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FDIC Seeking to Recoup Failed Bank Losses from Bank Directors

By Craig McCrohon and Aaron H. Stanton

After an almost 20 year hiatus since the savings and loan crisis (when over 1,800 financial institutions failed), and in the wake of the recent rash of bank failures (325 between 2008 and January 2011), the FDIC appears to be back with a vengeance. Between November 2010 and January 2011, the FDIC authorized lawsuits against over 100 officers and directors at failed banks seeking to recoup over $2.4 billion in losses.

In the first salvo against directors of a failed bank—*FDIC v. Saphir, et al.*, No. 10 CV 07009 (N.D. Ill.)—the FDIC filed an action against all of the directors of Heritage Community Bank, a small community bank in suburban Chicago (the "Heritage Bank Case"). The FDIC alleged that the directors breached their fiduciary duties to the bank and were negligent and grossly negligent in violation of 12 U.S.C. § 1821(k) by: (1) approving loans with inadequate documentation; (2) failing to implement a process to ensure loans were properly assessed for risk and to properly monitor loans once approved; (3) authorizing loans for "speculative" developments in neighborhoods "saturated with [similar] projects"; (4) neglecting to anticipate the real estate bubble bursting; (5) sanctioning loans too large given the bank's size and capital; (6) disregarding criticism by regulators of the bank's policies and procedures; (7) ignoring internal bank procedures and policies; and (8) and awarding excessive pay packages and bonuses to officers and employees and dividends to the shareholders, which included the outside directors.

Under internal FDIC policy, established during the savings and loan crisis, the FDIC will pursue claims against directors based on: (1) dishonest conduct; (2) insider transactions; (3) violations of internal policies, law, and regulations; (4) failure to establish, monitor, or follow proper underwriting procedures; and (5) refusal to heed regulatory warnings. In the current crisis, however, based on the Heritage Bank Case, the FDIC appears initially to have taken a more aggressive position, seeking to hold directors liable not just for failing to follow proper underwriting procedures, but for making real estate loans when the directors allegedly should have known of the real estate meltdown just around the corner.

The FDIC, however, did not assert any regulatory violations in the Heritage Bank Case. In addition to the general fiduciary duty claims, directors and officers are in theory liable for specific statutory violations. The FDIC can bring claims for breaches of lending limit violations, 12 U.S.C. § 84; 12 C.F.R. § 32.1 et. seq.; of safety and soundness standards; 12 U.S.C. §§ 1818, 1831; 12 C.F.R. § 364; or of general provisions of cease and desist orders, and unjust enrichment (12 U.S.C. § 1818(b)). The reason for the lack of any statutory claims in the Heritage Bank Case is that directors and officers (D&O) insurance policies often contain exclusions from coverage for bank regulatory violations and penalties and fines thereunder. If the FDIC alleged that the officers and directors of the bank committed regulatory violations or sought statutory penalties, the carrier would likely deny coverage. The FDIC seems to realize this and so far appears to be aiming to collect from the applicable D&O policies plus whatever it can collect from the officers and directors personally. While the FDIC might take some of the more egregious cases (e.g., fraud) to trial, it will most likely settle the vast majority of the current cases, as it did in the savings and loan crisis.

Standard for Liability of Bank Directors

Under the Financial Institutions Reform, Recovery, and Enforcement Act (FIRREA), 12 U.S.C. § 1821(k), to prevail on a claim against an outside director, the FDIC must prove at least gross negligence. Where, however, the applicable state law provides for a stricter standard, i.e., ordinary negligence, the director can be held liable for less than gross negligence. FIRREA directs courts to look at the applicable statute to determine the definition of "gross negligence." The chart below sets forth the states that have had a significant number of bank failures and whether the state provides for a cause of action for negligence against bank directors for simple negligence and how state law defines "gross negligence."

State	Simple Negligence	Standard for Gross Negligence
California	Yes *F.D.I.C. v. Castetter*, 184 F.3d 1040, 1046 (9th Cir. 1999).	"[V]ery great negligence, or the want of even scant care. It has been described as a failure to exercise even that care which a careless person would use," *Decker v. City of Imperial Beach*, 257 Cal. Rptr. 356, 357 (Cal. Ct. App. 1989).
Florida	No *F.D.I.C. v. Gonzalez-Gorrondona*, 833 F. Supp. 1545, 1556 (S.D. Fla. 1993).	"[D]efendant's conduct was so reckless or wanting in care that it constituted a conscious disregard or indifference to the life, safety, or rights of persons exposed to such conduct," *BDO Seidman, LLP v. Banco Espirito Santo Intern.*, 38 So.3d 874, 877 (Fla. Dist. App. Ct. 2010).
Georgia	No *Mobley v. Russell*, 164 S.E. 190, 193 (Ga. 1932).	"[T]he failure to exercise that degree of care that every man of common sense, however inattentive he may be, exercises under the same or similar circumstances; or lack of the diligence that even careless men are accustomed to exercise," *Currid v. DeKalb State Court Probation Dept.*, 618 S.E.2d 621, 625 (Ga. Ct. App. 2005).
Illinois	No *Kelley v. Baggott*, 273 Ill. App. 580, 1934 WL 2768 (Ill. App. Ct. 1933).	"[V]ery great negligence," but less than willful, wanton, and reckless conduct, *FDIC v. Gravee*, 966 F. Supp. 622, 636 (N.D. Ill. 1997).

Defenses to the Current FDIC Claims

The FDIC's current wave of claims against bank directors so far can be grouped into three categories: (1) the failure to implement a system to assess risk and monitor loans (oversight failure); (2) the decision to approve loans that defaulted; and (3) the approval of excessive executive compensation and/or dividends.

With respect to director oversight failure, many courts use the standard set forth by the Delaware Supreme Court in *In re Caremark Int'l*, 698 A.2d 959 (Del. 1996). *King v. Baldino*, 648 F. Supp. 2d 609, 621 (D. Del. 2009), held that to prevail on a director oversight case under *Caremark*, the FDIC must prove that: (1) "the directors utterly failed to implement any reporting or information systems or controls"; or (2) implemented a system or controls but "consciously failed to monitor or oversee its operations thus disabling themselves from being informed of risks or problems requiring their attention." A lack of oversight claim "is possibly the most difficult theory in corporation law upon which a plaintiff might hope to win a judgment." To prevail under this theory "requires a showing that the directors knew that they were not discharging their fiduciary duties, which requires the FDIC to prove a sustained or systematic failure of oversight." To prove a systematic failure, the FDIC will need to prove that the directors either completely ignored the business of the bank and/or red flags that would have alerted a reasonable bank director to the underlying problems.

Similarly, with respect to director decisions to approve loans that went bad, or decisions on executive compensation and dividends, the business judgment rule creates a presumption that in making a business decision the directors of a corporation acted on an informed basis, in good faith, and in the honest belief that the action was taken in the best interest of the company. Absent a showing that the directors failed to make an informed decision or the decision was not made in good faith (i.e., the director personally benefited from the decision), the business judgment rule protects the directors from decisions that turn out to be poor ones in hindsight, particularly where other banks made similar decisions.

In assessing director liability, courts often separate outside directors (those directors that are not officers or employees of the bank) from inside directors (those directors that are also officers or employees of the bank). Outside directors are entitled to rely on the advice and reports from the bank's officers and generally have a different degree of duty to the bank with respect to the day-to-day responsibilities and decisions of the bank. To impose a higher duty on outside directors or to subject them to liability for good faith decisions made based on information provided by the bank would result in banks not being able to obtain responsible local businesspeople to sit on their boards. Bank directors should not be sued every time a loan proves to be uncollectible. Such a result would be catastrophic to banks, particularly small community banks that need to have directors drawn from the local business community.

A good example of a successful defense by directors in a failed bank in the savings and loan crisis is found in *Washington Bancorportion v. Said*, 812 F. Supp. 1256 (D.D.C. 1993). The FDIC brought an action against 10 directors and one officer of the failed bank alleging negligence, gross negligence, and breach of fiduciary duty, based, in part, on the board's approval of: (1) a $10 million line of credit to a law firm; and (2) a golden parachute to the bank president. With respect to the negligence claims, the court held that bank directors could only be liable for negligence for extraordinary transactions, such as when a bank loans "a great amount of its capital to a new customer and the subject of the loan is an area in which the bank is

unfamiliar (for instance, a local savings and loan investing for the first time in speculative oil fields)." In such instances, the "bank directors would be under an obligation to thoroughly investigate the prudence of making such a loan." For more routine transactions, however, the gross negligence standard applied. As a result, the court dismissed all the negligence counts under Rule 12(b)(6) based on the fact that from the complaint it was apparent that the transactions at issue—extending a line of credit to an existing customer and payment to the bank president—were routine transactions and not subject to the negligence standard.

The court also entered summary judgment in favor of the directors on the gross negligence counts. In so ruling, the court held that the bank directors were not grossly negligent in approving the loans that went bad because: (1) the directors made an informed decision based on the information provided to them by the bank's officers; and (2) several major New York City banks made similar loans. The court rejected the FDIC's contention that the directors were grossly negligent for failing to look at the borrower's most recent financial statement because the FDIC failed to show that this would have "been so negative as to put the board on notice that the loan was unreasonably or inordinately risky." The court likewise found that the directors' decision to approve the payment of a golden parachute to the bank's president was not grossly negligent because in making this decision the directors relied on lawyers and bank committees.

Accordingly, under *Washington Bancorportion* and the above cases, directors, and particularly outside directors, should have very strong defenses to allegations of gross negligence and negligence where the directors: (1) relied on reports and information provided by the failed bank's officers; (2) followed the bank's contractual requirements; and (3) made decisions similar to directors at similarly situated banks.

What Directors at Troubled Banks Should Do

There are several steps that directors at troubled and failed banks can take to help protect themselves from potential FDIC lawsuits.

FDIC's Pre-Suit Investigation

When regulators close a bank, the FDIC steps in as receiver and obtains all the rights and privileges of the bank. Upon taking over, the FDIC begins a formal inquiry into the actions of the bank's officers and directors. The FDIC immediately takes control of the bank's books and records and interviews officers, directors, and key employees (e.g., loan originators). Unlike a typical plaintiff, before filing suit, the FDIC can issue document subpoenas to officers, directors, and employees and can also depose those persons. After conducting its pre-suit investigation, which can take between 18 and 24 months, the FDIC publishes its findings in a report entitled "Material Loss Review" and sends a demand letter for the failed bank's losses to officers, directors, and employees that the FDIC deems culpable seeking compensation. Absent a settlement, the FDIC will then file a lawsuit.

Director Checklist––Troubled Banks

Directors of "troubled" banks must not wait until the FDIC closes the bank to take proactive action. The troubled bank is one that is effectively on probation by the FDIC—usually the subject of a cease and desist order or memorandum of understanding. These regulatory orders often direct the bank to rapidly improve its management and finances. Also, the bank may show significant losses due to loan write-offs, and will often not have sufficient capital to absorb another non-accrual loan.

Directors should take the following steps to protect themselves before the FDIC takes over the bank.

- ❑ *Work overtime to address as many of the criticisms as possible in the memorandum of understanding or cease and desist order*. These days, safety and soundness is king––which means addressing problems in making and managing loans. Have the files reviewed, organized, and completed. Distressed banks frequently have a troubled history of documenting loans. Thus, it is important for the bank's staff to make sure that the loan files are organized and complete. If the regulators demand new management, look for ways to supplement or shift management responsibilities. If regulators demand higher capital ratios, adjust the balance sheet and solicit more investors. Failure to substantially address criticisms will provide great ammunition to the FDIC as it tells a judge that the directors repeatedly demonstrated a fatal nonchalance toward regulatory orders.
- ❑ *Update and complete policies and procedures*. All policies should be vetted to ensure that they are at least as good as those of similar banks, if not better. Because a court will subject management practices to scrutiny, the policies and procedures should likely be more complete than those of the bank's peers. These policies include those mandated by regulations and industry practices—such as loan approval and underwriting procedures, liquidity policies, and policies for approving and managing investments.
- ❑ *Create committees of independent directors*. Banks should demonstrate a willingness to separate oversight of the board from the daily management of the institution. Frequently, banks encounter problems when the owner is the president and the dominant director. If the board is more of a rubber stamp than an independent overseer, the directors face a greater threat of liability. The bank should empower outside directors, even if this requires establishing independent committees to review loans and prior procedures.
- ❑ *Document personal effort*. FDIC lawsuits are personal attacks, and therefore the director needs a personal defense. This requires that the director document the effort to persuade the board to take actions requested by the regulators; if the other board members balk at addressing the problems, the minority squeaky-wheel director should send e-mails and memoranda that demonstrate an effort to convince the board to address problems.

- ❑ *Review the D&O insurance policies*. Notify the carrier if a claim is imminent. Be aware of actions that would trigger policy exclusions.

Director Checklist––Failed Banks

Once the FDIC closes a bank, the directors are out and can no longer affect bank policy. Directors (or rather, former directors), however, can take the following steps to protect themselves.

- ❑ *Hire a personal lawyer*. The moment the bank is seized, the bank's counsel is beholden to the receiver. The director no longer has any right to advice, documents, or confidentiality. Anything said to the bank's lawyer can, and probably will, be used against the director. Thus, it is imperative that directors obtain independent counsel that have experience dealing with the FDIC, lawsuits against officers, directors, and insurance carriers on D&O policies.
- ❑ *Limit discussion with other directors*. Each individual director and officer may be sued for different reasons. Outside directors with ownership stakes of less than 10 percent of the bank will be at odds with senior management or a controlling owner. The FDIC lawsuit will be a zero-sum game––the defense of one individual will come at the expense of others.
- ❑ *Review the D&O insurance polices—again*. The director's counsel should review the policies to determine limits, deductibles, and coverage exclusions. If the carrier has not already been notified, the director should immediately see that proper, timely notice is given.
- ❑ *Gather documents*. The FDIC will almost certainly demand copies of all records and correspondence of the director regarding the bank. The director should work with counsel to gather and organize documents. Counsel should also review the documents to determine the basis for possible claims by the FDIC and defenses by the director.

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Director Liability, the Duty of Oversight, and the Need to Investigate

By Jeremy S. Piccini

In today's turbulent economy, corporations are faced with a number of challenges beyond the threat of decreased stock value and the inability to cover monthly expenses. Recent corporate scandals, affecting the likes of Enron and Goldman Sachs, demonstrate that companies are often tempted to misrepresent and deceive in order to stay profitable. Acknowledging the trend of corporate fraud, Congress approved of the Sarbanes-Oxley Act of 2002 (SOX) and recently began to enact other regulatory schemes to prohibit such corporate fraud and provide for greater oversight. After SOX, however, the financial crisis beginning in 2007 further revealed the need for improved corporate regulations. Most recently, on July 21, 2010, the Dodd-Frank Wall Street Reform and Consumer Protection Act came into effect in the United States. One of its main objectives is to increase transparency and improve accountability in the corporate financial world. Aimed at preventing a repeat of the financial crisis and its various causes, the Dodd-Frank Act again demonstrates the need for corporate monitoring. Although many laws and regulations pertaining to oversight only apply to publicly held companies, such changes highlight Congressional and public awareness of the increasing potential for corporate fraud, the need for an independent counsel, and the importance of the corporate duty of oversight.

In reaction to such corporate scandals and regulatory actions, corporate boards are being held accountable for the failure to adequately oversee an institution's compliance function. For background purposes, a corporate board of directors is primarily responsible for overseeing the company, and in exercising these responsibilities, directors are charged with the fiduciary duties of care and loyalty. The duty of care mandates that a director act in good faith and use the degree of care that an ordinary person would exercise in a similar situation. The business judgment rule protects directors' decisions as long as the decision is informed, made in good faith, and with the honest belief that the action taken is in the company's best interest.

Director Oversight Liability

Director oversight liability is based on the concept of good faith. As a general matter, "a director's obligation includes a duty to attempt in good faith to assure that a corporate information and reporting system, which the board concludes is adequate, exists, and that failure to do so under some circumstances, may, in theory at least, render a director liable for losses caused by non-compliance with applicable legal standards." *In re Caremark International, Inc. Derivative Litigation*, 698 A.2d 959 (Del. Ch. 1996). Put differently, directors may be at "risk if they fail to reasonably oversee the organization's compliance program or act as mere passive recipients of information." *See* The Office of Inspector General of the U.S. Department of Health and Human Services and the American Health Lawyers Association, *Corporate Responsibility and Corporate Compliance: A Resource for Healthcare Board of Directors*. "A director has a duty to attempt in good faith to assure that (1) a corporate information and reporting system exists, and (2) this reporting system is adequate to assure the board that appropriate information as to compliance with applicable laws will come to its attention in a timely manner as a matter of ordinary operations." When a red flag or warning sign appears, this duty of care requires reasonable investigation and diligence. Accordingly, the board should be trained so that it is equipped to identify red flags and actively oversee the compliance program.

Thus, a corporate director is subject to liability when he (1) utterly fails to implement any reporting or information system or controls, or (2) having implemented such a system or controls, the director consciously fails to monitor or oversee its operations, rendering the corporation unable to recognize and address risks or problems. These bases of director liability are addressed in recent cases on the topic.

Case Law

Two Delaware Supreme Court decisions provide the necessary steps a corporation

should take in order to avoid director oversight liability. *In re Caremark International, Inc. Derivative Litigation*, 698 A.2d 959 (Del. Ch. 1996), established the need for a corporate program identifying potential wrongdoings in order to exercise the director's duty of oversight. Under the court's ruling, a corporate board cannot escape liability for monitoring issues if they have not implemented a program to detect violations, meaning that directors should not only have procedures to address possible or actual problems that may arise but to identify them as well. This safeguard would ensure that the potential issue is halted or ameliorated, and should also prevent a reoccurrence.

Stone v. Ritter, 911 A.2d 362 (Del. 2006), confirms the oversight standard of *Caremark*, adding that directors must exercise "good faith" in dealing with potential or actual violations of the law or corporate policy. At a minimum, when directors have actual knowledge of illegal or improper conduct or have knowledge of facts that should put the director on notice of such conduct, the directors must take good faith steps to remedy the problem. This includes measures aimed at preventing reoccurrence, as well as steps to stop the problem from materializing or progressing. Directors should also consider modifying their oversight programs to better address and enforce compliance issues such as those mentioned in this article and in the relevant cases.

There are various ways for a director to be considered on notice of possible wrongdoing. Whistle-blower calls, letters or public notice, public suspicion, consumer complaints, numerous and related civil litigation claims, and red flags discovered by a compliance program all adequately alert directors that something may be awry within the company. When there is actual knowledge, or there are blatant signs of wrongdoing, a director will be held liable for willfully ignoring or otherwise failing to investigate. Inaction, and failure to address such signs in good faith, may constitute grounds for director oversight liability.

In summary, a director may breach the duty of oversight by failing to implement a monitoring or compliance program, failing to oversee the program's operation and periodically reassess its effectiveness, or failing to investigate possible violations once the director is on notice.

Business Judgment Rule v. Duty of Oversight

It is important to reconcile the business judgment rule with the duty of oversight. The business judgment rule protects a director's informed and good faith decision. If directors are alerted to a potential violation of the law or corporate policy, and after proper internal investigation, the board determines in good faith that further action is not necessary, that decision is protected by the business judgment rule. In the above scenario there is an informed and conscious process, and as long as directors carry out the process in good faith, they likely have the protection of the business judgment rule. If, however, the board is alerted to a possible wrongdoing and fails to address the situation or consciously disregards it, there is no process and therefore the business judgment rule protection will not apply to protect the directors. The directors may instead face liability for failure to oversee and monitor. Accordingly, it appears that the duty of oversight may create a perceived incentive for directors to respond to potential indications of wrongdoing in order to gain the benefit of the business judgment rule.

The Investigation

Responses or investigations to these signs of possible violations can be carried out through in-house counsel or a company compliance department at the direction of the board or the board's independent audit committee or other investigative committee; however, such responses and investigations are best dealt with through consultation with independent, outside counsel. Internal employees are often ill-equipped to take on a crucial investigation because of time constraints and large work-loads. In-house counsel do not have unlimited time to devote to conducting investigations and instead are typically focused on managing transactions, litigation/pre-litigation matters, and managing the risks of the business while attempting to insert their own processes to streamline legal and business efficiencies. Due to these time constraints and lack of independence, it is possible that investigations may be compromised or not given the attention necessary for the directors to escape liability. However, if an investigation is determined to be for a claim relating to relatively small levels of liability or other minor compliance issues, it may be best conducted by in-house counsel for efficiency purposes, unless or until such matter unraveled into a more complex scenario.

The company and board of directors must balance benefits of control over the investigation with the need for the investigator to be independent in fact and appearance. While internal compliance or legal personnel may understand the business of the company better than outside counsel and may be more in-line with values and goals of the company executives or directors in charge of such investigation, utilizing internal employees may give the appearance that the investigation was conducted in a biased manner. Outside counsel would have a better chance of achieving a view of credibility and objectivity, would have fewer qualms with approaching management on an issue, and the matter would be perceived as taken more seriously by the company in the view of investors, government regulators or prosecutors, and the media. Furthermore, outside counsel may have more resources to devote to the investigation, the company would be better protected from potential wrong-doers being involved in the investigation, and outside counsel may better protect the attorney-client privilege by more aptly avoiding such advice or work-product being categorized as business advice (issues have arisen with the attorney-client privilege and work-product protection when investigations are conducted by in-house counsel or other employees of the subject company).

In addition, the company must also determine whether its regular outside counsel firm or special counsel should be utilized on such a matter. Regular counsel may be "tainted" in the sense that such a firm is closer to the business management

team and may have more vested in the matter, whereas appointing special outside counsel would strengthen the credibility of the company while decreasing any appearance of a conflict of interest and providing a special level of expertise.

In situations where corporations have used internal in-house counsel or investigators, a court may look less favorably on the application of the business judgment rule and corporate settlements. An independent corporate investigation demonstrates that the company is taking the possible violation seriously, and also ensures that the subsequent report and findings will be unbiased and accurate. Company personnel can potentially compromise the legitimacy and validity of any investigation because they are employed by the corporation. A relatively small initial investment in outside counsel can prevent colossal damage to a company in the future.

Utilizing Outside Counsel

In looking to outside counsel, it is important to consider a firm that has experience in internal audits and investigations. In addition to conducting investigations, the firm should also be able to counsel a corporation if a problem has already materialized. In such a transition from pre-litigation to litigation, a company that has already conducted an independent investigation by outside counsel would be better prepared in assessing the risk and liability of such claims and would be able to build its defense at an early stage. This is imperative to limit further liability and to maintain the corporation's current value and public image.

Conclusion

Directors should always keep in mind the possibility of oversight liability. While it is certainly not expected or demanded that directors be able to predict the future, directors still must implement compliance and monitoring programs within the corporation. Moreover, once implemented, directors must oversee such programs and look into possible law or corporate policy violations to which they are alerted. In the event that there is an impending violation, directors must, reasonably and in good faith, stop the wrongdoing from progressing. If a violation has already occurred, directors must fix the wrongdoing and add preventative measures to avoid reoccurrence. Although these steps are seemingly simple, it can be quite easy for a director to slip up and subsequently face liability. By retaining an outside firm to serve as independent counsel to aide in investigating allegations of wrongdoing, implementation, or oversight of programs, as well as to assist in damage control following an apparent violation, a board of directors further limits potential oversight liability for themselves and greater liability for the company. In adhering to these guidelines, directors invest the time and money that ultimately benefit not only them individually, but the entire corporation.

By investigating potential claims of fraud or other liability, directors may be best served by utilizing outside counsel to investigate and document the process and findings.

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Rogue Officers and Misled Auditors: Judicial Outcomes Vary

By Stuart L. Pachman

The following fact pattern is fairly classic. Sharp and Slick are respectively the CFO and vice president of finance for Market Corporation (MARC). MARC has enjoyed increasing sales and profits in recent years, but this year business has fallen off sharply. Sharp and Slick concoct a fraudulent scheme, perhaps with some customers, some vendors, or both, to improve MARC's numbers "just for this year." They represent as accurate financial statements containing false numbers to MARC's auditor, Pure, Young, and Naïve, CPAs (PYN). The auditor, unaware of the fraud, has no reason to doubt MARC's highly placed officers. The scheme is clever and well concealed. MARC receives an unqualified opinion from PYN. Because the true facts remain hidden from MARC's shareholders, creditors, and the public, the price of its shares does not decline, its relationship with its lender remains good, and additional credit is extended by suppliers. Sharp and Slick each receive a bonus, a salary boost, and are in line for promotion.

In the following two years as MARC's fortunes decline, Sharp and Slick continue the scheme. Eventually a member of PYN's auditing team discovers and discloses the fraud.

When the dust settles, MARC is a bankrupt memory, civil and criminal actions abound, creditors have been satisfied in whole or in part, and a trust (sometimes designated a committee) has been formed which, on behalf of the shareholders, takes an assignment of any claims MARC may possess. The trust, fixing its eye on PYN's "deep pockets," files a lawsuit asserting professional negligence, and claims that MARC incurred damages based on PYN's failure to uncover the fraud in year one. A second count asserts that not only was PYN negligent, but that it must also have been in collusion with Slick and Sharp.

Legal Issues; Policy Considerations

Because a corporation is an inanimate artificial person acting through its human agents, the knowledge and acts of those agents may be imputed to it. This rule of imputation is based on the law of agency: if the agent, the corporate officer or director, did something or knew something, then the corporation, the principal, may be charged with being aware of it. If Sharp's and Slick's wrongdoing were attributed to MARC, PYN would be able to move to dismiss the complaint on the basis of *in pari delicto*, a defense which generally bars one wrongdoer from recovering from another. *In re Citx Corporation, Inc.*, 448 F.3d 672 (3d Cir. 2006) at fn. 12. Thus, even had PYN been negligent (the allegation is assumed to be true on an application to dismiss at the pleading stage), it might escape the necessity of a trial, expensive in dollars and time lost, to defend its conduct.

When an agent is acting within the scope of his or her employment for the benefit of the corporation, it is reasonable to attribute the agent's knowledge and acts to the corporate principal. When the officer's wrongful acts are not taken *for* the corporation, but rather to take *from* the corporation for the officer's own benefit, the presumption dissolves and the imputation doctrine becomes subject to the "adverse interest exception." When that exception applies, the agent's knowledge is not imputed to the principal thus depriving the auditor of the *in pari delicto* defense at the pleading stage.

The legal issue is under what circumstances should the acts of the rogue officer not be imputed to the corporation. Courts struggle whether to limit the adverse interest exception solely to those situations where the corporation derives absolutely no benefit ("not even a peppercorn"), or to permit the exception to extend to situations where some degree of benefit arguably inured to the corporation. Often, even though the rogue officer is acting for his or her own interest, the corporation benefits to some degree. For example, when Sharp and Slick provided false numbers, in one sense they were acting for themselves in that each wanted the resulting bonus, salary boost, and promotion, but in another sense they were acting to give MARC the opportunity to recover from a bad year.

As we shall see, courts have dealt with this issue with varying results, and the outcome often depends on the answer to

the following question. As between (1) shareholders who were unaware of what the rogue agents were doing but who entrusted them to act, and (2) an auditor who relied and was misled, which should bear any loss resulting from the wrongdoing?

We turn to recent decisions in New Jersey, Pennsylvania, New York, and a federal court to see not only how different courts, but also different jurists sitting on those courts, have responded.

New Jersey

In *NCP Litigation Trust v. KPMG LLP*, 187 N.J. 353 (2006), the New Jersey Supreme Court decided that innocent plaintiff shareholders were entitled to a trial to determine (1) whether the misled auditor was negligent in performing its agreed duties and (2) the extent to which any negligence proximately contributed to any damage suffered by the corporation and through it, its shareholders. When stated in that benign fashion, the ruling is not remarkable. What commands attention is that the court reached its result by announcing a new "auditor's exception" to the imputation doctrine and treating the adverse interest exception liberally.

In *NCP*, it was clear that two corporate officers intentionally misrepresented the corporation's financial status to the independent auditing firm. A trust for the benefit of the corporation's shareholders charged that the accounting firm had failed to perform its audits in conformity with generally accepted auditing standards and generally accepted accounting principals, and failed to exercise professional care in the performance of the audit and preparation of the financial statements. The plaintiff claimed that had the auditor not been negligent, the auditor would have detected the fraud (two years before it did discover and disclose the fraud) and thus would have prevented the shareholders' losses. The trial judge imputed the knowledge of the officers' wrongdoing to the corporation and dismissed the action at the pleading stage, ruling that even if the auditor were negligent, it could not be sued unless it intentionally and materially participated in the fraud, a claim not alleged in the complaint.

The New Jersey Supreme Court majority did not agree. It found that the rationale for imputation in a simple principal-agent relationship breaks down in the context of a corporate audit where the allocation of risk and liability becomes more complicated. Thus it fashioned an "auditor's exception" to the imputation doctrine: by its alleged negligence in conducting the audit the misled auditor can be said to have contributed to the officers' wrongdoing, be barred from invoking the imputation doctrine, and lose the benefit of the *in pari delicto* defense at the pleading stage.

Although the court's majority did not distinguish between a fraud audit and a standard audit engagement, a deficiency emphasized by a dissenting justice, it said that the accounting firm had "an independent contractual obligation, at a level defined by its agreement with [the corporation], to detect the fraud, which it allegedly failed to do," and that an auditor can be expected to detect fraud that a reasonably prudent auditor, acting within the scope of its engagement, would uncover.

The court also rejected the principle that had been established in *Cenco Incorporated v. Seidman & Seidman*, 686 F.2d 447 (7th Cir. 1982), where the Seventh Circuit said that because shareholders are ultimately responsible for placing officers in a position to commit wrongdoing, shareholders should not be permitted to recover from accountants who were not complicit in the fraud. Instead the New Jersey court distinguished between shareholders who were aware, or who, through their positions in the corporation, should have been aware of the fraud, and those who were unaware and innocent. Because the first group should not be permitted to recover, any recovery awarded after a trial might be mitigated.

As to the adverse interest exception generally, the court found that inflation of revenues by corporate officers to enable the corporation to continue in business past the point of insolvency could not be considered a benefit to the corporation, and that even if the corporation had received some benefit from its officers' wrongdoing, the adverse interest exception should be applied liberally to avoid imputation. Any benefit to the corporation could be treated as another factor in apportioning damages.

Consequently, in New Jersey, whether the auditor actively participates in the corporate officer's wrongdoing or is simply misled, "innocent" shareholders have the right to attempt to prove at a trial that the auditor committed malpractice.

NCP was followed by *Thabault v. Chait*, 541 F.3d 512 (3d Cir. 2008), a case tried to a jury before a federal judge sitting in New Jersey. It was based on a claim for damages suffered by an insolvent insurance company as a result of the accountant's alleged negligence. The plaintiff, the Vermont insurance commissioner acting as the corporation's receiver, claimed that the auditor either knew or should have known at the time of its audit that the company was only marginally solvent, that the accountant failed to disclose the company's insolvency, and that instead the accountant negligently issued "unqualified and favorable audit opinions" prolonging the ability of the company to write new insurance policies which the insurance commissioner had to honor following the company's collapse. The court of appeals, citing *NCP*'s "auditor negligence" exception to imputation, affirmed the trial court's refusal to impute to the corporation the finding below that the chief officer had committed gross negligence and breach of fiduciary duty.

Whether the corporation itself has suffered compensable damage and thereby holds an assignable claim is another issue inherent in these cases. The Third Circuit found that the plaintiff had proved damages "under traditional negligence and malpractice principles," and that such traditional damages "do not become invalid merely because they have the effect of increasing a corporation's insolvency." Either a decrease in asset value or an increase in liabilities shown to have resulted from an accountant's negligence are damages for which the corporation may recover whether or not the corporation is insolvent or on the verge of insolvency.

Pennsylvania

Official Committee of Unsecured Creditors of Allegheny Health, Education and

Research Foundation v. PriceWaterhouseCoopers, LLP, 607 F.3d 346 (3rd Cir. 2010), involved a scheme designed by corporate agents to conceal how precarious the company's financial position was. The rogue officers knowingly misstated the company's finances to the auditor. In this case the plaintiff charged not only simply negligence, but also alleged that the auditor knowingly assisted the officers' "by issuing a 'clean' opinion" when the audits "should have brought [the] misstatements to light." The trial court imputed the wrongdoing officers' conduct to the company, applied the *in pari delicto* doctrine, and granted summary judgment to the auditor. It found the company "was at least as much at fault as" the auditor.

To determine Pennsylvania law, the court of appeals certified two questions to the Pennsylvania Supreme Court. The Pennsylvania court responded first by acknowledging the multiple levels of auditor review, and saying that the auditor's responsibility will depend on the terms of the retention. *Official Committee of Unsecured Creditors, etc. v. PriceWaterhouseCoopers, LLP*, 989 A.2d 313 (Pa. 2010). It rejected New Jersey's "auditor exception" to the imputation doctrine, ruling that even if the auditor were negligent, the corporate officers' wrongdoing could be imputed to the corporation so long as the auditor had dealt with the corporation in good faith. In allocating the risk, the court expressed the view that imputation creates an incentive for a corporation to choose its agents wisely.

As did the New Jersey court, the Pennsylvania court ruled that falsification of financial information, even though perhaps intended to benefit the corporation, cannot be regarded as a benefit to the corporation, and if the adverse interest exemption could be applied, the misled auditor's ability to invoke the imputation doctrine would be lost.

In any case, the auditor could not gain the benefit of the imputation doctrine if it were complicit in the wrongdoing.

Based on the opinion of the Pennsylvania Supreme Court, the Third Circuit remanded the case to the district court to determine (1) whether the auditor dealt in good faith with the corporation or colluded with the wrongdoing agents and (2) whether the adverse interest exception would apply even if there were no collusion.

New York

The philosophical question of which of two "innocent" parties should bear the loss created by a long gone rogue officer is illustrated in the majority and minority opinions that sharply divided New York's highest court in *Kirschner v. KPMG LLP*, 15 N.Y.3d 446 (Ct. App. 2010). The court was responding to questions certified to it from both the Second Circuit Court of Appeals and the Delaware Supreme Court. In one of the two cases it had been acknowledged that the wrongdoers were acting for the benefit of the corporation. In the other it was acknowledged that the auditor at worst was merely negligent and not in collusion with the wrongdoers. The basic issue was whether the adverse interest exception should be applied strictly or liberally.

The four judge majority began by taking note of the facts of business life. Preparation and approval of financial statements is part of the normal everyday activity of corporate management; it is within the scope of the authority of appropriate corporate officers. Further, the interests of corporate officers are often aligned with those of the corporation; the value of perquisites such as stock options and bonuses depends upon the corporation's health and survival. The majority also recognized that corporate agents' wrongdoing often provides the corporation a short-term benefit, allowing the business to survive, and enabling it to attract investors and customers that raise funds for corporate purposes. The fact that the corporation may eventually file for bankruptcy does not mean that the wrongful acts, at the time they were committed, were not for the benefit of the corporation.

The majority ruled that New York should continue to apply the adverse interest exception strictly to those cases where the agent has totally abandoned the corporation's interest and is acting entirely for his or her own benefit. To apply it more liberally would render the adverse interest exception meaningless. Moreover, a narrow application avoids the court having to deal with the troublesome ambiguity inherent where both the corporation and its officer benefit to one degree or another. In the majority's view, the principals of the corporation, rather than the third-party auditor, are "best-suited to police their chosen agents."

According to the three judge dissenting opinion, the majority has created a per se rule that bars actions in New York by corporations against outside professionals when corporate agents have engaged in wrongdoing, and permits imputation even when the accountant actively colludes with the corrupt corporate insider.

On January 3, 2011, the Delaware Supreme Court, based on the New York court's opinion, affirmed the Delaware Court of Chancery's dismissal of the case before it.

Federal Law

Misled accountants fare well under federal securities laws when the issue is limited to an allegedly negligent audit that may have aided and abetted wrongdoing. In *Public Employees' Retirement Association of Colorado v. Deloitte & Touche LLP*, 551 F.3d 305 (4th Cir. 2009), corporate personnel perpetrated frauds that resulted in an overstatement of earnings on the corporation's financial reports. The accounting firm was at first deceived, but ultimately uncovered the fraud. The Fourth Circuit said that to hold the accounting firm liable under federal law there must be a strong inference that the accountants acted with an intent to deceive, manipulate, or defraud. The claim could be dismissed at the pleading stage if, from the pleadings, the inference that the accountant was misled and acted innocently, even if somewhat negligently, is greater than the inference that the accountant acted with the required scienter. A federal judge sitting in New Jersey had applied similar reasoning to the NCP facts when, prior to the state court action, the NCP shareholder trust had sued KPMG in federal court alleging securities fraud violations.

Conclusion

Liability for intentional wrongdoing, as when an auditor actively participates in

collusion with the rogue officers, does not offend. It is no easy task, however, to ascertain the point at which innocent justifiable reliance crosses into actionable negligence. One cannot deny the court's statements in *In re Sunpoint Securities, Inc.*, 377 B.R. 513, 555 (Bankr. E.D. Tex. 2007): "The idea that fraud by a company's management is not reasonably foreseeable to an auditor is, of course, preposterous. Auditors are hired to provide reasonable assurance that a client's financial statements are free from material misstatement, whether occasioned by error or fraud." Nonetheless, even the New Jersey court allowed that auditors cannot be expected to catch every instance of corporate fraud. Few of us are infallible, and even the most careful auditor can be hoodwinked. In the *Deloitte* case, the Fourth Circuit observed: "It is not an accountant's fault if its client actively conspires with others in order to deprive the accountant of accurate information about the client's finances." Nor is it unreasonable to grant auditors the presumption of professional integrity in performing their engagements. As the New York majority concluded, tilting the scales against auditors will not result in greater incentive not to be negligent. It is also fair to say, however, that tilting the scales against shareholders will not result in their being more circumspect in their choice of managers—if indeed shareholders in large corporations have a meaningful choice.

By essentially requiring a trial on an allegation of auditor negligence, the New Jersey decision appears extreme. Whether the bent of other courts will be toward the shareholders or the auditor will turn on whether shareholders' are able to allege specific red flag transactions as a basis for the negligence claim and how the pleadings depict the comparative innocence of the parties.

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Keeping Current: Securities

SEC Adopts Final Rules Implementing Dodd-Frank "Say on Pay"

By Laura G. Thatcher

On January 25, 2011, in a 3–2 vote, the Securities and Exchange Commission adopted final rules under the Securities Exchange Act of 1934 to implement section 951 of the Dodd-Frank Wall Street Reform and Consumer Protection Act relating to newly required shareholder advisory votes on executive compensation (the "Say on Pay" vote) and the frequency of Say on Pay votes (the "Say on Frequency" vote). The final rules largely followed the commission's proposed rules issued on October 18, 2010, with a few notable exceptions.

- Say on Pay Vote: Final Rule 14a-21(a) requires companies, at least once every three years, to provide a separate shareholder advisory vote in proxy statements to approve the compensation of executives, as disclosed in the proxy statement.
- Say on Frequency Vote: Under final Rule 14a-21(b) companies are required, at least once every six years, to give shareholders an advisory vote as to whether the company's Say on Pay vote will occur every one, two, or three years.

Key Points

Key points about the Say on Pay and Say on Frequency votes include the following, all of which are generally consistent with the commission's proposed rules:

- No specific language is required for the Say on Pay or Say on Frequency proposals. Some companies have included supporting statements in the proposals while others have taken a more bare bones approach.
- Both the Say on Pay and Say on Frequency votes are advisory only and, as such, are not binding on the company or its board of directors.
- The compensation of directors is not subject to the Say on Pay vote.
- The result of the votes must be disclosed on a Form 8-K within four business days after the shareholders meeting.
- Companies are required to address in the next compensation discussion and analysis (CD&A) whether and how they have considered the most recent Say on Pay vote and how that consideration has affected their compensation decisions and policies.
- Brokers are not permitted to vote uninstructed shares in a Say on Pay or Say on Frequency proposal.
- Institutional investment managers are required to file with the commission their record of voting on Say on Pay and Say on Frequency proposals, including whether the vote was for or against management's recommendation.

Differences of the Final Rules

- Smaller reporting companies (public float of less than $75 million) will enjoy a two-year temporary exemption from the need to hold a Say on Pay or Say on Frequency vote. This exemption cuts approximately in half the number of companies required to hold the votes in 2011.
- While no specific language is required for the Say on Pay resolution, the proposal must specify that the vote is on compensation paid to the company's named executive officers. Companies are free to solicit shareholder votes on a range of additional compensation matters to obtain more specific feedback on the company's compensation programs and policies.
- No later than 150 days after the meeting at which a Say on Frequency vote is held, a company must disclose in a Form 8-K its decision on how frequently the company will hold Say on Pay votes in light of the Say on Frequency vote. The proposed rules had required that this information be filed in the Form 10-Q or 10-K for the quarter in which the vote was held. In response to public comments, the commission provided more time for a company to consider the results of the vote, including consultation with shareholders, before making a decision as to its policy on the frequency of future Say on Pay votes.
- If any one of the three Say on Pay frequency alternatives (i.e., every one, two, or three years) receives a *majority* of the votes cast, a company that adopts

a policy that is consistent with such majority-approved schedule may exclude any shareholder proposal that relates to future Say on Pay or Say on Frequency votes. The proposed rules had provided this relief for companies going along with the frequency alternative that received a *plurality* of the votes cast. The commission acknowledged the possibility that no one frequency alternative would receive majority support, in which case, the company would not be able to exclude subsequent shareholder proposals regarding say on pay, even if it adopted the frequency having the support of a plurality of the votes cast.

Observations

1. While more than a few companies have submitted their executive pay programs to shareholder voting on a voluntary basis, 2011 is the first year of full-scale mandatory Say on Pay in the United States. All eyes were on the voting results from several annual meetings held during the week of January 24, including Monsanto, Johnson Controls, Costco Wholesale, and Visa. These companies, like many others, took special care to make sure their compensation disclosures delivered a clear presentation, making it as easy as possible for shareholders to understand and evaluate the compensation paid to their leadership teams.

2. Notably, the first month of meetings held under the mandatory Say on Pay regime saw at least two failures: Say on Pay votes at Jacobs Engineering Group and Beazer Homes USA received 45.5 percent and 46.1 percent approval, respectively. If this percentage failure rate holds, we would see far more Say on Pay failures in 2011 than the three that failed during 2010. However, it is probably too early to extrapolate a trend based on the first month of meetings.

3. A company's board is not required to make any recommendation on the Say on Frequency proposal. If it does, there are several factors to consider, including what its shareholders are likely to prefer:

   - The 2011 voting guidelines of the leading proxy advisor Institutional Shareholder Services (ISS) indicate that it will uniformly recommend in favor of *annual* Say on Pay votes.
   - On January 31, a group of 39 institutional investors including Vanguard, State Street, Fidelity, and Putnam also endorsed an annual Say on Pay vote, but at least a few (including United Brotherhood of Carpenters and Joiners) have signaled they favor a less frequent vote, presumably to spread out the burden of evaluating thousands of proxy statements.

4. Of the approximately 250 companies that had filed proxy statements through February 18, 2011, containing Say on Frequency proposals, a majority (about 57 percent) recommended a triennial Say on Pay, and approximately 32 percent recommended an annual Say on Pay vote. The first month of meetings held under the new rules yielded noteworthy results.

   - First to report, Monsanto's shareholders approved an annual Say on Pay, against the board-recommended triennial schedule. Monsanto's board went along with the shareholders' preference of an annual vote.
   - Monsanto has not been alone. Based on reported voting results through mid-February, 54 percent of management recommendations for a triennial or biennial frequency vote have been bucked by shareholders in favor of an annual vote. Those companies whose multi-year recommendations have held tend to be smaller cap companies or have a significant block of "friendly" shareholdings.
   - The show of overwhelming shareholder support for annual Say on Pay is likely to reverse the early trend of management recommendations for a triennial approach.

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Keeping Current:

Hart-Scott-Rodino Thresholds Revised, Effective February 24

By Francis Fryscak and Howard Morse

The Federal Trade Commission (FTC) has set the effective date for its recently announced revisions to the Hart-Scott-Rodino Act (HSR) thresholds as February 24, 2011.

The HSR jurisdictional thresholds, along with related thresholds applicable to the three filing fee tiers and certain exemptions, are adjusted annually by the FTC, based on changes in gross national product (GNP). This year the thresholds have increased modestly—going up roughly 4 percent—compared to last year's first ever threshold decrease.

Once the new thresholds take effect, the "size of transaction" test will reach those transactions in which the value of the voting securities (or assets) to be held as a result of the acquisition will exceed $66 million (compared to the current $63.4 million threshold). The "size-of-person" test will require, in most cases, that at least one party (together with affiliates under common control) has total assets or annual sales of at least $131.9 million, and another party (together with affiliates under common control) has total assets or annual sales of at least $13.2 million. Those transactions which result in holdings valued in excess of $263.8 million (rather than the currently applicable $253.7 million) will satisfy the larger size of transaction test, at which a transaction is reportable, irrespective of the "size of person" test.

The key adjustments to the jurisdictional tests, notification levels, and filing fee tiers are set forth in the chart below.

BASE HSR THRESHOLDS	CURRENT THRESHOLDS	NEW THRESHOLDS (Effective 2/24/11)
$50 million "size of transaction" test	$63.4 million	$66 million
$10 million "size of person" test	$12.7 million	$13.2 million
$100 million "size of person" test	$126.9 million	$131.9 million
$200 million "size of transaction" test (renders size of person test inapplicable)	$253.7 million	$263.8 million
$50 million notification threshold	$63.4 million	$66 million
$100 million notification threshold	$126.9 million	$131.9 million
$500 million notification threshold	$634.4 million	$659.5 million
25% of stock worth $1 billion notification threshold	25% of stock (if worth at least $1,268.7 million)	25% of stock (if worth at least $1,319 million)
50% (if over $50 million) notification threshold	50% (if over $63.4 million)	50% (if over $66 million)
Level at which $45,000 filing fee is required	Value of the acquisition is greater than $63.4 million but less than $126.9 million	Value of the acquisition is greater than $66 million but less than $131.9 million

BASE HSR THRESHOLDS	CURRENT THRESHOLDS	NEW THRESHOLDS (Effective 2/24/11)
Level at which the $45,000 filing fee increases to a $125,000 filing fee	Value of the acquisition is at least $126.9 million but less than $634.4 million	Value of the acquisition is at least $131.9 million but less than $659.5 million
Level at which the $125,000 filing fee increases to a $280,000 filing fee—the highest HSR filing fee tier	Value of the acquisition reaches or exceeds $634.4 million	Value of the acquisition reaches or exceeds $659.5 million
Exemption thresholds applicable to acquisitions of voting securities or assets of foreign issuers; indirect acquisitions of exempt assets	Level ties to a $63.4 million threshold	Level ties to a $66 million threshold

Failure to file an HSR Notification and Report Form is still subject to a statutory penalty of up to $16,000 per day of noncompliance.

The FTC, at the same time, also adjusted the thresholds applicable for section 8 of the Clayton Act, which trigger prohibitions on interlocking directorates. The commission also revises those thresholds annually, based on the change in the level of gross national product. Those changes went effective immediately upon their publication in the Federal Register on January 25.

Section 8 prohibits, with certain exceptions, one person from serving as a director or officer of two competing corporations if two thresholds are met. Competitor corporations are now covered by section 8 if each one has capital, surplus, and undivided profits aggregating more than $26,867,000, with the exception that no corporation is covered if the competitive sales of either corporation are less than $2,686,700.

Be aware that the HSR thresholds are only one part of the analysis to determine whether an HSR filing will be required, and the analysis relating to interlocking directorates under section 8 of the Clayton Act turns on numerous complex factors.

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Keeping Current: Jurisdiction

Supreme Court Considers Foreign Manufacturer's Challenge on Jurisdiction

By Kelly Wilkins MacHenry

The United States Supreme Court is considering a fundamental issue for businesses whose products are sold in the United States: where can those businesses be sued? That is the central question in a product liability case that could either reinforce prior limits on where and if a foreign corporation may be sued in the United States, or could radically change the rules due to increased globalization of business. The U.S. Supreme Court has not taken a case focusing on such issues since 1987, nearly a quarter century ago. Through its upcoming opinions on this case and another that raises similar issues, the Supreme Court is likely to clarify this area of law. Regardless of the outcome, the decisions could have dramatic effects on businesses that sell products in or into the United States.

The legal interpretation at issue is "personal jurisdiction," which simply means a court's power over a particular defendant. More precisely, at issue in this case is "specific jurisdiction," meaning a claim that is based on the defendant's contacts with that specific state.

Consider the facts from the manufacturer's perspective. J. McIntyre Machinery, Ltd. (J. McIntyre) was a British corporation based in England. It manufactured heavy equipment used in the scrap metal industry. The machine at issue cut scrap metal into pieces. Curcio Scrap Metal, Inc. was a New Jersey company that bought one of the machines for its recycling business. Curcio Scrap Metal ordered the machine in 1995 from J. McIntyre's exclusive distributor in the United States. The distributor was a distinct Ohio corporation. J. McIntyre manufactured the machine in England and shipped it from England to the distributor in Ohio. That was the last direct connection that J. McIntyre had with that machine. J. McIntyre contended that reliable evidence was that only one of this type of its metal-shearing machines (this particular one) had ever been sold by the distributor into New Jersey.

Now consider the events from Mr. Nicastro's perspective. Robert Nicastro lived in New Jersey and worked for Curcio Scrap Metal for many years. On October 11, 2001, he was using the machine when his hand got caught in it, and four of his fingers were cut off by the machine. He and his wife later sued J. McIntyre in New Jersey state court. They asserted product liability claims, alleging the machine lacked adequate safety protections and was defectively designed. Nicastro was unable to recover against the Ohio distributor, because it went bankrupt and dissolved before he filed suit. Nicastro could not sue his employer because he was barred from doing so by worker's compensation laws. Nicastro had no other solvent defendant for his product liability claims other than J. McIntyre.

The New Jersey trial court dismissed Nicastro's case, finding there was no personal jurisdiction over J. McIntyre there because it did not have sufficient contacts with New Jersey. The appellate division disagreed and reversed, and the Supreme Court of New Jersey affirmed the appellate division's decision. The New Jersey Supreme Court's decision began, "Today, all the world is a market" and found that in the new global marketplace, the established standards for jurisdiction were "outmoded" and no longer applied. It rejected the ideas that J. McIntyre must have had "minimum contacts" with and "purposeful availment" of the state of New Jersey in order to be sued there. Instead, the New Jersey Supreme Court held that J. McIntyre knew or should have known that its distribution scheme could make its machines available to consumers in New Jersey. J. McIntyre appealed that decision to the United States Supreme Court, which accepted the case.

In its challenge at the U.S. Supreme Court, J. McIntyre argued that finding that it could be sued in New Jersey would "radically revise the test for personal jurisdiction over a foreign manufacturer." J. McIntyre contended that personal jurisdiction rests not on a consumer's activity or where a product ultimately ends up, but rather on the quality of the defendant's activities directed toward the state. It argued that the theme of a global marketplace had not been explored and was not supported by the evidence. It maintained that the basic methods of selling and transporting products across the world are essentially

the same as in past decades—over air, sea, land, and road. It asserted that the legislative and executive branches, not the courts, should be those to act to change the laws about jurisdiction.

Nicastro contended that J. McIntyre had the necessary minimum contacts with New Jersey. He maintained that J. McIntyre purposefully marketed its machine nationwide and put it into a distribution scheme for sales throughout the United States. He argued that J. McIntyre and its distributor worked together to promote and sell J. McIntyre's products in the United States.

During argument at the Supreme Court, the justices expressed concern about the policy problem of potentially subjecting small businesses and those in developing countries to suit in all 50 states where laws vary. They questioned about what constituted sufficient knowledge of the distribution scheme by the manufacturer and what was purposeful conduct toward a state. The justices were very interested in how manufacturers' websites or Internet communications could affect the analysis of jurisdiction.

If the Supreme Court upholds jurisdiction over J. McIntyre in this case, it could dramatically change how, and perhaps even whether, foreign companies do business in the United States. It would likely increase the prospect of plaintiffs bringing suits in any state or court in the country that they believe to be most favorable to them. It would probably change the way foreign companies advertise (including on the Internet), as well as how they deal with distributors and potential buyers. A decision in either direction by the Court could create serious economic challenges, particularly for smaller companies, on the one hand, or for injured plaintiffs, on the other.

The latest opinion from the Supreme Court directly on the same issue was decided in 1987. *Asahi Metal Industry Co. v. Superior Court*, 480 U.S. 102 (1987), related to a tire valve made by a Taiwanese company, and a claim between the valve supplier and the tire manufacturer. The Supreme Court agreed on the outcome and found there was no jurisdiction over the supplier. However, the Court was divided on the theory that should be applied, and two opinions were issued that split the Court and launched divergent views. The Supreme Court likely intends in its forthcoming decision in *J. McIntyre* to clarify and update this area of law.

Another product liability case with a similar central issue of general jurisdiction (*Goodyear Luxembourg Tires v. Brown*) is also being considered by the Court this term. The Supreme Court heard argument on *Goodyear* and *J. McIntyre* on January 11, 2011, and may issue its opinions at any time.

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