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A Checklist for Drafting an International Arbitration Clause

By Eric S. Sherby

Tried-and-true "plays" for the lawyer who is called upon to craft an arbitration clause late in the negotiating process.

Books have been written advising how to draft international arbitration clauses, and the websites of several large law firms provide "how-to" advice on drafting such clauses. Recently the International Bar Association got into the act by issuing its own guideline.

Undoubtedly the authors of those books and how-to sites are *preeminently qualified* to draft the most comprehensive and detailed international arbitration clauses known to the legal profession.

Yet none of those "how-to" works includes a chapter on the hardest part of the drafting process—convincing the transactional lawyers to involve the international arbitration specialist in the deal early enough for the specialist to get up to speed and be able to craft the most appropriate clause for the deal.

Rather, in many cases, the litigator or arbitration specialist receives an 11th-hour e-mail or phone call from a transactional lawyer, along the lines of "please send me your standard arbitration clause for an international transaction." At that late stage, there is no time for any lawyer involved to hit the "how-to" books.

Any lawyer (even an international arbitration specialist) who receives such an 11th-hour request is like the football coach who has a playbook full of different plays to be executed at various stages of the game—but who knows that, when there are only two minutes left to put points on the board, he has no choice but to go with a limited number of tried-and-true plays.

Put slightly differently, sometimes a lawyer has no choice but to conclude that there is not enough time left on the clock to ask all the questions that might have been asked had the international arbitration specialist been consulted earlier in the process.

This article outlines the tried-andtrue plays for the lawyer who, late in the drafting process, is called upon to craft an arbitration clause for an international transaction.

But before addressing each of the elements of a good international arbitration clause, a few words about the overriding issue in drafting any dispute resolution (not just arbitration) clause: Who is likely to sue whom? and Why arbitrate?

To Sue or to Be Sued—That Is the Question

At the time of contracting, there is never certainty on that issue. Nonetheless, probabilities help answer this question. For example, in the typical international distribution arrangement (or licensing arrangement), a terminated distributor (or licensee) is more likely to sue the manufacturer/licensor than vice versa. (Yes, there are manufacturers/licensors who sue former distributors for nonpayment of invoices or for wrongful disclosure of trade secrets, but those are the exception.)

Similarly, there are certain types of service providers that regularly work on a commission-only basis. (Examples include sales agents, finders, and brokers.) Those service providers generally get paid only after they have provided their services. As a result, it is more likely that they will have to sue for their commissions than it is

that they would be sued. (Again, claims for breach of fiduciary duty are the exception.)

Under what circumstances is it very difficult, at the contracting stage, to anticipate which party is more likely to sue? One example is a joint venture agreement because the two sides usually bring something of comparable value to the deal. Also, in contrast to the typical manufacturer/distributor (or licensor/licensee) situation, both parties in a joint venture usually have similar expectations as to the relationship (if any) after the conclusion of the joint venture, and they draft accordingly.

The conventional wisdom is that the lawyer who represents the party that is more likely to sue wants any arbitration to be easy and quick.

In contrast, the lawyer who represents the party more likely to be sued down the road does not want an arbitration to be commenced at the drop of a hat. More often than not, the lawyer who represents the likely defendant wants the potential plaintiff to be forced to think twice about commencing an arbitration.

These competing interests arise in deciding almost all of the subissues, discussed below, in drafting an international arbitration clause.

Do We Really Want Arbitration?

Not everyone likes arbitration. The general lack of appellate review, coupled with the cost of paying arbitrators, leaves no shortage of experienced lawyers who question whether arbitration is better than litigating in court.

Nonetheless, in the international context, most experienced practitioners agree that arbitration has one great advantage

over litigation in court—there is a multinational treaty, the Convention on the Recognition and Enforcement of Foreign Arbitral Awards (known as the New York Convention, see http://www.uncitral.org/uncitral/en/uncitral_texts/arbitration/NYConvention.html), which (as its name suggests) governs the recognition and enforcement of foreign arbitral awards. Approximately 140 nations are signatories to the New York Convention.

In contrast, the United States is not (yet) a party to any multilateral treaty that governs the enforceability of court judgments. (The Hague Convention on Choice of Court Agreements, which was signed by the United States in January 2009, deals only in part with the recognition of foreign judgments, and there are only a few signatories to that convention.)

Therefore, as a practical matter, there is often greater doubt as to the enforceability of a court judgment than there is as to the enforceability of an arbitral award; ergo, the attraction of arbitration in the international field. (The extent to which some signatory countries, in particular in Europe, recognize exceptions to the New York Convention's stay requirement is beyond the scope of this article.)

BLINC LLC

No, it's not a company that makes eye care products. It's a mnemonic device designed to enable you to remember a checklist for quickly drafting an international arbitration clause: Broad, Law, Institutional, Number, Costs, Location Language, and Carve-out.

Broad: Your arbitration clause should be broad, clear, and unambiguous. Although unclear arbitration clauses are a litigator's delight (because they generate legal fees), clients, understandably, hate them.

Unclear arbitration clauses plant the seeds for multiple legal proceedings, as one party tries to have the dispute adjudicated in an arbitration, while the other party goes to court, perhaps seeking to enjoin (or partially enjoin) the arbitration.

The lawyer who drafts an unclear arbitration clause is justifiably asked by his clients to explain how he got them into such a mess. After all, one of the reasons the client agreed to arbitration in the first place was to get an efficient resolution, and multiple proceedings—especially when one party is litigating abroad—are never

efficient.

The best way to avoid an unclear arbitration clause is to start with the traditional phrase:

... any and all disputes or claims arising under, concerning, or relating to this agreement, its interpretation, its validity (including, but not limited to, any claim that all or any part of this agreement is void or voidable), its termination, or the subject matter hereof will be resolved by confidential and binding arbitration . . .

Despite the clarity of the broad clause quoted above (and even though it has a long history of use), for many international transactions, that clause is not good enough. Take, for example, the typical agreement between a manufacturer in Country A and its distributor in Country B. Not only should counsel for the manufacturer be concerned with possible claims brought by the distributor against the manufacturer in Country B, but she also should be concerned with possible claims brought by customers in Country B against the distributor. Why? Because it is not uncommon for a distributor to be sued in connection with the products that it markets, and when that happens, the distributor often asserts a third-party claim against the foreign manufacturer, in court.

Counsel for the manufacturer (in Country A) does only half a job if she ignores the possible assertion of a third-party claim in Country B arising from a dispute between the distributor and its customer.

Therefore, when representing a manufacturer (or licensor) in a contract with a foreign distributor (or licensee), our law firm regularly adds a definition of "claim" that expressly includes third-party claims. As a result, the broad clause (from above) would be modified to read:

... any and all disputes or claims (*including*, *but not limited to, third-party claims*) arising under, concerning, or relating to this agreement, its interpretation, its validity (including, but not limited to, any claim that all or any part of this agreement is void or voidable), its termination, or the subject matter hereof will be resolved by confidential and binding arbitration . . .

Federal courts have held that, where a third-party claim is clearly covered by

an arbitration clause, the clause will be enforced notwithstanding any argument that it would be "inefficient" to have the third-party claim proceed independent of the main litigation. See, e.g., Acevedo Maldonado v. PPG Industries, Inc., 514 F.2d 614 (1st Cir. 1975); Schulman Investment Co. v. Olin Corp., 458 F. Supp. 186 (D.C.N.Y. 1978).

It is possible that, notwithstanding such language in an arbitration clause, a non-U.S. distributor or licensee will assert a third-party claim against the manufacturer (licensor) in a non-U.S. court. If that happens, and if a judgment were to be rendered against the American company, the language quoted above should be sufficient, under section 4(b)(5) of the Uniform Foreign Money Judgments Recognition Act, to enable the American company to oppose enforcement of such a judgment (at least in those states that have adopted the uniform act).

Law: It is surprising how many international agreements—including those that contain an arbitration clause—do not contain a choice-of-law clause. One can only assume that such omission stems from the assumption by the draftsmen that the arbitrator/institution would have no difficulty in deciding what law should apply.

Make the arbitrator's life easier, save his/her time, and save your client money. Include a choice-of-law clause.

Institutional: When parties agree to a specific arbitrator whose appointment is not connected to any arbitral institution, such arbitration is referred to as "ad hoc" arbitration. Very few international arbitration specialists recommend ad hoc arbitration; they almost always recommend institutional arbitration. The main reasons for that preference are accountability and enforceability.

Arbitral institutions (at least the major ones) oversee the work of the arbitrator—to some extent. Also, the conventional wisdom is that it is easier to enforce an award given by an arbitral institution than one given by an ad hoc arbitrator.

But there is a price for that increased accountability and superior chance of enforcement. Arbitral institutions have administrative staff and almost always some professional legal staff.

Nevertheless (as noted above), few international arbitration specialists recommend *ad hoc* arbitration.

But with so many arbitration institu-

Two Institutions Can Be Better Than One

In an article titled "A Different Type of International Arbitration Clause" (published by the ABA's International Law News (Vol. 34, Issue1, Winter 2005 edition), http://www.abanet.org/abanet/common/login/securedarea.cfm?areaType=premi um&role=ic&url=/intlaw/mo/premium-ic/ILN_34-1.pdf available at http://www.sherby.co.il/ILNpublished.pdf), I outlined the use of an arbitration clause that empowers two arbitral institutions in the same city. Essentially the two-institution clause mandates the city in which the arbitration will take place, but it allows the initiating party to choose one of two designated arbitral institutions.

Such a clause is useful when it is likely that the parties could agree on the arbitral situs but not on the institution.

The two-institution clause is rarely needed when the parties are able to agree on a third-party country as the situs for the arbitration

tions throughout the world, how is a lawyer to decide?

First, get familiar with at least some of the major institutions.

The leading international institution is the International Chamber of Commerce (the ICC). Not far behind (at least from an American perspective) is the American Arbitration Association (the AAA), which maintains multiple sets of domestic rules and a set of international rules. In the same tier as the ICC and the AAA is the World Intellectual Property Organization (obviously not for a dispute in, for example, the construction industry).

In connection with sole-arbitrator cases, the rules of each of the ICC, the AAA (international rules), and WIPO include a general preference to appoint an arbitrator from a third-party (neutral) country.

Most international practitioners consider the London Court of International Arbitration to be in a league not far behind the ICC, the AAA, and WIPO. In the United

States, in recent years, Judicial Arbitration and Mediation Services (JAMS) has made significant headway in the international field.

Beyond those institutions mentioned above, there are numerous national and regional arbitration institutions.

If your clients never have dealings in the Far East, then you likely will not need to be familiar with institutions such as the Chinese European Arbitration Centre or the Hong Kong International Arbitration Centre. However, if your clients do have dealings in the Far East, you should be familiar with those institutions.

There are also many industry-specific institutions.

When representing an American company in an international transaction, most American lawyers believe that it is safe to propose the AAA (through its International Rules), with the ICC being a fallback if the non-U.S. company objects to the AAA. It is difficult to argue with that conventional wisdom.

Number: Multi-arbitrator cases are costly—very costly. They take longer than cases heard by a sole arbitrator because arbitrators are busy people, and getting three of them in the same room, at the same time, takes time and effort. And, of course, having three meters running for almost every substantive action in the case greatly increases the expense.

The conventional wisdom is that the party likely to be sued is more inclined to insist on three arbitrators.

In the international context, the issue of the number of arbitrators can be tricky. Under the rules of the ICC and the International Rules of the AAA, the general default rule (albeit a flexible one) is that a *sole* arbitrator will be appointed. Yet under the rules of the United Nations Commission on International Trade Law (UNCITRAL), the default number of arbitrators is three. Many arbitral institutions incorporate the UNCITRAL rules as their default rules for international cases. Therefore, there is a risk in "leaving to the arbitral institution" to decide the number of arbitrators.

If you do not want a three-arbitrator arbitration, make sure that your arbitration clause expressly calls for the appointment of a sole arbitrator.

Costs: To an American litigant, costshifting in arbitration (or litigation) is not necessarily expected. Yet to most of the rest of the world, cost-shifting is expected. Not surprisingly, the rules of the ICC, the LCIA, the AAA, and WIPO provide generally that the arbitrator has significant discretion in awarding costs, including attorney fees.

Almost universally, the parties are free to address the cost issue in the arbitration agreement.

In my experience, the in-house lawyer of a corporate client can offer valuable insight on the issue of cost-shifting (in both the international context and the domestic context). The in-house attorney is likely to have a sense as to how litigation-averse his company is. The in-house lawyer might tell outside counsel that, if a (reasonably) valid claim is asserted against his company, it will look seriously at settling. In-house counsel also might tell outside counsel that his company will not commence an arbitration unless its case is strong. The lawyer at a company that considers itself litigation-averse will be more likely to recommend to his company to agree to a clause that provides for the prevailing party to be entitled to its costs.

The opposite also might be true. There are in-house lawyers who will tell outside counsel that their CEOs (and CFOs) can be unreasonable in assessing the settlement value of a dispute. Those in-house lawyers are less likely to request (or consent to) a cost-shifting clause.

The bottom line as to cost-shifting is that, even when there are only two minutes left to sign the agreement, outside counsel should generally consult with in-house counsel.

Location (sometimes called "situs"): Location is usually the most contentious issue in negotiating an international arbitration clause. The location is usually a function of bargaining power: the party with the greater bargaining power will insist that the situs of the arbitration be its home country. When the bargaining power is more or less equal, the parties often select a third-party country.

But before agreeing upon any situs for an arbitration, you should be sure that the country chosen is a signatory to the New York Convention. Otherwise, enforcement of an arbitral award will be in doubt.

Many lawyers assume that an arbitral institution will treat a choice-of-law clause as an implied agreement as to situs (in other words, that a clause calling for application of California law (for example) will

be construed as the parties' consent that California be the situs of any arbitration). That is an erroneous assumption. Arbitral institutions (such as the ICC and WIPO) may take various factors into account—not all of which can be identified at the time of contracting.

The issue of location/situs is too important to leave to doubt. Address it specifically in your arbitration clause.

Language: The major arbitral institutions will defer to the parties' pre-dispute agreement, in the arbitration clause, that the language for the conduct of the arbitration be English. However, if the parties are from countries where the official languages differ, absent the parties' agreement, all bets are off as to the language for conducting the arbitration.

Do not assume that the arbitral institution will naturally choose the language that your client prefers. Include in the arbitration clause the language that your client wants for the conduct of the arbitration.

Carve-out: A carve-out is a clause that excludes certain types of proceedings from the scope of the arbitration clause. The primary purpose of a carve-out is to ensure that applications for equitable relief—such as for an injunction or an order to attach assets—can be heard by a court wherever it might be necessary to take legal action against the defendant.

A carve-out is usually placed at the beginning of the arbitration clause:

Except with respect to motions or applications for equitable relief, any and all disputes or claims . . .

In the United States, the existence of an arbitration clause is generally not an obstacle to having a court grant equitable relief—even when the arbitration agreement is silent as to the issue of equitable relief. See, e.g., Faiveley Transport Malmo AB v. Wabtec Corp., 559 F.3d 110, 116 (2d Cir. 2009); Roso-Lino Beverage Distributors, Inc. v. Coca-Cola Bottling Co., 749 F.2d 124 (2d Cir.1984) (per curiam). Therefore, carve-outs are usually unnecessary in arbitration agreements in the domestic context.

However, you never know in what country your client will need to file a motion for an injunction to prevent a contracting party from misusing confidential information or infringing intellectual property.

The last thing you want to hear is that the courts of the foreign country refuse to consider your client's application for equitable relief because of the arbitration clause that you drafted. Therefore, a carveout is a must in almost any arbitration clause in an international agreement.

What about using the suggested or model arbitration clause of an arbitral institution? I have never seen a suggested clause of an institution that (1) contains a carve-out for equitable relief or (2) sets forth a definition of "claim" to include third-party claims. Also, the suggested clause rarely deals (expressly) with cost-shifting—perhaps because it is in the interest of the arbitral institutions for the contracting parties not to focus on the cost of an arbitration when they are drafting contracts.

For these reasons, I almost never find the model clause to be sufficient.

Eric S. Sherby specializes in international litigation and arbitration at the Israeli law firm that he founded in 2004, Sherby & Co., Advs.

Additional Resources

For other materials related to this topic, please refer to the following.

ABA Web Store

The ABA Web Store offers the following publication on this topic:

Commercial Arbitration at Its Best: Successful Strategies for Business Users

Edited by Thomas Stipanowich and Peter H. Kaskell

This book is arranged in a convenient question and answer format, and is logically organized according to the chronology of the dispute resolution process. Each chapter covers a key area of the arbitration process and addresses the most important issues that parties using or contemplating arbitration must address. A final chapter is devoted to the special concerns of international arbitration.

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M&A Under China's Anti-Monopoly Law

Emerging Patterns By Yee Wah Chin

China's Anti-Monopoly Law is becoming a major hurdle for larger cross-border transactions.

China's Anti-Monopoly Law (AML) became effective on August 1, 2008, following 13 years of drafting. Since then, businesses and lawyers with interests in China have closely followed every development. While there have been draft and final regulations issued by the enforcement agencies on most aspects of the AML, and complaints citing the AML have been filed in the courts and with the agencies alleging monopolistic conduct, the most closely watched developments have been on the M&A front, All but one of the announced

government enforcement actions to date have involved transactions. It is clear that China's merger control regime is becoming the third major antitrust hurdle for large, cross-border transactions, along with the United States and the EU. This article summarizes the AML, reviews provisions relating to mergers and acquisitions, and discusses patterns emerging in China's application of the AML in the M&A area.

Overview of AML

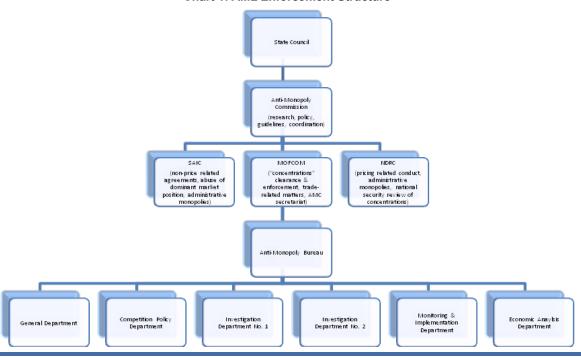
The AML is China's first comprehensive antitrust law, and generally is within the mainstream of modern competition laws. It includes the three pillars of most modern antitrust laws, with chapters on (1) "monopoly agreements," or cartels and other multiparty anticompetitive conduct; (2) "abuse of dominant market position," dealing with unilateral conduct; and (3) "concentrations," which covers mergers and acquisitions and joint ventures. The AML also includes distinctive provisions: a chapter on abuse of administrative power that is directed toward rampant local protectionism and articles on state-owned enterprises in sectors that are economically vital or implicate national security, businesses that have exclusive distribution rights pursuant to law, and trade associations.

The law establishes a multilevel and multifaceted enforcement structure under

chief executive body. It creates a new entity, the Anti-Monopoly Commission (AMC), to (1) research and draft competition policy, (2) organize and publish studies on the state of competition, (3) develop guidelines, (4) coordinate enforcement, and (5) fulfill assignments from the State Council. The AML specifies that the State Council will designate Anti-Monopoly Enforcement Authorities (AMEA) that will be responsible for enforcement. The State Council designated three existing agencies to share enforcement responsibilities: (a)

the State Council, the

Chart 1: AML Enforcement Structure



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the Ministry of Commerce, (b) the State Administration for Industry & Commerce (SAIC), and (c) the National Development & Reform Commission (NDRC). MOFCOM is the secretariat for the AMC as well as the AMEA responsible for merger control and enforcing the AML against anticompetitive conduct in international trade. The SAIC is assigned to enforce the AML with respect to all other violations except for pricing conduct. The NDRC is responsible for prosecuting pricing-related violations. The statute specifies the investigatory authority of the AMEAs, including mandating at least two officials on each investigation and written records of interrogations. The confidentiality of trade secrets is expressly protected. Chart 1 illustrates the AML enforcement structure.

The AML provides a range of remedies. Investigations may be suspended and terminated upon targets addressing the AMEA's concerns. In the case of "monopoly agreements," leniency is available to a participant who discloses the violation and cooperates with the investigation. Otherwise, and also in the case of abuse of dominant market position, "illegal gains" may be confiscated and fines may be imposed of between one and 10 percent of the previous year's turnover. Trade associations that organize monopoly agreements are subject to fines of up to RMB500,000 and cancellation of their registration. Fines and criminal sanctions are authorized for obstructing investigations. The law is notably lacking in significant remedies against competitive abuse of administrative powers. It provides for administrative review and review under the administrative law of AMEA decisions. There are administrative and criminal penalties for AMEA staff members who abuse their powers. Violators may be civilly liable for damages caused to others, creating a private right of action. The Supreme People's Court has

designated the intellectual property tribunals of the People's Courts to handle AML cases, apparently because the tribunals may be the sections of the People's Courts most experienced in handling complex matters. Otherwise, intermediate-level courts will adjudicate AML cases.

AML Provisions and Implementing Actions Relating to "Concentrations"

The AML establishes a premerger notification system, requiring transactions above a size threshold set by the State Council to be notified to the designated AMEA (MOF-COM) and undergo a waiting period before closing. Transactions within a corporate family are exempt. The law establishes a three-phase review period of 30, 90, and 60 days. If MOFCOM does not act by the end of a phase, the transaction is deemed approved. The waiting period begins when MOFCOM accepts a notification. Consummation of a transaction in violation of the AML may result in an order to divest, a fine of up to RMB500,000, or other orders to restore the status quo ante.

The AML sets forth the principle that businesses may, voluntarily and through fair competition, combine according to law to expand scale and increase their competitiveness. MOFCOM is to consider in its reviews factors including the parties' market shares, market concentration, and the impact of the transaction on market access, technological advance, consumers, other interested businesses, and national economic development. Transactions that will or may eliminate or restrict competition will be prohibited. Where the pro-competitive effects of the transaction outweigh its adverse effects, or where the transaction may benefit the public interest, MOFCOM may decide not to prohibit the transaction. It may permit a transaction upon conditions. Both prohibitions and conditional approvals must be published.

Perhaps most distinctively in this area, the AML provides that where foreign capital is involved in a concentration that implicates national security, the transaction will undergo separate review pursuant to relevant regulations.

Since the AML became effective, the State Council has announced the size-of-transaction thresholds, the AMC has issued market definition guidelines, and MOFCOM has issued procedural measures on premerger notifications and reviews of notified transactions as well as guidance on notification contents and the review process, and provisional rules on required divestitures. Drafts have been circulated regarding the substantive standards for merger review and the treatment of unnotified transactions.

Interaction with Other Laws Relating to M&A

There are reports that a multiministry committee is being formed to conduct national security reviews of transactions, pursuit to a Plan for National Security Review Mechanism that was announced at the March 2010 annual session of the National People's Congress. How that will affect transactions involving non-Chinese parties will be closely watched.

The AML itself does not distinguish between foreign and domestic businesses. However, until July 2009, foreign investors were also subject to premerger notification and competition review under the Provisions on M&A of a Domestic Enterprise by Foreign Investors (Foreign M&A Provisions). In July 2009, the Foreign M&A Provisions was amended to conform its premerger notification and review provisions to the AML, so that foreign buyers would be subject to only one competition notification and review requirement, that under the AML. Significantly, the 2009 amendments retained the requirement of a

Table 1:	Notification	Review Ti	melines

	Submitted	Accepted	2d Phase	3d Phase	Decision
InBev/Anheuser-Busch	9/10/08	10/27/08	_	_	11/18/08
Coca-Cola/Huiyuan	9/18/08	11/20/08	12/20/08	_	3/18/09
Mitsubishi Rayon/Lucite	12/22/08	1/20/09	2/20/09	_	4/24/09
GM/Delphi	8/18/09	8/31/09	_	_	9/28/09
Pfizer/Wyeth	6/9/09	6/15/09	7/15/09	_	9/29/09
Panasonic/Sanyo	1/21/09	5/4/09	6/3/09	9/3/09	10/30/09
HP/3Com	12/4/09	12/28/09	1/27/10	_	4/7/10*
Novartis/Alcon	4/20/10	4/20/10	5/17/10		8/13/10

^{*} No decision was published as it was an unconditional approval.

notification to and review by MOFCOM of transfers of control of domestic businesses that involve a critical industry, implicate national economic security, or own any famous trademarks or venerable Chinese brands. This clause, though not cited in MOFCOM's AML decisions, may underlie the difficulties experienced by foreign companies in several merger investigations. MOFCOM's AML decisions thus far raise questions of whether national brands will play an outsized role in premerger reviews even though the AML is silent in this respect.

Emerging Patterns

As of June 2010, there were over 140 transactions notified, and six decisions published. MOFCOM stated on August 12, 2010, that 95 percent of the notified transactions were cleared unconditionally, and that over 60 percent were cleared during the first phase of 30 days following acceptance of the notifications. On August 13, 2010, a seventh decision was announced. The seven decisions published to date reflect economic and competition analysis, though in some cases arguably analysis that has been abandoned by other jurisdictions. The analysis should become more refined with experience. What is of greater concern and more difficult to ameliorate is an emerging pattern of a merger control process that may be politicized and trumped by industrial policy and nationalism. The fact that all the published decisions relate to transactions involving non-Chinese entities may reflect that. Also, MOFCOM has introduced more procedural flexibility than is apparent in the AML.

The flexibility that MOFCOM has introduced into the process is revealed in its handling of filings. Since the AML time frame applies only after a notification is accepted, MOFCOM has effectively elongated that time frame by the time it takes to accept a notification, sometimes by months. Table 1 illustrates this effect.

Thus, although the AML may contemplate that a review would end after a maximum of 180 days, or six months, after a notification is filed, the reality has exceeded in one case over nine months. On the other hand, although the default under Chinese law is that "days" are "business days," MOFCOM has treated "days" under the AML to mean "calendar days" and adhered to the AML timeline once it accepts a notification. This provides parties with some certainty. Nonetheless, the practical effect is

that, in a transaction that MOFCOM concluded had no anti-competitive effect, it took over two months to complete its review and impose conditions. Hopefully, the fact that MOFCOM accepted the Novartis/Alcon notification on the day it was submitted indicates that there will be less advantage taken in the future of the flexibility that has been introduced into the AML time line.

Moreover, although a transaction is deemed approved if MOFCOM fails to act within the AML time frame, MOFCOM effectively prohibits a transaction by simply refusing to accept a notification and therefore to start the clock. An example of this "pocket veto" may be the attempt by the Internet portal company Sina.com to acquire an interest in Focus Media, a Chinese advertising and digital media company. The transaction was announced in December 2008 and notification submitted to MOFCOM, MOFCOM never accepted the notification, and the parties finally abandoned the deal in September 2009 since they could not close it without the expiration of the waiting period, which never began. Similarly, the proposed acquisition of General Motor's Hummer division by Sichuan Tengzhong Heavy Industrial Machinery may have been abandoned in February 2010 after being announced in June 2009, in significant part because MOFCOM apparently never accepted notification of the transaction. This may be one method to deter transactions that MOFCOM does not want to approve, without publishing any reasons. In both cases, it is unclear that there was any competitive impact reason for blocking the deal while there may have been industrial policy reasons to do so.

Nationalism may be reflected in the treatment of the InBev/Anheuser-Busch transaction. The merged entity would have accounted for only 13 percent of the beer industry in China. The four largest brewers in China together accounted for around 41 percent of industry revenues. In its conditional approval of the deal, MOFCOM found no anticompetitive impact from the transaction vet prohibited InBev from increasing its holding of the 27 percent of Tsingtao Beer that Anheuser-Busch held or its own 28.56 percent holding of Zhujiang Brewery, and from buying interests in two other Chinese beer brewers without prior MOFCOM review even if the transactions would otherwise be exempt from AML review. InBev must notify MOFCOM

of any changes in controlling shareholders. MOFCOM stated that the conditions were imposed because of the size of the transaction and the market position of the resulting entity, to minimize potential adverse effects in China's beer market. In the United States and EU, a transaction that is found not to be anticompetitive would have been cleared unconditionally. MOF-COM's approach seems to reflect concern over greater foreign control over a noted Chinese brand, Tsingtao, and foreign control over Chinese companies generally. It also may reflect a concern that, if there are anticompetitive consequences later, which would presumably fall under the jurisdiction of the SAIC and/or the NDRC, those agencies may fail to act, so that a prophylactic was adopted.

Nationalism may have been an even greater factor in the prohibition of the Coca-Cola/Huiyuan deal. The public reaction was vociferous and overwhelmingly negative, in the Internet and in the media, to the prospect of Coca-Cola ownership of the Huivuan brand. Competition concerns were less apparent. Coca-Cola accounted for over 60 percent of carbonated soft drink sales in China, but Huiyuan, China's largest juice manufacturer, was insignificant in that area. The combined entities would have accounted for under 30 percent of juice sales in China. MOFCOM based its prohibition on (1) Coca-Cola's post-acquisition ability to leverage its dominant position in carbonated drinks to fruit juice, thus affecting other fruit juice competitors and harming competition and consumers; (2) the potential of the merged entity to eliminate competitors, limit competition, and harm consumer welfare by tying, bundling, and other exclusionary practices; (3) the increased entry barriers resulting from the control that Coca-Cola would have on two major juice brands, Minute Maid and Huiyuan, when coupled with its position in carbonated drinks that may increase its dominance in juice; (4) the decreased opportunities for domestic small and medium-sized juice businesses to compete and innovate; (5) the adverse impact on competition in the China juice market and development of the Chinese juice industry; (6) the lack of offsetting positive effects or public interest; and (7) the lack of adequate remedies offered by Coca-Cola. This explanation is controversial among the antitrust bar and leaves the impression that it was the pretext for a

decision based on nationalism and political expediency.

The outcomes and stated analyses in the InBev/Anheuser-Busch and Coca-Cola/Huiyan transactions raise questions regarding the application of the Foreign M&A Provisions. MOFCOM made no reference to the Foreign M&A Provisions in its decisions, but it may be difficult to escape the conclusion that at least the national brands article of the Foreign M&A Provisions played a role. It may be nationalism more than industrial policy that prevailed in these two cases, since there appeared less an issue of protecting or building a national champion and more the national pride in retaining domestic control of a local brand name.

Industrial policy may be reflected in the conditions MOFCOM imposed on Mitsubishi Rayon's acquisition of Lucite. This transaction cleared competition law reviews elsewhere without fanfare, yet went into the second phase in China. The merged entity would have accounted for 64 percent of methyl methacrylate monomers produced in China, but new capacity was expected to come online shortly that may lower the merged entity's position below 40 percent. There was significant competition internationally. The key factor appears to have been the concern of Chinese competitors and customers. MOFCOM also noted that both Mitsubishi Rayon and Lucite are vertically integrated, so that there was the potential for exclusion of competitors in downstream markets. MOFCOM conditioned its approval on (1) Lucite China selling at cost 50 percent of its annual MMA production for five years to an approved third party, with a divestiture trustee to be appointed to complete that sale if it is not completed in six months; (2) Lucite China operating independently from Mitsubishi Rayon China's MMA monomer business until divestiture; and (3) the merged entity refraining for five years from further acquisitions or new plant construction in China in MMA monomer, PMMA polymer, or cast acrylic sheet without prior MOFCOM approval. A similar prohibition on greenfield expansion was last imposed in the United States 40 years ago, in Ford Motor Co. v. United States, 405 U.S. 562 (1972), requiring Ford to divest Auto-Lite, a spark plug and automotive parts manufacturer that Ford purchased in 1961, and prohibiting Ford from manufacturing spark plugs

for 10 years. This draconian condition on Mitsubishi Rayon would seem justifiable only on industrial policy grounds, to promote domestically owned industry, when the transaction raised little competitive concerns by most competition analyses.

Two of the more recent decisions raise fewer questions because the results were consistent with those in other antitrust jurisdictions. In approving GM's acquisition of Delphi, MOFCOM imposed firewalls and other conditions to ensure that GM's and Delphi's competitors would not be disadvantaged by the vertical integration. In Pfizer/Wyeth, with the merged entity accounting for almost 50 percent of swine mycoplasma pneumonia vaccine in China, the next largest competitor at only 18.35 percent, and high entry barriers, MOF-COM required Pfizer to divest two brands of the vaccine in China within six months to a MOFCOM-approved buyer. However, the conditions for an approved divestiture apparently meant that effectively only a Chinese buyer would be approved and that significant intellectual property would be transferred, leading to concerns that China may have taken the opportunity to further industrial policy. Harbin Pharmaceuticals was the buyer, becoming the largest producer of swine vaccine in China.

The decision on Panasonic's acquisition of Sanyo is notable for both the lengthy process and the extraterritorial conditions imposed. For the first time, MOFCOM defined worldwide relevant markets and required divestitures outside China, of battery plants in Japan. The later unconditional approval of the HP/3Com transaction, which received early termination of the Hart-Scott-Rodino waiting period in the United States and unconditional clearance in the EU, raised hopes of a continuing development toward rigorous competition analysis, as it might have been an opportunity to further industrial policy in the guise of remedying a competition concern by requiring a divestiture entailing technology transfer.

The latest published decision, granting conditional approval of Novartis's acquisition of Alcon, offers mixed support for those hopes. MOFCOM for the first time expressly considered the possible increased likelihood of coordinated anticompetitive conduct as a result of a transaction. The Novartis/Alcon combination would have accounted for almost 20 percent of contact lens care product sales in

China, which by itself was unproblematic. MOFCOM was concerned that the combination, together with Novartis's distribution arrangement and strategic partnership with Hydron Contact Lens, the largest seller in China which accounted for over 30 percent of sales of lens care products in China, would create competitive issues by increasing the likelihood of coordination over price, volume and territory by two players that together account for over 50 percent of sales in China. It required Novartis to terminate the distribution arrangement with Hydron within 12 months. On the other hand, MOFCOM also required Novartis to exit the distribution in China of ophthalmic anti-infective and anti-inflammatory compounds where it had less than 1 percent of sales and refrain from re-entering for five years, because the transaction would have resulted in a combined market share of over 60 percent. This minimal 1 percent increase in market share would be unlikely to result in the imposition of any condition in developed antitrust jurisdictions, especially since Novartis had expressed the intent of shutting down its business in that product line globally. Moreover, the remedy imposed, exit rather than divestiture, would seem to lessen instead of preserve competition. The decision offered little guidance as to the reasoning behind the conclusion of anti-competitive concern or remedy.

The strongest indicator that industrial policy trumps competition principles may be the fact that major transactions among Chinese companies have been completed without any AML notification, and any MOFCOM enforcement. State-sponsored reorganizations of the telecommunications, auto, and airline industries in the last few years have involved transactions that clearly exceed the notification thresholds, without any notification to or review by MOFCOM. A notable example is the China Unicom/China Netcom transaction in October 2008. A number of mergers of state-owned enterprises have been announced as approved by the State Council without any reference to the AML or MOFCOM.

Conclusion

There appear to be emerging patterns of industrial policy and nationalism trumping competition policy, greater procedural flexibility in the merger control regime than apparent at first glance, and analytic

approaches that may have been abandoned elsewhere. Nonetheless, the increasingly detailed published MOFCOM decisions reflect a policy of increasing transparency and applying economic analysis in merger control, to be in the antitrust mainstream. Moreover, MOFCOM's sensitivity to perceptions of discriminatory enforcement of the AML is reflected by the fact that the Director General of its Anti-Monopoly Bureau held a press conference on August 12, 2010, apparently for the specific purpose of emphasizing that China never

discriminated against foreign companies in the enforcement of the merger control provisions of the AML and that conditions were placed on transactions because they would otherwise adversely affect competition. Hopefully this sensitivity will temper deference to industrial policy and nationalism.

Yee Wah Chin is of counsel at Ingram, Yuzek, Gainen, Carroll & Bertolotti, LLP in New York City.

Additional Resources

For other materials related to this topic, please refer to the following.

Business Law Today

Keeping Current: Antitrust
China Passes Comprehensive
Anti-monopoly Law
By Jonathan S. Gowdy
Volume 17, Number 3
January/February 2008

BUSINESS LAW **TODAY**

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Proxy Solicitation and Contested Director Elections

By Kevin F. Brady and Francis G.X. Pileggi

With the burgeoning trend of shareholders having more input into how corporations are run, lawyers must know the law about contested director elections. What have the Delaware courts been saying recently about this very hot topic?

Recent Delaware decisions have addressed the nuances and the fundamentals involving how directors are elected, such as who is entitled to vote—record holders versus beneficial owners and the meaning of "stockholder of record," the confusion about "vote buying" and the decoupling of the vote from the economic interest in the company, and other factors that complicate an already entangled web.

Section 225—Directors and Contested Elections

Section 225 of the Delaware General Corporation Law (DGCL) provides a summary procedure to contest the director election process in order to resolve promptly disputes about whether a director was properly elected. Under section 225, a stockholder, director, or officer can ask the Court of Chancery to determine the validity of an election, removal, resignation, or appointment of a director or officer. Recent opinions from the Delaware Court of Chancery and the Delaware Supreme Court demonstrate the complexity of the analysis.

Kurz v. Holbrook, 989 A.2d 140 (Del. Ch. 2010), is a case that involved competing requests for relief under section 225 regarding control of the board of directors of EMAK Worldwide, Inc. (EMAK or the Company). The Delaware Court of Chancery, in an expedited challenge to a director election under section 225, addressed for the first time whether a bylaw amend-

ment may reduce the size of the board of directors. The court also addressed the issue of vote buying and provided an indepth discussion of the meaning of "shareholder of record." The Delaware Supreme Court, after an expedited appeal, reversed in part and affirmed in part. (Complete copies of all decisions referenced in this article are available at www.delawarelitigation.com.)

Consent Solicitation and Exchange Transaction

On October 12, 2009, Take Back EMAK LLC (TBE) delivered a consent regarding the election of directors to EMAK (the TBE Consent Solicitation). Without board intervention, the record date for consents would have been October 12, the date the first solicitation was delivered. However, under section 2.13(c) of EMAK's bylaws, the board had the power to set a record date for the TBE Consent Solicitation and so during the board's October 19, 2009, meeting, the board set October 22 as the record date. Also at the October 19 meeting, the board approved a transaction pursuant to which Crown EMAK Partners, LLC (Crown) exchanged its Series AA Preferred for new Series B Preferred Stock (the Exchange Transaction). The Series AA Preferred had the right to elect two directors to the board plus a third director if the board expanded the number of its members to more than eight members. The Series AA Preferred did not vote in the election of directors; instead, they voted on an as-converted basis with the common stockholders on all other matters. The Series B Preferred, however, voted on an as-converted basis with the common stock on all matters, including the election of directors.

As a result of the Exchange Transaction, Crown's Series AA Preferred had the right to vote approximately 28 percent of the total voting power in an election of directors. With an October 22 record date instead of an October 12 record date, the EMAK board permitted Crown to convert its Series AA Preferred into new Series B Preferred (and thus allow Crown to vote almost 28 percent of the total voting power in the election of directors) for the TBE Consent Solicitation. On October 26. 2009, a lawsuit was filed challenging the Exchange Transaction and while EMAK initially solicited consents to ratify the Exchange Transaction, on December 3, 2009, EMAK and Crown rescinded the Exchange Transaction.

Three Concurrent Consent Solicitations Prior to December 18, 2009, the EMAK board had six directors and one vacancy. On December 18, one of the six directors resigned, creating a second vacancy. On December 18, 2009, Crown delivered consents (the Crown Consents) to amend EMAK's bylaws to add two bylaws. One new bylaw (section 3.1) would reduce the size of the board to three directors. Because Crown had the right to appoint two directors under the terms of EMAK's Series AA Preferred Stock, reducing the board to three, if valid, would give Crown a board majority. Another new bylaw (section 3.1.1) provided that if the number of sitting directors exceeded three, then the EMAK CEO would call a special meeting of stockholders to elect the third director, who would take office as the singular successor to his multiple predecessors.

On December 20 and 21, TBE claimed to have delivered the TBE Consents, which were sufficient enough to remove two additional directors without cause and fill

three of the vacancies with their nominees which, if the TBE Consents were valid, would give TBE a board majority.

Roles of Beneficial Holders in the Consent Solicitation Process

The court in *Kurz* provided a summary of the process of voting stock that is not registered in the name of the person who bought the stock:

The vast majority of publicly traded shares in the United States are registered on the companies' books not in the name of beneficial owners-i.e., those investors who paid for, and have the right to vote and dispose of, the sharesbut rather in the name of "Cede & Co.," the name used by The Depository Trust Company (DTC). Shares registered in this manner are commonly referred to as being held in "street name . . . " DTC holds the shares on behalf of banks and brokers, which in turn hold on behalf of their clients (who are the underlying beneficial owners or other intermediaries)." (citation omitted).

DTC is generally understood to be the entity with the power under Delaware law to vote the shares that it holds on deposit for the banks and brokers who are members of DTC. Through the DTC omnibus proxy, DTC transfers its voting authority to the banks and brokers. The banks and brokers then transfer the voting authority to Broadridge, which votes the shares held at DTC by each bank and broker in proportion to the aggregate instructions received from the ultimate beneficial owners.

As of December 18, 2009, TBE was approximately 116,000 shares short of a majority when it discovered that Peter Boutrous, a former employee and a consultant of EMAK, owned 175,000 shares. TBE also learned that a restricted stock grant agreement governed 150,000 of Boutrous' shares. This agreement prohibited Boutrous from transferring, selling, pledging, or assigning his shares until March 2011. As a work-around, Boutrous, who originally wanted \$2.25 per share when the stock was trading at \$0.95 per share, entered into a purchase agreement with Kurz wherein Boutrous sold to plaintiff Kurz all shares that Boutrous owned and was entitled to sell, transfer, or assign as

of that date and all rights to receive all other shares that Boutrous may be entitled to sell for \$1.50 per share. As a result, the agreement purported to delay the transfer of actual title until after the restrictions had expired. Kurz believed that the purchase agreement provided him with the economic and voting rights but not legal title to the 150,000 shares so that he had a valid proxy to vote the 150,000 shares and execute a valid consent card. TBE thought that it had secured enough consents for a voting majority, but the inspector of elections thereafter invalidated consents representing more than one million shares of EMAK stock held in "street name" due to EMAK's failure to obtain a DTC omnibus proxy. Kurz filed suit challenging the validity of the Crown bylaw amendment and the vote-buying arrangement.

Court of Chancery Invalidates Bylaw Amendment

The Court of Chancery held that the bylaw amendments adopted through the Crown Consents were void because they conflicted with the DGCL, and noted that if a bylaw amendment reducing the size of the board could eliminate sitting directors, then directors would have the power to remove directors, which is not permitted under Delaware law. The court observed:

New [proposed bylaw] Section 3.1 would shrink the board to three directorships at a time when five directors are in office. There are two possible consequences for the suddenly surplus directors. One is that their terms would end. The other is that they would continue to serve, albeit without official seats, until their terms were ended by a statutorily recognized means. [B]oth possibilities conflict with the DGCL.

The notion that the terms of the extra directors would end conflicts with Section 141(b)'s mandate that "[e]ach director shall hold office until such director's successor is elected and qualified or until such director's earlier resignation or removal." Section 141(b) thus recognizes three procedural means by which the term of a sitting director can be brought to a close: (1) when the director's successor is elected and qualified, (2) if the director resigns, or (3) if the director is removed. Section 141(b) does not contemplate that a director's term could end

through board shrinkage. A bylaw that seeks to achieve this result conflicts with Section 141(b) and is void.

DGCL section 141(k) supports the general rule that a director or the entire board may be removed with or without cause by a majority of the shareholders entitled to vote. Although directors may, in certain instances, fill vacancies on the board, directors cannot remove a fellow director. In holding that the bylaw amendment at issue was a violation of the DGCL, the court stated:

In light of the three procedural means for ending a director's term in Section 141(b), I do not believe a bylaw could impose a requirement that would disqualify a director and terminate his service. Section 141(b)'s recognition of the bylaws as a locus for director qualifications instead contemplates reasonable qualifications to be applied at the front end, before a director's term commences, when the director is "elected and qualified."

The court also ruled in favor of TBE with respect to the validity of the consents for shares held in "street name," rejecting the defendants' argument that the TBE Consents cannot be effective because of the absence of the DTC omnibus proxy. The court also redefined the phrase "stockholder of record" to include the DTC participating banks and brokers listed in the Cede breakdown for purposes of determining the stockholders who would be entitled to vote (or act by written consent). The court noted that this was consistent with other sections of the DGCL including sections 219(c) and 220(b) where the Cede breakdown is part of the corporation's stock ledger as well as under federal law where banks and brokers are viewed as the record holders of the shares held by the depositories.

Court Rejects Claim of Illegal Vote Buying

With respect to Crown's claim that TBE engaged in illegal vote buying, the court rejected that argument, instead finding that the purchase agreement between Kurz and Boutrous transferred to Kurz "the full economic risk associated with the Boutrous shares and the voting rights appropriately followed the economic interest."

The court noted that the principle of vote buying is not per se illegal unless it is entered into for deleterious "purposes." The court found that the purchase agreement did not violate the restricted stock grant agreement and that Kurz did not engage in illegal vote buying.

Delaware Supreme Court Decision

On appeal, the Delaware Supreme Court, en banc on April 21, 2010, affirmed in part and reversed in part the Court of Chancery's decision in this case. See Crown EMAK Partners, LLC v. Kurz, 2010 WL 1610487 (Del. Apr. 21, 2010). The Delaware Supreme Court agreed with the Court of Chancery to the extent that there was no improper vote-buying. However, the Supreme Court found that there was a violation of the restricted stock purchase agreement, which prohibited any "transfer, [sale], pledge or hypothecat[ion] of Boutrous' restricted shares." The Supreme Court determined that the purchase agreement included a provision that Boutrous agreed to sell all shares that he owned and was permitted to sell and that, by its very terms, the restricted stock purchase agreement prohibited what the purchase agreement purports to do. As a result, the Supreme Court held that the purchase agreement did not operate as a valid sale or transfer so that Kurz was not entitled to vote the 150,000 shares and, by extension, TBE did not have the right to vote the majority of the shares.

With respect to the issue of whether the TBE Consents were effective even though there was no DTC omnibus proxy, the Supreme Court, like the Court of Chancery, reviewed the requirements for written consents of shareholders in lieu of a meeting, pursuant to DGCL section 228, and both recognized the requirement that such consents be executed by a stockholder of record. Where the two courts diverged, however, was at the point that the Court of Chancery determined that a Cede breakdown is part of the stock ledger for purposes of section 219(c). The Supreme Court regarded this part of the Court of Chancery decision as obiter dictum and reasoned that in light of the purchased votes being invalidated, it was not necessary to address or decide the issue of whether the Cede breakdown was part of the stock ledger for section 219 purposes.

Finally, with respect to the validity of the bylaw amendment, the Supreme Court agreed with the Court of Chancery that a bylaw amendment that purports to reduce the size of the board as a means of eliminating sitting directors is in violation of DGCL section 109(b). Rather, the correct procedure would have been for the dissidents to follow a three-step process: first, remove the sitting directors by written consent; then reduce the size of the board; and then elect new directors.

Scope of Section 225 Summary Proceedings

Other recent decisions have addressed nuances of section 225 cases. In Levinhar v. MDG Medical, Inc., No. 4301-VCS, 2009 WL 4263211 (Del. Ch. Nov. 24, 2009), the Delaware Court of Chancery explained the expansive scope of claims allowable in a summary proceeding pursuant to section 225 of the DGCL. Section 225 proceedings are summary in nature and are designed primarily to address the proper composition of a board. Typically, such actions address, for example, whether a particular director is a proper board member or was properly elected or removed. In this case, the penalty imposed by the court for not including related claims in a prior section 225 suit was to bar those claims in the present suit based on the doctrine of res judicata.

Section 225 Suits, "Related Claims," and Res Judicata

The court's opinion in this case "serves notice" to all who may have considered section 225 suits to be limited by the nature of such an action as a summary proceeding to the specific issue of proper board composition only. Whether or not one was laboring under that misconception, this opinion removes any doubt that failure to raise related issues creates the risk that those related issues may be barred by res judicata in later suits.

Alternative to "Related Claims"— Contemporaneous Companion Case

The court explained that an alternative to including related claims that are part of the same operative facts or the same transaction that forms the basis of the section 225 dispute is filing a contemporaneous companion case and then asking the court to consolidate the companion case with the section 225 case. The reasoning used by the court includes the following: "Although Section 225 actions are sum-

mary proceedings, claims that bear on the appropriate composition of the board of directors many be brought in connection with a Section 225 action." Moreover, the court added that "... it is common in Section 225 cases for this court to address the consequences that stockholder voting agreements have on the outcome of director elections or removal efforts."

New Election—Remedy for Improper Shareholder Meeting

In Portnoy v. Cryo-Cell International, Inc., No 4301-VCS, 2007 WL 4263211 (Del. Ch. Jan. 15, 2007), the Court of Chancery addressed a challenge to the election of directors under DGCL section 225 based on claims that the management engaged in inequitable behavior to entrench themselves, both in proxy battles leading up to the annual meeting as well as shenanigans during the annual meeting itself.

The court analyzed closely the issue of "vote-buying" to the extent that expression is used to refer to agreements to vote for certain board members in exchange for consent to act in a certain manner, such as working to secure a board seat for a major shareholder. Such arrangements are not per se illegal in the corporate context but will be closely scrutinized for inequitable conduct that interferes with the shareholder franchise especially in connection with the election of directors.

The court did not reject a deal with management that provided for a major stockholder to be seated on the board (in exchange for supporting management), but the court did find objectionable another part of the deal-that was not disclosed to stockholders prior to the election for the slate of directors-that provided for a new board seat to be created in connection with an expanded board that would be filled by someone whose past raised questions that may have made stockholders hesitate before supporting him. The problem was, as the court explained, that the "electorate voted in ignorance of the actual board that would govern them in the event the Management Slate won." However, the court found it was a breach of the CEO's fiduciary duty to use corporate machinery to coerce and to threaten economic penalties with commercial partners who did not vote in favor of management.

The CEO announced during the annual meeting at 2:00 p.m. that she was taking a

three-hour lunch break. (The meeting started at 11:00 a.m.) The court saw this as a transparent attempt to lobby for more votes for management—which ultimately prevailed by a razor-thin margin. The court determined that (what it called) the "lupper" break affected the election of the directors and the defendants could not carry their burden to show that the CEO's actions were "motivated by a good faith concern for the stockholders, and not by a desire to entrench [herself]."

The customized remedy that the court fashioned in this case was to order a prompt special meeting for the new election of directors-and to make the management slate pay for the costs of such a meeting. The court also ordered the removal of the new director who was elected at the tainted meeting. Moreover, the court declined to award attorneys' fees in part due to the apparent violation of a confidentiality agreement by the plaintiff.

Conclusion

There are several lessons that can be learned from the cases reviewed in this article. In Kurz, the Delaware Supreme Court described the correct procedure for dissidents to follow in order to properly reduce the size of an existing board of sitting directors: first, remove the sitting directors by written consent or other appropriate shareholder action; next, reduce the size of the board; and then elect new directors. In Levinhar, the Court of Chancery explains that in order to avoid potential res judicata bars, despite the summary nature of a section 225 proceeding, affiliated claims should be addressed either in the section 225 proceeding or in a contemporaneous companion case. In the Portnoy case, the court described as a remedy for an improperly conducted shareholder meeting where directors were elected an order to conduct a new meeting for the election of directors with the cost borne by the management slate that conducted the improper meeting.

Kevin F. Brady is a litigation partner and chair of the Business Law Group of the Wilmington, Delaware, office of Connolly Bove Lodge & Hutz LLP. Francis G.X. Pileggi is the founding partner of the Wilmington, Delaware, office of Fox Rothschild LLP.

Additional Resources

For other materials related to this topic, please refer to the following.

Business Law Today

Delaware Corporate Decisions

Key Cases from Early 2009

By Kevin F. Brady and Francis G.X. Pileggi

Business Law Today Volume 19, Number 1

September/October 2009

Keeping Current: Jurisdiction

By Francis G.X. Pileggi and Danielle S. Blount

Business Law Today March/April 2008

Avoiding the Preservation **Predicament**

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BUSINESS LAW TODAY

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National E-Discovery Trends and the Delaware Court of Chancery's Approach

By Denise Seastone Kraft and K. Tyler O'Connell

Eschewing the approaches taken by other jurisdictions, the Delaware Court of Chancery—widely regarded as the nation's preeminent forum for business litigation—has recently begun to chart a careful path through the minefield of electronic discovery.

Six years after the final Zubulake v. UBS Warburg LLC opinion-and despite additional guidance from the courts—litigants in disputes everywhere are still coming to terms with the problems associated with the discovery of electronically stored information (ESI). This article discusses developments since Zubulake and the ways in which courts and lawyers nationwide have approached e-discovery issues, including the cautionary tale of the recent Qualcomm v. Broadcom litigation. It then summarizes recent developments in the Delaware Court of Chancery-the nation's best-known business court-which for years had very little to say regarding e-discovery but has recently provided significant practical guidance to litigants.

Zubulake and the Promulgation of E-Discovery Standards

In *Zubulake*, the U.S. District Court for the Southern District of New York issued a series of opinions addressing parties' obligations to preserve and produce ESI. Issued prior to the 2006 revisions to the Federal Rules of Civil Procedure addressing ESI, the *Zubulake* opinions had a nationwide impact and set forth the following broad principles regarding discovery obligations:

 Once litigation is reasonably anticipated, a party must suspend its routine docu-

- ment retention and destruction practices and put in place a "litigation hold";
- Counsel must take steps to become familiar with the client's information and technology systems and see that the "key players" at the client comply with the litigation hold;
- Counsel must make clear that the production of active ESI is required, and that backup media are preserved; and finally
- Counsel's duties are continuing and include taking reasonable steps to monitor the client's compliance throughout the litigation.

The failure to comply with the foregoing may warrant sanctions, which in *Zubulake* included an award of attorneys' fees and a jury instruction permitting an "adverse inference" against the defendant, which ultimately led to a \$29 million jury verdict.

- The most notable post-Zubulake development in the field of e-discovery was the 2006 amendments to the Federal Rules of Civil Procedure in which the following amendments, among others, were enacted:
- Rule 26(b)(2) was amended to permit parties to initially withhold from production ESI that is "not reasonably accessible because of undue burden or cost"; however, the production of "not reasonably accessible" ESI may still be ordered where, under Rule 26(c)(2), the costs of discovery are outweighed by the potential benefits;
- Rules 26(f) and 16(f) were amended to require that e-discovery issues be raised at the parties' initial discovery confer-

- ence and included in the Rule 26(f) report provided to the court, with any e-discovery disputes being addressed in the initial scheduling conference with the court; and
- Rule 37(e) was amended to clarify that sanctions should not be imposed where ESI is lost through the "routine, good faith operation of an electronic information system." The Advisory Committee notes indicate this refers to the "alteration and overwriting of information, often without the operator's specific direction or awareness, a feature with no direct counterpart in hard-copy documents." The notes further state that "good faith" includes compliance with applicable document preservation obligations where litigation is anticipated.

Further, Rule 26(b)(5) and Federal Rule of Evidence 502 were amended to require the prompt return of any inadvertently produced privileged information, and to clarify that such a production does not waive the privilege so long as the holder of the privilege was reasonably prudent in protecting it. These amendments recognized the burden and cost of a thorough privilege review by counsel in the digital age. They even go so far as to contemplate judicial endorsement of so-called quick-peek arrangements, under which producing parties attempt to control costs by agreeing to turn over a broad range of documents to the requesting party without a prior document-by-document review by counsel. The requesting party then indicates what subset of documents it would like produced, and the producing party then does a thorough review for privilege

and any other applicable protection from discovery for that subset of documents. Relatedly, the amendments contemplate the use of so-called claw-back agreements, under which parties seek to reduce the costs of counsel screening voluminous ESI for privilege by requiring the swift return of any inadvertently produced materials, with a stipulation that such an inadvertent production will not result in the waiver of the privilege.

Many state courts soon adopted rules or guidelines based on similar principles. The North Carolina Business Court, for example, requires that before filing any motion or objection with respect to e-discovery, the parties shall discuss costshifting and other means of resolving the dispute, and file a certificate with the court detailing the results of their discussion. In addition, the Delaware Superior Court recently established a Complex Commercial Litigation Division, where cases are subject to an early scheduling conference, at which procedures for e-discovery will be court-ordered. Its guidelines also require an early meet and confer regarding e-discovery, with a written e-discovery plan to be submitted to the court prior to the scheduling conference. The New York state courts recently examined their practice and recommended pilot projects requiring early disclosures relating to electronic discovery, including disclosure of the parties' ESI preservation efforts, and requiring that counsel submit an "Affirmation of E-Discovery Compliance" before a preliminary conference with the court.

Apart from court rules and guidelines, a body of standards has emerged from groups with expertise in e-discovery, including the Sedona Conference and the Conference of Chief Justices, which has promulgated Guidelines for State Trial Courts Regarding Discovery of Electronically-Stored Information. Such sources set forth standards, like the Federal Rules, focusing on the need for (1) an early conference and agreements among counsel regarding e-discovery, (2) court supervision of the discovery process, (3) court-ordered approval of so-called claw-back and quick-peek arrangements, and (4) factors to consider with respect to an "undue burden" analysis and cost-shifting.

But under the Federal Rules and the other approaches, the determination of when a party should "reasonably anticipate" litigation, the parameters of a "reasonable" approach to collection and preservation, and what is an "undue burden" remain case-specific. The absence of bright-line rules has led to infamous circumstances where sophisticated counsel and clients have lost cases—either through a default judgment or in connection with an adverse inference—due to e-discovery violations. When things go wrong, counsel and their clients may point fingers at each other, and it is difficult to pinpoint where blame should lie.

The Cautionary Tale of Qualcomm v. Broadcom

These problems are perhaps best shown by the recently concluded case of *Qualcomm*, *Inc. v. Broadcom Corp.*, 2008 WL 66932 (S.D. Cal. Jan. 7, 2008)—a patent case where, after Qualcomm lost at trial, Broadcom's counsel made an oral motion to have Qualcomm and its counsel sanctioned for discovery misconduct. This engendered three years of post-trial litigation (unrelated to the merits of the initial dispute) devoted to the issue of whether 19 attorneys from Qualcomm's team of outside counsel should be sanctioned for their failure to ensure that important e-mails from key Qualcomm staff were produced.

On the initial referral from the trial judge, a magistrate sanctioned Qualcomm and six of its outside attorneys. The judge found that those counsel "chose not to look in the correct locations for the correct documents, to accept the unsubstantiated assurances of an important client that its search was sufficient, [and/or] to ignore the warning signs that the document search and production were inadequate[.]" It reasoned that if counsel knew its client would not comply with discovery obligations, counsel were ethically obligated to withdraw from the representation. The judge ordered Qualcomm to pay approximately \$8.5 million in Broadcom's attorneys' fees and referred each of the six counsel to the California State Bar for potential discipline.

The attorneys thereafter obtained a ruling that, because their client Qualcomm blamed them for the discovery misconduct, counsel could reveal otherwise privileged communications with Qualcomm under the self-defense exception to the privilege. The matter was remanded for reconsideration in light of the formerly privileged communications. 2008 WL 638108, at *3 (S.D. Cal. Mar. 5, 2008).

Additional litigation ensued, including extensive document discovery, 13 depositions, and a three-day evidentiary hearing, with the magistrate concluding in April 2010 that the attorneys' conduct did not amount to "bad faith" warranting sanctions. Quallcomm Inc. v. Broadcom Corps., 2010 WL 1336937 (S.D. Cal. Apr. 2, 2010). It concluded the discovery violations resulted from a lack of meaningful communication with the client regarding discovery obligations, a lack of oversight of the more junior lawyers doing discovery work, the failure to ensure that key witnesses' computers were searched after indications that they might contain relevant documents, and reliance upon the client's representations that additional searches of computers and laptops would be duplicative.

Despite the outcome, the litigation must have taken a significant toll. Five of the attorneys who were initially sanctioned were from the law firm of Day Casebeer Madrid & Batchelder, a firm that reportedly struggled financially after the initial imposition of sanctions, and that later merged with Howrey LLP. Four of the attorneys (including two partners) reportedly left the firm and large firm practice altogether. It has been suggested that, in ultimately declining to impose sanctions, the magistrate gave a pass to attorneys who had already been through enough.

The enduring problems of e-discovery recently prompted the judge who authored *Zubulake* to revisit its teachings in *The Pension Committee of the University of Montreal Pension Plan v. Banc of America Securities LLC*, 2010 WL 184312 (S.D.N.Y. 2010), where the court explained,

Courts cannot and do not expect that any party can meet a standard of perfection. Nonetheless, the courts have a right to expect that litigants and counsel will take the necessary steps to ensure that relevant records are preserved when litigation is reasonably anticipated, and that such records are collected, reviewed, and produced to the opposing party. As discussed six years ago in the *Zubulake* opinions, when this does not happen, the integrity of the judicial process is harmed and the courts are required to fashion a remedy.

Recent Developments in the Delaware Court of Chancery

In contrast to jurisdictions that reacted prospectively to e-discovery-and the headlines-creating sanctions handed down elsewhere-the Delaware Court of Chancery until recently has been silent on these issues. It did not amend its rules, none of which expressly touch on e-discovery, or issue any guidelines or standing orders. Perhaps the court believed that standards of "reasonableness" in discovery practice were already sufficiently reflected in its rules and jurisprudence, or that it need not order counsel to meet and confer, given that professionalism and prudence compel this anyway. Recent e-discovery disputes, however, have caused the court to issue rulings, summarized below, that have given more specific guidance. The court's rulings suggest that, while it will not hesitate to impose sanctions for the intentional or reckless destruction of ESI, it will generally defer to litigants' agreements regarding the contours of a reasonable approach to ESI. Further, while the burdens of e-discovery are frequently justified in the high-stakes business litigation in which the court specializes, the court nonetheless will take a case-by-case approach and consider reasonable measures to reduce the ultimate financial costs of e-discovery.

Recent Decisions Addressing Preservation and Spoliation

In several recent decisions, the Court of Chancery was confronted with cases involving the loss of ESI and made clear its expectations regarding parties' preservation obligations and the potential sanctions for causing the destruction of ESI after a preservation obligation attaches.

In Beard Research, Inc. v. Kates, 981 A.2d 1175 (Del. Ch. 2009), the failure to preserve ESI led to an adverse inference on key disputed facts. There, the plaintiff business accused the defendants-a former employee and a competing company-of misappropriating trade secrets. The former employee had made a particular presentation to the competitor, the only copy of which was on his employer-provided laptop. After the complaint was filed, the employee took actions resulting in ESI being purged from the laptop. The court set forth general principles to govern e-discovery disputes. It wrote that "absent affirmative steps to preserve it," some ESI is likely to be destroyed. It advised that "early and, if necessary, frequent communications among counsel" regarding e-discovery

should occur. The court would likely defer to the parties' agreements regarding ediscovery, but if the parties did not address ediscovery issues early on, the court was "not likely to be sympathetic" to spoliation claims based on parties' failure to impose "stringent measures" to preserve ESI. The court indicated it would take a "reasonable" approach by "taking into account the insights provided by caselaw and some of the guidelines and principles developed by respected groups," specifically including the Sedona Conference and the Conference of Chief Justices.

In imposing sanctions against all defendants—not only the former employee, but also the competing business where he went to work—the court reasoned they were all represented by the same counsel, that counsel did not notify them of the need to preserve ESI, and also that the employee's current (co-defendant) employer should have known that he had a laptop he used for work. The court awarded attorneys' fees and an adverse inference against all defendants with respect to a key dispute: whether the former employee shared a specific list of proprietary chemical compounds with plaintiff's competitor.

Similarly, the Court of Chancery granted an adverse inference in Triton Construction Corp. v. Eastern Shore Electrical Services, Inc., 2009 WL 1387115 (Del. Ch. May 18, 2009), aff'd, 998 A.2d 938 (Del. 2010), another case involving an employee's alleged disloyal conduct toward his employer. After the employee had resigned his position in order to work with a competing company, he "wiped" a computer provided by his former employer, and otherwise failed to produce ESI from his home computer and a thumb drive. The court reasoned that the employee should have reasonably anticipated litigation when he resigned his position in order to work with a competing company. As a sanction, the court awarded an adverse inference supporting the former employer's claim that the employee shared confidential information with his new company.

More recently, in *TR Investors LLC v*. *Genger*, 2009 WL 4696062 (Del. Ch. Dec. 9, 2009), the court issued a post-trial decision on spoliation issues—what it deemed "an expensive case within a case." When litigation was filed for control of a corporation, counsel to an incumbent director and CEO attempted to protect his client's personal information and at the same time

preserve potentially relevant documents. This was important to the client, who claimed to have various ESI of a sensitive, personal nature at the corporation. Unbeknownst to counsel, however, the client had an in-house IT worker permanently overwrite the unallocated space on his hard drive. Unallocated space contains temporary files, not visible in normal use, that are automatically saved. It could contain versions of files that are later changed or removed, such as drafts or deleted documents, and computer experts can access this information. When they later took control of the corporation, the plaintiffs' computer expert uncovered the defendant's actions.

Although it was impossible to know what information was lost, a certain memo was not produced by the defendant. The memo was relevant and had been produced by other recipients. If the defendant had received the memo by e-mail, and if he then deleted the e-mail, it could have been in the unallocated space. The defendant also had failed to produce eight other relevant e-mails that may have been in the unallocated space.

The court found defendant's actions to be reckless in that he proceeded without consulting with counsel, who he knew were engaged in preservation efforts. It found his purpose—at least in part—was to limit the information plaintiffs could use in litigation. The "reasonable probability" that relevant evidence was lost warranted sanctions. The court then awarded creative sanctions, including a limited waiver of the attorney-client privilege, imposing a higher burden of proof for his counterclaims, and ruling that he would be unable to meet his burden on any issue supported solely on his own testimony.

Diligence in Counsel's Collection of ESI

As practitioners in the court can attest, the Court of Chancery has high expectations for the conduct and professionalism of counsel appearing before it. The court has recently made clear that this expectation extends to counsels' responsibility to ensure that relevant ESI is collected and produced in discovery.

Two recent decisions of the court support that counsel are personally required to oversee the collection and production of ESI. In *Grace Bros. v. Siena Holdings*, *Inc.*, 2009 WL 1547821 (Del. Ch. June 2, 2009), the court granted a motion to

compel requiring a corporation to search individual directors' e-mail. Although counsel had inquired regarding the individual directors' e-mail practices-and may have reasonably believed that they had no "unique" responsive documents this did not suffice to sustain its burden to show that a search of their e-mails would be unreasonably cumulative or duplicative. Similarly, in Roffe v. Eagle Rock Energy, G.P., C.A. No. 5208-VCL (Del. Ch. Apr. 8, 2010), the court required counsel to personally review client e-mail. Counsel claimed that the particular defendant kept work documents on his personal computer interspersed with personal e-mail (making a review difficult), and that he should have no "unique" e-mails. The court ruled "you do not rely on a defendant to search their own e-mail system," reasoning that experience showed clients' statements regarding what documents are available are not always true. It ordered counsel to "get on a plane" and review the e-mails. Roffe is particularly salient because it involved discovery to confirm the fairness of a class action settlement, a context that often involves relatively truncated discovery.

Rulings on the Burden of E-Discovery

When issues regarding the burden of e-discovery are properly presented to the court, it has been willing to work with litigants to reduce the costs of e-discovery. For years, the leading Court of Chancery e-discovery case addressing an "undue burden" argument in the context of ediscovery was Kaufman v. Kinko's, Inc., 2002 WL 32123851 (Del. Ch. Apr. 16, 2002), which considered whether a producing party had to initiate an ESI retrieval system that could cost up to \$100,000. The court did not engage in a cost-benefit analysis. Rather, it reasoned that "[u]pon installing a data storage system, it must be assumed that at some point in the future one may need to retrieve the information previously stored." It reasoned that "deficiencies in the retrieval system

Additional Resources

For other materials related to this topic, please refer to the following.

Business Law Today

Cutting to the "Document Review" Chase

Managing a Document Review in Litigation and Investigations

By Ashish Prasad, Kim Leffert, and Shauna Fulbright-Paxton

Business Law Today

Volume 18, Number 2: November/December 2008

E-discovery and Electronic Evidence in the Courtroom

A Primer for Business Lawyers

By Timothy J. Chorvat

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Avoiding the Preservation Predicament

Preparing for E-discovery Obligations Before Disputes Arise

By Kevin F. Brady and Chad Breckinridge

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Responding to the "E-discovery Alarm"

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A Guide to Protecting Privileged Electronic Communications

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Communication Between Counsel and Corporate IT

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By Karl R. Wetzel

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The Tech side of E-discovery

Understanding Electronically Stored Information

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(or inconvenience and cost associated with the actual retrieval) cannot be sufficient to defeat an otherwise good faith request" for discoverable ESI.

More recently, however, in Omnicare, Inc. v. Mariner Health Management Co., 2009 WL 155609 (Del. Ch. May 29, 2009), the court acknowledged that it had the discretion to shift the costs of production in an appropriate case. It said there was "wisdom" in the Zubulake approach, which considers various factors in determining what should be produced and who should bear costs. The court declined to shift costs, however, because the cost of production was not large in light of the amount in controversy. While the movant requested that the court compel the production of backup tapes, the court ordered that active e-mail stores be searched first to help assess the benefit of reaching backup tapes and that there would be no need to search backup tapes, absent a showing that additional relevant information was likely to be found.

In recent years, the court also has endorsed the use of "quick peek" discovery arrangements (discussed above) in some

circumstances. It reasoned that such arrangements are the future of e-discovery because it is "impossible" to do a thorough document-by-document review for privilege prior to making a timely production of ESI. SLM Corp. v. J.C. Flowers II L.P., C.A. No. 3279-VCS (Del. Ch. Nov. 5, 2007) (Transcript). The court also entered an order affirming the use of a "quick peek" where the parties stipulated that a document-by-document review would "cause substantial delay and would be unduly burdensome" and where the parties agreed to use search terms to screen for privilege prior to production. See ACS Healthcare, LLC v. Wipro, Inc. and Wipro Ltd., C.A. No. 4385-VCP (July 23, 2009) (Order). This trend implies that—despite Delaware not having amended its Rules of Evidence comparable to those made to the federal rules—the judicially approved use of such arrangements would not waive the attorney-client privilege.

Conclusion

In contrast to the actions of other courts and jurisdictions, the Delaware Court of Chancery has not formally amended its

Rules of Evidence to specifically address discovery in the digital age. The court's recent opinions, however, provide practitioners with significant guidance as to their expectations. The court has made it clear that despite the absence of any bright-line rules regarding ESI, the court continues to require that counsel act with a high degree of professionalism in dealing with e-discovery issues and, through the imposition of sanctions, has indicated a willingness to address discovery misconduct that results in spoliation. Further, the court has indicated a willingness to defer to parties' agreements regarding e-discovery, including practices aimed at reducing the costs of litigation. The result is that the Delaware Court of Chancery, through its ESI discovery rulings, has preserved its historically flexible, creative, and equitable approach to business litigation.

Ms. Kraft is a partner with, and Mr. O'Connell is an associate with, the Wilmington, Delaware, office of Edwards Angell Palmer & Dodge LLP. The opinions expressed herein are not necessarily those of the firm or any of its clients.

BUSINESS LAW **TODAY**

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Litigation Implications of the Dodd-Frank Financial Reform Act

Times are changing for consumer finance litigators
By B. Rush Smith III, Thad H. Westbrook, and Sarah Nielsen

Change is on the horizon for consumer finance litigators. On July 21, 2010, President Barack Obama signed into law the largest financial regulatory overhaul since the Great Depression, the Dodd-Frank Wall Street Reform and Consumer Protection Act (Pub. L. No. 111-203, H.R. 4173, the Act). The Act's stated purpose is to "promote the financial stability of the United States by improving accountability and transparency in the financial system, to end 'too big to fail,' to protect the American taxpayer by ending bailouts, [and] to protect consumers from abusive financial services practices." While the majority of the Act's provisions require new regulations that will, in time, dramatically change the litigation landscape, there are some provisions that will begin to influence consumer finance litigation immediately.

This article will discuss the major changes to the Truth in Lending Act (TILA) and the Real Estate Settlement and Procedures Act (RESPA), outline the newly created Bureau of Consumer Financial Protection, and conclude with several questions that will remain unanswered well after the Act's effective date.

New Claims, New Defenses, and New Penalty Provisions

New Claims Available to Consumers

Title XIV of the Act significantly amends TILA as it relates to mortgage origination and residential mortgage loans. A "mortgage originator" is defined as any person "who, for direct or indirect compensation or gain," takes a residential mortgage loan application, assists a consumer in obtaining or applying to obtain a residential mortgage loan, or offers or negotiates terms of a residential mortgage loan. (Sec. 1401(2)(A)) It also includes any person "who represents to the public" that he can or will provide the above services. (Sec. 1401(2)(B)). Under the amendments, mortgage originators are now subject to two claims by consumers: (1) violation of the duty of care and (2) violation of the prohibition on steering incentives.

The duty of care for mortgage originators is twofold: (1) originators must be qualified, registered, and licensed under the SAFE Act and state law and (2) loan documents must include the unique qualifier provided by the Nationwide Mortgage Licensing System Registry. (Sec. 1402) This duty is subject to additional regulation by the Bureau of Consumer Financial Protection and consumers have a claim if it is violated. (Sec. 1404)

Additionally, mortgage originators are subject to a prohibition on steering incentives. In the amended TILA, a mortgage originator cannot be paid compensation that varies based on the terms of the loan, other than the amount of the principal. (Sec. 1403) Moreover, no person other than the consumer may pay the mortgage originator an origination fee or charge unless it is a bona fide third-party charge not retained by the creditor, mortgage originator, or an affiliate of the creditor or mortgage originator. The only exception allows a nonconsumer to pay a fee if the consumer does not pay any compensation

directly to the mortgage originator and the consumer does not make any upfront payment of discount points, origination points, or fees. Consumers have a cause of action for violation of this prohibition as well. (Sec. 1404) Moreover, the Board of Governors has authority to prescribe regulations to prohibit the steering of any consumer to a residential mortgage loan that the consumer lacks a reasonable ability to repay or that has predatory characteristics or effects (including equity stripping, excessive fees, or abusive terms). (Sec. 1403) The Board also may prescribe regulations prohibiting a mortgage originator from steering a consumer from a qualified mortgage to a nonqualified mortgage. These yet-to-be-promulgated regulations also create a right of action for the consumer and are subject to the same damages provision. (Sec. 1404 (creating a cause of action when a mortgage originator fails "to comply with any requirement imposed under this section and any regulation prescribed under this section"))

The damages available to consumers for a mortgage originator's violation of the duty of care or violation of the prohibition on steering incentives include "the greater of actual damages or an amount equal to 3 times the total amount of direct and indirect compensation or gain accruing to the mortgage originator in connection with the residential mortgage loan involved in the violation, plus the costs to the consumer of the action, including a reasonable attorneys' fee." (Sec. 1404)

TILA also provides that no creditor may make a residential mortgage loan until

it makes a "reasonable and good faith" determination that the consumer has a "reasonable ability to repay" the loan. (Sec. 1411) A creditor makes this determination by considering a variety of factors enumerated in the Act. This requirement is similar to the "ability to repay" factor in many states' consumer protection laws governing unconscionable loan transactions. Thus, many litigators are already dealing with this issue on the state level. By including the "reasonable ability to repay" in TILA, the federal government is similarly prohibiting "unconscionable" conduct at the federal level.

Violation of the reasonable ability to repay subjects the creditor to consumer claims. The damages available to consumers include all damages under 15 U.S.C. § 1640(a), including

- 1. any actual damage sustained by the person as a result of the failure;
- 2. twice the amount of any finance charge in connection with the transaction or in an action relating to a credit transaction not under an open-end credit plan that is secured by real property or a dwelling, a penalty not less than \$400 or greater than \$4,000; and
- 3. an amount equal to the sum of all finance charges and fees paid by the consumer unless the creditor demonstrates that the failure to comply is not material.

15 U.S.C. § 1640(a); Sec. 1416.

The Act provides creditors with one safe harbor—a rebuttable presumption that a consumer has a reasonable ability to repay all "qualified mortgages." (Sec. 1412) Under the Act, "qualified mortgage" is defined according to the following criteria:

- the periodic payments must not result in an increased principal balance, nor allow the consumer to defer repayment;
- the terms must not result in a balloon payment (unless allowed by federal regulation);
- income resources must be on file and verified;
- for fixed-rate loans the payment schedule must fully amortize and include all taxes, insurance, and assessments;
- for adjustable rate loans, the payment schedule must be based on the maximum rate permitted during the first five

years;

- it must comply with the Bureau's regulations relating to ratios of total monthly debt to monthly income;
- total points and fees cannot exceed 3 percent of the total loan amount; and
- the term of the loan cannot extend beyond 30 years (except in high-cost areas).

However, the Board of Governors has the authority to "prescribe regulations that revise, add to, or subtract from the criteria that define a qualified mortgage" and to include balloon loans within the definition. (Sec. 1412)

New Defenses for Consumers in Foreclosure

Consumers also have two new defenses to foreclosure: (1) if the newly created prohibition on steering incentives is violated by a mortgage originator or (2) if a creditor violates the reasonable ability to repay requirement. This section will discuss the two new consumer defenses.

Essentially, consumers have a defense of setoff or recoupment against a creditor, assignee, or holder in a foreclosure action or collection action if the creditor violates the newly created "reasonable ability to repay" provision or the mortgage originator violates the prohibition on steering incentives. The amount of setoff or recoupment is "equal to the amount to which the consumer would be entitled under subsection (a) for damages for a valid claim brought in an original action against the creditor, plus the costs to the consumer of the action, including a reasonable attorney's fee." (Sec. 1413) As noted above, TILA's civil liability provision provides that a consumer, in an original action, is entitled to actual damages, twice the amount of any finance charge or a penalty not less than \$400 or greater than \$4,000, and an amount equal to the sum of all finance charges and fees paid by the consumer. See 15 U.S.C. § 1640(a).

Therefore, the amount set off will include all of the damages above, plus reasonable attorneys' fees and costs. Because consumers are provided an independent action for violation of these provisions, they also can counterclaim, if within the statute of limitations period, and recover any amount of damages above the setoff.

If the newly created three-year statute of limitations runs, the consumer is entitled

Reasonable Ability to Repay

Basis for Determination—A determination of a consumer's ability to repay a residential mortgage loan shall include

- consideration of the consumer's credit history, current income, expected income the consumer is reasonably assured of receiving,
- 2. current obligations,
- 3. debt-to-income ratio or the residual income the consumer will have after paying non-mortgage debt and mortgage-related obligations,
- 4. employment status, and
- 5. other financial resources other than the consumer's equity in the dwelling or real property that secures repayment of the loan.

A creditor shall determine the ability of the consumer to repay using a payment schedule that fully amortizes the loan.

Income Verification—A creditor making a residential mortgage loan shall verify amounts of income or assets that such creditor relies on to determine repayment ability, including expected income or assets, by reviewing the consumer's Internal Revenue Service Form W–2, tax returns, payroll receipts, financial institution records, or other third-party documents that provide reasonably reliable evidence of the consumer's income or assets.

to the amount of setoff or recoupment up to the date of the running of the limitations period. (Sec. 1413)

New Defenses for Creditors

Under the Act, creditors have two new, but narrowly drawn defenses to TILA violations. The first defense is one for fraud on the part of the consumer. Specifically, the civil liability provision in TILA provides a new subsection stating "no creditor or assignee shall be liable to an obligor under this section, if such obligor, or co-obligor

has been *convicted* of obtaining by actual fraud such residential mortgage loan." (Sec. 1417 (emphasis added)) This defense protects creditors or assignees from rescission or damages only if the consumer is convicted of fraud in obtaining the mortgage loan. This defense provides no protection for creditors or assignees unless the consumer is *convicted* of actual fraud. Thus, if a borrower misrepresents information on his application, the misrepresentation alone is insufficient to provide the creditor with this defense.

The second new defense available to creditors or assignees is a "cure" defense. In the case of a creditor or assignee failing to satisfy any requirement under 15 U.S.C. § 1639, a creditor or assignee is protected from liability if it establishes either:

- within 30 days of the loan closing and prior to the institution of any action, the consumer is notified of or discovers the violation, appropriate restitution is made, and at the choice of the consumer, the loan is changed to satisfy the requirements or the terms are changed so the loan is no longer high-cost.
- 2. within 60 days of the creditor's discovery or receipt of notification of an unintentional violation or bona fide error and prior to the institution of any action, the consumer is notified of the compliance failure, appropriate restitution is made, and at the choice of the consumer, the loan is changed to satisfy the requirements or the terms are changed so the loan is no longer high-cost.

Thus, any violation, either intentional or unintentional, will not subject a creditor or assignee to liability under TILA if, within 30 days of the loan closing and prior to the institution of an action by the consumer, the violation is corrected. If the violation is unintentional or the result of a bona fide error, the creditor or assignee has 60 days to make corrections before becoming subject to liability.

Just as the fraud defense provides only limited protection for creditors or assignees, the corrective measures defense provides protection only when the creditor or assignee corrects the violation prior to the consumer instituting suit.

New Penalty Provisions and Extension of Statute of Limitations

In addition to the significant amendments

adding new claims for consumers and new defenses for creditors, the TILA amendments directly affect the civil penalty provisions. First, civil liability is increased to an amount not less than \$200, nor greater than \$2,000 for violations related to consumer leases. (Sec. 1416) Second, total recovery in class actions is now capped at the lesser of \$1 million or 1 per centum of the net worth of the creditor. In addition to greater damages, consumers also are given additional time to bring TILA actions with a three year statute of limitations.

Other Noteworthy TILA Amendments

Under the TILA amendments, a servicer must credit a payment to a consumer's loan account as of the date of receipt. (Sec. 1464) A servicer is excused from immediately crediting the payment when the delay in processing will not affect the consumer's credit report nor result in a charge on the creditor's account. Additionally, servicers and creditors must respond quickly to requests for payoff statements. When a consumer or an individual on behalf of the consumer requests a payoff statement, in writing, the servicer must send the statement within a reasonable time not to exceed seven business days from the date of receipt. Thus, under the newly amended TILA provisions, servicers must streamline processing of information to ensure compliance and avoid increased damages.

Also, TILA is amended to prohibit certain provisions in a mortgage loan or extension of credit, including mandatory arbitration provisions when the loan or extension of credit is secured by a principal dwelling and waivers of statutory causes of action. (Sec. 1414).

RESPA: Stiffer Penalties, Stricter Timelines, and Other Prohibitions

Servicers Are Subject to Stiffer Penalties and Stricter Timelines

In addition to the significant changes to TILA, the Act also makes several changes to RESPA. The amendments to RESPA provide for higher damages and stricter timelines for responding to qualified written requests (QWR). Specifically, borrowers in a class action are now entitled to actual damages and additional damages not to exceed \$2,000, per member of the class, when there is a pattern of noncompliance. (Sec. 1463) However, total recovery is capped at the lesser of \$1

Preemption: State Consumer Financial Laws

The preemption provisions of the Act apply solely to "state consumer financial laws," meaning that the existing preemption standards apply to all laws that are not "state consumer financial laws."

State Consumer Financial Law: A state law that does not directly or indirectly discriminate against national banks and that directly and specifically regulates the manner, content, or terms and conditions of any financial transaction (as may be authorized for national banks to engage in), or any account related thereto, with respect to a consumer.

Because this definition is broad and somewhat vague, only time will tell how the courts and the comptroller of currency define its scope.

million (up from \$500,000) or 1 percent of the net worth of the servicer. Individuals also are entitled to additional damages not to exceed \$2,000 (up from \$1,000), if the borrower shows a pattern or practice of noncompliance.

Similar to the limited amount of time provided to servicers and creditors under the new TILA provisions, RESPA time limits for responding to a QWR are decreased significantly:

- Time for servicer to provide a written response acknowledging receipt decreased from 20 days to 5 days.
- Time for servicer to make appropriate corrections or conduct an investigation reduced from 60 days to 30 days.

(Sec. 1463) These reduced response times are land mines to expose servicers to increased litigation.

A new subsection allows a servicer to request a 15-day extension when the servicer notifies the borrower of the extension and the reason for the delayed response. Without additional resources, servicers may not be able to respond to each QWR within 5 days and perform a thorough investigation

in 30 days.

New Rules for Force-Placed Insurance

Force-placed insurance will continue to be a hotly contested issue under the Act. RESPA is amended to prohibit servicers from force-placing insurance without a "reasonable basis"—an undefined term—to believe a borrower has failed to comply with property insurance requirements. (Sec. 1463) A servicer may not impose a charge for force-placed insurance unless the servicer has sent a written notice to the borrower, by first-class mail, stating there is no evidence of coverage and outlining the procedure for a borrower to demonstrate coverage. If the consumer fails to respond to the notice, a second notice is sent 30 days later. If the consumer does not respond to the second notice within 15 days, the servicer may then force-place insurance. The process does not end there.

The servicer must accept "any reasonable form of written confirmation from the borrower of existing insurance coverage"—again "reasonable" is not defined—and cancel force-placed insurance within 15 days of receipt. The premiums for any force-placed insurance must then be refunded to the borrower.

Other Prohibitions on Servicers

RESPA, 12 U.S.C. § 2605(k), now states that a servicer of a federally related mortgage loan is expressly prohibited from

- charging fees for responding to valid QWRs (as defined in regulations that the Bureau shall prescribe);
- failing to take timely action to respond to a borrower's requests to correct errors relating to allocation of payments, final balances, or other standard servicer's duties;
- failing to respond within 10 business days to a request from a borrower to provide the identity, address, and other relevant contact information about the owner or assignee of the loan; and
- failing to comply with any other obligation found by the Bureau, by regulation, to be appropriate to carry out the Act.

Any servicer who violates these new prohibitions is liable to the borrower "for each such failure" in the amount of actual damages to the borrower, any additional damages in an amount not to exceed \$2,000, and fees and costs incurred in a successful

action. 12 U.S.C. § 2605(f)(1) and (3). Accordingly, servicers should be careful not to participate in any of the newly prohibited actions described above.

Preemption: It's a Whole New World

Congress also took away a significant defense for some financial institutions when it changed the standards for preemption in the National Bank Act. Specifically, the Act preempts state consumer financial laws in only three limited situations:

- to the extent the law has a "discriminatory effect" on national banks or federal thrifts in comparison with the effect on state banks;
- in accordance with the standard for preemption in *Barnett Bank of Marion County, N.A. v. Nelson, Florida Insurance Commissioner, et al.*, 517 U.S. 25 (1996), the state consumer financial law "prevents or significantly interferes with the exercise by the national bank of its powers;" or
- express preemption by a provision of federal law other than the National Bank Act

Any preemption determination under *Barnett* may be made by a court, by regulation, or by the comptroller of currency on a case-by-case basis. Again, this leaves significant issues regarding preemption up to regulations and subsequent litigation, meaning application of the doctrine of preemption may be hotly contested for years.

The Act eliminates state law preemption for all subsidiaries and affiliates of national banks. (Sec. 1044) Under the Act, subsidiaries and affiliates are now exposed to all state laws, including licensing and regulation, and are not provided any protection under Watters v. Wachovia Bank, N.A., 550 U.S. 1 (2007). Prior to the Act, subsidiaries and affiliates could claim preemption as a defense under the Watters opinion, which held that a state may not exercise general supervision or control over a subsidiary of a national bank. This decision is now effectively abolished. Without this valuable defense, national banks must decide whether to have their affiliates and subsidiaries immediately comply with state laws that vary across state lines or fold all affiliates into the parent corpora-

This change in existing law is accomplished by an amendment to the National

Definitions and Background

(Secs. 1002, 1018, 1061)

- "Covered person" means
- a. any person that engages in offering or providing a consumer financial product or service; and
- b. any affiliate of a person described in subparagraph (A) if such affiliate acts as a service provider to such person.

"Consumer financial product or service" means any financial product or service that is offered or provided for use by consumers primarily for personal, family, or household purposes; or is delivered, offered, or provided in connection with a consumer financial product or service.

"Service provider" means any person that provides a material service to a covered person in connection with the offering or provision by such covered person of a consumer financial product or service, including a person that

- i. participates in designing, operating, or maintaining the consumer financial product or service; or
- ii. processes transactions relating to the consumer financial product or service (other than unknowingly or incidentally transmitting or processing financial data in a manner that such data is undifferentiated from other types of data of the same form as the person transmits or processes).

"Designated Transfer Date"—While the creation of the Bureau occurs on the date of enactment of the Act, the transfer of consumer financial protection functions does not occur until the "designated transfer date." (Sec. 1018, 1061) The "designated transfer date" is prescribed by the Secretary of the Treasury and must be 180 days to 12 months after the Act's enactment, unless the Secretary extends the date to no later than 18 months after enactment. (Sec. 1062)

Bank Act providing that neither the National Bank Act nor the Federal Reserve Act "preempt, annul, or affect the applicability of any State law to any subsidiary or affiliate of a national bank." (Sec. 1044 (emphasis added)) And, in even more concrete terms, the Act provides that "a State consumer financial law shall apply to a subsidiary or affiliate of a national bank ... to the same extent that the State consumer financial law applies to any person, corporation, or other entity subject to such State law." (Sec. 1044 (emphasis added)) While the applicability of preemption for national banks is specifically limited to state consumer financial laws, subsidiaries and affiliates of national banks are now subject to all state laws.

Creation of the Bureau of Consumer Financial Protection

In addition to the amendments to TILA and RESPA and changes in the applicability of the doctrine of preemption, the Act undertakes a significant regulatory overhaul that may have some peripheral effects on litigation. In addition to traditional rulemaking and administrative powers, the newly created Bureau has extensive authority to ensure consumers are protected under the alphabet soup of existing federal consumer protection laws—EFTA, ECOA, FCRA, FDCPA, HMDA, RESPA, SAFE Act, TILA—while potentially creating new requirements through regulation. (*See* Sec. 1061)

The Bureau is an independent entity established in the Federal Reserve System with its main purpose being to "seek to implement and . . . enforce Federal consumer financial law consistently for the purpose of ensuring that all consumers have access to markets for consumer financial products and services and that markets for consumer financial products and services are fair, transparent, and competitive." (Secs. 1011(a), 1021) In addition to overseeing new regulations related to established federal consumer financial laws, the Bureau has authority to declare an act or practice unfair or abusive for purposes of federal law. (Sec. 1031(c) and (d)) These practices are deemed "unlawful" under the Act and subject to the Bureau's enforcement powers. (Sec. 1036)

If the Bureau determines that a covered person or service provider has engaged in unlawful activity, it may issue a cease and desist order or pursue a civil action, in a federal district court or a state court, for violations of the enumerated federal consumer financial laws. (Secs. 1053, 1054(f)) In either instance, remedies available to the Bureau are broad: rescission or reformation, refund of moneys or return of property, restitution, disgorgement, damages, public notification of violation, and civil monetary penalties.

For civil penalties, the Act creates a "Consumer Financial Civil Penalty Fund" to be maintained and established at a federal reserve bank. If the Bureau receives any "civil penalty against any person in any judicial or administrative action under Federal consumer financial laws," it must deposit it into the fund. (Sec. 1017(d)(1)) The fund is then used to pay "victims of activities for which civil penalties have been imposed under the Federal consumer financial laws." (Sec. 1017(d)(2)) If victims cannot be located or payments are impracticable, the Bureau may use the funds for "consumer education and financial literacy programs."

In sum, the Bureau has sweeping rule-making, investigative, and enforcement authority to regulate all consumer financial products and services. Through its rulemaking, the Bureau has the ability to promulgate rules that could subject creditors, servicers, or mortgage originators to additional consumer actions. Moreover, the Bureau itself also may bring creditors, servicers, and mortgage originators into court for violations. Thus, while the litigation effects of the Bureau are not immediately apparent, they are far reaching.

Where Do We Go from Here?

Even though the Act spans over 800 pages, several questions remain unanswered, the most obvious question being whether Title X-the Consumer Financial Protection Act of 2010-provides for an implied right of action or a duty of care sufficient for a state law negligence per se action. As noted above, the Bureau and the state attorneys general have civil enforcement authority over violations of the Act. However, there is no mention as to whether consumers themselves may pursue a violation of Title X. When the bill was passed by the House on December 11, 2009, it included a provision providing that the title could not be construed so as to create a private right of action. (Sec. 4508) In contrast, when the bill was referred to the Senate and subsequently enrolled, it did not contain

Additional Resources

For other materials related to this topic, please refer to the following.

ABA Web Store

The ABA Web Store offers an ABA CLE product on this topic:

Financial Reform? Putting the Pieces Together (Audio CD Package)

On August 11, 2010, the ABA Banking Law and Business Bankruptcy Committees present the first in a two-part series on the Dodd-Frank Wall Street Reform and Consumer Protection Act which was recently passed by Congress. The Dodd-Frank Act is the most sweeping piece of financial regulatory reform since the Great Depression.

The panel for this session includes Congressional and Executive Branch officials who were actively involved in the Dodd-Frank Act's negotiation, drafting and implementation, and prominent practitioners representing the panoply of constituencies affected by the legislation.

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this provision, thereby leaving open the question of whether a private right of action exists for consumers.

The Bureau itself is given new powers, new staffing (including lawyers, economists, etc.), and broad authority to regulate all consumer financial products and services. Therefore, enforcement will depend largely on the funding available to the Bureau. Presumably the Bureau will be well-funded considering its funding comes from the budget of the Federal Reserve System, and is based on an amount re-

quested by the director that cannot exceed 10 percent of the fixed operating expenses for fiscal year 2011, 11 percent for fiscal year 2012, and 12 percent for fiscal year 2013, and each year thereafter. (Sec. 1017)

In addition to providing the Bureau with sweeping power, the Act leaves states with broad authority to regulate and enforce violations of consumer protection laws. For example, the state attorneys general have power to bring civil enforcement actions for violations of the Act and any regulations promulgated thereunder. (Sec.

1042) This authority subjects the enforcement and overall effectiveness of the Act to state funding. The question remains whether states are sufficiently funded to undertake enforcement.

Conclusion

The Act itself mostly represents only a framework for change, making it difficult now to determine how dramatically consumer finance litigation will be affected by its provisions. Over the course of the next year, the Bureau will begin to promulgate

regulations, begin investigations, and undertake civil administrative proceedings that will begin to clarify claims and defenses. While this article presents the most readily apparent implications, the authors and other consumer finance litigators will need to continue to evaluate the implications of the Act.

B. Rush Smith III and Thad Westbrook are partners, and Ms. Nielsen is an associate at the Columbia, South Carolina, office of Nelson Mullins Riley & Scarborough LLP.

BUSINESS LAW **TODAY**

The ABA Business Law Section's Online Resource

Keeping Current

Professional Privilege: EU Court Limits the Scope of Legal Professional Privilege
By Alasdair Balfour and Ianis Girgenson

On September 14, 2010, the Court of Justice of the European Union confirmed in Akzo Nobel v. Commission that documents prepared by in-house lawyers are not privileged under EU rules. Case C-550/07 P, Akzo Nobel Chemicals Ltd et al. v. Commission (not yet published in ECR). This approach is at odds with the principles applied in the United States, the United Kingdom, and some other jurisdictions, but is consistent with previous case law of EU courts. The court's ruling is of general application to investigations conducted by the European Commission (EC), although Akzo and previous cases related to antitrust investigations.

Court Denies Privilege to Notes Prepared by In-house Counsel

Legal professional privilege protects communications between lawyers and their clients. The EC cannot require disclosure of privileged documents and cannot use these documents, for example, as evidence of competition law infringements.

According to established EU case law, the privilege for written communications between lawyers and clients applies only if the following conditions are met: (1) the communications are made for the purposes and in the interest of the client's rights of defense and (2) the communications emanate from independent lawyers admitted in the European Economic Area (EEA).

On September 14, 2010, the Court of Justice confirmed that the requirement of independence precludes any employment relationship between the lawyer and his or her client. Therefore, legal professional privilege does not cover internal notes prepared by in-house counsel unless these notes (1) merely report the text or the

content of communications with external lawyers or (2) are drawn up exclusively for the purpose of seeking legal advice from external counsel.

Ruling Puts an End to a Seven-year Legal Battle

The case reviewed by the court goes back to 2003 when the EC, assisted by representatives of the U.K. Office of Fair Trading, raided the premises of Akzo Nobel Chemicals in the United Kingdom. The EC seized a considerable number of documents, including copies of two e-mails exchanged between Akzo's managing director and its in-house counsel, a member of the Dutch bar. The EC determined that these documents were not covered by legal professional privilege because they were not prepared by an external counsel.

Akzo challenged this decision, but in 2007 the Court of First Instance (now General Court) sided with the EC. Akzo appealed before the Court of Justice. Its appeal was supported by several lawyers' associations, all advocating for the extension of legal professional privilege to in-house lawyers. Akzo's appeal was also supported by Ireland, the Netherlands, and the United Kingdom. However, the Court of Justice rejected the appeal and confirmed the EC's decision.

EU Approach is at Odds with National Law in Several Countries

The court's ruling is consistent with the approach adopted by most European continental legal systems. However, it contradicts the principles applied in the United Kingdom and certain other EU Member States (Ireland, the Netherlands, Greece, Poland, and Portugal), as well as in

the United States, where legal professional privilege extends to communications with all lawyers, including in-house lawyers admitted to a national bar or law society. The court ruled that there was no justification for bringing EU law into line with the minority approach in EU Member States.

The court considered that even "enrolled" counsel (i.e., in-house lawyers admitted to a national bar or law society) do not enjoy the same degree of independence from their employers as external lawyers do vis-à-vis their clients. According to the court, notwithstanding their professional ethical obligations, in-house counsel cannot be treated in the same way as external lawyers.

The court also confirmed that communications with external counsel are privileged only if the counsel is admitted in one of the EEA Member States. In this respect, EU rules differ from the national rules of most EEA Member States, as well as those in the United States, which consider communications with external counsel admitted in other jurisdictions to be privileged (based on principles of reciprocity).

The approach adopted by the court applies only to investigations conducted under EU law. National rules continue to apply to investigations under Member State national laws.

How to Ensure Your Documents are Privileged under EU Rules

 Exchanges with external counsel are privileged if they are made for the purposes of the client's rights of defense and if the counsel is admitted in the EEA. Ensure that EEA-admitted counsel are always involved in communications which relate to EU law matters. Men-

- tion prominently on any notes prepared for the purpose of seeking external legal advice that they are prepared at the request of external counsel.
- Notes prepared by in-house counsel are not privileged unless they (1) are drawn up exclusively to seek legal advice from external counsel or (2) report the text or the content of communications with external counsel. Do not amend any written legal advice received from
- external lawyer (e.g., by adding further comments). Do not circulate privileged correspondence widely within the company.
- In the event of a dawn raid, object to seizure by EU officials of documents that you consider to be privileged. The officials are not entitled to a cursory look if this would reveal the contents. If EU officials insist on seizing privileged documents, ask for them to be placed

in a sealed envelope to have their status determined in court. Always have an external counsel present during a dawn raid.

Alasdair Balfour is a partner and Ianis Girgenson is an associate in the London office of Fried, Frank, Harris, Shriver & Jacobson LLP.

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Keeping Current: Securities

Proxy Access Year One: What to Do Now By William M. Kelly

Proxy access will be a reality beginning in the 2011 proxy season. The SEC's new Rule 14a-11 will enable long-term substantial shareholders, acting alone or in concert, to nominate candidates for up to a quarter of a company's board, and to include those nominees in the company's own proxy statement in competition with the incumbent board's nominees. The SEC also amended Rule 14a-8 to allow for shareholder proposals that would broaden proxy access.

How will shareholders use their newfound powers, and how should companies be preparing for this new world? These questions, once hypothetical, are now imminent: calendar year companies could begin receiving these notices as early as this fall, so now is the time to anticipate, prepare and, potentially, to act.

We have been discussing these matters with companies, institutional shareholders, regulators, and other market participants over the past year. Here are our initial thoughts as to what to expect for 2011, together with our recommended action plan.

Who will use proxy access?

To begin with, we do not expect a stampede of proxy access campaigns in the 2011 season. There are no useful precedents, there are a host of practical unknowns as to how proxy access will play out, and there is a natural disinclination on the part of large shareholders to associate themselves with risky ventures. Instead of a frontal assault on corporate America, we anticipate a series of exploratory skirmishes, in which activists select targets thought to be vulnerable, put forward plausible candidates, and seek to mobilize

shareholders and their advisors. The 2011 season, in other words, will likely be a modestly scaled clinical trial.

Who will be conducting the trial? Probably not your largest shareholders. The major mutual fund companies and similar institutional investors, who collectively are the single largest category of U.S. public company stockholders, have typically not been inclined to lead the charge, although they may support other shareholders' nominees. We don't think that the new rules are likely to change this mindset.

Some hedge funds have historically used proxy contests as a means of promoting their agendas. We don't expect these firms to be big users of proxy access. They have shown themselves more than willing to wage their own contests, and we think many will be unwilling to limit their flexibility by certifying a lack of intent to change control. And while Rule 14a-11 may provide cheap access to the proxy statement and the management proxy card, it comes with a variety of limitations that these firms are likely to find unattractive. In a traditional proxy contest the insurgent has its own proxy statement and proxy card, giving it control over messaging and, importantly, real-time information as to the success of its solicitation efforts. Under Rule 14a-11, by contrast, management is the party collecting the proxy cards, giving it first crack not only at counting the votes but at assessing the validity of proxies. We think that Rule 14a-11 will thus not usurp the place of proxy contests.

So who has the means, the motive and the opportunity? Pension funds and their allies in the activist community (e.g., unions) are a likely place to look. These organizations have been the leading pro-

ponents of governance proposals and withhold campaigns, and so putting forward their own candidates is a logical next step. We know that some of these organizations have been identifying targets and assembling lists of possible candidates for use in the event that proxy access came to pass. And pension funds are just the kind of large, long-term holders that Rule 14a-11 has been designed to empower. Some are suggesting that the 3 percent/three year standard will make it very difficult to assemble a nominating group, especially in the case of large companies. But even if no fund individually has owned 3 percent of your stock for the past three years, it may be possible to assemble a group of likeminded funds for this purpose.

In any case it's useful to remember that proxy access is only one of a growing spectrum of tools at the disposal of shareholders seeking to influence companies. That spectrum starts with dialogue and persuasion, escalates to include shareholder proposals and (with Dodd-Frank) mandatory say-on-pay votes, and now includes proxy access. Because a credible ability to escalate translates to negotiating leverage, we believe that the real impact of proxy access may be as much in the threat as in deployment.

Picking Targets

Who will make the short list for proxy access campaigns in 2011? At the company level the targets are likely to have:

a shareholder base that might be sympathetic to an insurgent (no substantial insider blocks, significant concentration of pension funds, a history of supporting shareholder proposals), and

 a performance, compensation or governance story that will provide the hook for arguing for new faces on the board.

If you've been the target of significant shareholder proposals in the past, or if your ISS GRiD ratings show significant concern in one or more areas, you should consider yourself vulnerable and, as discussed below, you should be developing an action plan designed to avoid being on the short list of activist targets and to defeat a shareholder nomination if one emerges.

But it is not just companies who are the targets here. Remember that companies will be distributing a single proxy listing all candidates, meaning that shareholders will be asked to select, say, eight out of 10 names. We expect that as a tactical matter shareholders will not only advocate for their own candidates but also may focus on one or two directors for whom votes are to be withheld. Individual directors may be vulnerable because of factors like:

- · poor attendance
- · overboarding
- · close association with the CEO
- long board tenure at companies that have had performance problems
- committee service in problematic areas
 (e.g., audit committee if there has been
 a restatement, or compensation committee if the company's pay practices are
 under fire).

Elements of an Action Plan

Revisit your advance notice bylaws.

Most companies have advance notice bylaws for director nominations, which typically require a minimum notice period (often in the range of 90-120 days prior to the meeting) and information about the nominee and the nominating shareholders. At a minimum you should ensure that your bylaw is consistent with Rule 14a-11, perhaps with a saving clause that provides that a notice that is valid under the rule will be valid under the bylaw.

Aligning your bylaw notice period with that in Rule 14a-11 would be desirable, but may be aggressive as a matter of Delaware law. A notice period that is deemed unreasonably long may not be enforceable, and the conventional wisdom in Delaware has been that periods of more than 120 days from the meeting date may be too long. The 14a-11 notice period, which is mea-

sured from the prior year's mailing date, could translate into 150 days or more prior to the meeting date.

Your bylaw may require information that goes beyond the information demanded by Rule 14a-11. Many bylaws, for example, require disclosure of derivative holdings not covered by new Schedule 14N. We think that additional requirements of this sort continue to be permissible with respect to non-14a-11 nominations.

If you have a majority voting policy, confirm that it will be disabled in a proxy access situation.

Majority voting policies generally do not apply in contested elections. A "contest" for this purpose should include any situation where there are more candidates than slots.

Assess your vulnerability and brief management and the board.

The material above reviews some of the factors that could cause your company or one or more of your directors to be especially susceptible to a Rule 14a-11 challenge. This is the time for an in-depth vulnerability analysis. If you conclude that you are at risk the time to begin the dialogue with the board is now, not after a nomination turns up. It may be that the prospect of a challenge will prompt a discussion as to potential changes in governance or other practices that would begin to address shareholder concerns. In any case an active discussion now will facilitate action later if required.

Consider enhancing your shareholder communications.

Most companies, and especially the larger companies, have in recent years increasingly been reaching out to large shareholders, including in some cases dialogue at the board level. These programs may not, however, have included those shareholders who are most likely to initiate or to be asked to support a proxy access nomination. This is thus a good time to assess how comprehensive your program has been. Affirmative outreach to key shareholders, particularly in the period prior to the deadline for proxy access nominations, could be the difference between being on or off the short list of targets.

This is also an opportunity to review the quality of your communications with

respect to issues that could emerge in a campaign. For example, we think many companies could benefit from enhanced public discussion of how the board has been assembled. S-K 401(e) was amended this past year to require discussion of the "specific experience, qualifications, attributes or skills" that the company thinks each director or nominee brings to the board. And an increasing number of companies have adopted formal director qualification standards which, although not effective as a basis for excluding proxy access nominees, nonetheless furnish a record of board deliberation on the subject. A thoughtful discussion of the design principles that lie behind the overall composition of the board can be particularly helpful for advocacy purposes if the removal of a targeted director would leave the board lacking a valuable skill set.

Develop a calendar and identify a response team.

Starting from the mailing date for your most recent annual proxy statement, build a calendar that reflects the 30 days during which valid notices may be received, the two 14-day periods for dispute resolution, and the other milestones reflected in the rule. The schedule should include a very prompt review and conclusion as to the validity of the notice. (Note, though, that the bases for excluding nominations are extremely narrow, and that nominating shareholders will often have an opportunity to cure.) If you do not have a basis to challenge the nomination (and perhaps even if you do) you will want to allow time to consider whether there can be a negotiated alternative to the nomination. These decisions may require multiple meetings on short notice.

Because the notice of nomination will be publicly available on Schedule 14N, and because the rule gives priority in the case of competing nominations to the largest shareholder or group, we think there will be some incentive for nominating shareholders to file late in the 30-day window to reduce the risk of competing nominations. This factor will only enhance the time pressure.

Depending on your vulnerability assessment, you may wish to begin to assemble a response team, which would include professionals in the proxy solicitation and investor communications fields as well as your legal team. In any case it makes sense

to identify the short list of firms you would consider for those roles.

William M. Kelly is a partner at the Menlo Park, California, office of Davis Polk & Wardwell LLP.

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