that applicable to the underlying sales transaction, emphasizing that since "defendant's guaranty was an undertaking separate from the sales arrangement itself...it is appropriate to treat the guaranty as an obligation separate and distinct from, rather than subsumed by, the underlying contract."[23] The Court's observation that, while ordinarily the liability of a guarantor will not exceed that of its principal, the guaranty may impose lesser or greater exposure on the guarantor, has been cited by many subsequent opinions applying the principle to various factual scenarios.[24] Indeed, it has now become axiomatic that even if the obligor should entirely escape liability, if the guaranty's language so provides, the guarantor remains liable.[25]

Exacerbating the plight of the guarantor is also the now well-settled maxim that a lender owes no independent duty to a guarantor and that a guarantor has neither an affirmative claim against a lender for negligent loan administration, nor a defense based upon the lender's breach of contract with the principal obligor. The guarantor is without standing to assert either, by way of counterclaim, defense, or independent action.[26] Thus, even if such potential claims and defenses are not expressly waived by the guaranty document itself, they are precluded by law.

C. Unconditional Guaranties Qualify for Expedited Adjudication Pursuant to CPLR 3213

Beyond the substantive legal clout afforded to unconditional guaranties, they enjoy preferred procedural status qualifying for expedited summary judgment disposition as permitted by New York Civil Practice Law and Rules ("CPLR") 3213.

Since the early 1980s some courts had held that an unconditional guaranty qualified as "an instrument for the payment of money"[27] whether or not it recited a sum certain,[28] and even though defenses advanced might raise issues beyond the confines the instrument supporting the summary judgment motion.[29] Initial authority for use of the CPLR 3213 device was largely based upon appellate division opinions until its use was expressly approved by the Court of Appeals in 2015.[30] Prior to then, the question of what constituted an "instrument for the payment of money only" was a "vexing" problem which was the subject of a plethora of irreconcilable case law.[31] While in *Weissman v. Sinorm Deli, Inc.*,[32] the Court impliedly approved the device for actions by lenders against guarantors, the question had not been squarely passed upon by the Court and doubt lingered concerning in what instances this procedure might be utilized given the Court's prior observations that "[w]here the instrument requires something in addition to defendant's explicit promise to pay a sum of money" or "if outside proof is needed, other than simple proof of nonpayment or similar de minimis deviation from the face of the document" the instrument does not so qualify.[33]

Although negotiable instruments, and particularly promissory notes, were most frequently and freely approved for CPLR 3213 treatment, some courts had already held that a negotiable instrument was not a prerequisite for expedited summary judgment treatment and that an agreement requiring payment was sufficient even if other terms and provisions were contained within the document, so long as no additional terms required further performance by the plaintiff as a condition precedent to payment.[34] Despite conceptual approval of the device in actions based upon unconditional guaranties, the outside limits of both the type and quantity of evidence that may be properly utilized in the context of a CPLR 3213 motion remained unaddressed by the Court, and these issues had been the subject of fact specific and less than uniform application.

In the Second Department's sweeping opinion in *European American Bank v. Lofrese*[35] ("*Lofrese*"), the court approved the use of CPLR 3213 and affirmed the granting of summary judgment in lieu of complaint despite submission with the guaranty document of 47 trust receipts and security agreements which plaintiff alleged evidenced the amounts outstanding under an automotive dealer floor plan agreement. The court rejected defendant-guarantor's contention that this action was beyond the scope of the "instrument for the payment of money only" provision of CPLR 3213 since: (1) defendant's guaranty constituted such an instrument; (2) the 25 trust receipts—since they did not make reference to any other document—independently qualified for CPLR 3213 treatment; and (3) the 25 "security agreements" submitted also constituted promissory notes which, although referencing the floor plan agreement, constituted free-standing obligations establishing plaintiff's right to payment.

While there are surprisingly few reported decisions involving revolving credit lenders utilizing this device as approved by the court in *Lofrese*, the breadth of the interpretation ascribed to the "money only" provision of CPLR 3213 and the expedited adjudication thereby available suggests valuable alternative strategies for prompt resolution of commercial obligations involving recalcitrant, difficult and contentious borrowers. An early direct action against guarantors on an unconditional guaranty employed with or without concurrent utilization of self-help remedies available under the base loan documentation offers the lender an expedited path to adjudication and enforcement largely free of traditional defenses asserted by the primary obligor, and which is thus unburdened by fact specific contentions, counterclaims, accountings and collateral disposition disputes that routinely bog down breach of contract actions—as well as the time consuming and costly discovery that necessarily accompanies these proceedings. Moreover, since most commercial loan guarantors also hold positions of substantial standing (and clout) with the principal obligor, the playing of the direct action card will often arm the plaintiff lender with invaluable supplemental leverage with which to facilitate speedier overall resolution.

III. Post-Execution Developments and the *Canterbury* Divergence

Neither *Plapinger* nor the Court of Appeals' decisions which preceded it had excepted or distinguished post-execution conduct from the general rules strictly enforcing unconditional guaranties and defense waivers. To the contrary, *Plapinger* emphasized defendants' affirmative representations in the guaranty that it was "absolute and unconditional irrespective of any...circumstances which might otherwise constitute a defense"[36] as a basis for defense preclusion. The Court had earlier signaled[37] that a guarantor could waive, in advance, anything which he or she may lawfully consent to, not otherwise proscribed by statute or violative of public policy. Pre-2015 appellate decisions had generally little difficulty concluding that waivers of all defenses contained in unconditional guaranties, except payment in full, precluded the assertion of any defense, including post-execution defenses.[38]

The notion that a lender's post-execution wrongful conduct could justify the assertion of defenses otherwise waived in an unconditional guaranty was first suggested in a controversial decision of the Third Department in *Canterbury Realty & Equipment Corp. v. Poughkeepsie Savings Bank*[39] ("*Canterbury*"), handed down three years after *Plapinger*. Although *Canterbury* has been distinguished and reinterpreted by courts on multiple occasions, it has never been abrogated.[40] While simultaneously reaffirming that a lender owed no duty to a guarantor to monitor the affairs of a borrower, administer a loan consistent with the intent of the lending instruments or in a non-negligent manner, the Court relied upon the asserted post-execution aggravated facts in *Canterbury* to distinguish *Plapinger* and other cases rejecting defenses waived by unconditional guaranties involving: (1) fraudulent inducement and claimed misrepresentations inconsistent with the terms of the guaranty; (2) instances where a guarantor claimed modifications based upon purported understandings agreed to *at the time of contract formation;*[41] and (3) the assertion of "traditional" guarantor defenses despite their express waiver. Emphasizing that the guarantors were only obligated to pay *Canterbury's* liabilities "when due"[42] and that the bank's justifications for accelerating the debt and seizing plaintiff's accounts after giving oral assurances that its credit line would be increased were issues of fact precluding summary judgment in the bank's favor,[43] the Court found that neither *Plapinger* nor other authorities strictly enforcing covenants contained in unconditional guaranties compelled a contrary result.

In concluding that none of the precedents cited by defendant dealt specifically with the issue there presented, the Court framed the central question as: "whether the post-execution conduct of the parties affected the existence of a necessary condition precedent to acceleration of liability under the express terms of the guarantee."[44] Having framed the issue in terms of when or whether the obligations of the principal obligor, and thus the guarantors, became lawfully "due" the Court found issues of fact relating to whether defendant "unfairly brought about the occurrence of the very condition precedent (*Canterbury's* suspension of business) upon which it relied to accelerate the loan against the guarantors."[45] It was thereafter reasoned that if defendant caused the default or made performance impossible through unjust conduct, the guarantors would be discharged, the Court noting that New York courts had barred promisors from defending contract actions by claiming failure of a condition precedent, which they had prevented from occurring. [46]

Owing in part to the outrageous facts alleged in opposition to summary judgment in *Canterbury*, courts have distinguished *Canterbury* more often than it has been followed[47] but it continues to stand as precedent where a guarantor can establish that a creditor's wrongful post-execution conduct *caused* the very event that resulted in the guarantor's liability.[48] In its only direct comments on this issue, the Second Circuit, in holding that a guarantor can consent in advance to remain liable following the post-execution discharge of the principal obligor, left open whether in its judgment a lender's post-execution conduct which exposed a guarantor to a materially heightened or "inflated risk" could warrant denial of enforcement of an otherwise unconditional guaranty.[49] Post-execution fraud (as contrasted from fraud in the inducement) has continued to enjoy some judicial support as a basis for avoiding strict enforcement of unconditional guaranties (*at least* until the 2015 Court of Appeals decision in *Cooperatieve Centrale* discussed *infra),* the maxim that "a written waiver in any form cannot operate to shield a party from his own fraud" having been cited with approval as late as 2010.[50] It is notable, however, that in more recent cases seemingly acknowledging that claims based upon fraud survived even sweeping guaranty waivers, summary judgment was nonetheless granted.[51]

If these and similar cases retain any vitality following recent judicial pronouncements, one is left to wonder under what circumstances a fraud defense by an unconditional guarantor can be successful. If alleged fraud occurred in the distribution of loan proceeds or the administration of the loan, the defense potentially created would ordinarily belong to the borrower and be unavailable to the guarantor regardless of the discrete guaranty language employed. In most instances, the UCC allows either waiver or contrary agreement as alternatives to its default provisions, and the contract with the guarantor may waive even mandatory protections afforded "debtors." As discussed above, an unconditional guarantor is in most instances not automatically discharged by discharge of the principal and remains liable even if the borrower escapes liability. Furthermore, the principle is now axiomatic that courts are to decline interference with agreements between sophisticated entities and business persons, particularly where represented by counsel, who are answerable for the consequences of agreements they freely negotiate and consent to.[52] Indeed, in transactions not governed by the UCC, the Court of Appeals has held that inquiry into "commercial reasonableness" is only warranted in agreements among such parties where a contract is ambiguous.[53]

IV. The Import of Recent Courts of Appeal Opinions: Ramifications and Unanswered Questions

Two important decisions were handed down by the New York State and Second Circuit Courts of Appeals in 2015 and 2016, which, if not dramatically altering the prevailing judicial landscape, served to meaningfully: (1) further fortify the existing prodigious armor enjoyed by unconditional guaranties and deplete the already barren quivers of guarantors; and (2) erode the continued vitality of declarations contained in prior opinions.

A. The New York Court of Appeals Decision in *Cooperatieve Centrale*

In *Cooperatieve Centrale Raiffeisen-Boerenleen Bank B.A. v. Navarro* ("*Cooperatieve Centrale*")[54] the New York Court of Appeals made express its concurrence with prior appellate decisions (and its own previously implied approval) by squarely holding that an "unconditional guaranty is an instrument for the payment of 'money only' within the meaning of CPLR 3213"[55] and reaffirmed that an absolute and unconditional guaranty containing language obligating a guarantor to payment without recourse to any defenses or counterclaims, and which waives all defenses except actual payment, "forecloses any challenge to the enforceability and validity of the documents which establish defendants' liability . . . [and] any other possible defense . . . to liability for the obligations."[56] The Court likewise reiterated that permitting defendants to raise defenses waived in the guaranty would "condone defendant's own fraud in deliberately misrepresenting [their] true intention" when they executed the guaranties.[57]

The Court swept aside the guarantors' arguments that the federal judgment upon which the state action was predicated was unlawful as obtained through collusion and that defendants' challenge was not a waived or precluded "defense" at all, but rather the failure of a necessary condition precedent to liability (i.e., that the obligations were not validly "due" as suggested by *Cantebury*) triggered solely by plaintiff's wrongful conduct.[58] Regardless of its characterization or label, the Court held, defendant's challenge was ultimately "based on a quintessential defense of fraud" which had been waived by the broad disclaimers contained in the guaranty.[59]

A careful reading of *Cooperatieve Centrale*, however, confirms that its significance extends substantially beyond formal recognition of the availability of the CPLR 3213 vehicle and its reaffirmance of the principles expressed in *Plapinger* and its progeny.

(1) In rejecting defendant's contention that his claimed liability did not constitute a "valid obligation," that necessary conditions precedent remained unfulfilled and that these circumstances did not constitute a waived "defense," and characterizing defendant's contentions as a "quintessential defense of fraud" waived by the disclaimers contained in the guaranty, the Court effectively nullified the future precedential value of prior authorities suggesting that post-execution fraud could not be waived in advance. Moreover, if post-execution fraud may be validly waived by a guarantor in advance, what remains of prior decisions holding that guarantors could not waive, in advance, a defense of commercial unreasonableness?[60]

(2) While expressly leaving open the question of whether any post-execution conduct by a creditor waived by the guaranty could be so egregious or devastating that it might override strict enforcement despite the principles expressed in *Plapinger*,[61] the Court sent an unmistakably strong message that the slope which a guarantor would be required to climb to avoid preclusion would be exceedingly steep. The Court declined to abrogate *Canterbury* directly despite interpreting its "more narrow" essence to be only that "an absolute and unconditional guaranty does not foreclose a guarantor's challenge that the creditor's wrongful post-execution conduct triggered [or caused the]...liability,"[62] and noted that the Second Circuit[63] had likewise left this question open by observing that circumstances "may exist" where post-execution actions may so impact the guarantor's exposure that strict enforcement of guaranty waiver language would be inappropriate. No mention was made of the Second Circuit's intervening 2011 Summary Order opinion in *HSH Nordbank AG New York Branch v. Street*[64] rejecting post-execution defenses claiming bad faith and frustration of performance as barred by the broad defense waivers contained in defendants' guaranties.

If post-execution fraud may be lawfully waived in advance, and the guarantor lacks standing to raise either improprieties or negligence by the obligee vis-à-vis the primary obligor or the validity of the underlying debt as a condition precedent to the guarantor's liability, it taxes the imagination to envision what circumstances might exist that would enable the guarantor to successfully challenge the preclusive effect of a guaranty.[65]

B. The Second Circuit and District Court Opinions in *136 Field Point Holding Co.*

The 2016 Summary Order opinion of the Second Circuit in *136 Field Point Holding Co., LLC v. Invar Int'l Holding, Inc.*[66] ("*136 Field Point*") dealt a riveting blow to unconditional guarantors seeking to escape or minimize liability and arguably established, by virtue of the peculiarity of its facts, a previously untested outer extreme in the enforcement of unconditional guaranties underscoring the separation of a primary obligor's liability from that of the unconditional guarantor. The opinion[67] affirmed the Southern District's[68] grant of summary judgment to the plaintiff against the corporate guarantor of a lease entered into by the guarantor's principals relating to a luxury mansion located in Greenwich, Connecticut.[69] The guarantor challenged liability under an absolute and unconditional guaranty that included a holdover fee of $1,000,000 characterized as "liquidated damages" should the lessees fail to "vacate the property immediately" at the conclusion of the stated term. The $1,000,000 liquidated damages provision was contained in the master agreement and lease and was to be "an immediate cash payment." The guaranty encompassed each and every liability and obligation of the lessees and was "absolute under any and all circumstances without regard to the validity, regularity or enforceability [of the underlying documents]." The guaranty document at issue did not contain the broad, sweeping waivers discussed at length and enforced by the Court of Appeals in *Plapinger* and *Cooperatieve Centrale*.

The essence of the guarantor's challenge centered on three questions: (1) whether the $1,000,000 holdover liquidated damage provision constituted an unenforceable penalty as a matter of law; (2) whether this provision, if an unenforceable penalty as against the primary obligor, was consequently unenforceable against the guarantor; and (3) whether the absence of broad or specific defense waivers in the otherwise absolute guaranty removed the case from the rule of *Plapinger* and *Cooperatieve Centrale,* thus permitting guarantor's assertion of defenses foreclosed in the former cases by the broad, sweeping waivers. An unusual development was also presented which intervened the opinions of the District Court and the Second Circuit. Prior to hearing on appeal, the plaintiff and primary obligor had stipulated in the state court action between them that the $1,000,000 liquidated damage clause contained in the lease, in fact, did constitute an unenforceable penalty. This stipulation was memorialized in an Interim Order and Judgment entered by the New York State Supreme Court approximately four months after the District Court opinion issued. The District Court decision was also, notably, published prior to the New York Court of Appeals' decision in *Cooperatieve Centrale*, while the Second Circuit opinion was handed down well afterward.

At the District Court level, although the legal status of the $1,000,000 holdover payment had not yet been adjudicated or stipulated, the court found this issue to be "irrelevant"[70] because the guaranty expressly provided that it was absolute and unconditional without regard to the enforceability of the lease and the master agreement and required payment "even if the guaranteed obligation itself is unenforceable."[71] The absence of express defense waivers was also found to be irrelevant since the guaranty recited that it was absolute under any and all circumstances.[72] Having found the guaranty to be absolute and unconditional under all circumstances, including the unenforceability of the primary obligation, the Court determined that the guaranty need not contain any additional defense waivers despite the Court of Appeals' reliance thereon in *Plapinger;* holding that neither *Plapinger* nor its progeny required an absolute and unconditional guaranty to contain "additional [waiver] words" to effectively waive all defenses.[73]

On appeal, the Second Circuit noted the state court stipulation confirming that the liquidated damage provision constituted an unenforceable penalty and its inclusion in the state court Interim Order and Judgment, but, like the District Court, found the stipulated resolution immaterial. The court found the unconditional guaranty language, even in the absence of express defense waivers, foreclosed any challenge by the guarantor to the enforceability or validity of the underlying documents and obligations thereby established, since the guaranty covenant that it "be absolute under any and all circumstances, without regard to the validity...or enforceability of the Lease" bound defendant to payment "regardless of whether the lease or its provisions were enforceable as to the [lessees]."[74] The court found the case "indistinguishable" from *Plapinger, Cooperatieve Centrale,* and *Compagnie Financiere de CIC et de L'union Europeenne v. Merrill Lynch, Pierce, Fenner & Smith Inc.* and that defendant was foreclosed from challenging its obligation to make the $1,000,000 payment.[75]

The court's opinion is significantly well beyond its express holding on the extraordinary facts presented. The opinion is silent respecting the Court of Appeals' passing concession to the underlying obligation in *Cooperatieve Centrale,* acknowledging that "a guarantor is only liable upon the non-compliance of the principal obligor,"[76] which in turn cited the First Department's opinion in *Madison Avenue Leasehold, LLC v. Madison Bentley Associates LLC*[77] (emphasizing that a guaranty is subject to the fulfillment of any condition precedent and accrues only after "default" of the principal obligor[78]). Unlike other cases in which challenges were premised upon expressly waived conduct by the obligor, in this instance the "obligation" was agreed by both the obligee and the primary obligor to be unenforceable as a matter of law in a stipulation incorporated into an Order and Judgment by the state court presiding over the action. Unenforceable penalty provisions, regardless of the sophistication of the parties or how freely and willingly they were agreed to, have been held to be *void* as against public policy.[79] The Court of Appeals long ago held that New York law prohibits penalties or forfeitures as against public policy, and "[p]arties cannot make a binding contract in violation of law or public policy."[80]

Certainly the existence of the provision at issue here was known pre-execution when the guarantor agreed that its guaranty would be absolute and unconditional under any circumstances. The decision squarely poses the question, however, whether an obligation can be due and enforceable against a guarantor if it is *void* as a matter of law. If so, a central question to be addressed in future case law is where courts will draw the line with regard to "voluntary" waivers of void or unlawful contractual provisions which aggressive counsel will no doubt attempt to build into loan documentation and guaranties in more and more imaginative and comprehensive ways.

V. Lessons, Conclusions, and Unanswered Questions

A. Judicial Development Summary

The First Department's characterization in 2007 of unconditional guaranties as an "insurmountable obstacle"[81] has proven to be an even more befitting description today than when initially written. The breadth of exposure confronting an unconditional guarantor has been judicially recognized as potentially far exceeding that of a primary obligor. Guarantors have been denied reliance upon defenses and counterclaims arising from aberrant practices or negligence of the creditor in the funding or administration of credit facilities and any right to challenge the legal enforceability of obligations provided for in the underlying agreements with the obligor. The unconditional guarantor frequently does not enjoy the same statutory protections afforded to the primary obligor, and recent appellate opinions illustrate a further widening of the potential defenses and rights that a guarantor may be deemed to have lawfully irrevocably waived in advance. Although both the New York Court of Appeals and Second Circuit have in theory left the door open the slightest sliver for a challenge to liability by an unconditional guarantor in unspecified egregious or unforeseen extraordinary circumstances, this crack appears largely illusory based upon authoritative recent precedent and prevailing judicial trends.

B. Creditor Responses and Planning

Lenders' counsel will no doubt continue to refine and augment disclaimer language contained in unconditional guaranties to keep pace with the outer boundaries established by favorable New York case law. National or regional lenders who continue to employ multi-state form guaranties are, and will continue to be, encouraged to have New York counsel examine their forms to assure that they are maximizing coverage available under New York law. Creditors obtaining guaranties or extending credit to business entities with sufficient contacts with New York State should actively consider choice of law provisions in their guaranty documents denominating New York law where feasible, absent countervailing considerations. As noted, creditors pursuing claims against both a primary obligor and guarantor should consider the efficacy and efficiency of commencing separate actions against each where feasible, to facilitate the most expeditious overall resolution.[82] In some instances, the facts, financial position and liquidity of the guarantor and availability of CPLR 3213 may warrant pursuing only the guarantor in the first instance, leaving to the latter the more difficult, time-consuming and muddy task of pursuing subrogation rights or indemnification against the principal obligor.

C. Guarantor Responses and Planning

Unconditional guarantors are plainly facing a "stacked deck" once default has occurred—even if the primary obligor holds, or believe it holds, valid defenses or counterclaims. Prospective "insider" guarantors and their counsel often pore over and tirelessly negotiate relative minutiae contained in the base lending or credit documents only to gloss over or offer passive resistance to strikingly onerous unconditional guaranties that leave a principal guarantor defenseless. While disparity in bargaining power often prevents or chills contentious negotiation of guaranty provisions, and guarantors are frequently reluctant to insist upon reasonable protections for fear that this will be interpreted by the lender as a lack of confidence or commitment to the borrower, the failure to negotiate guaranty terms *at least as* vigorously as the loan documentation itself is both foolish and unforgiving. Guarantors are routinely told that the terms of a proposed guaranty are fixed and non-negotiable, but this oft-repeated mantra should not be left untested, particularly where the loan or credit facility is significant and the borrower or guarantor can credibly suggest that other lenders may be in play. Lenders are, as a rule, highly competitive, and the prospect of landing or retaining a desirable business placement or "door opener" to a new market may well be enough to induce reasonable flexibility in the specific language contained in a guaranty. Even where a substantial divide in bargaining power exists and the prospect of another lender's involvement is remote, reasonable accommodations, whether added to the guaranty instrument itself or a contained in a rider modification, may be attainable, particularly once the momentum and focus of the lender is channeled to closing consummation.

From a guarantor's standpoint, modifications or "exceptions" which might be sought and prove acceptable to the creditor naturally depend upon leverage, desirability of the credit portfolio, the discrete risks posed by the particular business enterprise, the nature and intrinsic value of any collateral pledged to secure the credit, the guarantor's relationship to the borrower, and the financial holdings, clout, and existing credit commitments of the guarantor. Potential "reasonable" concessions which could be sought and "defined out" as exceptions from unconditional guarantor liability might include, for example: (i) where the primary obligor's indebtedness proves to be wholly or partially unenforceable against the borrower through no fault of the guarantor; (ii) where the creditor made material misrepresentations pre-execution, engaged in post-execution fraud, "bad faith," or other *active* misconduct transpired beyond the control of the guarantor which resulted in enhanced guarantor exposure; (iii) the insertion of a covenant that guarantors shall be entitled to raise as defenses any defense available to the primary obligor (including negligence, misfeasance or malfeasance in the administration of the credit facility) which substantially increased guarantors' exposure; and (iv) the insertion of an exception to guarantor liability relating to any act or omission beyond the control of the guarantor which would violate any statute or recognized state public policy or which, if committed or omitted by the creditor, would give rise to a lawfully recognized defense if asserted by the primary obligor.

Endnotes

1. The discussion and analysis contained in this article is limited to the law prevailing at the time of article submission in the State of New York only, as applied by New York State and United States Courts.
2. *Citibank, N.A. v. Plapinger*, 66 N.Y.2d 90, 495 N.Y.S.2d 309 (1985).
3. *Danann Realty Corp. v. Harris,* 5 N.Y.2d 317, 184 N.Y.S.2d 599 (1959).
4. *Id.* at 321-322.
5. *Id.* at 322.
6. *See Indianapolis Morris Plan Corp. v. Karlen*, 28 N.Y.2d 30, 319 N.Y.S.2d 831 (1971); *Executive Bank of Fort Lauderdale, Fla. v. Tighe*, 54 N.Y.2d 330, 445 N.Y.S.2d 425 (1981).
7. *Citibank, N.A. v. Plapinger*, 66 N.Y.2d 90, 95 (1985).
8. *Id.* at 95-96.
9. In the few instances in which these guaranties have not been specifically enforced so as to preclude defenses and counterclaims, it has almost invariably been due to post-execution anomalous facts rising to the level of fraud or unconscionable conduct on the part of the creditor or its successor. Post-execution divergences and their status as viable defenses are addressed in sections III, IV and V, *infra*.
10. *See, e.g., Compagnie Financiere de CIC et de L'union Europeenne v. Merrill Lynch, Pierce, Fenner & Smith Inc.,* 188 F.3d 31, 34 (2d Cir. 1999); *HSH Nordbank AG New York Branch v. Street*, 421 F. App'x 70, 73 (2d Cir. 2011); *Hotel 71 Mezz Lender LLC v. Mitchell*, 63 A.D.3d 447, 448, 880 N.Y.S.2d 67 (1st Dep't 2009); *European Am. Bank v. Lofrese*, 182 A.D.2d 67, 73, 586 N.Y.S.2d 816 (2d Dep't 1992); *Raven Elevator Corp. v. Finkelstein*, 223 A.D.2d 378, 636 N.Y.S.2d 292 (1st Dep't 1996), *lv. denied*, 88 N.Y.2d 1016, 649 N.Y.S.2d 382 (1996); *LFR Collections LLC v. The Matthews Law Firm,* 114 A.D.3d. 485, 979 N.Y.S.2d 806 (1st Dep't 2014).
11. *See, e.g., Red Tulip, LLC v. Neiva*, 44 A.D.3d 204, 209, 842 N.Y.S.2d 1 (1st Dep't 2007), *lv. denied* 10 N.Y.3d 741, 853 N.Y.S.2d 283 (2008); *JPMCC 2007—CIBC19 Bronx Apartments, LLC v. Fordham Fulton LLC,* 84 A.D.3d 613, 922 N.Y.S.2d 779 (1st Dep't 2011); *see also Export-Import Bank of the United States v. Agricola del*, *Mar BCS, S.A. de C.V.,* 334 F. App'x 353, 354-55 (2d Cir. 2009); *Valley Nat'l Bank v. 58 Vlimp LLC,* 38 Misc. 3d 1221(A), 972 N.Y.S.2d 147 (Sup. Ct., Suffolk Co. 2013).
12. *Citibank, N.A. v. Plapinger*, 66 N.Y.2d 90 (1985).
13. *Red Tulip,* 44 A.D.3d at 207-12; *Fortress Credit Corp. v. Hudson Yards, LLC,* 78 A.D.3d 577, 912 N.Y.S.2d 41 (1st Dep't 2010); *Chase Equip. Leasing Inc. v. Architectural Air, L.L.C.*, 84 A.D.3d 439, 922 N.Y.S.2d 69 (1st Dep't 2011) (citing *Chemical Bank v. PIC Motors Corp.,* 87 A.D.2d 447, 452 N.Y.S.2d 41 (1st Dep't 1982), *aff'd,* 58 N.Y.2d 1023, 462 N.Y.S.2d 438 (1983); *ING Real Estate Fin. (USA) LLC v. Park Ave. Hotel Acquisition, LLC*, 89 A.D.3d 506, 933 N.Y.S.2d 217 (1st Dep't 2011).
14. *Fortress Credit Corp.,* 78 A.D.3d 577.
15. *Hotel 71 Mezz Lender LLC v. Mitchell*, 63 A.D.3d 447, 448, 880 N.Y.S.2d 67 (1st Dep't 2009); *N. Fork Bank v. Computerized Quality Separation Corp.,* 62 A.D.3d 973, 974, 879 N.Y.S.2d 575 (2d Dep't 2009); *Chase Equip. Leasing Inc.,* 84 A.D.3d at 439.
16. *Quest Commercial, LLC v. Rovner*, 35 A.D.3d 576, 825 N.Y.S.2d 766 (2d Dep't 2006).
17. *Gannett Co. Inc. v. Tessler*, 177 A.D.2d 353 (1st Dep't 1991).
18. *See, e.g., Fortress Credit Corp., supra* (citing *Hotel 71 Mezz Lender LLC,* 63 A.D.3d at 447-48).
19. *Cooperatieve Centrale Raiffeisen-Boerenleenbank, B.A., "Rabobank Intl.," N.Y. Branch v. Navarro,* 113 A.D.3d 457, 978 N.Y.S.2d 186 (1st Dep't 2014), *aff'd,* 25 N.Y.3d 485, 15 N.Y.S.3d 277 (2015). *See also Inland Mortg. Capital Corp. v. Realty Equities NM, LLC*, 71 A.D.3d 1089, 900 N.Y.S.2d 79 (2d Dep't 2010); *Valley Nat'l Bank v. 58 Vlimp LLC,* 38 Misc. 3d 1221(A), 972 N.Y.S.2d 147 (Sup. Ct., Suffolk Co. 2013); *Orchard Hotel, LLC v. Zhavian*, 34 Misc. 3d 1219(A), 950 N.Y.S.2d 492 (Sup. Ct., Kings Co. 2012); *West Loan Acquisition Holdings, LP v. MWF Realty, Inc.*, 42 Misc.3d 1206(A), 984 N.Y.S.2d 635 (Sup. Ct., Suffolk Co. 2013).
20. *Red Tulip, LLC v. Neiva*, 44 A.D.3d 204, 209-10, 842 N.Y.S.2d 1 (1st Dep't 2007), *lv. denied* 10 N.Y.3d 741, 853 N.Y.S.2d 283 (2008).
21. While this trend of expanded exposure predated *Plapinger,* and *Plapinger* did not expressly address the intricacies of the guarantor agreement in contrast to that of the principal obligor, recognition of the guarantor's enhanced exposure was implicit in *Plapinger*. Moreover, the Court's express approval of the use of broad waivers and absolute language in *Plapinger* invariably led to more widespread utilization of sweeping waiver language and the continual refinement of guaranty disclaimer language to cover every imagined conceivable lawful scenario.
22. *Am. Trading Co., Inc. v. Fish*, 42 N.Y.2d 20, 396 N.Y.S.2d 617 (1977).
23. *Id.* at 26-27.
24. *See, e.g., Hyman v. Golio,* 134 A.D.3d 992-93 (2d Dep't 2015); *European Am. Bank v. Lofrese*, 182 A.D.2d 67, 73, 74, 586 N.Y.S.2d 816 (2d Dep't 1992); *Mfrs. Hanover Trust Co. v. Green*, 95 A.D.2d 737, 464 N.Y.S.2d 474 (1st Dep't 1983), *appeal dismissed*, 61 N.Y.2d 760 (1984); *Raven Elevator Corp. v. Finkelstein*, 223 A.D.2d 378, 636 N.Y.S.2d 292 (1st Dep't 1996), *lv. denied*, 88 N.Y.2d 1016, 649 N.Y.S.2d 382 (1996).
25. *See, e.g., Hyman*, 134 A.D.3d at 993; *Mfrs. Hanover Trust Co.*, 95 A.D.2d at 737.
26. *See, e.g., Canterbury Realty & Equip. Corp. v. Poughkeepsie Sav. Bank*, 135 A.D.2d 102, 109, 524 N.Y.S.2d 531 (3d Dep't 1988); *Matas v. Binghamton Sav. Bank*, 233 A.D.2d 545, 650 N.Y.S.2d 37 (3d Dep't 1996); *Bank Leumi Trust Co. of N.Y. v. Block 3102 Corp.,* 180 A.D.2d 588, 589, 580 N.Y.S.2d 299 (1st Dep't 1992).
27. *See, e.g., European Am. Bank & Trust Co. v. Schirripa*, 108 A.D.2d 684, 485 N.Y.S.2d 763 (1st Dep't 1985); *First Interstate Credit Alliance, Inc. v. Sokol*, 179 A.D.2d 583, 584, 579 N.Y.S.2d 653 (1st Dep't 1992).
28. *Mfrs. Hanover Trust Co.*, 95 A.D.2d at 737.
29. *See, e.g., Seaman-Andwall Corp. v. Wright Machine Corp.*, 31 A.D.2d 136, 137, 295 N.Y.S.2d 752 (1st Dep't 1968), *aff'd*, 29 N.Y.2d 617, 324 N.Y.S.2d 410 (1971).
30. *Cooperatieve Centrale Raiffeisen-Boerenleenbank, B.A., "Rabobank Intl.," N.Y. Branch v. Navarro,* N.Y.3d 485, 492, 15 N.Y.S.3d 277 (2015); *European Am. Bank & Trust Co.*, 108 A.D.2d at 684; *Mfrs. Hanover Trust Co.*, 95 A.D.2d at 737.
31. *Interman Indus. Prods., Ltd., v. R.S.M. Electron Power, Inc.,* 37 N.Y.2d 151, 154-55, 371 N.Y.S.2d 675 (1975).
32. *Weissman v. Sinorm Deli, Inc.*, 88 N.Y.2d 437, 444-46, 646 N.Y.S.2d 308 (1996).
33. *Id.* at 444.
34. *See, e.g., Afco Credit Corp. v. Boropark Twelfth Ave. Realty Corp.*, 187 A.D.2d 634, 590 N.Y.S.2d 519 (2d Dep't 1992); *Meyer v. La Barbera*, 35 A.D.3d 554, 555, 826 N.Y.S.2d 653 (2d Dep't 2006); *First Interstate Credit Alliance, Inc. v. Sokol*, 179 A.D.2d 583, 583, 579 N.Y.S.2d 653 (1st Dep't 1992) (holding that a guaranty in conjunction with an equipment lease met the requirements of CPLR 3213).
35. *European Am. Bank v. Lofrese*, 182 A.D.2d 67, 586 N.Y.S.2d 816 (2d Dep't 1992).
36. *Citibank, N.A. v. Plapinger*, 66 N.Y.2d 90, 92 (1985).
37. *Indianapolis Morris Plan Corp. v. Karlen*, 28 N.Y.2d 30, 35, 319 N.Y.S.2d 831 (1971).

38. *Fortress Credit Corp. v. Hudson Yards, LLC*, 78 A.D.3d 577, 912 N.Y.S.2d 41 (1st Dep't 2010) (citing *Hotel 71 Mezz Lender LLC v. Mitchell*, 63 A.D.3d 447, 448 (1st Dep't 2009)); *Sterling National Bank v. Biaggi*, 47 A.D.3d 436, 849 N.Y.S.2d 521 (1st Dep't 2008); *Chase Equip. Leasing Inc. v. Architectural Air, L.L.C.*, 84 A.D.3d 439, 922 N.Y.S.2d 69 (1st Dep't 2011).
39. *Canterbury Realty & Equip. Corp. v. Poughkeepsie Sav. Bank*, 135 A.D.2d 102, 109, 524 N.Y.S.2d 531 (3d Dep't 1988).
40. *See, e.g., Red Tulip, LLC v. Neiva*, 44 A.D.3d 204, 210-12, 842 N.Y.S.2d 1 (1st Dep't 2007), *lv. denied,* 10 N.Y.3d 741, 853 N.Y.S.2d 283 (2008); *Cooperatieve Centrale Raiffeisen-Boerenleenbank, B.A., "Rabobank Intl.," N.Y. Branch v. Navarro,* N.Y.3d 485, 495-97, 15 N.Y.S.3d 277 (2015).
41. *Canterbury*, 135 A.D.2d at 108.
42. *Id.* at 106.
43. The peculiar and seemingly egregious facts and assurances recited in *Canterbury* require careful reading by counsel seeking either support from or to distinguish this opinion. *Canterbury* must also be read in conjunction with the Court of Appeals' discussion of this decision in *Cooperatieve Centrale*, 25 N.Y.3d at 495-96 and the First Department's opinion in *Red Tulip,* 44 A.D.3d at 210-11.
44. *Canterbury*, 135 A.D.2d at 108.
45. *Id.* at 107.
46. *Id.* at 108 (citing, *inter alia, Kooleraire Serv. & Installation Corp. v. Board of Educ. of City of N.Y.,* 28 N.Y.2d 101, 106, 320 N.Y.S.2d 46 (1971)).
47. For a decision substantially following *Canterbury*, *see, e.g., Mfrs. & Traders Trust Co. v. Sullivan,* 188 A.D.2d 1023, 592 N.Y.S.2d 994 (4th Dep't 1992).
48. As discussed, *infra,* the Court of Appeals in its 2015 Opinion in *Cooperatieve Centrale* discussed *Canterbury* at length and, despite the Court's holding, declined to expressly overrule its fundamental tenet that a creditor's wrongful post-execution conduct which causes or triggers a guarantor's liability may allow for challenge to an otherwise absolute and unconditional guaranty.
49. *Compagnie Financiere de CIC et de L'union Europeenne v. Merrill Lynch, Pierce, Fenner & Smith Inc.,* 188 F.3d 31, 37-38 (2d Cir. 1999).
50. *See Pike v. New York Life Ins. Co.,* 72 A.D.3d 1043, 1050-1051, 901 N.Y.S.2d 76 (2d Dep't 2010) (citing, *inter alia, Sterling Nat'l Bank & Trust Co. of N.Y. v. Giannetti*, 53 A.D.2d 533, 384 N.Y.S.2d 176 (1st Dep't 1976)).
51. *See, e.g., Archer Capital Fund LP v. GEL, LLC*, 95 A.D.3d 800-802, 944 N.Y.S.2d 179 (2d Dep't 2012); *N. Fork Bank v. Computerized Quality Separation Corp.,* 62 A.D.3d 973, 974, 879 N.Y.S.2d 575 (2d Dep't 2009).
52. *Cooperatieve Centrale Raiffeisen-Boerenleenbank, B.A., "Rabobank Intl.," N.Y. Branch v. Navarro*, N.Y.3d 485, 497, 15 N.Y.S.3d 277 (2015).
53. *Fundamental Long Term Care Holdings, LLC v. Cammeby's Funding LLC,* 20 N.Y.3d 438, 445, 962 N.Y.S.2d 583 (2013).
54. *Cooperatieve Centrale,* 25 N.Y.3d 485.
55. *Id.* at 492.
56. *Id.* at 494.
57. *Id.* (citing *Citibank, N.A. v. Plapinger*, 66 N.Y.2d 90, 95 (1985); *Danann Realty Corp. v. Harris,* 5 N.Y.2d 317, 323, 184 N.Y.S.2d 599 (1959)).
58. *Id.* at 495.
59. *Id.*
60. *See, e.g., Bank of China v. Chan*, 937 F.2d 780, 785-86 (2d Cir.1996); *see also* the post-*Cooperatieve Centrale* discussion of the commercial reasonableness defense addressed in *Tabatznik v. Turner*, 2016 WL 1267792 (S.D.N.Y. 2016).
61. *Cooperatieve Centrale,* 25 N.Y.3d at 497.
62. *Id.* at 496.
63. *Compagnie Financiere de CIC et de L'union Europeenne v. Merrill Lynch, Pierce, Fenner & Smith Inc.,* 188 F.3d 31, 37-38 (2d Cir. 1999).
64. 421 F. App'x 70 (2d Cir. 2011).
65. *Cooperatieve Centrale* does not address the appellate decisions discussed above holding that a guarantor is owed no duty by the obligee and may not raise defenses belonging to the principal obligor relating to the administration or enforcement of the primary obligor's indebtedness.
66. 2016 U.S. App. LEXIS 5376 (2d Cir. 2016).
67. This Opinion is denominated a Summary Order unpublished opinion and may be cited to courts for persuasive purposes only, but does not constitute recognized formal precedent by the Second Circuit. Summary orders of the Second Circuit Court of Appeals are governed by Federal Rule of Appellate Procedure 32.1 and Second Circuit Court of Appeals Local Rule 32.1.1.
68. *136 Field Point Holding Co., LLC v. Invar Int'l Holding, Inc.,* 2015 U.S. Dist. LEXIS 34768 (S.D.N.Y. 2015).
69. There were related actions filed between the lessee principals of the guarantor and plaintiff in Supreme Court for New York County and in state court in Connecticut.
70. 2015 U.S. Dist. LEXIS 34768 at *12.
71. *Id.* at *13.
72. *Id.* at *15.
73. *Id.* at *14-15.
74. 2016 U.S. App. LEXIS 5376 at *6.
75. *Id.* at *10-11.
76. 25 N.Y.3d at 495.
77. 30 A.D.3d 2, 10, 811 N.Y.S.2d 47 (1st Dep't 2006), *aff'd*, 8 N.Y.3d 59, 828 N.Y.S.2d 254 (2006).
78. *Id.* at 5-6.
79. *See Interface Grp.-Nev., Inc. v. Trans World Airlines, Inc.* (*In re Transworld Airlines Inc.*), 145 F.3d 124, 135 (3d Cir. 1998) (applying New York law); *Restatement (Second) of Contracts,* Ch. 8 (1981); *Truck Rent-A-Center, Inc. v. Puritan Farms 2nd, Inc.,* 41 N.Y.2d 420, 424, 393 N.Y.S.2d 365 (1977); *Wilmington Trust Co. v. Global Aero Logistics Inc.,* No. 600401/09 (Sup. Ct., Com. Div., N.Y. Co., April 11, 2011) (Ramos, J.).
80. *Sternaman v. Metro. Life Ins. Co.,* 170 N.Y. 13 (1902).
81. *Red Tulip, LLC v. Neiva*, 44 A.D.3d 204, 209, 842 N.Y.S.2d 1 (1st Dep't 2007), *lv. denied,* 10 N.Y.3d 741, 853 N.Y.S.2d 283 (2008).
82. Care should plainly be taken by the lender and lender's counsel, in both the selection and prosecution of guarantors, to comprehensively assess operative federal and state protective statues. [*See, e.g.,* EEOA, 15 U.S.C. §§ 1691 *et. seq.* limiting situations in which a spousal guaranty may be demanded by a lender.].

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2016 Amendments to the Uniform Rules for the Commercial Division

By Marcy Einhorn

Consistent with its mission to engage in further periodic review of the needs and goals of the Commercial Division, the Commercial Division Advisory Council continues to promulgate Rules to enhance the functioning of the Commercial Division Parts across the State.

Most practitioners are now familiar with the series of Rules that were promulgated and then approved by the Chief Administrative Judge in 2014 and 2015.

These Rules were discussed in depth in previous issues of the *Commercial and Federal Litigation Section Newsletter*, from the Summer/Fall 2014 through the Spring 2016 editions.[1]

Previously adopted Rules addressed issues of proportionality, and developed new or revised guidelines for eligibility, entity depositions and summary jury trials, as well as a model status conference order form.

New Rules approved this year touch on the assignment of settlement conferences to a judge other than the justice assigned to hear the case, a newer Model Preliminary Conference Order Form, memorialization of rulings in discovery conferences, and an updated standard confidentiality order.[2]

Herein is a brief description of each of these four most recently enacted Rules and some insight into the Advisory Council's reasons for proposing them, as well as their effective dates.

I. Settlement Conferences Before a Justice Other Than the Justice Assigned to Hear the Case[3]

This Rule permits counsel who wish to proceed with a settlement conference in front of a judge other than the assigned Justice to jointly make such a request at any time during the litigation.

The Justice to whom the application is made will grant the request, in her discretion, on a finding that it would be beneficial to the parties and would serve the interests of justice, and that the justice who will conduct the conference has agreed to serve in that capacity.

The Advisory Council notes state that this Rule formalizes a collegial practice that is already in place and encourages settlements where parties might be concerned about telegraphing weaknesses in their case to the judge who will try the case.[4]

II. Memorialization of Rulings in Disclosure Conferences[5]

At all disclosure conferences conducted by non-judicial personnel, the parties must prepare a writing setting forth the resolutions reached, and submit it for court approval, or must dictate all the resolutions into the record prior to the conclusion of the conference and must then submit the transcript to be "so ordered."[6]

In telephone conferences, the parties have one business day to submit a stipulated proposed order memorializing their resolutions, or advise the court and seek further guidance if they are unable to agree to a proposed stipulation.

The Subcommittee on Procedural Rules to Promote Efficient Case Resolution recommended enactment of this Rule in order to "make more efficient the already expedient practice of resolving disclosure disputes through informal conferences."[7]

III. Newly Revised Preliminary Conference Order Form[8]

A Preliminary Conference Order Form was approved for use in the Commercial Division as of June 2, 2014. Since that time a substantial number of new Rules have been adopted which affect practice in the Commercial Division in general, and the discovery process in particular. With all of these new Rules in mind, the Subcommittee on Best Practices for Judicial Case Management proposed a new Model PC form with the goal of reducing the costly burden of discovery in the Commercial Division.

Some of the salient features of the new model form are:

- A new section for pre-answer motion practice;
- A more streamlined section for the description of the case, and
- A completely revamped section on discovery.

Discovery practices that have been impacted by the new Model PC Form, include:

- Document production
- Interrogatories
- Depositions of individuals

- Depositions of entities
- Disclosure disputes
- Electronic discovery and privilege logs
- Expert discovery

Also impacted by the new form is the section on Alternative Dispute Resolution. Finally, see the section on Additional Directives regarding notice to the Court when a matter is settled, and the mandatory use of eTrack to keep track of future court appearances.

IV. Standard Form Confidentiality Order[9]

Since the release of the Standard Form Confidentiality Order (SFO) in February 2007, most of the Commercial Division Justices throughout the State have explicitly incorporated it "into their individual rules of practice."[10] Effective 7/1/2016, the new SFO has been updated to reflect "lessons learned" since the original was first adopted. And the lessons learned are many. A redlined, multi-page, multi-paragraph revised form was attached to the proposal memo. The memo itself emphasizes the changes to the procedure for filing confidential documents under seal, and goes into detail on the need for new practices and procedures for filing such documents.[11]

A. Proposed Rule Regarding Direct Testimony in Non-Jury Trials by Affidavit[12]

Finally, a proposed Rule, which would permit testimony to be submitted by affidavit, was under consideration at press time, subject to a comment period that closed on July 25, 2016. The Advisory Council Memorandum states, "In recent years, federal and state judges have increasingly required direct testimony in non-jury trials to be presented through an affidavit or other sworn written statement. Those judges who adopt this practice find it streamlines the trial for both the Court and the parties."[13]

The proposal would not require adoption of this practice, or the precise mechanics, but would highlight the availability of this option, at the discretion of the presiding justice. The purpose of the proposed Rule is twofold: to encourage justices of the Commercial Division to consider adopting the practice, and to remind the business community that the Commercial Division embraces innovations designed to promote the efficient and cost-effective resolution of disputes.

Undoubtedly, the Advisory Council will continue to review the needs of the Commercial Division, with the goal of maintaining its stature as the premier forum for the resolution of business-related disputes.

Endnotes

1. Rebecca C. Smithwick, Chief Judge Lippman's Vision Coming to Life— The next Installment, Com and Federal Litig. Sec. Newsl., vol. 20, no. 3 at p. 12 (Winter 2014); Rebecca C. Smithwick, *Chief Judge Lippman's Vision Coming to Life— The ~~Third~~ Fourth Installment*, Com. and Federal Litig. Sec. Newsl., vol. 22, no. 1, at p. 14 (Spring 2016).
2. All of the Rules discussed in this article may be found on the New York State Unified Court System website at http://www.nycourts.gov/RULES/comments/index.shtml.
3. N.Y. Comp. Codes R. & Regs. Tit. 22, § 202.70(g), Rule 3. (Adopted by the Chief Administrative Judge, May 26, 2016, effective 7/1/2016).
4. Memorandum of the Commercial Division Advisory Council, Dec. 1, 2015, *Proposed Rule Regarding Settlement Conferences Before a Justice Other Than the Justice Assigned to Hear the Case,* p. 4., *available at http://www.nycourts.gov/RULES/comments/PDF/Public%20 Comment-Settlement%20Conferences.pdf.*
5. 22 N.Y.C.R.R. § 202.70 (g), Rule 14-a. (Adopted by the Chief Administrative Judge on June 2, 2016, effective 7/1/2016.).
6. *Id*.
7. Memorandum of the Commercial Division Advisory Council, Dec. 8, 2015, *Proposed Rule Regarding Memorialization and Effectuation of Rulings Issued During Conferences, at p. 1. Available at http://www.nycourts.gov/RULES/comments/PDF/DisclosureConferences.pdf.*
8. Memorandum of the Commercial Division Advisory Council, Sept. 4, 2015, *New Revised Model Preliminary Conference Order Form,* p. 1. *Available at http://www.nycourts.gov/RULES/comments/PDF/PC-Form-CoverMemo.pdf.* (This rule was promulgated by the Chief Administrative Judge on June 24, 2016 and became effective August 1, 2016).
9. 22 N.Y.C.R.R. 202.70(g), Rule 11-g. (Adopted by the Chief Administrative Judge June 16, 2016, effective 7/1/2016).
10. Memorandum of the Commercial Division Advisory Council, September 10, 2015, *Revision to Standard Form Confidentiality Order For Use in Commercial Division of the Supreme Court of the State of New York,* p. 2. *Available at* https://www.nycourts.gov/rules/comments/PDF/Public%20Comment%20Confidentiality%20Order%20_1%2019%2016%20final.pdf.
11. *Id.* p. 3, et seq..
12. Memorandum of the Commercial Division Advisory Council, March 18, 2016, *Proposed Rule Regarding Direct Testimony in Non-Jury Trials by Affidavit*, p. 1. *Available at* https://www.nycourts.gov/rules/comments/PDF/ProposedCommercialDivisionRuleAffidavitSubmission.pdf.
13. *Id.* at p. 1.

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You've Got Service: Service of Process by Email and Social Media

By James Ng

> Courts, however, cannot be blind to changes and advances in technology. No longer do we live in a world where communications are conducted solely by mail carried by fast sailing clipper or steam ships. Electronic communication via satellite can and does provide instantaneous transmission of notice and information. No longer must process be mailed to a defendant's door when he can receive complete notice at an electronic terminal inside his very office, even when the door is steel and bolted shut.[1]

Introduction

As the world changes, so does the law, but always a couple steps behind. The developments of email and social media have taken a great technological leap in closing the gaps between people. Despite the widespread usage of email and social media, the law has been somewhat reluctant to recognize these methods of communication for service of process.

Under New York law, electronic service has only been recognized as an alternative method to serve process when other more traditional methods have been found by the court to be "impracticable."[2] Under federal law, electronic service on foreign defendants is permissible when the court determines that it has not been prohibited by international agreement.[3]

When permitted by the applicable procedural rules, the central consideration that courts consider is whether electronic service comports with constitutional due process—namely, whether service through email or social media is reasonably calculated to provide notice to the defendant. This article will suggest that courts have generally analyzed two factors when making this due process assessment: authenticity and reliability.

Authenticity is a concern because it is often uncertain whether the email or social media account actually belongs to the defendant. Accordingly, the authenticity factor considers whether the named account, in fact, belongs to the defendant. Even if authenticity is confirmed, reliability remains a concern because there should be a high likelihood that the defendant will receive notice and be afforded an opportunity to respond. Reliability thus evaluates the likelihood that the defendant will receive notice from the email or social media account. Ultimately, this article will discuss the various circumstances when these twin due process factors have been examined in the context of electronic service.

I. N.Y. Practice

A. CPLR 308(5)

Under New York law, electronic service stands as an alternative to general practice. CPLR 308(5) permits electronic service after the plaintiff receives court approval that the traditional methods of personal service, substitute service, and "nail and mail" service have been shown to be "impracticable." An impracticability showing often involves demonstrating that service to a last known address has been attempted or that a current address could not be ascertained despite a duly diligent search.

Thereafter, the courts utilize authenticity and reliability assessments in order to determine whether service to the email or social media account is "reasonably calculated" to provide notice. As a practical consideration, electronic service is seemingly more readily approved when locating the physical whereabouts of the defendant is difficult, if not impossible. Additionally, courts seem more willing to sanction electronic service when it is coupled with other methods such as service by mail and service by publication.

> *"When permitted by the applicable procedural rules, the central consideration that courts consider is whether electronic service comports with constitutional due process—namely, whether service through email or social media is reasonably calculated to provide notice to the defendant."*

B. Authenticity

Predictably, courts have permitted service by email where the plaintiff has demonstrated that defendant had used a particular email account for prior correspondence with the plaintiff,[4] or when the defendant had provided the particular account as a possible contact.[5] In the social media context, a plaintiff sufficiently demonstrated authenticity by submitting copies of Facebook exchanges with defendant and submitted an affidavit attesting that the photographs appearing in the exchanges were of the defendant.[6]

C. Reliability

As a clear indication of reliability that the defendant will receive the service provided to a particular account, courts have determined a high likelihood of notice where the plaintiff recently corresponded with the defendant at a particular email account.[7] Furthermore, plaintiffs have shown that defendants are regularly online at a particular account by showing recently acknowledged delivery receipts of emails.[8] With regards to social media, a court has found that submitting copies of recent Facebook exchanges between the plaintiff and the defendant successfully addressed the issue of reliability.[9]

II. Federal Practice

A. Fed. R. Civ. P. R. 4(f)(3)

Under the federal Rules, so long as it is "not prohibited by international agreement," a district court may order foreign service of process by electronic means.[10] "Service of process under Rule 4(f)(3) is neither a last resort nor extraordinary relief. It is merely one means among several which enables service of process on an international defendant."[11] "[U]nder Rule 4(f)(3), a plaintiff is not required to attempt service through the other provisions of Rule 4(f) before the [c]ourt may order service pursuant to Rule 4(f)(3)."[12] While the decision to permit foreign service of process through electronic means is left to the sound discretion of the district court, the court conducts authenticity and reliability assessments in order to ensure electronic service comports with constitutional due process.[13]

B. Authenticity

Unsurprisingly, a plaintiff showed that an email account was sufficiently authentic because the defendant had acknowledged receiving a verified complaint by email.[14] Furthermore, email accounts that were used to "correspond regularly with customers" in the course of the defendant's business that operated "extensively, if not exclusively" through the internet,[15] or used for official government communications,[16] were found to be authentic. In the social media context, a district court found the Facebook accounts sufficiently authentic where the email addresses used in the business were used to register the Facebook accounts of the individual defendants, the individual defendants listed their job titles at the defendant companies in their Facebook profiles, and the individual defendants were "friends" of each other.[17]

C. Reliability

Most directly, district courts have been more lax in finding that the reliability factor is satisfied where the defendant had received actual notice of the litigation.[18] Furthermore, a district court found that there was a high likelihood that defendants would receive sufficient notice at a particular email address after they had sent messages to the court from the particular account on multiple occasions.[19] Reliability was also satisfied when the plaintiff showed that a defendant foundation representative promptly responded to an email within two months of a request for electronic service of process.[20]

III. Conclusion

While email and social media are new to the public conscience, electronic service of process will surely find a more prominent place as an alternative method of service. In the modern era of quickly dissolving physical borders and rapidly forming bridges of digital communication, courts will progressively recognize that email and social media comport with constitutional requirements as citizens become more susceptible to electronic notice. Until a mechanism for definitively gauging the likelihood the recipient defendant will receive electronic notice, courts will continue to balance the factors of authenticity and reliability in order to preserve the enduring principle of constitutional due process in this changing nation.

Endnotes

1. *New England Merchants Nat'l Bank v. Iran Power Generation & Transmission Co.*, 495 F. Supp. 73, 81 (S.D.N.Y. 1980).
2. N.Y. Civil Practice Law and Rules § 308(5) (CPLR).
3. Federal Rules of Civil Procedure Rule 4(f)(3) (Fed. R. Civ. P.).
4. *Hollow v. Hollow*, 193 Misc. 2d 691, 692, 747 N.Y.S.2d 704, 705 (Sup. Ct. 2002).
5. *See Snyder v. Energy Inc.*, 19 Misc. 3d 954, 958, 857 N.Y.S.2d 442, 445 (Civ. Ct. 2008).
6. *Baidoo v. Blood-Dzraku*, 48 Misc. 3d 309, 314-315, 5 N.Y.S.3d 709, 714 (Sup. Ct. 2015).
7. *Snyder*, 19 Misc. 3d at 957-958.
8. *Id.*; *Safadjou v. Mohammadi*, 105 A.D.3d 1423, 1425, 964 N.Y.S.2d 801, 803-804 (4th Dep't 2013).
9. *Baidoo*, 48 Misc. 3d at 315.
10. *See* Fed. R. Civ. P. R. 4(f)(3).
11. *AMTO, LLC v. Bedford Asset Mgmt., LLC*, 2015 U.S. Dist. LEXIS 70577, at *11-*12 (S.D.N.Y. June 1, 2015) (quoting *In re GLG Life Tech Corp. Sec. Litig.*, 287 F.R.D. 262, 265 (S.D.N.Y. 2012) (internal citations omitted)).
12. *Id.*, at *12 (*Stream SICAV v. Wang*, 989 F. Supp. 2d 264, 278 (S.D.N.Y. 2013) (alteration and internal quotation marks omitted)).
13. *See id.*, at *11-*12.
14. *Enovative Techs., LLC v. Leor*, 2014 U.S. Dist. LEXIS 178442, at *1 (S.D.N.Y. Dec. 24, 2014).
15. *Philip Morris USA Inc. v. Veles Ltd.*, 2007 U.S. Dist. LEXIS 19780, at *9 (S.D.N.Y. Mar. 13, 2007); *see also Sulzer Mixpac AG v. Medenstar Indus. Co.*, 2015 U.S. Dist. LEXIS 159762 (S.D.N.Y. Nov. 27, 2015) (find the defendant's email address reliable because it had been used "at least partially" to conduct overseas business); *AMTO, LLC*, 2015 U.S. Dist. LEXIS 70577, at *25 (finding the defendant's email address reliable because it was used for "business purposes"). *Cf. Nykcool A.B. v. Pac. Int'l Servs.*, 66 F. Supp. 3d 385, 391-392 (S.D.N.Y. 2014) (finding insufficient reliability because there was no evidence that the defendant used the email address for "business purposes or otherwise").
16. *Gurung v. Malhotra*, 279 F.R.D. 215, 220 (S.D.N.Y. 2011).
17. *See FTC v. PCCare247 Inc.*, 2013 U.S. Dist. LEXIS 31969, at *16 (S.D.N.Y. Mar. 7, 2013).
18. *See Gurung*, 279 F.R.D. at 220.
19. *Id.*, at *13-*15.
20. *Fisher v. Petr Konchalovsky Found.*, 2016 U.S. Dist. LEXIS 31014, at *6 (Mar. 10, 2016).

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Attorneys' Eyes Only? Confidential? Really?

Reducing Logistical Headaches in Confidentiality Agreements

By John M. O'Connor, Carrie Maylor DiCanio, and Jorge R. Aviles

I. Introduction

Business litigation these days frequently involves the production of voluminous documents in discovery. At the same time, clients may want their documents to be held confidential and to limit the persons who can examine them. The solution is usually for the parties to make the document production and related discovery subject to a Confidentiality Agreement.

Given the time pressures inherent in meeting discovery deadlines, and the prodigious number of documents to be reviewed and produced, counsel may adopt a Confidentiality Agreement that has been used before and a "let's worry about that later" approach when it comes to identifying specific documents that will be subject to the agreement.

However, kicking the can down the road in this fashion can lead to trouble later on. Two items that are problematic are "attorneys' eyes only" provisions and attempts to require that documents filed in court be sealed.

II. What About the Client?

"Attorneys' eyes only" provisions generally prohibit documents so designated from being disclosed to anyone other than the attorneys litigating the matter, including prohibiting disclosure to the client. Yet, many attorneys are not aware that such provisions may run afoul of two important and related principles:

1. A client is entitled to participate meaningfully in litigation in which it is involved,; and;
2. Outside counsel has an ethical obligation to inform the client of information obtained in the litigation so that the client can make informed decisions.

For these reasons, case law, both state and federal, and the New York Rules of Professional Conduct effectively counsel that "attorneys' eyes only" provisions must be strictly limited to trade secrets or information that is akin to a trade secret in that it would provide competitors with an advantage.

A. New York Law

In *Gryphon Domestic VI, LLC v. APP Int'l Fin Co., B.V.*, the New York Appellate Division held that documents should not be designated "attorneys' eyes only" when such a designation "prevents counsel from fully discussing with their clients all of the relevant information in the case so as to properly formulate a defense to the action against them."[1] In so holding, the First Department also pointed out that the defendants in the *Gryphon* case were not business competitors of the plaintiffs; instead, the parties were simply adversaries in litigation. Claims of "prejudice" in litigation, not involving trade secrets, do not justify marking documents "attorneys' eyes only."[2]

Similarly, the New York Rules of Professional Conduct compel lawyers to keep their clients informed to an extent that would violate most "attorneys' eyes only" provisions. Specifically, Rule 1.4(b) requires counsel to "explain a matter to the extent reasonably necessary to permit the client to make informed decisions regarding the representation."[3] The rules also require a lawyer to "reasonably consult with the client about the means by which the client's objectives are to be accomplished," to "keep the client reasonably informed about the status of the matter," and "promptly comply with a client's reasonable requests for information."[4] If an "attorneys' eyes only" provision prohibits counsel from consulting with in-house counsel or business principals concerning certain documents or information obtained in discovery, complying with that provision could result in a violation of the New York Rules of Professional Conduct.[5]

B. Federal Law

Courts within the Second Circuit have also held that "attorneys' eyes only" designations should be used "as sparingly as possible."[6] The information must be of a type, the disclosure of which would "work a clearly defined and very serious injury" to the party seeking to protect such information, for example, the revelation of trade secrets.[7] As do the New York cases, federal cases stress that "attorneys' eyes only" designations are meant to shield information from parties that are competitors within an industry.

III. What About the Public?

Provisions that require the sealing of "confidential" documents that are submitted in court are also problematic.

A. New York Law

The Appellate Division has held that there is a strong public interest, grounded in both constitutional and common law, in providing the public with access to documents and information that a court may use to render a decision.[8] In light of the "broad constitutional presumption" arising from the First and Sixth Amendments, "any order denying access must be narrowly tailored to serve compelling objectives, such as a need for secrecy that outweighs the public's right to access."[9] The right of the public to access is also recognized in common law principles, which have "long recognized that civil actions and proceedings should be open to the public in order to ensure that they are conducted efficiently, honestly, and fairly."[10]

Accordingly, rules in New York prohibit sealing of court records "except upon a written finding of good cause" that must specify the grounds for the sealing and must "consider the interests of the public as well as of the parties."[11] Even where the litigants agree to sealing, the strong public interest in the transparency of judicial proceedings may override their agreement.

B. Federal Law

Federal cases have also stated a strong common-law interest of the public in access to court proceedings. In *United States v. Amodeo*, the Second Circuit held that this public interest in access to information produced in litigation should be analyzed on a sliding scale.[12]

> In determining the weight to be given to public access, the Court in *Amodeo* suggested ranking the documents along a continuum ranging from those at the heart of the judicial process to those with little or no relationship to that process. Thus, it noted that the public has an "especially strong" interest in access to materials received in evidence at trial [citations omitted] and that any materials that informed the basis for a court's adjudication—even if on motion—should also be accessible absent "exceptional circumstances."[13]

At the other end of the *Amodeo* continuum are documents that have been produced in litigation but have not been submitted to the court on motions or presented as evidence at trial. The public interest in access to these documents produced privately in litigation is limited, "although most courts have held that the producing party still has the burden of demonstrating good cause for preventing public access to discovery materials."[14] In the middle of the continuum are documents filed with the court but that did not form the basis of the court's adjudication. As to these documents, the weight to be afforded the public's right to access is "determined by the exercise of judgment," taking into consideration whether such documents have generally been subject to public access.[15]

The classic situation in which there might be "good cause" for sealing would be a document containing a true trade secret, perhaps a patented manufacturing formula. In contrast, a claim of "prejudice" in the litigation is not sufficient, especially where the opposing party is not a business competitor but is only a garden-variety adverse party.[16]

IV. The Commercial Division and the New York City Bar Association Model Confidentiality Agreements

As mentioned above, both the Commercial Division of the New York State Supreme Court and the New York City Bar Association ("NYCBA") websites provide model Confidentiality Agreements.

Where a Confidentiality Agreement is warranted, the Commercial Division rules require the parties to use the model form that is contained in Exhibit B to the rules.[17] If the parties wish to deviate from the form in Exhibit B, they must submit a "red-line" of the proposed changes and a written explanation of why the deviations are warranted.

The model agreement appearing on the website of the NYCBA is endorsed by the NYCBA Committee on State Courts of Superior Jurisdiction ("Committee"). The introduction to the NYCBA model agreement states that the Committee specifically decided not to include an "attorneys' eyes only" provision out of concern that it would be invoked far more than necessary and would lead to inevitable disputes. The Committee encouraged counsel to use its model agreement, to modify the model agreement to accommodate the needs of each case, and to inform the Court that the parties are using the NYCBA model.

The Commercial Division's model Confidentiality Agreement and that of the NYCBA are very similar.[18] Among the differences are that the Commercial Division model agreement recognizes that: (1) non-parties may produce documents or information that they wish to designate confidential; and (2) non-parties may subpoena confidential information that is in the possession of a party. In each case, the model agreement includes provisions addressing these situations.[19] The Commercial Division model agreement also explicitly recognizes the prevailing law that the burden of establishing the propriety of a "confidential" designation remains with the Producing Party.

The basic structure of each model Confidentiality Agreement is the same, and, for simplicity, this article refers to the Commercial Division model agreement ("Agreement"). The Agreement defines "Confidential Information," the "Producing Party," and the "Receiving Party." Either party (or a non-party) may designate documents to be produced as "confidential"—for example, by stamping that legend on the document. Information subject to the Agreement may only be used in the litigation in which it is produced. The Receiving Party has the right to challenge the "confidential" designation at any time. If the Producing Party does not agree to declassify, the Receiving Party may move before the Court for an order declassifying the documents. The burden is always on the Producing Party to establish the propriety of its designations. The documents remain "confidential" unless and until the Court rules otherwise. The model

Agreement also contains provisions as to who may have access to the "confidential" information and how deposition transcripts or portions of deposition transcripts may be marked "confidential." Documents marked "confidential" may be used at depositions, subject to the other provisions of the Agreement designed to limit access.

A party that wishes to file with the court documents or transcripts that have been designated "confidential" must follow the procedures stated in the Agreement. Where there is electronic filing, a redacted version of the submission is electronically filed. A complete and unredacted version is provided to the other parties and the court. If the Producing Party does not move to seal within seven days of the electronic filing, the party that filed must replace the redacted version previously filed with an unredacted version. If a motion to seal is made, the information remains "confidential" until the court renders a decision. If a motion to seal is granted, there are detailed procedures for filing in court the unredacted versions of the submissions.

Where there is no electronic filing, the party filing serves upon the other parties, and transmits to chambers, both a redacted and unredacted version of the submission. A redacted version is filed with the court. The Producing Party then has three days to move to seal the documents or information designated "confidential."[20] As with electronic filings, if no motion is made, the filing party must file an unredacted submission, and if a motion is made, the information remains "confidential" until the court renders a decision. If a motion to seal is granted, the detailed procedures for filing submissions under seal must be followed.

Memoranda of law or other filings that contain references to confidential information are also subject to the redaction and sealing requirements.

V. Confidentiality and the Stages of Litigation

The need to enter into a Confidentiality Agreement usually arises initially in connection with document production. Especially where voluminous documents are being produced by category, it is possible that neither counsel nor the client is entirely sure of the extent of the information contained in the documents at the time they are being produced. They therefore welcome a Confidentiality Agreement that would limit the access to the documents—and the course of least resistance at this stage will likely result in an overuse of the "confidential" designation. Rather than examining the content of each document to determine whether it truly is confidential, it is much less time consuming, and also less expensive, to stamp all, or nearly all, of the documents produced "confidential." At this stage of the litigation, document production, this over-designation is not likely to cause significant problems.

However, as the litigation progresses and documents are identified for use in depositions and in motions, the prior overuse of the "confidential" stamp becomes troublesome. If the "confidential" designation remains, papers that contain confidential information and are submitted in support of a motion will have to be redacted or filed under seal, and pages of deposition transcripts where confidential documents are discussed would have to be marked "confidential" as well. The resulting logistical headaches will prompt counsel to consider taking steps to de-designate those documents that do not fit the criteria in the Confidentiality Agreement or do not match the criteria set out by the courts for the filing of documents under seal.

> *"Agreements such as the models offered by the Commercial Division and the NYCBA generally place the burden of moving for a de-designation of documents upon the party that seeks the de-designation."*

Agreements such as the models offered by the Commercial Division and the NYCBA generally place the burden of moving for a de-designation of documents upon the party that seeks the de-designation.[21] The documents retain their "confidential" status pending the court's ruling on the motion to de-designate. So, if the Producing Party decides not to do a document-by-document review and instead stamps nearly all of the documents it produces "confidential," it is the Receiving Party that must go to the trouble of preparing a motion to correct the over-designation. This arrangement would seem to reward and encourage the initial over-designation. There is little to lose in over-designating—the opposing party may not go to the trouble of making a motion, and even if the motion succeeds, the Producing Party is merely back where it started from—it has simply produced a document that is not confidential.

Of course, if the party that initially stamped the documents "confidential" would agree to the de-designation, it would save the time all counsel would otherwise devote to the motion, as well as saving the court's time in examining the documents and rendering a determination.

VI. Possible Modifications to Standard Confidentiality Agreements[22]

The various incentives and disincentives present in this situation suggest that it might be useful to consider at the outset placing in the Confidentiality Agreement a provision that would award attorneys' fees to the party prevailing on a motion to de-designate documents or on a motion for an order to seal documents. This would presumably compel a party that originally over-designated to take a hard look at its use of the "confidential" stamp on the documents at issue. It would also suggest that the moving party proceed with caution. In short, a provision for an award of attorneys' fees to the prevailing party on motion to de-designate would require both counsel and the client to give individualized and careful attention to each document that is challenged—which would provide a counterweight to the earlier tendency to take the expedient route and over-designate.[23]

While over-designation may not cause significant practical problems at the early, document-production stage, the same is not true at the deposition and motion stage. It may be that confidential documents that are used at depositions should be automatically de-designated within a specified time after the deposition unless the Producing Party affirmatively confirms the "confidential" designation. Documents that have been identified for use at deposition presumably are more likely to have a greater relevance to the issues in the litigation and it does not seem unreasonable to require the Producing party to make an individualized determination with respect to these documents.

VII. Court-Imposed Attorneys' Fees

Courts have sometimes imposed sanctions and awarded attorneys' fees following discovery disputes on issues related to the over-designation of documents under a Confidentiality Agreement. For example, in Broadspring, Inc. v. Congoo, the Confidentiality Agreement provided that "designations that are shown to be clearly unjustified" may "expose the Designating Party to sanctions." Relying on both Federal Rule of Civil Procedure 37 and a provision in the parties' Confidentiality Agreement, the Southern District imposed sanctions due to the defendants' "abuse of the AEO [attorney's eyes only] designation throughout the discovery process" because disclosure of the information at issue would not create a "substantial risk of serious injury that could not be avoided by less restrictive means."[24]

VIII. Conclusion

Model Confidentiality Agreements are available and on the website of the New York City Bar Association and in the rules of the Commercial Division of the New York Supreme Court. Neither model agreement includes an "attorneys' eyes only" provision and in most commercial cases such designations are probably unwarranted. The New York Rules of Professional Conduct militate against the use of such provisions in that the rules require counsel to keep clients informed of information obtained in litigation so that the client can exercise its right to make informed litigation decisions.

While it may seem convenient in the midst of document production to sign off on a Confidentiality Agreement and worry about the ramifications later, some provisions may warrant more immediate scrutiny and analysis so as to avoid significant problems down the road when documents designated "confidential" are used at depositions and in support of motions.

To address the problem of over-designation of documents as "confidential," counsel may wish to consider modifying the model agreements to provide: (1) that attorneys' fees will be awarded to the prevailing party on any motion involving a court determination as to whether documents have been properly designated; and (2) that confidential documents used at a deposition will automatically lose their "confidential" designation unless that designation is confirmed by the Producing Party within a specified time.

In commercial cases, designating as "confidential" a document that will be filed or presented in court should be limited to those situations, such as trade secrets, in which sealed filings are actually warranted. In other situations, the public interest in access to the workings of the judicial system will likely trump a party's interest in sealing court records in order to keep information private.

Endnotes

1. 28 A.D.3d 322, 326, 814 N.Y.S.2d 110, 114 (1st Dept. 2006); see *TC Ravenswood, LLC v. National Union Ins. Co.*, No. 400759- 2011, 2015 N.Y. Misc. LEXIS 4940, at *10 (Sup. Ct., N.Y. Co. June 10, 2015) (parties were not competitors; alleged harm in other litigation insufficient).
2. *Gryphon*, 28 A.D.3d at 326, 814 N.Y.S.2d at 114.
3. N.Y. Comp. Codes R. & Regs. tit. 22, §1200 (N.Y.C.R.R.) rule 1.4(b).
4. *Id.* at rule 1.4(a)(2-4).
5. Both the Rules of the Commercial Division of the New York State Supreme Court and the website of the New York City Bar Association provide model Confidentiality Agreements. Neither model agreement contains an "attorneys' eyes only" provision. However, as discussed below, both contain "sealing" provisions that can create both logistical and legal complications down the road. The model Confidentiality Agreement contained in the Commercial Division Rules is available at http://www.nycourts.gov/rules/trialcourts/202.70(g)%20-%20Rule%2011-g%20(attachment).pdf. The NYCBA model agreement is available at http://www.nycbar.org/pdf/report/ModelConfidentiality.pdf.
6. *Fendi Adele S.R.L. v. Burlington Coat Factory Warehouse Corp.*, No. 06 CIV 0085, 2006 U.S. Dist. LEXIS 89546, at *6 (S.D.N.Y. Dec. 5, 2006).
7. *HSqd, LLC v. Morinville*, No. 3:11CV1225, 2013 U.S. Dist. LEXIS 37356, at *6 (D. Conn. Mar. 18, 2013); *Renaissance Nutrition, Inc. v. Jarrett*, 747 F. Supp. 2d 374, 380 (W.D.N.Y. 2010).
8. *Danco Lab., Ltd. v. Chemical Works of Gedeon Richter, Ltd.*, 711 N.Y.S.2d 419, 423 (1st Dept. 2000).
9. *Gryphon Domestic VI, LLC v. APP Int'l Fin. Co., B.V.*, 28 A.D.3d 322, 324, 814 N.Y.S.2d 110, 112-113 (1st Dept. 2006).
10. *In re Conservatorship of Brownstone*, 594 N.Y.S.2d 31, 32 (1st Dept. 1993).
11. 22 N.Y.C.R.R. § 216.1.
12. 71 F. 3d 1044 (2d Cir. 1995).

13. *Byrnes v. Empire Blue Cross Blue Shield*, No. 98 Civ. 8520, 2000 U.S. Dist. LEXIS 702, at *8 (S.D.N.Y. Jan. 24, 2000). The *Byrnes* decision by Magistrate Michael Dolinger contains a clear and succinct summary of the federal law in the Second Circuit.
14. *Id.* at *4.
15. *Amodeo*, 71 F. 3d at 1050; *Byrnes*, 2000 U.S. Dist. LEXIS 702 at *9.
16. See Fed. R. Civ. P. 26(c)(G); *United States v. International Business Machines Corp.*, 67 F.R.D. 40 (S.D.N.Y. 1975); *Gryphon Domestic VI, LLC v. APP Int'l Fin. Co., B.V.,* 814 N.Y.S.2d 110 (1st Dept. 2006); *TC Ravenswood, LLC v. National Union Ins. Co.,* No. 400759- 2011, 2015 N.Y. Misc. LEXIS 4940, at *8 (Sup. Ct., N.Y. Co. June 10, 2015); *Mosallem v. Berenson*, 905 N.Y.S.2d 575 (1st Dept. 2010); *Mancheski v. Gabelli Group Capital Partners,* 835 N.Y.S.2d 595 (2d Dept. 2007).
17. See 22 N.Y.C.R.R. § 202.70 at rule 11(g).
18. It appears that the Commercial Division's model agreement is based upon an editing of the NYCBA model agreement, or perhaps they both are based upon the same source document.
19. The Commercial Division's model agreement also separately addresses procedures in counties with electronic filing and in counties without electronic filing and includes additional clarifying language as well as details of procedures.
20. No explanation is given as to why the Producing Party has seven days to move to seal in counties that have electronic filing, but only has three days in counties that do not have electronic filing. Both the seven and three day periods would appear to be unrealistic and to prompt requests for additional time.
21. Where documents are filed in unredacted form, the burden of moving for a sealing order is upon the Producing Party, the party seeking to retain the "Confidential" designation.
22. 22 N.Y.C.R.R. § 202.70 at rule 11(g) (the parties must submit a "red-line" of any changes proposed to the model Agreement that is contained in the Rules and a written explanation as to why the change is warranted).
23. It might be that each side prevails as to certain documents and that the Court would decide if there is an overall prevailing party.
24. *Broadspring, Inc. v. Congoo, LLC,* No. 13-CV-1866, 2014 U.S. Dist. LEXIS 116070, at *54, *56 (S.D.N.Y. Aug. 20, 2014). In *ULLICO Inc. Litig.*, 237 F.R.D. 314, 317-19 (D.D.C. 2006), the United States District Court for the District of Columbia awarded expenses and fees in connection with a successful motion challenging the over-designation of documents as "Confidential."

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Protecting Confidentiality When Compelled to Provide Discovery to Foreign Litigants Pursuant to 28 U.S.C. § 1782

By Matthew Katz, Francesca Dickson, Jonathan Hochman, Michael Mietlicki

I. Introduction

28 U.S.C. § 1782 provides foreign litigants a powerful means of obtaining discovery from third parties found in the United States for use in a foreign litigation, and is becoming an increasingly utilized federal statute. While the federal courts have articulated standards for petitions under the statute, § 1782 remains broad in scope and is, on its face, primarily a unilateral discovery mechanism.[1] The obvious byproduct of this discovery statute, and court interpretations of it, is that non-parties that are "found within the district" are exposed to discovery obligations and costs in a litigation in which they are otherwise not involved. However, an often overlooked, but no less significant, issue engendered by the statute is the potential exposure of parties' confidential or sensitive information. Because the statute provides a venue for foreign litigants to obtain discovery without reciprocal enforcement mechanisms to protect the confidential information, targets of § 1782 applications risk disclosure of the confidential information abroad.

This article discusses the means of protecting the confidential materials that are subject to discovery in response to a § 1782 application and the inherent weaknesses in those methods. In particular, this article highlights the pitfalls of relying on the most recognized method—confidentiality agreements. Indeed, in some instances entering into a confidentiality agreement in connection with discovery under the statute may be futile because it may be impossible to enforce. Specifically, the § 1782 target may have little ability to enforce a confidentiality agreement effectively in situations where the applicant is not subject to U.S. jurisdiction. If the foreign applicant is not otherwise located in the United States and has no assets here, a court order—be it an injunction, contempt or sanctions—could have little practical effect on the foreign applicant once he has obtained the sought-for discovery, even if the foreign applicant voluntarily (or as a condition precedent imposed by the court) subjects himself to a district court's jurisdiction with respect to enforcement of a confidentiality agreement and order.

II. Background of 28 U.S.C. § 1782

The key text of § 1782 provides:

> The district court of the district in which a person resides or is found may order him to give his testimony or statement or to produce a document or other thing for use in a proceeding in a foreign or international tribunal, including criminal investigations conducted before formal accusation . . . . To the extent that the order does not prescribe otherwise, the testimony or statement shall be taken, and the document or other thing produced, in accordance with the Federal Rules of Civil Procedure.
>
> A person may not be compelled to give his testimony or statement or to produce a document or other thing in violation of any legally applicable privilege.[2]

By its terms, the statute is broad in scope, and courts have liberally interpreted it, following Congress's lead.[3] Federal jurisprudence has identified three fairly low barriers to granting § 1782 applications:

> (1) [T]he person from whom discovery is sought resides (or is found) in the district of the district court to which the application is made, (2) the discovery is for use in a foreign proceeding before a foreign tribunal, and (3) the application is made by a foreign or international tribunal or any interested person.[4]

These prerequisites have enabled applicants to obtain discovery under § 1782 for use in foreign proceedings in a variety of forums and jurisdictions—even those lacking any American-style pretrial discovery mechanisms or procedures.[5] Historically, courts have permitted discovery for virtually any type of "proceeding in which an adjudicative function is being exercised."[6] However, following the Supreme Court's decision in Intel, some courts have narrowed the application of § 1782, refusing to grant § 1782 applications for use of discovery in foreign private arbitrations or other forums that are not subject to judicial review.[7]

III. Means of Limiting Disclosure and Protecting Confidential Materials

While the text and judicial interpretation suggest a virtually limitless statute, the target of a § 1782 application has a variety of means to either avoid disclosure altogether or to limit the scope of its discovery obligations.

A. The *Intel* Discretionary Factors Govern § 1782 Applications

First, in *Intel Corp. v. Advanced Micro Devices, Inc.*,[8] the Supreme Court identified four discretionary factors for the district courts to consider in evaluating a § 1782 application:

> (1) Whether the documents or testimony sought are within the foreign tribunal's

> jurisdictional reach, and thus accessible absent § 1782 aid;
>
> (2) The nature of the foreign tribunal, the character of the proceedings underway abroad, and the receptivity of the foreign government or the court or agency abroad to U.S. federal-court judicial assistance;
>
> (3) Whether the § 1782 request conceals a [*sic*] attempt to circumvent foreign proof-gathering restrictions or other policies of a foreign country or the United States; and
>
> (4) Whether the subpoena contains unduly intrusive or burdensome requests.[9]

Courts have often addressed confidentiality concerns under the fourth discretionary factor. These courts have reasoned that the lack of control over the confidential information, which may ultimately lead to the public disclosure of the information, amounts to an unduly intrusive or burdensome request under the section.[10] For example, in *In re Cathode Ray Tube (CRT) Antitrust Litigation*,[11] the district court specifically analyzed the risks of disclosure of confidential information. The defendants in the foreign litigation were a group of electronic companies and the § 1782 target was a law firm that was representing the defendants in a related domestic action. The plaintiff sought *all* of the non-party law firm's documents related to the domestic litigation, and the defendants in the foreign litigation would have no opportunity to review the documents and object to any that contained confidential information. After considering the *Intel* factors, the court denied the § 1782 application, finding it unduly intrusive without any protections for confidential documents because "confidential documents, which are now protected by an order of this court, could become exposed and not protected [abroad], and might become available for public use in business matters."[12]

B. Quashing a § 1782 Subpoena Pursuant to the Federal Rules of Civil Procedure

The protections from discovery that are available under the Federal Rules of Civil Procedure are also available to § 1782 targets. Section 1782 specifically references the Federal Rules: "To the extent that the order does not prescribe otherwise, . . . the document [shall be] produced, in accordance with the Federal Rules of Civil Procedure."[13] Courts have interpreted § 1782's reference to the FRCP to denote that those rules should apply to discovery pursuant to a § 1782 application.[14] Accordingly, a respondent may move to quash a subpoena issued in connection with a § 1782 application if compliance would require "disclosing a trade secret or other confidential research, development, or commercial information."[15] Indeed, some courts have barred discovery under the statute because confidential materials are sought.[16] The general rule, however, absent highly sensitive trade secrets or confidential information, is to permit discovery as fully as the Federal Rules of Civil Procedure allow.[17]

C. Obtaining a Protective Order or Confidentiality Agreement

The Federal Rules of Civil Procedure permit a court to condition discovery upon the entry of a protective order pursuant to Federal Rule of Civil Procedure 26(c):

> A party or any person from whom discovery is sought may move for a protective order in the court. . . .The court may, for good cause, issue an order to protect a party. . .including. . .requiring that a trade secret or other confidential research, development, or commercial information not be revealed or be revealed only in a specified way.[18]

Thus, in response to a § 1782 application, the U.S. court could issue a protective order, which would be enforceable against the parties subject to the court's jurisdiction. As discussed below, however, this may leave the disclosing party without a suitable remedy in the event of a breach of the confidentiality order if the § 1782 applicant has no significant presence in the U.S.

D. Foreign Protective Orders May Be Available to Protect the Confidentiality of a § 1782 Target's Documents and Information

Federal Rule of Civil Procedure 26(c) also permits "a protective order *in the court where the action is pending*" (emphasis added).[19] Accordingly, the discovery target could request that the district court enter an order predicating disclosure in the U.S. on the issuance of a protective order from the foreign tribunal. A protective order issued by the court where the applicant is a litigant avoids jurisdictional enforcement problems; but, apparently, courts have not frequently adopted this approach.

This was, however, the approach taken by the District Court in *Siemens AG v. W. Digital Corp*.[20] There, the Plaintiff applied for § 1782 discovery in the U.S. in connection with a patent infringement suit it initiated in Germany.[21] The Court permitted discovery of the relevant documents, but conditioned its order on a requirement that both parties jointly seek a protective order in the foreign proceeding.[22]

Because the discovery target in the *Siemens* § 1782 application was also the defendant in the underlying action in Germany, it had standing to seek a protective order in the foreign proceeding. Note, however, that if the target of a § 1782 application were not a party in the foreign tribunal, it might not have standing to move for a protective order in the foreign court, nor would it have control over the foreign party's petition for the protective order.[23]

IV. Considerations When Entering Into Confidentiality Agreements in Connection With § 1782 Applications

A. The Pitfalls Inherent in the Enforcement of Confidentiality Agreements Entered Into in Connection with § 1782 Applications

The most common method for a target of a § 1782 application to protect its confidential documents and information is to enter into a confidentiality agreement with the applicant party. In typical U.S. discovery, confidentiality agreements can be effectively enforced because the agreement is so ordered by the court and therefore has the weight of a court order. Further, where the discovery is sought from a party to the action, and the parties enter into a confidentiality agreement, both parties will have a mutual interest in adhering to its terms: violating or disregarding the terms of a confidentiality agreement may lead the opposing party to respond in kind. Enforcement mechanisms are also available whether the discovery is sought from a party or a non-party, as the court will at least have jurisdiction over the party seeking discovery. Therefore, the court will have authority to enforce a confidentiality agreement and may impose sanctions, hold parties in contempt of court, or issue an injunction based on a party's failure to adhere to the agreement.

However, § 1782 poses at least two challenges with respect to the entry and enforcement of confidentiality agreements. First, discovery under § 1782 is generally not bilateral, and the American discovery target will generally have no need for reciprocal discovery from the applicant.[24] Thus, threats of reciprocated disclosure do not exist.

Additionally, the second and more troubling issue presented by the disclosure of confidential or sensitive information pursuant to a § 1782 application arises in the circumstances where the applicant is strictly a foreign entity and not otherwise subject to U.S. jurisdiction. This is the case where the foreign applicant does not reside in the U.S., does not do business in the U.S., does not have any financial holdings or other property in the U.S., and (apart from the application itself) does not have other ties to the U.S. Enforcement of a confidentiality agreement in these circumstances can prove difficult, prohibitively expensive, time-consuming, or even impossible. Even where a disclosing party obtains an order from the district court enjoining disclosure or requiring the return of certain documents, it may be left without any easy enforcement mechanism to ensure compliance.

The difficulties of enforcing a confidentiality agreement against a foreign applicant are best demonstrated by considering the enforcement options available against a domestic applicant. Where the applicant is subject to U.S. jurisdiction, the disclosing party in a § 1782 petition will be able to seek and obtain injunctive relief or court sanctions. Likewise, the confidentiality agreement can provide for liquidated damages, which can be enforced in U.S. courts.[25]

If, however, the applicant has no presence or assets in the United States, any judgment against it for disclosing information subject to the confidentiality agreement would be essentially unenforceable. If a domestic court ultimately finds that it does have jurisdiction over the foreign applicant because of the party's local presence as a § 1782 applicant and finds that the party breached the confidentiality agreement, there is no guarantee that the disclosing party will be able to enforce any judgment obtained. Without property or presence in the jurisdiction, the aggrieved domestic disclosing party may find itself without recourse. There is no international treaty requiring foreign courts to enforce U.S. judgments.[26] Therefore, the recognition of a judgment will depend upon the rules regarding the recognition of judgments in the country in which recognition is sought.

B. Approaches to Confidentiality Agreements in Connection with § 1782 Disclosure

First, as mentioned above, when confidential information is disclosed, the § 1782 target may attempt to obtain a judgment domestically and enforce it abroad. The costs of doing so may be significant. Furthermore, the feasibility of obtaining foreign recognition of the judgment varies by jurisdiction.

As an alternative, the discovery target and the § 1782 applicant could enter into a confidentiality agreement enforceable in the jurisdiction where the foreign applicant is located and/or has assets. Doing so may lower the costs of enforcement because of the breaching party's presence in that jurisdiction. However, this solution also has its drawbacks: the costs of contracting could be significantly higher for the discovery target—particularly if that party has no presence in the foreign jurisdiction and is required to hire foreign counsel. Additionally, the disclosing party would bear the potentially significant expense of enforcing the contract in the foreign jurisdiction in the event of a breach.

Finally, one creative solution to ensure a foreign applicant's compliance with a domestic confidentiality agreement would be to require the § 1782 applicant to post a bond or place a sum of money in an escrow account to be returned once the materials obtained pursuant to a § 1782 subpoena are certified destroyed and there has been no disclosure of confidential materials. The authors are unaware of any circumstances requiring security of this sort, but it could provide a cost-effective means of ensuring compliance with a confidentiality agreement.

V. Conclusion

Section 1782 gives parties in foreign litigation a powerful discovery tool to obtain documents and information from persons and entities located in the U.S. Because of the broad scope and application of the statute, domestic targets of a § 1782 application have somewhat limited means of protecting the confidentiality of discovered materials. As outlined above, however, there remain several means that a disclosing party can use to protect confidential information disclosed under the statute. But disclosing entities must still be aware that determining the effectiveness of any confidentiality agreement or protective order requires a careful analysis of the § 1782 applicant's presence in the U.S. and the ability to enforce a breach of the agreement or order against the applicant.

Endnotes

1. Courts have, in many cases, permitted discovery pursuant to the statute only upon the bilateral exchange of discovery. *See, e.g., Intel Corp. v. Advanced Micro Devices, Inc.*, 542 U.S. 241, 262, 124 S. Ct. 2466, 2482, 159 L. Ed. 2d 355 (2004) (stating that "[w]hen information is sought by an 'interested person,' a district court could condition relief upon that person's reciprocal exchange of information"); *In re Esses*, 101 F.3d 873, 876 (2d Cir. 1996) (upholding the district court's decision to condition its order granting discovery under § 1782 upon a reciprocal exchange of discovery between the parties); *Minatec Fin. S.A.R.L. v. SI Grp., Inc.*, No. 08 Civ. 269, 2008 WL 3884374, at *9 (N.D.N.Y. Aug. 18, 2008) ("Consistently, the Second Circuit and the Supreme court, have suggested that a district court could condition relief under [§ 1782] upon a reciprocal exchange of information, as such would lend parity to the disclosure mix.") Nevertheless, bilateral discovery is not the *sine qua non* of § 1782.
2. 28 U.S.C. § 1782.
3. *See In re Edelman*, 295 F.3d 171, 180 (2d Cir. 2002) ("Congress has expressed as its aim that the statute be interpreted broadly"); *Euromepa S.A. v. R. Esmerian, Inc.*, 51 F.3d 1095, 1102 (2d Cir. 1995) (§ 1782's "underlying policy should generally prompt district courts to provide some form of discovery assistance"); *In re Clerici*, 481 F.2d 1324, 1331 (11th Cir. 2007) (quoting *U.K. v. U.S.*, 238 F.3d 1312, 1319 (11th Cir. 2001)) ("Congress has given the district courts such broad discretion in granting judicial assistance to foreign countries.").
4. *Brandi-Dohrn v. IKB Deutsche Industriebank AG*, 673 F.3d 76, 80 (2d Cir. 2012); *Application of Consorcio Ecuatoriano de Telecomunicaciones S.A. v. JAS Forwarding (USA), Inc.*, 747 F.3d 1262, 1269 (11th Cir. 2014) (recognizing that the text of § 1782 also includes a fourth requirement, that "the request must seek evidence, whether it be the 'testimony or statement' of a person or the production of 'a document or other thing'").
5. *Intel*, 542 U.S. at 262 n.12 ("The drafters [of § 1782] were quite aware of the circumstance that civil law systems generally do not have American type pretrial discovery" (internal citation omitted).); *In re Application for an Order Permitting Metallgesellschaft AG to Take Discovery*, 121 F.3d at 79 ("We have rejected any requirement that evidence sought in the United States pursuant to § 1782(a) be discoverable under the laws of the foreign country that is the locus of the underlying proceeding."); *In re Application Pursuant to 28 U.S.C. § 1782 for an Order Permitting Christen Sveaas To Take Discovery From Dominique Levy, L & M Galleries And Other Non-Participants For Use In Actions Pending In The Norway*, 249 F.R.D. 96, 107-08 (S.D.N.Y. 2008) (granting § 1782 application for discovery to assist French legal proceeding). *But see In re Application Pursuant to 28 U.S.C. Section 1782 of Okean B.V. & Logistic Solution Int'l to Take Discovery of Chadbourne & Parke LLP*, No. 12 MISC. 104 PAE, 2014 WL 5090028, at *11 (S.D.N.Y. Oct. 10, 2014) ("the Court is particularly loathe to subvert foreign laws limiting discovery. . .by reconceiving them to include" American-style exceptions).
6. *Lancaster Factoring Co.*, 90 F.3d at 41, *citing In re Application of Gianoli Aldunate*, 3 F.3d 54, 57-62 (2d. Cir. 1993) (holding that a foreign competency proceeding was within the meaning of § 1782, when the court-appointed provisional guardians sought discovery in order to inventory the incompetent's property); *In re Application for an Order Pursuant to 28 U.S.C. § 1782 to Conduct Discovery for Use in Foreign Proceedings*, No. 14-2807-CV, 2014 WL 6997484, at *1 (2d Cir. Dec. 12, 2014) (explaining legislative history and holding that § 1782 "applies to a foreign criminal investigation involving an investigating magistrate seeking documents in the United States"); *Intel Corp.*, 542 U.S. 241 (EU directorate conducting antitrust investigation was determined to be a foreign tribunal).
7. *NBC, Inc. v. Bear Sterns & Co., Inc.*, 165 F.3d 184, 186-91 (2d Cir. 1999) (explaining that an ICC arbitration is a private arbitration and not a "foreign or international tribunal" under § 1782); *Republic of Kazakhstan v. Biedermann Int'l*, 168 F.3d 880, 883 (5th Cir. 1999) (same) (citing *NBC, Inc.*, 165 F.3d 184, 186-91); *In re Dubey*, 949 F. Supp. 2d 990 (C.D. Cal. 2013) (finding that private arbitration established by contract was not a tribunal under 28 U.S.C. § 1782); *In re Operadora DB Mexico, S.A. de C.V.*, No. 6:09–cv–383–Orl–22GJK, 2009 WL 2423138 (M.D. Fla. Aug. 4, 2009) (citing *Intel*) (holding that Congress did not intend to include private arbitral proceedings constituted under the non-governmental International Chamber of Commerce International Court of Arbitration within the scope of the § 1782). *But see In re Chevron Corp.*, No. 10-MC-208, 10-MC-209, 2010 U.S. Dist. LEXIS 134970 (E.D. Pa. December 20, 2010) (holding that international arbitration initiated pursuant to United Nations Commission on International Law constituted a tribunal within the meaning of 28 U.S.C. § 1782), *rev'd on other grounds*, 650 F.3d 276; *In re Application of Roz Trading Ltd.*, 469 F. Supp. 2d 1221, 1224-28 (N.D. Ga. 2006) (holding international commercial arbitral body located in Austria was a tribunal within the meaning of 28 U.S.C. § 1782 but discussing fact of foreign arbitration's relation to the country's court system).
8. *Intel Corp.*, 542 U.S. 241.
9. *In re Microsoft Corp.*, 428 F. Supp. 2d 188, 192-93 (S.D.N.Y. 2006) (citing *Intel*, 542 U.S. at 264-65); *see also In re Request for Subpoena by Ryanair Ltd.*, No. 5:14MC80270-BLF-PSG, 2014 WL 5583852, at *1 (N.D. Cal. Oct. 31, 2014).
10. *See, e.g., Kulzer v. Esschem, Inc.*, 390 F. App'x 88, 92-93 (3d Cir. 2010) (holding that the district court did not abuse its discretion in finding no undue burden after the applicant promised certain protections for target's confidential information); *Andover Healthcare, Inc. v. 3M Co.*, No. 14-MC-44 SRN/JJK, 2014 WL 4978476, at *8 (D. Minn. Oct. 6, 2014) (declining to exercise its discretion to grant discovery where subject of § 1782 request's confidentiality "concerns are valid and. . .[applicant] has not presented evidence that those concerns will be adequately addressed"); *Siemens AG v. W. Digital Corp.*, No. 8:13-CV-01407-CAS, 2013 WL 5947973, at *6 (C.D. Cal. Nov. 4, 2013) (considering the possible dissemination of target's confidential information under the fourth *Intel* factor).
11. No. 07-5944 SC, 2012 WL 6878989, at *4 (N.D. Cal. Oct. 22, 2012), *report and recommendation adopted*, No. C-07-5944-SC, 2013 WL 183944 (N.D. Cal. Jan. 17, 2013).
12. *In re Cathode Ray Tube (CRT) Antitrust Litig.*, 2012 WL 6878989 at *4.
13. 28 U.S.C. § 1782.
14. *See Weber v. Finker*, 554 F.3d 1379, 1384-85 (11th Cir. 2009) (quoting *In re Clerici*, 481 F.3d 1324, 1335-36 (11th Cir. 2007)) ("[o]nce discovery is authorized under § 1782, the federal discovery rules, Fed. R. Civ. P. 26–36, contain the relevant practices and procedures for the taking of testimony and the production of documents"). *See also In re Google Inc.*, No. 14-MC-80333-DMR, 2014 WL 7146994, at *3 (N.D. Cal. Dec. 15, 2014) (granting application under § 1782 and explaining that subject of subpoena was "not preclude[d] . . . from contesting the subpoena based on undue intrusion, burden, or other grounds").
15. Fed. R. Civ. P. 45(d)(3)(B); *see also In re Google Inc.*, 2014 WL 7146994 at *3.
16. *See In re Cathode Ray Tube (CRT) Antitrust Litig.*, 2012 WL 6878989 at *4 (denying the § 1782 application as intrusive and burdensome

because there was no way to anticipate and protect against all of the ways in which their confidential documents might become available for public use in business matters).

17. *Intel Corp.*, 542 U.S. at 245; *In re Google Inc.*, 2014 WL 7146994 at *3.
18. Fed. R. Civ. P. 26(c)(1)(G).
19. Fed. R. Civ. P. 26(c)(1) (emphasis added).
20. No. 8:13-CV-01407-CAS, 2013 WL 5947973 (C.D. Cal. Nov. 4, 2013).
21. *Id.* at *1.
22. *Id.* at *6 (upon application for discovery under § 1782 proceeding, "direct[ing] the parties to jointly seek a protective order in the [foreign] court"). It is also important to note that the *Siemens* court notes the plaintiffs' representation that German court proceedings are confidential by default, so usage of this information in the foreign tribunal would not lead to disclosure. *Id.*
23. In this hypothetical, however, a party in the foreign tribunal could move for a protective order on the domestic party's behalf, thus making it more likely the court will grant the order. Alternatively, the party could oppose the protective order, thus making it impossible for the § 1782 applicant to obtain the information if discovery is contingent on the issuance of a protective order.
24. The District Court, however, *can* condition relief upon the reciprocal exchange of information. *See Euromepa, S. A. v. R. Esmerian, Inc.*, 51 F.3d 1095, 1102 (2d Cir. 1995); *see also Minatec Fin. S.A.R.L.*, 2008 WL 3884374 at *29-30 (granting Section 1782 application, but ordering reciprocal discovery of Section 1782 applicant).
25. *Via Vadis Controlling GmbH v. Skype, Inc.*, No. CIV.A. 12-MC-193-RGA, 2013 WL 646236, at *3 (D. Del. Feb. 21, 2013) (denying request under § 1782 for source code as "[s]ource codes are the most sensitive and confidential property of Respondents. When disclosed in U.S. litigation, extreme measures are ordered to protect their confidentiality.").
26. U.S. State Department, *Enforcement of Judgments*, Travel.State.Gov, http://travel.state.gov/content/travel/english/legal-considerations/judicial/enforcement-of-judgments.html (last visited July 10, 2016) ("There is no bilateral treaty or multilateral convention in force between the United States and any other country on reciprocal recognition and enforcement of judgments.").

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Fair Value Measurements: In the Crosshairs of Regulators

By Mark L. Zyla, CPA/ABV, CFA, ASA

Fair value measurements in financial reporting are becoming increasingly scrutinized by regulators. Recent inspection reports of accounting firms that audit publicly traded entities by the Public Company Accounting Oversight Board ("PCAOB") have indicated an increasing focus on the audit procedures related to fair value. The Securities and Exchange Commission ("SEC") has also showed concerns regarding outside valuation specialists who assist management in determining fair value measurements. The increased scrutiny has put a spotlight on the process of measuring fair value in financial reporting.

Fair value in financial reporting is defined by the Financial Accounting Standard Board ("FASB") as "the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date."[1] The objective of fair value measurement is to estimate a transaction price from the perspective of a market participant for a particular asset, liability, or equity instrument. There are well over three dozen accounting standards which require fair value as the unit of measurement in financial reporting. The accounting standards most commonly requiring fair value are those that govern the financial reporting of business combinations and subsequent testing of acquired assets for impairment. Additionally, certain accounting standards allow entities to report various financial assets and liabilities at their relative fair values.

Fair value is a unit of measurement in accounting which requires or permits entities to report assets and liabilities at prices other market participants would pay for those assets or paid to transfer the liabilities. In other words, fair value is an exit or market based notion. Since many individual assets and liabilities are not sold or transferred in active markets, their fair value measurements are often determined using assumptions as if they were to be sold or transferred to a market participant. Market participants generally are those buyers and sellers that have certain defined characteristics and are willing and able to transact for the asset or liability. Since fair value measurement requires special expertise, management often uses outside valuation specialists to assist with the measurement.

The benefit of fair value measurement is that it allows the users of the financial statements to better understand the actual financial position of the entity. The challenge with fair value measurement is that the process places significant judgment in the hands of the professional performing the measurement. The challenge extends to auditing fair value measurements.

PCAOB Inspections

The PCAOB conducts inspections of registered public accounting firms as required by the Sarbanes-Oxley Act of 2002. The inspections are designed to identify and address deficiencies in a firm's audit engagements and to determine whether deficiencies indicate a weakness or defect in the firm's system of quality control over audits. The annual inspection process encompasses a review of selected audits and a review of the firm's system for quality control.

PCAOB reviews of selected audits are intended to identify financial statement misstatements, including failures to comply with disclosure requirements and failures to perform applicable audit procedures. When a deficiency reaches a level of significance that appears to indicate the firm failed to obtain sufficient audit evidence to support its audit opinion on the financial statements or on the effectiveness of internal control over financial reporting, the deficiency is described in the PCAOB's inspection report, which is publicly available.

> *"The objective of fair value measurement is to estimate a transaction price from the perspective of a market participant for a particular asset, liability, or equity instrument."*

The individual PCAOB inspection reports themselves do not define deficiency. However, Auditing Standard No. 7 *Engagement Quality Review* provides a description, saying that a significant audit engagement deficiency "exists when (1) the engagement team failed to obtain sufficient appropriate evidence in accordance with the standards of the PCAOB, (2) the engagement team reached an inappropriate overall conclusion on the subject matter of the engagement, (3) the engagement report is not appropriate in the circumstances, or (4) the firm is not independent of its client."[2]

My firm, Acuitas, Inc., conducts an annual review of the PCAOB's inspection reports, particularly as they relate to fair value.[3] *Acuitas Inc.'s Survey of Fair Value Audit Deficiencies* is intended to assist financial statement preparers, auditors, and valuation specialists in understanding the underlying causes of fair value measurement ("FVM") and impairment audit deficiencies, as reported by the PCAOB. There are a number of key findings and trends that were noted from the 2008 to 2013 inspection reports. At the time of our most recent survey, the 2013 inspection reports were the most currently available.

The PCAOB inspections for annually inspected firms from 2008 through 2013 indicate several trends. First, the percentage of all audit engagements with deficiencies has increased dramatically since 2009[4] and remains high. In connection with the 2013 annual inspections, the PCAOB found deficiencies in 132 issuers, or 42.9% of audits and other engagements examined, which is similar to 2012 inspections. Comparatively, in 2009 the inspection reports for the same firms cited deficiencies in 61 issuers, or 16.0% of audits examined.

A second trend indicates that audit deficiencies involving fair value measurements and testing for impairment remain relatively high. In 2010, fair value and impairment deficiencies were 48.4% of all deficiencies. In 2013, fair value and impairments issues represented 31.0% of total audit deficiencies. The focus of the fair value measurement in prior years involved primarily the auditing of financial instruments. However, the focus changed dramatically in 2013 to almost half of fair value deficiencies involving the audits of business combinations, reflecting the increased level of transactions.

Our analysis of PCAOB inspection reports indicates that the number of audits with deficiencies remains fairly high. A significant number of these deficiencies relate to the auditing of fair value measurements and impairment testing. In prior years, audit failures were primarily attributable to deficiencies in the fair value measurement of financial instruments caused by pricing problems and failure to adequately test the value. However, the most recent inspection reports indicate an increase in the number of deficiencies related to the fair value measurements in business combinations. The inspection reports indicate that the PCAOB considers that audit failures related to fair value measurements are primarily attributable to failures to assess risk of proper measurement and test internal controls related to the measurement.

The PCAOB is also expected to issue additional guidance on auditing estimates, including fair value and the use of valuation specialists, as part of the auditing process in the Fourth Quarter of 2016.

SEC and Fair Value Measurements

The SEC also has had some concerns as to proper measurement of fair value.

In prepared remarks to the 2011 AICPA National Conference on Current SEC and PCAOB Developments, the then-Deputy Chief Accountant of the U. S Securities and Exchange Commission Paul A. Beswick commented on the SEC's observations of the valuation profession, particularly as the profession relates to the development of fair value measurements.

Beswick commented on:

- A "lack of unified identity," meaning that there are numerous organizations that provide valuation credentials, unlike the accounting profession.
- The market confusion, as well as "identity void," for the profession.
- His feeling that the profession have a "single set of qualifications with respect to education level and work experience, a continuing education curriculum, standards of practice and ethics, and a code of conduct."
- A need for a disciplinary mechanism to enforce rules in the public interest.[5]

Since Mr. Beswick's initial remarks, the valuation profession, led by several valuation professional organizations, leaders of the valuation practices in international accounting firms, the Appraisal Foundation and the International Valuation Standards Council, has begun working on a fair value quality initiative within the valuation profession to respond to the SEC's concerns. These groups are currently working on a process to develop common education and experience requirements for a credential for valuation specialists focusing on fair value measurements, as well as establishing governance and oversight for professionals who work in this area. The fair value credential is expected to be introduced sometime in 2016.[6]

The Enforcement Division of the SEC has also brought actions in the past several years against three investment funds alleging that fair value measurements were improperly applied to certain assets in their funds, particularly during the credit crisis.[7] These enforcement actions reflect the commission's concerns as to proper controls and measurement procedures related to fair value.

Conclusions

Fair value measurements provide more relevant information to the users of financial statements as to the current financial position of the entity. However, the measurement often requires professional judgment. Best practices as to proper fair value measurements continue to evolve both within the accounting and valuation professions. In the interim, regulators such as the PCAOB and the SEC have increased their scrutiny of fair value measurement in financial reporting. Management, auditors and valuation specialists should be aware of and understand the particular focus of the regulatory scrutiny of fair value measurements in financial reporting.

Endnotes

1. Financial Accounting Standards Board Master Glossary, www.fasb.org.
2. PCAOB Auditing Standard No. 7 *Engagement Quality Review.*
3. Acuitas, Inc.'s The *Survey of Fair Value Audit Deficiencies* can be found at www.acuitasinc.com.
4. The percentage of audit engagements with deficiencies is not available for 2008.
5. Source: Beswick, Paul A. Prepared Remarks for the 2011 AICPA National Conference on Current SEC and PCAOB Developments December 5, 2011, Washington D.C., www.sec.gov.
6. http://www.aicpa.org/Press/PressReleases/2015/Pages/AICPA-Approves-Development-of-Two-Fair-Value-Measurement-Credentials.aspx
7. Bartholomew, Christian and Jill Baisinger, "SEC Turns Focus to Valuation Issues," Bloomberg BNA Accounting Policy & Practice Report, March 29, 2013, pages 234–36. http://www.bna.com/sec-turns-focus-to-valuation-issues/.

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A New York Litigator's Guide to the New Federal Trade Secret Law

By Heath J. Szymczak and Bradley A. Hoppe

I. Introduction

On May 11, 2016, President Barack Obama signed into law the Defend Trade Secrets Act of 2016 ("DTSA"), creating the first federal civil claim for theft of trade secrets. This is one of the most significant developments in trade secret law in decades. Prior to DTSA, trade secrets did not receive the same protections afforded to other forms of intellectual property such as trademarks, copyrights, and patents. DTSA elevates the status of trade secrets to the point where its remedies, in many instances, now exceed those which may have been previously available under state law, including aggressive ex parte seizure mechanisms (similar to those used to seize counterfeit goods under trademark law), exemplary damages, and attorney's fees.

Trade secret misappropriation was previously governed by state law, with almost all other states adopting various versions of the Uniform Trade Secrets Act ("UTSA").[1] New York is one of the last states that have refused to adopt UTSA. The passage of DTSA thus has significant implications for a commercial litigator in New York, as he/she, for the first time, will have available to him/her a statutory framework for enforcement of trade secrets.[2]

DTSA is a civil amendment to the Economic Espionage Act of 1996 ("EEA"), a criminal statute.[3] The EEA makes it a federal criminal offense to misappropriate a trade secret that is linked to interstate or foreign commerce. The EEA, however, did not provide for a private right of action in federal court. Instead, trade secret owners seeking protection under the EEA had to stand in line and hope for investigation and prosecution by an already overextended Federal Bureau of Investigation and Department of Justice. Consequently, prosecutions under the EEA have been limited and have not provided an effective deterrent to trade secret theft.[4] By providing trade secret owners with direct access to federal courts through a mechanism to vindicate private rights, together with robust remedial provisions, DTSA is designed to create a greater deterrent to trade secret theft than previously existed at the federal level.

The purpose of this article is to provide New York commercial litigators, who may be unfamiliar with UTSA and the EEA, with an understanding of the background and context from which DTSA evolved, as well as a clearer picture of the scope of DTSA generally and how federal courts are likely to construe its provisions specifically. The reader will gain an understating of why DTSA was enacted and how it is different from and broader than both New York law and UTSA. Specifically, this article will provide: (1) a comparison of New York law and UTSA; (2) a description of the EEA and New York's *Aleynikov* case and how that led to DTSA's enactment; (3) a description of the procedural background and evolution of DTSA; and (4) a summary of DTSA's key provisions and how they are likely to be interpreted.

II. Comparison of New York Law and UTSA

DTSA draws significantly from UTSA and was designed, in part, to provide a mechanism for greater state-to-state uniformity, albeit an incomplete one.[5] As such, an understanding of UTSA is important in approaching DTSA, particularly for a litigator in New York where UTSA has never been adopted.

UTSA was originally published by the Uniform Law Commission (the same group that brought us the Uniform Commercial Code) in 1979, and later amended in 1985, for the purpose of providing a uniform act throughout the United States to create more predictability in the law of trade secrets for companies operating in multiple states. UTSA has since been enacted in varying forms—sometimes in whole, other times in part and, still others, with material changes to reflect certain aspects of a particular state's common law. As noted, New York and Massachusetts are the lone holdouts.

While there has been a recent push in New York (as well as Massachusetts) to enact some form of UTSA,[6] New York courts continue to rely upon and apply highly developed, albeit often complex, common law rules for trade secret protection. As explained below, UTSA is in many respects broader than the common law, both in terms of the protections afforded and the remedies provided to litigant victims of trade secret theft.

With respect to the scope of the protections afforded under UTSA, a trade secret is defined more broadly and with far less complexity than its common law counterpart. Specifically, New York common law defines a trade secret as any "formula, pattern, device or compilation of information which is used in one's business, and which gives him an opportunity to obtain an advantage over competitors who do not know or use it," and then applies the following six-factor balancing test to determine whether the information meets the definition:

> (1) the extent to which the information is known outside of the business; (2) the extent to which it is known by employees and others involved in the business; (3) the extent of measures taken by the business to guard the secrecy of the informa-

tion; (4) the value of the information to the business and its competitors; (5) the amount of effort or money expended by the business in developing the information; (6) the ease or difficulty with which the information could be properly acquired or duplicated by others.[7]

UTSA, on the other hand, applies a far simpler definition and test for trade secret protection by defining a "trade secret" as "information…that (i) derives independent economic value…from not being generally known to, and not being readily ascertainable by proper means by, other persons who can obtain economic value from its disclosure or use, **and** (ii) is the subject of efforts that are reasonable under the circumstances to maintain its secrecy."[8] While the purpose of the two definitions/rules are obviously the same (i.e., to protect information of value that is secret from competitors), the complexity and ambiguity of the New York rule leaves far more to interpretation (and litigation). While the New York rule may be good for litigators, such is often not the case for clients, as it leads to increased litigation costs and interjects greater uncertainty into the predictability of outcomes for business transactions and relations.

In addition, the New York rule, unlike UTSA, requires that the information be actually "used in one's business,"[9] which has been construed as a "continuous use" requirement for trade secret protection.[10] While courts have clarified that "continuous use" means only that the alleged trade secret cannot be "information as to a single or ephemeral event[] in the conduct of the business,"[11] the fact remains that this requirement would seemingly preclude protection of information pertaining to a past failed and/or abandoned secret process or formula that could nevertheless have economic value to a competitor. The rule under UTSA, on the other hand, is significantly broader in this respect and provides trade secret protection to any secret information, currently in use or long since abandoned, which derives any economic value.[12] While one could argue that the New York rule favors innovation by disincentivizing a company from squatting on new, unpatented technology, it also creates a loophole of sorts in the law by seemingly permitting a competitor to reap the benefits of another company's valuable research and development.

Not only does UTSA expand the scope of trade secret protection afforded by the common law, but it also provides additional remedies not otherwise available. For example, in the event that a UTSA plaintiff can establish that a defendant's misappropriation was willful or malicious, or if a defendant can establish that a plaintiff's claim was made in bad faith, the statute provides for attorneys' fees to the prevailing party.[13] Similarly, a plaintiff who establishes that a defendant's misappropriation was willful or malicious may be awarded "exemplary damages in an amount not to exceed twice any [damage] award" for actual loss.[14] Under the common law, a litigant is, of course, only entitled to its actual damages for any losses sustained and, in the absence of extraordinary circumstances or a "prevailing party" attorneys' fees provision in an employment or other contract, will not be awarded any attorneys' fees incurred in the litigation.

Finally, unlike New York law where an injunction prohibiting employment on the basis of "inevitable disclosure" is, at best, on shaky ground,[15] there exists a significant body of case law standing for the proposition that UTSA permits (and, in essence, codifies) "inevitable disclosure" to enjoin an employee from taking employment with a competitor.[16] While criticized by some other courts,[17] the fact that UTSA permits injunctive relief based upon both "actual and **threatened** misappropriation"[18] has given far more traction and credibility to the applicability of the "inevitable disclosure" to prohibit employment than what currently exists under New York law.

While UTSA affords broader protection to trade secrets and provides greater remedies to litigants than what exists under the common law, it has largely failed in its stated purpose of providing uniformity and predictability for trade secrets across state lines, as there remain two major holdouts (New York and Massachusetts) and numerous states which have adopted only variations of the "uniform" statute. As discussed below, DTSA, which is modeled after UTSA, goes a step further than UTSA by not only creating a federal civil claim for trade secret misappropriation on par with other intellectual property rights, but also providing greater protection and remedies than what exists under UTSA.

III. EEA, New York's *Aleynikov* Case, and DTSA

Given the lack of uniformity in trade secret law across state lines, DTSA was partly designed to provide an overarching umbrella statute to UTSA. More directly, however, DTSA was aimed at the limitations of the EEA by expressly amending that statute. Thus, an understanding of the EEA is also important since a New York commercial litigator may not have had much—if any—exposure to this federal criminal statute either.[19]

The EEA criminalizes "economic espionage" by a foreign[20] entity as well as domestic misappropriation for financial gain.[21] Notwithstanding the purpose and objectives of the EEA, its application has proven ineffective due to limited prosecutorial resources and problems with the textual limitations in the statute itself.

For example, the New York case of *United States v. Aleynikov*[22] exposed major holes in the EEA and the ability of the government to prosecute claims for trade secret theft. In *Aleynikov*, Sergey Aleynikov was a computer programmer employed by Goldman Sachs & Co. to develop computer source code for the company's trading system.[23] Aleynikov left Goldman Sachs to work for another company looking to develop a similar computer system.[24] He was offered over twice his salary ($400,000 to $1,000,000) to develop a similar system in a fraction of the time that it would usually take to develop such a system.[25]

On his last day at Goldman Sachs, Aleynikov encrypted and uploaded more than 500,000 lines of source code for Goldman Sachs' computer trading system.[26] After uploading the source code, Aleynikov deleted the history of his computer commands.[27] When he returned to his home in New Jersey, Aleynikov downloaded the source code from a remote server in Germany to his home computer.[28] Aleynikov then flew to Illinois to meet with his new employer, bringing a flash drive and a laptop containing portions of Goldman Sachs' source code with him.[29] When he flew home the next day he was arrested by the FBI at Newark International Airport.[30]

Following a jury trial in the United States District Court for the Southern District of New York, Aleynikov was convicted under Section 1832 of the EEA.[31] He was sentenced to 97 months of imprisonment followed by a three-year term of supervised release, and was ordered to pay a $12,500 fine. Aleynikov appealed. On April 11, 2012, the Second Circuit reversed Aleynikov's conviction, finding that his conduct did not constitute an offense under the EEA because the source code was not "related to or included in a product that is produced for or placed in interstate or foreign commerce," thus significantly undermining and weakening the EEA's ability to deter misappropriation of valuable trade secrets.[32]

In December 18, 2012, Congress amended the EEA to try to close the "Aleynikov loophole"' in a law referred to as the "Theft of Trade Secrets Clarification act of 2012."[33] That same year Congress also began working toward the creation of a federal civil claim for misappropriation of trade secrets. In 2012, Senators Herb Kohl, Christopher Coons, and Sheldon Whitehouse introduced, without success, the "Protecting American Trade Secrets and Innovation Act of 2012" in the 112th Congress. In 2014, a new bipartisan bill was introduced in the Senate by Senators Christopher Coons and Orrin Hatch in the 113th Congress, entitled "Defend Trade Secrets Act of 2014." An identical textual bill was also introduced in the House by Congressman George Holding, though under the name "Trade Secret Protection Act of 2014." While the Senate bill stalled, the House bill was unanimously passed by the House Judiciary Committee on September 17, 2014, but failed to come to the floor for a vote.

Finally, in July of 2015, identical textual bills were introduced simultaneously in the 114th Congress. This time both bills were entitled "Defend Trade Secrets Act of 2015." The House bill was introduced by Congressman Doug Collins. The Senate Bill was once again introduced by Senator Hatch. The 2015 version contained several modifications to the 2014 version in order to make it more palatable to past critics and bring it more in line with UTSA.[34] On April 4, 2016, the U.S. Senate passed the legislation with a unanimous vote of 87-0. On April 27, 2016, DTSA was approved by the U.S. House of Representatives by a vote of 410-2. As noted, President Obama signed DTSA into law on May 11, 2016.

IV. DTSA's Key Provisions

Definition of "Trade Secret"

With the background and context of DTSA explained, we now turn to the key provisions of DTSA itself. In particular, DTSA uses the definition of "trade secret" found in the EEA, with a few slight modifications, as shown below:

> (3) the term "trade secret" means all forms and types of financial, business, scientific, technical, economic, or engineering information, including patterns, plans, compilations, program devices, formulas, designs, prototypes, methods, techniques, processes, procedures, programs, or codes, whether tangible or intangible, and whether or how stored, compiled, or memorialized physically, electronically, graphically, photographically, or in writing if—
>
> (A) the owner thereof has taken reasonable measures to keep such information secret; and
>
> (B) the information derives independent economic value, actual or potential, from not being generally known to, and not being readily ascertainable through proper means by, the ~~public; and~~ **another person who can obtain economic value from the disclosure or use of the information**. . . .[35]

As noted above, DTSA's definition tracks the most widely used state definitions under USTA,[36] and, significantly, is broader than the definition currently available under New York law.[37] The additional language added by the amendment (in bold) also creates greater protection by restricting the scope of trade secret discovery (and resulting loss of status) from the "public" in general to a smaller class which is essentially limited to competitors, bringing DTSA in closer conformity with USTA than exists under the EEA.[38]

"Misappropriation" may be established by showing acquisition of the trade secret by "improper means" or disclosure or use of the same where the person in possession of the trade secret (1) knew or should have known that the information was acquired by improper means or under circumstances giving rise to a duty of secrecy, or (2) prior to making a material change in position, the person in possession knew or should have known that the trade secret was disclosed by accident or mistake.[39] As under UTSA, "wrongful means" under DTSA includes theft, bribery, misrepresentation, breach, or inducement of a breach of a duty to maintain secrecy, or espionage though electronic or other means. However, reverse engineering and independent derivation of the trade secret do not constitute improper means.[40]

Ex Parte Seizure

One of the most controversial aspects of DTSA, and a remedy not found in UTSA, is its allowance for a trade secret owner to seek ex parte seizure of trade secret materials under "extraordinary circumstances."[41] In order to obtain such an order, however, several onerous requirements must be met. As a preliminary matter, a court will not issue such an order unless the applicant meets the threshold requirement for issuance of an injunction, including irreparable injury and a balancing of the equities, as well as a finding by the court that an order issued pursuant to Rule 65 of the Federal Rules of Civil Procedure or another form of equitable relief would be inadequate because the party to which the order would be issued would evade, avoid, or otherwise not comply with such an order.

"One of the most controversial aspects of DTSA, and a remedy not found in UTSA, is its allowance for a trade secret owner to seek ex parte seizure of trade secret materials under 'extraordinary circumstances.'"

The applicant must then also show a likelihood of success in establishing that (1) the information is a trade secret; (2) the person against whom seizure would be ordered misappropriated the trade secret of the applicant by improper means (or conspired to do so); and (3) the person against whom seizure would be ordered has actual possession of the trade secret (described with reasonable particularity) and that the order is needed to prevent dissemination of the trade secret (which could render the trade secret without value). The applicant must also show that he has not publicized the requested seizure.[42] These requirements are similar to, but slightly more rigorous than, a showing required for the seizure of counterfeit goods under trademark law (i.e. the Trademark Act of 1946 or the Lanham Act).[43]

DTSA also provides detailed requirements for what a seizure order must contain, including (1) mandates for narrowly tailored seizures; (2) reasonable steps to avoid interruption of the business of third parties, as well as the defendant's legitimate business operations; (3) guidance to law enforcement on how to proceed in effecting the seizure; (4) a prompt hearing date following the order's issuance; (5) protection of the seized material; and (6) posting of a bond on the part of the petitioning party. A court must take custody of any seized materials and hold a seizure hearing within seven days. An interested party may file a motion to encrypt seized material. A party harmed by a wrongful or excessive seizure may move to dissolve or modify the order and may also seek relief against the applicant of the seizure order for any resulting losses.[44]

Damages (Including Exemplary Damages and Attorney's Fees)

DTSA allows for an award of damages for actual loss caused by the misappropriation of the trade secret, as well as damages for any unjust enrichment that is not addressed in computing damages for actual loss. In lieu of damages measured by any other methods, DTSA also permits for damages to be measured in terms of the imposition of a reasonable royalty for the defendant's unauthorized disclosure or use of the trade secret. Moreover, and most importantly for litigators and clients alike, if a plaintiff is able to show that the trade secret was "willfully and maliciously misappropriated," a court may award exemplary damages in "an amount not more than 2 times the amount of the damages awarded."[45] Finally, if (1) a claim of misappropriation is made in bad faith, (2) a motion to terminate an injunction is made or opposed in bad faith, or (3) the trade secret was willfully and maliciously misappropriated, a court may disregard the American rule for attorney's fees and award reasonable attorney's fees to the prevailing party.[46]

"Inevitable Disclosure Doctrine" Not Adopted

DTSA specifically states that an injunction issued thereunder cannot "prevent a person from entering into an employment relationship" and that any conditions placed on such a relationship must be based on more than "the information the [former employee] knows[.]"[47] Thus, DTSA makes clear that the "inevitable disclosure doctrine" will not apply in any circumstances under the statute. This doctrine, which exists under New York law, albeit on shaky ground, allows an employer to restrain a former employee from working for a competitor (at least temporarily) based on a showing that the former employee's knowledge of the employer's critical proprietary information is so comprehensive that the employer's trade secrets would inevitably be disclosed and used in the course of the former employee's new employment.[48] Needless to say, the clear language in DTSA would preclude a New York litigant from pursuing such an argument under the terms of the statute. This is not to say, however, that a litigant cannot seek an injunction with respect to the "conditions placed on such employment" (such as not contacting customers the employee dealt with), though the scope and breadth of such conditions and restrictions will necessarily be fleshed out by the courts, hopefully in the near future.

Whistleblower Immunity Notice Requirement

Imbedded within the text of DTSA is a warning that a plaintiff will not be able to recover exemplary damages or attorney fees if it fails to include a "whistleblower immunity notice" in "any contract or agreement with an employee that governs the use of a trade secret or other confidential information," such as non-disclosure, non-solicitation, and non-competition agreements.[49] The notice must inform the employee (among other things) that he or she cannot be held liable under any trade secret law for the disclosure of a trade secret that is made (1) in confidence to a government official or to an attorney for the sole purpose of reporting a suspected violation of law or (2) in a document in a lawsuit or proceeding filed under seal.[50]

DTSA further provides, however, that an "employer shall be considered to be in compliance with the notice requirement. . .if the employer provides a cross-reference to a policy document provided to the employee that sets forth the employer's reporting policy for a suspected violation of law."[51] Significantly, this notice requirement also may extend to individuals who are independent contractors performing work for a company, as DTSA defines an "employee" to include "any individual performing work as a contractor or consultant for an employer."[52] The notice, however, appears to only be required with "individuals" and may not be required for a third-party company in a joint venture non-disclosure agreement or other such agreement.

V. Conclusion

By adding a private civil claim for theft of trade secrets, federal law now provides protection to trade secrets in a manner similar to other forms of intellectual property (such as trademarks, copyrights and patents). While the full impact of DTSA will not be fully known until after a body of federal case law is developed construing its many significant provisions, it is clear, even at this early stage, that the statute will provide litigants and practitioners in New York new and stronger protections and remedies not available under the common law or even the proposed UTSA legislation.

Although DTSA seeks to create uniformity in trade secret law across state lines, the failure of DTSA to preempt state law dilutes the effectiveness of this stated purpose.[53] This may mean that it will take much longer for uniformity to develop until a substantial body of federal case law is established. Ultimately, however, it is expected that greater uniformity (and predictability for business decisions) will emerge, either through development of jurisprudence or by direct amendment.

New York litigators should take note of DTSA's rejection of the "inevitable disclosure doctrine" as a predicate to obtaining injunctive relief to prevent employment, which is a departure from both UTSA and New York law. Although the relatively weak state of this doctrine in New York may not represent a significant issue (particularly given the upside of the stronger remedial provisions found in DTSA), it is a factor that should be considered in deciding whether to proceed under DTSA or solely in state court under New York common law.[54] It should also be noted that the availability of the federal forum provides mechanisms under the Federal Rules of Civil Procedure which may be broader than what may exist in state court practice, including the availability of expert discovery.[55]

Finally, DTSA's whistleblower immunity notice requirements means that your clients may need to review and revise their non-disclosure, non-solicitation, and non-competition agreements to not only maximize the protections available under DTSA, but also ensure they are consistent with other changes in the ever-evolving case law on the subject. Moreover, there is also the possibility that the failure to include the immunity notice could be interpreted as evidence of overreaching for purposes of refusing to "blue pencil" or reform a restrictive covenant.[56]

Endnotes

1. UTSA has been adopted in 48 States and the District of Columbia, but not in New York or Massachusetts. *See Uniform Law Commission: The National Conference of Commissioners on Uniform State Laws, Uniform Trade Secrets Act*, available at http://www.uniformlaws.org/Act.aspx?title=Trade+Secrets+Act.
2. The authors forecasted the passage of DTSA in the Commercial and Federal Litigation Section's *Newsletter*, Winter 2014, Vol. 20, No. 3, page 7, *Federal Trade Secret Legislation Moves Forward,* available at http://www.nysba.org/WorkArea/DownloadAsset.aspx?id=54068.
3. 18 U.S.C. §§ 1831 *et seq*.
4. *See Economic Espionage and Trade Secret Theft: Are Our Laws Adequate for Today's Threats?: Hearing Before the Senate Judiciary Comm., Subcomm. on Crime and Terrorism*, 113th Cong. (2014) (statement of Randall C. Coleman, Assistant Director, Counterintelligence Division, FBI); *see also* Robin L. Kuntz, *How Not to Catch a Thief: Why the Economic Espionage Act Fails to Protect American Trade Secrets*, 28 Berkeley Technology Law Journal Issue 4 (2013).
5. As discussed below, DTSA does not expressly preempt USTA.
6. New York is currently considering a bill, Senate Bill 3770, to adopt UTSA without significant modifications. It is currently in committee. *See* https://www.nysenate.gov/legislation/bills/2015/s3770. Massachusetts has also recently moved closer to adopting UTSA. Massachusetts House Bill H4434, which adopts UTSA, unanimously passed the House and was transmitted to the Senate Rules Committee. *See* "Massachusetts Senate Votes for Tough Noncompete Bill and Adoption of Uniform Trade Secrets Act," (July 14, 2016), available at https://faircompetitionlaw.com/2016/07/14/massachusetts-senate-votes-for-tough-noncompete-bill-and-adoption-of-uniform-trade-secrets-act/.
7. *Ashland Management v. Janien*, 82 N.Y.2d 395, 407 (1993) (quoting Section 757 of the Restatement of Torts, comment b).
8. Uniform Trade Secrets Act § 1(4) (emphasis added).
9. *Janien*, 82 N.Y.2d at 407.
10. *See, e.g., Lehman v. Dow Jones & Co.*, 783 F.2d 285, 297-298 (2d Cir. 1986).

11. *Id.; see also Zylon Corp. v. Medtronic, Inc.*, 2015 N.Y. Misc. LEXIS 1276 (N.Y. Co. Sup. Ct. 2015).

12. Uniform Trade Secrets Act § 1(4).

13. Uniform Trade Secrets Act § 4.

14. Uniform Trade Secrets Act § 3(b).

15. *See, e.g., Janus et Cie v. Kahnke*, 2013 U.S. Dist. LEXIS 139686 (S.D.N.Y. 2013) (rejecting claim of inevitable disclosure in the absence of a noncompete or evidence of actual misappropriation).

16. *PepsiCo, Inc. v. Redmond*, 54 F.3d 1262 (7th Cir. 1995).

17. *Kelly Services v. Greene*, 535 F.Supp. 2d 180, 188 (D. Me. 2008) (rejecting argument that the MUTSA (Michigan Uniform Trade Secrets Act) permits an injunction based on "inevitable disclosure").

18. Uniform Trade Secrets Act § 2(a) (emphasis added).

19. Some New York litigators may be familiar with the federal Computer Fraud and Abuse Act, 18 U.S.C. § 1030, which does provide a private right of action. However, that statute is fairly limited in application to cases involving computers of the federal government or certain financial institutions or where the crime is interstate in nature. The statute is more commonly aimed at computer "hacking" rather than directly at theft of trade secrets (which also do not always reside on a computer). It is usually difficult to apply this statute to situations where an employee (such as in the *Aleynikov* case discussed below) accesses his employer's computer in the process of uploading trade secret data since the access to the computer itself was not necessarily "unauthorized."

20. *See* 18 U.S.C. § 1831(a).

21. *See* 18 U.S.C. § 1832(a).

22. *United States v. Aleynikov,* 676 F3d 71 (2d Cir. 2012).

23. *Id.* at 74.

24. *Id.*

25. *Id.*

26. *Id.*

27. *Id.*

28. *Id.*

29. *Id.*

30. *Id.*

31. Aleynikov was charged with violating 18 U.S.C. § 1832 (trade secret theft), not § 1831 (economic espionage).

32. *Id.* at 74. 18 U.S.C. § 1832 (trade secret theft) imposes a limitation not found in § 1831 (economic espionage): "Whoever, with intent to convert a trade secret, that is related to or included in a product that is **produced for or placed in** interstate or foreign commerce, to the economic benefit of anyone other than the owner thereof, and intending or knowing that the offense will, injure any owner of that trade secret, knowingly. . .without authorization. . . downloads, uploads, ... transmits,. . .or conveys such information" is guilty of a federal offense, and may be imprisoned for up to 10 years. *Id*. § 1832(a) (emphasis added). The Second Circuit found that evidence of this limitation was lacking with respect to the source code.

33. S. 3642 (112th Congress). Aleynikov would subsequently be prosecuted under state law, which would continue for several years, and also ultimately fail. Litigation continues over payment of Aleynikov's legal fees, with a decision as recently as July 13, 2016. *See Jef Feeley "Goldman Sachs Wins Fight Over Ex-Programmer's Legal Fees,"* available at http://www.bloomberg.com/news/articles/2016-07-13/former-goldman-sachs-programmer-loses-fight-over-legal-fees.

34. *See* Substitute Amendment EHF16041 and Leahy-Grassley Amendment ALB16037.

35. *See* 18 U.S.C. § 1839 (3) and (4); 114 P.L. 153, 130 Stat. 376 at 380-381 (deletions shown by strikethrough and additions shown in bold).

36. The language of the proposed Section 279-N(D) of the UTSA bill currently pending in New York (S.3770), proposed new Article 17-B of the New York Business Corporation Law, is nearly identical.

37. *See* Restatement of Torts §757, requiring actual and continuous use.

38. Both the Court of Appeals for the Seventh Circuit, in *United States v. Lange*, 312 F.3d 263, 267 (7th Cir. 2002), and the Court of Appeals for the Third Circuit, in *United States v. Hsu*, 155 F.3d 189, 196 (3d Cir. 1998), have identified the potential significance of this difference between UTSA and the EEA. The Senate Judiciary Committee noted that it did not intend for DTSA definition of a trade secret to be meaningfully different from that generally used in states that have adopted UTSA.

39. 114 P.L. 153, 130 Stat. at 381. "Misappropriation" and "improper means" are also defined identically to the definitions used by most states under UTSA.

40. *Id.*

41. *Id.* at 376.

42. *Id.* at 376-377.

43. *See* Section 34 of the Lanham Act, 15 U.S.C. § 1116(d)(4)(B).

44. 114 P.L. 153, 130 Stat. at 377-379.

45. A treble damages provision was included in the 2014 version of DTSA but was replaced with a double damages provision in the 2015/2016 version adopted.

46. *Id.* at 379-380.

47. *Id.*

48. *See, Willis of N.Y., Inc. v. DeFelice*, 299 A.D.2d 240, 242, 750 N.Y.S.2d 39 (1st Dept. 2002) (citing *EarthWeb, Inc. v. Schlack*, 71 F. Supp. 2d 299 (S.D.N.Y. 1999)).

49. 114 P.L. 153, 130 Stat. at 384-385.

50. *Id.*

51. *Id.* at 385.

52. *Id.*

53. The lack of express preemption, means that New York litigators may still simultaneously assert both DTSA and common law theft of trade secret claims, which may also result in increased litigation costs.

54. The statute of limitations under DTSA is three years; *see* 114 P.L. 153, 130 Stat. at 380, which is consistent with the limitations period for misappropriation of trade secrets in New York. *See* CPLR 214(4).

55. Recent amendments to New York's Commercial Division Rules, however, are narrowing the gap between federal and state practice in cases subject to those rules. *See* 22 N.YC.R.R. § 202.70.

56. *See Columbia Ribbon & Carbon Mfg. Co., Inc. v. A-1-A Corp.*, 42 N.Y.2d 496, 398 N.Y.S.2d 1004, 369 N.E.2d 4 (1977); *BDO Seidman v. Hirshberg*, 93 NY2d 382, 388-389, 712 NE2d 1220, 690 NYS2d 854 (1999); *Brown & Brown, Inc. v. Johnson*, 115 A.D.3d 162, 980 N.Y.S.2d 631 (4th Dept. 2014).

Heath J. Szymczak and Bradley A. Hoppe are members in Bond Schoeneck & King, PLLC's Litigation Department and have extensive experience in protecting companies from trade secret theft, particularly from former employees. Messrs. Hoppe and Szymczak have developed an innovative Trade Secret Protection Audit which systematically reviews a company's agreements, policies and protocols, as well as its physical and electronic security measures.

International Arbitration: Enforcing Arbitral Awards Against Non-Signatories

By Clara Flebus

A recent decision from the U.S. District Court for the Southern District of New York, *Alstom Brasil Energia e Transporte LTDA. v. Mitsui Sumitomo Seguros S.A.*,[1] addressed the issue of enforcing foreign arbitral awards against non-signatories to an arbitration agreement. The existence of a valid agreement to arbitrate is a prerequisite to the enforcement of arbitral awards under the Federal Arbitration Act ("FAA") and the international arbitration conventions it implements. Given the contractual nature of arbitration, parties who have not signed an arbitration agreement generally are not required to arbitrate unless certain exceptions apply. At issue in *Alstom* was whether an insurer enforcing its insured's rights, as a subrogee, under a contract between the insured and a third party, was bound by an arbitration clause in the insured's contract with the third party, even though the insurer had never agreed to arbitrate. The court found that the non-signatory insurer stepping into the shoes of its insured was required to arbitrate disputes with the third party, and thus confirmed the award.

The *Alstom* decision also reaffirmed the principle enunciated in *First Options of Chicago, Inc. v. Kaplan*[2], *i.e.*, the question of a dispute's arbitrability is presumptively for the court to decide—this principle is forcefully applied in proceedings seeking enforcement of an award against a non-signatory to the arbitration agreement. When faced with the "gateway" issue of whether the parties agreed to arbitrate the question of whether a party has agreed to arbitrate, a court will perform a full arbitrability analysis to determine if a non-signatory is bound by the arbitration clause. In other words, the court will review *de novo* the tribunal's determination on its jurisdiction over the non-signatory.

Background

In *Alstom*, two power generation-service companies incorporated in Delaware and Brazil (collectively, "Alstom") entered into a supply contract with an aluminum refiner in Brazil ("Alunorte"). The contract contained an arbitration clause providing for arbitration in New York under the auspices of the International Chamber of Commerce ("ICC"), and a peculiar choice of law provision selecting Brazilian law as the law governing the arbitrators' award, "but only to the extent such law [was] consistent with the Articles of this Agreement" and "if the subject matter for the. . .award [was] not provided for in such Articles."[3]

Pursuant to the supply contract, Alstom sold and delivered to Alunorte two steam generation units. An incident ensued in 2007 due to ruptures in the specialized aluminum tubing that was a component part of the steam generation units. The incident caused Alunorte to shut down its facility. As the facility was restarted a month later, a fire developed due to debris in the steam generation system. As a result of both incidents, Alunorte suffered significant property damage and lost profits. In 2009, Alunorte and Alstom entered into a compromise agreement providing that the parties had complied with their contractual obligations and released each other from all actual and potential claims.

> *"When faced with the 'gateway' issue of whether the parties agreed to arbitrate the question of whether a party has agreed to arbitrate, a court will perform a full arbitrability analysis to determine if a non-signatory is bound by the arbitration clause."*

Subsequently, Alunorte made a claim against its insurer ("Mitsui") to recover losses under an insurance and indemnity contract. Mitsui settled the claim and paid Alunorte $24,558,073.11. Notably, Mitsui's insurance agreement with Alunorte provided for subrogation rights to Mitsui against third parties "whose acts or deeds … cause[d] the indemnified damage."[4] Consequently, Mitsui commenced an action against Alstom in the Brazilian courts, seeking to recover the indemnity payment made to Alunorte. Alstom, however, initiated arbitration proceedings against Mitsui in New York, pursuant to the arbitration clause in the supply contract with Alunorte. Alstom also moved to dismiss the lawsuit pending before the Brazilian courts.

Mitsui entered a special appearance in the New York arbitration to contest the jurisdiction of the arbitral tribunal. The ICC tribunal rendered an award concluding that it had jurisdiction over the parties and the dispute. The award held that, under Brazilian law, Mitsui was bound by the arbitration clause in the Alunorte-Alstom supply contract, and was also obligated to abide by the release given by Alunorte to Alstom. Accordingly, the award stated that Mitsui could not sue Alstom in Brazil, the parties' claims and counterclaims in the arbitration were dismissed, and each party was responsible for its own fees and costs.

Confirmation of the Award in New York

Initially, Alstom filed a petition to confirm the award in New York Supreme Court, but Mitsui removed the proceeding to the Southern District, pursuant to Chapter 2 of the FAA, implementing the United Nations Convention on Recognition and Enforcement of Foreign Arbitral Awards (the "New York Convention").[5] Once in federal court, Mitsui sought to dismiss the petition arguing that the award was not enforceable because Mitsui was not a party to the arbitration agreement and thus was not bound by it. Mitsui also argued that dismissal was warranted because the court lacked personal jurisdiction and on *forum non conveniens* grounds.

At the outset, the court focused on the arbitrability question—who, as between the court or the arbitrators, had the primary authority to decide whether a party had agreed to arbitrate? The court relied on the leading case of *First Options of Chicago, Inc. v. Kaplan*,[6] holding that a presumption in favor of judicial resolution of arbitrability normally applies, unless there is "clea[r] and unmistakabl[e] evidence" that the parties intended to allow the arbitrators to determine questions about their own jurisdiction. As Mitsui was not a signatory to the arbitration agreement, the court concluded that it could not have clearly intended to submit the question of arbitrability to arbitration. As such, the court found it was entitled to conduct its own independent review of whether Mitsui was bound by the arbitration clause.

Applying Brazilian law, the ICC tribunal had held that Mitsui, as a subrogee of Alunorte, was obligated to arbitrate disputes with Alstom. As no deference was due to the arbitrators' decision on this issue, the court performed its own choice of law analysis to decide which law determined Mitsui's obligation to arbitrate. The court reasoned that the parties' choice of New York as the seat of the arbitration reflected their expectation that the issue of whether Mitsui, as subrogee, was bound by the arbitration clause signed by its insured would be governed by U.S. federal arbitration law and its liberal arbitration policy.

The court found that under "clearly established principles" applied in federal courts, a party may be bound to arbitrate "even in the absence of a signature" on the arbitration agreement, and that "an insurer-subrogee stands in the shoes of its insured."[7] Consequently, an insurer is obligated to arbitrate those claims made on behalf of its insured that, if pursued by the insured directly, would be subject to arbitration.[8] Since Mitsui had a clear subrogation right under the insurance and indemnity contract, it acquired no better or different rights that those belonging to its indemnified insured. Therefore, the court concluded that by pursuing Alunorte's claims against Alstom arising out of the supply contract, Mitsui was bound by the same arbitration clause that would have been binding on Alunorte.[9]

Additionally, the court made two interesting points with respect to Mitsui's alternative dismissal grounds. First, it rejected the argument that the petition to confirm the award should be dismissed for lack of personal jurisdiction due to Mitsui's alleged lack of contacts with the forum state (New York). Since the arbitration agreement designated New York as the arbitral forum, the court reasoned that it would have personal jurisdiction over Alunorte based on its consent to arbitrate in New York. The court then found that Alunorte's consent to jurisdiction was equally binding on Mitsui because the terms of an insurer-subrogee's right of recovery are the same as those applicable to its insured.[10] Second, the court dismissed Mitsui's *forum non conveniens* argument, observing that parties who choose to arbitrate in New York are deemed to have also agreed that New York is a convenient forum for enforcement proceedings.[11]

Conclusion

The *Alstom* decision further refines existing common law theories that support a non-signatory's obligation to arbitrate pursuant to an arbitration clause in a contract signed by other parties. So far, courts have relied on six main doctrines to compel a non-signatory to arbitrate: incorporation by reference, assumption by conduct, agency, alter ego/piercing of the corporate veil, estoppel, and third-party beneficiary. It should be noted that generally it is easier for a non-signatory to enforce an arbitration clause against a signatory to a contract—because it is undisputed that the signatory has agreed to arbitrate with someone—then it is for a signatory to enforce an arbitration agreement against a non-signatory who has never agreed to arbitrate with anyone in the first place.[12]

Endnotes

1. 15-cv-08221-AKH, ECF 32 (S.D.N.Y. June 20, 2016) ("Alstom").
2. First Options of Chicago, Inc. v. Kaplan, 514 U.S. 938, 942 (1995).
3. Alstom, at 4.
4. *Id.*
5. *See* 9 U.S.C. §§ 201, 203 & 205.
6. First Options of Chicago, Inc. v. Kaplan, 514 U.S. 938, 944 (1995).
7. Alstom, at 9.
8. *Id*.
9. *Id.* at 10.
10. *Id.* at 11.
11. *Id.* at 13.
12. James H. Carter & John Fellas, International Commercial Arbitration In New York, 218-222 (Oxford University Press 2010).

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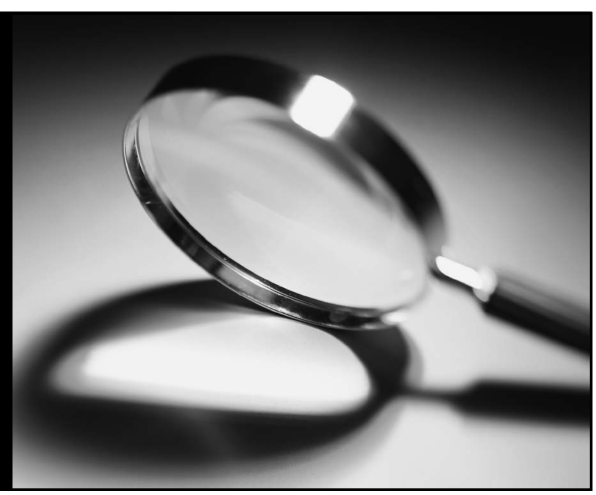

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