BUSINESS LAW **TODAY**
The ABA Business Law Section's Online Resource

Vendor Due Diligence: Could It Catch On Here?

By Lee J. Potter, Jr.

The due diligence process associated with most prospective M&A transactions here in the United States tends to generally follow a fairly well-worn path. A buyer's legal and financial advisors will review documentation provided by the seller or the target company and perhaps interview members of its management. Other advisors hired by the buyer, such as environmental consultants, will separately perform inquiries. Thereafter, the advisors will prepare one or more written reports for the client to review. These reports (at least the legal report prepared by the buyer's counsel) will usually contain language stating that no party other than the client may rely on its contents.

Over the past decade or so, a quite different process has become popular in many European jurisdictions, at least in situations involving auctions. This alternative approach, referred to as "vendor due diligence" or "VDD," is now fairly common in transactions involving multiple potential buyers. In a typical VDD, the seller, rather than the buyer, will hire financial, legal and/or tax and other advisors to review the relevant documentation of the target company. These advisors will then prepare drafts of written reports that will be provided to prospective buyers to review. Prior to receiving a copy of the draft report, each prospective buyer first must sign a non-reliance letter agreeing that the report provider has no liability to that prospective buyer for any mistakes or omissions that may be contained in such draft reports. Once the non-reliance letters are signed and delivered, the draft VDD reports are then provided to the prospective buyers for review. In addition to reviewing the VDD reports, the seller oftentimes will allow the bidders, or perhaps a select subset of them, access to the underlying documentation of the target for purposes of performing confirmatory due diligence. The time period permitted for such confirmation will vary, depending on numerous factors, such as the amount of documentation, the detail of the VDD reports, and the relative bargaining strength of the seller and buyers. However, the amount of time allotted likely will be less than would have been the case if no draft VDD reports had first been provided and the prospective acquirers instead were performing their own due diligence.

Some VDD processes culminate with the report providers delivering to the ultimate buyer a final copy of the VDD reports at the time the buyer signs the definitive acquisition agreement. The report providers and the buyer will, at the same time, enter into an agreement that permits the buyer to rely on the final reports, subject to the terms and limitations contained in the agreement (these terms usually include a cap on liability).

The VDD process offers some interesting potential advantages when compared to the buyer-led due diligence process with which U.S. dealmakers are familiar. When there are numerous prospective buyers, providing them with draft VDD reports rather than having multiple sets of advisors involved would reduce significantly the burden on the seller to respond to multiple document requests and redundant queries. It would also reduce the amount of time bidders need to obtain a reasonable familiarity with the target company's businesses, operations, finances and legal issues (depending on the scope and detail of the reports). It would also reduce the cost to prospective buyers, particularly in the initial stages of their inquiry, when they might otherwise need to incur significant legal and other advisory fees to gain a baseline understanding of the target company. These cost savings could result in more prospective buyers remaining in the hunt and might result in a higher purchase price or better sale terms for the seller. In addition, delivering a draft VDD report that describes all known material risks and liabilities of a target company diminishes a prospective bidder's ability to submit a high initial bid merely to get exclusivity and later negotiate a lower price based on problems subsequently discovered. Lastly, having fewer advisors involved reduces the risk that news of a confidential sales process could be leaked.

The VDD process clearly has some potential disadvantages as well. First, a seller or target company has to incur the costs of hiring legal, accounting, and perhaps other advisors to prepare the VDD reports. These costs could be rather significant if the intent is to provide prospective buyers

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with reasonably comprehensive reports covering most or all material aspects of the target's businesses, finances, operations, and liabilities. (If the reports are not comprehensive, prospective buyers will reasonably assert that they will need to undertake additional due diligence to fill in the gaps.) Secondly, a buyer may be reluctant to place sole or primary reliance on the contents of the reports, as they are prepared by advisors for the seller, rather than its own advisors. Thirdly, the information in the reports would usually be presented in a very dry and stiff format, with little or none of the insight, advice, or recommendations that a buyer might expect from a report prepared by its own advisors. Lastly, VDD may pose some vexing issues for U.S. law firms involved in such projects.

A U.S. law firm that is invited to participate in a multi-country VDD needs to understand up front the contemplated process and the expectations of the parties, and carefully assess its risk exposure. It is not customary for an American law firm to permit a non-client to rely on a report prepared by it. Most U.S. law firms will not permit a non-client even to see its due diligence report unless the non-client first signs a letter agreeing that it may not rely on its contents. This practice presumably results from liability concerns—malpractice claims against law firms are more commonplace here in the United States than elsewhere. Moreover, ethics rules applicable to lawyers in the United States disallow them from capping or otherwise limiting the amount of their liability for malpractice. A U.S. law firm that contractually permitted a buyer to rely on its due diligence report therefore would be liable, without any limitation, for any losses incurred by the buyer that result from mistakes or omissions contained in its report. Moreover, when preparing the report, the law firm would not yet know the identity of the ultimate buyer, and thus would not have an understanding of that buyer's particular concerns or focuses. It is difficult to envision a law firm here in the United States agreeing to such an arrangement.

Therefore, before an American lawyer accepts a VDD engagement, he or she should have a clear understanding of the anticipated process, including whether the lead law firm or office (which may be a separate firm in the country of the seller or perhaps a foreign office of the same firm) will be required to deliver a reliance letter to the ultimate buyer, and whether the U.S. firm or office is itself expected to also deliver such a letter. A process that contemplates the U.S. firm itself affirmatively agreeing to permit reliance on its VDD report by the buyer may prove to be too unpalatable for the firm to accept. Alternatively, the foreign lead law firm may decide to include the U.S. information within its own VDD report, under its own name. This approach affords the U.S. firm at least a possibility that any dispute over U.S.-related information in the report would take place between the lead firm and the buyer, with the U.S. firm remaining in the background (albeit with liability over to the lead firm as its subcontractor), and that any resulting liability would be subject to the agreed-upon cap. However, even if the U.S. firm has no direct contact with the buyer, the buyer might nonetheless decide to file a malpractice claim directly against the U.S. firm in an American court. Such a claim would not be subject to any contractual cap, as (1) malpractice is a tort, not a contract-based claim, and (2) applicable ethics rules in the U.S. disallow lawyers from capping their liability in the terms of their engagements.

Because of the differences in the U.S. legal system versus those of European countries, VDD, at least in its most fulsome form that permits buyer reliance on the final reports, is not likely to become popular here in the United States. Even so, U.S. lawyers need to be somewhat familiar with this growing European practice, in order to properly address potentially problematic issues that could arise should they be invited to participate in such a project.

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From Private to Public Ordering: An Expanding Federal Role for Regulating Privacy and Data Security?

By Edward A. Morse

Consumers have reason to be wary about the security of their personal information—and so do the businesses that handle that information. Recent news accounts of major security breaches highlight the reality that security efforts at even the most reputable firms sometimes fall short. Epsilon, one of the largest distributors of permission-based e-mail services in the world, experienced a breach that disclosed millions of client e-mail addresses. Sony's online gaming network also experienced the theft of names, addresses, and potential credit card numbers affecting more than 77 million user accounts. These events are not rarities, but are part of a continuing litany of security failures affecting consumer information.

Hackers and thieves aren't the only ones after personal information. Compounding consumer angst, legitimate firms also attempt to collect and use personal information for commercial purposes. Privacy policies and click-through agreements are common—but are consumers reading them? And how is one to know that these policies are followed? Targeted advertising made possible by tracking consumer information offers potential benefits for consumers and businesses alike. However, advocacy groups have been shining a light on privacy concerns, potentially enhancing consumer awareness and causing changes in business practices. Third-party services, such as TRUSTe®, have also developed to provide consumers with additional assurance.

Political responses to these threats to consumer privacy and data security are predictably leaning toward solutions that are likely to involve an expanded role for government. Elected officials at the state and federal level have called for investigations and have proposed new legislation. The White House has vetted legislative proposals involving cyber-security policies. The Federal Trade Commission has also signaled greater openness toward discretionary intervention in cases involving perceived consumer harms, and proposed legislation may expand these powers. Finally, the Federal Reserve is also getting into this business, as it seeks to promulgate regulations under the Dodd-Frank Act to address concerns in the payments industry.

All of this froth in the water suggests that businesses who handle consumer data may be facing new legal risks and burdens. Just as Sarbanes-Oxley emerged from notable cases of accounting fraud, a similar movement may be under way in the matter of privacy and data security. This article places these prospects for new government intervention into a broader context, in which private ordering and market forces have played an important role in generating additional consumer protections. Good politics and good economics don't always go together, and business lawyers and their clients will need to be vigilant to understand market and legal risks presented in this changing environment.

Private Ordering––Self-regulation

Private ordering describes a range of approaches for organizing relationships that are rooted to varying degrees in the efficacy of self-regulation, as opposed to government intervention. Most private ordering regimes operate within boundaries formed by existing laws and regulations. For example, contracting parties have considerable latitude in fashioning terms, but public legal constraints may nevertheless affect the substance of their agreement (e.g., unconscionability) or the remedy for a breach (e.g., even ADR awards may be enforced in government-sanctioned courts).

Although law still plays an important role—either casting a shadow or shining a light, depending on the metaphor you prefer—preserving space for private ordering is often desirable. Among other things, private ordering preserves flexibility and allows firms to adapt to changing conditions without many of the public political constraints that affect the dynamics of legal rulemaking. To the extent that market forces demand more or less of something, private ordering allows the parties to adjust their positions and expectations accordingly.

Private ordering has been a signifi-

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cant part of the emerging framework for privacy and data security. As public norms valuing privacy and security have emerged, firms have adopted business practices that are responsive to the interests of their customers. Firms that experience security breaches receive significant public attention and incur significant costs. For example, Sony Corporation has estimated that the hacking breach of its Playstation and entertainment networks may cost the company $171 million over the next year, including benefits to consumers—a powerful incentive for security. Within the payment card industry, Form 10-K disclosures routinely recognize the risk to profits associated with security breaches in the network. No one makes money if consumers or merchants are afraid to use payment cards.

Private ordering does not necessarily entail a laissez-faire approach to all relationships, as it can occur within boundaries that are otherwise formed by external rulemaking. For example, formal processes may emerge to develop common rules and a means of policing the membership of specific communities, as in the case of GAAP and GAAS in financial accounting and PCI DSS in the payment card industry. Private firms can also assist in validating compliance, perhaps auditing or assessing based on predetermined standards, such as provided by TRUSTe® in the consumer realm. Such validation provides efficiency for consumers, who recognize a seal of approval and thereby avoid burdens associated with detailed assessments.

Self-regulation can thus operate as a form of private law that delivers a framework for fair dealing. However, the benefits of this system can also extend beyond the members of the business community, also reaching third parties, including consumers. Just as investors benefit from the application of financial accounting standards, consumers can also benefit from private ordering efforts aimed at conformity to data security standards.

But these desired benefits are never perfectly achieved, as private ordering regimes must also deal with the practical realities of monitoring and enforcement. When a self-regulation regime fails in some manner, it can become politically attractive for government to intervene. For the accounting profession, massive accounting frauds triggered additional government intervention through Sarbanes-Oxley, which injected new rules and additional government oversight into financial reporting processes. A similar movement is arguably underway in privacy and data security.

An Overview of Government Intervention

Current laws and regulations governing consumer privacy and data security are neither comprehensive nor consistent. In the United States, individual states have generally led the way with legislation, with the federal government intervening later on selected matters of federal significance. The resulting patchwork of laws is not easily cognizable. Multistate businesses face challenges in deciding the applicable laws and how to comply with all of them.

State Privacy and Data Security Laws

State privacy statutes are numerous and far-reaching, covering a broad range of business and government practices affecting the privacy of citizens. Some impose specific constraints on consumer relationships, thus interfering with the private ordering regime. Others may be viewed as reinforcing the private ordering regime through ensuring disclosure of information that may be necessary for market forces to incentivize responsible behavior.

State disclosure laws exemplify provisions that are designed to mobilize market forces and thus reinforce private ordering regimes. However, they are not without problems. These provisions usually require personalized notice to each affected consumer, which entails significant transaction costs above that of a public announcement. Many consumers already engage private firms to monitor the use of their personal information, causing them to ignore these notices. Moreover, a security breach does not necessarily cause any tangible damage to the consumer. If fraud occurs, it can be difficult, if not impossible, to trace its cause to a particular disclosure of information. In the case of credit card information, the combination of protections in federal law (e.g., 15 U.S.C. § 1643(a)(1)) and from card brand policies to limit consumer liability make it unlikely that consumers will directly bear costs associated with a fraudulent credit card transaction. However, business cards may be exempt from these policies, and thus present cause for concern.

Consumers are not the only category protected by state laws addressing data security. Banks have crept in to the protected category, seeking a statutory basis for redress from merchants with lax security practices that cause card information breaches and, consequently, cause credit card issuers to incur additional costs to cancel and reissue affected cards. Legislatures in Minnesota, Nevada, and Washington have enacted provisions that allow banks to recover from merchants who fail to meet certain security targets with payment card data. While those targets are likely to be met or exceeded through obligations imposed by payment card networks through agreements with acquiring banks, this legislation shows that politics can affect a redistribution of costs among network members. Whether this ultimately benefits consumers by reinforcing merchant incentives toward security in an efficient manner is unclear. Those same merchants likely face fines and other fiscal sanctions through a private ordering regime imposed by the card network, and the ultimate bearer of costs in a network presents a difficult economic question to unravel.

The Current Federal Regime

State laws provide an opportunity to enact laws and regulations that can be implemented and tested on a smaller scale. As Justice Brandeis stated in his famous dissent in New State Ice Co. v. Liebman, 285 U.S. 282, 311 (1932), "It is one of the happy incidents of the Federal system that a single courageous state may, if its citizens choose, serve as a laboratory . . . and try novel social and economic experiments without risk to the rest of the country." Of course, Justice Brandeis' made his risk

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assessment without the benefit of modern transportation and communication networks, which have increased the level of interstate business contacts and potentially wide-ranging impacts of the laws of particular states. Indeed, this issue has grown to embrace new challenges of privacy and data security compliance for transactions with international dimensions. Even national laws may not effectively govern these situations, thereby reinforcing the value of private ordering regimes.

Federal laws governing privacy and data security have developed in specific areas to address significant segments of the economy and significant interests of concern to consumers, (such as education, healthcare, and financial services) but they generally have not displaced this patchwork of state laws. Congress has not yet provided comprehensive solutions to the privacy and security puzzle. The states—and private firms—are left to continue experimenting with their own approaches for addressing threats to consumer privacy and security, as well as to develop the proper balance between consumer preferences and the economic advantages of sharing information.

The Federal Trade Commission (FTC) has also played a significant role in developing federal solutions to the privacy and security puzzle. In addition to enforcing federal laws directed at consumer protection, the FTC also exercises broad authority under 15 U.S.C. § 45, which permits the agency to address "unfair or deceptive acts or practices in or affecting commerce." This broad authority has been used to influence the privacy and data security practices of firms with deficiencies in protecting consumer information, including data security breaches or firms that failed to follow private ordering solutions as reflected in their privacy policies.

Although the FTC's enforcement resources only permits attention to the most significant cases, the prospects of FTC enforcement proceedings sends a message to others in the marketplace. In this sense, less can be more: the mere threat of intervention can cause business firms to take notice and change their practices in order to avoid government intervention. Moreover, the development of settlement solutions through public consent decrees, while not rising to the level of a judicial opinion, provides a roadmap that tends to shape the compliance behavior of other firms. The case-by-case approach allows solutions to be developed that take into account the nuances of particular business contexts. An approach based on "fairness" can lead to inappropriate discretionary justice, but solutions developed through consent decrees avoid sweeping generalizations and take into account the emerging standards of best practices within the industry. To the extent rulemaking often lags behind technological change, this approach also leaves room for adaptation to new developments.

Pending Legislation and Regulation by the CFPB

Pending legislation and regulations have the potential to inject a larger federal government presence in the matter of regulating privacy and data security. The FTC is likely to play an even greater role in the design and implementation of new federal standards. And there is a new kid on the block, the Consumer Finance Protection Bureau (CFPB) created by Dodd-Frank, which also may present a formidable new source of regulations in the financial services sector.

Pending Legislation

Legislation to address consumer privacy and data security issues has been percolating through Congress, and new bills will likely be introduced while this article is being edited. One recent example is S. 799, introduced April 12, 2011, by Senator John Kerry. Styled as the "Commercial Privacy Bill of Rights Act of 2011," this bill resembles several others that died with the 111th Congress, in that it seeks to expand the FTC's role in regulating and protecting consumer privacy interests.

The bill notes the shortcomings of the current patchwork of state and federal legislation, including "inadequate" privacy protection. The bill states a legislative finding that "with the exception of FTC enforcement of laws against unfair and deceptive practices, the Federal Government has eschewed general commercial privacy laws in favor of industry self-regulation, which has led to several self-policing schemes, some of which are enforceable, and some of which provide insufficient privacy protection to individuals." Noting that additional state regulation "could lead to a patchwork of inconsistent standards and protections," the bill offers a federal solution that will displace not only state laws, but also the self-regulation model.

The bill suggests that "enhancing individual privacy protection in a balanced way that establishes clear, consistent rules, both domestically and internationally, will stimulate commerce by instilling greater consumer confidence at home and greater confidence abroad. . . ." It may be hard to disagree with the ideal of a balanced approach that provides clear and consistent rules for all to follow, but providing the content of those rules is a considerable undertaking. In this sense, the federal solution being offered is a partial one, at best.

The bill attempts to scale this difficulty by delegating authority on the particulars to the Federal Trade Commission, thereby expanding the role for the commission in this area beyond its work in enforcing the mandate to address unfair trade practices. Significantly, even the commission's rulemaking authority is limited, in that the "Commission may not require a specific technological means of meeting a requirement [to protect covered information]." Further, these regulations shall be "consistent with guidance provided by the commission and recognized industry practices for safety and security" in existence before enactment. Thus, to a considerable extent, the bill appears to "insource" what has already developed in private industry, albeit with considerably less precision and certainty than may exist in the context of private rulemaking, such as may be found in PCIDSS. By eschewing specific technologies, the bill may leave room for technical advance, but in many cases the existing technology (such as encryption) is indeed a part of industry practice. The content for these rules remains to be seen, if indeed this bill moves forward. Significantly, those already subject to federal regulation (including, for example finan-

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cial services or healthcare) will be exempt from these rules.

In addition to directing the FTC to prescribe new regulations, the bill also addresses enforcement. Designing an effective means to enforce these new consumer protections is an important component of any legislative solution. On one hand, enforcement by the government potentially allows for the systemic protections afforded by government bureaucracies, which assuming proper training and experience, may exercise discretion to address significant harms. However, in an era of shrinking budget prospects, one wonders how an agency will have sufficient resources to effectively enforce these rules.

Although the Kerry bill expands the enforcement regime to include state attorneys general, it does not allow for private enforcement. However, state law claims based on fraud, or on state laws addressing health or financial information, are specifically preserved from preemption. The full extent to which other state law claims are preempted by this legislation is unclear, but in some respects this approach may actually be preferable to a regime of private enforcement through litigation. Schemes that provide for statutory damages and attorney fees have the potential to impose crippling liability that extends far beyond the benefits to consumers.

The Kerry bill also attempts to be sensitive to concerns about the size of the affected business. First, the bill technically applies only to covered entities, which are defined in part as those who handle information concerning more than 5,000 individuals during any twelve-month period. (Whether other firms will be held to similar standards through other enforcement channels remains to be seen.) The bill also requires that regulations for security measures will be "proportional to the size, type, and nature of the covered information a covered entity collects." Significantly, covered entities may not only be businesses, but may also include non-profit organizations. To the extent that churches and other religious organizations may be covered, and "religious affiliation" of an individual is designated as "sensitive information" by the bill, this may significantly expand the FTC's rulemaking and enforcement roles beyond the traditional business realm. Will the FTC knock on the church's door for maintaining a prayer list for those who are in hospital?

The Kerry bill is also significant for what it does not address. The bill leaves intact state law regimes for data security breach notification requirements. Other bills, including H.R. 1841, the Data Accountability and Trust Act of 2011 (DATA), which was introduced on May 11, 2011, would preempt state notification laws and impose a single federal standard. Many in the business community may welcome a single standard, which will clarify their compliance burdens. However, some issues still need to be resolved, including the proper latitude granted to business to evaluate whether there is any risk of harm to a consumer and the allowable period for delay between discovery and disclosure. Moreover, as noted above, whether public notice should be allowed in lieu of personal notice should also be considered in order to ensure that compliance costs don't outweigh likely consumer benefits.

The matter of online tracking and targeted advertising has also attracted legislative attention at both the federal and state level. In California, S.B. 761 (introduced March 23, 2011) would give consumers the right to opt-out of online tracking and it reinforces this right with a private remedy for damages and attorney fees. In the U.S. House of Representatives, H.R. 654 would provide a similar right, but with no private cause of action. The Kerry bill, noted above, would also provide a requirement for opt-out consent regarding use of covered information by third parties for behavioral advertising or marketing. However, no such consent is apparently required if the marketing or advertising involves the same website.

Federal legislation that preempted competing state regulation would likely solve problems for multistate businesses (presumably all Internet businesses). However, the appropriate content for this legislation is controversial. Consumers may indeed prefer not to be tracked, but will this preference persist if their decision means that free Internet content is otherwise restricted? The pervasive funding of Internet growth through the advertising model generates significant complexity in any attempt to interfere with this private ordering model, as even the FTC has recognized in a December 2010 report.

Dodd-Frank Regulations

In addition to pending legislation, additional government intervention may also come from new regulations affecting the financial services industry. The Dodd-Frank Wall Street Reform and Consumer Protection Act and particularly Title X, known as the "Consumer Financial Protection Act of 2010," creates a new agency, the Bureau of Consumer Financial Protection, established within the Federal Reserve System, which "shall regulate the offering and provision of consumer financial products or services under the Federal consumer financial laws."

Thus, another agency may enter into the rulemaking and enforcement mix, effectively invoking new opportunities for federal intervention and potentially new conflicts among the various federal interests. Provisions in Dodd-Frank appear to contemplate that the FTC and the bureau will negotiate their enforcement roles in areas where their authority may overlap. Moreover, the bureau is expressly granted enforcement authority over any rule prescribed by the Federal Trade Commission "with respect to an unfair or deceptive act or practice" when it affects consumer protection matters covered by the bureau. The role of the bureau remains to be seen, as its official rulemaking and enforcement activities have not yet begun.

Dodd-Frank, at 15 U.S.C.A. § 1693o-2, also grants regulatory authority to the Federal Reserve to "address reasonable fees and rules for payment card transactions." Although this does not specifically implicate data security requirements, proposed regulations contemplate efforts to regulate credit card fraud losses. Thus, the Federal Reserve may also get into the data security business, adding new requirements on the industry beyond those already imposed through private ordering. Complexities of implementing these rules, including the network impact when the rules, as a technical matter, only apply to large banks, remain unresolved.

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A Future for Private Ordering?

Our federal system presents challenges for businesses seeking to comply with their legal obligations concerning privacy and data security. The Internet and its environs are especially problematic, as jurisdictional boundaries are often blurry. Consumer angst creates a powerful incentive for politically accountable branches of government to intervene on their behalf with new legal protections. In a networked environment, intervention at the state level is bound to be ineffective due to geographic constraints; this alone may create an impetus for federal intervention to harmonize the various state requirements.

Government actors at the federal level face the same challenges as in the states: defining the appropriate level of protection and an appropriate enforcement regime is a Herculean task. Privacy expectations can vary widely among industries and within various population demographics. As for data security, technology is a moving target. Specific rules are likely to embrace yesterday's technology, which hackers have already discovered.

Private ordering remains a workable ideal that can continue to provide significant consumer protection, even if government involvement expands. A regulatory approach that borrows human and social capital from self-regulation models, thereby appropriating and defining industry practices, effectively "in-sources" a private ordering regime. It remains to be seen whether that approach will present any significant improvement in consumer protection on account of involving government actors.

Enforcement issues are likely to loom large in any rulemaking efforts, as intentions to protect consumers must be tempered by the reality of fiscal constraints. Will fines and penalties become a new source for these revenues, effectively becoming a new tax on business? Allowing private enforcement may solve resource constraints, but when the regulatory infraction doesn't present significant risks for consumers, the resulting economic distortions may ultimately disadvantage consumers. There are significant complexities to be resolved in this area; hopefully the political impetus to expand consumer protection does not overlook the broader context of consumer well being and the importance of preserving space for private ordering.

Edward A. Morse, professor of law, holds the McGrath, North, Mullin & Kratz endowed chair in Business Law at Creighton University School of Law in Omaha, Nebraska. *This article benefitted from a panel discussion at the ABA Spring Meeting in Boston, "Privacy Police to Security Sheriffs: The Expanding Federal Role in Regulating Privacy and Data Security Protection." The author is grateful to his fellow panelists, Thomas Brown, Erika Brown Lee, and Mozelle W. Thompson, for their helpful discussion and contributions, and to Michael Fleming for his helpful comments.*

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Additional Resources

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

Business Law Today

So Many Privacy Rules! The Developing Standard of Care for Data Security and Identity Theft Protection

By Jonathan T. Rubens
Volume 18, Number 6
July/August 2009

Business Law Section Programs

2011 ABA Annual Meeting

Enforcement of Data Breach Notification Laws and Other Laws Safeguarding Personal Information:
Legal Perspectives from Both Sides of the Counsel Table
Sponsored by Business and Corporate Litigation; Cosponsored by Cyberspace Law
Saturday, August 6: 2:30 PM - 4:30 PM
Westin Harbour Castle, Salon A, Convention Level

2011 Spring Meeting of the ABA Business Law Section

Privacy Police to Security Sheriffs:
The Emerging Federal Role in Regulating Privacy and Data Security Protection
Spring 2011 Meeting of the ABA Business Law Section

This program will attempt to shed light on these emerging sources of Federal regulation for privacy and data security. The program is intended to assist practitioners and in-house attorneys with a broad range of clients dealing with consumer data (including payment card information), in assessing, navigating, and limiting legal and economic risks, with particular attention to areas outside current sector-specific regulations, such as banking and health care.

ABA Web Store

Books:

Information Security and Privacy: A Practical Guide for Global Executives, Lawyers and Technologists

Thomas J. Shaw
(February 17, 2011)

This book provides a practical and comprehensive approach to information security and privacy law for both international and domestic statutes. It provides all the tools you need to handle the business, legal, and technical risks of protecting information on a global scale. For anyone responsible for or advising a corporation involved in domestic or international business, who must comply with a dizzying array of statutes, regulations, technologies, methodologies, and standards, this book is the invaluable resource you've been looking for.

Data Security Handbook
(March 2008)

The purpose of the Data Security Handbook is to provide legal practitioners and information technology specialists with a concise, practical guide that summarizes: common information security vulnerabilities and how to manage them; legal and industry information security safeguard requirements and recommended practices; the legal obligations that apply when an organization has incurred a data breach; factors that contribute to a compliant information security program; and potential legal theories in actions involving the alleged misuse or compromise of personal information.

Other Materials

Edward A. Morse and Vasant Raval, Private Ordering in Light of the Law: Achieving Consumer Protection Through Payment Card Security Measures, SSRN Working Paper, available at *http://ssrn.com/abstract=1670112*

Edward A. Morse, The FACTA the Matter: Recent Cases Involving Payment Card Receipts Illustrate Flaws in "Bounty" Enforcement Regime, Lydian Journal at 14 (April 2011), available at *www.pymnts.com/The-FACTA-the-Matter-Recent-Cases-Involving-Payment-Card-Receipts-Illustrate-Flaws-in-Bounty-Enforcement-Regime/*

Department of Commerce Internet Policy Task Force, Commercial Data Privacy and Innovation In the Internet Economy: A Dynamic Policy Framework (December 16, 2010), available at *http://www.ntia.doc.gov/reports/2010/iptf_privacy_greenpaper_12162010.pdf*

Federal Trade Commission, Protecting Consumer Privacy in an Era of Rapid Change (December 1, 2010), available at *www.ftc.gov/os/2010/12/101201privacyreport.pdf*

Federal Trade Commission, Privacy Initiatives *www.ftc.gov/privacy/privacyinitiatives/promises_enf.html* (listing FTC enforcement actions under section 5 of the FTC Act).

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Hanging by a Thread:

Finding Arbitrability without Clear Evidence of a Contract

By Bruce M. Polichar

It is not unusual for business deals to fall apart just at the moment when everyone thought they were concluded. Well, not everyone—actually about half of those involved. The other half feels that it was just a potential deal that never came together. This scenario plays out in business every day, and just as frequently spawns legal disputes over whether enforceable contractual rights and obligations have been created or not. This article addresses a little-known body of law arising under the Federal Arbitration Act (as well as various state laws) that may find parties to a business negotiation binding themselves to arbitration as a dispute resolution forum even though their dealings never result in a fully binding contract on the larger substantive deal terms. I have structured the discussion of this potentially surprising situation by first relating an international arbitration that was recently presented to me for ruling, and then analyzing the federal and state law that brought the matter within my jurisdiction as an arbitrator. Suggestions for drafting arbitration provisions that address this situation appear at the end of the article.

The international commercial arbitration I referred to involved an American company, "Americo," against a European company, "Euroco." The notice of arbitration that commenced the proceeding quickly generated a vigorous response from Euroco contending that no arbitration could take place inasmuch as the parties had never entered into a contract and, thus, there was no agreement to arbitrate. As is often the case, an arbitrator was being asked to make a threshold determination as to whether the matter could proceed at all—whether the dispute was arbitrable—or, to put it another way, whether the arbitrator and the arbitral institution under whose rules the proceeding was initiated had jurisdiction to conduct an arbitration. My initial inclination in reviewing the arbitrability challenge was to take a step back from trying to determine the overall scope of the possible agreement of the parties in assessing the arbitrability issues without becoming immersed in the potential merits of the larger contract claims.

Factual Background

A brief overview of the exchange between Americo and Euroco presents a fact situation quite common in commercial disputes, particularly those where arbitrability is challenged. Americo and Euroco negotiated and exchanged various draft documents over many months in an attempt to reach a final and comprehensive agreement on their overall business arrangement. Americo argued that by reason of alleged oral agreements reached between the parties concerning the business Euroco was to conduct for Americo in certain European territories, as well as certain draft deal memos intended to confirm the parties' agreement (the deal memo), a legally binding written agreement was entered into establishing jurisdiction to arbitrate before the "XYZ" arbitral institution. A surface review suggested that the parties may not have fully reached an agreement on the substantive business terms of the underlying transaction. But the critical question for me was whether they had sufficiently agreed to confer jurisdiction on an arbitrator to resolve the dispute.

The version of the deal memo that Americo included in its notice of arbitration contains a provision that states, "In case of any dispute the parties agree to XYZ arbitration." The deal memo does not appear to have been signed by either of the parties. There appeared to have been various notes between the parties evidencing an exchange of comments and proposed modifications and revisions by each of the parties to the original draft of the deal memo. Their correspondence suggested that the parties concurred on numerous points, some potentially significant and material to the formation of a contract, and others seemingly much less important. There appeared to have been agreement on a number of negotiated points by the comment "Okay" offered by one or the other at various points in the course of the communications. In one e-mail exchange there is a comment from Americo's negotiator which reads, "13. In case of any disputes, we would like to use XYZ arbitration." Appended to that, and

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admittedly written by Euroco's negotiator is the comment, "Okay." Euroco acknowledged this "Okay" comment, but raised issues concerning its meaning, intent, and significance to this inquiry. On that same date Euroco's negotiator incorporated the XYZ arbitration clause into a revised draft of the deal memo and sent it back to Americo along with various other comments reflecting their ongoing negotiations. At some point, following this last written exchange, Euroco notified Americo that Euroco did not intend to proceed with the deal, with no reference being made to any unacceptable terms or other reason for withdrawing from the discussions of a business arrangement. Sometime thereafter, Americo initiated the arbitration.

Procedural Discussion

In its objection to the jurisdiction of the tribunal, Euroco argued that, under the XYZ's published Rules (XYZ Rules) and California law, a written contract between the parties agreeing to arbitration was a pre-requisite to the conduct of an arbitration, and no such written agreement had been consummated by the parties. The overall thrust of the challenge was that there was no contract upon which to base an agreement to arbitrate. I treated this as a motion to dismiss the arbitration proceeding.

Analysis

The ruling on the motion to dismiss focused solely on the question of arbitrability and jurisdiction of the tribunal to proceed under the XYZ Rules. The larger range of questions concerning a comprehensive agreement between the parties, its contents if any, or any questions regarding any breach of such an alleged agreement, was explicitly deemed outside the scope of the discussion and my ruling. The sole question addressed was: "Did the parties agree to arbitrate?" As noted below, this distinction is central to the applicable case law.

It is well-established that arbitration is a matter of private contract, and arbitrability and the jurisdiction of an arbitration tribunal require that the parties entered into a written agreement to arbitrate. The XYZ Rule in question states that "the Arbitrator shall exercise all powers granted to commercial Arbitrators under the laws of the State of California, USA, or the laws of the jurisdiction where the arbitration takes place . . . ." Under the XYZ Rules, all such arbitrations are conducted under California law unless the parties agree otherwise. With respect specifically to international arbitrations, the governing California law is found in Code of Civil Procedure (CCP) Section 1297 *et seq*. Section 1297.72 provides that:

> An arbitration agreement shall be in writing. An agreement is in writing if it is contained in a document signed by the parties *or in an exchange of letters, telex, telegrams, or other means of telecommunications which provide a record of this agreement*, or in an exchange of statements of claim and defense in which the existence of an agreement is alleged by one party and not denied by another . . . .

The XYZ Rule granting the arbitrator authority to rule on his/her jurisdiction was modeled on CCP Section 1297.161. The language of both provisions is almost identical. Section 1297.161 of the Code states:

> The arbitral tribunal may rule on its own jurisdiction, including ruling on any objections with respect to the existence or validity of the arbitration agreement and for that purpose, an arbitration clause which forms part of a contract shall be treated as an agreement independent of the other terms of the contract, and a decision by the arbitral tribunal that the contract is null and void shall not entail *ipso jure* the invalidity of the arbitration clause.

The arbitrability clauses of most major international arbitral institutions use almost identical language in this regard. If the contract containing the arbitration agreement designates such rules of a named tribunal, then the court is to defer to them and leave arbitrability and all other issues to the arbitrator. (There is case law that makes this occasionally unclear; but it normally applies).

The *Nicaragua* Line of Cases

Americo cited *Republic of Nicaragua v. Standard Fruit Co.*, 937 F.2d 469 (9th Cir. 1991), *cert. denied*, 503 U.S. 919 (1992), for the general proposition that "even the most minimal indication of the parties' intent to arbitrate international disputes must be given effect." The case is instructive with respect to the complex issues presented in cases such as "*Americo vs. Euroco*." In any case in which the Federal Arbitration Act (FAA) applies, federal substantive law governs the question of arbitrability. This means the FAA applies to all cases involving interstate or international commerce. *Nicaragua* is a pivotal decision on this issue (having been cited favorably in over 100 subsequent state and federal decisions), and deserves careful analysis.

In *Nicaragua*, the newly-installed Sandinista government had begun negotiations with a group of affiliated American and Nicaraguan corporate entities comprising Standard Fruit Company (Standard) with respect to an expansive new arrangement for the growing and export of the nation's economically-critical banana crop. This followed an initial attempt by the rebels to nationalize the industry—an effort which they came to realize could be economically disastrous. While a written memorandum of agreement regarding certain aspects of the overall arrangement had been reached with some of the Standard-affiliated entities through an extended series of negotiations, additional implementing contracts were required to fully realize the overall understanding the contracting parties intended, and some of the Standard entities had not even signed the initial memo. However, the memo did contain a somewhat clumsy and incomplete arbitration provision which the parties intended to further refine and document in what ultimately became a failed series of further negotiations on the overall business arrangement between the parties. It read, very simply: "Any and all disputes arising under the arrangements contemplated hereunder . . . will be referred to mutually agreed mechanisms or procedures of international arbitration, such as the rules of the London Arbitration Association."

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(In all likelihood they contemplated the London Court of International Arbitration which had been a major center for international commercial arbitration for many years.)

The court noted that "Nicaragua admits that this is less than crystal clear, and in fact refers to an association that does not exist. . . . During the negotiations themselves, neither side could remember the name of the arbitration body in London."

In reversing the district court's denial of Nicaragua's motion to compel arbitration, the Ninth Circuit carefully reviewed the provisions and policies of the FAA and the various federal court cases interpreting them. To begin with, the court stated that the FAA reflects the strong Congressional policy favoring arbitration by making arbitration clauses "valid, irrevocable, and enforceable." The court in *Nicaragua* said that "the standard for demonstrating arbitrability is not a high one: in fact, a district court has little discretion to deny an arbitration motion. The court noted that "as with any other contract, the parties' intentions control, but those intentions are generously construed as to issues of arbitrability. . . . The only issue properly before the district court was whether the parties had entered into a contract evidencing a transaction involving commerce under the Act and committing both sides to arbitrate the issues of the contract's validity."

A Surgical Look at the Initial Evidence

We are all trained as lawyers, and certainly as quasi-judicial officers, to refrain from drawing conclusions until all of the evidence is in and carefully examined. However, that normally appropriate approach is exactly what the cases have historically warned against in assessing challenges to arbitrability based on claims of "no contract." Instead, an arbitrator must avoid delving into the merits of whether the parties had entered into a fully binding comprehensive agreement, and only seek out clear evidence of an agreement to arbitrate.

Nicaragua's reversal of the district court turned significantly upon the fact that the lower court had looked to the existence of a contract as a whole to determine arbitrability. This was squarely contrary to the Supreme Court's landmark ruling in *Prima Paint v. Flood & Conklin Mfg. Co.,* 388 U.S. 395 (1967). *Prima Paint* expressly held that courts may not consider challenges to a contract's validity or enforceability as defenses against arbitration. That case demands that arbitration clauses be treated as severable from the documents in which they appear unless there is clear intent to the contrary. An arbitration clause may thus be enforced even though the rest of the contract is later held invalid by the arbitrator.

Euroco had argued that, while it did respond to Americo's request that disputes be resolved under XYZ arbitration with an "Okay," it only meant that it was agreeable if all the rest of the terms of the arrangement were fully finalized. However, this reservation or explanation of the assent to arbitration was not included in any of the communications between the parties, and appears only to have been raised in defense of the effort by Americo to engage the arbitration process. A statement that a party did not intend to arbitrate, made only after a dispute over arbitrability has arisen, when the circumstances demonstrate otherwise, is ineffective to avoid the obligation to arbitrate.

Severability of the Arbitration Clause is Key

What was pivotal for my analysis in *Americo vs. Euroco* was the portion of *Nicaragua* and *Prima Paint* that requires the arbitrator to disregard the surrounding contract language as formulated in the communications exchanged by the parties, and consider only issues relating to the making and performance of the agreement to arbitrate. *Nicaragua*, referred to an earlier case to emphasize the logic of these rules:

> White argues that if there is no contract to buy and sell motors there is no agreement to arbitrate. The conclusion does not follow its premise. The agreement to arbitrate and the agreement to buy and sell motors are separate. Sauer's promise to arbitrate was given in exchange for White's promise to arbitrate and each promise was sufficient consideration for the other.

Thus, the court in *Nicaragua* concluded that in the absence of anything in the ambiguous arbitration clause that was included in the incomplete agreement between the parties showing that it was not intended to be severable, **"**we must strictly enforce any agreement to arbitrate, regardless of where it is found." The arbitrator or a court can only determine whether a written arbitration agreement exists, and if it does, enforce it in accordance with its terms. As noted above, various types of writings evidencing the agreement to arbitrate are appropriate to evaluate the existence of the agreement. Similarly, the doctrine of severability of an arbitration clause is firmly based on both state and federal statutory and case law, as well as most tribunal rules.

Policy and the Agreement to Arbitrate

It is well established that where the contract contains an arbitration clause, there is a presumption of arbitrability. The *Nicaragua* court discussed what, in fact, constitutes an agreement to arbitrate. It begins by emphasizing the emphatic federal policy in favor of arbitral dispute resolution (which) applies with special force in the field of international commerce. The Federal Arbitration Act's presumption in favor of arbitration carries "special force" when international commerce is involved.

And, *Nicaragua* notes:

> According to the Supreme Court, when international companies commit themselves to arbitrate a dispute, they are in effect attempting to guarantee a forum for any disputes. Such agreements merit great deference, since they operate as both choice-of-forum and choice-of-law provisions, and offer stability and predictability regardless of the vagaries of local law. The elimination of all such uncertainties by agreeing on a forum acceptable to both parties is an

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> indispensible element in international trade, commerce, and contracting. An agreement to arbitrate before a specified tribunal is, in effect, a specialized kind of forum-selection clause that posits not only the situs of suit but also the procedure to be used for resolving the dispute. The fact that the United States has enacted the International Convention on the Recognition and Enforcement of Foreign Arbitral Awards as part of the Federal Arbitration Act, 9 U.S.C. Sec. 201-208, is further evidence of this federal policy.

Even where there are problematic issues about the clarity of an agreement to arbitrate, *Nicaragua* says that "the clear weight of authority holds that the most minimal indication of the parties' intent to arbitrate must be given full effect, especially in international disputes," and "the scope of the clause must also be interpreted liberally. As a matter of federal law, any doubts concerning the scope of arbitrable issues should be resolved in favor of arbitration." If the agreement in question can be interpreted to allow arbitration, the clear federal policy of liberal application of the FAA to resolve any doubts in favor of arbitration. *Nicaragua* continues to be relied on by courts and is an important source on these issues almost 20 years after its issuance.

A State Law Perspective

As regards consideration of arbitrability in *Americo v. Euroco*, the propositions articulated in the *Nicaragua* line of cases are, of course, consistent with a large body of state court opinion as well. In light of the comprehensive statutory scheme regulating private arbitration, state courts will generally indulge every intendment to give effect to such proceedings. This is generally consistent with arbitration in most jurisdictions, particularly where the Uniform Arbitration Act has been used as a foundation for state arbitration statutes.

Thus, even though the proposal to submit the dispute to XYZ arbitration and the responsive "Okay" were exchanged between Americo and Euroco in the course of negotiating a preliminary agreement regarding the proposed business arrangement, such a preliminary agreement appears to be binding under both California and federal law regardless of whether a subsequent contract is finalized. The standard for demonstrating arbitrability under most state law is also not high, and such agreements are usually rigorously enforced. Parties may identify the arbitrable claims indirectly by choosing a body of private arbitration rules, such as the XYZ Rules, that specifies the scope of arbitrable claims. They may also exclude certain matters from arbitrability either explicitly or by refusing to allow certain substantive provisions into their agreement.

In light of such strong and clear judicial statements of policy regarding arbitration agreements in international commerce, the facts in the *Americo vs. Euroco* arbitration clearly supported a finding that Americo and Euroco, whatever other issues they may have been left open, reached a written agreement that disputes surrounding their dealings would be resolved through arbitration, and under the XYZ Rules. In the end, an analysis of the parties' communications made clear that they had agreed upon a forum and a body of rules for the resolution of any future disputes. Under applicable law, the arbitrator's jurisdiction included the authority to rule on the issue of arbitrability itself, even though the overall posture of the parties' comprehensive agreement—if any—was hanging by a mere thread based upon the uncertainties that remained in the communications.

Considerations in Drafting

The situations that we have discussed start early on when business people are working out potential terms of an agreement. The consequences of casual communications about arbitration are not usually the focus of early-stage deal making, and the consequences of those communications are usually not apparent to the people trying to hammer out the basics of the deal. When the deal falls apart and litigators or arbitrators get involved, the parameters for dealing with the dispute may are already be fixed in place. It is important, then, that business people, as well as their corporate and outside counsel, are aware of how arbitrability issues may affect them, and recognize the importance of communicating clearly about how they want to handle disputes if they arise in the future. As noted in the recently-published Protocols of the College of Commercial Arbitrators:

> Business users, guided by knowledgeable and experienced counsel, are in the best position to determine how and when arbitration will be brought to bear on business disputes, and what kind of arbitration process to prescribe. If business parties really want arbitration to be a truly expeditious and efficient alternative to court, they have to assume control of the process and not delegate the responsibility to outside counsel–in other words, principals and not agents, should act as principals. This must include not only choices made after disputes arise, but also active choice-making at the time of contracting. Ideally, it begins even earlier with strategic discussions regarding the management of conflict in which arbitration is considered among the variety of tools and approaches.

There are three principal issues involved in the creation of a contractual arbitration provision: (1) whether arbitration is desired at all, and when to address that choice; (2) the so-called "delegation" questions defining the arbitrator's authority to rule on arbitrability and jurisdiction; and, (3) the scope of arbitral issues.

Consider Arbitration Early in the Process

In most business dealings, negotiators will tend to focus on major commercial terms in the early stages of discussions and in the preparation of deal memoranda or draft agreements. Choice of forum issues tend to arise as afterthoughts or become important points only when a deal has failed to conclude or was concluded but has later gone sour, and the parties are seeking remedies. As we have seen, casual treatment of the question of where and under what rules disagreements are addressed may produce surprises that one or more parties may not be happy experiencing when a dispute subsequently arises. In-house corporate counsel (or other contract negotiators), need to determine early on in a business

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negotiation the issue of forum selection in the event the contracting process aborts, and to lay the groundwork accordingly. Likewise, it behooves outside advisors to counsel their clients on the importance of thinking through the arbitration issues even as they begin to consider new business dealings. This starts with the not-always simple issue of whether or not to adopt arbitration as the designated forum for dispute resolution.

Just as a specific choice of law provision will address the rule structure for future disputes, the designation of a particular forum or arbitral institution for dispute resolution may also serve to define a set of rules which, in themselves, affect issues such as authority to rule on arbitrability and the scope of the arbitration provision's coverage. It would therefore be prudent to look carefully at both a specific designation of governing law as well as the language of the arbitration provision to assure that the choices are complementary to the desired result, i.e., whether the choice of law is favorable to the selection of a particular arbitration institution and its rules. As noted earlier, there may be potential issues to consider on procedural as well as substantive matters concerning the interplay of state and federal law. The extent to which an arbitration clause can anticipate and can be negotiated so as to determine how those issues will be decided in future proceedings is open to some question as the law in this area is not stable.

These choices may arise as part of the early contract-negotiation process without being initially apparent, and counsel should identify and make clients aware of them as they begin the process of exchanging proposals and early-stage forms of agreement. Inasmuch as a focused approach to these issues is going to arise as soon as any form of agreement—interim or more formal—is exchanged, the nature of the communications among the parties deserves close attention. As seen from *Americo v. Euroco*, the arbitration issue may often arise very casually, but often has substantial impact on the outcome of the dispute. To the extent that participants in the deal-making process have reservations about pinning themselves down to various choices of forum and law, they may want to consider explicitly stating in their written exchanges that all terms, including dispute resolution provisions, remain conditioned upon finalization of a full and formal written agreement.

Another potential trap for the unwary is the equally-common situation in which the parties negotiate a legally binding deal memo, and reference the possibility of moving to a more detailed formal agreement at a later date. Even though the deal memo might not contain any reference to arbitration, it is often the case that the parties will reference a particular long form agreement as the intended model for further documentation. In many industries parties are likely to reference an "industry model" long form agreement. These broadly used contract forms frequently contain arbitration protocols. If the parties negotiating the deal are not sure about whether to adopt arbitration in the early stages they would be well-advised to note that the arbitration provisions of the potential long form will also not come into force and effect unless and until the long form is in fact fully adopted and executed by the parties.

Delegate Issues as within the Arbitrator's Authority

While courts often suggest that the question of whether a matter is clearly within the purview of the arbitrator is unequivocally a threshold issue for a court, I would submit that a survey of the cases makes this anything but clear and predictable. If a decision has been made to submit future potential future disputes to arbitration, one would be well-advised to adopt the language used by most of the major arbitral institutions, which tends to track the language of CPP 1297.161 noted above. I am not aware of any reported case in which a specific, explicit delegation of authority of the arbitrator to rule on his or her jurisdiction has been rejected by a court. Bear in mind, however, that the matter of delegation of arbitral authority, and the delineation of the scope or range of issues that fall within the authority of the arbitrator to rule, are often expressed in one comprehensive arbitration clause. In drafting these provisions it is important to analyze each of these arbitrability issues with a clear focus and careful choice of language. We have seen that the attempt to use broad and general language may not be sufficient to assure the desired scope of authority.

Define the Scope of the Arbitrator's Authority

A broadly-worded arbitration clause is not a guarantee that it will be honored and applied by a court, even with comprehensive, inclusive language employed. Thus, issues of who—court or arbitrator—should decide arbitrability, the inclusion or exclusion of any issue, including the formation, ratification/finalization, validity, enforceability, or other application of the overall terms of the agreement, are subjects that might be wise to explicitly incorporate in the arbitration clause itself. One must be cognizant of the current case law and Congressional exploration of certain subjects as possible exclusions from the arbitral forum, namely the issue of unconscionability and, potentially, contracts involving employment and consumer dispute-resolution mechanisms. If the drafter's desire is to achieve the most comprehensive, inclusive arbitrability coverage, he or she should consider adding to the customary broad language of the arbitration clause language, such as, "any and all matters arising under, related to, growing out of, or otherwise pertinent to the subject matter of this agreement, *including, but not limited to, all issues of any nature concerning the formation, ratification, validity, enforcement or breach of this agreement; save only those matters which, by law raise challenges specifically to this arbitration provision, and/or whose substantive subject matter has been removed from arbitral jurisdiction by statute."*

However, if the parties negotiating a commercial contract are only prepared to have disputes submitted to arbitration once the contract has been fully completed and executed, they would be well-advised to state that specifically in their negotiation communications from the very beginning. A failure to do so may well result in

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the application of arbitral jurisdiction under the principles that I have explored in this article. Similarly, negotiation communications might also address the question of where arbitrability is to be determined in the absence of a fully-detailed arbitration clause that would normally be the place to fix a venue, either explicitly or by reference to a body of arbitration rules of a chosen institution.

Conclusion

Whether arbitration is or is not a desired forum for resolution of potential disputes in the future of a business agreement is a question requiring careful analysis. The conclusions that business negotiators come to on this issue may vary by the specific circumstances of each business dealing; and one doesn't always guess right in hindsight. Arbitration has its pluses and minuses in each situation and business context. Given the nuances of the law in applying arbitration to a future dispute, it is extremely important that this be given thoughtful consideration in the formulation of contracts at every stage of the negotiation process.

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Keeping Current: Securities

U.S. Supreme Court Limits Reach of Primary Liability in Securities Fraud Cases

By Jay G. Baris, Jordan Eth, and Mark David McPherson

On June 13, 2011, in a 5–4 decision, the U.S. Supreme Court narrowed the circumstances under which a defendant can be held liable in a private action under Rule 10b-5 for "making" a false or misleading statement. The decision, *Janus Capital Group, Inc., et al. v. First Derivative Traders*, 564 U.S. ___ (2011), No. 09-525, slip op., June 13, 2011, held that an investment adviser did not "make" statements contained in prospectuses of the adviser's mutual fund clients, even though the adviser may have assisted the mutual funds in preparing the statements. The decision has important implications not just for mutual funds and their advisers, but for all investment advisers, accountants, and others who provide services to issuers of securities. The decision may also have broader ramifications in securities litigation brought under Rule 10b-5.

Janus is another in a long line of cases in which plaintiffs sought to overcome the Supreme Court's holding in *Central Bank of Denver, N.A. v. First Interstate Bank of Denver, N.A.*, 511 U.S. 164 (1994). In *Central Bank*, the Supreme Court rejected a private action for aiding and abetting liability under federal securities laws. Ever since, plaintiffs have struggled to hold secondary actors in the securities markets—such as banks, financial advisers, accountants, and lawyers—liable for securities fraud.

In *Janus*, plaintiffs sought to assert securities fraud claims against a group of mutual funds' investment adviser, Janus Capital Management LLC (JCM), and its parent company, Janus Capital Group Inc. Plaintiffs alleged that JCM made misrepresentations about the mutual funds' rules prohibiting market timing. Recognizing that they could not establish liability by claiming that Janus aided and abetted the mutual funds' representations, plaintiffs alleged that JCM actually "made" the representations at issue, even though the prospectuses containing the alleged misrepresentations were not attributed to JCM.

The Supreme Court rejected plaintiffs' theory that JCM "made" the statements. Writing for the Court, Justice Thomas offered a succinct but forceful primer in plain English, and concluded that "[o]ne 'makes' a statement by stating it." He analogized to the relationship between a speechwriter and a speaker: "Even when a speechwriter drafts a speech, the content is entirely within the control of the person who delivers it. And it is the speaker who takes the credit—or blame—for what is ultimately said."

Control is therefore the key factor distinguishing speechwriting from speechmaking, and it is control that the Court now uses to define the scope of liability under Rule 10b-5. "The rule we adopt today," Justice Thomas wrote, is that "the maker of a statement is the entity with authority over the content of the statement and whether and how to communicate it."

In defending its new rule, the Court noted that its conclusion of who "makes" a statement is consistent with its precedent that Rule 10b-5's private right of action does not extend to suits against aiders and abettors. *Central Bank*, the Court reminded litigants, prohibited private actions under Rule 10b-5 against those who aided and abetted securities fraud. Construing the phrase "make a statement" to include those who do not control the content of a statement would, the Court ruled, "substantially undermine *Central Bank.*"

The Court also rejected the argument that, in light of the relationship between an investment adviser and a mutual fund, the adviser "should generally be understood to be the 'maker' of the statements by its client mutual fund." Even though the officers of the mutual funds at issue were all employees of JCM (the adviser), the Court stressed that corporate formalities were observed and that all but one of the directors were not "interested persons" of the funds, as defined in Section 2(a)(19) of the Investment Company Act of 1940. In Justice Thomas's words, therefore, the Court does not view the investment adviser as "a playwright whose lines are delivered by an actor" (the mutual fund prospectus).

In its most specific application—in the world of mutual funds and their advisers—*Janus* both limits advisers' liability under Rule 10b-5, and raises significant questions for mutual fund directors. Most importantly, if investment advisers did not "make" the statements contained in a

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mutual fund's prospectuses, who did? The mutual fund's directors signed the registration statements of the mutual funds on whose boards they sit. Yet *Janus* suggests that individual directors, alone, cannot be considered to have "made" the statements because they alone do not have "authority over the content of the statement and whether and how to communicate it"; only the board as a whole does.

While *Janus* does not by itself increase potential liability of boards or individual directors, directors should nevertheless take care to satisfy themselves that the funds maintain a rigorous process to ensure that investment, legal, and compliance disclosures are adequate.

Janus may have significant implications beyond the world of mutual funds and their advisers. In announcing a bright-line rule to determine who "makes" a statement for purposes of Rule 10b-5, the Court has resolved an area of uncertainty. Many circuits previously applied highly fact-specific tests, such as whether an individual or entity had "substantially participated in" or was "intimately involved with" the statement, to determine whether the individual or entity was primarily liable under Rule 10b-5. Today's decision eliminates these tests. Now, only the "speechmaker" is on the hook for alleged misstatements; the speechmaker's staff of speechwriters (including, potentially, investment advisers, accountants, lawyers, and others who provide services to securities issuers) is not.

Janus may therefore prove to limit the expansive theories of liability that plaintiffs have been pushing since the Court's decision in *Central Bank*. Indeed, in tying its decision in *Janus* to *Central Bank*, the Court seems to be enforcing the line between enforcement actions the SEC may bring and private actions. As it noted before explaining its holding, the Court approached the question of who "makes" a statement "mindful that we must give 'narrow dimensions . . . to a right of action Congress did not authorize when it first enacted the statute and did not expand when it revisited the law.'" The decision restricts Rule 10b-5's liability for "making" a statement to those narrow dimensions.

Justice Breyer's dissenting opinion, joined by Justices Ginsburg, Sotomayor, and Kagan, disagreed with the majority's construction of the phrase, "make a statement." As Justice Breyer put it: "Every day, hosts of corporate officials make statements with content that more senior officials or the board of directors have 'ultimate authority' to control." He later asked, "What is to happen when guilty management writes a prospectus (for the board) containing materially false statements and fools both the board and public into believing they are true?" The dissent worries that the majority's new rule immunizes such "guilty management" from liability under Rule 10b-5. Whether the majority's rule provides such immunity remains to be seen.

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Keeping Current: Securities

SEC's Whistleblower Program Finalized

By Howard E. Berkenblit and Stacy H. Louizos

On May 25, 2011, the Securities and Exchange Commission issued final rules to implement provisions of the Dodd-Frank Wall Street Reform and Consumer Protection Act designed to encourage whistleblowers to report suspected securities violations to authorities. Dodd-Frank, enacted in July 2010, established a whistleblower program that instructed the SEC to pay awards (referred to by some as "bounties"), worth between 10 and 30 percent of sanctions collected, to whistleblowers whose tips lead to the recovery of monetary sanctions exceeding $1 million. Under the new rules, whistleblowers can report violations directly to the SEC instead of going through their companies' internal reporting channels. However, the rules include provisions designed to encourage whistleblowers to utilize their companies' internal compliance and reporting systems. The rules will become effective on August 12, 2011.

Internal Reporting Not Required Before Going to SEC

The most controversial aspect of the new rules is the lack of a requirement for whistleblowers to report violations of securities laws first through their companies' internal reporting and compliance systems before submitting the information to the SEC. The SEC staff believes that there are a significant number of whistleblowers who would not report violations if they were required to report internally. In addition, the SEC anticipates that the new rule will motivate companies to promote a corporate environment where whistleblowers would feel more comfortable reporting violations internally. Further, in some cases, law enforcement interests will be better served if the SEC is notified of a company's violations without the company's knowledge, particularly when the company may try to hinder or obstruct an SEC investigation.

In response to concerns that the proposed rules would provide an incentive for whistleblowers to bypass internal reporting procedures, the SEC included some provisions in the new rules designed to continue to encourage use of internal programs. First, the SEC will consider a whistleblower's participation in internal reporting as a factor that can increase the amount to be awarded, and it will consider a whistleblower's interference with internal reporting systems as a factor that can adversely affect the amount to be awarded.

Second, a whistleblower will still receive an award for reporting a violation internally as long as the company provides that information to the SEC. The whistleblower could potentially receive a greater award under this provision because he or she would be attributed credit for any information uncovered during the company's subsequent internal investigation.

Third, the SEC provides whistleblowers a window of time, during which they can first report violations internally but still be eligible for an award from the SEC. The final rules set the length of this window of time, known as a "lookback period," at 120 days. Thus, a whistleblower will have 120 days after initially reporting violations internally, during which he or she can then report the violation to the SEC and still be treated as if he or she had reported to the SEC at the earlier reporting date (i.e., the date at which the whistleblower reported the violations internally). As a result, making an internal report will not preclude the whistleblower from collecting an award, as long as he or she reports the same information to the SEC within 120 days.

Not All Personnel Eligible for Whistleblower Awards

In order for a whistleblower to be eligible for an award, four elements must be fulfilled: the whistleblower must (1) "voluntarily provide" the SEC with (2) "original information" about a violation of securities laws that (3) leads to the successful enforcement of an action by the SEC that (4) results in sanctions exceeding $1 million. For purposes of calculating whether the collected monetary sanctions exceed the $1 million threshold, the rules provide for aggregation of multiple monetary sanctions arising out of the same nucleus of operative facts.

Certain categories of persons and information are not eligible for the new

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whistleblower program. These include, among others and with some exceptions such as to prevent substantial injury to the financial interests of investors, (1) individuals with a pre-existing legal or contractual duty, or a duty arising from a judicial or administrative order, to report violations to authorities, (2) attorneys who become aware through communications subject to the attorney-client privilege, unless state attorney conduct rules, SEC regulations, or other applicable laws permit disclosure, (3) internal compliance personnel to whom violations are internally reported as part of their investigative responsibilities, (4) foreign government officials, including employees of foreign state-owned entities, and (5) whistleblowers who are substantially responsible for the violations they report.

Rules Continue to Provide Anti-Retaliation Protection

The new rules provide anti-retaliation protection to whistleblowers who have a reasonable belief that violations have occurred. This protection applies whether the whistleblower satisfies all of the conditions to qualify for an award or not and even if it is determined that the issue reported by the whistleblower did not constitute a violation. Whistleblowers are protected by the anti-retaliation provisions in Dodd-Frank, which include a private right of action against employers for retaliation as a result of the whistleblower's reporting of a violation or disclosure of information pursuant to an investigation.

Moreover, in certain cases, the Dodd-Frank anti-retaliation provisions protect whistleblowers who report violations related to private companies. Whistleblowers who provide tips to the SEC voluntarily or pursuant to an investigation will be protected even if their tips pertain to private companies. However, whistleblowers who make disclosures that are required or protected under the Sarbanes-Oxley Act, Securities Exchange Act, or any other law subject to the jurisdiction of the SEC will generally only be protected if their tips pertain to public companies.

Companies Need to Assess the Implications

The new rules surrounding the whistleblower program may result in an increase in the number of reports submitted by whistleblowers both internally and to the SEC. Although the rules do not require whistleblowers to report violations internally, there could be an uptick in internal tips because of the rules' incentives for internal reporting, such as the possibility of earning a greater award, and the 120 day "lookback period."

The final rules have a number of implications for companies. Companies should review and update their compliance systems to ensure that they are able to sufficiently process and investigate the potential for an increased number of tips. Companies should assume that the reports they receive from whistleblowers will also be submitted to the SEC shortly thereafter; therefore, they should be prepared to conduct investigations of tips in accordance with SEC demands.

In addition, in order to encourage whistleblowers to report possible violations internally rather than directly to the SEC, companies should promote a corporate environment that fosters compliance with securities laws. The SEC suggested that where employees feel that compliance is a priority and tips are thoroughly investigated, whistleblowers will be more likely to submit reports internally because they will be eligible for a potentially greater award.

Lastly, in dealing with an increased number of whistleblowers, companies should be mindful of the anti-retaliation protections provided by Dodd-Frank and Sarbanes-Oxley. Accordingly, companies should take steps, such as limiting the access of supervisors to information about the identities of whistleblowers, to avoid even the appearance of retaliation in any subsequent adverse employment action against the whistleblower.

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BUSINESS LAW **TODAY**
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Keeping Current: Initial Public Offerings

New FINRA Rule 5131 Will Affect Lock-Up Agreements for IPO Shares Held by Officers and Directors of the Issuer

By Peter W. LaVigne, Christopher J. Austin, and Richard A. Kline

FINRA Rule 5131 (the Rule), portions of which became effective on May 27, 2011, provides new prohibitions and requirements for underwriters when they are pricing and allocating IPO shares. While the Rule technically applies only to FINRA member firms, as a practical matter the Rule will affect IPO issuers and venture capital investors with board seats holding shares subject to lock-up agreements. The spinning prohibition in the Rule will also affect investment funds and others who purchase "new issues" under the Rule because FINRA member firms will require representations from each purchaser about the purchaser and, in the case of an investment fund, the purchaser's beneficial interest holders. These representations will be necessary to permit the underwriters to determine that they are not selling to a prohibited account.

Background

The Rule had its origins in the IPO market of the late 1990s and 2000. During that period, IPO shares would often begin trading in the market immediately at prices significantly above the IPO price. As a result, allocations of IPO shares were in high demand. In the course of its investigations into certain IPO offerings during the so-called IPO bubble, the SEC learned that some underwriters had a practice of allocating IPO shares to executive officers and directors of companies for whom they were providing investment banking services or hoped to provide investment banking services. This practice came to be known as "spinning." At the same time, there were complaints by some IPO issuers that their shares had been priced too low in the public offering.

In 2003, many of the major investment banks entered into what has become known as the Voluntary Initiative, which specifically curtailed the practice of spinning. By its terms, the Voluntary Initiative was due to expire when FINRA (at that time, the NASD) adopted a rule regulating the practice, but no later than 2008. Although there was not a FINRA rule during the period from 2008 to May 2011, the signatories to the Voluntary Initiative, along with other investment banks, generally continued to abide by its terms. The rulemaking process that the NASD began in 2003 has culminated in Rule 5131.

Spinning and Pricing Provisions

Some provisions of the Rule have gotten a lot of attention, notably the so-called spinning prohibition, which prohibits the allocation of IPO shares by an underwriter to an account in which an executive officer or director of a public company or covered non-public company, or a person materially supported by such an officer or director, has a beneficial interest if the underwriter is currently providing, or expects to provide, investment banking services to the public or covered non-public company. Because of concerns about the ability of firms to implement programs for compliance with the spinning prohibition (which will require certifications not only by purchasers to firms but by fund investors to funds that seek to purchase new issue shares from underwriters), FINRA has extended the effective date of that provision to September 26, 2011.

The provisions on IPO pricing are effective as of May 27. These are designed to create greater transparency for issuers around the indications of interest process. The Rule will require the book-running lead manager to provide the issuer's pricing committee (or if none, its board of directors) with regular reports of indications of interest before the offering, and of final allocations after settlement, including the names of institutional investors and number of shares indicated or purchased by each, and aggregate numbers for retail investors. Since most private funds (generally those with at least $50 million in assets) will be treated as institutional investors, the names of private funds indicating an interest in receiving allocations will be made known to the issuer.

New Requirements for Lock-Up Agreements

The provisions relating to lock-up agreements covering shares held by the issuer's officers and directors, which have not been as widely discussed as the spinning prohibition, are in effect for lock-up agreements executed on or after May 27, 2011. The

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Rule affects new lock-up agreements in two ways. First, if a lock-up agreement applies to shares held by an officer or director of the issuer, it must apply to the officer or director's issuer-directed shares as well as to shares acquired before the IPO. Second, the agreement must provide that, at least two business days before the release or waiver of any lock-up restriction on the transfer of the issuer's shares, the book-running lead manager will:

- Notify the issuer of the impending release or waiver, and
- Announce the impending release or waiver through a major news service.

The Rule does not by its terms limit the notification and announcement requirement to cases of discretionary release or waiver by underwriters. Notification and announcement are not required when the lock-up period expires, but FINRA has advised informally that notice to the issuer and public announcement would be necessary in the case where release occurs before expiration as a result of satisfaction of price conditions in the lock-up agreement.

Notification and announcement are not required where the release or waiver is effected solely to permit a transfer of securities that is not for consideration and where the transferee has agreed in writing to be bound by the same lock-up agreement. The public announcement requirement may be satisfied by an announcement made by the book-running lead manager, another member of the syndicate or the issuer.

The requirements for lock-up agreements apply only to agreements to which the members of the underwriting syndicate are parties (i.e., underwriter lock-ups). They also apply only to shares of officers and directors of the issuer. Unlike the spinning prohibition, the lock-up provision does not limit its application to officers who are executive officers. Venture capital investors who hold seats on the boards of issuers and enter into underwriter lock-up agreements will have their agreements subject to both of the provisions mandated by the rule. Of particular significance is the fact that any release or waiver of the lock-up restrictions before the expiration of the lock-up period will be the subject of a public announcement. Venture capital investors who are board members and who do not want release of their lock-up agreements to be publicly announced may wish to consider resigning from the board before signing the lock-up agreement.

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