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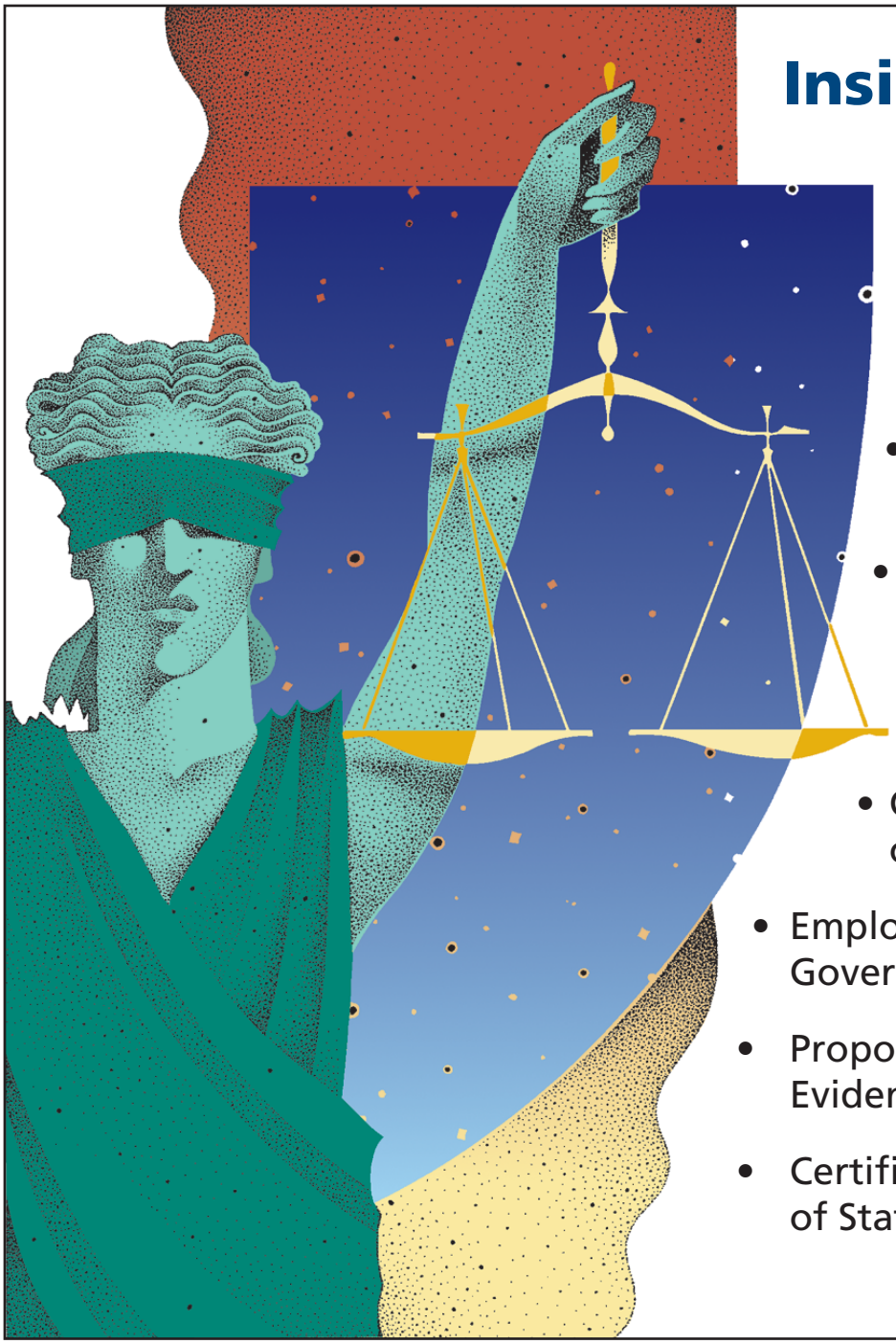

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Section Reports

Commercial and Federal Litigation Section

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Message from the Chair

By Lesley Friedman Rosenthal

These pages are a testament to our busy and productive season for our Section. Several hundred of us hosted dozens of members of the federal judiciary in a first-ever celebration of five new Chief Judges of federal courts in New York. That festive occasion, "Hail to the Chiefs," took place at Lincoln Center in New York City in September 2006, and some of the remarks from that evening are captured here.

Our Annual Meeting, ably chaired by Section Vice-Chair Peter Brown, with the cool-headed Section Secretary-Elect Kyana McCain, was memorable as always, including a panel on what in-house counsel are (and are not) looking for in their outside litigation counsel. The remarks of the panel are reproduced here: a must-read for anyone looking to generate new business at a firm or take good care of litigation business in-house.

The thought-provoking remarks by United States District Judge Lewis A. Kaplan upon receiving the Stanley H. Fuld Award for excellence in commercial jurisprudence have already resulted in several requests for publication, further elaboration and discussion. We satisfy at least the first of those requests here.

The work of our committees is the lifeblood of the Section, and committee work is well represented here: reports by our committees on Federal Procedure, E-Discovery, Appellate Practice, Ethics and Professionalism and Class Actions, as well as the *NYLitigator* debut of our recently formed Corporate Litigation Counsel Committee.

Articles by individual authors on dissolution law and the settlement privilege round out the issue.

We owe a debt of gratitude as always to the Editor-in-Chief, Bernard Daskal, for putting together this edition of *NYLitigator*.

I hope you find this volume to be a valuable part of your membership in the Section.

[Editor's Note: On January 24, 2007, the Commercial and Federal Litigation Section of the New York State Bar Association presented its Stanley H. Fuld Award to Judge Lewis A. Kaplan of the United States District Court for the Southern District of New York. The following remarks were delivered by Judge Kaplan upon his acceptance of the Fuld Award.]

Should We Reconsider Corporate Criminal Liability?

By Hon. Lewis A. Kaplan

Thank you to the Commercial and Federal Litigation Section for honoring me with this wonderful award. I place a very high value on your recognition because I am such an admirer of the wonderful work you have done for so many years.

"We . . . have moved . . . from a system in which prosecutors prosecuted and courts and juries decided guilt or innocence to a system in which prosecutors as a practical matter threaten business entities with unbearable extrajudicial consequences and thus exact acquiescence in the government's demands."

It is humbling to be mentioned in the same breath as the late, great Stanley H. Fuld, let alone to receive an award named in his memory. As you have heard, Judge Fuld was a giant. But he was not simply a superb legal craftsman. As Judge Jack Weinstein, one of Judge Fuld's first law clerks, said, Judge Fuld "was at that cusp between an older style of looking at the law which was more protective of property rights and the more flexible people-oriented law we have had since World War II."[1] Judge Fuld repeatedly took positions, often in dissent in his early years and later for majorities of the Court of Appeals, that espoused protection of individual rights. The values that animated his jurisprudence are at least equally important today. In sum, Judge Fuld was everything a judge ought to be. He was brilliant. He was wise. And he understood that law exists to better the lives of everyone—rich and poor, black and white, advantaged and disadvantaged. His life is an example to all of us.

My first thought when I contemplated speaking to you on this occasion, was this: as much as I admire those who can give humorous and entertaining talks, I am not one of them. It's a mistake to try. So I apologize in advance for turning to something more serious and, I hope, something of particular interest to this section.

Over the course of my career, we have seen a sea change in the use of the criminal law in the business world.[2] When I was a little younger than I am now, government dealt with business misconduct principally by regulation and civil litigation. When there were criminal investigations, they typically proceeded in what by now is an old-fashioned way. The government got a tip or a cooperating witness. Grand jury subpoenas went out. Witnesses were turned or immunized. Cases were built. Sometimes indictments were returned. Even where corporations or other business entities were indicted, the potential consequences of conviction usually were such that mounting a defense was a feasible course of action.

That has changed. For a variety of reasons that are familiar to many of you, the return of an indictment against many public companies and other prominent organizations would threaten their very existence, regardless of whether they were guilty. In those cases, defending against criminal charges is not a viable option. The entity in such a case has little choice—it must make a deal with the government that avoids a criminal prosecution. This frequently means waiving the attorney-client privilege, firing employees whom prosecutors regard as culpable, paying large fines, and often accepting major changes to the manner in which the entity does business. We thus have moved, in some cases and in some degree, from a system in which prosecutors prosecuted and courts and juries decided guilt or innocence to a system in which prosecutors as a practical matter threaten business entities with unbearable extrajudicial consequences and thus exact acquiescence in the government's demands.

This is made possible by the conjunction of two principles. The first is the proposition that a corporation is a legal person and thus capable of committing a crime. The second is the fact that a corporation, however large, is guilty of a crime if even a single agent commits a prohibited act with the requisite mental state as long as that act was intended to benefit the corporation and was directly related to the performance of the kind of duties the agent had the general authority to perform.[3]

These principles, neither of which is self-evident, have not been with us from the beginning of time. Blackstone said that corporations are incapable in their corporate capacities of committing crimes, although their members may be criminally liable in their individual capacities.[4] Nevertheless, these principles have been with

us for a very long time. The Supreme Court accepted the constitutionality of imputing criminal responsibility to corporations on agency principles in 1909.[5]

The concept of the corporation as a legal person is older than that. Thus, the environment in which corporate criminal liability became a matter of black letter law was very different from today. Certainly the Supreme Court, when it upheld the *respondeat superior* theory of criminal liability 98 years ago, could not have conceived of anything like the Arthur Andersen case. It is, I suggest, time for an objective consideration of whether any change is warranted in present circumstances.

"When people commit crimes, they should be punished, regardless of whether their collars are white or blue."

Let me begin with some disclaimers.

First, these remarks are not about any pending case or any case that recently was dismissed.

Second, I have no more sympathy for corporate or white collar crime than for any other variety. When people commit crimes, they should be punished, regardless of whether their collars are white or blue. Moreover, crimes committed by white collar criminals out of a studied calculation of likely costs and benefits of engaging in the criminal behavior perhaps are especially reprehensible.

Third, I am not squeamish about the fact that the criminal process often, and quite appropriately, presents defendants and prospective defendants with choices between unpalatable alternatives. That is what happens whenever a criminal defendant accepts a plea bargain, and plea bargaining is not the only circumstance in which it occurs. But it is important to recognize that corporations and other business organizations are different than individuals and that the difference is relevant to the extent to which they should be treated in exactly the same way.

Although corporations are regarded by the law as persons, they are not persons in the same sense as those of us who live and breathe. They are collections of individuals and, often, other organizations that are bound together by complex webs of contracts and legal rights and duties. At a minimum, these collections include stockholders, directors, officers, and employees.

One consequence of this difference between corporations and individuals is that a criminal conviction of a corporation does not punish the wrongdoers. It punishes the stockholders and, in some cases, other corporate constituents. These groups bear the consequences regardless of whether they have any culpability. You do not have to look any further than the thousands of innocent former partners and employees of Arthur Andersen to see what I mean. But there are other, perhaps less obvious, examples. In the Adelphia scandal, to mention one, the bankrupt company, as part of a deal to avoid indictment, agreed to pay $715 million to a government-established restitution fund. This deprived the bankruptcy estate of a vast sum that otherwise would have been distributed in accordance with the priorities applicable in bankruptcy. Some creditors were disadvantaged for the benefit of ultimate beneficiaries of the government's fund. While there was no error in the bankruptcy court's approval of the settlement with the government,[6] the case illustrates the point that criminal prosecutions of corporations may injure innocent constituencies even more remote than stockholders and employees.

I do not question the application of conventional agency principles in the civil context. When the constituents of a corporation or business entity join together in a collective effort to make a profit, it seems entirely fair to require that the entity compensate anyone whom its actions injure, just as it is entirely fair to require that the entity pay its debts. Such compensation is a part of the collective enterprise.

The criminal side may, and I emphasize the word "may," be different. Most say that the criminal law serves a number of purposes. Criminal convictions afford an institutionalized means of exacting retribution. The punishment deters others from engaging in similar offenses. In some cases, as where an individual is imprisoned, it disables the offender from committing other crimes. So let us consider corporate criminal liability in terms of these purposes.

The first question is whether convicting corporations of crimes serves the purpose of institutionalizing vengeance. Certainly one can understand that punishing living and breathing criminals for their misdeeds satisfies the basic human desire to see the guilty pay for their crimes. Indeed, criminal law developed in part to avoid private vengeance by satisfying that desire. But that doesn't seem to be much of a concern where the offender is a legal entity that is a "person" only in a metaphorical sense. And I wonder whether people who are victims of crimes committed by agents of a corporation feel better when the corporation is convicted of a crime than they would feel if the guilty individuals alone were convicted.

The case for corporate criminal liability appears differently when viewed from the standpoint of general deterrence. The empirical question is whether a board of directors or corporate managers would be more likely to ensure that subordinates conduct themselves in accordance with the law if the company were subject to crimi-

nal conviction than they would be if the company could not be prosecuted criminally. It is an interesting question to which I do not pretend to have the answer. There is an arguable case, however, for the proposition that corporate criminal liability may have a deterrent effect on other companies, but I'm not sure it is something that is so obvious as to be taken on faith.

Specific deterrence is yet another matter. I wonder whether convicting a corporation of a crime has much effect, one way or the other, on the question whether it will engage in wrongdoing in the future—unless, of course, the effect is to put it out of business. Certainly conviction of corporate agents who committed the wrongdoing would take them out of the picture quite effectively regardless of whether the corporation is prosecuted.

"I wonder whether convicting a corporation of a crime has much effect, one way or the other, on the question whether it will engage in wrongdoing in the future—unless, of course, the effect is to put it out of business."

These are only some of the relevant considerations, and I quickly concede that I have only scratched the surface of a very complicated subject. I confess also that I do not have a view as to whether any change in the current state of the law would be advisable. I do suggest, however, that this is an appropriate subject for consideration, particularly in light of the devastating consequences of potential criminal liability that we first have seen only recently. This Section and this Association are well suited to play an important part in that process, and I urge you to do so.

I cannot close without adding a word of thanks to my family, who are entitled to a good deal of any credit for anything that I may have accomplished. My bride of three very happy years, Lesley Oelsner, supports my judicial service with the ferocity of a tiger, a ferocity born of her own passionate commitment to justice and public service. My late wife, Nancy, encouraged and supported my going on the bench and was my partner for 33 wonderful years. My parents, though I disappointed at least my father in not becoming a doctor, encouraged my legal career. My father did so quite inadvertently by making a refugee's admiration of our legal system clear to me even at a very young age, and my mother did the same through her concern for the powerless. And my mother-in-law, Doris Gelberg, who I am pleased to have here with us today, has been a tower of strength in all things for more than 40 years.

Finally, let me once again express my sincere gratitude to the Section for the high honor it has conferred upon me. I shall always cherish it, and doubly so for the identities both of the donor and of the exemplar of judicial achievement for whom it is named.

Endnotes

1. Douglas Martin, *Stanley Fuld, Former Judge, Is Dead at 99,* New York Times A21:1 (July 25, 2003).
2. *See generally, e.g.,* Leonard Orland, *The Transformation of Corporate Criminal Law,* 1 Bklyn. J. Corp., Fin. & Comm'l Law 45 (2006).
3. *See* Leonard B. Sand, et al., Modern Federal Jury Instructions, Instruction 2-7.
4. 1 William Blackstone, Commentaries on the Laws of England 464 (1765).
5. *New York Central and Hudson River R.R. Co. v. United States,* 212 U.S. 481 (1909).
6. *Ad Hoc Adelphia Trade Claims Comm. v. Adelphia Comm'ns Corp.*, 337 B.R. 475 (S.D.N.Y.), *appeal dismissed as moot sub nom. In re Adelphia Comm'ns Corp.,* Nos. 06-1417-BK, 06-1738-BK, 2006 WL 3826700 (2d Cir. Dec. 26, 2006).

"Hail to the Chiefs"

[Editor's Note: The following remarks are from the September 29, 2006 "Hail to the Chiefs" event, celebrating the appointment of five new chief judges to the New York federal courts: (1) Hon. Dennis Jacobs, Chief Judge of the United States Court of Appeals for the Second Circuit; (2) Hon. Kimba Wood, Chief Judge of the United States District Court for the Southern District of New York; (3) Hon. Norman A. Mordue, Chief Judge for the United States District Court for the Northern District of New York; (4) Hon. Melanie Cyganowski, Chief Judge of the United States Bankruptcy Court for the Eastern District of New York; and (5) Hon. Lisa Margaret Smith, Chief Magistrate Judge for the Southern District of New York. The event was sponsored by the Commercial and Federal Litigation Section of the New York State Bar Association and held at the Walter Reade Theatre at Lincoln Center.]

Welcoming Remarks

By Lesley Friedman Rosenthal, Chair of the Commercial and Federal Litigation Section of the New York State Bar Association

Chief Judge Jacobs, Chief Judge Wood, Chief Judge Mordue, Chief Judge Smith and Chief Judge Cyganowski, other esteemed members of the federal and state judiciary in New York, sponsoring firms, Section members and guests: Hail and Welcome!

What an extraordinary event we are celebrating here tonight.

". . . I can say there is not a more impressive, intelligent, consequential, or good-looking gathering to be found—here at Lincoln Center or anywhere—than those assembled in this theater tonight: the leading members of New York's bench and bar."

We at Lincoln Center follow the "know your audience" rule, and accordingly, I have been studying this audience *very* carefully. So it is with utter confidence that I can say there is not a more impressive, intelligent, consequential, or good-looking gathering to be found—here at Lincoln Center or anywhere—than those assembled in this theater tonight: the leading members of New York's bench and bar. And an auspicious occasion it is: a changing of the guard, a harmonic convergence of term endings and 70th birthdays, giving rise to such a large number of new chief judges in one year.

Serendipitous though it may be, the convergence of these milestones provides an opportunity—Chief Judge Jacobs would say an excuse—for a party but also an opportunity to celebrate the distinguished service of these five new Chief Judges and hear about their plans and priorities in their terms as Chief; to give the practitioners who regularly come before these preeminent jurists a chance to meet them and hear firsthand their visions for the courts they have come to lead; and to enable our Section's members, both preexisting and new, to get to know one another better and to extend once again an offer to be of service to the court system and the administration of justice.

It is indeed an honor and a privilege for the Commercial and Federal Litigation Section to celebrate these five new Chief Judges this evening. For in honoring these Chief Judges, we also celebrate the long and dynamic relationship of the Commercial and Federal Litigation Section of the New York State Bar Association and the federal judiciary in New York.

- The Commercial and Federal Litigation Section has valued and supported the work of the federal judiciary throughout the Section's nearly 20 years.
- The Section has consistently worked to increase funding from Congress for the Federal Courts and the federal judiciary's budget and salaries.
- Over the years, we have publicized and explicated important commercial decisions of the Court of Appeals, District Courts, Magistrate Judges and Bankruptcy Courts through interviews, reports and articles published in our Section's flagship publication, *NYLitigator*.
- Our Section served on a Special Committee of the Southern District under the leadership of then-Chief Judge Griesa in providing information and recommendations regarding access to and usage of that court. This project included surveys of attorneys on usage and experience in Federal Court, State Court, and arbitration proceedings.

- The Section has broadened the experience of both attorneys and judges throughout New York State through educational programs and receptions with, by and for federal judges.
- Our Section's Annual and Spring Meetings serve as a forum for judges, both federal and state, both as speakers and guests as we take on the critical legal issues of the day. This past spring, right here at Lincoln Center, we were pleased to confer the Robert L. Haig Award for public service to outgoing Chief Judge John M. Walker, Jr., giving rise to a joint bench-bar project to help foster judicial independence in emerging democracies around the world.
- And our Section's major policy statements and positions reflect the voices and the priorities of the federal judiciary, as we are privileged to include several judicial members on our Executive Committee. In fact, Chief Judge Cyganowski, a founding member of our Section and one of its longest continuing members, chairs our nominating committee.

Later this evening, Lincoln Center is celebrating the opening night of the New York Film Festival; earlier this week the Metropolitan Opera premiered the new Anthony Minghella production of *Madame Butterfly*, including plaza-casts here and in Times Square for all the world to see; and next month the Lincoln Center Theater will present the American premiere of Tom Stoppard's trilogy, *The Coast of Utopia*.

I am sure it did not escape your notice as you treaded carefully over our glorious construction site this evening that Lincoln Center is in major transition, physically as well as artistically. The construction around us heralds a reinvigorated civic and cultural institution that is very much looking ahead to the next 50 years.

But Lincoln Center is not the only player in town bringing off major new building projects: in Brooklyn, a gleaming new federal courthouse has been opened in the Civic Center of downtown Brooklyn, visible as a beacon of justice from the Brooklyn Bridge, the Manhattan Bridge, lower Manhattan and surrounding neighborhoods. The courtrooms and chambers in that new courthouse are arranged in a collegial layout with a single chambers floor located between two court floors, with a forward-thinking design plan that leaves room to grow. Meantime, our beloved federal courthouse at 40 Centre is about to receive its first wholesale renovation since it opened 70 years ago, and major federal courthouse projects have been completed in Central Islip and in Buffalo as well.

The federal judiciary appears to be at a point of inflection of various other sorts as well. Federal judges are noting—and lamenting—their loss of certain important types of discretion, even as they are being asked to manage increasingly large and varied dockets. As Judge Colleen McMahon recently noted at a meeting of our Section's Executive Committee:

- supplemental jurisdiction has been expanded;
- the demise of court-created doctrines of hypothetical standing and personal jurisdiction now requires district courts to devote precious time to questions of standing and jurisdiction, all subject to appeal, regardless of the complaint's merit;
- the federalization of crimes previously considered the exclusive domain of the state courts has also increased the size of federal judges' dockets;
- the rolling back of the Rooker-Feldman doctrine in 2005 now encourages federal court review of final decisions by state courts;
- at the same time, judicial pay in both the federal and state courts has not kept pace with the rest of the profession.

"It is critical that calls for 'accountability' not be conflated with incursions into the independence of the judiciary that we all hold so dear."

Other matters loom as well. Last week the Judicial Conference enacted new rules pertaining to disclosure of conflicts of interest, and separately, a committee headed by Supreme Court Justice Breyer has issued a report recommending certain changes in how federal courts handle ethical complaints filed by members of the public against judges. Just a few days ago, the House Judiciary Committee passed a bill to empower the Inspector General's office to oversee the judiciary's handling of ethical complaints.

It is critical that calls for "accountability" not be conflated with incursions into the independence of the judiciary that we all hold so dear.

The Commercial and Federal Litigation Section reiterates today its unflagging support for the judiciary in the federal and state courts in New York. We offer to the new Chief Judges, and the courts they lead, our fellowship, and our partnership, in protecting, preserving, and enhancing the true administration of justice.

"Hail to the Chiefs"

Before I introduce individually our honored guests, I wish to mention a few individuals without whom this evening would not be possible.

It has been a pleasure working on this evening's event with Section Secretary Susan Davies, the Co-Chairs of the Section's Committee on the Federal Judiciary Jay G. Safer and John D. Winter; Juli Turner, Section Liaison from the New York State Bar Association; and my indefatigable Executive Assistant, Cecelia Gilchriest. United States Circuit Judge and my esteemed friend Robert Katzmann helped hatch the idea for this celebration many months ago, and although he is rushing back from Washington D.C. to try to catch the end of this event, I would like to express my personal appreciation to him.

From left to right: Section Chair Lesley F. Rosenthal; State Bar President Mark H. Alcott; Hon. Lisa Margaret Smith (Chief United States Magistrate Judge, Southern District of New York); Hon. Norman A. Mordue (Chief United States District Judge, Northern District of New York); Hon. Melanie L. Cyganowski (Chief United States Bankruptcy Judge, Bankruptcy Court for the Eastern District of New York); and Hon. Dennis Jacobs (Chief United States Circuit Judge, Court of Appeals for the Second Circuit)

Finally, this celebration could not have been possible without the generous support of its law firm sponsors, whose names appear in your program. I hope you will take a moment to thank the representatives of those firms as we resume our reception after the speaking portion of the program.

I would now like to introduce the new Chief Judges and offer the audience an opportunity to congratulate them for yourselves:

Incoming Chief United States Circuit Judge for the Second Circuit, Dennis G. Jacobs, entered on duty as a U.S. Circuit Judge in 1992. Prior to ascending to the bench, Chief Judge Jacobs was a partner with the firm of Simpson Thatcher & Bartlett. Chief Judge Jacobs is a product of Queens College–City University of New York, and NYU. Before entering the legal profession, Chief Judge Jacobs was a lecturer in the English Department at Queens College. Jumping the gun by just two calendar days, please allow me to be the first to publicly introduce, as of October 1, 2006, the new Chief United States Circuit Judge for the Second Circuit, Dennis Jacobs.

Chief United States District Judge for the Southern District of New York, Kimba M. Wood, ascended to the federal bench in 1988. Immediately following law school, Judge Wood worked with Steptoe & Johnson, and then joined the Office of Special Counsel within the Office of Economic Opportunity Legal Services project. In 1971, she joined the firm of LeBoeuf, Lamb—not coincidentally one of our sponsors this evening—and became a partner in 1978.

Chief Judge Wood is a denizen of Bar Association work, as an active member of the Association of the Bar of the City of New York, the New York State Bar Association, the Federal Bar Council and the American Bar Association. Thank you, Chief.

Our next honoree is Hon. Norman A. Mordue, Chief United States District Judge, United States District Court for the Northern District of New York. Chief Judge Mordue entered on duty as United States District Judge for the Northern District of New York in 1998. Prior to the bench, Chief Judge Mordue spent 12 years with the Onondaga County District Attorney's office, beginning as a law clerk and becoming Chief Assistant District Attorney in 1977. For several years, he was in charge of felony and homicide prosecutions with a one hundred percent conviction rate. He served as an Onondaga County Court Judge from 1983 to 1985 and a New York State Supreme Court Justice of the Fifth Judicial District from 1985 until his appointment to the federal bench.

Prior to attending law school, Chief Judge Mordue was commissioned as a Second Lieutenant in the United States Regular Army and served in Vietnam in 1966 and 1967. He received the Distinguished Service Cross for extraordinary heroism, Bronze Star with "V" for heroism, the Air Medal, the Combat Infantryman's Badge and the Purple Heart.

"Hail to the Chiefs"

Chief Judge Mordue is accompanied here today by his wife Christina, and his immediate predecessor Chief Judge, the Honorable Frederick J. Scullin, Jr. and his wife Cricket, all of whom have traveled here today from Syracuse, New York.

Our next honoree is Hon. Lisa Margaret Smith, Chief United States Magistrate Judge for the Southern District of New York. Chief Magistrate Judge Smith entered on duty as a Magistrate Judge in 1995. Upon graduation from law school in 1980, she served as an Assistant District Attorney in the Kings County District Attorney's office, becoming Supervising Senior Assistant District Attorney until 1985. From 1985 to 1986, she was Assistant Attorney General for the Appeals and Opinions Division of the New York State Department of Law in Albany. In 1986, Chief Magistrate Judge Smith rejoined the Kings County District Attorney's Office as a Supervising Senior ADA. In 1987, Chief Magistrate Judge Smith became an Assistant United States Attorney in the Southern District of New York until her induction to the bench in 1995.

Chief Magistrate Judge Smith is a member of the Westchester County Bar Association, the Westchester County Women's Bar Association, the New York State Women's Bar Association, the National Association of Women Judges, Judges and Lawyers Breast Cancer Awareness, and the Federal Magistrate Judges Association. She is also a member of the Boards of Editors of the *Federal Courts Law Review* and the *Federal Bar Council News*.

Although all of our honorees are equally special, our next honoree is, well, especially special to our Section because she is one of our own. Hon. Melanie Cyganowski, Chief United States Bankruptcy Judge for the Eastern District of New York, was appointed to the Bankruptcy court bench in 1993. Upon graduation from law school, Chief Bankruptcy Judge Cyganowski was law clerk to the Honorable Charles L. Brieant (who, by the way, was Chief Judge of the Southern District when I was a law clerk to the Honorable Shirley Wohl Kram in 1989—a special welcome to Judge Brieant, who is with us here this evening). Following her clerkship, Chief Bankruptcy Judge Cyganowski was an associate with Sullivan & Cromwell until 1989, when she joined Milbank Tweed's litigation department until her appointment to the bench.

Judge Cyganowski is a legal scholar as well as a jurist, with an adjunct teaching post at St. John's University School of Law and numerous published articles appearing in leading law journals and periodicals. Have I mentioned that she is a founding and still very active member of our Section? She is also a member of the American Bar Association, the National Conference for Bankruptcy Judges, and a Fellow of the American Bar Foundation.

It now gives me great pleasure to introduce Mark H. Alcott, President of the New York State Bar Association.

Prior to becoming President of the New York State Bar Association, Mark Alcott served as chair of our Section, the Commercial and Federal Litigation Section, and has held numerous other posts within the organization and the profession. Most notably from our Section's perspective was Mark's chairmanship of a special Task Force appointed by another former Section Chair, Kevin Castel, now a United States District Judge for the Southern District of New York. The task force Mark Alcott led in 1994 built both a *case* and a *coalition* in support of the idea that New York should have a body of commercial jurisprudence befitting its stature as the financial capital of the world, and that the jurisprudence would evolve and develop most effectively when specialized commercial courts were established in the State. The work of Mark's task force, and that of the committee he subsequently served on, established by Chief Judge Judith S. Kaye and chaired by another former Section Chair, Bob Haig, gave rise directly to the creation of Commercial Division of the New York State Supreme Court—a development that has literally transformed the way commercial disputes are litigated in New York State courts.

A senior partner in the Litigation Department of Paul Weiss Rifkind Wharton & Garrison LLP and my personal mentor, please join me in welcoming Mark Alcott.

Keynote Address: Judicial Independence

By Mark H. Alcott, President of the New York State Bar Association

It is a treat to attend another Lesley Rosenthal spectacular, but I am a little jealous about the title assigned to this one. Some of you will recall that, at the reception to mark my first day in office, Lesley actually took out her fiddle and played "Hail to the Chief" for me. So when I was invited to this event, I thought they will be playing our song. Instead it is being played for some real chiefs.

"[T]his Association must be in the vanguard of the fight to defend the reputation of our profession, resist political interference in our court system and preserve the independence of our judiciary."

It is always a pleasure to attend an event of this Section—where I started my bar association career 20 years ago; where Shira Scheindlin anointed me, and Melanie Cyganowski nominated me, to be Section Chair; and where I served as Chair-Elect during the tenure of Kevin Castel. I am especially pleased to join a gathering of luminaries from our federal courts. I hope you will not mind if I single out for special mention those who were my friends and colleagues before they went on the bench, including Lew Kaplan, Colleen McMahon, Jed Rakoff, Nina Gershon, Sid Stein, Andy Peck, Ed Korman, and Allyne Ross.

We are here to honor an outstanding group of new chief judges, who truly deserve this recognition. In so doing, we express our admiration and respect not only for them as individuals but also for the extraordinary institutions they lead—our federal courts.

There has never been a time when the courts—especially the federal courts—were more deserving or more in need of our support. Our courts are grappling with the defining issues of this era. They are on the front lines of the battle to preserve due process and our constitutional birthright, while the country is locked in a grim struggle with a lethal but almost invisible adversary. And they are engaged in that battle at a time of unprecedented attack against courts, judges and lawyers—attacks that threaten the independence of our legal institutions.

Independence of the bench and bar are the cornerstones of our legal system, the enduring concerns of our Association—and they are irrevocably linked. That is why those who attack the courts and judges also attack lawyers and the legal profession. So this Association must be in the vanguard of the fight to defend the reputation of our profession, resist political interference in our court system and preserve the independence of our judiciary.

Make no mistake about it: our courts are under siege. I am not referring to disagreements about controversial decisions. As lawyers, we have such disagreements all the time. I am referring to efforts to intimidate judges and strip them of their ability to serve as neutral arbiters of disputes, as we have seen in so many instances in the recent past, including the *Schiavo* episode; the deplorable response to the *Kelo* decision; the habeas-stripping bill, and the like. Courts have no armies, no weapons. They depend on their moral authority. Society undermines that authority at its peril.

Recently, there were heavy attacks on Judge Anna Diggs Taylor and on her decision in the warrantless surveillance case. The latter were acceptable; the former were not.

"Courts have no armies, no weapons. They depend on their moral authority. Society undermines that authority at its peril."

The distinction we must draw is between criticizing a decision, on the one hand, and attacking the judge who made the decision, on the other hand. A decision is fair game; criticizing a decision is not only appropriate but healthy. Lawyers do it; dissenting or reversing judges do it; law professors do it. Certainly, then, editorial writers and even politicians can do it. That is so even if the criticism is harsh. Of course, criticism of a decision could become so extreme that it is beyond the pale, but the bar is set pretty high for that.

On the other hand, personal attacks on the judge who made the decision—as biased, corrupt, impeachable, etc.—are problematic and warrant a response from the bar. I say that for several reasons. First, the judge herself cannot respond, nor can anyone other than the organized

bar effectively do so on her behalf. Accordingly, we have a duty to respond. Second, such attacks can intimidate not only the judge at whom they are directed but also other judges, and I believe that is often the intent. For that reason, they truly undermine judicial independence. Third, when they are orchestrated by pressure groups, ideological movements or political parties, attacks of this kind constitute political interference in the judicial process and threaten to turn the court system into a partisan, ideological battleground, instead of a neutral arena for resolving disputes. Fourth, they undercut everything we are trying to do to get the public to understand and have confidence in our legal system.

What troubled me about some of the criticism of Judge Diggs Taylor was the contention that the judge was not just wrong or even very wrong (fair criticism) but ideologically biased, intellectually dishonest and result-oriented; that she made up her mind in advance and reached the decision she wanted to reach without fair consideration of the merits. Critics did not have to make that attack in order to make a strong, effective critique of the decision; nor was there any evidence in support of this contention other than the perceived weakness of the decision. It disturbs me that purportedly learned critics, challenging a decision as baseless as they claimed this one to be, felt it necessary to make a personal, political attack on the judge rather than simply criticizing the decision itself.

The action of other critics was even more disturbing, because they treated the judicial process like a political campaign. Have we reached the point where, when an ideological group disagrees with a decision, it engages in negative research to find "dirt" on the judge? If the decision is so wrong-headed, will not it be corrected on appeal? The decision should be debated on its merits. The attack on the judge adds nothing to the debate on whether the decision is right or wrong. It simply politicizes the process. The bar must defend judges who are subjected to such attacks.

I recognize that an even-handed application of this doctrine might have required us to defend from personal attacks those who stood with the majority in *Bush v. Gore*; and to defend Justice Scalia against personal attacks based on his decision in the *Cheney* case, following his duck-hunting with Vice President Cheney. So be it. Under this doctrine, the bar's refutation of personal attacks against a judge does not turn on whether we agree with the judge's decision or share his politics.

"Have we reached the point where, when an ideological group disagrees with a decision, it engages in negative research to find 'dirt' on the judge? If the decision is so wrong-headed, will not it be corrected on appeal?"

In some generations, judicial independence was threatened by tyrannical dictators or invading armies. In our generation, the threats to judicial independence arise from ideological passions; cultural disputes; and the need to preserve freedom, liberty and due process, while fighting a different kind of war.

But today's threats to the independence and integrity of bench and bar are no less real. They require our constant vigilance and passionate advocacy. They require us to speak our minds and raise our voices. I can assure you that I always will.

Pro Bono Panels

By Hon. Kimba M. Wood, Chief Judge of the United States District Court for the Southern District of New York

This Section is known for its contributions to our district court, for which I and all of my colleagues thank you. Section Chair Lesley Friedman Rosenthal asked me whether there are ways in which you can help our Court in the coming year, and I am delighted to have this opportunity to describe to you the help we need.

We have a large number of *pro se* cases in which the presiding judge has decided that the *pro se* litigant's claim warrants appointment of counsel. We are looking for lawyers like you to join a panel of lawyers whom we can contact to describe these cases. Joining the panel carries no responsibility with it. It simply means that you will receive, once a month, case descriptions; then, if you decide you would like to see the file on a particular case (before you decide whether to take on the case), it will be sent to you. If you decide not to take the case, you simply return the file.

The advantage to the Court of your volunteering is that you can help us do justice in these cases. The advantage to you is that you will get more experience litigating in federal court (perhaps even a trial), and you can decide when you have the time to take on a case.

There is a similar program that calls upon much less of your time—you can volunteer to represent a *pro se* litigant only in mediation. In order not to waste your time, the cases from which you choose will be only cases in which all parties have agreed to mediate. After mediation, you have no further responsibility for the case.

Speaking on behalf of myself and all of my colleagues, I hope to see you join our *pro bono* panels. I have left at the door copies of a memo describing these programs more fully.

Thank you very much for inviting us to join you for this delightful reception.

[Editor's Note: To receive a copy of the pro bono panel memo mentioned in Chief Judge Wood's remarks, please call the Southern District Pro Bono Panel at (212) 805-0175.]

Addressing Bankruptcy Court Challenges

By Hon. Melanie L. Cyganowski, Chief Bankruptcy Judge of the United States District Court for the Eastern District of New York

What a pleasure to be here and, truly, what an honor. I have been a member of the Commercial and Federal Litigation Section and its predecessor committee for over 20 years and I must confess that I do not recall ever attending a program that is as delightful and innovative as this one is. I came upon a quote from our late President John F. Kennedy who was once asked what his favorite song was. He responded that "I think 'Hail to the Chief' has a nice ring to it." I think I now understand what he meant!

"As we as a Court embrace the challenge of dealing with the ever increasing numbers of pro se debtors . . . it is all the more important for the legal community and the bar to become personally involved and provide pro bono *services to the indigent persons in need of debt relief."*

Let me begin by thanking and extending my personal congratulations and kudos to the officers—Lesley Friedman Rosenthal, the Section's Chair; Carrie Cohen, the Chair-Elect; Peter Brown, the Vice-Chair; Susan Davies, the Secretary; and Vincent Syracuse, the Treasurer—who together with Jay Safer and John Winter, Co-Chairs of this event, Juli Turner of the NYSBA, Cecelia Gilchriest of Lincoln Center, and many others made this event possible. Let us give them a round of applause for their good work.

I am also honored to be sharing this podium with the other honorees—Chief Judge Dennis Jacobs, Chief Judge Kimba Woods, Chief Judge Norman Mordue, and Chief Judge Lisa Margaret Smith. I feel truly humbled to stand amidst such esteemed company.

I am now completing my tenth month as Chief Judge of the Bankruptcy Court for the Eastern District of New York. And, as I think back and reflect upon all that we, as a Court, have accomplished, I cannot help but have a greater appreciation for the maxim that "teams work better when they work together." In the Eastern District of New York, I am fortunate to have as my colleagues, Judges Feller, Eisenberg, Bernstein, Craig, Milton and Stong—many of whom are here tonight—and, together with the leadership in our Clerk's office (led by Joseph Hurley, our Clerk of Court), we have indeed put together a team that has worked better and harder than ever before.

What are the challenges that confront our Court? And how do those challenges involve you, the members of the legal community and, in particular, the members of the Commercial and Federal Litigation Section of the New York State Bar Association?

Let me outline but a few of the many significant issues that we are in the midst of confronting:

First, we are about to observe the first anniversary of the significant amendments made to the Bankruptcy Code that are known as the Bankruptcy Abuse Prevention and Consumer Protection Act. People may differ as to whether these amendments are good or bad, a benefit or a travesty. However they may be perceived, there is no doubt that the amendments have created a thicket of hoops and hurdles for persons seeking debt relief. Particularly in the Eastern District where the population of people spans the spectrum of languages and economic levels, these difficulties are magnified and it is all the more important that we, as a Court, be able to provide a basic map of information that enables potential debtors to navigate their way through the bankruptcy process.

I am indeed pleased to announce that, with the blessing and wholehearted support of the Judges of the Second Circuit—under Chief Judge Walker's and Chief Judge Jacobs's leadership—we have taken the first step and will be initiating a program to enhance education for *pro se* debtors. A critical component of this effort is that we will have, on our staff, a *Pro Se* Law Clerk assigned to my office who will serve as the focal point of our pro se efforts. This is a pilot program: the first of its kind anywhere in the bankruptcy system.

How does this impact you? It is neither our intent nor purpose to provide legal counsel or representation to *pro se* debtors. That is clearly the province and responsibility of the legal community. As we as a Court embrace the challenge of dealing with the ever increasing numbers of *pro se* debtors—now averaging over 25 percent of the

debtors who appear before us—it is all the more important for the legal community and the bar to become personally involved and provide *pro bono* services to the indigent persons in need of debt relief.

All too often, we hear the complaints of lawyers that the "new laws" are too complicated and hard to understand. If that is true for lawyers skilled in the nuances of the law, how difficult must it be for those with no knowledge or familiarity whatsoever? We thus hope that you will hear the cry and meet the challenges we face in the bankruptcy courts.

A second challenge facing us is the ever increasing threat to judicial independence. But a few days ago, the House Judiciary Committee passed the Inspector General bill by a vote of twenty to six. Among other things, the Inspector General bill provides that the Office of the Inspector General "shall . . . conduct investigations of alleged misconduct in the Judicial Branch . . . that may require oversight or other action within the Judicial Branch or by Congress." We in the Judiciary strongly oppose this bill and believe that it will seriously undermine a fair and impartial federal judiciary and, more seriously, threaten to politicize judicial decision-making. Like Congress, we believe that the judiciary can and already does address its own conduct and ethical issues—and that the need for a person outside the boundaries of the Third Branch to regulate our system, our process and ourselves is neither warranted nor appropriate.

While we may voice our concerns through the Administrative Office of the United States Courts, we are not lobbyists and will not become involved in the political battles of Washington. The consequence is that you—the members of the bar—the members of the Commercial and Federal Litigation Section—must hear the cry and respond to those threatening the sanctity of the legal process as established by the Founders of our Constitution. It is a challenge as to which the battle must be waged by each of you and, I believe, that we as a public will be all the better if you succeed.

A third challenge—and, while there are many more, the last that I will share with you today—is one that is closely tied to the threat I just mentioned and that is the need to increase judicial pay. During the fourteen years that I have served as a bankruptcy judge, my pay has now grown to a salary that is less than that enjoyed by a first-year associate in New York City. None of us entered the public sector with the belief that we would become rich or wealthy. But there is a far cry between getting paid the salary that we now receive from one that reflects the respect and esteem of the position that we hold.

Under the present salary system, many judges are required to supplement their incomes by having their spouses work or by teaching as adjunct professors in law schools or by writing and publishing their works. Another unfortunate consequence is that many skilled lawyers, who could and should join the bench, are unable to suffer the financial consequences and turn away from the opportunity of becoming a federal judge.

This too is a challenge for the bar: it is for you to raise your voices because we cannot. To have and continue the judicial system as we know it—to maintain the pride that we in the federal judiciary feel so strongly—requires a vigilant response from the bar. The legal community has a role to play and I trust that you will hear the cry and address the many challenges that remain.

One of my favorite statesmen is Yogi Berra, and if I might close by quoting one of his many sayings: "You got to be careful if you don't know where you're going, because you might not get there."

I trust that with the help of my colleagues, the Court staff and the assistance of the legal community, I will find where I am going and get to the place where the Bankruptcy Court of the Eastern District of New York should be.

Thank you very much.

Effective and Efficient Utilization of Magistrate Judges

By Hon. Lisa Margaret Smith, Chief Magistrate Judge of the United States District Court for the Southern District of New York

Thank you so much, and good evening. I told my colleagues in the Southern District of New York that I was embarrassed to be honored at tonight's event, because my appointment as Chief Magistrate Judge this past January is purely an accident of timing, but then I was reminded that for each of the honorees timing played a part in putting us here, so I guess I will just relax and enjoy the celebration.

It is our tradition in the Southern District of New York to rotate the Chief Magistrate Judge position every two years, typically passing the chief's hat to the next most senior Magistrate Judge in January of the second year. When I say that we pass the chief's hat, we actually have a red plastic fire chief's hat, probably purchased at a novelty shop in Chinatown, that we pass from one of us to the next as the symbol of our vaunted position. I thought about bringing the hat to show you, but the plastic is so flimsy that I was concerned that it might not make it through in one piece, so I left it in its normal place of honor in my chambers. The acquisition of the chief's hat carries some responsibilities, including chairing monthly Magistrate Judge meetings and acting as the point person for contact with our constituents and our support agencies, most particularly the District Judges whom we serve.

Here in the Southern District of New York, I represent fourteen full-time Magistrate Judges and one part-time Magistrate Judge. Eleven of my colleagues sit in the Pearl Street courthouse, and three of us sit in the federal courthouse in White Plains. While I am at it, I will give a plug for the White Plains courthouse, because I know that some of you who never leave the confines of the five boroughs think it sits on the border with Canada. In fact, we are just a short train ride away from Grand Central Terminal, and we are a full service courthouse with four District Judges, three Magistrate Judges and a Bankruptcy Judge. The next time you have a case that might be venued just as easily in the northern part of the Southern District, think of us and consider coming up for a visit to the country.

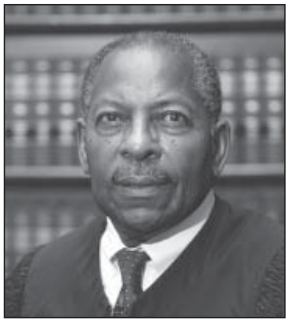
Speaking of the country, most of you are probably not aware that Magistrate Judge Marty Goldberg is our part-time Magistrate Judge. He is currently in borrowed space in Middletown while we await the completion of a new stand-alone federal courthouse in Middletown, New York. Judge Goldberg handles mostly misdemeanor and petty offense cases that emanate from arrests on federal property like the West Point military reservation, the Roosevelt national historic sites, and portions of the Delaware Water Gap, among others. Some of you may be interested to know that once the new courthouse is completed in Middletown, not only will Judge Goldberg be able to hold misdemeanor trials there, but my colleague Magistrate Judge Fox will hold civil trials, on consent of the parties, to accommodate some of our attorneys who come from Newburgh, Middletown, Goshen, and other places most of you have never heard of.

One of the issues that concerns Magistrate Judges is the effective and efficient utilization of Magistrate Judges. Our purpose is to assist the District Judges in whatever way is most useful, and we encourage you to think of Magistrate Judges when you are litigating in federal court, and, if it is appropriate, to ask to have your matter referred to one of us. Not only can we assist litigants who may have thorny and time-consuming discovery issues to deal with, or who may need assistance in brokering a settlement, but we also are very experienced at presiding at trials, with the consent of the parties. Statistical records from the administrative office show that in the fiscal year 2005, Magistrate Judges nationwide resolved more than 12,000 cases on consent of the parties, including presiding at more than 600 jury and non-jury trials. You may not be aware that in the Southern District of New York the experience of the Magistrate Judges ranges from 5 to 22 years on the bench, with an average among the 15 of us of 12 years' experience as federal judges. I think you will find that Magistrate Judges are seasoned and may be able to help you, either to get your cases ready for trial, to help you to resolve them without trial, or to handle the trial if all parties agree it would be appropriate.

Finally, I would like to express my sincere appreciation to Section Chair Lesley Friedman Rosenthal and the Commercial and Federal Litigation Section of the New York State Bar Association for putting together this evening's celebration, and for including me as a representative of the Magistrate Judges among tonight's honorees.

Remarks Upon the Establishment of the Hon. George Bundy Smith Pioneer Award

Hon. George Bundy Smith



I am honored to be the recipient of this inaugural award and to have the award named for me. We often hear of the need for diversity in our profession. The establishment of this award, together with the establishment of the fellowship for a student who has an interest in law and possibly in federal and commercial litigation, are meaningful, concrete steps to put diversity into practice.

I extend my appreciation to Barry Cozier, a friend of long standing who is the Chair of the Diversity Committee of the Commercial and Federal Litigation Section of the New York State Bar Association; Kenneth Standard, a friend of over forty years, who has had a remarkable and rewarding career in law; the Commercial and Federal Litigation Section; the NYSBA Committee on Diversity and Leadership Development; the NYSBA Committee on Minorities in the Profession; and all of those that have had a hand in this award. My appreciation also goes to my firm, Chadbourne and Parke, as well as other law firms and groups that have lent their support to the effort to increase diversity in our professions. Chadbourne, like other law firms, has a commitment to diversity and Chadbourne seeks to join forces with others in the legal profession to insure that the practice of law, including diversity, becomes a model to be followed.

The increase in the number of minorities in our profession can only be a positive force as both New York State and America seek to maintain their leadership of the legal profession and the world. I am particularly pleased at the opportunity presented to lawyers, through this award and through grants, to inspire and aid students to become better prepared for success and for service. It is my hope that years from today, those of you in this room who are still active in the profession can look back and say, "I and we had a significant hand in making our profession the diverse and strong and significant force that we dreamed of and worked for."

"The increase in the number of minorities in our profession can only be a positive force as both New York State and America seek to maintain their leadership of the legal profession and the world."

Again, my sincere thanks for this singular honor. I accept it with the hope that all of us in this room will strive to be the best that we can be, always with the thought that law is a privilege and that service to others is its primary goal.

Panel Discussion: Litigation Requirements for Corporate Counsel

Panel Chair:
Peter Brown, Partner, Thelen Reid Brown Raysman & Steiner LLP

Panelists
Stuart M. Cobert, Associate General Counsel, Unilever United States, Inc.
Irene Chang, General Counsel, Lower Manhattan Development Corporation
Michael S. Solender, General Counsel, Bear, Stearns & Co., Inc.

PETER BROWN: We are now going to be commenting a little bit on practical issues facing trial lawyers and litigation lawyers. And it is my pleasure to act as the moderator of what should be a very interesting discussion among some really important leaders in the bar and in the corporate world.

I would like to very briefly introduce our three speakers. First, Irene Chang is general counsel and secretary to the Lower Manhattan Development Corporation. She is responsible for all of their legal and regulatory matters. Most significantly, the Lower Manhattan Development Corporation is involved, to a large extent, in issues relating to and arising from the World Trade Center disaster, the non-construction related parts of that. As a result, she has been supervising a wide variety of litigation arising out of 9/11.

The Lower Manhattan Development Corporation's funding comes from the federal government. There is over $3 billion, which is part of that group's supervision. And she has to deal with and supervise and coordinate the City of New York, the Port Authority of New York and New Jersey, other governmental agencies and private developers.

Before Irene was in this position, she began her career at Shearman and Sterling, was Assistant U.S. Attorney, and then she was a deputy general counsel of Kozmo, a dot.com.

Sitting next to her, to my far left, is Stuart Cobert. Stuart is the assistant general counsel for litigation for Unilever U.S. As a result, he is responsible for all of their business litigation matters across the United States involving such important consumer products as Lipton Tea.

Stuart began his career as a law clerk in the Central District of California, worked at Paul Weiss, and in 1999 joined Unilever.

And finally, furthest to the left, Mike Solender. Mike is general counsel of the Bear, Stearns Companies, the financial organization with a mere 13,500 employees worldwide. He also serves as chairman of the Securities Industry and Financial Markets Association, Federal Regulation Committee. He is also on the board of directors of the Lawyers Alliance For New York.

Michael began his career as a law clerk to local judge Leonard Sand, became general counsel of the U.S. Consumer Product Safety Commission and was also a partner in the Washington office of Arnold and Porter before joining Bear, Stearns.

This is a group of people who watch litigation and watch how it develops over time. My first question to the group is: We have heard about some fairly sophisticated and fairly expensive litigation techniques. Have any of you had experience in using these techniques? Stuart?

STUART COBERT: Yes, we have used mock jury and jury research any number of times. The one thing I can confirm is that it is definitely scaleable. We have done a wide range of things off the menu in terms of very small-scale jury research, half-day session with panels, and I found them extremely useful. Even the smallest things give you a different perspective on what the jurors are thinking. I thought one of the most interesting things actually was the mock judge presentation, which we certainly had never done. And this is something different.

MR. BROWN: When you do use these techniques, do you use them for issues relating to product liability or to other areas? What are the sensitive hot buttons that you try to focus in on?

MR. COBERT: You know, it really depends. Our products' liability is actually not the principal focus, especially of our more significant litigation. We have used them in employment cases. We have used them in some personal injury cases and in business disputes as well.

MR. BROWN: Michael, have you had any experience in using them?

MICHAEL SOLENDER: Yes, nothing quite like the full-blown sequence that was described in the presentation. But we have certainly used pieces of that. And this has come out of many comments and questions from the floor, it's always a question of whether the cost justifies it in the case. It has to be a very substantial case to warrant

a lot of that. We have used it. I found it to be useful. I've also seen it in my private practice days.

I've seen it where it was done wrong, which is immensely frustrating. You have a lot of expense put in it. So it is extremely important that it is structured correctly and done right and particularly relevant to that case.

MR. BROWN: Okay, let's forewarn people, when you say "done wrong," is that because the consultant sort of takes you down the garden path? Or because the lawyers are sort of pushing for a result which is sort of self-fulfilling prophecy.

MR. SOLENDER: I was thinking of two instances. One is where it is the classic locker-room syndrome, where everybody starts to preach to the converted and they get so confident in their case that it was presented in a way that was very uneven. And as a result, it wasn't really representative and the other side, frankly, wasn't well represented. That was one instance.

The second instance, it was just technically wrong. I think they anticipated that the trial would go in a particular direction, and the issues that actually became relevant were a little different. So they actually didn't have anything of value when it came down to it.

MR. BROWN: Stuart?

MR. COBERT: The other thing I'd say is you have to look at the results in a more limited way. You should view it largely as directional. Sort of, what themes work better than others. But when you talk about the jury deliberations and look at them, it is an artificial environment. So some areas, particularly, for example, in the area of damage awards, in a type of case where there's no formula—it is pain and suffering, those types of things, jurors—the mock jurors are not playing with real money, so they don't feel constrained. It's much more, I think, directional than definitive.

MR. BROWN: Well, now, it seems to me that if you are in-house counsel, you need to convince the CFO, "My mock jury just came in for half a billion dollars," a couple million bucks to settle the case seems reasonable in those circumstances. Can it be used against you, at least, politically?

MR. COBERT: That information is very valuable.

MR. BROWN: Now, have either of you had experience—I am sorry, Irene, I didn't mean to exclude you, but I assume that the City has not had those kinds of resources. Have you had that opportunity to use it?

MS. CHANG: Well, I have not. But in thinking about it during the last presentation, I think the Lower Manhattan Development Corporation, being a government-funded operation, is very, very focused on community views of the work that we do. And I thought that, if there ever had been a big litigation, you might really want to look at some of the press, the feedback that you get. But you would have to confirm whether that posture is representative of what you might see and encounter with a jury. And that I experienced at the dot.com level, too. Kozmo was a highly, sort of, cover company that was on the verge of going public, and I was brought in on a civil rights litigation over redlining in D.C.

So there again, if we had gone to trial, I think it would have been important to test whether what you read in the newspaper is necessarily going to be the same issue you're going to encounter.

MR. BROWN: For those of you who have had experience in using these mock juries or panels, can either of you give me an example of a time when you saw a real change in strategy, a change in approach because what you heard or learned about during the presentations really changed your perception of the manner in which you're going forward?

MR. SOLENDER: I can. I don't have a direct response, but I have had occasions where we did two or three of these mock jury things and they all went terribly south. And we settled the cases very quickly with that. So it was an easy way to tell whether you really had a defense to something or not. In that case, there were people both on the defense team and the lawyers' team and, ultimately, the client that needed to be persuaded and that was pretty persuasive.

MR. COBERT: The only time that's happened with me was actually in private practice, where we had a large—I was representing a company in a large insurance coverage dispute against insurance companies, obviously. And I think we had gone in thinking that the jury would really hate insurance companies even more than the corporation we represented, which was actually sort of a sexy, high-profile company. And they just distrusted everybody.

MR. BROWN: And the lawyers, most of all.

MR. COBERT: Of course—the lawyers, most of all. So we had to think about that and just look back at what we were doing.

MR. BROWN: I'm going to ask the panel now to sort of switch gears a little bit. One of the things that we told the people attending today was we are going to talk a little about some of the practical aspects of the relationship between inside counsel, particularly litigation inside counsel, and outside litigation counsel and some of the dynamics of that. And I've asked each of our panel members to talk about one narrow topic, at least for a few minutes, so that we can get our discussion going. And the last part of this, I think, will end up being much more of an open, free-wheeling panel discussion with the audience.

Michael, as the general counsel to a very large multinational corporation, you have to pick defense coun-

sel—and I assume it is mostly defense counsel every day of the week. What process do you go by and what is the selection process that you think is valid for picking outside counsel?

MR. SOLENDER: Let me start by dividing up the litigation world because the process works quite differently depending on what type of case or matter you're dealing with. I have four categories I thought about when putting this together.

You have the small arbitration, small cases and relatively routine, well, quite routine regulatory matters as category one.

Category two are medium-level arbitrations and court litigation, and then a little bit unusual regulatory matters. Again, not severe, but sort of that middle tier.

Then you have what I call heavy arbitrations or litigations or big regulatory matters which are sufficiently serious.

And then finally you have your company litigation or multi-regulator sort of death-knell type of case, which, unfortunately, many companies saw in the early part of this decade.

I think the selection process for each of those is quite different. So let me walk through each category.

The first category, the smaller routine matters, increasingly we try to do those in-house. I think a lot of firms have found that's a more efficient way to do this. It is a challenge because the resources have to be devoted to it. That means they are taken from something else. But we have tried to do that. It has been more cost efficient. We have also used temps for these kinds of things. As they become more and more routine, you become more comfortable with bringing the function in-house. That's an area where cost is a very heavy factor, and you try to deal with those as efficiently as you can.

For the more medium-type cases, again, this is an area where practice sensitivity is the cross to bear. We want to be well defended, want to be competent counsel, but we are not willing in those types of cases, because of what's at stake, to pay some exorbitant amount. Many of the top tier New York firms are just too expensive for these types of case.

What we have done for these, especially for the routine cases, is that we've done beauty contests, where we have people come in and present to us and set up longer term relationships with the firm because, we believe, they have the level of competence, are priced correctly and sufficiently attentive to our matters.

So I can think of four or five different places within our organization we have these relationships that are on a more long-term track. It becomes economical for the lawyer of the firm we have picked because the business is so predictable and routine. It becomes beneficial for us because the litigator knows the company and is, frankly, willing to take a substantial cost cut because of the volumes there.

Moving to the third category, which is more of the heavier cases and the more major regulatory matters. Typically, there is more criteria used to look at the firm. Often, this is a question of specific expertise. If this is a type of case that requires some specific expertise—whether it be bankruptcy, antitrust, intellectual property, you can go down the list—we typically now are aware of a number of firms on our list for those types of cases. Typically, we'll have had them in, often several times, and many times have used them in the past. So we'll have several criteria. Again, competence and expertise are important in this area. Some measure of loyalty to us has been very helpful in these situations. So whether it is a past relationship or whether it's a business relationship from our business side—whether it is banking or trading or something that we do—is always helpful there.

Again, this is one where price continues to be relevant. So typically, we will be price-conscious of this again. Maybe less of a driving factor here, but we will be aware of it. And again, this will be looking at the specific case as to what's needed and getting a short list of firms that will make sense for this. We might have a mini-type beauty contest where we'll ask them about their specific expertise in a particular case. Or we might, amongst ourselves, meet with the top litigation people and say this is a logical firm, an obvious firm. Let's make sure the price is right, but this is who we are going to go with, for that third category.

Finally, in the fourth category, which is the really heavy, big cases, and we, like many other big corporations, have had some in the last few years. There, typically, you're looking for a very high level of expertise, an extremely deep measure of experience in the particular area you're in. In our case, for example, we are often dealing with the SEC or the SROs, the self-regulatory organizations. In the past few years the New York Attorney General's Office, Department of Justice, it can be any one of a number of different players involved.

And in those instances, you want people with a lot of experience with that. Typically, you want somebody whose name and experience will be known or, at least, easily presentable to your clients and management because this is something where there will be a lot of tension in this case. You want to make sure they are comfortable. You might, in some instances, even get the management involved in the selection process so there is a little bit of ownership on the client side as you go into it, because this one is obviously going to be particularly important.

In these cases you're also looking for somebody, if you can, that you've had experience with in the past and you know personally.

Here, cost, while it might be a factor, is probably much less relevant than it was in the categories I was describing before. Then I thought I'd give you a few of the things that actually sort of define the five major clichés that you hear in these beauty contests when companies come in and the five things that actually work. It is amazing—we did a litigation beauty contest and we actually had many, many firms come in. And I think, of the firms we had, virtually all of them said at least two of the five I'm going to give you, which is kind of interesting, although lawyers, having been in private practice, we always thought this was the competitive edge.

Number one of the clichés: "We try the cases." Okay, everyone says that. Literally everyone says that coming in. It is really quite fascinating. That, I think—yes, our presumption is that if you're a litigator, at some point, if you've been in practice, you will have tried cases.

"We staff very quickly." Second one, everyone says it. We want it to be true. We monitor it. We see the bills, but it is another one where everyone says it.

"We'll drop everything for you," is the next one that you hear a lot. Great thing to hear, if it's true. We'll battle test it, but it is a common one.

This one is interesting. We have heard from many people—and this will change now for reasons apparent when I tell you: "You know, I'm friends with Mel Rice or Eliot Spitzer." So often people say they have the relationship with the person constantly suing you. Again, seems to be very useful, but everyone seems to have it.

And finally, "We have many, many former prosecutors working." Everyone now seems to have in their firms a lot of former prosecutors. It is something you want, but it is not a direction typically.

Here's what I found that really worked and what gets your attention: Show us where you really are different from the other firms. If you've got and there are marquis practices—firms, for example, that are really marquis firms in bankruptcy or intellectual property—showcase that, because that's where you're different. That's where you really have an edge, and that's what we are interested in. I found that to be impressive.

There's a firm out there, for example, we're getting a lot of bankruptcy litigation, trustees constantly bringing interesting, aggressive and imaginative claims against us. It is interesting from a litigation standpoint because they are good cases. There is a firm out there, couple of firms actually, that really have bankruptcy litigation groups that are particularly tailored to working on these particular claims. That was interesting because not everyone had that.

Similarly, with antitrust, people who work specifically on antitrust cases that involve our industry and have groups that are around those types of issues. Very interesting.

We like to hear typically that you've done some—not too much, but some—work for our competitors because you're going to have a lot of comparison there. That will be very useful to us. We don't want you in the pocket of one of our competitors, that's a problem too. But again, if you've never done anything for our industry and you're not familiar with it, you've got a very steep learning curve.

Now, this is the converse: Lean staffing is good. We are always looking for price sensitivity. We, as in-house counsel, are increasingly very aware of what this is costing. Rate increases, staffing issues, use of temps, all of these sorts of things, we are very aware of especially in the large case.

Electronic billing is all transparent now, so we can see everything and people are looking at all levels. Whatever work you're doing is not going to get hidden in some stack of paper.

Expertise, regulatory expertise. I found SEC, SRO, there's probably an analogy for someone who's familiar with it, I'm sure that Food and Drug, FDA, some business, whether it is FDC, whatever it is, there is a regulator, or multi-regulators that you do a lot of work with. If you really have people out of that area who have a lot of experience and relationships, that is something very interesting to us. There aren't that many people out there that really have that level of experience.

Finally, which is really important from our standpoint is if you're interested in helping our business, we typically have a lot of our legal spin for us—I'm sure it is different for colleagues here—a lot of our legal spin is in the positive side of the business. We are in the underwriting business. We're in the investment banking business. We use firms there a lot. And a lot of times the firms are decisive in how the business comes in on that end. So a lot of times those relationships are a great way to form a relationship with us. Start bringing in underwriting business. Then you're going to get an introduction and get into the door. Principally, a lot of relationships are formed that way. We find litigators who we really like who were brought in by their partners who are doing a lot of work with us elsewhere.

Within the firms, you talk a lot about cross-fertilization. You'll find that very frustrating because you bring the person in, it is a lunch and never hear anything. If it is really a strong corporation relationship with business going back and forth, the likelihood is that those lunches won't be wasted. Those will be something where the in-house people will be attending.

MR. BROWN: Michael, thank you. I'm sure we can go on to each of these topics in greater length.

Irene, once you've hired somebody, you've got to communicate with them on a regular basis. And in your case, you've got multiple, multiple cases going on. Talk a little bit about how communication between in-house counsel, trial and litigation counsel, affects you.

MS. CHANG: Sure. I think I want to pick up on something which Michael started with, which is what is the relationship and whether you have a pre-existing relationship that enhances the understanding of the counsel and outside counsel. Because I think one of the most important things, and this may be a restatement of the obvious, is what are the goals of the general counsel and the corporation as a whole with respect to this litigation? What implications does it have for its business? How does it view the potential outcome of the litigation with respect to its regular business or on the particular issue at hand?

At the LMDC—and for those of you who don't know exactly what we are, we are something called a "public benefit corporation," where we have a limited array of funds. We have obligations to spend it in accordance with federal regulations. And a challenge to what we do is, in essence, a possible disallowance of the expense, where we don't have other funds to make up what we have misspent under federal regulations. So there's a really big investment in defending our decisions—for those of you, again, who don't know what we do, the selection of the memorial design, the plan for rebuilding of the World Trade Center was a heavily processed and publicly involved approval process that involved New York State rules as well as federal environmental law and state environmental law.

So our environmental lawyers had the greatest understanding of what our objectives were, what the philosophy behind the plan was. And when litigation arose, we went to that firm first because we already had a base for the understanding of what it was that we were trying to do, how important is it to us to defend this case.

Now for a lot of other folks here, you know, numbers matter and how much is it going to cost you to litigate it? What are you willing to compromise the case for? Is it a complex decision that you really need, as outside counsel, to have an understanding of that internal process, which is obviously going to involve many more people than the general counsel? But being able to be sensitive to balancing those needs is important.

So identifying whether there are, from a litigation standpoint, opportunities for resolution, how you fashion your arguments, what the implications are of those arguments on the rest of the business of the agency or the corporation is important.

And for—I think it may or may not go without saying, but I think many general counsels are not originally litigators. And I think in litigation you have to understand some of the thinking and go through the process of: What are the arguments? And how can they be fashioned differently? I think you have to fashion them with sensitivity, once again, to the general counsel or to the person who is responsible within the corporation.

To that end, I think regular communication is important when there are key documents being prepared. It may be that an attorney in-house who is a litigator is much more interested in seeing that draft early and being able to weigh in or modify statements that may make sense to you as a litigator as a strong legal argument, but it may be that some tweaking to adjust to the nuances of the context of that matter is very, very important.

We have experienced that a lot because, from a case law standpoint, you can make definitive statements about how you're allowed to do something. I think LMDC, as a public corporation, may not want to be so strident in saying that we can decide it however we wish. I think we have made our decisions taking into consideration a lot of public input. That's something that was important for us, even in defending ourselves in litigation, to never lose sight of the fact that the public had a very strong interest in the outcome of the litigation as well.

So we have had a variety of litigations. Our counsel has been very sensitive to us. We have a very good record in that regard and hopefully none of you have heard about the cases.

MR. BROWN: For example, a case comes up for a possible summary judgment motion. When do you want to hear about that possible summary judgment motion? What is your relationship to the outside counsel?

And how do you communicate back and forth with someone who is an environmental expert and that's not personally your expertise, but that's the kind of motion that's pending?

MS. CHANG: I think we want to hear about that at the earliest point possible. Because it is public funds, I am very concerned about every exercise undertaken by our outside counsel. I want to know if someone is doing a memo. I want to know who is working on the matter and what the philosophy and approach is of that outside counsel before those bills come in with 10, 20, 30 thousand-dollar memos where, maybe, somebody could have asked me whether I was interested in making a motion or let's just go.

So I think that is a standard I would think that most litigators in-house would practice, which is, "Let's talk about what the strategies are, what are the approaches."

That's not to suggest that legal research is not necessary in order to formulate the advice of outside counsel.

So my part is really about the communication, making sure that you're proceeding on the same assumptions.

MR. BROWN: The good news about the world of electronics is that you and I can communicate real well with your outside counsel. But I could send you two or three e-mails every day telling you how we have now researched sub-point three and here are our brilliant insights as of today, but tomorrow we might change our opinion. How much communication do you really want?

MS. CHANG: That's a really interesting question because in some cases you want information right away. The thing I personally find most annoying is people send you an e-mail with an outcome. One hour later, you get an update to, "Well, let me modify what I sent you an hour ago," and then the next day you'll get a memo. So I think it is important to think about when are you ready; that just because you can deliver some sort of immediate advice, is that necessarily the time? And is it worse, if I then took this information and in the hour between when you sent it to me and then you sent me a modification, I actually told somebody higher up, "This was the outcome"?

So I think there's a frequency and a benefit to technology, but you have to really think about it. Is it time yet? Are you committed? I think the standard is now different because you're able to deliver it electronically. I want to be able to rely on the advice.

MR. BROWN: Stuart, the entire litigation process is strategic from day one through the day the case is settled or goes to the jury. What involvement do you want to have in that strategic plan and what do you view as the appropriate role for in-house counsel?

MR. COBERT: Well, I think in-house counsel plays a very important role in strategic determination. Because each case is different, one of the things we look for from our outside counsel is obviously a very strategic approach. That does not mean that the strategy is to win the case. That's a desire and outcome, but it's very simplistic.

There are three key elements that really factor into this that inside and outside counsel need to work very closely on. The first one is to determine what your objectives are in this case. Secondly, what is your evaluation of whether you can achieve them? And then how are you going to achieve the plan?

Just talking about the first for a second, some of this is similar to what Irene was talking about, you really have to figure out what you hope to achieve in the case, and there are a lot of different factors. You have some cases where it is a stand-alone case, and you want to win. And if you think you're not going to win or settle it, you should do it in the most cost-effective way possible.

But that's for the one-off thing sort of standing out there by itself. You need to know a lot more about your client and about the circumstances before you figure out what's really important in a situation.

First of all, one single case can have a lot of implications for other cases for other issues. You get one Vioxx case, you have to know that there are thousands of others out there, which will obviously affect what you do in those types of cases.

You need to understand your client's general litigation philosophy very, very well. There are some clients who really believe the most effective thing is to fight virtually every case because it deters other litigants. There are other clients who figure you're going to get sued anyhow. It is a cost-benefit analysis.

There are key business concerns. In some cases your adversary or potential adversary can be a very close business partner to the company. For example, you could have a dispute with a supplier of a key product. If that supplier gets mad and stops shipping, it can destroy your business for months. So winning that case is a very Pyrrhic victory if you go about it in the wrong way.

On the flip side of that, sometimes your customers are involved. Obviously a lot of our cases, especially not the necessarily large ones, our customers may also be a participant and may be making demands from us which, from an objective perspective in terms of us stepping up to the plate, are a little unreasonable. But it really does not matter.

The other thing you have to be aware of is there can be business solutions to litigation problems. For example, disputes with suppliers can be resolved by giving them your business and they giving you a reduced rate over time, rather than just getting payment.

Finally, there are public relations and employee relations concerns about cases. All of those issues factor into whether winning the case is what it is all about. First thing you have to do is understand that. Obviously, in-house counsel should have a better perspective on that and is a crucial partner in telling outside counsel, especially telling people who don't have tremendous experience with the company, how all these things factor in.

But it is equally important for the outside counsel to be thinking about those things proactively, especially when you look at the body of cases that people like me are responsible for and may not have time to do that as fully as we should in every circumstance. It is really a partnership in that area.

The next thing I think is really important for both partners in this is an early case evaluation, which everybody always says. And it's obvious really because cases settle.

Most cases settle. It makes a lot of sense to settle them early if you can. Both because just of the legal fees some-

times, you know, you might have witnesses who you really don't want to testify, those types of things. So a very early evaluation is critical.

Then finally, once you've done that, you develop a plan that will get you where you want to go and that reflects the nature of the case. There's a wide range of cases, and in some ways it is a lot more easy and nerve-wrecking to defend the big cases, because you spend a lot of money to defend the case. It's the other cases that are the hardest in some ways because you want to defend them, but there's a cost-benefit analysis.

So you have to come up with a way to deal with all of those issues and come up with a plan. That's the easy part, following that. I get budgets all the time. Do we really live up to the budgets? Do we enforce the budgets and all of that? That's the cooperative venture.

MR. BROWN: Now in about the last eight or ten minutes we have left, I have a series of questions up here, but this is also your opportunity to ask questions that have always bugged you about your presentations to in-house counsel. So I'm going to start asking questions until I see some hands go up. Just wait for my associate to come by and give you the microphone. We'll continue this dialogue as a two-way street.

Let's just talk quickly about the first step, the fact-gathering process. The fact-gathering process, is that something that you want in-house counsel to do, or do you want outside counsel to be the driver on the fact-gathering aspects of, let's say, a medium-size case? Mike?

MR. SOLENDER: Yes, I want the in-house people for a number of reasons to do as much as they can. Obviously, the outside counsel has to get up to speed so there will be some measure of what they need to do on their end. There are a number of reasons. One is obviously cost. More importantly, our in-house lawyers, because of the fact that they are there all day working with the client, know where to go, know who to talk to, will know the place. And increasingly, at least on my team, they are very sophisticated and experienced litigators. So they are able to cut through very quickly in a lot of ways and a lot of issues and get right to it. So I've found, by and large, at that stage, that initial fact gathering in-house is a big advantage. You'll want somebody from the outside law firm there to see what's going on, but you don't want them as the driver. That would be very inefficient.

AUDIENCE MEMBER: I'm Stan Turow. I'm outside counsel now, but I spent several years in-house as a purchaser of services. There are certain companies that have signed on to rigid diversity requirements of their law firms in trying to have law firms that reflect the company's goals for a diverse workplace. What, if anything, have your companies done or—I don't know in the case of city government—do in terms of looking to see, both internally and with your vendors, what you can do to provide more of a diverse workplace?

MS. CHANG: Well, I'll speak for government. The Lower Manhattan Development Corporation is a state entity. So we apply both state and federal requirements on diversity, both in terms of contractors, in terms of ownership, as well as on the law firm side.

On the law firm side, I'll tell you, it is very interesting. They can't meet the types of percentage requirements that we apply to all other vendors. So we recognize that, but I will say that I personally look to ask specifically—and we run a much more public process. We do something called an RFP and we publicize it. And firms come forward and they have to submit information on partners, associates, programs, et cetera. Where possible, I really do look for a firm that has prominent women partners on the project that are going to be able to contribute to our exercise as well as partners of color. And I think we have succeeded in doing that, although we only use about six firms.

MR. BROWN: What about one or two private firms?

MR. COBERT: Well, diversity is very important to us. It's a general corporate initiative at Unilever. In our guidelines, which point that out, we look for diversity in staffing of our matters. We have written to all of our law firms telling them that, and it is a factor. I mean frankly, it's not the only factor, but it is a very positive factor and we are sensitive to it in trying to do the best we can.

MR. BROWN: Just to note, there's a reference to Unilever outside corporate guidelines, those are part of the written materials which you have in the binder that we gave you.

Next question is in the back.

AUDIENCE MEMBER: Yes, I was going to ask, other than Unilever, do you have a standard engagement letter or procedure similar to the outline that Unilever has in its manual?

MR. BROWN: Michael, I guess that's for you.

MR. SOLENDER: We do have standard engagement letters, and we do try to use them. We have outside counsel guidelines, we have all of the standard forms. They are becoming very standard.

AUDIENCE MEMBER: What role does the in-house counsel play, to your knowledge, on this panel with litigation committees?

MR. SOLENDER: Of the board of directors?

AUDIENCE MEMBER: Yes.

MR. SOLENDER: You hope you don't have that.

AUDIENCE MEMBER: Litigation committees don't exist?

MR. SOLENDER: No, no, they certainly have existed out there. But those tend to be cases where there's a fairly large problem. When the board of directors is getting involved, at that point, it is something you don't like to happen. I've not had that. I do work quite closely with the audit committee and the board of directors, which is very involved, in our case, in the litigation, regulatory, profiling phase. So I spend a lot of time with our board discussing those issues. I hope never to have that case, because that means we have a problem.

MR. COBERT: We have fortunately not had that situation either. It is more complicated for us because Unilever is a foreign-based company, and the rules are a little different for our board over in England and the Netherlands.

There is an issue, putting aside the litigation committees, but the client investigations that may lead to these types of things. There is an issue about whether in-house counsel should be involved with respect to privilege issues and things like that. I mean, frankly, most of our matters are serious because we take ethics seriously but are not earth-shaking in a corporate perspective. In-house litigators are closely involved, but there are times when we defer to outside counsel because of privilege issues or the other—is there a conflict? We haven't really faced that, just concerns about privilege issues.

AUDIENCE MEMBER: Richard Freeman. Our corporate counsel litigation committee has discussed the issue of prospective conflict waiver language in retainer agreements. And this issue has obviously become rather controversial in light of the lawsuit involving a major law firm. And I'm curious about each of your perspectives as to whether or not you would ever sign such agreements, or whether you have outright policies prohibiting them, and whether the issue has even arisen.

MR. SOLENDER: We won't sign them.

MS. CHANG: We wouldn't, but we have actually gone so far in an engagement—because we have a limited area of development, it's all Manhattan/South Houston Street where we actually want folks, whenever they take on a matter in lower Manhattan, to come to us first so that we will specifically clear it. Even where there may not appear to be a conflict.

So we take it very seriously under the new administration, which is the new governor. I think it is really great that Manhattan has been doing this all along.

MR. COBERT: We don't like them.

AUDIENCE MEMBER: Very quickly on the last point about the use of in-house. There have obviously been a huge number of very big awards in connection with discovery in recent years. What kind of push back do you get if it is the outside counsel signing the pleadings and making representations in court and may be found liable for very substantial costs like in some of these recent matters where you have adverse interests, et cetera? How does that factor into that decision-making?

MR. SOLENDER: Interestingly enough, we have not had that push back. You're identifying an interesting issue that does have to be a balance so that the outside counsel can get sufficiently comfortable with what you have done, specifically technology. So many of the matters you're referring to are really based on technology issues rather than preservation of electronic data and records. So we do expect our outside counsel to get familiar with that. We have people now whose job it is all day to work in electronic records and IT and clients. Those people are available to outside counsel and we want them to get comfortable with that. We have not had an instance where it's been a problem to date.

MR. BROWN: Okay, this is a panel which I could keep going on and on and on until all of you finally figure out the secret combination to getting retained by all of them. However, the constraints of time forces me to call this panel to a halt. Thank you to the members of this panel.

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The Contours of Common-Law Dissolution in New York

By Philip M. Halpern

I. Introduction

New York's Business Corporation Law Section 1104-a, which became effective on June 11, 1979, creates a statutory cause of action in New York for the dissolution of a closely held corporation by a shareholder owning twenty percent (20%) or more of the outstanding shares of the corporation.[1] The statute provides for the presentation of a petition for dissolution on the grounds of illegal, fraudulent or oppressive actions by directors or those in control of the corporation toward the complaining shareholder; or the looting, waste or diversion of corporate property or assets by the corporation's directors, officers or those in control of the corporation.[2] As a result of this legislation, shareholders owning at least twenty percent (20%) of the voting stock have had available to them in New York, since 1979, recourse for corporate malfeasance in the form of statutory dissolution.[3] However, shareholders of a closely held corporation owning less than 20% of the voting shares have no recourse pursuant to § 1104-a. Shareholders in that situation have had, and continue to have, recourse in the form of common-law dissolution.

Common-law dissolution, which predates BCL § 1104-a,[4] is alive and well in the State of New York. It is an equitable cause of action which permits shareholders below the 20% ownership threshold to seek dissolution of a private corporation under certain circumstances of malfeasance. Although common-law dissolution cases are relatively rare in New York, a body of case law has evolved (and continues to evolve) which sheds light on this cause of action, the burden of proof necessary to sustain such a cause of action, and the available remedies if liability is found to exist.

II. Burden of Proof for Common Law Dissolution

The decision to dissolve a corporation is typically left in the hands of the directors and majority shareholders of any corporation. The legislature in New York has constituted these individuals as guardians of the corporation's welfare and, in the normal course, they determine whether dissolution is in the best interest of all shareholders.[5] With this power, however, comes responsibility. As guardians of the corporate welfare, directors and majority shareholders are cast in the role of fiduciaries and must exercise their responsibilities "with scrupulous good faith."[6] If they "so palpably[7] breach the fiduciary duty they owe to the minority shareholders that they are disqualified from exercising the exclusive discretion and the dissolution power given to them by statute . . . ," New York's common-law permits minority shareholders to sue for a judicially ordered dissolution.[8]

The "palpable breach of fiduciary duty" standard is the standard a plaintiff must satisfy to sustain his burden of proof for common-law dissolution. Courts in New York have universally cited to this standard—grounded in clear violations of the fiduciary relationship—when considering common-law dissolution causes of action.[9]

"Common-law dissolution, which predates BCL § 1104-a, is alive and well in the State of New York."

Although the "palpable breach" standard is the articulable standard which applies in New York, the vagueness of the standard begs the question as to what type and degree of breach must be shown to sustain the dissolution cause of action. Stated differently, the question becomes, at what point does the majority "so palpably breach" their fiduciary duty that their exclusive power to dissolve is relinquished to a judge sitting in equity? Several courts in New York have pinpointed two specific circumstances warranting dissolution: (1) looting of the corporation by the majority so as to impair the capital of the corporation and (2) continuing the existence of the corporation for the sole or special benefit of the majority at the expense of the minority.[10] Although these fact patterns are indeed examples of palpable breaches which rise to the level sufficient to sustain a dissolution cause of action, they are not the only categories of misconduct which warrant equitable relief. The implicit argument set forth in the appellate case law that these two categories—and only these two categories—are required to sustain a common-law dissolution cause of action is overly narrow, and ignores the broader nature of the "palpable breach" standard. It also ignores the fact that New York's Court of Appeals has never defined the "palpable breach" standard as limited to these two circumstances; and the fact that the determination of whether a sufficient showing has been made is adjudicated on a case-by-case basis considering all of the circumstances pertaining to the particular case in question. This conclusion is consistent with the fact that the cause of action arises in equity, where there are no bright line rules for automatically sustaining or rejecting such a claim. The Court, acting in equity, has the discretion and authority to do what is appropriate and fair given all of the circumstances of the case.

The universe of cases in New York concerning common-law dissolution is not large and a review of these cases confirms that the narrow approach as to what constitutes the necessary "palpable breach" is not in favor. For example, in *Leibert v. Clapp*,[11] plaintiff, who owned a small number of shares in the defendant Automatic Fire

Alarm Company, complained that those in control of the company were engaged in a conspiracy to manipulate and depress the market of the shares of the company, and squeeze the minority shareholders out of the company. It was alleged that the conspiracy included siphoning off the income and profit of the company to a parent corporation and, rather than declare dividends for the benefit of all shareholders, the majority caused a huge earned surplus to be accumulated and diverted to the parent corporation. This in turn depressed the value of the shares of the company and allowed the majority to increase their shareholdings and control of the company. The plaintiff in *Leibert* alleged not only looting of corporate assets and the continuation of the corporation for the sole benefit of the majority, but also that the majority was attempting to force minority shareholders to sell their holdings to them at a sacrifice and to freeze them out of the corporation. The Court of Appeals held, in the context of a motion to dismiss the *Leibert* complaint, that the allegations, if true, would establish that the directors and majority shareholders "so palpably breached the fiduciary duty they owe to the minority shareholders . . . " and reversed dismissal of the dissolution cause of action.[12]

Plaintiffs in *Kroger v. Jaburg*[13] also made allegations beyond that of "looting" and "sole benefit" fact patterns. The *Kroger* case involved a corporation which had been unsuccessful and unprofitable since its inception, and because of changes in the trade, could not be made profitable for the future. Despite this circumstance, the president of the corporation, who was inexperienced and incompetent to run the corporation, used his stock control to increase his salary substantially and prevent the corporation from being dissolved. Plaintiffs alleged in the case that the business at issue was unprofitable and could not be made profitable in the future; the corporation's capital was being impaired; its property was being wasted and dissipated; no dividends were paid on its common stock; a default in dividends existed on its preferred stock; and the corporation had become obsolete. The Court in *Kroger*, reversing dismissal of plaintiffs' first cause of action for common-law dissolution, recognized that "in courts of equity directors of a corporation are accountable as such for fraud, bad faith, and other breaches of trust . . . ," and concluded that "the first cause of action sets forth facts sufficient to constitute a cause of action."[14]

Lewis v. Jones[15] involved a plaintiff who was the sole minority shareholder of each of the defendant corporations, and who was also an employee of said corporations. Plaintiff alleged that those in control engaged in a conspiracy designed to freeze him out including failing to pay him salary, failing to pay dividends, and accumulating excessive earnings beyond those needed for foreseeable projects. The purpose of the scheme was to force plaintiff to sell his shares to the majority at prices vastly below their value, otherwise he would be permanently prevented from receiving any return on his investments. Plaintiff's allegations of fraud, misappropriation and use of corporate assets for personal gain were viable for dissolution, and the Court, affirming denial of defendant's motion to dismiss, concluded that the plaintiff was not limited to a shareholder's derivative suit and that the complaint was sufficient to state a cause of action for common-law dissolution.

Fedele v. Seybert[16] involved a successful food market venture. The minority shareholder plaintiff brought his action for dissolution because the majority shareholders, who also owned a competing food market, were allegedly diverting business opportunities to the competing market, and created phony financial statements to cover up their wrongdoing. The majority also attempted to amend the bylaws of the shareholder's agreement to divest the minority shareholder of his management responsibilities, and took other steps to exploit the company to the detriment of the minority shareholder—e.g., executed secret, unauthorized promissory notes, wrote checks drawn on the company's account, hired an employee whose salary was in excess of $50,000—without the minority shareholder's consent. The Court in *Fedele* recognized that beyond "looting" and "sole benefit" allegations, plaintiff had alleged a pattern of "illegal, unfair and oppressive conduct severely prejudicing plaintiff," and that the cause of action should properly proceed as a common-law dissolution cause of action.[17]

In re Charleston Square, Inc.[18] involved two corporations whose primary purpose was to purchase unimproved land and build houses thereon for profit. Plaintiffs were minority shareholders, one of whom was also employed by the corporations to build and sell houses. It was agreed that the employee plaintiff would receive compensation for each house constructed, as well as a real estate commission for each house he sold. Plaintiffs ultimately had a falling out with the majority and asserted causes of action for common-law and statutory dissolution. In support thereof, they made allegations that the majority usurped corporate opportunities by selling undeveloped plots of land to other corporations (one of which was wholly owned by a majority defendant), wrongfully terminated the employee plaintiff, failed to compensate the employee plaintiff for services rendered, and failed to distribute dividends. In effect, the minority plaintiffs were squeezed out and deprived of the benefits of their investment. The Court agreed with the lower court that the corporations at issue should be dissolved, and affirmed the lower court order dissolving same.

The case law associated with the burden of proof in New York will continue to evolve as more common-law dissolution cases are litigated. However, the case law to date, as referenced above, indicates that "palpable breaches of fiduciary duty" can run the gamut of a broad range of corporate malfeasance.

What is also important to remember in assessing actionable dissolution conduct based upon the sparse holdings to date is the fact that for such conduct to be actionable it must injure the minority shareholders specifically, and not just the corporation. The factual foundation for any common-law dissolution case is that the majority engages in conduct injurious to the minority and that the conduct of the majority will continue into the future. Contrariwise, conduct injurious to the corporation as a whole can only be remedied by a derivative action. When misconduct targeted at the minority exists, the law in New York is clear that the minority is not relegated to the exclusive remedy of a derivative suit. This dichotomy makes sense because a derivative action would only ultimately serve to place any monetary recovery back in the hands of the corporation, an entity controlled by the majority wrongdoer(s) and would not remedy the minority shareholders' issues prospectively. The Court of Appeals in the *Leibert* case expressly rejected the notion that the remedy of a derivative suit under such a circumstance would be sufficient. The Court stated, in relevant part, as follows:

> In light of the serious charges of persistent corporate abuses by the directors and the majority shareholders, it would be inadequate and, therefore, inappropriate to remit the minority shareholders to the exclusive remedy of a derivative suit. . . . [T]o restrict the minority shareholders to a derivative suit would be to commit them to a multiplicity of costly, time-consuming and difficult actions with the result, at most, of curing the misconduct of the past while leaving the basic improprieties unremedied. It is the traditional office of equity to forestall the possibility of such harassment and injustice.[19]

Limiting a claim to a recovery by the corporation when that entity, by its majority, is breaching its duties to the minority is precisely what the doctrine of common-law dissolution seeks to avoid.

III. Available Remedies

If a plaintiff meets the burden of proof and establishes liability for common-law dissolution, the Court must next turn to the question of a proper remedy. Although a plaintiff asserting a cause of action for common-law dissolution, by definition, seeks dissolution of the corporation, the Court is not limited to awarding such extreme relief. In fact it should consider less drastic and intrusive relief, which would nonetheless make the plaintiff whole.[20]

Judge Fuld, in rendering the Court's majority opinion in the *Leibert* case, discussed the issue of the proper remedy and stated:

> [I]f the plaintiff does prove those allegations [establishing entitlement to common-law dissolution], the Court should grant either the relief of dissolution which the plaintiff seeks or, alternatively, such other relief as might seem more appropriate once the actual facts and circumstances are ascertained.[21]

Judge Fuld expanded upon this thought less than two years later, in his dissenting opinion in the *Kruger* case, and stated:

> Although the Court would be empowered to direct that the stock (the asset of the venture) be voted for dissolution, such an extreme step may not be necessary to accomplish a fair result. For example, a practical solution might be found in a procedure under which either interest may purchase the shareholdings of the other at an appraised value found by the Court and upon terms set by it. Flexibility of remedy, tailored to all the facts and circumstances of the case, including the good faith of the parties on both sides, their conflicting interest and motivations, if any, is the key.[22]

IV. Stock Buy-out Alternative

Judge Fuld in the *Kruger* case specifically identified a practical alternative to dissolution in that case: a buy-out of a stockholder's shares at an appraised value determined by the Court. This buy-out remedy has been acknowledged in New York as a viable alternative to dissolution, and is currently incorporated in New York's Business Corporation Law applicable to statutory claims for dissolution. The statutory remedy and related case law is instructive in the common-law context, particularly because the statutory remedy has its origins in the common law.

Section 1118 of New York's Business Corporation Law, which became effective on June 11, 1979, provides that in any statutory dissolution proceeding brought pursuant to BCL § 1104-a, any other shareholder or shareholders of the corporation can elect to buy-out the petitioning shareholder at fair value upon such terms and conditions as may be approved by the Court.[23] Courts in New York have applied the Section 1118 buy-out concept in statutory cases and have expanded the concept beyond that of a mere election to be exercised at the whim of an electing shareholder.

The Court of Appeals addressed a BCL § 1104-a statutory dissolution cause of action in *In re Kemp & Beatley, Inc.*[24] The Court in *Kemp* affirmed an order of dissolution conditioned upon permitting the corporation to purchase

the petitioning shareholders' stock at fair value. The Court of Appeals ultimately concluded that dissolution was the appropriate remedy but, citing to BCL § 1118, stated that the order of dissolution must be conditioned upon first providing the corporation with a thirty (30) day buy-out option.[25] Relying on the *Kemp* decision, the Appellate Division, Third Department, in *In re Dissolution of Wiedy's Furniture Clearance Center Co., Inc.*,[26] a statutory dissolution case, affirmed the remedy of a court-ordered buy-out at fair value. Here, however, the Appellate Division did not order dissolution conditioned upon a buy-out option. It acknowledged the lower court's power to order a buy-out in lieu of dissolution, regardless of whether or not the corporation elected to avail itself of a buy-out option. This went well beyond the buy-out election provided for in BCL § 1118. In other words, the Court applied a common-law buy-out alternative in a statutory case, separate and apart from the strictures of the BCL statute.

The viability of the buy-out remedy does not depend on whether dissolution is sought under the BCL statute or at common-law. New York Courts determining statutory BCL cases have the discretion to require a fair value buy-out, as in *Wiedy*, or, at a minimum must, according to the *Kemp* decision, provide the option of a buy-out prior to dissolution proceeding forward. This is wholly consistent with Judge Fuld's conclusion in the common-law *Kruger* case that, "[f]lexibility of remedy, tailored to all the facts and circumstances of the case . . . is key."[27] In fact, the buy-out remedy makes even more sense in the common-law context where the stockholdings of the plaintiff do not reach the 20% threshold of stock ownership necessary for statutory dissolution. It allows the larger majority of shareholders to continue the existence of the corporation if they so desire, while providing a fair and just return to the "below 20%" minority plaintiff. It is also less of a burden for a company to buy-out a shareholder owning less than a 20% interest as compared to a shareholder owning a larger stake, and who is able to pursue statutory dissolution.

V. Legislative History

The legislative history of BCL §§ 1104-a and 1118 further confirms the viability of the fair value, buy-out remedy in a common-law dissolution action. The incorporation of this remedy into the BCL statutory framework came directly from the common law.

To understand the genesis of the BCL § 1118 buy-out provision, the legislative history pertaining to that provision is worthy of review. Indeed, the bill jacket reveals a number of telling facts. Contained in the bill jacket is a letter dated May 29, 1979 from William B. Finneran of the New York State Assembly to then Governor Hugh L. Carey recommending approval of the legislation. Assemblyman Finneran, in support of the legislation, submitted a section of a legal treatise with his letter. He stated in his letter:

> I am enclosing a section of F. Hodge O'Neal's esteemed work *"Squeeze-Outs" of Minority Shareholders (Expulsion or Oppression of Business Associates)*. Note Chief Judge Fuld's strong advocacy on page 591.

O'Neil addresses the buy-out alternative in this treatise section and explains its use at common law. He states:

> In many situations a court can offer quarreling shareholders one or more alternatives to dissolution. . . . A court order compelling one faction of shareholders to buy-out the other faction is another possible solution of a shareholder conflict. In an Idaho case, the court, as an alternative to dissolution, gave majority shareholders a reasonable time to reduce the corporation's capital so as to enable it to pay the complaining shareholder his pro rata share of corporate assets in exchange for his stock. Along a similar line, a practical solution might be found in a procedure under which either shareholder may purchase the holdings of the other at an appraised value found by the court and upon terms set by it. Flexibility of remedy, tailored to all the facts and circumstances of the case, including the shareholders' conflicting interests and motivations, is the key.[28]

O'Neil points to two cases in the common law as the basis for the buy-out remedy. The Idaho case he references is the case of *Riley v. Callahan Mining Co.* (28 Idaho 525, 155 P. 665 (Sup. Ct., Idaho 1916)). The Supreme Court of Idaho in *Riley*, relying on equitable principles, fashioned a buy-out remedy in that case. It stated in relevant part as follows:

> From its very nature, and in order to attain its objects, equity must often act without specific statutory authority and sometimes without legal precedent. Each case must stand on its own facts, and the degree of relief applied must be commensurate with the wrong to be remedied. As remarked by Mr. Justice Field in *Sharon v. Tucker*, 144 U.S. 533, 12 S. Ct. 720, 36 L. Ed. 532, in quoting from Pomeroy's treatise on Equity Jurisprudence: "It is absolutely impossible to enumerate all the special kinds of relief which may be granted, or to place any bounds to the power of the courts in shaping the relief in accordance with the circumstances of particular cases."

> We shall not in this case compel the dissolution of the defendant corporation, but we conclude that plaintiffs are at least entitled to such a measure of equitable relief as will require the defendant corporation to reduce its capital stock to the extent required in order to enable it to distribute among plaintiffs, in exchange for the surrender and cancellation of their share certificates, a proportionate share of the corporate assets, after all the corporate obligations are paid. The stockholders will at once take the proper statutory proceedings to reduce the capital stock accordingly. If they prefer to dissolve the corporation altogether, they may of course exercise their statutory rights in that respect, but it is not the purpose of this decision to force them to do so.[29]

After citing the Idaho case, O'Neil in his treatise cites the New York case of *Kruger v. Gerth*, *supra,* and Judge Fuld's dissenting opinion therein. Judge Fuld, expanding on the thoughts he expressed in the majority opinion of the *Leibert* case, offered the buy-out remedy as a practical, alternative solution to dissolution, and stressed that "Flexibility of remedy, tailored to all the facts and circumstances of the case including the shareholders' conflicting interests and motivations is the key."

Assemblyman Finneran, in his May 29, 1979 letter to Governor Carey, specifically directed the Governor's attention to Judge Fuld's thinking as set forth in the O'Neill treatise ("Note Chief Judge Fuld's strong advocacy on page 591.").

BCL § 1104-a and BCL § 1118 (buy-out provision) became effective on June 11, 1979, less than two weeks after Assemblyman Finneran wrote to Governor Carey.[30] The letter gives insight into the thinking behind BCL § 1118, namely the O'Neill legal treatise and its citation to common law advocating the buy-out alternative. There can be no question that such alternative is a creature of equity and the common law, and the practical nature of such an alternative spurred its incorporation into the statutory framework of the BCL in June, 1979. Judge Fuld's "strong advocacy" of this alternative remedy is as relevant today as it was in 1965 and 1979. A court, exercising its equitable powers, can and should consider the alternative remedy of a buy-out at fair value when the facts and circumstances warrant such alternative. Flexibility of remedy is indeed the key.

VI. Choices for the Court

The objective of a common-law dissolution cause of action is to assure recovery of a minority plaintiff's interest in the corporation at issue, and prevent further malfeasance by the majority, who have control over the corporation. The Court in exercising its equitable power can accomplish this objective by choosing from a number of possible remedies.

The most obvious possible remedy is that of dissolution. The Court may order that the corporation in question be dissolved, that pursuant to such dissolution the assets of the corporation be sold, and that each shareholder receive his share of the proceeds based upon his percentage ownership of the corporation. The remedy satisfies the objective of assuring a fair recovery by the plaintiff and preventing further majority malfeasance; however, there are downsides to the dissolution option. Dissolution is the nuclear option, and would prevent the corporation from continuing in existence. The dissolution process itself takes time. The costs associated with the process can be high and will be borne by all shareholders including the plaintiff. For example, a receiver needs to be appointed to marshall the assets of the corporation, liquidate those assets which can be sold, address existing liabilities of the corporation, and ultimately distribute the remaining cash and assets to the corporation's shareholders.[31] Furthermore dissolution may create substantial tax liabilities for all shareholders including the plaintiff.

A second possible remedy is a required, court-ordered buy-out of the plaintiff's interest at fair value. The Court may hold a hearing to determine the limited issue of the fair value of plaintiff's interest, and then order the corporation to buy out plaintiff's interest at that fair value within a fixed period of time. This remedy is similar to the remedy ordered in *Wiedy* described above. The attractive feature of such a remedy is that it allows the existence of the corporation to continue for its remaining shareholders; avoids the time, costs and potential tax liabilities associated with dissolution; and accomplishes the objective of plaintiff's cause of action—assuring him a fair recovery upon his minority interest and preventing majority abuses against him in the future.

A third possible remedy is a court order providing for dissolution conditioned upon first offering the corporation a buy-out option, to be exercised within a fixed period of time, e.g., within thirty (30) days. This is identical to the remedy ordered in the *Kemp* case. This type of remedy permits a corporation the flexibility to determine its best alternative once the minority shareholder is gone.

A fourth possible remedy is a buy-out variation involving an aliquot share distribution of the corporation's assets. The corporation "buys out" the minority shareholder by distributing to the plaintiff his proportionate share of the company's assets (rather than cash only) in exchange for his stock. This form of remedy could be used in the situation where the corporation's assets are easily divisible.

In all, a Court confronted with a common-law dissolution claim has a wide variety of reasonable alternatives to consider short of dissolution.

VII. Conclusion

Common-law dissolution, albeit rare, is alive and well in New York. A plaintiff satisfies his burden of proof if he establishes that the majority "so palpably breached their fiduciary duties" that the majority by their own conduct have relinquished the exclusive power to dissolve the corporation. If liability is established, the Court must then turn to the issue of the appropriate remedy. The Court, in equity, must consider all of the facts and circumstances of the case and fashion a remedy which is fair and reasonable to all. A practical alternative to the extreme remedy of dissolution is a buy-out of the plaintiff's interest by the corporation. The buy-out remedy can be fashioned in a variety of ways. Importantly, the Court has broad discretion to choose the most appropriate remedy and should attempt to balance the needs of the parties in fashioning the most equitable solution.

Endnotes

1. Public corporations and corporations registered as investment companies under the Investment Company Act of 1940, 15 USDA §§ 80a-1 *et seq.*, are not subject to § 1104-1 dissolution. *See* BCL § 1104-a (a).
2. BCL § 1104-a(a)(1) and (2).
3. Many states other than New York also have statutory dissolution provisions. *See*, *e.g.* Conn. Stock Corp. Act § 33-382(b); Dist. Columbia Business Corp. Act § 90; Fla. Gen. Corp. Act § 607.274; I1. Business Corp. Act § 86; In. Gen. Corp. Act § 25-242; Md. Gen. Corp. Law § 4-602; Me. Business Corp. Act § 1115; Mn. Business Corp. Act § 301.50; N.H. Gen. Corp. Law § 294.97; N.C. Business Corp. Law § 55-125; Pa. Business Corp. Law § 1107; R..I. Business Corp. Law § 7-1.1-90; Tn. Gen. Corp. Law § 48-1008; W.V. Corp. Act § 31-1-134.
4. Prior to the passage of § 1104-a, common-law dissolution was the avenue by which *all* shareholders, those owning 20% or more of the voting shares and those owning less than 20%, could seek dissolution of a private corporation.
5. *See Leibert v. Clapp*, 13 N.Y.2d at 313, 316, 247 N.Y.S.2d 102, 105 (1963). *See also* BCL §§ 1001 and 1103.
6. *Leibert*, 13 N.Y.2d at 317, 247 N.Y.S.2d at 105.
7. "Palpable" is commonly defined as tangible, easily perceptible, noticeable. *See, e.g.*, Webster's Ninth New Collegiate Dictionary (Merriam-Webster, Inc. 1988).
8. *Leibert*, 13 N.Y.2d at 317, 247 N.Y.S.2d at 105.
9. *See Kroger v. Jaburg*, 231 A.D. 641, 248 N.Y.S. 387 (1st Dep't 1931); *Leibert v. Clapp*, 13 N.Y.2d 313, 247 N.Y.S.2d 102 (1963); *Nelkin v. H.J.R. Realty Corp.*, 25 N.Y.2d 543, 307 N.Y.S.2d 454 (1969); *In re Kemp & Beatley, Inc.*, 64 N.Y.2d 63, 484 N.Y.S.2d 799 (1984); *In re: Dubonnet Scarfs, Inc.*, 105 A.D.2d 339, 341, 484 N.Y.S.2d 541, 543 (1st Dep't 1985); *Lewis v. Jones*, 107 A.D.2d 931, 932, 483 N.Y.S.2d 868, 869 (3d Dep't 1985); *Fedele v. Seybert*, 250 A.D.2d 519, 521, 673 N.Y.S.2d 421, 423 (1st Dep't 1998); *Collins v. Telcoa Int'l. Corp.*, 283 A.D.2d 128, 132–33, 726 N.Y.S.2d 679, 683.
10. *See*, *e.g.*, *Kruger v. Gerth*, 22 A.D.2d 916, 255 N.Y.S.2d 498, *aff'd w/o opinion*, 16 N.Y.2d 802, 263 N.Y.S.2d 1 (1965); *Shapiro v. Rockville Country Club, Inc.*, 22 A.D.3d 657, 802 N.Y.S.2d 717 (2d Dep't 2005).
11. 13 N.Y.2d 313, 247 N.Y.S.2d 102 (1963).
12. *Id.*, 13 N.Y.2d at 317, 247 N.Y.S.2d at 105.
13. 231 A.D.641, 248 N.Y.S. 387 (1st Dep't 1931).
14. *Id.*, 231 A.D. at 643 and 645, 248 N.Y.S. at 390 and 392.
15. 107 A.D.2d 931, 483 N.Y.S.2d 868 (3d Dep't 1985).
16. 250 A.D.2d 519, 673 N.Y.S. 2d 421 (1st Dep't 1998).
17. *Id.*, 250 A.D.2d at 520–24, 673 N.Y.S.2d at 422–24.
18. 295 A.D.2d 425, 743 N.Y.S.2d 170 (2d Dep't 2002).
19. *Leibert*, 13 N.Y.2d at 317, 247 N.Y.S.2d at 105–106.
20. *See*, *e.g.*, *In re Kemp & Beatley, Inc.*, 64 N.Y.2d 63, 74, 484 N.Y.S.2d 799, 806 (1984) ("Every order of [statutory] dissolution, however, must be conditioned upon permitting any shareholder of the corporation to elect to purchase the complaining shareholder's stock at fair value.").
21. *Id.*, 13 N.Y.2d at 318, 247 N.Y.S.2d at 106.
22. *Kruger*, 16 N.Y.2d at 807, 263 N.Y.S.2d at 4–5.
23. BCL § 1118.
24. 64 N.Y.2d 63, 484 N.Y.S.2d 799 (1984).
25. *Id.*, 64 N.Y.2d at 75, 484 N.Y.S.2d at 807.
26. 108 A.D.2d 81, 487 N.Y.S.2d 901 (3d Dep't 1985).
27. *Kruger*, 16 N.Y.2d at 807, 263 N.Y.S.2d at 4–5.
28. O'Neill, *"Squeeze Outs" of Minority Shareholders (Expulsion or Oppression of Business Associates)* (Callaghan & Co. Chicago, Il.)
29. *Riley*, 28 Idaho at 591.
30. New York was not alone in adopting the buy-out remedy as part of its statutory scheme. At that time several other states had already adopted similar legislative provisions. *See, e.g.*, S.C. Code Ann. § 12-22.23(a)(4) (Supp. 1968); Maryland Gen. Corp. Law § 4-603 (1967); W. Va. Code Ann. § 31-1-80 (1966); Conn. Gen. Stat. Rev. §§ 33-117 (1958); Ca. Corp. Code § 4658 (1955).
31. *See*, *e.g.*, BCL § 1005(a)(3)(A) and (B).

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Unsettling Observations on the Settlement Privilege

By Ronald G. Blum and Andrew J. Turro

I. Introduction

After years of litigation, your adversary finally understood the strength of your client's case—and, as significant, your advocacy skills. The terms of the settlement are confidential, so all you can say is that the matter is resolved and the client pleased. You sent the files to storage, mailed the client a final bill and turned to other matters.

Not long after, you receive a subpoena from a party in a different matter. Not for the usual—the documents exchanged during discovery—but for the settlement agreement in your case, as well as all drafts of that agreement and the testimony of your client about the negotiations leading up to the agreement. You update the client, reassuring: "Don't worry, the settlement agreement is confidential and the settlement discussions won't be discoverable." *Not so fast*! Your assurance may be no more than wishful thinking.

Although many attorneys assume that settlement talks and documentation will remain confidential and that nonparty discovery requests cannot reach them, the law is less clear, and often to the contrary. Only a handful of federal courts have recognized a settlement privilege; the majority have expressly rejected the privilege.[1]

II. Only a Few Courts Have Recognized the Privilege

The minority view recognizing a settlement privilege is best articulated by the Sixth Circuit in *Goodyear Tire & Rubber Co. v. Chiles Power Supply, Inc.*[2] *Goodyear* involved two federal actions: a contract action in Ohio between Goodyear and Chiles Power and a later Colorado action by homeowners against Goodyear and Chiles Power.

In the earlier Ohio case, Goodyear sued Chiles Power for breach of contract because the defendant had not paid Goodyear for hoses used in home heating systems. Chiles Power counterclaimed, alleging breach of the implied warranty of merchantability. The Ohio federal court granted Goodyear summary judgment on its contract claim but denied summary judgment on defendant's counterclaim. Thereafter, the Ohio court presided over settlement talks, warning the parties that the discussions were to remain confidential.[3] The settlement negotiations proved unsuccessful and the trial resulted in a jury verdict in favor of Goodyear on defendant's remaining counterclaims. Afterwards, Daniel Chiles, a co-founder of the defendant company, was quoted in a newspaper claiming that on the eve of trial Goodyear offered to settle by paying Chiles Power and indemnifying it from homeowner lawsuits in exchange for a written statement "agree[ing] that the fault is with the homeowners and contractors."[4] Goodyear subsequently sought relief based upon Chiles' statement. The Ohio district court held a hearing and issued an order stating that "the content of settlement discussions are always confidential" and may never be disclosed even after the matter is over.[5] The court further permitted Goodyear to issue a corrective statement in response to Chiles' remark.[6]

While the Ohio action was pending, Colorado homeowners commenced an action against Chiles Power and Goodyear alleging that Chiles Power had used defective hose manufactured by Goodyear in the plaintiffs' home heating systems. When the plaintiffs learned of Daniel Chiles' statement, they requested that the Colorado district court direct defendant to testify about the settlement discussions. That court denied the motion on the ground that it lacked jurisdiction to overturn the Ohio court's ruling that the discussions were confidential. Undeterred, the Colorado homeowners intervened in the Ohio action, seeking to compel Chiles to testify. The Ohio district court denied the request and the homeowners appealed.

Before the Sixth Circuit, the homeowners argued that Federal Rule of Evidence 408 demonstrates that settlement discussions are discoverable: the rule allows introduction into evidence of settlement discussions to prove bias or prejudice, even though it makes them inadmissible for other purposes.[7] The Sixth Circuit rejected the homeowners' claim based on Rule 408, and relying on public policy considerations, recognized a settlement privilege:

> There exists a strong public interest in favor of secrecy of matters discussed by parties during settlement negotiations. This is true whether settlement negotiations are done under the auspices of the court or informally between the parties. The ability to negotiate and settle a case without trial fosters a more efficient, more cost-effective, and significantly less burdened judicial system. In order for settlement talks to be effective, parties must feel uninhibited in their communications. Parties are unlikely to propose the types of compromises that most effectively lead to settlement unless they are confident that their proposed solutions cannot be used on cross examination, under the ruse of "impeachment evidence," by some future third party. Parties must be able to abandon their adversarial tendencies to some degree. They must be able to make hypothetical concessions, offer creative *quid pro quos*, and generally make statements that would otherwise belie their litigation efforts. Without a privilege, parties

> would more often forgo negotiations for the relative formality of trial. Then, the entire negotiation process collapses upon itself, and the judicial efficiency it fosters is lost.[8]

Noting that Federal Rule of Evidence 501 authorizes the federal courts to determine new privileges by examining "common law principles . . . in light of reason and experience,"[9] the Sixth Circuit concluded that "a settlement privilege serves a sufficiently important public interest, and therefore should be recognized."[10]

A few district courts have reached similar results. For example, in *Cook v. Yellow Freight System*,[11] a California court denied defendant's motion to compel disclosure of the content of settlement negotiations based on the "well established privilege relating to settlement discussions."[12] While expressly recognizing that Rule 408 addresses the "inadmissibility of evidence at trial and [is] generally pertinent to the inadmissibility of compromise material to prove damages or liability," the *Cook* court nevertheless concluded that the same policy concerns support the invocation of the settlement privilege in the context of pre-trial disclosure. More specifically, the court invoked the settlement privilege and refused to direct disclosure of the non-party's settlement materials. It reasoned that settlement discussions frequently are not the "product of truth seeking," but rather "puffing and posturing."[13]

More recently, an Ohio district court upheld a plaintiff's refusal to produce documents related to settlement correspondence because they were protected by a "settlement privilege."[14] After inspecting the materials *in camera*, the court quoted and relied on *Cook* in denying the motion to compel because "discovery of such unreliable 'facts' would be highly misleading."[15]

III. The Majority of Courts Reject the Privilege

Most federal courts refuse to recognize a settlement privilege. For example, more than 25 years ago, the Seventh Circuit rejected the proposition that a settlement privilege protects settlement negotiations from discovery.[16] The *General Motors* case arose from a class-action settlement and a challenge by objectors to the trial court's refusal to allow disclosure of settlement negotiations. The district court had refused to allow the discovery on the ground that the conduct of the negotiations was irrelevant to the fairness of the settlement. Although not raised by either party, the Court of Appeals, *in dicta*, rejected suggestion of a settlement privilege because Rule 408 governs only admissibility, not discoverability, and therefore provides no basis to bar disclosure of the settlement documents.[17]

A District of Columbia court recently reached the same conclusion. *In re Subpoena issued to Commodity Futures Trading Commission* involved an underlying action brought by E. & J. Gallo Winery in a California district court against WD Energy Services alleging manipulation of energy prices.[18] The Commodity Futures Trading Commission had earlier investigated WD Energy Services, and Gallo served a non-party subpoena on the Commission, seeking documents it had received from WD Energy Services in connection with its investigation. The California court had protected from disclosure some of WD Energy Services' documents on the basis of a federal settlement privilege and the CFTC urged the District of Columbia court to recognize the privilege.[19]

Rejecting that request, the court noted that although Rule 501 directs courts to continue development of privileges, recent cases have urged restraint.[20] It also observed that Rule 408 limits only admissibility, not discoverability, of settlement material, and that the rule contemplates a number of circumstances under which settlement documents may be used at trial. Citing a leading treatise on evidence, *Weinstein's Federal Evidence*, the court explained that Rule 408 cannot be used to curtail discovery rights.[21] Accordingly, the court granted Gallo's motion to compel disclosure of the documents despite the California court's ruling.[22]

A Southern District of New York judge reached the same conclusion, contrasting the purposes of Rule 408, which governs evidence, and Federal Rule of Civil Procedure 26, which governs discovery.[23] *In re Initial Public Offering Securities Litigation* concerned whether Wells submissions to the Securities and Exchange Commission are discoverable in subsequent civil litigation. In holding the submissions discoverable, the court observed that Rule 408 addresses only admissibility, while the broader Federal Rule of Civil Procedure 26 governs discoverability and requires only a showing of relevance, even of inadmissible evidence. This holding is in accord with many district court decisions that have refused to recognize the settlement privilege.[24]

IV. Even When Refusing to Recognize a Settlement Privilege, Some Courts Have Protected Settlement Discussions or Documents

While courts have refused to recognize a settlement privilege, many of these same courts have protected some settlement discussions or documents.

For example, even in the face of Seventh Circuit precedent rejecting the privilege, an Illinois district court relied on policy grounds in prohibiting discovery of settlement negotiations that did not culminate in an agreement. In *ABN Amro Inc. v. Capital Int'l Ltd., et al.*,[25] the defendant denied being a "placement agent" or "distribution agent" for the other defendants. The parties subsequently engaged in settlement discussions that proved unsuccessful. Thereafter, at his deposition, defendant's senior executive officer conceded that Capital International had acted as a distribution agent for co-defendant Deutsche Bank. During the deposition, co-defendant Eirles Four Ltd. sought to question the witness on the substance of the settlement discussions. Both plaintiff and defendant Capital objected, contending that

the settlement negotiations were protected from disclosure by Rule 408.

While readily acknowledging that the Seventh Circuit had declined to recognize a settlement privilege in *General Motors* and that other courts had directed disclosure because settlement terms and agreements may be relevant in establishing bias or prejudice, the Illinois district court doubted that unsuccessful settlement negotiations could be probative on any such issue:

> It is a harder question whether settlement negotiations that do not lead to any agreements are discoverable. Eirles has stated that the negotiations are themselves relevant to bias. But, settlement negotiations that do not lead to any *quid pro quo*, may not be probative of bias. Eirles has not demonstrated how the substance of negotiations, in the absence of any settlement, may be relevant to bias. To allow defendant Eirles to discover settlement negotiation information without sufficient justification, particularly in the absence of a settlement actually being reached, could frustrate the policy encouraging confidential settlements and have a chilling effect on a party's willingness to engage in settlement discussions.[26]

Based on this reasoning, the court refused to permit inquiry into the unsuccessful settlement negotiations and ruled that the movant could discover only whether a settlement had been reached and, if so, the substance of the agreement.[27]

Similarly, one court noted that disclosure of ongoing settlement negotiations might conflict with the policy of encouraging settlement, and therefore disclosure could be denied under Federal Rule of Civil Procedure 26 on the ground that it might cause undue burden or embarrassment.[28]

Other courts have fashioned a different approach, allowing discovery only upon a "heightened" showing of necessity. For example, in *Bottaro v. Hatton Associates*,[29] the plaintiff settled with one of three defendants and the remaining defendants sought discovery of the terms of the settlement. In support of their application, defendants claimed that although the settling parties' agreement was inadmissible under Rule 408 "to prove liability for or invalidity of the claim or its amount," it should be disclosed because "it may produce admissible evidence on the question of damages."[30] The district court acknowledged that Rule 408 would not insulate from disclosure documents or factual admissions "merely because they were exchanged in the course of negotiating a settlement."[31] Nonetheless, the *Bottaro* court held that the party seeking disclosure of settlement materials must support the application with something more than a "hope that it will somehow lead to admissible evidence on the question of damage" and opined that "the better rule is to require some particularized showing of a likelihood that admissible evidence will be generated by the dissemination of the terms of a settlement agreement."[32]

V. Practical Considerations

As the foregoing discussion suggests, the possible disclosure of settlement information must be carefully considered by the practitioner. Prospectively speaking, when an attorney is negotiating and crafting a settlement, a few steps may help preserve the confidentiality of such materials. Given a choice, settle in the Sixth Circuit. Absent that choice, a practitioner wanting to ensure the confidentiality of the agreement should insist that it contain more than a standard confidentiality provision. Such a provision should, at the very least, require notice to all parties and an opportunity to be heard in the event disclosure of the settlement agreement or settlement materials is sought. Buttress the confidentiality provision by explaining the need for confidentiality and its importance to the settlement. Consider requiring that drafts of the agreement be destroyed. Nonetheless, be sure to caution a settling client that despite these efforts, the settlement information and documents may become discoverable.

Where discovery disputes concerning the disclosure of settlement information arise, courts may balance the broad scope of Rule 26 disclosure of any non-privileged matter "that is relevant to the claim or defense of any party," and Rule 408's goal of encouraging settlement of disputes. Therefore, the practitioner seeking disclosure of settlement materials should be mindful that under Rule 26 a party must establish that the information is relevant or reasonably calculated to lead to discovery of admissible evidence. And, as discussed above, some courts require even more.[33] Even courts reluctant to recognize a settlement privilege may be sensitive to the pitfalls presented by discovery of settlement materials. Such discovery may jeopardize on-going discussions. It may bring to light offers and counter-offers that are far removed from the merits of the underlying litigation. And, of course, it may discourage discussions that could lead to amicable resolutions. Accordingly, when crafting arguments urging disclosure of settlement information, do not overlook the particular policies underlying Rule 408's goal of encouraging settlement of disputes and be sure to highlight with particularity the relevance of the information sought to the material issues in the case at hand.

On the other hand, a party seeking to convince a federal court to adopt the settlement privilege bears an especially heavy burden since most courts reject the privilege. As the D.C. Circuit noted, the proponent of a privilege bears the burden of establishing facts sufficient to warrant applying the privilege.[34] This requires a threshold showing of entitlement to a ruling on the existence of the privilege.[35] The proponent of the settlement privilege can learn from the mistakes of WD Energy: clearly identify the allegedly privileged documents with detailed descriptions and, if

that detail would undermine the privilege, seek an *in camera* review by the court.[36]

Evidence Rule 408 and Civil Procedure Rule 26 address different concerns. While those disparate concerns may have caused many courts to reject the privilege, a number of courts nonetheless have relied on these concerns to reaffirm that settlement information should be afforded a higher degree of protection from discovery than other types of materials. Balancing those concerns challenges even the best judge. Navigating this unclear area of the law—whether it be to protect settlement materials or to access them through discovery—remains the practitioner's challenge.

Endnotes

1. This article discusses the settlement privilege as it arises in federal courts under federal common law. Where state law supplies the rule of decision as to an element of a claim or a defense, questions of privilege are decided under state law. Fed.R. Evid. 501. This article does not address a different, but related privilege—the mediation privilege. *See Sheldone v. Penn. Turnpike Comm.*, 104 F. Supp. 2d 511 (W.D. Pa. 2000)(adopting federal mediation privilege); *Folb v. Motion Picture Ind. Pension & Health Plans*, 16 F. Supp. 2d 1164 (C.D. Ca. 1998)(same); *but see Deluca v. Allied Domecq Quick Service Restaurants*, 2006 WL 2713944 at *8 (E.D.N.Y. Sept. 22, 2006)(upholding magistrate judge's report that noted that the Second Circuit has not recognized the mediation privilege).
2. 332 F.3d 976 (6th Cir. 2003).
3. *Id*. at 978.
4. *Id*.
5. *Id*.
6. *Id*.
7. *Id*. at 979.
8. *Id*. at 980.
9. Fed.R.Evid. 501.
10. 332 F.2d at 980. *Goodyear* has been criticized on the ground that jurisdiction was based on diversity and, therefore, the privilege issue should have been governed by state law pursuant to Fed. R. Evid. 501. *See Ohio Consumers' Counsel v. Public Utilities Commission*, 111 Ohio St. 3d 300, 322 (2006)(noting criticism, finding *Goodyear* unpersuasive and declining to recognize settlement privilege under Ohio law).
11. 132 F.R.D. 548 (E.D. Cal. 1990).
12. 132 F.R.D. at 554.
13. Indeed, the *Cook* court concluded:

    > [T]he court finds that one consideration in precluding documents generated in the course of settlement discussions lies in the fact that such discussions are frequently not the product of truth seeking. Settlement negotiations are typically punctuated with numerous instances of puffing and posturing since they are "motivated by a desire for peace rather than from a concession of the merits of the claim." *United States v. Contra Costa County Water Dist.*, 678 F.2d 90, 92 (9th Cir. 1982). What is stated as fact on the record could very well not be the sort of evidence which the parties would otherwise actually contend to be wholly true. That is, the parties may assume disputed facts to be true for the unique purposes of settlement negotiations. The discovery of these sort of "facts" would be highly misleading if allowed to be used for purposes other than settlement.

    Id. at 554.
14. *Allen County v. Reilly Indus,* 197 F.R.D. 352 (N.D. Ohio 2000).
15. *Id*. at 354.
16. *In re General Motors Corp. Engine Interchange Litig.*, 594 F2d 1106, 1124 (7th Cir. 1979).
17. *Id*. at 1124, n.20.
18. *In re Subpoena Issued to Commodity Futures Trading Commission*, 370 F.Supp.2d 201 (D.D.C. 2005), *aff'd on other grounds*, 439 F.3d 740 (D.C. Cir. 2006).
19. *Id*. at 207–08.
20. *Id*. at 208–09, citing *Univ. of Pennsylvania v. EEOC*, 493 U.S. 182, 194 (1990) and n. 8, cases rejecting privilege for identity of reporters' confidential sources, child abuse records, parent-child communications, academic peer-review records and many additional circumstances.
21. *Id*. at 211, citing 2 *Weinstein's Federal Evidence* § 408.07 at 408-26 (2005).
22. On appeal, the D.C. Circuit declined to reach the settlement privilege issue, affirming the trial court because WD Energy had not met its burden of building a record sufficient to allow a court to rule on its claim to settlement privilege protection. 439 F.3d at 754.
23. *In re Initial Public Offering Securities Litigation*, 2004 WL 60290 (S.D.N.Y. Jan. 12, 2004).
24. *Id*. *2, n. 11, *3, n. 12 and 13 (citing cases); *see also Newman Assoc. v. J.K. Harris & Co.*, 2005 WL 3610140 (S.D.N.Y. Dec. 15, 2005).
25. 2006 U.S. Dist. LEXIS 3780 (N.D. Ill. Jan. 30, 2006).
26. *Id*. at 5.
27. *Id*. at 6.
28. *In re Initial Public Offering Securities Litigation*, 2004 WL 60290 at *5 (S.D.N.Y. Jan. 12, 2004); *see also Primetime 24 Joint Venture v. Echostar Communications Corp*., 2000 WL 97680 (S.D.N.Y. Jan. 28, 2000)(refusing to order a witness to disclose ongoing settlement negotiations, but holding that Rule 408 does not create a settlement privilege).
29. 96 F.R.D. 158 (E.D.N.Y. 1982).
30. *Id*. at 159.
31. *Id*. at 160; *see also United States v. American Soc'y of Composers, Authors and Publishers*, 1996 WL 157523 at *3 (S.D.N.Y. Apr. 3, 1996).
32. *Id*. at 160. Courts have criticized requiring a "heightened" showing on the ground that such a standard is contrary to Rule 26. *See, e.g., Rates Technology Inc. v. Cablevision Systems Corp.* 2006 WL 3050879 at *4 (E.D.N.Y. Oct. 20, 2006).
33. *See, e.g., Vardon Golf Co. v. BBMG Gold Ltd.,* 156 F.R.D. 641, 650 (N.D. ILL 1994)(requiring party seeking settlement materials to articulate both "what kind of information it reasonably expects to find in the documents sought and how this will lead to other admissible evidence.").
34. 429 F.3d at 750.
35. *Id*.
36. WD Energy did not give a detailed description of the documents for fear of vitiating the privilege. That fear led to the release of the documents—the circuit court held that lack of specificity fatal to WD Energy's claim. 439 F.3d at 752.

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Report: Treating the Federal Government Like Any Other Person: Toward a Consistent Application of Rule 45

I. Introduction

On June 16, 2006, the District of Columbia Circuit Court of Appeals in *Yousuf v. Samantar*[1] halted a disturbing trend that had emerged over the previous two years, principally in the D.C. district courts. The district courts had concluded that an agency of the federal government could not be subpoenaed as a "person" under Rule 45 of the Federal Rules of Civil Procedure to produce documents in cases to which the government was not a party.[2] The Court of Appeals, after finding that "the text of the Rule is unhelpful," nonetheless held that "the Government is a 'person' subject to subpoena under Rule 45 regardless whether it is a party to the underlying litigation."[3] Accordingly, Rule 45 or the Advisory Committee notes or both should be amended to make it explicit that the federal government may be subpoenaed under the standards of Rule 45 to provide documents or testimony as a third party to cases pending in the federal courts.[4]

The district court cases that excused federal government agencies from the scope of Rule 45 did so on the grounds, as urged by the federal government,[5] of: (a) a presumption that the sovereign may not be considered a "person," (b) the Dictionary Act[6] definition of "person" does not mention the federal government or its agencies, and (c) the lack of an explicit statement in Rule 45 covering the federal government. These arguments were rejected by the Court of Appeals in *Yousuf*.

II. No Presumption of Sovereign Immunity Applies to Rule 45

In *In re Vioxx Products Liability Litigation*,[7] the district court exhaustively analyzed Supreme Court precedent regarding the "recognized interpretative rebuttable presumption that with regard to the application of substantive laws, the sovereign may not be considered a 'person.'"[8] The court in *Vioxx* and the D.C. Circuit in *Yousuf*, relying on the Supreme Court's decision in *Nardone v. United States*,[9] found that this presumption applied in only two classes of cases: (1) "where an act, if not so limited, would deprive the sovereign of a recognized or established prerogative title or interest," such as a statute of limitations; and (2) where deeming the government a person would "work [an] obvious absurdity as, for example, the application of a speed law to a policeman pursuing a criminal or the driver of a fire engine responding to an alarm."[10] Both the *Yousuf* and *Vioxx* courts found that Rule 45, as a procedural rule, fell into neither class.[11] The government has no "established prerogative" not to respond to subpoenas, and application of Rule 45 would work no "obvious absurdity."[12] Therefore, there is no presumption that "person" as used in Rule 45 excludes the federal government as a matter of sovereign immunity.[13]

III. The Dictionary Act Is Inapplicable

The Dictionary Act states that "[i]n determining the meaning of any Act of Congress, unless the context indicates otherwise . . . the words 'person' and 'whoever' include corporations, companies, associations, firms, partnerships, societies, and joint stock companies, as well as individuals," but not the federal government.[14] Nonetheless, without reaching the question of whether the Dictionary Act applies to judicially adopted rules, the D.C. Circuit in *Yousuf* rejected its applicability. The Dictionary Act was passed in 1947, and, when Rule 45 was adopted in 1937, the predecessor of the Dictionary Act, the Act of Feb. 25, 1871, 16 Stat. 431, provided that "in all acts hereafter passed . . . the word 'person' may extend and be applied to bodies politic and corporate . . . unless the context shows that such words were intended to be used in a more limited sense."[15]

IV. Under Ordinary Rules of Statutory Construction Rule 45 Includes the Federal Government

The D.C. Circuit in *dicta* in *Al Fayed v. CIA*,[16] which interpreted 28 U.S.C. § 1782 as not including the federal government within the word "person" for purposes of enforcing a foreign country subpoena, and in *Linder v. Calero-PortoCarrero*,[17] which declined to decide the issue because the government had not raised it below, suggested that it was an open question whether "person" in Rule 45 included the federal government. In subsequent decisions, exemplified by *AlohaCare*, the D.C. district court, building on *Al Fayed* and *Linder*, had found that, although Rule 30(b)(6) included the federal government within the description of a person for purposes of an oral deposition, the federal government was not included within the definition of a person for purposes of a third-party subpoena under Rule 45, even when an oral deposition was being sought.[18] *Yousuf* rejected such a distinction.[19]

First, *Yousuf* found that "the text of the Rule itself is unhelpful" in determining whether the federal government is a "person" bound by Rule 45.[20] The D.C. Circuit then "turn[ed] to the context in which the Rule resides, that is, to the Rules as a whole."[21] After reciting the Supreme Court's instruction in *Marek v. Chesny*,[22] that "words and phrases [in the Federal Rules of Civil Procedure] . . . *must* be given a consistent usage and be read *in pari materia*" (emphasis in original), the court found that Rules 4(i)(3)(A),[23] 14,[24] 19(a)(1), 19(a)(2),[25] 24,[26] and

30(b)(6)[27] all included the federal government within the scope of a "person" subject to the particular Rule and concluded that "person" in Rule 45 must be read similarly.[28]

V. The Applicable Standard of Review

Since *Yousuf*, the federal government has sought to prevent disclosure under third-party subpoenas on the grounds that the requestor has failed to comply with so-called *Touhy* regulations and that the government's withholding of information should be reviewed under the arbitrary and capricious standard of the Administrative Procedure Act ("APA") § 706(2)(A).[29]

In *United States ex rel. Touhy v. Regan*,[30] the Supreme Court held that an FBI agent could not be held in contempt of court for refusing to obey a subpoena to produce papers based on a regulation issued by the United States Attorney General under the Housekeeping Act,[31] declaring such papers confidential, which it found within his authority to issue.[32] Thereafter, the APA was amended to provide that a reviewing court may set aside an agency action only if it is found to be "arbitrary, capricious, an abuse of discretion, or otherwise not in accordance with law."[33]

There is a split in authority as to the standard of review to apply in determining whether a federal agency has properly refused to comply with a subpoena. *Exxon Shipping Co. v. United States Department of Interior*[34] held that the undue burden standard of Rule 45 applied; *COMSAT v. National Service Foundation*,[35] held that the arbitrary and capricious standard of the APA controlled; *Houston Business Journal v. Gill*[36] held that a subpoena *duces tecum* was reviewed under the undue burden standard, while a subpoena *ad testificandum* was considered under the APA; and *United States Environmental Protection Agency v. General Electric Company*[37] left the issue open.

The government has justified resistance to third-party subpoenas by citing rationales for enacting *Touhy* regulations in the first place: centralization as to whether a subpoena will be obeyed or challenged, minimization of the use of governmental resources unrelated to official business, and a policy determination about the best use of an agency's resources.[38]

However, there is no reason that the government, like any other person, could not present any concerns about burden or privilege to a court for a determination as whether to quash a subpoena. Courts can consider all the federal government's policy arguments in the context of ruling on the need for compliance with the subpoena. In fact, courts have not had trouble determining issues of burden or privilege appropriately raised by the federal government.[39] Moreover, APA § 706(2)(A) explicitly provides that a court reviewing an agency action may set it aside if it is "not in accordance with law," that is, not in accordance with the standard of Rule 45.

The standards of administrative agency review should not be applied to an action to enforce a subpoena against the federal government under Rule 45. If a governmental agency has information relevant to a dispute, even if it is not a party, it should be required to produce that information, as any other person would, under the same standards that govern any other third party. There is no need to treat the federal government under a different standard under Rule 45. Accordingly, cases requiring exhaustion of administrative remedies before entertaining a motion to compel under Rule 45 and imposing an arbitrary and capricious standard in evaluating agency non-compliance are flawed. Rule 45 or the Advisory Committee notes or both should be amended to describe the appropriate standard to be applied to federal government agencies in reviewing subpoenas issued to them.

VI. Conclusion

Agencies of the federal government, if in possession of relevant and material evidence, should be compelled to provide it to litigants in a civil case to which it is not a party, like any other person. Because of the confusion principally in the D.C. district courts over whether agencies of the federal government should be subject to a subpoena under Rule 45 in a case in which they are not parties and because the D.C. Circuit has indicated that Rule 45 does not explicitly state that, when the Rule refers to a "person," it includes the federal government, Rule 45, the Advisory Committee notes or both should be amended to make explicit that a subpoena may be served and enforced under the standards of Rule 45 against the federal government or an agency thereof even when the United States is not a party to the litigation in which discovery is sought.

Endnotes

1. 451 F.3d 248, 255 (D.C. Cir. 2006).
2. *See Truex v. Allstate Ins. Co.*, No. 05-0439 (ESH), 2006 WL 241228, at *5 (D.D.C. Jan. 26, 2006); *SEC v. Biopure Corp.*, No. 05-506 (RWR/AK), 2006 U.S. Dist. LEXIS 12889, at *15 (D.D.C. Jan. 20, 2006); *AlohaCare, Inc. v. Hawaii ex rel. Dep't of Human Servs.*, No. 04-498 (CKK), 2005 U.S. Dist. LEXIS 41202, at *21 (D.D.C. June 28, 2005); *Ho v. United States*, 374 F. Supp. 2d 82, 84 (D.D.C. 2005); *United States ex rel. Taylor v. Gabelli*, 233 F.R.D. 174, 176 (D.D.C. 2005); *Yousuf v. Samantar*, No. 05-110 (RBW), 2005 WL 1523385, at *4 (D.D.C. May 3, 2005), *rev'd*, 451 F.3d 248, 257 (D.C. Cir. 2006); *Lerner v. Dist. of Columbia*, No. 00-1590 (GK), 2005 WL 2375175, at *5 (D.D.C. Jan. 7, 2005); *see also Robinson v. City of Phila.*, 233 F.R.D. 169, 172 (E.D. Pa . 2005).
3. 451 F.3d at 257; *see also In re Vioxx Prods. Liability Litig.*, 235 F.R.D. 334, 342 (E.D. La. 2006). This proposition was first expressed in *United States v. Proctor & Gamble Co.*, 356 U.S. 677, 681 (1958). Justice Douglas cited nothing for this principle; it was self-evident. It should also be noted that, prior to the D.C. Circuit decision in *Al Fayed v. CIA*, 229 F.3d 272 (D.C. Cir. 2000) (interpreting 28 U.S.C. § 1782, permitting discovery in aid of foreign tribunals), it had been assumed that Rule 45 applied to the federal government even when not a party. *See Vioxx*, 235 F.R.D. at 343 (citing cases explicitly and implicitly holding that federal government was subject to subpoena). A later D.C. Circuit case, *Linder v. Calero–PortoCarrero*,

251 F.3d 178 (D.C. Cir. 2001) considered whether *Al Fayed* required a finding that Rule 45 did not apply against the federal government without actually deciding the issue.

4. Rule 45(a)(1) provides:

> Every subpoena shall (A) state the name of the court from which it is issued and (B) state the title of the action, the name of the court in which it is pending, and its civil action number; and (C) command each person to whom it is directed to attend and give testimony or to produce and permit inspection and copying of designated books, documents or tangible things in the possession, custody or control of that person, or to permit inspection of premises, at a time and place therein specified; and (D) set forth the text of subdivisions (c) and (d) of this rule. A command to produce evidence or to permit inspection may be joined with a command to appear at trial or hearing or at deposition, or may be issued separately.

A party is required to comply with a request for deposition or documents by mere notice under Rules 30 and 34. *See* Rules 30(a)(1) and 30(b)(1) and Rule 34(a). Both rules refer to discovery from non-parties by subpoena under Rule 45. *See* Rules 30(a)(1) and 30(b)(1) and Rule 34(c).

5. *See, e.g., AlohaCare, Inc.*, 2005 U.S. Dist. LEXIS 41202, at *7, *12–*13, *15–*21.

6. 1 U.S.C. § 1.

7. 235 F.R.D. at 339–41.

8. *Id.* at 339. The seven cases generally cited for this presumption of statutory construction are *Vermont Agency of Natural Resources v. United States ex. rel. Stevens*, 529 U.S. 765, 778–88 (2000)(state not subject to *qui tam* liability and not a "person" under 31 U.S.C. § 3729(a)); *International Primate Prot. League v. Administrators of Tulane Educ. Fund*, 500 U.S. 72, 79–87 (1991)(federal agency not a "person" under 28 U.S.C. § 1442 (a) (1) – reading would produce absurd results, as an agency would be acting under an officer of same agency); *Will v. Michigan Dep't of State Police*, 491 U.S. 58, 72–87 (1989)(state not a "person" under 42 U.S.C. § 1983 and subject to liability for rights violation); *Wilson v. Omaha Indian Tribe*, 442 U.S. 653, 666–69 (1979) (state not a "white person" under 25 U.S. § 194 permitting suit); *United States v. United Mine Workers*, 330 U.S. 258, 269–89 (1947)(federal government not an "employer" under 29 U.S.C. § 52 enabling it to be divested of sovereign power to seize mines); *United States v. Cooper Corp.*, 312 U.S. 600, 604–14 (1941)(holding United States was not a "person" under Sherman Act subjecting it to treble damages). Finally, in *United States v. Fox*, 94 U.S. 315, 321 (1876), cited in *Cooper*, the Supreme Court, without any presumption, ruled that the federal government could not be a "person" under the New York Statute of Wills as it would cause New York to have impliedly divested sovereign control of land within its borders. In addition to these cases consisting of statutes using the word "person" in the context of a sovereign, the dissent in *Vermont Agency of National Resources* cited several cases for the proposition that a statute is pressured only not to be apply to the enacting sovereign, 529 U.S. at 789–802 (Steve, J. dissenting). *See also* cases cited in *Vioxx*, 235 F.R.D. at 342. A complete catalogue of federal statutes using the word "person" is outside the scope of this report.

9. 302 U.S. 379, 383–84 (1937).

10. *Yousuf*, 451 F.3d at 254; *Vioxx*, 235 F.R.D. at 340.

11. *Yousuf*, 451 F.3d at 254; *Vioxx*, 235 F.R.D. at 341–42.

12. *Yousuf*, 451 F.3d at 254.

13. *Vioxx*, 235 F.R.D. at 342.

14. 1 U.S.C. § 1.

15. *Yousuf*, 451 F.3d at 253–54.

16. 229 F.3d 272, 275–76 (D.C. Cir. 2000).

17. 251 F.3d 178, 181 (D.C. Cir. 2001).

18. 2005 U.S. Dist. LEXIS 41202, at *19. *See also Truex*, 2006 WL 241228, at *4; *Biopure*, 2006 U.S. Dist. LEXIS 12889, at *9, *15; *Ho*, 374 F. Supp. 2d at 84, n.4; *Gabelli*, 233 F.R.D. at 175–76; *Yousuf*, 2005 WL 1523385, at *3–*4, *rev'd*, 451 F.3d at 257; *Lerner*, 2005 WL 2375175, at *4–*5.

19. *Vioxx* also rejected the distinction:

> [T]here is no language in Rule 45 which would lead this Court to determine that "person" includes the government when it is a party, but not when it is a non-party. Therefore, if the government is a "person" when it is a party and there is no language in Rule 45 differentiating parties from non-parties, principles of consistent interpretation require "person" as used in Rule 45 to encompass the government when it is both a party and a non-party.

235 F.R.D. at 342.

20. 451 F.3d at 255.

21. *Id.*

22. 473 U.S. 1, 21 (1985).

23. Rule 4(i)(3)(A) addresses a party's failure to serve "all *persons* required to be served in an action governed by Rule 4(i)(2)(A)" (emphasis added), which, in turn, governs "[s]ervice on an agency or corporation of the United States." *Yousuf*, 451 F.3d at 255.

24. The United States may be impleaded as a third-party defendant under Rule 14, which provides for a "summons and complaint to be served upon a *person*." *See United States v. Yellow Cab Co.*, 340 U.S. 543, 556–57 (1951)(emphasis added).

25. Although not expressly named in the Rules governing joinder, the "United States is a *person* described in Rule 19(a)(1), (2)." *Carlson v. Tulalip Tribes of Wash.*, 510 F.2d 1337, 1339 (9th Cir. 1975)(emphasis added).

26. The United States may intervene as of right under Rule 24, which requires "a *person* desiring to intervene [to] serve a motion." *Roeder v. Islamic Republic of Iran*, 333 F.3d 228, 232–33 (D.C. Cir. 2003)(emphasis added).

27. Rule 30(a)(1) states that "[a] party may take the testimony of any *person*, including a party, by deposition upon oral examination . . . The attendance of witnesses may be compelled by subpoena as provided in Rule 45" (emphasis added). Rule 30(b)(6) states that "[a] party may in the party's notice and in a subpoena name as the deponent a . . . governmental agency." The *Vioxx* court concluded, "reading Rules 30(a)(1) and 30(b)(6) in conjunction, a party may take the deposition of a governmental agency, whether a party or not, and compel the attendance of witnesses through the use of a Rule 45 subpoena." 235 F.R.D. at 342.

28. *Yousuf*, 451 F.3d at 256.

29. *See Abdou v. Gurrieri*, No. 05-CV-3946 (JG) (KAM), 2006 WL 2729247, at *2, *4 (E.D.N.Y. Sep. 25, 2006); *SEC v. Selden*, 445 F. Supp. 2d 11, 13–14 (D.D.C. 2006).

30. 340 U.S. 462 (1951).

31. Now codified at 5 U.S.C. § 301, the Housekeeping Act provides:

> The head of an Executive department or military department may prescribe regulations for the government of his department, the conduct of its employees, the distribution and performance of its business, and the custody, use, and preservation of its records, papers, and property. This section does not authorize withholding information from the public or limiting the availability of records to the public.

Federal agencies have adopted regulations, now called *Touhy* regulations, governing disclosure of information in their control.

32. 340 U.S. at 465, 468, 470. Concurring, Justice Frankfurter cautioned that "the decision and opinion in this case cannot afford a basis for a future suggestion that the Attorney General can forbid every subordinate who is capable of being served by process from producing relevant documents and later contest a requirement upon him to produce on the ground that procedurally he cannot be reached." 340 U.S. at 472.

33. 5 U.S.C. § 706(2)(A).

34. 34 F.3d 774, 777 (9th Cir. 1994).

35. 190 F.3d 269, 274 (4th Cir. 1999).

36. 86 F.3d 1208, 1212 (D.C. Cir. 1996).

37. 212 F.3d 689, 690 (2d Cir. 2000).

38. *See* the Memorandum of the United States Department of State in Opposition to Motion to Compel Compliance with a Rule 45 Subpoena, filed March 21, 2005 in connection with the *Yousuf v. Samantar*, No. 05-RL-00110 (RBW), in the District Court of the District of Columbia, 2005 WL 2523385. The government cited *Touhy*, 340 U.S. at 468; *COMSAT*, 190 F.3d. at 278; and *Boron Oil Co. v. Downie*, 873 F.2d 67, 73 (4th Cir. 1989).

39. *See Vioxx*, 235 F.R.D. at 344–345 (the court considered policy reasons advanced by government and held that, even under an arbitrary and capricious standard, much less under an undue burden standard, the government decision not to produce a witness deprived a party of necessary evidence and ordered that testimony be taken); *Abdou*, 2006 WL 2729247, at *3–*4 (under both the arbitrary and capricious and undue burden standards, the government's interest in protecting its informant outweighed the need for a detective's testimony).

This report was prepared by the Committee on Federal Procedure of the Commercial and Federal Litigation Section of the New York State Bar Association. The Committee on Federal Procedure of the Commercial and Federal Litigation Section is chaired by Gregory K. Arenson. The principal authors of this report are Mr. Arenson and Stephen T. Roberts. The report was adopted as the position of the Commercial and Federal Litigation Section by a vote of its Executive Committee at a meeting on November 14, 2006.

A Review of *HF Management Services LLC v. Pistone*: Does an Underwriter's Due Diligence Counsel Have a Fiduciary Duty to an Issuer?

I. Summary

Whether an underwriter's due diligence counsel has a fiduciary obligation to the issuer of a security, and, in turn, whether such obligation warrants disqualification of counsel in a later action against the issuer, are matters of unsettled law in New York State. The differences of opinion on these issues are brought to a head in *HF Management Services LLC v. Pistone*, 818 N.Y.S.2d 40 (1st Dep't 2006) ("*HF Management Services*"), a recent decision handed down by the Appellate Division, First Department. The majority in *HF Management Services* reversed the lower court's order disqualifying plaintiff's litigation counsel, on the ground that no fiduciary obligation existed between an underwriter and an issuer, and, thus, none can be imputed to underwriter's counsel. The dissent, on the other hand, found that a fiduciary obligation did arise when underwriter's counsel obtained confidential information regarding the issuer, that it would not have been privy to, but for its role as counsel to underwriter.

This Report of the Commercial and Federal Litigation Section of the New York State Bar Association (the "Report") first sets forth a summary of the majority and dissenting opinions in *HF Management Services,* with a focus on identifying the primary basis for each opinion. The Report then analyzes the issues and case law crucial to the positions taken by both the majority and the dissent, and analyzes the strengths and weaknesses of those positions. Finally, consideration is taken of several policy concerns including: 1) the potential for countless conflicts to arise if it is found that underwriter's due diligence counsel owes a fiduciary duty to an issuer; 2) the additional burden placed upon law firms and attorneys to assess such potential conflicts; 3) the additional limitations placed on clients in selecting the counsel of their choice; 4) that by expanding the fiduciary obligation of counsel to non-clients, law firms and attorneys face the risk of additional liability; and 5) that faith in the legal profession could be lost if clients are allowed to seek and retain counsel who possess confidential information concerning a particular adversary.

II. *HF Management Services LLC v. Pistone*

A. Case Overview and the Motion Court's Finding

HF Management Services, an action premised upon breach of employee non-solicitation agreements and unfair competition, presents issues of ethical concern that could greatly impact the landscape of attorney conflict and disqualification. Plaintiff, HF Management, appealed from the lower court's disqualification of its counsel on the ground that a fiduciary relationship exists between an underwriter and an issuer of securities, and that such relationship is imputed to that underwriter's due diligence counsel. *HF Management Services LLC v. Pistone*, Index No. 602832/2004 (Sup. Ct., N.Y. County Feb. 16, 2005) (Ira Gammerman, J.H.O.).

Specifically, plaintiff HF Management alleged that two employees of WellCare Health Plans, Inc. ("WellCare"), who had previously been employed by HF Management, breached their non-solicitation agreements. *HF Management Services*, 818 N.Y.S.2d at 41. In addition, plaintiff alleged that WellCare engaged in unfair competition by raiding plaintiff's sales force. *Id.* Significantly, the law firm representing plaintiff HF Management in the action, Epstein, Becker & Green ("EBG"), had previously served as due diligence counsel to WellCare's underwriter, Morgan Stanley, in connection with the recent initial public offering ("IPO") of WellCare stock. *Id.* In its role as counsel to Morgan Stanley, EBG: 1) spent several hundreds of hours reviewing files and interviewing WellCare personnel; 2) reviewed business plans, strategic and market analyses, employee policies, and recruitment and retention documents; and 3) discussed pending litigations and related litigation strategies with WellCare's head of litigation and general counsel. *Id.*

Based upon the foregoing, defendants moved to disqualify EBG as HF Management's counsel on the grounds that, in the course of the IPO due diligence investigation, EBG had acquired confidential information, and that such information would prejudice the defense. Granting defendants' motion, the lower court reasoned that the lack of a formal attorney-client relationship was not dispositive, and that "the crux of disqualification is not the attorney-client relationship itself, but the fiduciary relationship that results from it." *Id.* In so holding, the Court found that: 1) Morgan Stanley in its role as an underwriter owed a fiduciary duty to WellCare, and 2) EBG as Morgan Stanley's agent in the IPO shared the underwriter's fiduciary duty to WellCare. *Id.*

B. The Majority

The majority agreed with the lower court that even "where no formal attorney-client relationship exists," a fiduciary obligation may be sufficient grounds for attorney disqualification. However, the majority held that because "no fiduciary relationship existed between Morgan Stanley and WellCare, . . . none may be imputed to EBG as Morgan Stanley's agent." *Id.* at 41.

Having first found that New York law does not recognize the existence of a fiduciary obligation "based solely on the [typical] relationship between an underwriter and

issuer," the majority held that "nothing in the record even remotely suggests that the relationship between Morgan Stanley and WellCare rose above the typical contractual relationship of an underwriting agreement between a buyer and a seller." *Id.* at 42–43. The majority specifically noted that "[b]oth parties were separately counseled," and that "there is no indication or suggestion that Morgan and WellCare enjoyed any type of pre-existing relationship, or that Morgan acted as an 'expert advisor on market conditions' to WellCare." *Id.* at 43.

The majority did find, however, that even though the "typical relationship between an underwriter and issuer based upon an underwriting agreement . . . does not create any fiduciary obligations," where a "pre-existing relationship created independently and apart from the contractual one" exists, a fiduciary obligation may arise. *Id.* at 42. However, the majority in *HF Management Services* found that a pre-existing and independent relationship did not exist between Morgan Stanley and WellCare.

C. The Dissent

The dissent, rather than focusing upon the fiduciary obligation between an underwriter and an issuer, emphasized that "confidential information obtained by plaintiff's counsel Epstein Becker & Green, P.C. (EBG) from defendant WellCare Health Plans, Inc. in the course of its prior due diligence work for Morgan Stanley, may be reasonably perceived as placing such confidences in jeopardy of disclosure to plaintiff." *Id.* at 44–45.

The dissent found that EBG had obtained information in the due diligence process within the context of a fiduciary relationship, and that such information is reasonably related to the issues presented in the present action.[1] *Id.* at 45. The dissent stated that a fiduciary relationship did exist between Morgan Stanley and WellCare, "at least to the extent that Morgan Stanley was bound to preserve from adverse use against WellCare in other contexts confidential information elicited from it to facilitate the underwriter's due diligence." *Id.* Further, the dissent agreed with the lower court that this fiduciary obligation would be imputed to Morgan Stanley's counsel, EBG. *Id.*

Specifically, the dissent, in agreement with the motion court, found that "the crux of disqualification is not the attorney-client relationship itself, but the fiduciary relationship that results from it." *Id.* at 45. The heart of the dissent's opinion was that EBG, acting as Morgan Stanley's agent, obtained "secret" information from WellCare within the meaning of Code of Professional Responsibility DR 4-101 (22 N.Y.C.R.R. 1200.19), to which it would not otherwise have been privy. *Id.* at 45. Having obtained such information, EBG then owed "WellCare a fiduciary or special obligation not to disclose to anyone other than Morgan Stanley the 'secret' information obtained by it in the course of rendering professional services to Morgan Stanley, so that Morgan Stanley could use it for the purposes for which EBG was retained." *Id.* at 45-46. In effect, the dissent acknowledges the existence of a fiduciary or special obligation between EBG, underwriter's counsel, and WellCare, the issuer, primarily on the basis that having obtained confidential information to facilitate its due diligence, Morgan Stanley brought upon itself a fiduciary duty not to use such information adversely against WellCare in other situations.

Thus, both the majority and the dissent in *HF Management Services* acknowledge that under certain circumstances, even where no formal attorney-client relationship exists, a fiduciary obligation may be sufficient grounds for attorney disqualification. The dissent however, unlike the majority, finds the existence of a special obligation between underwriter's counsel and a third party, i.e., the issuer, solely on the basis that underwriter's counsel acquired confidential information. What the dissent failed to address, however, is that the information provided by WellCare to Morgan Stanley was not provided with an expectation of confidentiality.

D. An Analysis of Relevant Legal Issues and Case Law

1. Attorney Disqualification

The disqualification of an attorney is a matter that rests within the sound discretion of the court. *Flores v. Willard J. Price Assocs.*, 20 A.D.3d 343, 344 (1st Dep't 2005). *See also Nationwide Assoc. v Targee St. Internal Medicine Group*, 303 A.D.2d 728 (2d Dep't 2003). "Attorneys owe fiduciary duties of both confidentiality and loyalty to their clients." *Tekni-Plex, Inc. v Meyner & Landis*, 89 N.Y.2d 123, 130 (1996). Thus, attorneys have continuing obligations to protect their clients' confidences. *Flores*, 20 A.D.3d at 344. Moreover, an attorney "must avoid not only the fact, but even the appearance, of representing conflicting interests." *Cardinale v Golinello*, 43 N.Y.2d 288, 296 (1977).

Courts in New York State "recognize that the importance of preserving client confidences and secrets requires that all doubts be resolved in favor of attorney disqualification. *First Hudson Fin. Group, Inc. v. Martinos*, 812 N.Y.S.2d 767, 770 (Sup. Ct., N.Y. County 2005). Courts, however, are also cognizant both that disqualification interferes with a party's right to retain counsel of his choice, and, in the current reality of litigation, disqualification motions are often utilized as a tactical tool. *Id.* Therefore, motions to disqualify an attorney are subject to a high burden of proof. *Hickman v. Burlington Bio-Medical Corp.*, 371 F. Supp. 2d 225 (E.D.N.Y. 2005). Moreover, the appearance of impropriety, without more, is insufficient to grant a motion to disqualify. *In re Stephanie X*, 6 A.D.3d 778, 773 N.Y.S.2d 766 (3d Dep't 2004).

2. A Fiduciary Obligation Has Been Sufficient Grounds for Attorney Disqualification Despite the Absence of a Formal Attorney-Client Relationship

As an initial matter, both the majority and dissent, in reliance upon *Greene v. Greene*, 47 N.Y.2d 447, 418 N.Y.S.2d 379, 391 N.E.2d 1355 (1979), acknowledge that a fiduciary obligation is sufficient ground for attorney disqualification,

notwithstanding the lack of a formal attorney-client relationship. In *Greene*, plaintiff alleged that the law firm she used in connection with the creation and management of an *inter vivos* trust, and one of its partners at the time, committed breaches of fiduciary duty, fraud and other wrongs. Two third-party defendants, former members of defendant law firm, became members of the law firm retained by plaintiff against defendant law firm. Determining that disqualification of plaintiff's retained law firm was appropriate, the Court of Appeals of New York held that since the members of the law firm currently representing plaintiff had been members of the defendant law firm, they were liable for all conduct occurring during their employment at that firm, and thus, had a financial interest in the present lawsuit. Further, the Court found that an attorney may not act on behalf of a client in an action where the attorney has a direct interest of the subject matter of the suit.

Specifically, the Court of Appeals held that:

> An attorney traditionally has been prohibited from representing a party in a lawsuit where an opposing party is the lawyer's former client. . . . Underlying this rule is the notion that an attorney, as part of his fiduciary obligation, owes a continuing duty to a former client—broader in scope than the attorney-client evidentiary privilege—not to reveal confidences learned in the course of the professional relationship. . . . As former partners in defendant law firm, Grutman and Bjork owe a fiduciary obligation similar to that owed by an attorney to his client. . . . In view of these allegations, we cannot discount the possibility that ***information obtained by Grutman and Bjork in their role as fiduciaries*** will be used in the pending lawsuit.

Greene, 47 N.Y.2d at 453 (emphasis added).

In essence, the *Greene* court found that attorney disqualification is warranted, despite the absence of a formal attorney-client relationship, where a retained law firm or members of that firm hold an independent fiduciary obligation, at odds with their current representation. In *Greene*, this obligation manifested itself in the form of a fiduciary duty that two former partners owed to the defendant law firm. Thus, under *Greene*, the acquisition of confidential information alone, absent a conflicting fiduciary obligation or former attorney-client relationship, does not appear to necessitate attorney disqualification.[2]

3. The Fiduciary Relationship Between an Underwriter and an Issuer

a. The Fiduciary Relationship

A fiduciary relationship "exists between two persons when one of them is ***under a duty to act for or to give advice for the benefit of another*** upon matters within the scope of the relation." Restatement [Second] of Torts § 874, Comment *a* (emphasis added). *See also HF Management Services,* 818 N.Y.S.2d at 42; *EBC I Inc. v. Goldman, Sachs & Co.*, 5 N.Y.3d 11, 19, 799 N.Y.S.2d 170, 175, 832 N.E.2d 28, 31 (2005).

Moreover, a fiduciary relationship generally does not arise between parties that are involved in arm's-length transactions. *See Northeast Gen. Corp. v. Wellington Adv.*, 82 N.Y.2d 158, 162 (1993)("many forms of conduct permissible in a workaday world for those acting at arm's length, are forbidden to those bound by fiduciary ties. . . . If the parties find themselves or place themselves in the milieu of the 'workaday' mundane marketplace, and if they do not create their own relationship of higher trust, courts should not ordinarily transport them to the higher realm of relationship and fashion the stricter duty for them."); *EBC I*, 5 N.Y.3d at 19 (a fiduciary relationship, "necessarily fact specific, is grounded in a higher level of trust than normally present in the marketplace between those involved in arm's-length business transactions").

b. New York Has Long Recognized the Non-Fiduciary Nature of the Underwriter-Issuer Relationship

Generally, New York courts have recognized that "an underwriting contract does not create a fiduciary duty between the underwriter and the issuer." *Blue Grass Partners v. Bruns, Nordeman, Ra & Co.*, 75 A.D.2d 791, 791, 428 N.Y.S.2d 254, 255 (1st Dep't 1980)(court noted the lower court's finding that "an underwriter, in a best-efforts underwriting, owes no fiduciary duty to an issuer" with respect to the sale of assets it acquired from the issuer to the public).

Other jurisdictions applying New York law have also recognized that an underwriting contract does not generally give rise to a fiduciary relationship between underwriter and issuer. For instance, in *Breakaway Solutions v. Morgan Stanley & Co.*, 2004 Del. Ch. LEXIS 125, *51 (2004), the court found that "[a] fiduciary duty is an example of a duty which 'must be separate and beyond any contractual duties. A fiduciary relationship may exist where one party reposes confidence in another and reasonably relies on the other's superior expertise or knowledge, but an arms-length business relationship does not give rise to a fiduciary obligation.'" (citation omitted). The *Breakaway Solutions* court found that to allege a fiduciary obligation between underwriter and issuer a complaint must set forth "allegations showing a pre-existing relationship between plaintiff and defendant that justified the alleged trust the former placed in the latter in setting the price of its shares." *Id.* at *53.

c. The Pre-Existing Relationship Exception

The New York Court of Appeals has recently emphasized the non-fiduciary nature of the relationship between an underwriter and an issuer. In *EBC I*, the court described the relationship between an underwriter and an issuer, in connection with an initial public offering, as essentially one between a buyer and a seller "whereby the 'issuer'—or

company seeking to issue the security—sells an entire allotment of shares to an investment firm who purchases the shares with a view to sell them to the public." *EBC I,* 5 N.Y.3d at 16. The court found that this contractual relationship alone does not give rise to any fiduciary obligations. *Id.* at 20.

However, the *EBC I* court did find that in limited situations, where a pre-existing relationship created independent of the underwriting contract is alleged, an underwriter may have a fiduciary obligation to an issuer. For example, in *EBC I* the issuer had hired Goldman Sachs, its lead managing underwriter with respect to an initial public offering, for its "knowledge and expertise to advise it as to a fair IPO price . . . with [the issuer's] best interest in mind." *Id.* at 20. Focusing exclusively upon these specific and independently agreed upon terms, the court found that under these circumstances the "parties are alleged to have created their own relationship of higher trust beyond that which arises from the underwriting agreement alone. . . ." *Id.* at 22.

Highlighting that the typical underwriter-issuer relationship does not give rise to a fiduciary obligation, the Court of Appeals stated, "[w]e stress, however, that the fiduciary duty we recognize is limited to the underwriter's role as advisor. We do not suggest that underwriters are fiduciaries when they are engaged in activities other than rendering expert advice." *Id.* at 21–22.

d. Federal Securities Laws

Statutorily imposed duties of an underwriter to an issuer's investors, under the Federal securities laws, further support the non-fiduciary nature of the underwriter-issuer relationship. Specifically, pursuant to the Securities Act of 1933, 15 U.S.C. §§ 77 *et seq.*, an underwriter bears the responsibility to prepare a registration statement that provides full and adequate information to investors with respect to the issuer of a particular security and the distribution of those securities. *See* 15 U.S.C. § 77g (stating, in relevant part, that any registration statement shall contain information and documents "necessary or appropriate in the public interest or for the protection of investors.") Thus, as stated by the majority in *HF Management Services*, "not only is a fiduciary aspect absent from the majority of underwriting relationships, such relationships are better characterized as adversarial since the statutorily imposed duty of underwriters is to investors." *HF Management Services,* 818 N.Y.S.2d at 43.[3]

e. An Underwriter May Not Profit From Corporate Information Gained in Its Capacity as Underwriter

As noted by the majority in *HF Management Services*, "the motion court established Morgan Stanley's fiduciary obligation as arising from the principle that an underwriter 'may not profit from corporate information gained in its capacity as underwriter.' In so doing, [the motion court] mistakenly relied on case law like *Frigitemp Corp. v. Fin. Dynamics Fund, Inc.*, 524 F.2d 275, 279 (1975), that allow a characterization of underwriters as fiduciaries of corporations ***primarily in situations involving confidential, insider information used for profit or benefit prior to an IPO.***" *HF Management Services,* 818 N.Y.S.2d at 43 n.1. (emphasis added). *See Dirks v. Sec. Exch. Comm.*, 463 U.S. 646, 655 n.14 (1983)("[u]nder certain circumstances, such as where corporate information is revealed legitimately to an underwriter, accountant, lawyer, or consultant working for the corporation, these outsiders may become fiduciaries of the shareholders. The basis for recognizing this fiduciary duty is not simply that such persons acquired nonpublic corporate information, but rather that they have entered into a special confidential relationship in the conduct of the business of the enterprise and are given access to the information solely for corporate purposes. . . . When such a person breaches his fiduciary relationship, he may be treated more as a tipper than a tippee").

While the majority in *HF Management Services* rejects the motion court's reliance on case law such as *Frigitemp* and *Dirks*, the dissent appears to embrace these cases in finding that an independent fiduciary obligation arises upon receipt of confidential information by an underwriter. Specifically, the dissent, in agreement with the motion court, explains that a fiduciary "relationship did exist between Morgan Stanley and WellCare, at least to the extent that Morgan Stanley was bound to preserve from adverse use against WellCare in other contexts confidential information elicited from it to facilitate the underwriter's due diligence." *HF Management Services,* 818 N.Y.S.2d at 45.

4. Attorney Disclosure of Confidences and Secrets

a. Code of Professional Responsibility DR 4-101 (22 N.Y.C.R.R. 1200.19)

Canon 4 of The Lawyer's Code of Professional Responsibility generally prohibits a lawyer from revealing a client's confidences and secrets. Similarly, Code of Professional Responsibility DR 4-101 (22 N.Y.C.R.R. 1200.19) states in relevant part:

> (a) Confidence refers to information protected by the attorney-client privilege under applicable law, and secret refers to other information gained in the professional relationship ***that the client has requested be held inviolate or the disclosure of which would be embarrassing or would be likely to be detrimental to the client.***
>
> (b) Except when permitted under section 1200.19(c) of this Part, a lawyer shall not knowingly:
>
> > (1) reveal a confidence or secret ***of a client***;
> >
> > (2) use a confidence or secret ***of a client*** to the disadvantage of the client; and

(3) use a confidence or secret ***of a client*** for the advantage of the lawyer or of a third person, unless the client consents after full disclosure.

(c) A lawyer may reveal:

(1) Confidences or secrets with the consent of the client or clients affected, but only after a full disclosure to them.

(2) ***Confidences or secrets when permitted under disciplinary rules or required by law or court order. . . .***

(d) A lawyer shall exercise reasonable care to prevent his or her employees, associates, and others whose services are utilized by the lawyer from disclosing or using confidences or secrets of a client, except that a lawyer may reveal the information allowed by subdivision (c) of this section through an employee.

(emphasis added).

As demonstrated by the emphasized portions of the text above, DR 4-101 (22 N.Y.C.R.R. 1200.19) is intended to protect the confidences and secrets of a client, not those of a third party. This distinction is significant to the *HF Management Services* action in that EBG was hired specifically as Morgan Stanley's counsel, and not as counsel to WellCare. Thus, based upon the text of DR 4-101 (22 N.Y.C.R.R. 1200.19), EBG would be under no obligation to refrain from revealing confidential information provided by WellCare to Morgan Stanley, and in turn to EBG.

b. A Confidentiality Obligation May Not Attach to Information Provided for the Purpose of Preparing Public Documents in Connection With a Security Issuance

Even if it is assumed that underwriter's counsel owed a fiduciary obligation to an issuer, a confidentiality obligation would likely not attach to the information obtained in the due diligence process, as such information is generally provided in order to prepare public documents which are not intended to be confidential, including the registration statement and the prospectus.

For instance, in *John Doe Corp. v. United States*, 675 F.2d 482 (2nd Cir. 1982), defendant argued that the prior disclosure of a particular document to its underwriter's counsel should not waive defendant's attorney-client privilege with respect to the document. Rejecting defendant's argument, the court held that the privilege of confidentiality was lost after selective disclosure to underwriter's counsel for a beneficial purpose, i.e., a securities offering, and not for the purpose of legal advice. Specifically, the Second Circuit held that "[o]nce materials are utilized in that disclosure, they become representations to third parties by the corporation. The fact that they were originally compiled by attorneys is irrelevant because they are serving a purpose other than the seeking and rendering of legal advice." *Id.* at 489.

Moreover, information provided by an issuer to underwriter's counsel is generally not exchanged under circumstances that give the issuer a right to believe counsel would respect its confidences, since among other reasons, an underwriter bears the responsibility to prepare a registration statement that provides full and adequate information to investors with respect to the issuer. *See Cutner & Assocs. P.C. v. Kanbar*, 300 A.D.2d 157, 751 N.Y.S.2d 733 (1st Dep't 2002)(motion for disqualification of defendant's counsel was properly denied, where among other factors, law firm did not receive confidential information under circumstances in which client had the right to believe that the law firm would respect such confidences).

E. EBG's Fiduciary Obligation to WellCare and the Resulting Need for Disqualification

1. Majority's Focus—The Existence of an Independent Fiduciary Relationship Prior to the Exchange of Confidential Information Between Issuer and Underwriter's Counsel

As the majority in *HF Management Services* notes and as the case law above demonstrates, "New York law . . . essentially does not recognize the existence of a fiduciary obligation that is based solely on the relationship between an underwriter and issuer." *HF Management Services*, 818 N.Y.S.2d at 42. Therefore, as an initial matter, the majority appears to have appropriately determined that Morgan Stanley, as WellCare's underwriter, did not owe a fiduciary duty to WellCare solely based upon the underwriting agreement between the parties. In turn, the absence of any fiduciary obligation between Morgan Stanley and WellCare, based exclusively on the traditional underwriting agreement entered into by the parties, relieves EBG of any fiduciary obligation to the issuer.

However, as recognized in *EBC I*, a fiduciary obligation may arise between issuer and underwriter where there is a pre-existing relationship created independently and apart from the contractual one. *EBC I*, 5 N.Y.3d at 20. An example of such a pre-existing relationship can be taken from the *EBC I* case itself, in which the issuer had hired Goldman Sachs, the lead managing underwriter, to specifically "advise it as to a fair IPO price . . . with eToys' best interest in mind." *Id.* In *HF Management Services*, the record does not suggest that the relationship between Morgan Stanley and WellCare was anything other than the typical contractual relationship dictated by a traditional underwriting agreement. In fact, not only were both parties counseled separately, but the underwriting agreement specifically set forth that EBG's role was as "special regulatory counsel for the underwriters." Thus, as the majority aptly found "there is no indication or suggestion that Morgan and WellCare enjoyed any type of preexisting relationship, or that Morgan acted as an 'expert advisor on market conditions.'" *HF*

Management Services, 818 N.Y.S.2d at 43. Further, unlike the dissent, as discussed below, the majority did not find that a fiduciary obligation arose between EBG and WellCare at the point in time that confidential information was made available to Morgan Stanley in order to complete its due diligence.

2. Dissent's Focus—Fiduciary Relationship Arising from the Receipt of Confidential Information Itself

As noted above, the dissent focuses almost exclusively upon the lower court's finding that "the crux of disqualification is not the attorney-client relationship itself, but the fiduciary relationship that results from it." *Id*. at 45. In so doing, the dissent pays little attention to the fact that case law and federal statutes explicitly rebut the existence of a fiduciary relationship between underwriter and issuer, absent certain exceptions that do not appear to exist in *HF Management Services*. In fact, the dissent specifically asserts that "[w]hether or not Morgan Stanley, as underwriter, was a fiduciary in the limited sense that Goldman Sachs was found to be in *EBC I*," should not be determinative of the fiduciary duty owed by Morgan Stanley to WellCare. *Id.* Rather, the dissent finds that a fiduciary relationship arises not out of an existing relationship between Morgan Stanley and WellCare, but due to the fact that "EBG obtained 'secret' information from WellCare within the meaning of Code of Professional Responsibility DR 4-101 (22 N.Y.C.R.R. 1200.19), to which it would not otherwise have been privy." *Id.* at 45–46. However, this view tends to conflict with the specific authorities the dissent relies upon.

First, in reliance on *Greene*, the dissent asserts that "EBG's disqualification was proper since it obtained confidential information in the due diligence process within the context of a fiduciary relationship," notwithstanding the lack of a formal attorney-client relationship. As noted above, the majority in *HF Management Services* also recognized that disqualification may be appropriate despite the absence of an attorney-client relationship. *Id.* at 45. However, in determining that a fiduciary relationship did not exist between Morgan Stanley and WellCare, the majority found that disqualification was not appropriate in the *HF Management Services* action. The dissent, in finding that disqualification is appropriate, does not focus on the relationship between Morgan Stanley and WellCare, but rather on the fiduciary relationship that arose strictly based upon the receipt of confidential information by Morgan Stanley and EBG from WellCare. However, the *Greene* decision does not appear to support disqualification on this basis.

Rather, the majority's holding in *Greene* tends to support the position that absent an existing fiduciary relationship or obligation ***at the time confidences were obtained***, disqualification would not be appropriate. In fact, crucial to the opinion in *Greene* was the court's finding that "[a]s former partners in defendant law firm, Grutman and Bjork ***owe a fiduciary obligation similar to that owed by an attorney to his client***. . . . In view of these allegations, we cannot discount the possibility that ***information obtained by Grutman and Bjork in their role as fiduciaries*** will be used in the pending lawsuit." *Greene*, 47 N.Y.2d at 453 (emphasis added). What appears to be missing in *HF Management Services* is a fiduciary obligation that existed independent of the fact that Morgan Stanley and EBG obtained confidential information in the due diligence process that they would not have otherwise been privy to. In *Greene*, for example, the existing obligation arose from the fiduciary duty that two former partners owed to their former law firm. Thus, under *Greene*, the acquisition of confidential information alone, absent an independent and existing fiduciary obligation or formal attorney-client relationship, does not appear to necessitate attorney disqualification.

Additionally, the dissent relies upon Code of Professional Responsibility DR 4-101 (22 N.Y.C.R.R. 1200.19) in finding that "even if it was not a fiduciary as found in the context of *EBC I*, at the very least, EBG owed WellCare a fiduciary or special obligation not to disclose to anyone other than Morgan Stanley the 'secret' information obtained by it in the course of rendering professional services to Morgan Stanley, so that Morgan Stanley could use it for the purposes for which EBG was retained." However, as noted above, DR 4-101 (22 N.Y.C.R.R. 1200.19) explicitly pertains only to *client* "confidences" and "secrets," and thus, the dissent seems to stretch the scope of the rule by including under its reach, information obtained from third parties or non-clients.[4]

Moreover, there is no expectation of confidentiality in an IPO setting. As discussed above, the expectation is that an underwriter will publicly disclose, by way of a registration statement and prospectus, the information the underwriter and its counsel obtain in performing their due diligence.

The preceding analysis demonstrates that the dissent's position is not sufficiently supported by case law and legal authority, and thus, this Report adopts the majority's position. Additionally, an analysis of the policy considerations set forth below also weighs in favor of adopting the majority opinion. However, as discussed in detail below, there is at least one policy consideration that tends to support the dissent's view.

F. Policy Considerations

The *HF Management Services* action presents for resolution "the potentially difficult problem of balancing the interests of a client [*i.e.*, HF Management Services] desirous of retaining an attorney of [its] personal choice and preference against the interests of the opposing litigant to be free from the risks of opposition by a lawyer once privy to that litigant's confidences." *Greene*, 47 N.Y.2d at 454. The following policy considerations are factors that assist in balancing these interests.

1. Policy Considerations that Militate Against Disqualification and the Finding of a Fiduciary Obligation Between Underwriter's Counsel and Issuer

If the *HF Management Services* court were to find that an underwriter's due diligence counsel owed a fiduciary duty to an issuer, who in essence is a non-client, law firms would likely be faced with a significant rise in attorney conflicts, which in turn, would lead to a rise in attorney disqualifications. The direct consequence of an increase in disqualifying events would be the additional limitations placed on a client's freedom to select the law firm of his, her or its choice. Another negative effect of this trend would be to place an additional burden upon attorneys and law firms to monitor traditional conflicts with respect to their actual clients, as well as potential conflicts with respect to all third-party and non-client entities from whom the law firm had obtained "confidential" or "secret" information. In the IPO context, this policy concern is bolstered by the fact that an issuer has no expectation of confidentiality when providing documentation to underwriter's due diligence counsel. Additionally, by expanding the fiduciary obligation of counsel to non-clients, law firms and attorneys will be faced with the very real and potentially significant risk of additional liability.

Finally, because security offerings and the related due diligence process around such offerings involve arm's-length transactions between highly sophisticated parties, as noted in the case law above, an issuer should be expected to protect itself through limited confidentiality agreements in the event concerns arise that confidences obtained (in the due diligence process) may be used against it at a later point in time.

2. Policy Considerations Supporting Disqualification

While legal authority generally supports the position that underwriter's due diligence counsel does not owe a fiduciary duty to an issuer, and thus, disqualification is not warranted on that ground alone, there is at least one policy consideration that would support a different result. Putting aside the issues of fiduciary obligation and the disclosure of client "confidences" and "secrets," it is important to consider that in the context of a security offering, an issuer, in order to facilitate the issuance of its securities, openly provides underwriter's counsel with nearly unfettered access to confidential corporate information, which would not have been accessible, but for the due diligence process. If courts then allow "advantaged" law firms to use the confidences and secrets as weapons against an issuer, who openly provided the information in the first place, clients will actively and deliberately seek and retain those law firms privy to the confidential information. This phenomenon, while not necessarily illegal, tends to foster an unethical attorney selection process which could ultimately give rise to a loss of faith in the legal profession.

Canon 9 of the Code of Professional Responsibility supports this view. Specifically, Ethical Consideration 9-1 provides that "Continuation of the American concept that we are to be governed by rules of law requires that the people have faith that justice can be obtained though our legal system. A lawyer should promote public confidence in our system and in the legal profession." Moreover, Ethical Consideration 9-6 states that:

> Every lawyer owes a solemn duty to uphold the integrity and honor of his profession: to encourage respect for the law and for the courts and the judges thereof; to observe the Code of Professional Responsibility; to act as a member of a learned profession, one dedicated to public service; to cooperate with his brother lawyers in supporting the organized bar through the devoting of his time, efforts, and financial support as his professional standing and ability reasonably permit; to conduct himself so as to reflect credit on the legal profession and to inspire the confidence, respect, and trust of his clients and of the public; and to strive to avoid not only professional impropriety but also the appearance of impropriety.

Interestingly, the concurrence in *Greene* embraced similar considerations in finding that attorney disqualification was appropriate in that case. *Greene*, 47 N.Y.2d at 454. In fact, the *Greene* concurrence specifically noted that it reached its conclusion "without reliance on obligations which attach when there is an attorney-client relationship." *Id.* Specifically, the *Greene* concurrence explained, in relevant part, that

> [t]he focus . . . , must be on the right of defendants in the lawsuit brought against them by Mrs. Greene not to have her represented by a law firm which includes, or until very recently did include, two lawyers who were members of the defendant law firm and allegedly privy to its affairs at the time of the transactions which form the basis of Mrs. Greene's claims.
> . . . To permit another law firm with which Grutman and Bjork subsequently became affiliated to represent Mrs. Greene in her lawsuit against their former firm ***would be inappropriate***, at least when there is tendered no special reason why Mrs. Greene selected the Eaton, Van Winkle firm over others to represent her. The information and any documents and records which Bjork and Grutman might have acquired while in the inner councils of defendants' affairs should not be made available to

> Mrs. Greene other than by discovery or on trial in the action. From the perspective of defendants they are entitled to be protected from having their adversary represented by an attorney who was directly or indirectly an inside participant on their side of the transactions on which the lawsuit is based.
>
> * * * *
>
> From the opposing point of view of Mrs. Greene, the client, it may surely be said that, absent any countervailing considerations, she should be entitled to an attorney or law firm of her preferential choice. In this instance, however, the substantive rights of defendants do countervail and must be held sufficient to require Mrs. Greene to seek legal representation elsewhere. Conceivably the result might be different with recourse had to other means adequately to protect the legitimate rights of defendants not to have one of their former members sit in the councils of the enemy if there were special reasons, such as prior association, personal confidence or relationship, or singular experience and competence, supporting the client's initial desire to be represented by the particular law firm or lawyer.

Id. at 454–55.

In *HF Management Services*, as in *Greene*, defendant is faced with the predicament of having openly provided "confidential" information to an attorney, which is now at risk of being used against the defendant in a separate legal proceeding. Notwithstanding that the attorney in *HF Management Services*, EBG, likely did not owe a fiduciary duty to WellCare, disqualification may nonetheless be warranted considering that: 1) EBG was privy to confidential information regarding WellCare that would not have been available to HF Management other than through eventual discovery, and 2) there is no "special reason" why HF Management selected EBG over others to represent it in an action against WellCare.

III. Conclusion

Case law and legal authority support the majority's position that a fiduciary obligation does not arise between an issuer and an underwriter solely based upon the traditional underwriting agreement. Focusing strictly on the absence of this fiduciary obligation, it is appropriate to conclude that underwriter's counsel has no fiduciary duty to an issuer with respect to confidences obtained during the due diligence process. Thus, disqualification on fiduciary obligation grounds alone would not be appropriate. This conclusion is supported by policy considerations including, among others: 1) the limitations that would be placed upon a client's freedom in selecting counsel, 2) the additional burden placed upon attorneys in monitoring conflicts with respect to "non-clients," and 3) the fact that in the IPO context an issuer does not provide information to underwriter's counsel with an expectation of confidentiality.

However, although this Report adopts the opinion of the majority, at least one policy consideration supports a different conclusion. Specifically, if law firms and attorneys were allowed to use purported confidences obtained from an issuer in the due diligence process, as weapons against that issuer at a later point in time, future litigants would be motivated to seek and retain those law firms privy to the confidential information. While not necessarily illegal, this practice fosters an unethical attorney selection process which could ultimately give rise to a loss of faith in the legal profession.

Endnotes

1. The dissent specifically noted that the confidential information turned over by WellCare to EBG in the course of Morgan Stanley's due diligence work was "directly relevant to the unfair competition claims now brought by plaintiff against WellCare." *Id.* at 46.
2. Significantly, as discussed in greater detail below, *Greene* is distinguishable from *HF Management Services* in that in *Greene* the conflicted attorneys were actually fiduciaries of their former law firm, and thus, had a pre-existing fiduciary obligation at odds with their current representation. In *HF Management Services*, on the other hand, the existence of a fiduciary relationship between underwriter's counsel and issuer arose, if at all, solely upon Morgan Stanley's receipt of confidential information necessary to complete its due diligence in connection with the issuance of WellCare securities.
3. The court in *HF Management Services* also notes that "the creation of a fiduciary duty from underwriter's counsel to the issuer of securities makes no sense under the federal securities laws," since the due diligence defense afforded to an underwriter, pursuant to Section 11 of the Securities Act, against liability for material misstatements in the registration statement, is not available to the issuer of the securities. *HF Management Services,* 818 N.Y.S.2d at 44. "Consequently . . . , there is 'no conceivable basis for any conclusion that the due diligence is being performed for the issuer's benefit.'" *Id.*
4. Further, the dissent does not address the motion court's misplaced reliance on case law such as *Frigitemp* and *Dirks*. As discussed above, those cases deem an underwriter to be a fiduciary in the limited sense that the receipt of confidential insider information may not be used by the underwriter *for profit or benefit prior to an IPO*. However, *HF Management Services* presents no facts demonstrating that EBG used the confidential information it obtained in the due diligence process to improperly benefit from trading in EBG securities.

The report was prepared by the Ethics and Professionalism Committee of the Commercial and Federal Litigation Section of the New York State Bar Association. The principal author was Michael Marks. The Ethics and Professionalism Committee is chaired by Anthony J. Harwood and James Wicks, The Executive Committee adopted the report by unanimous vote on October 18, 2006.

Protecting Employees' Constitutional Rights in Governmental Investigations: The *U.S. v. Stein* Decisions

On July 9, 2002, in response to various high-profile corporate scandals, President George W. Bush established a Corporate Fraud Task Force headed by then-Deputy Attorney General Larry Thompson. The Task Force created a memorandum entitled Principles of Federal Prosecution of Business Organizations (the "Thompson Memorandum"), which directed federal prosecutors to consider various factors when determining whether to indict a corporation. In particular, the Thompson Memorandum required prosecutors to consider a corporation's willingness to waive the attorney-client privilege and "a corporation's promise of support to culpable employees and agents, either through the advancing of attorneys' fees, [or] through retaining the employees without sanction for their misconduct."

From the outset, the Thompson Memorandum provoked controversy within the national legal community. Practitioners and state bar associations criticized its perceived interference with the attorney-client privilege and with a corporation's implementation of policies governing employee indemnification. The New York State Bar Association House of Delegates passed a resolution in June 2006 critical of the Memorandum's reward for corporations that decline to pay defense costs for their employees.

In *U.S. v. Stein*, 435 F. Supp. 2d 330 (S.D.N.Y. 2006) ("*Stein I*"), Judge Lewis Kaplan held that the Thompson Memorandum unconstitutionally coerced companies to deprive their employees of the means of defending themselves against criminal charges in violation of the Fifth and Sixth Amendments of the Constitution because it interfered with the rights of employees to receive a fair trial and to benefit from the effective assistance of counsel.

The *Stein* decision emerged amidst a backdrop of IRS and Senate Subcommittee investigations concerning the development and implementation of abusive tax shelters. KPMG found itself at the center of one such Senate Subcommittee investigation, and some of its partners were subpoenaed to testify in November of 2003. In response to that testimony, KPMG retained Skadden Arps to design a plan of cooperation with the government in an effort to avoid indictment.

Federal prosecutors investigating KPMG were keenly focused on whether KPMG planned to pay the legal fees of its employees under investigation. On more than one occasion during these discussions, the government referred to the Thompson Memorandum, and suggested that KPMG's payment of these fees would be viewed as rewarding misconduct. Judge Kaplan determined that the government's admonitions constituted a warning that "payment of legal fees by KPMG, beyond any that it might legally be obligated to pay, could well count against KPMG in the government's decision whether to indict the firm."

Judge Kaplan found that KPMG had in the past advanced and paid legal fees, without respect to a cap or condition of cooperation with the government, for its employees who found themselves having to defend civil, criminal or regulatory proceedings arising out of activities within the scope of their employment. He also found that, as a direct result of the government's coercion, KPMG had reversed this practice. KPMG's employees under investigation were instructed that KPMG would pay their legal fees and expenses, only up to $400,000, and only on condition that the employee "cooperate with the government and . . . be prompt, complete, and truthful." Significantly, KPMG told these employees that "payment of . . . legal fees and expenses will cease immediately if . . . [the employee] is charged by the government with criminal wrongdoing."

Although each of the individual KPMG defendants in *Stein* subsequently made proffers to the government, the circumstances surrounding Defendant Smith were noteworthy. Acting upon the advice of counsel, Smith initially declined to make a statement about the tax shelters at issue. When the government reported Mr. Smith's lack of cooperation to KPMG, KPMG told Smith that unless he provided the government investigators with the information they requested, KPMG would cease payment of his legal fees and would possibly take further disciplinary action "including expulsion from the firm." Smith relented, rejected his attorney's advice, and agreed to make the proffer to save his job.

Judge Kaplan held that the government's implementation of the Thompson Memorandum coerced KPMG to eliminate payment of its employees' attorneys' fees, a benefit they would have otherwise received. This denial impinged upon the KPMG defendants' ability to defend themselves, and was thus constitutional only if it could survive strict scrutiny—if it were narrowly tailored to achieve a compelling objective. It did not, the Court held, because it "burdens excessively the constitutional rights of the individuals whose ability to defend them-

selves it impairs." In so holding, the Court noted that if the government wanted to prohibit a corporation from rewarding employees engaged in the obstruction of justice, it could have easily achieved this goal by taking the payment of legal fees into account in making charging decisions only if such payments were part of an obstruction scheme. Accordingly, the Court held that the government's implementation of the Thompson Memorandum violated the KPMG defendants' Sixth Amendment right to counsel because the government "acted with the purpose of minimizing [their] access to the resources necessary to mount their defenses."

Shortly after *Stein* I, Judge Kaplan decided *U.S. v. Stein*, 440 F. Supp. 2d 315 (S.D.N.Y. 2006) ("*Stein II*"), in which he suppressed the statements made by Defendant Smith and another KPMG partner on the ground that they were coerced by the government's implementation of the Thompson Memorandum. And, in September, the court also held that it had ancillary jurisdiction to hear claims by the KPMG employees against KPMG.

Stein shows that at least one prominent professional organization was prepared to sacrifice the rights of its employees to curry favor with prosecutors in an effort to avoid indictment. While *Stein* seems to protect employees whose companies have had longstanding practices of reimbursement for legal expenses, the fate of employees at companies without such policies remains unclear. If, however, *Stein*'s underlying premise is to prevent the government from coercing corporations into sacrificing the constitutional protections of its employees, courts would be hard-pressed to distinguish between the two situations.

This article was prepared by the Corporate Litigation Counsel Committee of the Commercial and Federal Litigation Section of the New York State Bar Association. The co-chairs of the Corporate Litigation Counsel Committee are Carla M. Miller and Richard B. Friedman. Special thanks for the preparation of this article are extended to Committee members Jamie B.W. Stecher, David J. Kanfer, Stanley Pierre-Louis, and Robert D. Shapiro.

Report on Proposed Federal Rule of Evidence 502

I. Introduction

On May 15, 2006, the Advisory Committee on Evidence Rules ("Advisory Committee") published proposed Federal Rule of Evidence 502 for public comment. The following report contains the comments of the New York State Bar Association's Commercial and Federal Litigation Section in response to proposed Rule 502. The proposed rule addresses certain issues associated with waivers of attorney-client privilege and work product protection in the contexts of both voluntary and inadvertent disclosure.

Movement towards a federal rule of evidence that would address the issues targeted by proposed Rule 502 generally can be traced to two relatively recent developments: a) the increased volume of information that must be reviewed for purposes of legal proceedings as a result of electronic discovery, and the concomitant increased likelihood of inadvertent disclosure of privileged information, and b) the reportedly increased tendency of government prosecutors and regulators to request privilege waivers from parties from whom the government seeks documents. In the Section's view, the rule is well crafted to achieve its stated goals in some respects, but in other respects is problematic.

II. Summary

The Section's position on each subsection of the proposed rule is as follows:

> 502(a): The Section does not support the adoption of this subsection, which would limit the scope of waiver resulting from a disclosure of otherwise attorney-client privileged or work product protected information to undisclosed documents regarding the same subject matter, based on a "fairness" test.
>
> 502(b): The Section supports the adoption of this subsection, which provides that inadvertent disclosure does not waive the attorney-client privilege or work product protection, if certain conditions are met.
>
> 502(c): The Section does not support the adoption of this subsection, which would codify a "selective waiver" rule under certain circumstances where otherwise privileged or protected information is disclosed to government agencies acting in certain capacities and third parties subsequently seek disclosure of the same information.
>
> 502(d) and (e): The Section supports the adoption of subsections (d) and (e), which build on the provisions of proposed Rule 502(b) to prevent inadvertent disclosures from being considered a waiver of attorney-client privilege or work product protection. These subsections provide that party agreements to the same effect will be binding in the litigation in which they are involved (Rule 502(e)) and, when encompassed in a court order, will be binding on third parties (Rule 502(d)).

III. Comments on Proposed Rule 502 by Subsection

A. The Section Does Not Support the Adoption of Proposed Rule 502(a)

Proposed Rule 502(a) provides:

> **Rule 502. Attorney-Client Privilege and Work Product: Limitations on Waiver**
> **(a) Scope of waiver.** In federal proceedings, the waiver by disclosure of an attorney-client privilege or work product protection extends to an undisclosed communication or information concerning the same subject matter only if that undisclosed communication or information ought in fairness to be considered with the disclosed communication or information.

Although not stated expressly, proposed Rule 502(a) is directed at the non-inadvertent (that is, voluntary) disclosure of communications or information protected by the attorney-client privilege or the work product doctrine.[1] Proposed Rule 502(a) would also apply to the effect in federal litigation of both judicial and extrajudicial disclosures, without differentiating between the two.

The justification for proposed Rule 502(a) is two-fold. First, the Advisory Committee claims that it will reduce the time and effort expended during discovery in reviewing documents to preserve the attorney-client privilege or work product protection, and thus reduce the costs of discovery. *Report of the Advisory Committee on Evidence Rules*, dated May 15, 2006, at 2, 8 ("*Advisory Committee Report*"). The Advisory Committee suggests that "the discovery process would be more efficient and less costly if documents could be produced without risking a subject matter waiver of the attorney-client privilege or work product protection." *Advisory Committee Report* at 2. Second, the proposed Rule "seeks to provide a predictable, uniform set of standards under which parties can determine the consequences of a disclosure of communications or information covered by the attorney-client privilege or work

product protection." *Advisory Committee Report* at 9. As discussed below, neither justification holds up

We are aware of no empirical evidence, and the Advisory Committee has not provided any, that establishes that limiting the scope of waiver in the case of voluntary discovery disclosures will significantly reduce the time, effort and expense of reviewing and producing documents, the principal justification for the proposed Rule. To the contrary, it is likely that limiting the scope of voluntary disclosure waiver will not achieve this goal. It can reasonably be expected that parties will still conduct careful "privilege" reviews before producing documents, for at least two reasons. First, such reviews are performed to avoid disclosing to adversaries harmful documents that are protected from disclosure. Second, such reviews are performed to preserve the ability to argue that if a document protected by the attorney-client privilege or the work product doctrine is produced, the production was inadvertent. If proposed Rule 502(b) is enacted, inadvertent production will not waive attorney-client privilege or work product protection, but only if reasonable steps have been taken to prevent disclosure.[2]

Clearly, that form of the Rule would still require reasonably careful screening of documents before they are produced.

Proposed Rule 502(a) also resolves a fundamental question—what the scope of voluntary disclosure waiver should be in the case of both attorney-client privilege and work product—without addressing critical issues. Those issues are whether the rule should be the same in both cases, and, if so, what that rule should be, taking into account the different purposes served by the attorney-client privilege and work product protection, and considering that the attorney-client privilege has been strictly construed because it can serve as an obstacle to the search for the truth in derogation of the "public's right to every man's evidence."[3]

The Advisory Committee assumes that the rule should be the same in both cases. Yet the courts, after analyzing the purposes served by the attorney-client privilege and work product protection, for the most part, have concluded that two different waiver rules are warranted. In the case of voluntary judicial waiver of the attorney-client privilege, the rule generally is that such voluntary disclosure of a document or information protected by the attorney-client privilege waives the privilege with respect to undisclosed documents and information relating to the same subject matter.[4] In the case of work product, there is a split in authority, but the majority rule appears to be that voluntary judicial disclosure of a document or information protected by the work product doctrine only waives protection for the document or information produced (there is no subject matter waiver).[5] Whether limited waiver or subject matter waiver is preferable and whether the rule should be the same with respect to waiver of the attorney-client privilege and waiver of work product protection needs to be addressed on the merits, which the Advisory Committee has not attempted to do. "The attorney-client privilege and the work product doctrine are based on different public policies, protect different though frequently complementary interests, and are subject to different analyses when considering the propriety of finding a waiver." *Chimie v. PPG Indus., Inc.*, 218 F.R.D. 416, 421 (D. Del. 2003). "[I]t is not necessary to apply the same waiver rules to both attorney-client privilege and work product protection, since each serves a distinct purpose. . . . " *In re Hechinger Investm. Co. of Del.*, 303 B.R. 18, 24 (D. Del. 2003).

The Advisory Committee's recommendation appears to be based solely on consideration of the supposed impact on the expense of privilege review in pre-trial discovery and the Committee's unsubstantiated conclusion that a limited waiver rule will significantly reduce discovery costs. While the effect, if any, on the time, effort and expense of responding to discovery can certainly be taken into account in the course of that debate, it should not be the only factor considered or even the decisive factor, as the Advisory Committee has made it here.

The proposed Rule further provides that waiver will extend to an undisclosed communication or information concerning the same subject matter if, as a matter of "fairness," the undisclosed communication or information ought to be considered. This portion of the proposed Rule will undoubtedly spawn innumerable discovery disputes and a proliferation of motion practice that will add substantially to the burden of the courts, as parties try to use claims of voluntary disclosure and "fairness" as a means to obtain other protected documents. It is, moreover, largely an unworkable concept in the situation where parties will most likely be fighting over whether additional documents or information should be disclosed. (*See* discussion below.)

The Advisory Committee has indicated that the language concerning subject matter waiver and "fairness" is taken from Rule 106. However, the situation addressed here is not at all comparable to the situation addressed by Rule 106. That the "fairness" concept may work in the Rule 106 context is, therefore, no ground for concluding that it will work here. In the Rule 106 situation, the party who claims that "fairness" requires the introduction into evidence of other parts of, or documents additional to, the document that the other party seeks to introduce knows what the additional material is and can explain to the court why "fairness" requires the introduction of the additional material. It is not a matter of a guessing game or constant *in camera* reviews.

In contrast, how does the party to whom voluntary disclosure has been made of a document or information covered by the attorney-client privilege or work product protection know what else "in fairness" ought to be produced? The receiving party has not seen and does not know what else there is relating to the same subject mat-

ter and therefore whether "fairness" requires its disclosure. At most, that party has the disclosed document and a privilege log, which usually provides scant information about the contents of the documents listed.

Moreover, the receiving party, whose discovery of potentially helpful information is being blocked, may well move to require that further communications or information be disclosed just to have a neutral determine whether "fairness" requires such disclosure. Then, the producing party will have to expend additional time, effort and money in locating and providing those documents to the court. The producing party will also incur the additional time and expense of motion practice. These additional costs undercut at least to some degree the cost-saving justification for the proposed Rule.

The court may then have to conduct an *in camera* review of the documents to determine whether "fairness" requires that any of them be produced. This review is likely to impose a considerable burden on the courts because of the frequency with which such reviews may be required and the quantity of documents involved. Moreover, the non-producing party will be unable to give much, if any, meaningful input to the court since it will not have seen the undisclosed documents. Thus, the court will receive "meaningful" guidance only from the party opposing further disclosure, hardly a level playing field. No one can predict in advance what "fairness" will or will not require.

In addition, by adding the "fairness" test, proposed Rule 502(a) does not provide a "predictable" standard under which parties can determine the consequences of a disclosure, the second justification for the proposed Rule.

Another failing of the proposed Rule is that it does not distinguish between judicial and extrajudicial disclosure (litigation vs. non-litigation disclosure). The fact that extrajudicial disclosure may result in only a limited waiver does not mean the rule should be the same for a voluntary disclosure in a judicial setting—during discovery. *See, e.g., In re von Bulow*, 828 F.2d 94, 101–03 (2d Cir. 1997)(disclosure of privileged communications in an extrajudicial setting—a published book—waived privilege only with respect to particular communications or portions of communication disclosed); *In re Keeper of the Records* (*Grand Jury Subpoena Addressed to XYZ Corat*), 348 F.3d 16, 23–25 (1st Cir. 2003)(extrajudicial disclosure of attorney-client communications not thereafter used by client to gain adversarial advantage in judicial proceedings does not effect subject matter waiver; subject matter waiver involves "a disclosure made in the course of a judicial proceeding"). Again, the Advisory Committee has not addressed this issue. Certainly, no showing has been made that the reasons underlying a rule of limited waiver in the case of extrajudicial voluntary disclosure apply in the case of voluntary judicial disclosure waiver. Indeed, the courts in *von Bulow* and *In re Keeper of the Records* did not believe the same rule applied in both situations.

While the quest for a uniform rule for all federal courts is laudable, uniformity at the expense of a correct rule is self-defeating. Proposed Rule 502(a) will not achieve its professed objectives and is a back-door attempt to resolve an issue that courts have struggled with for years—the scope of voluntary disclosure waiver—without addressing the merits of that issue. The Section opposes its adoption.

B. The Section Supports the Adoption of Proposed Rule 502(b)

Inadvertent disclosure is covered by proposed Rule 502(b), which provides that inadvertent disclosure does not waive the attorney-client privilege or work product protection if certain conditions are met. It also is meant to be binding in state proceedings, the constitutionality of which is discussed later in this report under Federalism Issues. Proposed Rule 502(b) states:

> **(b) Inadvertent disclosure.**—A disclosure of a communication of information covered by the attorney-client privilege or work product protection does not operate as a waiver in a state or federal proceeding if the disclosure is inadvertent and is made in connection with federal litigation or federal administrative proceedings—and if the holder of the privilege or work product protection took reasonable precautions to prevent disclosure and took reasonably prompt measures, once the holder knew or should have known of the disclosure, to rectify the error, including (if applicable) following the procedures in Fed. R. Civ. P. 26(b)(5)(B).

The Section endorses the position that the inadvertent production of privileged or protected information, especially when dealing with voluminous electronically stored information, should not automatically be considered a waiver of privilege. Frequently, especially in complex cases, parties spend large, and perhaps inordinate, amounts of time reviewing hard-copy discovery materials prior to production to determine whether they are privileged, which can substantially delay access for the party seeking discovery. *See Zubulake v. UBS Warburg LLC*, 216 F.R.D. 280, 290 (S.D.N.Y. 2003)("*Zubulake III*") (the producing party decided on a review protocol of having a senior associate at a cost of $410 per hour read every word of every document rather than having a paralegal at a cost of less than $170 per hour conduct a series of targeted key-word searches). The time and expense to review electronically stored information can be greater than with hard-copy documents, because there is more of it, including many duplicates, and the informal nature of many e-mails makes it more difficult to determine whether the information is privileged. *See Computer Assocs. Int'l Inc. v. Quest Software, Inc.*, No. 02 C 4721, 2003 WL 21277129, at *1 (N.D. Ill. June 3, 2003)(cost to remove privileged

information from eight hard drives between $28,000 to $40,000); *Medtronic Sofamor Danek, Inc. v. Michelson*, No. 01-2373-MIV, 2003 WL 21468573, at *7 (W.D. Tenn. May 13, 2003)(estimates of privilege review costs regarding backup tapes between $16.5 million and $70 million); *Cognex Corat v. Electro Scientific Indus., Inc.*, No. Civ. A 01CV10287RCL, 2002 WL 32309413, at *2 (D. Mass. July 2, 2002)(a seven-person team of lawyers and paralegals took approximately 10 weeks of work to review eight CDs of electronic files).

C. The Section Does Not Support the Adoption of Proposed Rule 502(c)

(a) Introduction

The Advisory Committee takes no position on the ultimate merits of this portion of proposed Rule 502(c). *Advisory Committee Report* at 3. For the reasons discussed below, the Section does not support the adoption of the proposal based on currently available information as to its likely effects. The proposed subdivision states:

> In a federal or state proceeding, a disclosure of a communication or information covered by the attorney-client privilege or work product protection—when made to a federal public office or agency in the exercise of its regulatory, investigative, or enforcement authority—does not operate as a waiver of the privilege or protection in favor of non-governmental persons or entities. The effect of disclosure to a state or local government agency, with respect to non-governmental persons or entities, is governed by applicable state law. Nothing in this rule limits or expands the authority of a government agency to disclose communications or information to other government agencies or as otherwise authorized by law.

The proposed subsection would codify a rule of "selective" waiver designed to protect targets of federal governmental investigations from having their "cooperation" with government investigators, in the form of waiving privilege to satisfy a government request for such a waiver, used against them by private litigants claiming that such disclosure to the government requires disclosure of the same information in civil litigation to which such information is relevant (information which, absent the prior disclosure to the government, would have been protected from disclosure by privilege). This proposed rule would override a number of Court of Appeals decisions from various circuits holding that there is no right to maintain privilege as to third parties where the information in question has already been disclosed to the government. *See*, *e.g.*, cases cited in *Advisory Committee Report* at 12. The Advisory Committee states that particularly important to its determination as to the merits of this proposal will be any evidence of a "statistical or anecdotal" nature that shows whether such a provision would "1) promote cooperation with government regulators and/or 2) decrease the cost of government investigations and prosecutions." *Advisory Committee Report* at 6.

The Section is unable to support the proposed provision at this time given the lack of evidence as to whether it will actually have the desired impact. This uncertainty is exacerbated by the fact that organizations representing the interests of corporate parties who would presumably stand to gain from the potential decrease in cost referenced by the Committee, as well as by the proposed provision's rule of non-waiver as to non-governmental persons or entities where the conditions of the provision are met, have expressed serious concerns that the proposal will be harmful to the very corporate parties it ostensibly is designed to protect. Finally, the process by which at least the Department of Justice has sought the kinds of waivers at issue appears to be in flux in a way that may affect the policy considerations raised by the proposed rule.

(b) The Section Is Unaware of Evidence that the Proposed Rule Is Likely to Accomplish the Objectives Articulated by the Committee

At this time, the Section is not aware of any significant body of reliable information supporting the notion that the proposed rule will either "promote cooperation with government regulators" or "decrease the cost of government investigations and prosecutions." In particular, we are unaware of any situation where concern over privilege waiver vis-à-vis third parties resulted in diminished cooperation with the government. Moreover, this possibility seems unlikely to occur with any significant frequency given the weight of the incentives motivating parties to cooperate with governmental investigations.

Similarly, it seems unlikely, and we are aware of no information supporting a different conclusion, that a protection from privilege waiver as described in the proposed rule would have any significant impact on the cost to the producing party involved in a governmental investigation. Regardless of whether a further waiver will be effected by production of otherwise privileged documents to the government, producing parties will still undertake careful review of the privileged documents before turning them over simply because without knowing what is in the documents it would be impossible to represent the producing party's interests effectively. Furthermore, such a careful review would be necessitated by the proposed rule's various limits on the protection afforded the producing party—including the absence of any restrictions on the government's subsequent use of the privileged documents and absence of any effect on production to state and local governments. It is precisely this careful review that gives rise to the most significant

cost elements because of the many hours of attorney time required to review the large volumes of information, typically electronically stored, commonly requested by government investigators.

(c) The Impact of the Proposed Rule on Governmental Requests for Privilege Waiver Is Uncertain

The proposed Advisory Committee note reviews the varying case law addressing whether disclosure of privileged information to a government agency conducting an investigation results in a waiver of privilege as to third parties, such as private plaintiffs, seeking disclosure of the same information in the context of civil litigation. As the Advisory Committee states, most courts have rejected this "selective waiver" concept. *See Advisory Committee Report* at 12. The committee notes go on to state that the "selective waiver" rule "furthers the important policy of cooperation with government agencies, and maximizes the effectiveness and efficiency of government investigations." No evidence or other basis for this conclusion is articulated.

Groups representing corporate interests have expressed concern that the proposed rule may encourage an erosion of the attorney-client privilege which will usurp the important policy reasons for having the privilege at all. Such concerns are articulated in comments submitted by the Association of Corporate Counsel[6] ("ACC"), dated June 20, 2006. ACC expresses the position that "the attorney-client privilege and work product doctrine are in serious jeopardy" as a result of what it describes as inappropriate government pressure to waive privilege protection. Letter from Susan Hackett to David Levi dated June 20, 2006 ("June 20, 2006 ACC Letter") at 3. ACC refers to this asserted atmosphere as the "culture of waiver" and cites a survey conducted by a coalition of organizations with diverse interests containing attestations about the government's practice in regard to requests for privilege waivers. *Id*. at 4. The fact that private plaintiffs are able to access the documents acquired by the government as a result of having pressured corporate parties to waive privilege, because most courts do not recognize a "selective waiver" concept, is cited by ACC as "inequitable." *Id*. Nonetheless, ACC believes that codifying the proposed selective waiver provision "would not solve—and could exacerbate—the crucially important underlying problem of government enforcement policies eroding attorney-client and work product protections." *Id*. at 5. ACC states that the proposed rule "might have the impact of creating a presumption on the part of the government that it is appropriate to demand waiver in all circumstances (indeed, that it is indefensible for a company to reject a waiver request), given that the government can now offer protection against third party disclosures." *Id.* The ACC is not alone in decrying a perceived erosion in the attorney-client privilege as a result of government pressure. *See generally* William R. McLucas, et al., *The Decline of the Attorney-Client Privilege in the Corporate Setting*, The Journal of Criminal Law and Criminology (2006).

Much of the discontent with the current environment derided as the "culture of waiver" appears to stem from a policy document issued by then-Deputy Attorney Larry Thompson on January 20, 2003, known as the Thompson Memo. This document states that prosecutors, in considering whether to bring charges against a corporation, should consider "the corporation's timely and voluntary disclosure of wrongdoing and its willingness to cooperate in the investigation of its agents, including, if necessary, the waiver of corporate attorney-client and work product protection." *See id*. at 632. This statement has been interpreted as a message to prosecutors that corporations who decline to waive privilege will be deemed uncooperative. *Id*. at 634.

The possibility that the so-called "culture of waiver" represented by the Thompson Memo may be changing in certain respects is raised by another memorandum, published on December 12, 2006, in which the Deputy Attorney General, Paul McNulty, issued new guidelines for prosecutors seeking waiver of privilege. These new guidelines require, *inter alia,* that prosecutors establish legitimate need for privileged information, and obtain prior written approval before requesting it. The memo cautions that privileged communications should be sought only in rare circumstances. *See* Department of Justice document available at http://www.usdoj.gov/opa/pr/2006/December/06_odag_828.html.

Clearly, a debate is developing as to the impact of the proposed rule and the propriety of governmental requests for privilege waivers, and there is little or no reported empirical evidence on the effect the proposed rule might have on the perceived erosion of the privilege cited by some corporate interests. Moreover, the facts relevant to this debate seem to be in flux (i.e., as demonstrated by the recent publication of the McNulty Memo). Under these circumstances, the Section cannot support proposed Rule 502(c).

(d) Other Potential Problems with Proposed Rule 502(c)

The proposed rule has other, more technical limitations as to its effectiveness in achieving the desired results of promoting cooperation and reducing expense as well. While these other limitations may not impact the weighty policy considerations involved in the "culture of waiver" debate, they are nonetheless potentially significant barriers to the utility of the proposed rule. For example, the proposed rule would not protect disclosures to local or state governments, which disclosures would still be governed by state law.[7] In addition, there would be no restriction on government use of the information, or on the effect such use might have in effecting a waiver. This limitation effectively means that even with the protections

currently incorporated in the proposal, a producing party would still take a significant risk of triggering a broader waiver by providing privileged documents to the federal government. Accordingly, it is unclear whether and to what extent cooperation with the government would be improved materially by the proposed rule, or whether and to what extent less money would be spent to pay lawyers conducting painstaking reviews of privileged information.

The proposal that has been offered, albeit tentatively and in brackets, to limit the effect of disclosures of privileged information to federal government investigators, does not appear to be based in any empirical evidence as to whether it will achieve its intended impact, nor does it appear to be supported by any inherent logical supremacy that would mandate its adoption. Accordingly, the Section does not support proposed Rule 502(c) unless further evidence comes to light regarding its likely effect. Given the robust debate that is developing regarding the subject matter, we are hopeful that such evidence will be developed and that the issues raised by the proposed rule can be reconsidered in an informed manner in the near future.

D. The Section Supports the Adoption of Proposed Rules 502(d) and 502(e)

Proposed Rules 502(d) and 502(e) build on the provisions of proposed Rule 502(b) protecting inadvertent disclosures from being considered waivers of privilege or protection by providing that non-waiver agreements will be binding in the litigation in which they are involved (Rule 502(e)[8]) and, when encompassed in a court order, will be binding on third parties (Rule 502(d)[9]). The Section supports these provisions as necessary adjuncts to the limitations on inadvertent disclosure contained in proposed Rule 502(b).

In proposing Rules 502(d) and (e), the Advisory Committee on Evidence Rules means to sanction the use of agreements by parties to protect against the waiver of the attorney-client and work product privileges during the discovery process. The *Advisory Committee* Report, at 13, recognized that, in the age of electronic discovery, where document productions can grow to unwieldy proportions, the cost of conducting a thorough privilege review can be exorbitant and the time needed to complete such a review incompatible with a reasonable litigation schedule. According to the Advisory Committee, proposed Rules 502(d) and (e) also are meant to "provide a predictable, uniform set of standards under which parties can determine the consequences of a disclosure of communications or information covered by the attorney-client privilege or work product protection." *Advisory Committee Report* at 8. Parties can be assured that their confidentiality agreements, embodied as court orders, and bolstered by a rule enacted by Congress, will be enforced.

Most importantly, proposed Rules 502(d) and (e) give a level of reassurance to parties that they could not achieve by entering into a non-waiver agreement alone, by providing that a court order incorporating the agreement of the parties is binding on non-parties in both federal and state litigation. As the Advisory Committee reasoned, "the utility of a confidentiality order in reducing discovery costs is substantially diminished if it provides no protection outside the particular litigation in which the order is entered. Parties are unlikely to be able to reduce the costs of pre-production review for privilege and work product if the consequence of disclosure is that the information can be used by non-parties to the litigation."[10] *Advisory Committee Report* at 13.

In the absence of proposed Rules 502(d) and (e), it is not entirely clear whether a court's order incorporating the parties' non-waiver agreement is enforceable against non-parties who assert waiver by disclosure in a subsequent litigation. Parties to a litigation may enter into "claw back" or "quick peek" agreements that bind the parties themselves, and those agreements may be "so-ordered" by a court, so that any breach is not just a breach of the agreement, but a violation of the court's order.[11] However, in refusing to extend such agreements and orders to non-parties, some courts have relied on the traditional waiver doctrine, which provides that disclosure to third parties waives the attorney-client privilege unless the disclosure serves the purpose of enabling clients to obtain informed legal advice.[12] Notably, at least one court has suggested that, had the non-waiver agreement between the parties expressly stated that it was binding on third parties, it might have ruled otherwise.[13]

There has also been some suggestion that a court's power to limit the use of information obtained in discovery through such devices as a protective order might suffice to bind non-parties to orders providing that privilege is not waived in subsequent state and federal proceedings. In *Transamerica Computer Co., Inc. v. IBM Corat*, 573 F.2d 646 (9th Cir. 1978), the plaintiff, TCC, moved to compel IBM to produce privileged documents that it originally produced in connection with accelerated discovery proceedings in a prior case. In that prior case, the court issued an order requiring IBM to produce 17 million pages of documents in a three-month period.[14] Understandably, some privileged documents were inadvertently produced.[15] When IBM realized that privileged documents had been produced, the court issued an order preserving claims of privilege so long as IBM employed reasonable screening techniques.[16] TCC argued that "being a stranger" to the prior case, the court's order did not apply to it.[17] IBM argued that because discovery was extremely accelerated, IBM's production of some privileged documents was effectively compelled and therefore, the basic legal principle that a party does not waive the attorney-client privilege for documents which it is compelled to produce should apply.[18]

The Ninth Circuit concluded that the order preserving IBM's claims of privilege was binding on TCC, holding that "it would be disingenuous . . . to say that IBM was not, in a very practical way, 'compelled' to produce privileged documents which it certainly would have withheld and would not have produced had the discovery program proceeded under a less demanding schedule."[19] The court also found the order explicitly protecting and preserving all claims of privilege important, pointing out that Federal Rule of Civil Procedure 26(c)(2) empowers a district court judge to dictate "the specified terms and conditions" of discovery.[20]

While the *Transamerica* case may provide some support for the enforceability of non-waiver agreements against non-parties, the Ninth Circuit did insist that IBM maintain reasonable procedures in screening for privilege.[21] Proposed Rule 502 imposes no such requirement. Rather, "the proposed rule . . . is an independent basis for the court order authorizing inadvertent production. It can be viewed simply as part of the definition of what is covered by the attorney-client and work product protections."[22]

Under proposed Rule 502(d), it is unclear whether a court order on non-waiver of privilege that does not incorporate an agreement between the parties is binding on non-parties. The language of the proposed rule does not expressly provide protection for such a court order. Under the proposed rules as drafted, parties must be careful to have every agreement on waiver of privilege so-ordered by the court to ensure that it is binding on non-parties. For example, if the parties agree at a deposition that certain testimony will not constitute a waiver of privilege, parties should get court approval for that agreement.

IV. Federalism Issues

A. Federalism Issues Should Not Impede the Passage of Rule 502 by Congress

The Section has concluded that, if enacted by Congress under its Commerce Clause powers, the proposed Rule will quite likely withstand constitutional scrutiny. That the Rule may be constitutional, however, does not make it good policy. As detailed below, federalism concerns remain, even if the proposed Rule is constitutional.

B. Authority to Enact the Rule

The framers of proposed Rule 502 were well aware of federalism and constitutional issues associated with the proposed Rule. Indeed, Professor Daniel Capra (of Fordham University Law School), one of the principal drafters of the Rule, and Ken Broun, a consultant, have suggested (based on their discussions with the Advisory Committee):

> The waiver rules must be uniform at both the federal and state level. If, for example, conduct does not constitute a waiver in federal practice but does so in a state court, parties would have no assurance that information protected by privilege or work product will remain protected.

See Daniel J. Capra and Ken Broun, *Memorandum Re: Consideration of Rule Concerning Waiver of Attorney Client Privilege*, SLO81 ALI-ABA 245, 247 (2006) [hereinafter, Capra & Broun].

Capra and Broun note:

> If a statute or rule governing inadvertent waiver, scope of waiver and selective waiver of an evidentiary privilege is to be effective in eliminating the need for unnecessarily burdensome document review and rulings on privilege in mass document cases, the provision would have to be binding in all courts, state or federal.

Capra & Broun at 263. As a result, they conclude:

> [T]he Rule would have to be enacted by Congress using both its powers to legislate in aid of the federal courts under Article III of the Constitution and its commerce clause powers under Article I.

The form of enactment (through direct congressional action, rather than through the normal rules amendment process) is dictated by the Rules Enabling Act, which provides (among other things) that any "rule creating, abolishing or modifying an evidentiary privilege" must be approved by Act of Congress.[23] *See* 28 U.S.C. § 2074(b); Capra & Broun at 265 (issue of enactment procedure is "moot" if Rule is enacted by Congress). This approach, however, also recognizes that modifications to privilege law essentially involve substantive rights, rather than the procedural issues that federal rules of evidence and procedure normally address.[24]

Even if a federal court has the power to issue an order to avoid privilege waiver that is binding on parties in subsequent proceedings—in essence compelling accelerated discovery on condition of non-waiver—a rule enacted by Congress can certainly aid in confirming that power. Congress' authority to enact such a rule stems from its broad powers to legislate in aid of the federal courts and its power under the Commerce Clause.[25] The provision of legal services increasingly crosses state borders and can be characterized as interstate activity. Even if the provision of legal services is largely an intrastate activity, the sheer volume of legal activity, often involving clients that operate on a national scale, affects the national economy generally. Therefore, privileged communications, which underpin and are fundamental to the attorney-client relationship, are arguably properly regulated by Congress

pursuant to the Commerce Clause.[26] As one commentator has argued,

> Nationwide legal practices and national litigation continue to grow. . . . Moreover, in our modern regulatory regime of varied and complex legal rules, businesses and individuals engaged in interstate commercial activity must resort constantly to attorneys for their continuous and sound advice. And in addition to that, they must resort to attorneys to comply with broad federal regulatory regimes which would themselves govern interstate commerce. . . . It is precisely because of this nexus between what attorneys do and interstate activity, or the interstate activity of their clients, that a uniform national treatment of waiver doctrine is needed.[27]

In addition, where federal substantive law preempts state law, federal rights cannot be defeated by the application of state procedural rules.[28]

Capra and Broun conclude, moreover, that to gain "constitutional comfort" for federal privilege waiver rules that bind state courts, "Congress' Commerce powers would have to come into play." Capra & Broun at 267. They assert what they describe as a "strong argument" for federalized attorney-client privilege, enacted under the Commerce Clause powers of the Constitution (Article I, Section 8, Clause 3). *See* Capra & Broun at 267–68 (citing Timothy P. Glynn, *Federalizing Privilege*, 52 Am. U. L. Rev. 59 (2002)) [hereinafter, Glynn].

Capra and Broun discount U.S. Supreme Court decisions, such as *United States v. Levy*, 514 U.S. 549 (1995)(invalidating act making possession of a gun near school premises a federal crime); *United States v. Morrison*, 529 U.S. 598 (2000)(invalidating act providing federal remedy for victims of gender-motivated violence), which suggest limits on the reach of congressional Commerce Clause powers. Similarly, they dismiss Tenth Amendment concerns, suggested by such cases as *New York v. United States*, 505 U.S. 144 (1992)(invalidating Radioactive Waste Act because it effectively required states to implement legislation) and *Printz v. United States*, 521 U.S. 898 (1997)(invalidating Brady Handgun Act, which would have required state law enforcement officials to administer federal policy). In their view, the proposed Rule 502 is "self-executing," and "simply needs to be enforced by the courts of the state." Capra & Broun at 268 (citing *Reno v. Gordon*, 528 U.S. 141 (2000)(upholding Federal Driver's Privacy Protection Act, which would protect confidentiality of state drivers' license information)). They suggest that, although a wholesale "supplanting" of state attorney-client privilege might go "too far," the "more modest legislation dealing with the existence and scope of waiver seems likely to be upheld." Capra & Broun at 268. Nevertheless, they recognize the potential for "situations in which waiver questions might not affect interstate commerce," and in those situations, they say, "we decided as an initial matter not to extend the rule." Capra & Broun at 269.

Proponents of the Rule, moreover, analogize it to the Federal Arbitration Act ("FAA"), which essentially compels uniform recognition (in both federal and state courts) of the validity of contracts of arbitration, based on congressional Interstate Commerce power. *See* Glynn at 167. Supreme Court jurisprudence over the past 20 years has, indeed, recognized the correctness of that view.[29] *See Doctor's Assocs., Inc. v. Casarotto*, 517 U.S. 681 (1996)(state franchisee law, restricting enforcement of arbitration clauses preempted by FAA); *Southland Corp v. Keating*, 465 U.S. 1 (1984)(recognizing "authority of Congress to enact substantive rules under the commerce clause"); *see also Citizens Bank v. Alafabco, Inc.*, 123 S. Ct. 2037 (2003)(debt restructuring agreement entered in Alabama between Alabama residents nevertheless subject to FAA); *Circuit City Stores, Inc. v. Adams*, 532 U.S. 105 (2001)(FAA intended to regulate to "outer limits" of Commerce Clause); *Allied-Bruce Terminix Cos. v. Dobson*, 513 U.S. 265 (1995) (recognizing "broad" meaning of term "in commerce," as used in FAA).

We believe, on the basis of this precedent upholding application of the Federal Arbitration Act in state courts, that the proposed Rule can be constitutionally enacted. Further revision of interstate commerce doctrine by the Supreme Court, however, might, at some point, place the validity of the Rule at risk. And the fact that the Rule would rely on interstate commerce as the basis for application means that in some cases challenges to application of the Rule could be mounted, due to lack of an obvious interstate commerce connection. Of perhaps larger concern are the principles of federalism (outlined below) that are implicated even if the proposed Rule is constitutional.

C. Remaining Federalism Concerns

It is no small thing that Congress, in the 1970s, refused to adopt federal rules of privilege. Indeed, Professor Glynn, a modern proponent of such an approach (and an authority on whom the framers of Rule 502 rely) recognizes that such an approach may be called a "radical solution." Glynn at 63.

It is also significant that the Conference of Chief Justices of the State Courts ("CCJ"), in their August 2, 2006 board of directors resolution, noted that the Rule, as proposed, "may conflict with principles of federalism." *See* ccj.ncsc.dni.us/FederalismResolutions. The CCJ also suggested that, due to principles of "comity and federalism," changes in rules regarding privilege should be determined through the actions of state legislatures, "which

are best situated" to determine policy and reform "within their own communities."[30] The CCJ suggests a "dialogue" with the Advisory Committee regarding proposed Rule 502.

The "basic premise" of proponents of uniform federal privilege rules is that "privilege must be predictable in order to serve its purposes." Glynn at 75. Yet, Rule 502 cannot entirely ensure predictability.

- Even within the federal common law system, as it now exists, the boundaries of privilege and waiver vary somewhat from court to court. The addition of uniform rules will inevitably be subject to some interpretation, and variation.
- Built into the proposed Rule are concepts such as the taking of "reasonable precautions" to prevent disclosure, and taking "reasonably prompt measures" to protect privilege once the holder "knew or should have known" of disclosure. Thus, even if the interpretation of the Rule is uniform, there will be variations based on the facts of the individual case.
- The proposed Rule depends upon the application of interstate commerce authority. There may be cases where such authority is thin, resulting (at very least) in motion practice to determine whether the federal rule can be applied (and conceivably in rejection of application of the federal rule).
- The Rule leaves state law regarding disclosure to state and local government agencies intact. Where simultaneous investigations by federal and state authorities are ongoing, a party may face potent conflicts in the effects of disclosure to authorities that may be operating in parallel.

Additionally, there is the question of how best to achieve uniformity. The value of federalism includes: (1) limiting the central government, to avoid concentration (and abuse) of power; and (2) encouraging local experimentation. Proponents of the Rule suggest that neither is advanced significantly by the present system. *See* Glynn at 170. But, one may ask whether such policies could be advanced, if the movement toward uniform privilege rules were pursued separately at the state and federal levels. That is, if Rule 502 were adopted and applied only at the federal level (with no binding effect in state courts), then state policy-makers (based on whatever positive experiences might be documented at the federal level) would be free to determine that similar rules should be adopted at the state level (perhaps through nationwide adoption of an appropriate Uniform Act).

The impact on federalism should give the Advisory Committee pause before proposing changes in the parameters for waiver of the attorney-client privilege and attorney work product protection that apply to the states.

Endnotes

1. Inadvertent disclosure is covered by proposed Rule 502(b), which is discussed elsewhere in this report.
2. Under existing case law, there are three distinct lines of federal authority on the effect of inadvertent disclosure: (i) it will always effect a waiver; (ii) it will never effect a waiver; and (iii) application of a balancing test to determine whether a waiver is effected. *See Hydraflow, Inc. v. Enidine Inc.*, 145 F.R.D. 626, 637 (S.D.N.Y. 1993); *Amgen Inc. v. Hoechst Marion Roussel, Inc.*, 190 F.R.D. 287, 290–292 (D. Mass. 2000). In federal courts that apply a balancing test, one of the factors considered is whether reasonable steps were taken to prevent disclosure. *See U.S. v. Mallinckrodt, Inc.*, 227 F.R.D. 295, 297 (E.D. Mo. 2005)(in determining whether inadvertent production waives attorney-client privilege, court considers reasonableness of precautions taken to prevent inadvertent disclosure); *Zapata v. IBP, Inc.*, 175 F.R.D. 574, 576–577 (D. Kan. 1997)(same regarding attorney-client privilege and work product); *Lois Sportswear, U.S.A., Inc. v. Levi Strauss & Co.*, 104 F.R.D. 103, 105 (S.D.N.Y. 1985)(same); *Hartford Fire Ins. Co. v. Garvey*, 109 F.R.D. 323, 331–332 (N.D. Cal. 1985)(same regarding work product); *Amgen Inc. v. Hoechst Marion Roussel, Inc.*, 190 F.R.D. 287, 292 (D. Mass. 2000)(same regarding attorney-client privilege and work product).
3. *See*, *e.g.*, *In re Grand Jury Proceedings*, 219 F.3d 175, 182 (2d Cir. 2000); *In re Keeper of the Records (Grand Jury Subpoena Addressed to XYZ Corat)*, 348 F.3d 16, 22 (1st Cir. 2003); *In re Grand Jury Proceedings*, 727 F.2d 1352, 1355 (4th Cir. 1984); *Hydraflow, Inc. v. Enidine Inc.*, 145 F.R.D. 626, 632 (W.D. N.Y. 1993).
4. *See*, *e.g.*, *Bowne of New York City, Inc. v. AmBase Corat*, 150 F.R.D. 465, 484–485 (S.D.N.Y. 1993)(subject matter waiver); *Fullerton v. Prudential Ins. Co.*, 194 F.R.D. 100, 103 (S.D.N.Y. 2000)(same); *Painewebber Group, Inc. v. Zinsmeyer Trusts Partnership*, 187 F.3d 988, 992 (8th Cir. 1999)(same), *cert. denied*, 529 U.S. 1020 (2000); *Bowles v. National Ass'n of Home Builders*, 224 F.R.D. 246, 257 (D.D.C. 2004)(same); *In re United Mine Workers of Am. Employee Benefit Plans Litig.*, 159 F.R.D. 307, 310 (D.D.C. 1994)(same); *In re Consolidated Litig. Concerning Int'l Harvester's Disposition of Wisconsin Steel*, 666 F. Sup. at 1148, 1153 (N.D. Ill. 1987)("general rule is that voluntary disclosure of privileged attorney-client communication constitutes waiver of the privilege as to all other such communications on the same subject"); *In re Hechinger Inv. Co. of Del.*, 303 B.R. 18, 26 (D.Del. 2003)("When considering the scope of [voluntary] waiver of the attorney-client privilege, other courts have adhered to the following standard: 'The general rule that a disclosure waives not only the specific communication but also the subject matter of it in other communications'").
5. *See* discussion regarding split in authority in *Bank of America, N.A. v. Terra Nova Ins. Co.*, 212 F.R.D. 166, 174–75 (S.D.N.Y. 2002); *compare In re United Mine Workers of America Employee Benefit Plans Litig.*, 159 F.R.D. 307, 312 (D.D.C. 1994)(limited waiver); *Bovis Lend Lease, LMB, Inc. v. Seasons Contracting Corat*, 2002 WL 31729693, at **12–14 (S.D.N.Y. Dec. 5, 2002)(limited waiver); *Pittman v. Frazer*, 129 F.3d 983, 988 (8th Cir. 1997)(limited waiver); St. *Paul Reinsurance Co., Ltd v. Commercial Fin. Corat*, 197 F.R.D. 620, 639 (N.D. Iowa 2000)(limited waiver); *In re Chrysler Motors Corat Overnight Evaluation Program Litig.*, 860 F.2d 844, 846 (8th Cir. 1988)(limited waiver) *with Bowne v. AmBase Corat*, 150 F.R.D. 465, 485–86 (S.D.N.Y. 1993) (subject matter waiver); *Fullerton v. Prudential Ins. Co.*, 194 F.R.D. 100, 104 (S.D.N.Y. 2000)(disclosure of work product on the subject of certain claims waived work product protection with respect to other documents relating to those claims); *Bristol-Myers Squibb Co. v. Rhone-Poulenc Rorer, Inc.*, 1997 WL 801454, at *3 (S.D.N.Y. Dec. 31, 1997)(subject matter waiver); *see also Bowles v. National Ass'n of Home Builders*, 224 F.R.D. 246, 258–259 (D.D.C. 2004)(subject matter waiver of work product protection under circumstances akin to deliberate disclosure to gain a tactical advantage); *In re Martin Marietta Corat*, 856 F.2d 619, 625 (4th Cir. 1988)(disclosure of non-opinion work product to government in attempt to settle criminal investigation was considered a "testimonial use" and thus effected subject matter waiver), *cert. denied sub nom., Martin Marietta Corat v. Pollard,* 490 U.S. 1011 (1989).

6. ACC is an organization that describes itself as: "the in-house bar association, with more than 19,000 members worldwide who practice inside the legal departments of corporations and other organizations in the private sector. ACC presents the perspective of in-house counsel who advise corporate clients on virtually every conceivable matter of law, compliance, and legal policy, including on issues of how clients should treat attorney-client privileged communications that are sheltered by the attorney-client privilege and the work product doctrine." Letter from Susan Hackett to David Levi, dated June 20, 2006 at 2.
7. We note that on October 16, 2005, legislation was enacted that protects disclosures to banking regulators, whether federal, state or foreign, from claims of waiver by third parties. Section 607 amending Section 18 of the Federal Deposit Insurance Act (12 U.S.C. 1828) and Section 205 of the Federal Credit Union Act (12 U.S.C. 1785).
8. Proposed Rule 502(e) provides:

   > **(e) Controlling effect of party agreements.**—An agreement on the effect of disclosure of a communication or information covered by the attorney-client privilege or work product protection is binding on the parties to the agreement, but not on other parties unless the agreement is incorporated into a court order.

9. Proposed Rule 502(d) provides:

   > **(d) Controlling effect of court orders.**—A federal court order that the attorney-client privilege or work product protection is not waived as a result of disclosure in connection with the litigation pending before the court governs all persons or entities in all state or federal proceedings, whether or not they were parties to the matter before the court, if the order incorporates the agreement of the parties before the court.

10. *See also Chubb Integrated Sys. v. National Bank,* 103 F.R.D. 53, 67–78 (D.D.C. 1984)(holding that a non-waiver agreement did not apply to third parties, that such "agreement is for the mutual convenience of the parties, saving the time and cost of pre-inspection screening," and that it is "merely a contract between two parties to refrain from raising the issue of waiver or from otherwise utilizing the information disclosed."); Advisory Committee on Evidence Rules, *Hearing on Proposal 502,* (Apr. 24, 2006) at 3–4 (Comments of Hon. John G. Koeltl), *available at* http://www.uscourts.gov/rules/advcomm-miniconference.html ("[e]ven the courts in the District of Columbia Circuit, which takes a very strict view against limiting waiver find that agreements for non-waiver are binding as matters of contract between the parties to the agreement").
11. *See Hopson v. Mayor & City Council of Baltimore*, 232 F.R.D. 228, 239–40, 244 (D. Md. 2005)(court order incorporating non-waiver agreement between the parties is a viable method of dealing with privilege review of electronically stored information without running a risk of subject-matter waiver, but parties must still complete a reasonable pre-production privilege review or demonstrate why a review should not be done); *Zubulake III,* 216 F.R.D. at 290 ("many parties to document-intensive litigation enter into so-called 'claw-back' agreements that allow the parties to forgo privilege review altogether in favor of an agreement to return inadvertently produced privileged documents"); *see also* Manual for Complex Litigation (Fourth) § 11.446 (2004) ("[J]udges often encourage counsel to stipulate at the outset of discovery to a 'non-waiver' agreement, which they can adopt as a case management order. Such agreements protect responding parties from the most dire consequences of inadvertent waiver by allowing them to 'take back' inadvertently produced privileged materials if discovered within a reasonable period.").
12. *See Westinghouse Elec. Corat v. Republic of the Philippines*, 951 F.2d 1414, 1425 (3d Cir. 1991)(so-ordered agreement between litigant and Department of Justice that documents produced in response to investigation would not waive privilege against different entity in unrelated civil proceeding); *see also Bowne v. AmBase Corat*, 150 F.R.D. 465, 478–79 (S.D.N.Y. 1993)(non-waiver agreement between producing party in one case not applicable to third party in another civil case).
13. *Bowne,* 150 F.R.D. at 478–79.
14. 573 F.2d 646, 648.
15. *Id.* at 649–50.
16. *Id.* at 650.
17. *Id.*
18. *Id.* at 651.
19. *Id.* at 652–53.
20. *Id.*
21. 573 F.2d 646, 650.
22. Advisory Committee on Evidence Rules, *Hearing on Proposal 502* (Apr. 24, 2006) at 6 (Comments of Hon. John G. Koeltl), *available at* http://www.uscourts.gov/rules/advcom-miniconference.html.
23. This restriction follows the refusal of Congress, under the Rules Enabling Act process, to approve Federal privilege rules in the early 1970s. *See* John Hart Ely, *The Irrepressible Myth of Erie*, 87 Harv. L. Rev. 693, 740 (1974) [hereinafter, Ely].
24. Professor Glynn, one of the progenitors of the modern movement toward federal privilege law, candidly notes that "privilege doctrine is substantive because it serves interests extrinsic to the particular litigation in which the privilege is asserted." Glynn at 149. This view reinforces, in part, the argument that changes in privilege law "affect commerce," and thus are appropriate for regulation under the congressional commerce power.
25. Advisory Committee on Evidence Rules, *Hearing on Proposal 502* (Apr. 24, 2006) at 69–71 (Comments of Timothy Glynn); Broun & Capra, 58 S.C.L. Rev. 211, 243; *Advisory Committee Report* at 8.
26. Advisory Committee on Evidence Rules, *Hearing on Proposal 502* (Apr. 24, 2006) at 70–74 (Comments of Timothy Glynn).
27. *Id.* at 71–72 (Comments of Timothy Glynn).
28. Broun & Capra, 58 S.C.L. Rev. 211, 243 n. 241 (citing *Felder v. Casey*, 487 U.S. 131, 153 (1988)(finding that federal civil rights law prevented the state from applying its notice-of-claim rule in a federal civil rights action filed in state court); *Brown v. Western Ry. of Ala.*, 338 U.S. 294, 296 (1949)(finding that the federal pleading test should have been applied in a Federal Employers Liability Act action filed in state court)).
29. Yet, the FAA contains its own set of federalism issues. Section 2 of the FAA, for example, recognizes the enforceability of arbitration agreements "save upon such grounds as exist at law or in equity for the revocation of any contract." Thus, the FAA has not eliminated variations in treatment of arbitration contracts. Rather, it has simply ensured that arbitration contracts are treated the same as any other contracts, *according to state law*. *See Volt Info. Science, Inc. v. Bd. Of Trustees Of Leland Stanford Junior Univ.*, 489 U.S. 468 (1989)(choice of California law in arbitration contract, included choice of California arbitration procedure).
30. Professor Glynn notes that "the states have a long tradition of regulating the practice of law," but asserts that "their disparate approaches to the privilege may inhibit and burden the attorney-client relationship[.]" Glynn at 157.

This report was prepared by the Committee on Electronic Discovery, chaired by Adam I. Cohen and Constance M. Boland, and the Committee on Federal Procedure, chaired by Gregory K. Arenson, of the Commercial and Federal Litigation Section of the New York State Bar Association. The principal authors are Adam I. Cohen, Constance M. Boland, Steven C. Bennett, Gregory K. Arenson and James F. Parver. The report was adopted as the position of the Section by a unanimous vote of its executive committee at a meeting on February 13, 2007.

Report: Certification of Questions of State Law in the Second Circuit

This report of the Appellate Practice Committee of the Commercial and Federal Litigation Section of the New York State Bar Association is intended to review the actual practice within the Second Circuit of certification of state law questions to state high courts in the wake of the 20-year anniversary of initiation of the procedure in New York State. In 1986, New York joined a growing number of states that allowed questions of state law arising in cases pending in another jurisdiction to be certified to the state's highest court for resolution. The New York Court of Appeals is authorized, but not required, to consider and decide questions of New York state law certified by certain other courts. New York's Chief Judge has been an especially strong proponent of the certification procedure and consequently, as the report concludes, the New York Court of Appeals has effectively implemented the procedure so that the benefits of certification are achieved without significant delay. Although data on cases certified by the Second Circuit to the high courts of other states are more sparse, the report preliminarily concludes that the certification procedure has been most successful with respect to state courts in jurisdictions such as New York, which have been active in the "cooperative judicial federalism" partnership by devising measures and practices to mitigate the potential burdens or delays of litigating a certified question.

I. Background

Forty-eight states permit their court of last resort to accept inter-jurisdictional certified questions of state law. All of these jurisdictions permit certification from the United States Supreme Court, a United States court of appeals, or a sister state court of last resort. Some jurisdictions go even further, permitting certification from all federal courts, including bankruptcy courts and the United States Court of Claims. Before World War II, there was no mechanism for federal courts to certify questions of state law to state courts. The trend in favor of the certification protocol has been gradual. New York State, for instance, adopted the practice in 1986.[1]

The principal justification for the practice of certification is that it serves as a means of building a "cooperative judicial federalism." *Lehman Bros. v. Schein*, 428 U.S. 386, 391 (1974). Since *Erie Railroad Co. v. Tompkins*, 304 U.S. 64 (1938), federal courts have applied substantive state law as the rule of decision in federal diversity cases. In so doing, federal courts may encounter questions of state law for which there are no clear answers, or for which there are only discordant answers. Often, these questions of state law implicate significant state policy matters.

Certification provides a means for federal courts to defer to state courts on important questions of state law and policy. Thus, certification helps to promote certainty and to preserve the authority of state courts, which is one of the central values of the federalist structure of our government, even in cases properly commenced in federal court. Because it does not require dismissal of the federal case, certification can also serve as a less drastic tool for federal courts than doctrines such as abstention or deferring to state courts on important matters of state law and policy while avoiding difficult constitutional questions. *See Arizonans for Official English v. Arizona*, 520 U.S. 43, 75–76 (1997)(observing that, in contrast to traditional abstention, certification fulfills the federalism goal of permitting a state court to decide a state law question while simultaneously "reducing the delay, cutting the cost, and increasing the assurance of gaining an authoritative response").

Adoption by the vast majority of state jurisdictions of statutes permitting certification and the increased reliance on the certification procedure provides compelling evidence that the practice has been widely and well-received by both federal and state courts. Several studies of the certification process, moreover, speak of a generally favorable judicial attitude towards the practice. *See* Corr & Robbins, *Interjurisdictional Certification and Choice of Law*, 41 Vand. L. Rev. 411 (1998); Goldschmidt, *Certification of Questions of Law: Federalism in Practice* (American Judicature Society 1995). As a report and recommendation of a committee of the Association of the Bar of the City of New York's Council on Judicial Administration observed, these studies by and large have found that certification: (i) promotes federalism by permitting state courts authoritatively to define state substantive law; (ii) avoids the embarrassment of erroneous federal decisions; (iii) deters forum-shopping; and (iv) promotes certainty and uniformity. *See* Committee on Federal Courts, *Report and Recommendations on Second Circuit Certification of Determinative State Law Issues to the New York Court of Appeals* (December 1, 1998).

Notwithstanding the substantial reasons supporting certification, some commentators have expressed doubts about its merits. *See, e.g.*, Bruce M. Selya, *Certified Madness: Ask a Silly Question . . .* , 29 Suffolk U. L. Rev. 677, 690 (1995). Some of the most frequently cited criticisms are as follows: (i) increased delay and cost for litigants; (ii) inconsistent application; and (iii) increased burden on state courts, whether it be in terms of improperly framed questions or additional workload. Moreover, some critics of certification question whether certification's benefits—

including a correct decision on state law—outweigh the costs of delay and expense.

II. Nature of the Report

The purpose behind the sub-committee's report has been to build on prior studies of certification procedure and practice in New York and in the Second Circuit by testing certain of the arguments in favor of and against certification. Specifically, the sub-committee has been interested in examining the issues of cost and delay, fairness, burden on state courts, and consistency of application. To the extent possible, the sub-committee has endeavored to develop and to incorporate empirical data into its report.

The report has involved gathering information about certification practice in the three jurisdictions within the ambit of the Second Circuit (i.e., New York, Vermont and Connecticut). The data we have been developing touch on issues such as reversal rates, the length of time for disposition of a certified question, subsequent litigation course, voting patterns among judges, nature of the question certified, and rates of acceptance and declination by state courts of last resort. The sub-committee has selected the year 2000 as the early cut-off date, in part because it coincides with the publication of Chief Judge Kaye's and Mr. Weissman's article, which sets a baseline for study, and has analyzed data from that date up through July 2006.

III. Preliminary Observations

1. Fairness and Deference to State Court Interpretations of State Law

Skeptics of certification dismiss the benefit to litigants of having state law issues considered by state courts. They assert, for example, that litigants are not entitled to a "right" answer, only to an impartial judge who follows the available law to the best of his or her abilities. Beyond that, a litigant before a federal court that gets the "wrong" answer is in the same position as a litigant before a lower state court who is not granted an appeal when a higher state court comes to a different conclusion in a later case. *See, e.g.*, Bruce M. Selya, *Certified Madness: Ask a Silly Question . . .* , 29 Suffolk U. L. Rev. 677, 690 (1995).

Setting aside both the federalism implications of this argument and its merits with respect to what any individual litigant is entitled to, one way to begin approaching the question of fairness and impact on litigants is to consider the error rate of federal court decisions on questions that ultimately are certified. The higher the error rate, then so also arguably would be the greater the unfairness to litigants of not certifying questions to state courts. The unfairness would be systemic in nature and even more acute where questions raise significant issues of state policy, affect many cases or are otherwise recurring.

Of the cases in which the Second Circuit received answers from a state court and directed the district court accordingly, our analysis reveals that approximately one-third of the district court decisions were reversed. Therefore, federal district courts are incorrect in their analysis of a particular class of complex, policy-sensitive state law questions with some regularity. Because many of the questions certified are significant to state policy, the error rate supports the benefits of the practice of certification.[2]

2. Consistency and Nature of Usage of Certification Procedures

Although the sub-committee is still reviewing the certification decisions to develop a more accurate picture, it appears that the Second Circuit is relatively consistent in the types of questions that it certifies for state court review. Questions of law affecting highly regulated industries such as insurance, are the most commonly certified. Fully one-fourth of all cases that were certified in the period from May 2000 to July 2006 related to the insurance industry. Otherwise, tort liability cases have also represented a large proportion of certified questions, which is consistent with the trend previously reported by Chief Judge Kaye and Mr. Weissman with respect to certifications accepted by the New York Court of Appeals. *See* Kaye & Weissman, *supra*, at 399.

In this vein, one question worth considering is whether or how overall consistency in certification is affected by the underlying philosophies of judges. Our preliminary analysis suggests that there may be some variation in judges' approaches to certification. The frequency with which some judges' names appear in decisions certifying questions to the state courts varies. Some preliminary patterns are noteworthy. Judge Calabresi, who is a proponent of certification (*see* Guido Calabresi, *Federal and State Courts: Restoring a Workable Balance*, N.Y.U. L. Rev. 1293 (2003)), voted eleven times to certify a question to a state court of last resort between May 2000 and February 2006, the most of any judge on the Second Circuit. Chief Judge Walker, who is tied for the fewest certifications of questions, only voted to certify twice in that same time period and dissented once on the three occasions in which he had an opportunity to decide the issue. The nature of cases and case assignments certainly need to be considered as factors in this analysis, but a particular judge's views about the merits of certification generally perhaps may have an impact on the frequency and consistency of certification in particular cases.[3]

3. Efficiency, Delay and Expense

Efficiency is a central issue to the certification debate. Critics of certification assert that it is an inefficient option. *See* Selya, *supra*, at 687–88. The argument states that certification significantly delays litigation because of the inevitable period of waiting for the state court to accept certification, briefing and argument in the state court on the certified question and the time for state court decision.

Proponents of certification acknowledge the inherent delay in the process, but counter that, in the long run, there are efficiency gains because future litigants will not have to address the same issues. Although it is difficult to settle on an absolute measure or criterion that distinguishes between efficient and inefficient handling of certified questions, some insight into the issue of efficiency may be obtained by comparing and contrasting the experiences of different jurisdictions.

One measure of efficiency is the promptness by which the certified question is resolved. In New York, the average time from the Court of Appeals' receipt of a request for certification to determining whether to accept is 38 days and the average time from certification to resolution is approximately seven months. *See* Advisory Group to the New York State and Federal Judicial Council, *Practice Handbook on Certification of State Law Questions by the United States Court of Appeals for the Second Circuit to the New York State Court of Appeals*, 10 (Second Ed. Feb. 1, 2006). This sub-committee's preliminary review indicates that, in cases in which questions were certified, answered and acted upon by the Second Circuit, the time between certification by the Second Circuit and the Second Circuit's subsequent order conforming to the decision by the Court of Appeals averaged less than twelve months. Indeed, to avoid delay where harmful, the New York Court of Appeals in at least one instance exercised its discretion to *decline* certification because there had already been a "lengthy delay in adjudication of" the claims and in view of "the mutual interest of expeditious resolution of the preliminary injunction/prior restraint issue" in the civil rights action. *See Tunick v. Safir*, 94 N.Y.2d 709, 711 (2000)(*per curiam*).

The average for other jurisdictions within the ambit of the Second Circuit is different. The data gathered thus far for cases referred to the Connecticut Supreme Court indicate that the average time between certification by the Second Circuit and subsequent order conforming to the state court's decision is over 18 months. In one instance in which Vermont's court of last resort accepted a certified question during the time period examined, the time between certification and conformance by the Second Circuit was 734 days—or more than two years. Thus, the comparative data preliminarily suggest that the New York Court of Appeals has succeeded in establishing a relatively efficient mechanism for handling certified questions, but that other states have been less successful in doing so.

A related issue of efficiency concerns the willingness of a state court of last resort to accept certified questions. The existence of a statute does not necessarily speak to the actual practice of a state's court of last resort. *See, e.g., Blue Cross & Blue Shield of Al., Inc. v. Nielsen*, 116 F.3d 1406, 1413 (11th Cir. 1997)(noting that "the last two times this Court certified questions of state law to the Alabama Supreme Court, it declined to answer them," but declining to "assume the Alabama Supreme Court has . . . adopted a policy or practice against answering certified questions from this Court"); *see also* Selya, *supra*, at 682 (arguing that some state courts resist accepting certified questions). Declining acceptance of certified questions can occur for numerous reasons. For example, in the case of the New York Court of Appeals, that court has indicated that it may decline to accept a certified question if the question is not likely dispositive of the underlying matter, will not be recurring, is abstract, raises an issue of applying established law to fact, or there already has been lengthy delay in adjudication. *See* Advisory Group to the New York State and Federal Judicial Council, *supra*, at 8–9 (summarizing factors).

Even so, some comparative considerations could be suggestive of potentially important concerns. For example, in the time period under study, the New York Court of Appeals accepted all of the questions certified to it by the Second Circuit. By contrast, the Supreme Court of Vermont declined to accept as many questions as it accepted.[4] Of course, many more questions were certified to New York, and the specific substantive reasons why Vermont declined acceptance in particular cases would be important to study and to understand before drawing definitive conclusions.

The scope of certified questions also implicates efficiency concerns. There is tension between specificity and generality in framing questions to state courts, and either extreme can result in inefficiency. A question that asks a state court to decide an overly abstract legal issue may result in the state court declining to accept the certified question. Thus, the New York Court of Appeals has stated that it will decline acceptance if the question posed is theoretical, abstract or "overly generalized." *Yesil v. Reno*, 92 N.Y.2d 455, 457 (1998)(*per curiam*). One way for a federal court to mitigate potential problems here is for it to include, as does the Second Circuit in virtually every certification, language permitting "[t]he certified questions [to] be expanded or narrowed as the [state c]ourt sees fit, and . . . welcom[ing] any further guidance the [state c]ourt . . . elects to offer." *New York Univ. v. First Financial Ins. Co.*, 322 F.3d 750, 757 (2d Cir. 2003). In the time period under consideration, the only significant reformulation of a certified question by a state court was done specifically to avoid rendering an advisory opinion. *See Mortgage Lenders Network, USA v. Sensenich*, 873 A.2d 892, 893 (Vt. 2004).

At the other extreme, if a certified question is so fact-specific that it does not inform other cases, then systemic significance, which is one of the justifications for delaying the individual case, will be lost. On occasion, the Second Circuit has tended toward this latter extreme. *See Murdza v. D.L. Peterson Trust*, 292 F.3d 328, 333 (2d Cir. 2002)(limiting the certified questions to the exact facts of the case).

In assessing the effectiveness of certification and its consonance with the stated goal of addressing legal questions that have far-reaching impact, further study could focus on how circumscribed the questions certified are. Our preliminary conclusion is that, by and large, the Second Circuit has framed questions appropriately and, where it may not have, the New York Court of Appeals in particular has been vigilant and declined to exercise its discretion to accept certification. A comparative study with one or two other circuit courts of appeal would provide further insight.

IV. Conclusion

Despite the existence of some academic and judicial literature that is skeptical of the certification process, our review of the practice of certification within the Second Circuit suggests that where a state jurisdiction has embraced the procedure and the "cooperative judicial federalism" partnership, the certification procedure is successful and produces important benefits. New York, in particular, is a jurisdiction that is active in the "cooperative judicial federalism" partnership and has devised measures and practices that enable it to mitigate the delay and burden of litigating a certified question. Although data from other jurisdictions suggest that they have been less successful than New York in this endeavor, further analysis of such data and possible fine-tuning of their procedures might enable litigants within those jurisdictions also to achieve the benefits of the certification procedure.

Endnotes

1. *See* Judith S. Kaye & Kenneth I. Weissman, *Interactive Judicial Federalism: Certified Questions in New York*, 69 Suffolk L. Rev. 373, 381-97 (2000), for a detailed account both of the origins of adopting certification statutes nationally and the New York experience.
2. The more difficult question is how frequently would the Second Circuit mistakenly construe state law. This issue is difficult to track almost by definition, because the objective behind certification is to permit the state court, not the referring court, to rule. Nevertheless, when certifying questions, the Second Circuit occasionally discusses its views of the issue. But, of the five times since May 2000 that the Second Circuit has indicated how it would rule in the absence of the question being accepted by the state court, only two of the questions have actually been answered by the state court and one of those was remanded for further development of the record. The cases do not provide a sufficient sample to come to definitive conclusions.
3. Another dimension of this analysis is to consider the rate in which the Second Circuit declines certifications overall. During the time period under consideration, the Second Circuit declined to certify questions on fifteen occasions, or approximately thirty percent of the time. Whether a judge's voting pattern is consistent with this percentage could be indicative of a philosophy favoring certification.
4. During the time period in question, the Second Circuit has certified five questions to the Supreme Court of Vermont, two of which have been rejected by that court of last resort. *See City of Burlington v. Indem. Ins. Co. of N. Am.*, 346 F.3d 70 (2d Cir. 2003) ("In an unpublished order filed July 2, 2003, the Vermont Supreme Court declined certification."); *Travelers Ins. v. Carpenter*, 858 A.2d 702 (Vt. 2004). This constitutes fully 50 percent of the certification questions the Supreme Court of Vermont has decided. Of the remaining three questions, two were accepted and answered, *see Presault v. City of Burlington*, 908 A.2d 419 (Vt. 2006); *Mortgage Lenders Network, USA v. Sensenich*, 873 A.2d 892 (Vt. 2004), and one had not been accepted or declined during the period at issue. *See Doe v. Newbury Bible Church*, 455 F.3d 594 (2d Cir. 2006).

This report was prepared by Cyrus Amir-Mokri, Dan Levitt, Jerauld Brydges, Ira Matetsky, Aaron Pam, Kelso Anderson and Erika Duthiers of the Appellate Practice Committee of the Commercial and Federal Litigation Section of the New York State Bar Association. The Appellate Practice Committee is chaired by Preeta D. Bansal and David Tennant.

Report on Class Certification for Particular *Issues* Pursuant to Federal Rule of Civil Procedure 23(c)(4)(A)

I. Introduction

This report analyzes the Second Circuit's recent decision, *In re Nassau County Strip Search Cases*, 461 F.3d 219 (2d Cir. 2006), and its impact on case law in other jurisdictions regarding the parameters of Federal Rule of Civil Procedure ("FRCP") 23(c)(4)(A). FRCP 23(c)(4)(A) provides: "When appropriate [] an action may be brought or maintained as a class action with respect to particular *issues*. . . ." (emphasis added). The question that follows from this language is how broadly or narrowly do courts interpret the term "issue" for the purpose of certification.

Analysis of court decisions from various jurisdictions sets forth the so-called "split" among the courts. The "split" has arisen from Fifth Circuit dicta enunciated in a footnote, which interpreted "issue" narrowly to mean a claim or cause of action as a whole within a lawsuit. Other jurisdictions, however, have applied FRCP 23(c)(4)(A) more broadly to include certification of a class with respect to particular issues, including subject matters that are not, by themselves, causes of action. *Valentino v. Carter-Wallace, Inc.* 97 F.3d 1227 (9th Cir. 1996). Some courts have permitted the use of FRCP 23(c)(4)(A) to certify a class with respect to an element within a claim where such element is dispositive. *See Endo v. Albertine*, 147 F.R.D. 164, 173 (N.D. Ill. 1993)(allowing certification pursuant to FRCP 23(c)(4)(A) to certify a class with respect to the element of materiality of a misrepresentation in a § 12(2) claim).[1] However, no court has interpreted "issue" to mean the entire lawsuit. *See Gunnells v. Healthplan Servs. Inc.*, 348 F.3d 417, 443 (4th Cir. 2003)("no court has required a *lawsuit*-specific predominance analysis").

Whether the various decisions of the courts regarding the breadth of FRCP 23(c)(4)(A) truly establish a "split" among the Circuits, or are, in reality, much ado about nothing remains to be seen. This is particularly interesting when one considers the underlying analysis supporting the rulings. The fact of the matter is that regardless of how courts interpret "issue," they analyze the question against the same test: Would the certification of particular issues pursuant to FRCP 23(c)(4)(A) advance the litigation or reduce the complexity of the issues?

II. History of Applying FRCP 23(c)(4)(A)

Long before the Second Circuit's recent interpretation of "issue" in the context of FRCP 23(c)(4)(A) in *In re Nassau*, other courts had already grappled with this issue. *See, e.g., In re Tetracycline Cases*, 107 F.R.D. 719 (W.D. Mo. 1985); *Central Wesleyan College v. W.R. Grace & Co.* 6 F.3d 177 (4th Cir. 1993); *Gunnells,* 348 F.3d 417; *Harding v. Tambrands Inc.*, 165 F.R.D. 623 (D. Kan. 1996). One decision—*In re Tetracycline*—led the way in formulating a test to address the scope of FRCP 23(c)(4)(A); other courts have followed this test in considering the application of FRCP 23(c)(4)(A).

A. Leading the Way: *In re Tetracycline*

In 1985, the test for deciding whether to apply FRCP 23(c)(4)(A) to certify "particular issues" for class treatment was first enunciated in *In re Tetracycline*, 107 F.R.D. at 733. There, plaintiffs who suffered tooth discoloration as a result of the ingestion of Tetracycline sought class certification for their claims against the drug manufacturer. *Id.*

In deciding whether to certify certain issues pursuant to FRCP 23(c)(4)(A), the court articulated the following:

> If the requirement under Rule 23(c)(4)(A) was not only that there be one or more issues which met the Rule 23(a) tests for commonality, typicality and adequacy of representation, but also that those issues "predominate," in the usual Rule 23(b) sense, when compared with *all* the issues in the case, there would obviously be no need or place for Rule 23(c)(4)(A). Reference to the general rules of construction suggests that any interpretation which makes a federal rule superfluous is to be avoided. I believe, accordingly, that the appropriate meaning of Rule 23(b)'s predominance requirement, as applied in the context of a partial class certification request under Rule 23(c)(4)(A), is simply that the issues covered by the request be such that their resolution (as a class matter) will materially advance a disposition of the litigation as a whole.

Id. at 727 (citation omitted). Applying that test, the court denied plaintiffs' motion for class certification of issues of causation, liability relating to the marketing and sale of Tetracycline, and damages. *Id.* at 736. Considering the problems of manageability relating to warnings by individuals doctors and knowledge of individual patients, problems allocating fault to individual physicians, the difficulties of maintaining a punitive damages claim, and the fact that a large number of individual issues would remain, the court concluded that the issues raised for class certification "would not, even when appropriately defined and restated, significantly advance this litigation or reduce the complexity of the

individual issues remaining for later determination." *Id.* at 733–35. Nevertheless, the court recognized the position that a court "always should consider the possibility of determining particular issues on a representative basis as permitted by Rule 23(c)(4)(A) . . . whenever that might prove efficient and economical." *Id.* at 727 (*quoting* 7A CHARLES ALAN WRIGHT & ARTHUR R. MILLER, FEDERAL PRACTICE AND PROCEDURE 57 (1972)).

B. Decisions Since *In re Tetracycline*

Since the *In re Tetracycline* decision, how courts in various circuits interpret and apply FRCP 23(c)(4)(A) to certify a class with respect to "particular issues" seems to focus more on an analysis of the "advance the litigation" test, set forth in *In re Tetracycline*, rather than on any hard and fast rule.

1. Ninth Circuit

On the heels of the *In re Tetracycline* decision, the Northern District of California decided *In re Activision Sec. Litig.*, 621 F. Supp. 415 (N.D. Cal. 1985). There, following various motions to dismiss, plaintiffs sought class certification of a plaintiffs' class with respect to their § 11 and § 12(2) of the Securities Act of 1933 claims, as well as state common law claims of fraud, deceit, and negligent misrepresentation. *Id.* at 419. Plaintiffs also moved for class certification of a defendant class as to their § 11 claim as well as with respect to a single issue of whether a registration statement and prospectus contained materially misleading statements or omissions pursuant to § 12(2). *Id.* at 427. The court granted class certification as to all of these claims. *Id.* at 439.

Addressing the single § 12(2) issue of whether the registration statement and prospectus contained material misstatements or omissions, the court held that it was "appropriate and desirable to certify a defendant class of underwriters to litigate the single issue under § 12(2) of material misrepresentations and omissions in the offering materials." *Id.* at 438. The court reasoned that the express language of FRCP 23(c)(4)(A) "imposes a duty on the court and gives it ample power to 'treat common things in common and to distinguish the distinguishable.'" *Id.* (*quoting* 7A CHARLES ALAN WRIGHT AND ARTHUR R. MILLER, FEDERAL PRACTICE AND PROCEDURE: CIVIL § 1790). The court explained how FRCP 23(c)(4)(A)'s application would advance the litigation: "[s]ince subdivision (c)(4) is designed to give the court maximum flexibility in handling class actions, its proper utilization will allow a Rule 23 action to be adjudicated that otherwise might have had to be dismissed or reduced to a nonrepresentative proceeding because it appears unmanageable." *Id.* at 438.

The next year, the same court decided *In re Computer Memories Sec. Litig.*, 111 F.R.D. 675 (N.D. Cal. 1986). In that case, plaintiffs' complaint contained claims pursuant to §§ 11 and 12(2) of the Securities Act of 1933, § 10(b) of the Securities Exchange Act of 1934 and Rule 10b-5. The complaint also contained common law fraud, deceit and negligent misrepresentation claims. *Id.* at 679.

Plaintiffs moved for class certification of a plaintiffs' class and two defendant classes with respect to those claims. *Id.* at 679. As to the defendants' class, plaintiffs sought class certification regarding their § 12(2) claim only with respect to the issue of whether the registration statement and prospectus contained material misstatements or omissions. *Id.* at 687. The court granted all of plaintiffs' motions. *Id.* at 689. However, because of typicality and adequacy concerns regarding the proposed class representative, the court limited class treatment of the plaintiffs' § 12(2) claim to the issue of whether the registration statement and prospectus contained material misrepresentations or omissions under FRCP 23(c)(4)(A) and noted that: "The Federal Rules of Civil Procedure authorize certification of a class to litigate particular issues, as opposed to entire claims." *Id.* at 681 & n.4 (*citing In re Activision*, 621 F. Supp. at 438).

In 1996, the Ninth Circuit decided *Valentino v. Carter-Wallace, Inc.*, 97 F.3d 1227 (9th Cir. 1996). There, plaintiffs brought a products liability action against manufacturers of an epilepsy drug. The district court certified the class pursuant to FRCP 23(c)(4)(A) as to several issues, including "strict liability, negligence, failure to warn, breach of implied and express warranty, causation in fact, and liability for punitive damages," finding that the predominance requirement was met as to those issues. *Id.* at 1229. The district court excluded from certification what it deemed to be individual issues of proximate cause, compensatory damages, and the amount of punitive damages, finding they did not meet the predominance or superiority requirements of FRCP 23(b)(3). *Id.* at 1229.

On appeal, the Ninth Circuit concluded that the district court abused its discretion. *Id.* at 1230. Invoking the "advancement of the litigation" concept, the Ninth Circuit criticized the district court for its failure to "discuss whether the adjudication of the certified issues would significantly advance the resolution of the underlying case, thereby achieving judicial economy and efficiency." *Id.* at 1229. The Ninth Circuit vacated the district court's ruling because "there has been no demonstration of how this class satisfied important Rule 23 requirements, including the predominance of common issues over individual issues and the superiority of class adjudication over the other litigation alternatives" and remanded the case for further proceedings. *Id.* at 1230. However, the court stated, "[e]ven if the common questions do not predominate over the individual questions so that class certification of the entire action is warranted, Rule 23 authorizes the district court in appropriate cases to isolate the common issues under Rule 23(c)(4)(A) and proceed with class treatment of these particular issues." *Id.* at 1234.

2. Seventh Circuit

In 2005, the Northern District of Illinois decided *In re Factor VIII or IX Concentrate Blood Prods. Litig.*, No. 93 C 7452, WL 497782 (N.D.Ill. Mar. 1, 2005). Although the court declined to certify a class pursuant to FRCP 23(c)(4)(A) with respect to negligence issues, it recognized the "advance the litigation" concept, stating that "[e]ven though a court decides that the common questions do not predominate for purposes of Rule 23(b)(3) . . . the court always should consider the possibility of determining particular issues on a representative basis as permitted by Rule 23(c)(4)(A) . . . whenever that might prove efficient and economical." *Id.* at *2 (citation omitted)(alterations in original).

One week later, the Seventh Circuit decided *In re Allstate Ins. Co.*, 400 F.3d 505 (7th Cir. 2005). There, the district court certified the class with respect to an ERISA claim under FRCP 23(b)(2). *Id.* at 506. The Seventh Circuit vacated the district court's decision, finding that certification under FRCP 23(b)(2) was improper. *Id.* at 508. However, the court stated that the issue of whether defendants had a policy of forcing employees to quit could be certified pursuant to FRCP 23(c)(4)(A), as that would advance the litigation rather than "litigating the class-wide issue of Allstate's policy anew in more than a thousand separate lawsuits." *Id.* Accordingly, the court concluded "that this class action should have been certified, if at all, under Rule 23(b)(3), rather than under (b)(2)." *Id.*[2]

3. Fifth Circuit

In 1996, the Fifth Circuit confronted the scope of FRCP 23(c)(4)(A). *Castano v. Am. Tobacco Co.*, 84 F.3d 734 (5th Cir. 1996). Plaintiffs brought an action on behalf of all smokers and nicotine-dependent persons against tobacco companies. The district court organized the class action into four categories consisting of: (1) "core liability"; (2) causation, reliance, affirmative defenses; (3) compensatory damages; and (4) punitive damages. *Id.* at 739.

The district court then certified the class with respect to "core liability" and punitive damages. The circuit court reversed and chastised the lower court for failing to conduct any analysis regarding its finding of predominance. Specifically, *Castano* noted the absence of any consideration of the impact on predominance of questions, such as variations in state law and the necessity of individualized proof of reliance, as well as the superiority of the class action.

The *Castano* court, like other courts that considered FRCP 23(c)(4)(A), sought to determine if class certification would advance the litigation. The fact that certain common issues might arise in a multitude of individual actions does not mandate class-wide treatment. *Id.* at 744–45. Indeed, because of the threat of duplicative jury findings in both the proposed class trial and subsequent individual trials, the *Castano* court concluded that the plaintiffs failed to meet their predominance burden. *Id.* at 745, 749–50. The court went even further stating in *dicta* that "[t]he proper interpretation of the interaction between subdivisions (b)(3) and (c)(4) is that a cause of action, as a whole, must satisfy the predominance requirement of (b)(3) and that (c)(4) is a housekeeping rule that allows courts to sever the common issues for class trial." *Id.* at 745 n.21. Further, "[r]eading rule 23(c)(4) as allowing a court to sever issues until the remaining common issue predominates over the remaining individual issues would eviscerate the predominance requirement of rule 23(b)(3)." *Id.*[3] Despite the fact that the footnote was completely unnecessary to the resolution of the case, it has gained prominence as a "holding" by other courts considering this issue, and is what underlies the purported "split."

4. Fourth Circuit

In 1993, the Fourth Circuit affirmed the district court's decision to conditionally certify a class with respect to eight particular issues in the discovery phase of an asbestos litigation. *Central Wesleyan College v. W.R. Grace & Co.*, 6 F.3d 177, 180–81 (4th Cir. 1993). In so doing, the court recognized that "Rule 23(c)(4)(A) specifically allows an action to be maintained 'as a class action with respect to particular *issues*.'" *Id.* at 185 (citation omitted)(emphasis added). In that case, some of the "particular issues" included "the state of the art" issue, "whether defendants participated in conspiratorial activities," and "whether defendants breached a duty of care." *Id.* at 184. In affirming the district court's decision, the Fourth Circuit found that "the class mechanism may advance this action and reduce the need for repetitive litigation in this area." *Id.* at 180. Once again, the "advance the litigation" test prescribed the scope of FRCP 23(c)(4)(A).

Ten years later, in 2003, the Fourth Circuit decided *Gunnells v. Healthplan Servs., Inc.*, 348 F.3d 417 (4th Cir. 2003). There, plaintiffs brought claims against a third-party administrator of a health care plan and against individual agents responsible for selling the plan. *Id.* at 421. The district court certified a plaintiffs' class on a single claim against the defendant third-party administrator for the violation of its duties. *Id.* at 424–25. Additionally, the district court certified several subclasses with respect to liability issues against the agents. *Id.* at 434.

The Fourth Circuit affirmed the district court's decision as to the third-party administrator because it found that common questions predominated over individual questions as to liability. *Id.* at 428. However, the Fourth Circuit reversed the district court's certification with respect to the agents because it determined that the predominance and commonality requirements could "only be established after considerable individual inquiry." *Id.* at 434. Specifically, because the claims against the agents involved fraud, reliance was an issue and, therefore, common issues could not predominate because "a fraud class

action cannot be certified when individual reliance will be an issue." *Id.* at 435 (*quoting Castano,* 84 F.3d at 745).

In its analysis of FRCP 23(c)(4)(A), the court stated:

> [P]recedent from our own court flatly rejects the dissent's sequential interpretation of Rule 23. In *In re A.H. Robins [Co., Inc.]*, 880 F.2d [709] at 740 [4th Cir. 1989], we counseled that "courts should take full advantage of the provision in subsection (c)(4) permitting class treatment of separate issues in the case." We expressly recognized that "*if* [*an*] *action includes multiple claims, one or more of which might qualify as a certifiable class claim, the court may separate such claims* from other claims in the action *and certify them* under the provisions of subsection (c)(4)," provided that "each subclass must independently meet all the requirements of (a) and at least one of the categories specified in (b)." *Id.* at 728 (emphasis added). Thus, contrary to the dissent's protests in this case, we do not espouse a new rule. Rather we follow the rule articulated in *A.H. Robins*—that subsection 23(c)(4) should be used to separate "one or more" claims that are appropriate for class treatment, provided that within that claim or claims (rather than within the entire lawsuit as a whole), the predominance and all other necessary requirements of subsections (a) and (b) of Rule 23 are met.

Gunnells, 348 F.3d at 441 (some alterations in original).

Citing to *Robinson v. Metro-North Commuter R.R. Co.,* 267 F.2d 147 (2d Cir. 2001) as well as *Valentino v. Carter-Wallace, Inc.* 97 F.3d 1227 (9th Cir. 1996), the court examined what it characterized as the "circuit conflict" as to "whether predominance must be shown with respect to an entire cause of action, or merely with respect to a specific issue, in order to invoke (c)(4)." *Gunnells*, 348 F.3d at 444. However, the court concluded that it had "no need to enter that fray . . . because . . . [p]laintiffs' *cause of action* as a whole . . . satisfies the predominance requirements of Rule 23. *Id.* Thus, the court never reached the issue regarding the full breadth of FRCP 23(c)(4)(A).[4]

5. Sixth Circuit: Western District of Michigan

In 1998, the Western District of Michigan was asked to certify a nationwide class on plaintiffs' "core theory" relating to fraudulent inducement. *See In re Jackson Nat'l Life Ins. Co. Premium Litig.*, 183 F.R.D. 217, 224–25 (W.D Mich. 1998). Although the court recognized *Valentino*'s holding regarding the use of FRCP 23(c)(4)(A) "to isolate the common issues under Rule 23(c)(4)(A) and proceed with class treatment of these particular issues," (*id.* at 224 (*quoting Valentino*, 97 F.3d at 1234)), it cautioned against using FRCP 23(c)(4)(A) to "manufacture predominance." *Id.* at 224–25 (*citing Castano*, 84 F.3d at 745 n.21). The court ultimately applied the *Tetracycline* test and concluded that, even if it were to certify the class for specific issues, it would not advance the litigation: "even a jury determination favorable to plaintiffs at this step would not in itself justify a finding of liability on any claim. A second jury would still be required to determine [defendant]'s ultimate liability. . . . In such a situation the second jury could find itself impermissibly reconsidering the findings of the first jury." *Id.* at 225.

6. Tenth Circuit: District of Kansas

In *Harding v. Tambrands Inc.*, 165 F.R.D. 623 (D. Kan. 1996), plaintiffs brought a products liability action against tampon manufacturers for damages suffered as a result of contracting Toxic Shock Syndrome allegedly from the use of their products. The *Harding* plaintiffs requested that the court certify any individual issues it deemed fit to certify. *Id.* at 632. Citing *In re Tetracycline*, the *Harding* court agreed that the test for certifying "particular issues" pursuant to FRCP 23(c)(4)(A) is that: "[t]he issues must be such that their resolution as a class matter would materially advance the disposition of the litigation as a whole." *Harding*, 165 F.R.D. at 632 (*citing In re Tetracycline*, 107 F.R.D. at 727). Applying that test, the court declined to certify a class on any issue, or as a whole. The court found that the non-common issues of general causation within the proposed class, including whether plaintiffs' contraction of Toxic Shock Syndrome was caused by using defendants' products, were "inextricably entangled with the common issues." *Id.* Accordingly, the court concluded that resolution of the potentially common issues would not materially advance the litigation. *Id.*

In *Emig v. Am. Tobacco Co., Inc.*, 184 F.R.D. 379 (D. Kan. 1998), the court confronted the issue of whether to certify a class of smokers suing the American Tobacco Company with respect to particular claims such as negligence, strict liability, and breach of the implied warranties. The court articulated application of FRCP 23(c)(4)(A) as: "when common questions do not predominate when compared to all questions that must be adjudicated to dispose of a suit, Rule 23(c)(4) asks whether a suit limited to the unitary adjudication of a particular common issues [sic] will achieve important and desirable advantages of judicial economy and efficiency." *Id.* at 395 (*quoting* 1 NEWBERG ON CLASS ACTIONS § 4.25, at 4-81 (3d ed. 1992)). Applying the *Harding* test, the court denied plaintiffs' motion for certification of particular issues because it would not "materially advance the litigation as a whole." *Id.*

7. Eleventh Circuit: Middle District of Florida

Whether to allow class certification pursuant to FRCP 23(c)(4)(A) with respect to seventeen issues regarding

willfulness, causation, and legal defenses that plaintiffs claimed predominated their suit for strict product liability, negligence, negligent infliction of emotional distress, and toxic trespass was the question presented in *Rink v. Cheminova, Inc.*, 203 F.R.D. 648 (M.D. Fla. 2001). Although the court disagreed with the Magistrate's report and recommendation to the extent that it differed from the court's views as to the correctness of the *Castano* rationale, it nevertheless agreed with the Magistrate to the effect that class treatment of the common issues would not measurably advance the litigation. *See id.* at 653, 670.

8. Third Circuit: Eastern District of Pennsylvania

In 2004, the Eastern District of Pennsylvania confronted the application of Rule 23(c)(4)(A) to certify the issue of whether a proposition regarding NCAA eligibility rules intentionally discriminated against plaintiffs—a group of African American and/or dyslexic student-athletes. *Pryor v. Nat'l Collegiate Athletic Ass'n*, No. Civ. A. 00-3242, 2004 WL 1207642, at *4 (E.D. Pa. Mar. 4, 2004). The court agreed with plaintiffs' articulation that "in order to grant partial certification under Rule 23(c)(4)(A), [plaintiffs] need only show that . . . the Rule 23(b)(3) predominance requirement ha[s] been met with regard to the limited issues plaintiffs seek to certify." *Id.* at *2. With that predicate, the court noted that "[t]he underlying philosophy of Rule 23(c)(4)(A) . . . is that the advantages and economies of adjudicating issues that are common to the entire class on a representative basis should be secured even though other issues in the case may have to be litigated separately by each class member." *Id.* at *5. The court then applied the *Tetracycline* test, and determined that certification would not materially advance the litigation. Accordingly, plaintiffs' motion was denied. *Id.* at *6.

9. Second Circuit

The scope of FRCP 23(c)(4)(A) was addressed by the Second Circuit for the first time in 2001, in *Robinson v. Metro-North Commuter R.R. Co.*, 267 F.3d 147 (2d Cir. 2001). There, plaintiffs sought, among other relief, to bifurcate and certify the liability stage of their pattern-or-practice claim in an employee race discrimination action. *Id.* at 167. In reviewing the district court's denial of certification, the Second Circuit considered both Fifth Circuit case law that had rejected a similar claim for certification (*Allison v. Citgo Petroleum Corp.*, 151 F.3d 402 (5th Cir. 1998)(*citing Castano*, 84 F.3d 734), *id*. at 167 n.12), as well as Ninth Circuit case law that supported certification of particular issues (*Valentino v. Carter-Wallace, Inc.* 97 F.3d 1227 (9th Cir. 1996)). *Id.* However, like the court in *Gunnells*, the Second Circuit refused to "enter the fray" and declined to decide the full scope of FRCP 23(c)(4)(A). *Id.* Nevertheless, the court applied the *Tetracycline* test and held "litigating the pattern-or-practice liability phase for the class as a whole would both reduce the range of issues in dispute and promote judicial economy"—i.e., it would advance the litigation. *Id.* at 168. Accordingly, the Second Circuit vacated the denial of class certification with instructions to certify the claim. *Id.* at 154.

III. Analysis of Second Circuit's Decision in *In re Nassau*

In its most recent decision, *In re Nassau County Strip Search Cases*, the Second Circuit decided, as an issue of first impression, the scope of FRCP 23(c)(4)(A) with respect to a particular issue, where a claim has not met the predominance requirement of FRCP 23(b)(3). 461 F.3d 219, 225 (2d Cir. 2006). The Second Circuit held that a court may apply FRCP 23(c)(4)(A) to certify a class as to a particular *issue* even when the entire claim has not met the predominance test. *Id.* at 221.

A. Background

Plaintiffs-arrestees initiated an action against Nassau County and others, alleging that the County's blanket policy to strip search all newly admitted misdemeanor detainees was unconstitutional. Plaintiffs, who were subject to these strip searches, sought a declaration that the policy was unconstitutional, damages, and an injunction. *Id.* at 222.

Plaintiffs moved to consolidate and certify a class pursuant to FRCP 23(b)(3). *Id*. The district court granted consolidation, but denied class certification based on a lack of predominance. *Id.* While the district court noted the possibility of *sua sponte* certification of a class solely on the issue of liability pursuant to FRCP 23(c)(4)(A), it referred to *Castano* as holding that a court may not use FRCP 23(c)(4)(A) "to single out the issue of liability for class treatment unless the 'cause of action, *as a whole*,' first satisfies Rule 23(b)(3)'s predominance requirement." *Id.* at 223 (*quoting Castano*, 84 F.3d at 745 n.21). Plaintiffs subsequently modified their class definition and moved for reconsideration. *Id.* Despite the fact that the district court agreed that the new class "removes the possibility of individualized liability determinations," it denied plaintiffs' motion. *Id. (quoting O'Day v. Nassau County*, No. 0:99-CV-2844-DRH, slip op. (May 23, 2001)).

Thereafter, plaintiffs again redefined their class and renewed their class certification motion as to liability. *Id.* In opposing the motion, defendants conceded that the common issue of whether the strip search policy was constitutional "might be appropriate for class certification." *Id.* at 224 *(quoting O'Day v. Nassau County*, No. 0:99-CV-2844-DRH, slip op. (May 23, 2001)). However, the district court again denied the motion concluding that defendants' concession removed all common liability issues from its predominance analysis leaving only the issue of liability as an individual one. *Id.* Although the parties later settled, plaintiffs reserved their rights to appeal the district court's denial of class certification. *Id.*

On appeal, the Second Circuit reversed the district court's decision and remanded, in part, with instructions

to certify a class with respect to liability and to also consider certifying a damages class. *Id.* at 230–31.

B. Second Circuit's Analysis

The Second Circuit viewed prior circuit case law regarding the scope of FRCP 23(c)(4)(A) as presenting a circuit split. *See In re Nassau*, 461 F.3d at 226 (this is "a matter as to which the Circuits have split"). In reaching that conclusion, the court, referring to *Castano*, stated that "[t]he Fifth Circuit has adopted a 'strict application' of Rule 23(b)(3)'s predominance requirement." *Id.* (citation omitted). Citing *Castano*'s dicta, the Second Circuit stated: "[u]nder this view, '[t]he proper interpretation of the interaction between subdivisions (b)(3) and (c)(4) is that a *cause of action*, as a whole, must satisfy the predominance requirement of (b)(3) and that (c)(4) is a housekeeping rule that allows courts to sever the common issues for a class trial.'" *Id.* (*quoting Castano*, 84 F.3d at 745 n.21)(second alteration in original)(emphasis added). In contrast, the Second Circuit recognized that "[t]he Ninth Circuit holds a different view. Pursuant to that court's precedent, '[e]ven if the common questions do not predominate over the individual questions so that class certification of the entire action is warranted, Rule 23 authorizes the district court in appropriate cases to isolate the common issues under Rule 23(c)(4)(A) and proceed with class treatment of these particular issues.'" *Id.* (*quoting Valentino*, 97 F.3d at 1234)(second alteration in original).[5] The Second Circuit agreed. *Id*.

In reaching its decision, the Second Circuit looked to the plain language of Rule 23. "When appropriate [] an action may be brought or maintained as a class action *with respect to particular issues*. . . ." *Id.* at 226 (*quoting* FED. R. CIV. P. 23(c)(4)). The court then cited the Advisory Committee notes which stated, "the action may retain its 'class' character *only* through the adjudication of liability to the class; the members of the class may thereafter be required to come in individually and prove the amounts of their respective claims." *Id.* (*citing* FED. R. CIV. P. 23(c)(4) Advisory Committee's notes to 1966 amend.). The Second Circuit further explained that "a court may employ Rule 23(c)(4) when it is the 'only' way that a litigation retains its class character, i.e., when common questions predominate only as to the 'particular issues' of which the provision speaks." *Id.* Lastly, the Second Circuit relied on commentators, who have supported the notion that subsection (c)(4) may be employed for class treatment of single issues when the whole action does not satisfy Rule 23(b)(3). *Id.* (*citing* 7AA CHARLES ALAN WRIGHT & ARTHUR R. MILLER, FEDERAL PRACTICE AND PROCEDURE § 1790 (3d ed. 2005); 6 ALBA CONTE & HERBERT B. NEWBERG, NEWBERG ON CLASS ACTIONS § 18:7 (4th ed. 2002)).

The Second Circuit refused to follow what it characterized as the Fifth Circuit's view—that the predominance requirement must be met with respect to the *entire action* before FRCP 23(c)(4)(A) can be used. Rejecting that rationale as well as the notion that FRCP 23(c)(4)(A) is merely a "housekeeping rule," the court found it would "render[] subsection (c)(4) virtually null, which contravenes the 'well-settled' principle 'that courts should avoid statutory interpretations that render provisions superfluous.'" *Id.* at 226–27 (citation omitted). According to the Second Circuit's understanding of the Fifth Circuit's view, "a court considering the manageability of a class action—a requirement for predominance under Rule 23(b)(3)(D)—[would have] to pretend that subsection (c)(4)—a provision specifically included to make a class action more manageable—does not exist until after the manageability determination [has been] made." *Id.* at 227. (*quoting Gunnells*, 348 F.3d at 439)(alterations in original). Therefore, "a court could only use subsection (c)(4) to manage cases that the court had already determined would be manageable *without* consideration of subsection (c)(4)." *Id.* (*quoting Gunnells*, 348 F.3d at 439).

IV. Circuit Court Split?

Technically, there appears to be a split of authority as to the scope of FRCP 23(c)(4)(A) certification between the Fifth Circuit on one side (restrictive application to a cause of action as a whole), and the Ninth and Second Circuits on the other side (broader application to particular issues). However, the "split" may be form over substance.

Indeed, courts, which have grappled with this issue for many years, are in agreement that a class may be certified pursuant to FRCP 23(c)(4)(A) as long as certification will advance resolution of the litigation. *See, e.g., Gunnells*, 348 F.3d 417, 428–29 (class treatment of a single claim against defendant health plan administrators would advance the litigation because the common issues do not require any individualized inquiry); *Valentino*, 97 F.3d 1227, 1229 (vacating the district court's decision and remanding the action because, *inter alia*, the district court failed to address whether certification of the issues would advance resolution of the litigation); *Pryor*, 2004 WL 1207642 at *6 (Applying the *Tetracycline* predominance test, court denied class certification because it would "do substantially nothing" to advance the litigation); *Rink*, 203 F.R.D. 648, 670 (finding that class-wide determination of the common issues would not measurably advance the litigation); *Emig*, 184 F.R.D. 379, 395 (holding that certification of particular issues would not advance the litigation which is the relevant inquiry under 23(c)(4)(A)). Even *Castano*, 84 F.3d 734, 739 recognized this concept (reversing the district court's decision to certify a class under FRCP 23(c)(4)(A) because *inter alia*, the lower court failed to analyze how core liability issues would advance the cases.)

While *In re Nassau* may be a "benchmark" decision, it too recognized the advancement of the litigation concept. *See In re Nassau*, 461 F.3d at 225, 230. ("[T]his action already has progressed substantially and, again, offers the

benefit of a liability phase that can be resolved quickly and conclusively") *Id.* at 230. Perhaps resolution of this issue will come from the Supreme Court; or perhaps, courts will abstain from deciding with which side of the "circuit split" they agree, focusing instead on whether certification will advance the litigation.

V. The Prognosis

In both the securities and antitrust arenas, it seems unlikely that the Second Circuit's decision will have much of an impact. The issues in antitrust cases—relevant market, anticompetitive behavior, price-fixing, etc.—are so intertwined that it would be difficult to accomplish any efficiencies of class litigation by certifying only one of the issues. For example, even if one could establish the overall issue of anticompetitive conduct on a class-wide basis, each plaintiff would still have to demonstrate the existing relevant market in order for such conduct to become actionable. Thus, certification of the anticompetitive conduct issue would not advance the litigation. The same would appear true for securities class action litigation in those instances where reliance may not be presumed. It seems doubtful that a court would certify all but the reliance issue (necessary for a securities fraud claim) and countenance the inefficiencies of separate trials on that issue.

Endnotes

1. There, the only "element" that was certified pursuant to FRCP 23(c)(4)(A) was the dispositive element of materiality in a Securities Act of 1933 § 12(2) claim. Such claim is essentially strict liability; thus, the litigation is advanced once the materiality of a misrepresentation has been established.
2. On remand, the district court certified the class pursuant to FRCP 23(b)(3). *Flanagan v, Allstate Ins. Co.*, No. 01 C 1541, 2006 WL 1444919, slip copy, (N.D. Ill. Jan. 11, 2006).
3. This footnote is sometimes misunderstood as supporting the proposition that an *action* as a whole must satisfy the predominance requirement before certification can be granted. *See In re Factor VIII*, 2005 WL 497782, at *2 (defendants rely on the *Castano* footnote for the proposition that prior to certifying issues under FRCP 23(c)(4)(A), a class must meet the predominance requirement; the court concedes that "the footnote has gained a following"); *Rink v. Cheminova, Inc.*, 203 F.R.D. 648, 671 n.20 (M.D. Fla. 2001)("if the view expressed in *Castano* is correct, then there can be no certification of an issues class . . . because Plaintiffs cannot satisfy the predominance requirement of Rule 23(b)"). However, a simple reading of *Castano* makes clear that the footnote refers to a *cause of action*—not the entire action. *See Gunnells*, discussed *infra.*
4. *Gunnells* is also instructive in its attempt to clarify the confusion between the terms "action," "cause of action," and "claim" within the context of the application of FRCP 23(c)(4)(A). *See Gunnells,* 348 F.3d at 441–44. *Gunnells* instructs that the *Castano* footnote's reference to a "cause of action" does not mean an entire lawsuit as the *Gunnells* dissent suggests, but rather denotes a claim within a lawsuit. *Id.* at 444. Further, *Gunnells* points out that "*no* court has adopted the dissent's interpretation of Rule 23; no court has required a *lawsuit*-specific predominance analysis." *Id.* at 443.
5. Additionally, the Second Circuit noted that the Fourth Circuit, in *Gunnells*, allowed certification as to one cause of action under FRCP 23(c)(4)(A). *In re Nassau*, 461 F.3d at 226 (*citing Gunnells*, 348 F.3d at 439).

This report was prepared by Susan Salvetti of the Class Action Committee of the Commercial and Federal Litigation Section of the New York State Bar Association. The Class Action Committee of the Commercial and Federal Litigation Section is chaired by Ira A. Schochet.

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