

Important Legal Topics Affecting Companies Today

International Society of Primerus Law Firms

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International Society of Primerus Law Firms

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How to (Positively) React When Told That Your Organization May Have Destroyed Electronic Evidence

By Stephen D. R. Taylor

Kohner Mann & Kailas, S.C.

Washington Building, Barnabas Business Center
4650 N. Port Washington Road
Milwaukee, WI 53212
United States

414.962.5110 phone

414.962.8725 fax

staylor@kmksc.com

kmksc.com

I was recently asked by a senior executive what a business leader should do if he or she becomes aware that past actions may have exposed the organization to the potential for allegations of spoliation (destruction of responsive evidence). His point is a valid one—in operational management, particularly in larger organizations; bad news has a habit of coming to the attention of senior decision-makers after the window for “advance planning” has passed. Yet most of the electronic discovery guidance available focuses on advance best practice, aimed at pre-empting future risks of unnecessary cost, compromised advocacy, and potential for sanctions related to spoliation. There is not much in the way of practical guidance for those who find themselves in circumstances where potential spoliation has occurred or has been alleged.

In practice, of course, the precise nature of the response to such a discovery will be dependent upon the circumstances of the parties and the dispute. However, it is possible to suggest general steps that may be useful to executives seeking to quantify and minimize risk in such circumstances and also as guidelines for ensuring appropriate remedial action by in-house or external counsel.

It is important to state that, once spoliation has occurred, it cannot be undone—since, by definition, the evidence has been destroyed. There may, however, be means to alleviate the prejudicial effect on (or to show that there was no prejudice to) any adverse party. There are also potential ways for the responding party to limit its perceived culpability, the assessment of the degree of prejudice and to minimize additional litigation and expert costs that typically accrue in the wake of potential spoliation.

Generally, issues relating to the improper loss of electronic information arise as a result of failing to understand and comply with litigation obligations, whether through ignorance (common) or bad faith (less so). One subcategory of the latter is where a client misleads its counsel (counsel should be aware that this excuse is a poor shield, as courts increasingly regard counsel as obliged to do more than merely accept client assertions of compliance and to advise accordingly). In-house personnel should look for affirmative actions by external counsel on whom they are relying, not merely statements of what is required. Outside counsel should plan for and monitor effective preservation and production in practice—and may need to demonstrate



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reasonable affirmative initiatives on his or her part to ensure that adequate preservation has been achieved in terms of scope and timeliness.

Whether a plaintiff or defendant, if potential spoliation is a concern, it likely stems from a failure by the responding party to in relation to one or more of the following one of the following:

1. Understand the information that you and your client possess.
2. Know what your (and your client's) obligations to preserve are, both in general terms and in relation to the specific dispute.
3. If not comfortable with technical issues raised, bring in expert assistance.
4. Implement and monitor compliance with a reasonable litigation hold.
5. Identify and document aspects of any request or sources of information that would be particularly burdensome to produce, and the reasons why.
6. Approach the mandatory conferral process able and willing to provide reasonable information about the location, form and accessibility of potentially responsive information.

So what should one do? Consider the opposite perspective for a moment: if a requesting party believes that the other party possesses evidence that it is not disclosing, or has potentially destroyed information that should have been in existence, the first task is to document what is potentially absent from disclosures, and the reasons for believing that it should have been preserved. Often, non-specific discomfort with the adequacy of a production emerges either as a result of a failed pre-trial conferral process, or a failure of realized production to

square with representations made during that process. A more definite indication arises if documents are located from another source that should have been included in a responsive production or testimony reveals a similar basis for suspecting incomplete production. The response should be dictated by whether there is a realistic basis for believing that the omitted production will actually prejudice the requesting party's ability to support its claims. If such information becomes available, the plaintiff would be well-advised to document why its absence impairs his or her ability to argue. The first step should generally be to confront opposing counsel in writing and to request a justification or proposals to identify any wider deficiency. Should these be unsatisfactory, or not be provided, the requesting party may wish to seek the intervention of the court.

If there is no direct evidence, the best advice is to document a failure to provide information enabling a narrowly-tailored request for additional production. Divergence between actual production and that reasonably anticipated usually produces anomalies that raise questions that can legitimately be brought to the court if the respondent is unable to provide adequate explanations. Examples include missing information from particular periods--if one month is devoid of, or significantly underrepresented in terms of, e-mails from key individuals. Perhaps there is an inadequate explanation for the relative absence of documents of one type, subject or source.

Unless the litigation has progressed to a point where the prejudice is actual rather than potential, initially, the best tactic is likely to be to request lesser intervention, perhaps request through a production protocol or other method of scrutinizing the production, such as the



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appointment of a special master, accompanied by a request that the respondent bear the additional expense, and that it meet the costs of bringing the motion. Depending upon the severity, this may not be granted, but the request will set the stage for next steps, should the spoliation dispute intensify. Thus, an adept requesting party will be seeking to document the rationale for asserting a failure to produce, and to narrow the specification of the missing information to support the framing of a request for court intervention that is as clear and defined as possible.

In such circumstances, decision-makers within the responding party should also seek to frankly determine any deficiency without delay, to determine exactly what has happened. There are a variety of defensible explanations that could apply. Alternatively, there may be a basis for asserting a lack of prejudice because the information is either not material to the claims asserted, or is largely duplicative of other available information--spoliation sanctions require prejudice. If there is any question of lack of comfort with the subject matter, or doubt over the ability to secure clear understanding of the legal and technical requirements across both functions, seek expert help. An effective response requires a rapid, accurate, and, above all, candid appraisal to determine, first, if there is a genuine issue, and, second, to identify the least expensive means to remedy any prejudice that may be caused in order to minimize loss of control over the process (to the court) and the risk of punitive financial or evidentiary sanctions.

The first step is to immediately verify if the information at issue was in existence at the time the duty to preserve commenced. At this point, a genuine, documented, investigation of systems, practices and preservation actions is required, not mere inquiry of primary client contacts. If the information did not exist, it is likely that all that will be necessary to defend the spoliation charge is to demonstrate

this fact. If the information did exist, was its destruction according to a document retention policy that was in place and enforced prior to the duty to preserve being triggered, or did it take place within a justifiable time window after that point? If not, is there any reason to believe that the information was potentially relevant and that this source was the only source of that information? If there are genuine reasons to believe that the information was duplicative, or simply not relevant, then it would fall outside of the duty to preserve. If the information was likely relevant, does it still exist in an alternative, unsearched form? For example, suppose email was improperly destroyed for a given month after the duty to preserve attached, but a back-up tape remains. In such circumstances, investigate the cost of recovering those e-mails. The cost of recovery will likely have to be shouldered, but significant prejudice to the other party, and thus a court-imposed sanction, would likely be avoided. If the information does not exist in an equivalent form, for example, all electronic copies of the emails are gone, but paper printout of e-mails remain, then the first question is whether metadata was specifically requested, and, if so, what types? In other words, was the information not present in the printouts relevant? Absent a specific request or obvious relevance to the pleaded claim, metadata may be only relevant as a means of preserving searchability. In many such instances, the original search utility can be replicated by scanning the printouts into .pdf and .tiff formats, for example, and then creating indexing files.

If irreplaceable and likely responsive information has probably been destroyed, the best advice is to conduct a final thorough search. More than one party to a law suit has found "lost" back-up tapes in boxes or on shelves, having become lost in warehousing or moving, for example. Alternatively, could the information reside on a legacy system not previously accessed due to cost?

If actual destruction has occurred, the best answer is to come clean with the opposing party and court as soon



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as possible. In doing so, it is advisable to be in a position to fully describe the likely relevance, any mitigating factors to weigh against the failure, any partial alternative sources available, and, finally, to volunteer to undertake the financial burden of any possible retrieval of substitute data as may be available on sources that would otherwise have been inaccessible for reasons of cost and labor. Most sanctions related to electronic information are imposed to repair prejudice to the other party or for continued failures to comply with court orders. A forthright statement, coupled with a willingness to shoulder the cost of repairing the resulting harm, may help avoid any significant monetary or evidentiary penalties, at least to the extent that material prejudice can be offset by such efforts.

The information provided above is intended for general informational purposes only and does not represent legal advice. It should not be relied upon to make legal decisions.

Stephen D. R. Taylor, Kohner Mann & Kailas, S.C.
staylor@kmksc.com

Prior to becoming an attorney with Kohner, Mann & Kailas, S.C., Stephen Taylor was a businessman and venture capitalist who focused on business strategy, primarily in the information technology field. Mr. Taylor advises businesses on how to manage electronic information to protect their interests in the event of litigation, and on the conduct of electronic discovery. He also provides transactional and strategic support to businesses involved in trading across international and cultural boundaries and in identifying effective dispute resolution strategies arising out of such activities. An American attorney, Stephen also holds an MBA and Bachelor's degrees in both International Trade and Politics & International Relations from British universities.

Kohner, Mann & Kailas, S.C. www.kmksc.com

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Contractual Indemnities – Look Before You Leap!

By Michael Baig, Esq.

Kubasiak, Fylstra, Thorpe & Rotunno, P.C.

Two First National Plaza
20 South Clark Street, 29th Floor
Chicago, IL 60603
United States

312.630.9600 phone
312.630.7939 fax

mbaig@kftrlaw.com
kftrlaw.com

Background

Today, many companies, particularly large companies with strong bargaining power, require their contracting partners to sign contracts that contain indemnity provisions. The indemnities are often very broad, and operate to shift a great deal of risk away from the large companies and onto their partners.

During the contracting phase, smaller, less powerful companies, in particular, often accept the contracts (and the onerous indemnities) with little, if any, negotiation. They do so because they fear that if they make waves by quibbling over the indemnity, the larger companies will take their highly coveted business elsewhere.

Smaller companies that take this leap of faith and accept the indemnities “as is” reason that: (1) the indemnities will only come into play in situations in which losses occur as a result of their own negligent performance under the contract; and (2) they will not be negligent in their performance and, thus, will never be the cause of any losses from which a claim for indemnification will arise.

The Problem

The problem with the smaller companies’ reasoning is that, in many jurisdictions, it is permissible for one party to contractually indemnify another party, not only for losses arising out of the first party’s negligence, but also for losses arising out of the other party’s negligence. Put another way, SmallCo may perform flawlessly under its contract with BigCo, yet, by virtue of the indemnity in the contract, be required to foot the bill for losses that are solely caused by BigCo’s negligence.

The Judicial “Safeguard”

Courts recognize that agreements by one contracting party to indemnify another for losses arising solely out of the other party’s negligence embody an extraordinary shifting of risk. Therefore, to prevent injustice, courts generally require that the risk be *readily apparent* from the language of the indemnity itself.





Contractual Indemnities – Look Before You Leap!

For example, in Illinois, a party may be liable to indemnify another for damages arising out of the other's negligence, only if "such a construction is required by *clear and explicit language* of the contract or such intention is expressed in *unequivocal terms*" in the contract. *Buenz v. Frontline Transport Co.*, 227 Ill.2d 302, 309 (2008) (emphasis added). While this seems at first blush to be a reasonable safeguard, in actuality, it is a trap for the unwary. This is because Illinois courts interpret the phrases "clear and explicit language" and "unequivocal terms" very broadly.

Indeed, Illinois courts need not find, as one might expect, any "*specific reference* to indemnification against liability arising out of the indemnitee's [own] negligence ... in the agreement" in order to determine that the parties unequivocally intended to shift that liability from indemnitee to indemnitor. *Hadler v. St. Louis Southwestern Railway Co.*, 207 Ill.App.3d 1001, 1011 (5th Dist. 1991) "[G]eneral inclusive language" indicating such an intention is sufficient under Illinois law. *Id.* at 1012.

The *Buenz* Case

In *Buenz*, the Illinois Supreme Court's most recent and most comprehensive opinion addressing contractual indemnification by one party for losses arising out of another party's negligence, the equipment interchange agreement between the parties (Frontline and COSCO) contained an indemnity which provided, in pertinent part, that:

[Frontline] shall indemnify [COSCO] against, and hold [COSCO] harmless for any and all claims, demands, actions, suits, proceedings, costs, expenses, damages and liability, including without limitation (sic) attorneys' fees, arising out of, [in] connection with, or resulting from the possession, use, operation or returning of the equipment

Buenz, 227 Ill.2d at 306. The Court found this indemnity to be "specific and clear enough to provide indemnification [by Frontline] for claims arising out of [COSCO's] own negligence." *Id.*

The Court reasoned that the words "any and all" were all inclusive and unlimited in scope. *Id.* at 318. Additionally, the equipment interchange agreement contained no language limiting the broad scope of the indemnity to losses arising solely out of Frontline's negligence. The absence of such limiting language was of crucial importance to the Court's determination. As the Court succinctly stated, "Frontline did not agree to indemnify COSCO *for any and all claims arising out of Frontline's negligence*. Instead, Frontline agreed to indemnify COSCO for *any and all claims, [which] ... encompasses even claims which arise out of COSCO's negligence*." *Id.* at 318 (emphasis added).

A Recent Firm Case

In a recent case in which Kubasiak, Fylstra, Thorpe & Rotunno, P.C. (KFT&R) served as counsel, a worker who was injured while working at a client's Chicago facility sued the client. The worker alleged that his injuries were the direct and sole result of the client's negligence.

The worker had been supplied to the client by an outside vendor pursuant to the terms and conditions of an employee leasing agreement entered into by and between the vendor and the client. The leasing agreement contained an indemnity, pursuant to which the vendor agreed to:

protect and indemnify and hold harmless [client] from any loss, damage, liability and expense for death or injury to person or damage to property, directly or indirectly arising out of, or in connection with [vendor's] work under this contract ... and at [vendor's] expense, answer or defend any action, claim, suit, demand or proceeding instituted against [client] ... arising out of, or in connection with, the work performed under this contract by [vendor].



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After settling with the injured worker, the client sued the vendor for indemnification of the full amount of its “losses,” which included the settlement payment, plus the fees and costs it incurred defending the injured worker’s suit. The Court construed the words “any loss, damage, liability and expense” broadly to include losses of all sorts, even those arising out of litigation in which the client (and not the vendor) was alleged to have been negligent. The Court accordingly entered judgment in the client’s favor, and against the vendor, for the entire amount requested.

The Takeaway

The takeaway from all of this is: if your company is asked to sign a contract that includes an indemnity, read it very carefully. Do not dismiss the indemnity as “boilerplate,” and do not assume it only comes into play if your company negligently performs under the contract.

If the indemnity requires your company to indemnify its contracting partner for “*any and all*” losses “*directly or indirectly arising out of*” work being performed under the contract, or uses other similarly inclusive language (which is not uncommon), the onus is on your company to narrow the scope of the language. You should not be afraid to propose the interjection of language that unequivocally makes clear that your company is not undertaking an obligation to indemnify its contracting partner for losses caused by the partner’s negligence.

If your company decides in the end to take a leap of faith and enter into a contract that contains a broadly worded indemnity, be mindful that the costs of that decision could outweigh the benefits your company receives under the contract.

Michael Baig is a partner at the law firm of KUBASIAK, FYLSTRA, THORPE & ROTUNNO., P.C., the Chicago, Illinois based firm of the Primerus Business Law Institute.

A Majority of States now have Electronic Discovery Rules: Is Your Business Prepared?

By Stephen D. R. Taylor

Kohner Mann & Kailas, S.C.

Washington Building, Barnabas Business Center
4650 N. Port Washington Road
Milwaukee, WI 53212
United States

414.962.5110 phone
414.962.8725 fax

staylor@kmksc.com
kmksc.com

By now, most businesses and attorneys are aware of the federal rules governing the discovery of electronically stored information. However, perhaps less appreciated is the fact that courts in approximately three quarters of the fifty states now also mandate (different) evidentiary rules governing the preservation and production of electronically stored information. The result is that familiarity with electronic discovery rules and developing best practice is increasingly indispensable.

States in which statutory or court rules address the discovery of electronically stored information in civil proceedings as of August 2011:

- | | | | |
|----|-------------|----|-------------------------------|
| 1 | Alabama | 20 | Missouri (25th Judicial Cir.) |
| 2 | Alaska | 21 | Montana |
| 3 | Arizona | 22 | Nebraska |
| 4 | Arkansas | 23 | New Hampshire |
| 5 | California | 24 | New Jersey |
| 6 | Connecticut | 25 | New Mexico |
| 7 | Delaware | 26 | New York |
| 8 | Florida | 27 | North Carolina |
| 9 | Idaho | 28 | North Dakota |
| 10 | Illinois | 29 | Ohio |
| 11 | Indiana | 30 | Oklahoma |
| 12 | Iowa | 31 | South Carolina |
| 13 | Kansas | 32 | Tennessee |
| 14 | Louisiana | 33 | Texas |
| 15 | Maine | 34 | Utah |
| 16 | Maryland | 35 | Vermont |
| 17 | Michigan | 36 | Virginia |
| 18 | Minnesota | 37 | Washington |
| 19 | Mississippi | 38 | Wisconsin |
| | | 39 | Wyoming |



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In the current business environment, most experts agree that nearly all business data is created and maintained in electronic form. See, e.g., Jay E. Grenig et. al., *ELECTRONIC DISCOVERY AND RECORDS MANAGEMENT GUIDE: RULES, CHECKLISTS, AND FORMS*, at v. Thomson West (2009 edition) (estimating that 98% of all business records are electronic, that 80% of them never hit paper). In such circumstances, it is hard to imagine litigation of a dispute in which a business is a party where electronic information is not going to exist and be relevant. Thus, effective navigation of electronic discovery rules should be anticipated as an inevitability of both effective and compliant advocacy. Business leaders and counsel can ill afford to proceed without understanding their obligations under the federal and state rules.

While state rules differ (both from the federal rules and between states) somewhat, the broad risks that the rules pose for unprepared businesses are similar and best practices relating to the preservation and production of information are generally applicable. State rules and courts have frequently drawn from federal rules and interpretive case law, and impose many comparable obligations from the moment a company contemplates litigation, or is placed on notice of potential adverse litigation. The rules imposed in most states do not mirror the federal rules exactly: there are some important omissions or variations, but the overall effect is to subject litigants to obligations in state proceedings that resemble those imposed in the federal system.

Recent state rules impose new and more defined obligations on any entity that may become involved in litigation in state courts—effectively any business trading in the state—that it would be unwise to overlook. The consequences of non-compliance can include significant financial penalties and potentially outcome-determinative evidentiary sanctions. In the federal system, to which

state courts (and adverse parties) often look for guidance, sanctions are increasingly common. One-quarter of reported federal electronic discovery opinions in 2008 involved sanctions issues. There were more sanctions cases heard in federal courts in 2009 alone than in all years prior to 2005, and the trend is expected to continue: 2009 represented a more than 35% rise over 2008. Dan H. Willoughby Jr., et. al., “Sanctions for E-Discovery Violations: By The Numbers,” 60 *Duke L.J.* 789, at 794-95 (Dec. 2010). The trend is for courts to be increasingly intolerant of missteps in preserving and producing electronic information and of failure to enter litigation fully informed of digital assets. As a significant 2010 federal opinion noted, “much of the recent case law on sanctions for spoliation has focused on failures by litigants and their lawyers to take adequate steps to preserve and collect information in discovery.” As three contributors to the form of the new Wisconsin rules have commented, “it may be malpractice not to take careful account of the probability that much of the evidence the client needs access to for litigation may reside on an adversary’s computer system.” Richard J. Sankovitz, et. al., “What You Need to Know: New Electronic Discovery Rules,” *Wisconsin Lawyer*, Vol. 83, No. 7, July 2010.

Business leaders should be particularly concerned, since while outside counsel share the burden, the reality is that the obligation to preserve and produce rests ultimately with the client. Failure to do so can lead to significant financial sanctions (seven-figure amounts have been levied), even where a party actually wins on the merits. Typically, even where counsel is also at fault, the clients have borne the larger share of financial penalties. In addition to financial penalties, parties are barred from entering evidence, subjected to negative jury instructions or, in severe instances, dismissal without consideration of the merits. Sanctions aside, such failures also undermine advocacy. Unless a business knows what digital assets exist, where they are kept, how they will be preserved and how



A Majority of States now have Electronic Discovery Rules: Is Your Business Prepared?

much recovery will cost, it will be hamstrung when arguing its case, as well as being potentially exposed to significant unnecessary costs and operational disruption.

The responsibility to provide informed responses commences with the start of the litigation process. Federal, and most states', rules require parties to confer meaningfully about discovery of electronically stored information at the outset of proceedings, including preservation of the information pending discovery and the form or forms in which the information will be produced. Parties should also address the protection of privilege and discuss the cost of discovery including whether it is appropriate to agree to any limitation on discovery. In states (like Wisconsin) with rules containing no default mechanism for preserving privilege from waiver due inadvertent production, any party subject to production requests would be prudent to seek specific protections during the conferral process and court endorsement of any agreement. If no agreement can be reached, a protective order should be considered.

Generally, a party requesting discovery should specify the format for production. The respondent may object if the request is for a form in which the information is not kept in the ordinary course of operations. A requesting party that desires metadata may wish to place that desire on record early, and with as much particularity as possible. If no format is specified, the respondent may choose a form, as long as it does not detract from the information content or searchability of the form in which the information is ordinarily kept. Degrading these risks an order to repeat production and associated additional costs.

Poor preparation for the conferral process carries real risk. A respondent may be on the back foot if it later asserts burden objections. If the court comes to suspect that over-generalized requests are due to a lack of knowledge on the part of the respondent (or willingness to provide

information), the respondent risks a court order requiring more expansive production, potentially in a more expensive form than would have otherwise been necessary. Further, such a suspicion inevitably places a party on the defensive should problems arise as production progresses. Conversely, generalized or ill-focused requests that are attributed to a lack of diligence by the requesting party are likely to result in the court restricting the scope and nature of production, or shifting costs to the requesting party.

Overall, parties are expected to familiarize themselves with the locations, format and content (including metadata) associated with the information that they maintain or control. Respondents should anticipate being obliged to apply this knowledge in developing and explaining a timely preservation and production strategy of adequate scope. Requesting parties are expected to have the understanding necessary to ask pertinent questions and develop specifically-tailored requests based upon the responses. As time passes, courts seem to be increasingly intolerant of missteps by parties relating to electronic evidence, and the threshold for competent compliance appears to be rising.

Effective preparation for electronic discovery ideally starts before litigation is anticipated, with a general assessment of digital assets in light of the specific characteristics of your business. This assessment enables technological and human processes to be put in place to support effective, cost-efficient compliance in the event of future litigation. Once litigation is anticipated, the first step is to obtain a comprehensive understanding of potentially relevant information. Building on effective prior planning will significantly reduce the cost and time involved in securing an adequate preservation and discovery strategy for specific litigation. It also serves to protect your position as the litigation progresses—some courts have begun to state that a lack of a specific plan is suggestive of bad



A Majority of States now have Electronic Discovery Rules: Is Your Business Prepared?

faith. Outside vendors are commonly used. Costs can vary significantly, and providers vary in breadth of expertise. Issues of confidentiality may also arise if subcontracting will be required. It is important to research providers thoroughly and to ensure that the skills that they offer match the characteristics of the systems at issue and the nature of envisaged litigation.

If there is uncertainty within your business concerning the ability to comply with state or federal electronic discovery rules, the likelihood is that your business is not adequately prepared. The one universal constant is that the sooner advice is sought the better: the stakes for businesses that procrastinate are rising. Both in-house and outside counsel should consider whether they understand the issues posed by electronic discovery. If electronic evidence is implicated, the first step is to very honestly determine whether counsel is competent to protect either himself or herself and the client. If not, counsel should either seek assistance from a competent colleague or retain expert assistance to assess the situation immediately, because the mere opening of electronic files may irretrievably destroy certain kinds of information. *If you have doubts as to the adequacy of your current knowledge or resources, the best advice is to seek additional guidance now.*

The information provided above is intended for general informational purposes only and does not represent legal advice. It should not be relied upon to make legal decisions.

Stephen D. R. Taylor, Kohner Mann & Kailas, S.C.
staylor@kmksc.com

Prior to becoming an attorney with Kohner, Mann & Kailas, S.C., Stephen Taylor was a businessman and venture capitalist who focused on business strategy, primarily in the information technology field. Mr. Taylor advises businesses on how to manage electronic information to protect their interests in the event of litigation, and on the conduct of electronic discovery. He also provides transactional and strategic support to businesses involved in trading across international and cultural boundaries and in identifying effective dispute resolution strategies arising out of such activities. An American attorney, Stephen also holds an MBA and Bachelor's degrees in both International Trade and Politics & International Relations from British universities.

Kohner, Mann & Kailas, S.C. www.kmksc.com

Founded in 1937, KMKSC is a business and commercial law firm. KMKSC provides quality legal expertise across the areas of law encountered by businesses in the course of their operations and growth. Our services range from high-profile appellate representation and international business issues to ensuring that critical everyday needs, such as debt recovery, are fulfilled efficiently and expertly. Our purpose is to deliver excellent results for our clients, whether the issue is advice on the avoidance of legal disputes, closing a transaction, protecting assets or winning in court. KMKSC is continually advancing the interests of its clients in negotiations, transactions, litigation and alternative dispute forums across North American and beyond. We help U.S. companies address the legal issues raised by trading across international borders and provide legal support and advice to foreign companies operating in American markets.

The World is Shrinking

By: Paul Milligan

Ford & Warren Solicitors

Westgate Point

Westgate

Leeds, WYK LS1 2AX

United Kingdom

+44(0)1132436601 phone

+44(0)1132420905 fax

paul.milligan@forwarn.com

forwarn.com

When I first entered the legal profession as a family lawyer, some 29 years ago, it was almost unknown that you would be dealing with any case from outside of your home town.

As the years have rolled by the catchment area for clients has increased and it was not uncommon to be involved in acting for clients from the North or the South of the country.

As I am sure other members of Primerus have found it is common now to be involved in cross border cases from Australia to the States. The concept of forum shopping as to where the divorce will take place is now well established. It is well known that England has become the legal centre for wives wishing to make financial claims against their husbands and the highest awards have been made in the Royal Courts of Justice. As time goes by the volume of cases and the diversity of cases will continue to increase. It will be important that family lawyers have knowledge of the procedures in other jurisdictions around the world. If they do not have that knowledge then it is important that they are in contact with like-minded solicitors throughout the world whose expertise they can rely upon. The role of Primerus

and its member firms will be an ever increasing resource to rely upon.

Family lawyers have for some time been looking at the standardisation of family work across the world. We are familiar with the Hague convention covering child abduction, last year there was the Washington convention regarding the permanent removal of children out of their country of origin into a new jurisdiction.

There are however few conventions dealing with financial matters and the enforcement of financial orders outside ones own jurisdiction, I have recently been involved in an English case where the assets and the husband were in Spain. The husband was a rogue to say the least and was doing all he possibility could to defeat the wife's claims. He was in breach of many an English court order. The Spanish courts would not automatically recognise the English matrimonial court orders. The English court orders had to be ratified by the Spanish courts which was a process I was informed could take between 3 and 6 months. I was able to use a seventeenth century common-law practice and issue a Writ Ne Exact Regno. This writ has been very rarely used since the seventeenth hundreds.





The World is Shrinking

In 1740 – 1760 there were several applications made before the courts to use Writ Ne Exact Regno to prevent slave traders leaving the shores of England to go and collect slaves. This old almost distinct procedure did however come to my aid in this Spanish case.

The format of the writ has not changed over the centuries and I set out below the preamble to the order which is hardly plain English:

“Elizabeth II by the grace of God of the United Kingdom and Great Britain and Northern Ireland and of our other realms and territories Queen head of the Commonwealth defender of the faith, to the tipsstaff attending our Supreme Court of Judicature his Deputy and all Constables and other peace officers greetings.

“Whereas it is represented unto us in our High Court of Justice on the part of the Applicant that the Respondent amongst other things it is said is greatly indebted to the Applicant and designs quickly to go into parts beyond the seas as by oath made in that behalf of piers which tends to the great prejudice and damage of the said Applicant, therefore in order to prevent injustice we hereby do command you that he will not go or attempt to go into parts beyond the seas without the leave of the said court.”

Following the issue of the writ the husband in my case returned from Spain to England. On entry into the United

Kingdom and on the scanning of his passport the authorities were altered and the husband’s passport was taken from him, thereby stopping him from leaving the country. This enabled me to bring him back before the English court for the enforcement of the orders in favour of my client. The husband had to purge his contempt and comply with the court’s orders upon fear of being sent to prison.

I would hope that in the years to come that family lawyers form around the world could begin to look at standardising and recognising orders from other jurisdictions.; putting in place common procedures with more cooperation between participating states. This would certainly have assisted in the case that I have mentioned above and could move some parts of the English legal system out of the seventeenth century and into the modern world.

Paul Milligan is Chair of Primerus’ Family & Matrimonial Law Practice Group, and Head of Family Law at Ford & Warren Solicitors, Leeds, UK

Federal Agencies Hold Powerful Key to Government Funds

By: Kathleen H. Hatfield

Law Offices of Stewart and Stewart

2100 M Street, N.W., Suite 200
Washington, DC 20037
United States

202.785.4185 phone
202.466.1286 fax

katfield@stewartlaw.com
stewartlaw.com

Washington, D.C. (September 2, 2011)—Senate Appropriations Committee Chairman Daniel K. Inouye surprised longtime observers of the U.S. appropriations process early this year when he embraced a moratorium on congressionally-directed spending, also known as “earmarks.” As the “power of the purse” has shifted from earmarks to discretionary funding provided by 26 grant-making federal agencies, so must strategies employed by corporations and others to elicit monies from the government.

Observers note that, despite the earmark ban, Congress continues to be bombarded by constituents anxious to fill funding needs in the face of dwindling national coffers. The advice of congressional staff and seasoned lobbyists is twofold: 1) deliver your requests directly to both your congressional delegation and federal agencies with jurisdiction over the funding you need; and 2) strengthen your relationships with your state and local governments.

Without earmarks, federal agencies wield tremendous control over the distribution of federal funds to chosen

grant recipients. Their awards can be based on need or be determined by discretionary criteria, agency guidelines, or demographic and other formulas that govern dollars to state and local governments. In fact, some federal agencies even “earmark” in their own way by issuing “sole source” justifications as to why otherwise competitive awards potentially available to numerous grantees should instead be awarded to a single recipient.

The probability of success in obtaining federal funding can be increased by requesting help from elected representatives, while making a parallel case in face-to-face meetings with the federal officials charged with reviewing applications for funding. Ideally, parties should request support letters from their elected officials; the letters should accompany the grant applications they submit to the agencies. Most federal officials are open to both letters and meetings, because the encounters provide an opportunity for the officials to learn more about the applicants whose submissions they will review. They can then render more



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Federal Agencies Hold Powerful Key to Government Funds

informed decisions about whom to fund. This has proved particularly true with respect to offices within the U.S. Department of Health and Human Services (HHS) charged with implementation of the health care reform law, also known as “The Patient Protection and Affordable Care Act (PPACA).”

U.S. Department of Health and Human Services

Notably, a particular agency within HHS, the Centers for Medicare and Medicaid Services (CMS), has established a new “Center for Innovation” authorized by PPACA at \$10 billion through FY 2019. The Center is to receive “New Ideas” to streamline and improve the delivery of healthcare in America. As the Center proclaims, it will “take the best ideas, turn them into Innovation Center initiatives, and invite you and others to compete to bring them to fruition.” In practical terms, this means the Center will take the best ideas, turn them into grant opportunities, and post them at www.grants.gov, where eligible parties can submit applications and compete for funding.

As illustrated by PPACA, the enactment of a new law can afford a unique opportunity for organizations, personnel, and institutions of all types to come to Washington and explain to agency officials how their corporate model, healthcare/hospital plan, non-profit initiative, or community development project comports with the provision of a new law still to be fully understood, implemented, and funded.

Further, certain programs in new laws are sometimes “authorized” by Congress without appropriated funds. In such instances, it can literally “pay” to come to Washington to make the case for funding those provisions. While press reports about today’s budget constraints can make anyone wonder about the availability of federal funds, the government continues to invest in worthy projects. Deep deficits have never been the “norm” in our nation, and

few expect them to exist in perpetuity. For example, the Congressional Budget Office recently released a report projecting the U.S. deficit will decline by mid-decade:

If the recovery continues as CBO expects, and if tax and spending policies unfold as specified in current law, deficits will drop markedly as a share of GDP over the next few years. Under CBO’s baseline projections, which generally reflect the assumption that current law will not change, deficits fall to 6.2 percent of GDP next year and 3.2 percent in 2013, and they average 1.2 percent of GDP from 2014 to 2021. Those projections incorporate the effects of the deficit reduction measures in the recently enacted Budget Control Act of 2011; they also reflect the sharp increases in revenues that will occur when provisions of the Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010 (the 2010 tax act) expire.¹

Consequently, organizations and individuals willing to make the investment would be wise to come to Washington, D.C., and introduce themselves to both their congressional delegations and federal officials. They should prepare to make a positive and convincing case for their program or project, and they should follow up repeatedly and systematically to sustain their newly-acquired relationships. Those who complete these simple steps historically have a greater probability of receiving federal investment than those who do not make the effort.

While these steps can be helpful to obtain funds for programs authorized in previously-enacted legislation, they are also important in seeking federal funding in the form of grants known to be issued by agencies on a regular basis.

U.S. Department of Energy

For example, grants awarded through the Department of Energy (DOE)’s Office of Energy Efficiency and Renewable Energy (EERE) constitute a primary funding vehicle for energy projects undertaken by businesses,



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industries, universities, Native American tribes, and other organizations. While most EERE grants are awarded based on a competitive basis, in rare circumstances EERE may award a grant or a cooperative agreement on a non-competitive basis. For a grant to be awarded on a non-competitive basis, it must meet one of the criteria of Section 10 CRF 600.6 of the EERE financial assistance rules. According to DOE, the award must meet one or more of the following criteria:

- Be necessary to the completion of, or be a continuation or renewal of, an activity already funded by the Department of Energy;
- Be conducted with the applicant's resources or resources donated by a third party;
- Be awarded to a unit of government for an activity related to a government function;
- Be awarded to an applicant with exclusive domestic capacity to perform the activity successfully;
- Implement an agreement between the United States and a foreign government to fund a foreign applicant;
- Be restricted by time constraints associated with public health, safety, welfare, or national security;
- Be awarded for an unsolicited proposal; or
- Be determined to be in the public interest.

Further information on state, local, utility, and federal incentives that promote renewable energy and energy efficiency can be obtained at DOE's DSIRE (Database of State Incentives for Renewables and Efficiency).

U.S. Department of Commerce

The U.S. Department of Commerce's Economic Development Agency (EDA) similarly has a history of investing in projects that use both public and private sector resources to promote competitiveness. For example, on August 24, 2011, the agency announced a \$1.2 million EDA grant to the Redevelopment Authority of Johnstown, Pa., to make infrastructure improvements that will

support development of the Rosedale Business Park. Joint Ammunition and Technology, Inc., a manufacturer of both consumer and military munitions, has committed to open operations at the Park and is expected to create 240 new jobs and generate \$14 million in private investment. EDA awards federal funds to worthy applicants on a quarterly basis. Meeting with EDA officials to make a case for funding is a good idea before and after applications are submitted. Further, while the EDA Office of Legislative and Intergovernmental Affairs will often meet with potential applicants for funding, because the agency has regional offices nationwide, a trip to Washington, D.C. is not always necessary.

U.S. Department of Transportation

Early in October 2011, the U.S. Department of Transportation (DOT) accepted pre-applications for \$527 million in discretionary grants to be awarded on a competitive basis to State and local governments as part of a third round of the TIGER (Transportation Investment Generating Economic Recovery) infrastructure development program. Eligible projects included but were not limited to: (1) highway or bridge projects; 2) public transportation projects; 3) passenger and freight rail transportation projects; and 4) port infrastructure investments. While the deadline for this year's TIGER applications has passed, it is probable that a fourth round of TIGER grants will be forthcoming. Interested applicants may request meetings with U.S. transportation officials to discuss their applications for funding now and at various stages throughout the process. TIGER first appeared as part of the Obama Administration's stimulus package. A second round, TIGER II, was included in the 2010 budget and the latest round of funding, TIGER III, was part of the 2011 budget. The President's FY 2012 budget has requested even more funding, \$2 billion, for a program similar to the TIGER program. If the Congress approves even part of the President's request, applications for TIGER IV will be solicited by the U.S. Department of Transportation next year probably around mid-summer.



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U.S. Department of Homeland Security (DHS)

Most homeland security grants are awarded to State and local governments and therefore may be of interest to firms that represent or work closely with municipal entities. Often, private hospitals, EMS contractors, and other businesses partner with municipalities to request funding under grants awarded by DHS. Members of Congress and local elected officials can be extremely helpful in advocating on behalf of their constituents for these grants by contacting DHS in person, by phone, and through correspondence. Consequently, it is helpful for applicants to approach their congressional delegations to request such assistance early in the year, before the agencies have drafted their grant solicitations, and again in June and July when new grant opportunities are normally posted by the agency.

U.S. Department of Defense (DOD)

While DOD offers a broad range of research, hi-tech and security-related grant opportunities, some of the most interesting are issued by the Defense Advanced Research Projects Agency (DARPA) and the Army Research Office (ARO) with respect to its “Minerva Research Initiative.” DARPA was established in 1958 to maintain the technological superiority of the U.S. military. Today, it offers a wide range of funding opportunities that seek, among other things, to enhance U.S. wireless communications capabilities, upgrade cloud computing, improve cyber security, and overcome antibiotic resistant microbes.

While DARPA will consider unsolicited proposals, its preferred method for submitting concepts is in response to a Broad Agency Announcement (BAA). However, in either case, DARPA encourages parties to seek meetings with the agency and make preliminary contact with appropriate field personnel before preparing a detailed unsolicited

proposal or submitting proprietary data. Per DARPA, such contact “provides insight into the need for the type of effort contemplated.” Further, preliminary contact allows ultimate referral to appropriate organizations in DOD, saving time and resources.

The Minerva Initiative is a different, DOD-sponsored, social science research initiative launched by Secretary of Defense Robert Gates in 2008, which focuses on areas of strategic importance to U.S. national security policy. While the program was initiated as a university-based research program, DOD states that, for 2011 and most probably into the future, “non-profit institutions and commercial entities are eligible to compete and receive Minerva basic research funding as a collaborator in a university-led team proposal.” An illustrative list of projects funded previously under Minerva reflects the broad thinking sought by the originators of the program.

Conclusion

Until this year, many entities sought federal funding in the form of non-competitive earmarks provided by powerful Members of Congress. Today, such monies remain available but are awarded largely at the discretion of federal agencies. While the earmark moratorium is set to expire on or about December 2011, the political environment may require that funding remain in agency hands. If so, it is more probable to be funded if parties lay the groundwork for their requests or applications by continuing to work through their congressional delegations but also meeting in person with agency personnel.

¹ CBO Budget and Economic Outlook: An Update at 1 (August 24, 2011).

Kathleen H. Hatfield (khatfield@stewartlaw.com) is government relations and an international trade attorney and Of Counsel to the Law Offices of Stewart and Stewart, 2100 M Street, N.W., Washington, D.C., 20037, www.stewartlaw.com, tel: (202) 785-4185.

A Comprehensive Look at the Bermuda Form Excess Insurance Policy

By: Jeffrey Kaufman

Brydon Hugo & Parker

135 Main Street, 20th Floor
San Francisco, CA 94105
United States

415.808.0300
415.808.0333

jkaufman@bhplaw.com
bhplaw.com

Introduction

Companies buying higher level excess insurance coverage written on one of the Bermuda forms need to understand the difference in coverage provided from typical domestic or London excess forms. The differences are significant and can create gaps in coverage between lower level and upper level excess coverage.

This article takes a detailed look at the Bermuda form. It is must reading before buying any Bermuda coverage.

A Brief History of Time: The Development of the Bermuda Excess Liability Form

The excess liability form underwritten in the Bermuda market is an outgrowth of the collapse of the US excess insurance market in the mid-1980's. Initially, some of the Bermuda companies were funded by large American companies interested in establishing insurance pools for themselves. This quickly changed as the market expanded. The Bermuda companies now reportedly collect billions of dollars in premiums every year.

What is commonly referred to as the "Bermuda form" is in substantial part a legacy of the insurance coverage wars in the late 1970's and early to mid-1980's over the liability from mass tort litigation. The court decisions on the trigger and scope of coverage under CGL and excess policies for asbestos, silica, pollution, DES and other claims largely went against insurers and took an expansive view of the coverage available under the policies. Some of those wars continue even today. Many courts found that injury in these tort claims occurred over time and triggered multiple policies, from first exposure (often as early as the 1940's) to as late as the date of claim or death. Some courts held each triggered insurance policy covered "all sums" the insured was liable to pay up to the policy limits. Excess policies were held to drop down whenever the lower level policy was exhausted or the insurer was insolvent. Some courts held that insureds could satisfy their SIR's in one year by using coverage from another year. Defense obligations were also broadly construed. In general, insureds were largely protected from paying anything as long as they had any policies available to pay.





A Comprehensive Look at the Bermuda Form Excess Insurance Policy

Understanding the typical Bermuda policy form provisions is much easier if one reads them with this history in mind. While the policies are often touted as being a balanced approach between the insurer and insured interests, they are really an effort to avoid the above historic expansive liabilities. Set forth below are some of the principle terms of the Bermuda form.

The Bermuda Policy Form

A. Coverage

The Coverage section is divided into Coverage A and Coverage B. Coverage A relates to the policy period, and Coverage B relates to the discovery period, which is after the termination of the policy. Coverage B is discussed further below.

Occurrence based policies were typically triggered by bodily injury or property damage occurring during the policy period. This led many courts to find that injuries from repeated exposures occurred over time, triggering multiple policies. The typical Bermuda form seeks to avoid this result in the Coverage section by requiring that the occurrence or claim first be reported to the company within the policy period or the discovery period. Unlike the occurrence policy, it is the notice to the company, not the occurrence of injury or damage, that defines which policy will apply. Unlike the typical claims made policy, it is the notice to the company, not receipt of a claim by the insured, that defines which policy will apply. This has led to the policy being referred to as an “occurrence-reported” policy. The applicable limits, retention, terms, conditions and exclusions are to be determined under the policy in effect on the date of first report of occurrence or claim. This difference in coverage can create discontinuities with lower level policies which apply on a typical occurrence or claims made basis.

The discovery period is like the extended reporting period in a claims made policy. For a premium, which is a percentage of the policy premium, the insured can extend the period for reporting additional occurrences and claims which came within the original policy coverage but were not known until after the termination of the policy. The purchase of the discovery period coverage does not extend coverage to occurrences or bodily injury or property damage after the policy has terminated. All occurrences and claims

reported during the discovery period are handled under the policy terms and limits in the policy immediately prior to termination.

The discovery period option can be quite expensive. In some policies, for example, it costs 30% of the last 12 months annual premium for the first year of the discovery period, 20% for the second year, 10% for third year, 10% for the fourth year, and 9% per year thereafter.

I. Occurrence

Additional limitations on coverage are derived from the “occurrence” definition. The definition is separately stated as to occurrences not involving the insured’s products and occurrences involving the insured’s products.

The definition of occurrences not involving the insured’s products restricts the policy to occurrences that start after the policy inception or retroactive date, and before the termination date. This is also intended to prevent the claim from triggering multiple policies, as occurred under the CGL policies. This language also raises serious risks of occurrences or claims not being covered by any policy. Take, for example, a repeated exposure type of injury from being located near the insured’s plant that starts during one policy period and continues during another, when injury finally manifests and a claim is made. This claim would not meet the requirement of involving exposures commencing after the inception date of the second policy and it would not meet the requirement of reporting the claim during the first policy. Thus, it is very important that whenever there is a policy change, that the discovery period option be seriously considered. That would satisfy the reporting requirement under the first policy. For long tail type claims, where the time between first exposure and manifestation of injury is 10 or 20 or more years, it is likely that the discovery period option will not have been purchased and the claim will not be covered.

The occurrence definition with respect to the insured’s products treats injuries spanning policy periods differently. Instead of requiring the event or exposure start after the Inception Date, the policy prorates the liability to that portion of the event or exposure which occurs during the policy period.



A Comprehensive Look at the Bermuda Form Excess Insurance Policy

This definition still requires that the personal injury or property damage take place after the Inception Date or Retroactive Date and prior to the Termination Date, and also that it arise from the insured's products. If the personal injury or property damage commenced prior to the Inception Date or Retroactive Date, then the company is only liable for a pro-rata share based on the period of injury or damage during the policy compared to the total period of injury or damage.

This provision is intended to avoid the "all sums" rulings of the courts, in which each triggered insurance policy has to pay "all sums" for which the insured is liable up to its limit of liability, and many courts allowed the insured to pick which policy it wanted to apply, subject to rights of contribution among insurers.

It is questionable, however, whether this language accomplishes that purpose. While it limits the policy's liability for the bodily injury or property damage to a pro-rata share, that does not necessarily limit its liability for the damages caused by that bodily injury or property damage. The Coverage agreement applies to "damages" on account of bodily injury or property damage. With an indivisible type of bodily injury or property damage (such as asbestosis), liability for all the damage could be assessed to any part of the bodily injury, making all parts jointly and severally liable for all the damage. Indeed, in the liability case a manufacturer that is responsible for a portion of the claimant's exposure could be jointly and severally liable with all other defendants for all the damages assessed.

In other words, if a claimant suffered a continuing harmful exposure to a type of product manufactured by the insured and others, and the exposure to each defendant's product took place at different times, the insured might be held jointly and severally liable for all the damages to the claimant even though exposure to its product was only during a part of the total period of exposure. In that situation, the policy would be liable only for a portion of the bodily injury, but it should still be liable for all the damages the insured had to pay.

Perhaps a scenario more likely to be faced by an insured is one where its product causes injury over

time and during that time the insured changes insurers and gets a new policy and doesn't buy Coverage B (the discovery period) from the first insurer. The second insurer might claim it is liable for only a portion of the damages. But the insured could be liable for all the damages because of the portion of the injury that occurs during either one of the policies. So the second insurer might be held liable for all the damages.

Other issues from the Occurrence definition arise from the requirement that the personal injury or property damage be "neither expected nor intended from the standpoint of the insured." This is a concept carried over from CGL policies. Some Bermuda forms contain what is called a "Maintenance Deductible." That is not a term which actually appears in the policies. What it does is recognize that some products are expected to cause a certain number of injuries, such as vaccines. In order to keep the insurer from arguing that all injuries from the vaccines are expected and intended, the policy preserves coverage to the extent the claims are "fundamentally different in nature or at a level or rate vastly greater in order of magnitude" than expected injury. There is obviously a great deal of ambiguity in this concept. While it has been touted as showing how balanced the policies are, in practice it eliminates coverage for the "expected" claims when most courts would not have done so based on the expected or intended language.

2. Integrated Occurrence

The policies use a concept called the Integrated Occurrence to batch together claims from the same cause. As to products claims, it is defined as follows:

V. Integrated Occurrence means:

- (1) with respect to the Insured's Products, Personal Injury or Property Damage which takes place on or after the Inception Date or Retroactive Date, if applicable, and arises from two (2) or more discrete units of the same or substantially similar Insured's Products, but only if all such Personal Injury or Property Damage results from the same cause, hazard, defect, failure to warn or instruct or any combination thereof;



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- (2) with respect to other than (a) Employment Liability, (b) the Insured's Products and (c) Advertising Liability, Personal Injury to two (2) or more persons, or Property Damage to two (2) or more properties or residential or office units within a building, if such Personal Injury or Property Damage arises from continuous, intermittent or repeated exposure to the same general harmful consecutive days;
- (3) with respect to Advertising Liability, multiple or repeated advertisements, telecasts, broadcasts or publications of the same or substantially similar material causing to two (2) or more persons or organizations;

but only if all such Personal injury, Property Damage or Advertising Liability has been identified as an Integrated Occurrence in a Notice of Integrated Occurrence.

Thus, for multiple claims arising from the same product or from exposures by two or more persons to the same general harmful conditions for longer than thirty (30) days, the insured can elect to give a Notice of Integrated Occurrence. Such notice is not mandatory. The notice must be designated as a Notice of Integrated Occurrence. For an Integrated Occurrence, all of the occurrences or resulting claims that are part of it are subject to the limits, retention, terms, conditions and exclusions in the policy in effect on the date the Notice of Integrated Occurrence is given. Thus, all similar occurrences or claims for which regular notice has been given previously, and all subsequent similar occurrences and claims, even if after the policy terminates, are included.

There are several ramifications from the Integrated Occurrence concept. One is that all the claims are treated under the same policy and limit, so the insurer gets to limit its exposure to one policy. Another is that by telescoping claims into one period, the insured can more easily exhaust underlying limits or per-occurrence retentions. A third is that occurrences or resulting claims after the policy terminates can be brought

under the policy's coverage if they arise from products or completed operations exposures. On the other hand, coverage can be lost for occurrences from other exposures that happen after the Notice of Integrated Occurrence. (See Exclusion P discussed below).

3. Notice

Notice is a singularly important concept under the occurrence-reported policies. It is the triggering event for coverage under the policy. It is also a condition precedent to obtaining coverage. In all likelihood, failure to comply with the notice requirements will forfeit coverage regardless of whether the insurer is prejudiced by the failure or delay. Most courts hold that failure to give timely notice under a claims made policy bars coverage regardless of prejudice to the insurer, and there is no reason to think a different rule will apply to notice under a Bermuda form.

If any executive officer or manager or equivalent level employee of the insured's risk management, insurance or law departments becomes aware of an occurrence or claim that is likely to involve the policy, "written notice" must be given "as soon as practicable" during the policy period or the discovery period "as a condition precedent" to coverage. Failure to provide the required notice "shall result in forfeiture of any rights to coverage."

The requirements for what must be contained in the notice are set forth in detail. These include the nature of the event, when it allegedly commenced, a description of the products involved and the characteristics thereof which allegedly gave rise to the occurrence, the period during which the products were sold, the date the insured first learned of the alleged injury or damage, the nature of the alleged injury or damage, the identity of parties involved, a description of parties who may in the future suffer injury and efforts undertaken or contemplated to prevent it. The notice must include copies of demands and complaints. It is important to try to satisfy these requirements to the extent possible in order to avoid any arguments over the sufficiency of notice.



A Comprehensive Look at the Bermuda Form Excess Insurance Policy

4. Retroactive Dates

The retroactive date, used in determining which occurrences are covered, is set forth in the declarations. It typically is the inception date of the insured's first policy with the particular insurer, but has in some cases been negotiated to be an earlier date.

B. Exclusions

The Bermuda form policies contain a number of exclusions. As with other terms in the policy, they can be modified by negotiated endorsements. A detailed discussion of all the exclusions is beyond the scope of this Report, but in general the policy forms contain the following exclusions:

A. Previously Notified Occurrences or Claims -- This exclusion is a companion to the Coverage agreement language which seeks to prevent occurrences or claims from being covered under more than one policy. It excludes occurrences or claims as to which notice was given under any other policy.

B. Workers' Compensation – Excludes obligations under any workers' compensation, unemployment compensation or disability benefits law or similar law.

C. Professional Services – Excludes any liability for property damage for any act, error or omission in professional services.

D. Owned Property – Excludes property damage to property owned or occupied by or rented to the insured, to property loaned to the insured or in its care, custody or control, and to the part of the property damaged in operations by or for the insured.

E. Failure of Insured's Products or Work – Excludes liability for certain business risks.

F. War – Excludes liability for injury or damage occasioned by war or hostile actions.

G. Toxic Substances – Excludes injury or damage arising out of certain toxic substances including asbestos, tobacco, DES, IUD's, and others.

H. Aircraft – Excludes liability arising out of manufacture, use or operation of aircraft, with several exceptions.

I. Watercraft – Excludes liability arising out of manufacture, use or operation of watercraft, with several exceptions.

J. Pollution – Excludes injury or damage arising from pollution, whether sudden or gradual.

K. Nuclear – Excludes injury or damage from nuclear material.

L. Radioactive Contamination – Excludes liability for radioactivity outside the US.

M. Employee Retirement Income Security Act of 1974 – Excludes liability arising from administration of employee benefit programs.

N. Securities, Antitrust, Etc. – Excludes liability under any law relating to securities or antitrust and a number of other unrelated areas.

O. Known Occurrences – Excludes liability from any occurrence which any executive officer or manager level employee in the risk management, insurance or law departments was aware of prior to policy inception, whether or not such person believed or expected such occurrence would involve the policy.

P. Occurrences After Notice of Integrated Occurrence – Excludes occurrences which occur after a Notice of Integrated occurrence and are part of the Integrated Occurrence, except those which arise from products as to which the insured relinquished possession and completed operations which were completed prior to the Notice of Integrated Occurrence. In other words, occurrences arising from other than products or completed operations which are included in a Notice of Integrated Occurrence and which take place after that Notice is given are excluded. These would otherwise be covered occurrences.

Q. Occurrences Excluded From Integrated Occurrence – Excludes occurrences which are part of an Integrated Occurrence and which an executive officer or manager level employee in the Risk Management, Insurance or Law Departments first became aware of more than five (5) years prior to the Notice of Integrated Occurrence. The title to this exclusion indicates any such occurrence is excluded from being part of an Integrated Occurrence, but not excluded from coverage altogether.



A Comprehensive Look at the Bermuda Form Excess Insurance Policy

R. Exclusions Applicable to Advertising Liability – Common exclusions relating to advertising liability coverage.

S. Certain Contractual Liability – Excludes liability assumed by contract if the assumption was after the commencement of the occurrence.

C. Disputes

Bermuda policies have several features which make disputes more difficult for policy holders. First, they require all disputes be arbitrated in Bermuda (some policies specify London) by a three arbitrator panel. (Condition B). Second, they call for application of New York law, which is generally viewed as more favorable to insurers than other states' laws. (Condition M(1)). Third, they attempt to negate the universal principal that ambiguities in the insurance policy are to be construed against the insurer. They require that the policy be construed "without regard to authorship of language; without any presumption, arbitrary interpretation, construction in favor of either the Insured or the Company or reference to the 'reasonable expectations' of either party; and without reference to parol or other extrinsic evidence." (Condition M(2)). Then, buried in the Condition on Cancellation (Condition E(4)) is the right of the company to cancel the policy if the insured files or commences a suit or proceeding against the company other than as provided in Condition B, the Arbitration provision.

These provisions have many ramifications. Arbitrating in an unfamiliar venue is likely to be expensive and more difficult. Strategically, it will be best to retain both American and local lawyers, and arbitrators will have to be paid. The insurers, on the other hand, who arbitrate in Bermuda regularly will be playing on their "home court." It may be necessary to litigate in several venues, if not all involved insurers have these arbitration clauses, or, call for London arbitrations. The elimination of the principles of contra preferentem (interpreting ambiguities against the insurer who drafted the policy) and reasonable expectations removes vitally important arrows from the policy holder's quiver. In the author's personal opinion, having practiced insurance law for over thirty years, those two principles

have resulted in more policy holder victories than any other factor in insurance litigation. In addition, the effort to prohibit "extrinsic evidence" theoretically means that none of the discussions which put context around the language of endorsements or other policy provisions can be referred to. Further, because arbitrations are confidential and decisions are not officially reported, there currently is and likely will continue to be a dearth of decisions interpreting the policy language available to the policy holder. Yet, the insurers who are involved in multiple arbitrations will know about prior arbitration decisions.

There are many questions over the validity and enforceability of these provisions on disputes. A number of states have statutes which remove insurance claims from those subject to their arbitration statutes or which outright bar insurance policies from requiring arbitration. Also, some courts have ruled blanket arbitration clauses invalid. The effort to preclude reliance on well entrenched pro-policy holder interpretation principles and on otherwise relevant evidence might also be looked upon with disfavor.

D. Other Provisions

A number of other provisions in the policy forms bear discussion.

1. Indemnity Policy

The policy is an "indemnity" policy which requires that the loss must actually be paid before the company can be called upon to reimburse the amount due. This result is achieved in several ways. While the Coverage provision sounds like the typical insurance policy (the company agrees "To indemnify the insured for Ultimate Net Loss which the Insured becomes obligated to pay") (Section 1-A), Ultimate Net Loss is defined in terms of "Damages" the insured is obligated to pay (Definition AH), and "Damages" is defined as amounts the insured "shall be obligated to pay, and has paid" (Definition D). More directly, Condition Q (the Loss Payable Condition) provides that liability under the policy does not attach until the insured's liability has been fixed by judgment or settlement "and the Insured shall have paid such judgment or settlement." Moreover, demand for payment under the policy must be made within twelve (12) months after the insured has paid.



A Comprehensive Look at the Bermuda Form Excess Insurance Policy

2. No Duty to Defend

The policies state that the company has no duty to defend and shall not be called upon to assume charge of the settlement or defense. However, the company has the right and shall be given the opportunity to associate in the defense, in which event the insured and company must cooperate in the defense. The company must pay its own expenses and these are not included in Ultimate Net Loss. (Condition D).

3. Defense Costs Are Within Limits

As noted, Ultimate Net Loss is defined as the sum the insured is liable to pay as damages. Damages is defined to include "Defense Costs." (Definition I). Defense Costs are defined to include reasonable and necessary legal costs and expenses incurred in connection with the defense of claims for which indemnity is sought under the policy. (Definition J). Thus, defense costs paid by underlying insurers or the insured are included in the determination of the exhaustion of underlying insurance and retentions, and are included in the policy limits of the Bermuda policies.

4. No Drop Down Over Uncollectible Coverage

As noted in the history above, insurer insolvencies led some courts to require higher level insurers to drop down and fill gaps left in coverage by the insolvency. The drafters of the Bermuda form sought to foreclose this possibility. The policy will not drop down over uncollectible coverage. It applies to Ultimate Net Loss in excess "of the amounts indicated as the limits" of the underlying policies and retentions to the extent they "have not been reduced or exhausted solely by actual payment" of damages, "regardless of whether such limits are collectible." (Section II-A). Applicable retentions "shall be reduced or exhausted solely by the actual payment" of damages. (Section II-D). Further, the Loss Payable clause provides that liability under the policy does not attach until the underlying insurers or the Insured have paid. (Condition Q).

One favorable result of this language is that in a situation where there is an underlying insurer that does not pay its limits, the insured should be able to

pay the loss for the underlying insurer in order to reach the higher level policy. At least one case has held that, under the particular language of the policy involved, the higher level insurer could not be reached even if the insured was to pay for the gap left by a lower level insurer. *Qualcomm, Inc. v. Certain Underwriters at Lloyd's* (2008) 161 Cal. App. 4th 184 (where lower level insurer and insured settled for less than insurer's limits, insured could not reach upper level insurer by paying the remainder of the limits).

5. Discovery Period

The discovery period is essentially the extended reporting period. Once the policy terminates, other than because of failure to pay a premium or instituting a lawsuit instead of an arbitration, the insured can purchase Coverage B for the following annual period or periods. If the insured doesn't purchase Coverage B for the first annual period following termination, it cannot purchase it for later periods. Notice of occurrence or claim given during the discovery period is deemed to have been given on the last day of the final annual policy period. The limits are not reinstated for the discovery period. If the insured gives notice of an Integrated Occurrence during the discovery period, only occurrences which would otherwise be part of the Integrated Occurrence and which began prior to termination of Coverage A are included. (Condition K).

If a subsidiary or affiliated company which is an insured ceases to be a subsidiary or affiliated company, then Coverage A immediately terminates for that insured, and Coverage B automatically begins to run for the remainder of the annual policy period for that insured, without additional premium. Other insureds continue to be insured under Coverage A. Prior to the end of the annual period, the former subsidiary or affiliate can elect, with the Named Insured's permission, to continue Coverage B beyond the end of the annual policy period on such terms and conditions and for such premium as may be agreed upon with the company. (Condition L).



A Comprehensive Look at the Bermuda Form Excess Insurance Policy

6. Other Insurance

The policy attempts to take advantage of all other valid and collectible insurance that might cover an occurrence or claim by making itself excess to all such insurance, whether issued before, during or after the policy period, except other insurance specifically issued in excess of the policy. If the policy is held liable to contribute with other insurance because the insured failed to list the other insurance in Schedule B, then the insured must indemnify the company for the amount of such contribution. (Condition S).

7. Aggregate Reinstatement

The policy allows for one reinstatement of the aggregate during the annual period of the policy. The insured must elect the reinstatement of some or all of the aggregate limit in writing and pay the reinstatement premium. All occurrences of which the insured was aware and gave notice prior to the notice of reinstatement are subject to the original aggregate. Only occurrences of which the insured was not aware and as to which notice is given after reinstatement are subject to the reinstated aggregate. (Condition V).

8. Punitive Damages

The policy covers punitive damages. They are expressly included within the definition of “Damages” (Definition D), and they are excepted from the clause which applies the law of New York (Condition M(1)(a)). However, the definition of “Damages” also excludes civil or criminal fines and penalties.

Conclusion

Clearly understanding how the Bermuda policy is written is essential to getting the coverage expected. The Bermuda form is restricted in many ways. Insurance professionals need to assess whether it meshes with other insurance in the program and affords the coverage n

Damages in Defamation Cases

By: Junko Izumi

Hayabusa Asuka Law Offices

4th Floor, Kasumigaseki Building 3-2-5

Kasumigaseki, Chiyoda-ku

Tokyo, JP 100-6004

Japan

+81-(3)-3595-7070 phone

+81-(3)-3595-7105 fax

junko.izumi@hawlaw.jp

halaw.jp

I. Defamation Cases - General

In this thesis, “defamation” means a case where a party tells its competitor’s customers or potential customers about defamatory, negative information concerning their competitor for the purpose of taking customers from the competitor. When faced with defamation, how can the competitor deal with the problem?

Unfair Competition.

Under the Japanese Unfair Competition Prevention Law, disclosure and distribution of false facts to harm the trust which customers have in a competitor, constitutes “unfair competition”. A victim of unfair competition can (i) seek an injunction against such disclosure and distribution, and (ii) claim compensation for damages caused by such unfair competition. However, calculating the damages arisen from unfair competition is always difficult.

Damages.

The Japanese Unfair Competition Prevention Law has a general provision which states that the profit which a defendant has gained from unfair competition is presumed to be the damages incurred by the plaintiff. This presumption is intended to make it easier to argue and prove by the plaintiff (i) the causal connection between the damages and the unfair competition, and (ii) the amount of damages that have arisen from the unfair competition.

However, courts are generally reluctant to apply such presumption to defamation cases because it is difficult to define how much profit is gained from the defamation. Also, this presumption is made on the basis that the plaintiff has lost profit equal to the profit gained by the defendant; however, this basis is said to be questionable as such profit gained by the defendant only arises from the services of the defendant. As such, courts tend to deny the causal connection between the profit earned by the defendant and the damages incurred by the plaintiff. Accordingly, it is necessary for the plaintiff to argue and prove the damages with respect to the harm to the plaintiff’s reputation caused by such unfair competition.



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Damages in Defamation Cases

II. Introduction of Actual Case

Recently, we succeeded in a lawsuit against our client's competitor who had sent out flyers with a number of defamatory statements to the customers of our client. Our client and the competitor are routinely competing against each other quite fiercely.

We commenced a lawsuit in which we sought an injunction against the disclosure and circulation of the untrue parts of the flyers, and claimed damages; namely (i) damages for harm to reputation, (ii) actual costs (labor costs and lost profit), and (iii) attorney fees. The defendant tried very hard to persuade the Court to dismiss all of our arguments, asserting that the statements on the flyers are true and that no damages were incurred even if the statements include false facts, and moreover, even if false facts were included in the flyers, there is no causal connection with their disclosure and the circulation of the flyers.

The court supported most of our arguments and awarded an injunction against the disclosure and circulation of certain content in the flyers. In addition, the court awarded compensation for damages in the amount of JPY 3,495,608. This includes JPY 2,000,000 as damages for harm to the reputation of our client and approximately JPY 1,190,000 as damages for the actual costs (labor costs) caused by the distribution of the flyers.

It should be noted that the above amount of damages for harm to reputation is quite high considering the tendency of the Japanese courts to be restrictive in this regard. We argued how these flyers greatly affected the

reputation of our client, providing specific examples of how customers responded to our client's business after receiving such flyers. In fact, many court precedents have awarded compensation for such damages of below JPY 1,000,000. The defendant argued that the appropriate amount of damages, if any, should be from a few hundred thousand yen to JPY 1,000,000, citing such precedents as proof that the damages should be a very low amount. Therefore, obtaining an award of JPY 2,000,000 was a very successful achievement.

As for the claim for actual costs, it is rare that damages for actual costs (labor costs) are awarded because it is difficult to prove the causal connection between such damages and the unfair competition. Generally, it is difficult to receive an award for labor costs as damages for the reason that labor costs arise anyway, even if there is no unfair competition. Nevertheless, in our case, the Court acknowledged that certain employees spent extra time, above and beyond their ordinary assignments, in order to deal with such flyers, such as collecting correct information on how, to whom, and how long these flyers had been sent to our client's customers, and then providing an explanation to their customers.

As for the claim for attorney fees, our client was awarded 10% of the amount of damages, which is commonly the amount given as an award for attorney fees in defamation cases.

IP Litigation Practice in Taiwan Intellectual Property Court — Focus on Patent Infringement Cases

By: Yvonne Lin, Esq.

Formosan Brothers, Attorneys-at-Law

8F, No. 376 Section 4, Jen-Ai Road

Taipei, TW

Taiwan

+886-2-2705-8086 phone

+886-2-2701-4705 fax

yvonne@mail.fblaw.com.tw

fblaw.com.tw

In the past, with respect to the dispute resolution regarding intellectual property rights, the civil action, criminal action and administrative action in Taiwan are usually conducted separately and concurrently. Such system of conducting separate and concurrent litigations, although favorable in maintaining the professionalism of each litigation procedure, is likely to delay the time for seeking judicial relieves as several judgments are rendered in respect to the same set of facts. It not only wastes the time and efforts of the parties and the relevant judicial resources, it also prevents the right holders from getting instant protection. As a result, the appropriateness and stability of judgments under such system are often questioned by the public. After years of anxious waiting, the Taiwan Intellectual Property Court (“IPC”) was established in July 1, 2008, and the two newly enacted intellectual property laws as announced by the President in the beginning of 2008, “Intellectual Property Case Adjudication Act” and “Intellectual Property Court Organization Act” also came into force on the same day.

I. IPC Overview

One of the key characteristics of the IPC is that it is a court specialized in civil, criminal and administrative actions. Pursuant to the provisions of “Intellectual Property Case Adjudication Act” and “Intellectual Property Court Organization Act,” the cases adjudicated by the intellectual property court include:

1. First instance and second instance civil actions for the protection of intellectual property rights and interests arising under the Patent Act, Trademark Act, Copyright Act, Optical Disk Act, Regulations Governing the Protection of Integrated Circuits Configuration, Species of Plants and Seedling Act, or Fair Trade Act.
2. Criminal offenses under Articles 253 through 255 (counterfeit of trademark or trade name; sale, display and importation of products with counterfeited trademark or trade name; false labeling on the products and the sale, display and importation of the said products), Article 317 (disclosure of trade secret



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IP Litigation Practice in Taiwan Intellectual Property Court —Focus on Patent Infringement Cases

learned during the course of business) and Article 318 (disclosure of trade secret during the course of employment) of the Criminal Code or appeal of the first instance decision of a criminal action rendered by a district court for the violation of the Trademark Act or Copyright Act, or Paragraph 1, Article 35 of the Fair Trade Act concerning offences under Paragraph 1, Article 20, and Article 36 of the Fair Trade Act regarding concerning under Subparagraph 5, Article 19.

3. First instance administrative actions and compulsory enforcement actions concerning the application, revocation and cancellation procedure regarding intellectual property rights, unfair competition and disputes arising from other public administrative laws under the Patent Act, Trademark Act, Copyright Act, Optical Disk Act, Regulations Governing the Protection of Integrated Circuits Configuration, Species of Plants and Seedling Act, or Fair Trade Act.

II. The IPC Practice under the new Laws

1. The inclusion of “Technical Examiner” to assist the judge in clarifying specialized and technical issues. There are 12 technical examiners in IPC and each of them respectively specialized in the fields of electronics and electric engineering, information technology and photonics, chemistry and chemical engineering, mechanical engineering, civil engineering and architecture, biotechnology and pharmaceuticals, and new design. They attend the court sessions as scheduled to clarify the disputes relating to the case based on their own professional knowledge.
2. The inclusion of “Confidentiality Preservation Order” to protect the trade secret or any confidential information of the parties. Parties may request IPC to issue a confidentiality preservation order (“protective order”) of the content of pleadings or evidence involves the trade secrets of the parties. Persons subject to the order shall not use the trade secrets for purposes other than those related to the case and shall not disclose the information subject to the order; otherwise, they will violate the order and have to burden the criminal liability.

3. During the civil and criminal litigation, the court shall determine the validity of IP right if the defendant raises such defense. If IPC found the patent/claims in disputed are invalid, the patentees could not assert the patent/claim against the defendants in such particular case.
4. Moreover, with respect to the temporary injunction cases involving intellectual property rights, the new acts explicitly provide that the court shall dismiss the application if the applicant fails to fully explain the necessity for such injunction and the court shall not allow the applicant to post a security bond in place for such explanation. The acts further clarify in the legislative reasoning that, in adjudicating a case, the court shall take into consideration of factors such as the likelihood of success in the main action, whether the applicant will suffer irreparable harm if such application is not granted, the balance of both parties’ interests; and the impact on the public interests, etc.. Since the standard for issuing an preliminary injunction is much higher than before, from July, 2008 to March, 2011, there are 31 preliminary injunctions cases filed in the IPC but, except for 11 withdrawn application, only 5.5 (granted+ (partially granted and partially dismissed)/2) cases are granted, and 11.5 cases are dismissed. In other words, 41% of the cases was dismissed and only 20% of the cases was allowed.

III. Patent Litigation in IPC

Litigation Cost

According to the Code of Civil Procedure of Taiwan, in a civil litigation, plaintiff shall pay litigation fees to the court upon filing the complaint. In addition, if the plaintiff has no domicile, offices or business establishment in Taiwan, the court may order plaintiff to pay Litigation fee Security (“Security”), including the litigation fees for the 2nd and 3rd instances plus the attorney’s fee for 3rd instances (3% of the price value of the litigation object or no more than NT\$500,000), upon the request of defendant. And defendant may refuse to answer the case before the security has been paid by plaintiff.



IP Litigation Practice in Taiwan Intellectual Property Court —Focus on Patent Infringement Cases

The litigation fee shall be calculated based on the value of the litigation objects (about 1.1% of the value); based on the Supreme Court’s opinion and IPC’s current practice for most of the cases, the value of the litigation objects are

- Injunction claim: NT\$1.65 million, if both parties did not have objection on this amount.
- Damages claim: need not to be counted when also claim injunction

Validity Defense:

According to a seminar presentation by President of the IP Court in April 2011, from July, 2008 to January, 2011, the statistic of invalidity defense raised in patent litigation cases is as follows:

The success rate of invalidity defense in patent infringement judgments---by case number per instance (2008.07.01~2011.01.31)

	①no. of cases	②no of cases raised invalidity defense	③the percentage of raising invalidity defense ③=②÷①	invalidity defense success		
				④no of cases	⑤success rate	
					⑥=④÷①	⑦=④÷②
1 st instance	196	115	58.67%	76	38.78%	66.09%
2 nd instance	117	56	47.86%	29	24.79%	51.79%
total	313	171	54.63%	105	33.55%	61.40%

Note : the above figure dose not include the cases closed due to settlement, withdrawal, or other reason.

• Average Length of patent litigation

According to a seminar presentation by President of the IP Court in April 2011, the length of patent civil litigation cases are:

Period	2008.07.01~2008.06.30		2008.07.01~2011.01.31	
Court	High Court	District Court	IP Court	
Days	684.79	502.48	1st instance	171.52
			2nd instance	197.75

• Average Winning Rate of Patentee

According to the Seminar Presentation by Prof. Ming-Yang Hsieh of NTU in Dec. 2010The average winning rate of patentee is:

Period	2008.07.01~2010.10.31
Patent Infringement cases	Winning Rate (including partial victory)
1 st Instance	12%
2 nd Instance	11%

• Damage

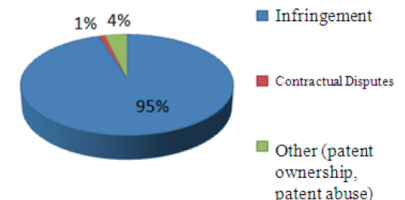
According to the Patent Act of Taiwan, there are three methods for calculating the damages in a patent litigation case: the patentee’s lost of profit and the injury actually suffered, the profit earned by the infringer, or reasonable royalties. Plaintiff may choose one of the above methods to claim damages from the defendant. In addition, if it is an intentional infringement, plaintiff can also claim for treble damages. Furthermore, if the business reputation of the patentee has been downgraded or injured as a result of the infringement, plaintiff can also assert for business reputation damages.

IV. Statistical Analysis on IPC Cases for the past year

From January, 2010to February, 2011, the number of patent infringement case in Taiwan is approxmte186. In these 186 judgments issued by the IPC at the 1st and 2nd instances:

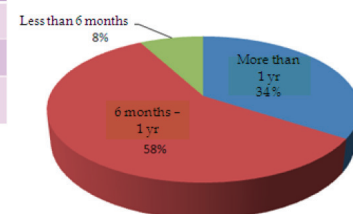
(1) Type of patent litigation cases

Litigation Type	No. of Suits
Infringement	177
Contractual Disputes	2
Other (Patent ownership, patent abuse)	7



(2) Length of litigation (Based on the 76 judgments at the 2nd instance)

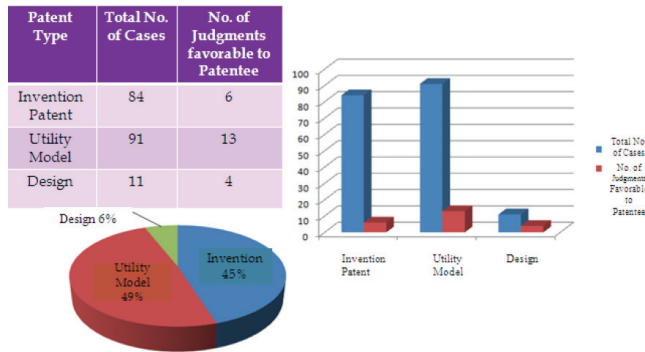
Length of Litigation	No. of Suits
More than 1 yr	26
6 months - 1 yr	44
Less than 6 months	6



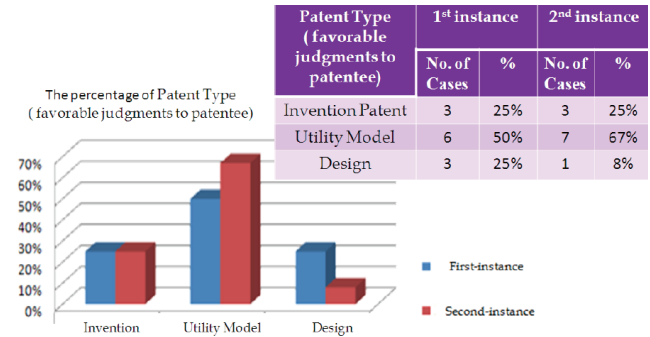


IP Litigation Practice in Taiwan Intellectual Property Court —Focus on Patent Infringement Cases

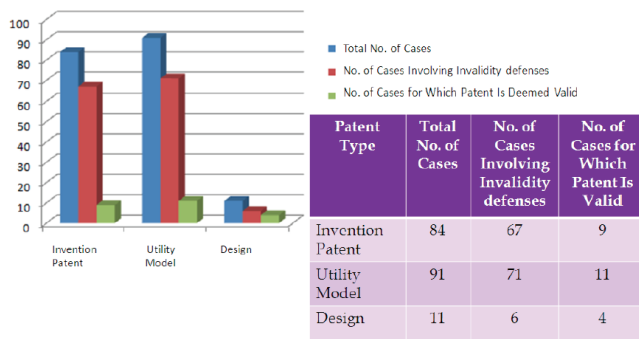
(3) Type of patent vs. judgment outcome



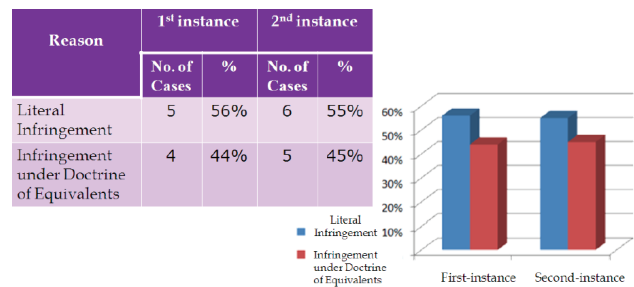
(6) Favorable Judgments –Types of Patents (Based on 110 cases at 1st instance & 76 cases at 2nd instance)



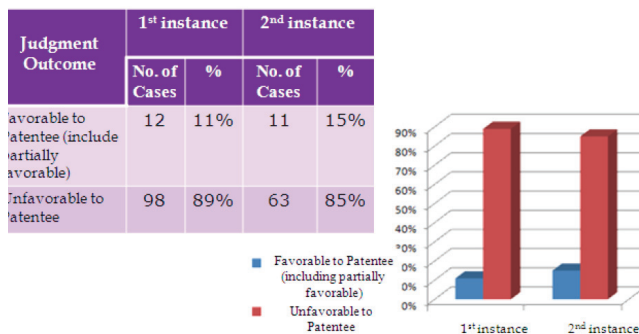
(4) Invalidity defenses and related statistics



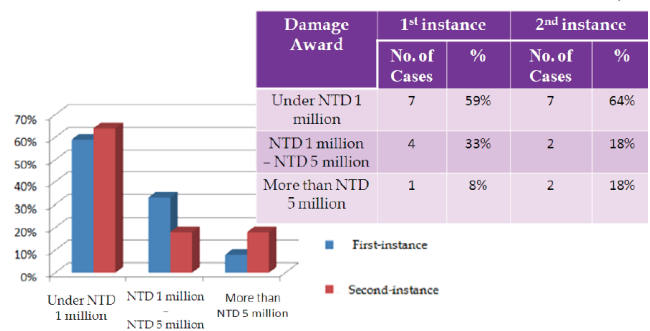
(7) Favorable Judgments –Ground (Out of IPC’s 110 cases at 1st instance & 76 cases at 2nd instance, there are 102 cases relating to Invention & 72 cases relating to Utility Model)



(5) Judgment Outcome (Based on 110 cases at 1st instance & 76 cases at 2nd instance)



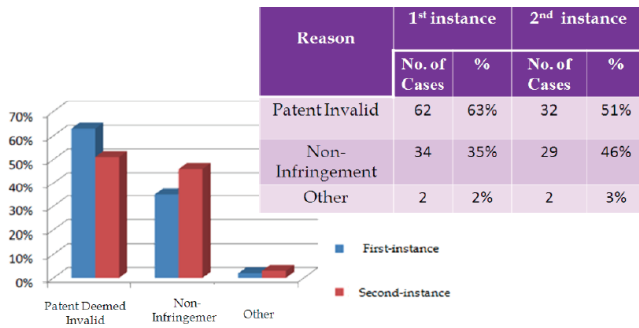
(8) Favorable Judgments –Damages award (Based on 110 cases at 1st instance & 76 cases at 2nd instance)





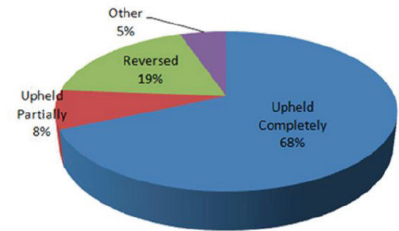
IP Litigation Practice in Taiwan Intellectual Property Court —Focus on Patent Infringement Cases

(9) Unfavorable Judgments—Ground (Based on 110 cases at 1st instance & 76 cases at 2nd instance)

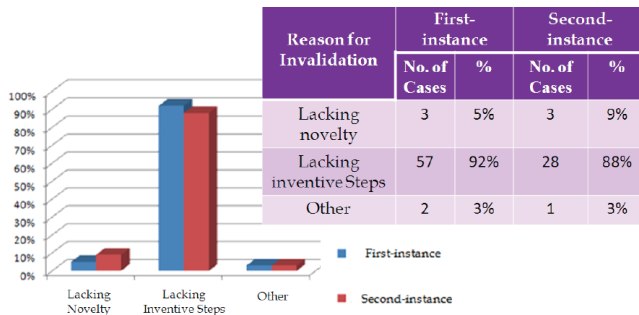


(11) Upholding the judgment at 2nd instance (Based on the 76 cases at 2nd instance)

Judgment Outcome	No. of Cases
Upheld Completely	52
Upheld Partially	6
Reversed	14
Other	4



(10) Unfavorable Judgments-Invalid reason (Based on 110 cases at 1st instance & 76 cases at 2nd instance)



Website Privacy Policies and Terms of Use — What Are They For and Why Must They Be Posted?

By: Natasha Shabani

Rutter Hobbs & Davidoff Incorporated

1901 Avenue of the Stars
Suite 1700
Los Angeles, California 90067
310.286.1700 phone
310.286.1728 fax
nshabani@rutterhobbs.com
rutterhobbs.com

Most Internet users, both attorneys and non-attorneys, have no doubt noticed at some point those “Privacy Policy” and “Terms of Use” hyperlinks at the bottom of many website homepages. The few who chance to click on one of these online policies generally observe that they are dense, long, and full of “legalese,” so the vast majority of online consumers opt not to read them. So what do these documents really mean and why are they necessary? This article explains the key provisions that a website owner’s policies should contain.

Privacy Policies

A privacy policy is a legal notice on a website that provides information about the use of consumers’ personally identifiable information (“PII”) by the website owner. Although there currently is no general federal law mandating a privacy policy to be posted on any website, there is a California state law that is discussed below. Additionally, the Federal Trade Commission (“FTC”) and state Attorneys General routinely investigate and pursue legal action against web site operators who collect and share PII without consumers’ consent. Accordingly, any website

that includes e-commerce, facilitates social networking, or otherwise engages in the online collection and/or sharing of PII should post a privacy policy on the homepage of the company’s website.

PII is typically defined as any information collected online about an individual consumer, including his/her name, street address, e-mail address, telephone number, social security number, and/or any other information that permits the physical or online identification or contacting of a particular individual.

In 2004, California became the first state to enact a law requiring a privacy policy to be posted on any commercial website that collects PII about California residents. The California Online Privacy Protection Act (“OPPA”), codified at California Business & Professions Code §§ 22575 – 22579, extends beyond California’s borders because websites all over the United States (and even the world) can be accessed by California residents who may submit their PII at any time. OPPA requires online privacy policies to disclose what information is collected and how it is shared. Those who fail to comply with OPPA risk civil lawsuits for unfair business practices.





Website Privacy Policies and Terms of Use — What Are They For and Why Must They Be Posted?

To comply with OPPA requirements, as well as FTC and other states' standards, online privacy policies should address all of the following points:

- What specific items of PII are collected on the website?
- How is the collected information used? Is it stored or discarded? Is it disclosed to any third parties? If so to whom and for what purpose(s)?
- Are cookies used and if so, what type of information is recorded?
- How can consumers opt out from receiving emails from the website and from disclosure of their information to third parties?
- Does the website collect information from children under the age of 13? If so, how does the website obtain verified parental consent for information about their children in compliance with the Children's Online Privacy Protection Act ("COPPA"), a federal statute?
- How does the website owner keep its server and online operations secure?
- How can a user review and make changes to his or her PII, if the website allows such review and changes?
- How will the website alert its users of changes made to its website privacy policy?
- What is the effective date of the privacy policy?

Once a company has a privacy policy in place, it is vital that the company act in accordance with its stated policy. Various companies have faced trouble with the FTC for having a "deceptive" privacy policy — one that does not reflect the actual practices of the company. Specifically, FTC enforcement actions in this area have focused on companies that posted privacy policies promising not to share their customers' PII, but subsequently did disclose data to third parties. A related trouble area is when companies change their privacy policies without giving consumers appropriate notice and an opportunity to opt-out.

Most website privacy policies simply state in essence, "If we make changes to our Privacy Policy we will post those changes on our website and you are responsible for reviewing the changes." For minor revisions to a Privacy Policy, this is acceptable, but if a company is going to

materially change its privacy practices, and intends to start using its customers' PII in new ways, it is not a good idea to apply a new policy retroactively without giving notice and obtaining consent from consumers who were subject by the company's old privacy policy.

The FTC has brought several complaints against companies who did just this. For instance, in 2004, the FTC charged Gateway Learning (developer of the "Hooked on Phonics" series) with violating its online representations about how information collected from consumers would be used. On its website, Gateway Learning stated that it would not "sell, rent or loan any personally identifiable information regarding its consumers to any third party," without consent from the consumer. The FTC found, however, that Gateway Learning did rent out consumer information without first obtaining consent. The company attempted to remedy its mistake by updating its Privacy Policy. But the FTC held that while the updated policy may be sufficient for information collected after the new policy was posted, it was insufficient relative to information already collected.¹

Most of the legal action to date has been based on the FTC Act and state consumer protection statutes that prohibit "unfair and deceptive practices." The FTC and state Attorneys General have applied these laws to website owners that fail to comply with their own posted privacy policies.

Once an online business has adopted a legally-compliant privacy policy that it is comfortable with, the privacy policy must be "conspicuously posted" on the company's website, in accordance with OPPA. This means that a link to the privacy policy should appear on the homepage of the company's website. The link should contain the word "privacy," and should be written either in capital letters equal to or greater in size than the surrounding text, in a type, font, or color that contrasts with the surrounding text of the same size, or be otherwise distinguishable from the surrounding text on the homepage. Finally, to the extent possible, privacy policies should be written in clear and simple language that the average consumer can understand. Certainly legal compliance with OPPA and other laws is a key consideration; however, if a company's privacy policy is so filled with legal jargon and



Website Privacy Policies and Terms of Use — What Are They For and Why Must They Be Posted?

technicalities that its consumers feel confused about and distrustful of its practices, they may lack confidence in the business and will not feel comfortable providing their PII online. Thus, online businesses should always engage legal counsel to help them draft website privacy policies that are not only legally compliant but also clear, concise and easy to understand.

Terms of Use

Website “Terms of Use” (aka “Terms of Service,” “Terms and Conditions”) provide information about the content of a website and what users are and are not permitted to do with the website. Unlike a Privacy Policy, in which a website owner sets forth promises to protect users’ PII, a website’s Terms of Use sets forth terms and conditions that protect the website operator. There is no federal or state law setting forth any required provisions that should be included in a Terms of Use, nor is there a law mandating the inclusion of a Terms of Use policy at all. However, because the Terms of Use protect the website owner, most online businesses who have any online features that go beyond a basic, informational website find that it is in their best interests to include a Terms of Use policy on their site.

A well-crafted Terms of Use policy should include the following key provisions:

- Statement that use of the website constitutes consent to the Terms of Use and Privacy Policy.
- Disclaimer of warranties, and statement that the website is provided “as-is, as available.”
- Limitation of liability and indemnification clauses.
- Statement of intellectual property ownership pertaining to copyrights and trademarks on the website, and an infringement notification policy in accordance with the provisions of the Digital Millennium Copyright Act (“DMCA”), if the website contains any content posted by others (“user generated content”).
- A license to, and disclaimer regarding, user generated content posted on the site, if applicable.
- Arbitration, choice of law and venue clause stating that any dispute relating to use of the website will be subject to arbitration in the home state of the website owner.

- Prohibition against interfering with the website or using it for an illegal or improper purpose.
- Statement that the website is only open to children 13 years of age or older. If the site is targeted toward, or attractive to, children under the age of 13, and collects personal information from children under 13, then compliance with a federal statute called Children’s Online Privacy Protection Act, or COPPA, will be required relative to both the Terms of Use and the Privacy Policy.
- Statement that the Terms of Use and Privacy Policy may change at any time.

Some courts have held that merely posting a link to Terms of Use in small print at the bottom of a homepage is insufficient and may render the Terms of Use unenforceable. Accordingly, a better practice is to require users to affirmatively click an “I AGREE” or similar button, posted along with the Terms of Use and Privacy Policy, in order to access the website or conduct transactions. Moreover, if important provisions such as arbitration clauses are hidden deep within the policy, they are less likely to be enforceable. Arbitration clauses should be bolded or highlighted and/or listed under a separate heading (rather than buried within a “General” or “Miscellaneous” section).

Conclusion

In today’s digital age, websites are an essential and prominent aspect of a business owner’s operations. Online businesses should always enlist the expertise of qualified attorneys to help them prepare clear and concise Privacy Policies and Terms of Use that will protect their interests and ensure that they are compliant with the law.

Natasha Shabani is an attorney at Rutter Hobbs & Davidoff Incorporated in Los Angeles. Natasha specializes in transactional intellectual property law and advises clients on matters including software and trademark licensing; prosecution and enforcement of worldwide trademark portfolios; contests, sweepstakes and promotions; domain name registration and dispute resolution; copyright counseling; website design and development agreements, terms of use and privacy policies; and drafting and negotiating the intellectual property aspects of corporate transactions.

So You Think You Have a Patentable Idea? In the Wake of *Bilski*, *Prometheus*, *CyberSource*, and *Classen*

By: David L. Applegate

Williams Montgomery & John Ltd.

Willis Tower
233 South Wacker Drive, Suite 6100
Chicago, IL 60606-3094

312.855.4851 phone
312.630.8578 fax

dla@willmont.com
willmont.com

The most basic precept of intellectual property is that ideas can not be protected. “What’s that?” you say. “Isn’t that what patents, trademarks, and copyrights are all about?” Ummm ... actually, no. Trademarks simply designate the source or origin of goods and services, like the familiar McDonald’s Corporation “golden arches” or the TurboTax® name and logo, but neither McDonald’s Corp. nor the TurboTax® people can prevent you from selling hamburgers or providing income tax preparation services, so long as you don’t do so using their trademarks.

Patents and copyrights are just a little bit different. Both find their U. S. origin in the United States Constitution, which gives Congress the power to provide time-limited monopolies to authors (as well as artists, sculptors, architects, and the like) and inventors, but not for their ideas – instead, only for their “respective Writings and Discoveries.” U.S. Const., Art. I, Sec. 8, Cl. 8. (By “Discoveries,” the Framers meant what we currently call “inventions.”) Leaving copyrights for another day, this article discusses four recent important cases concerning what constitutes a potentially patentable invention.

To be patentable, Sections 102 and 103 of the current patent statute require in part that an invention be new, useful, and non-obvious. 35 U.S.C. §§ 102, 103. The threshold for usefulness is low (the stereotypical paragon of a non-useful invention is a perpetual motion machine, which would be both thermodynamically impossible and useless): essentially all that is required is that the invention be more than ornamental (design patents exist for that). “New” means that the invention not have been invented before (the technical requirements are more specific); and “non-obvious” means that those experienced in the field would not have readily thought of the invention themselves (again, the technical requirements are more specific). But before the Patent Office or the courts even reach the questions of novelty, utility, and non-obviousness, the invention must pertain to patentable subject matter under Section 101.

When the invention is a machine (a product), the question of patentable subject matter is at least intuitively easy: someone has either designed or constructed (in patent parlance, “reduced to practice”) a machine or a



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device – something tangible. Perhaps it's useful, novel, and nonobvious, perhaps not; but there's usually little question that it's tangible. But Section 101 also permits the Patent Office to issue a patent for any new and useful "process ... or any new and useful improvement thereof ..." 35 U.S.C. 101. So what constitutes a potentially patentable "process"? Unfortunately, the statutory definition of "process" is partly tautological, beginning with "[t]he term 'process' means process ..." and continuing in part that it "includes a new use of a known process," 35 U.S.C. § 100(b). Three recent decisions of the Court of Appeals for the Federal Circuit in the wake of a Supreme Court ruling may show that the courts are as confused (and confusing) as the statute.

The *Bilski* decisions

First, in *In re Bilski*, 545 F.3d 943 (Fed. Cir. 2008), the U. S. Court of Appeals for the Federal Circuit held en banc that a patentable "process" must (a) be tied to a particular machine or apparatus or (b) transform a particular article into a different state or thing. *Id.* at 954. In *Bilski v. Kappos*, 561 U.S. ___, 130 S.Ct. 3218 (2010), however, the U. S. Supreme Court decided that this "machine-or-transformation" test, although providing an "important and useful clue" to patentability, was too narrow. Instead, according to the Supreme Court, the only three specific exceptions to patentability under Section 101 are (1) "laws of nature," (2) "physical phenomena," and (c) "abstract ideas." 130 S. Ct. at 3232. Thus, for example, one cannot get a United States patent on gravity, lightning, or the idea of hedging commodity price risks. But beyond that, the definition of Section 100(b), and the Supreme Court's own precedents, the high court gave no further guidance to practitioners and has left the question to the federal district courts and to the Court of Appeals for the Federal Circuit to refine.

Prometheus v. Mayo

Following *Bilski v. Kappos*, the Federal Circuit responded with a second decision in a case involving patents for determining and administering optimum dosages of certain pharmaceuticals. On remand from the Supreme Court (*Mayo Collaborative Services v. Prometheus Laboratories, Inc.*, ___ U.S. ___, 130 S. Ct. 3543 (2010)), the Federal Circuit found for a second time in *Prometheus Laboratories, Inc., v. Mayo Collaborative Services, et al*, No. 2008-1403, ___ F. 3d ___ (Fed. Cir. Dec. 17, 2010) that the patents in suit still claimed patentable subject matter under Section 101.

Prometheus Laboratories had sued *Mayo Collaborative Services* and *Mayo Clinic Rochester* for allegedly infringing claims of two patents directed to determining and administering optimum dosages of certain drugs used for treating autoimmune diseases such as Crohn's disease and ulcerative colitis. Too high a drug dosage is toxic for the patient, but too low a dosage has no effect, so patents that could help health care providers monitor the proper level of the metabolites into which the drugs break down once in the human body would be useful indeed. But did the patents claim patentable subject matter in the first place, or were they too akin to laws of nature, physical phenomena, or abstract ideas to be patentable?

As written, the claimed methods included two steps: (a) "administering" a drug that provides a certain metabolite to a patient and (b) "determining the level" of the drug's metabolites in the patient, then comparing the patient's measured metabolite levels to pre-determined levels to ascertain whether to increase or to decrease the level of the administered drug in order to minimize toxicity and maximize efficacy. (Slip. Op. at 4, citing, e.g., '623 patent, claim 1.) The district court had found that the discovered correlations between toxicity and therapeutic efficacy on the one hand, and the metabolite levels of the identified drugs on the other, were simply natural phenomena and therefore not potentially patentable.



So You Think You Have a Patentable Idea? In the Wake of *Bilski*, *Prometheus*, *CyberSource*, and *Classen*

The Federal Circuit initially found, however, that both “administering” and “determining” were not merely data-gathering steps but were “transformative” under its “machine-or-transformation” test of *In re Bilski*, 581 F.3d at 1342, 1345-49. On remand following the Supreme Court’s *Bilski* decision, the Federal Circuit first found that the claimed application of naturally occurring correlations was potentially patentable because it did “not wholly preempt all uses of the recited correlations.” Instead, the patent simply recited specific treatment steps involving a “particular application of the natural correlations,” leaving the field open to the administration of other drugs that might also optimize therapeutic efficiency. (Slip. Op. at 15-16.) Second, the court reaffirmed that the claimed methods satisfied the “transformation” prong of the machine-or-transformation test by transforming an article into a “different state or thing’ ... central to the purpose of the claimed process” in two ways: (1) by transforming the human body and bodily fluids following administration of the specified class of drugs, and (2) by causing chemical and physical changes of the drugs’ metabolites that enable their concentrations to be determined. (Slip. Op. at 16.)

The Federal Circuit went on to say that claims to “methods of treatment” are **always** transformative “when one of a defined group of drugs is administered to the [presumably human] body to ameliorate the effects of an undesired condition.” (Slip. Op. at 17.) In contrast to *In re Grams*, 888 F.2d 835 (Fed. Cir. 1989) (in which the applicant had claimed a process involving performing a clinical test on individuals and applying an algorithm to data obtained from that test to determining if an abnormality existed and its possible causes), neither the administering nor the determining step in *Prometheus* constituted mere “insignificant extra-solution activity” that would “detract from the patentability of the *Prometheus*’s claimed methods as a whole. (Slip. Op. at 21.)

CyberSource v. Retail Decisions

More recently, in *CyberSource v. Retail Decisions*, No. 2009-1358 (Aug. 16, 2011), the Federal Circuit focused on a specific genre of “process” patent that the Supreme Court had declined in *Bilski* to exclude categorically from patent protection, namely so-called “business method” patents. There, *CyberSource* claimed rights in a method for detecting credit card fraud in transactions conducted over the Internet. Although traditional fraud detection methods work well for face-to-face and even in on-line transactions where the seller ships a product to the purchaser, address and identity information are not sufficient to prevent fraud where the only “product” purchased online is simply downloadable content.

A simple and intuitively obvious way to do this would be to (1) collect information on electronic transactions associated with that credit card, (2) examine the Internet addresses from which they originated, and (3) then compare them. The more closely the uses of a credit card match up with the same email or IP addresses, the less likely the chance of fraud, and vice-versa. *CyberSource* nonetheless claimed as a novel and nonobvious invention a process for determining whether “Internet address” information like IP and email addresses are consistent with other Internet addresses used in connection with other transactions using the same credit card.

Claim 3 of its patent, for example, claimed a three step method: (a) obtaining information about other transactions utilizing an Internet address associated with the credit card transaction; (b) constructing a “map” of credit card numbers based upon those transactions; and (c) utilizing the resulting “map” to determine if the credit card transaction is valid. In an effort to involve a machine, Claim 2 claimed “a computer readable medium” containing “program instructions for detecting fraud” in which one or more of the computer’s processors essentially carried out the above three steps. (Slip. Op. at 4.) (More simply put, Claim 3 claimed a



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process as the invention and Claim 2 claimed a computer readable medium that would enable a computer to carry out that process. (Slip. Op. at 5-6.)

The Federal Circuit was tasked with determining whether either claim addresses patentable subject matter in the wake of *Bilski*. On appeal, the court first found that Claim 3 neither described a machine nor involved a transformation because (1) merely “obtain[ing] and compar[ing] intangible data pertinent to business risks” (Slip. Op. at 8, quoting *CyberSource*, 620 F. Supp. 2d at 1073) does not “transform” anything from one state to another and (2) the claim language does not require the use of a machine at all. Because *Bilski* has left an undefined patentable subject matter area somewhere between “machine-or-transformation” on the one hand and unpatentable abstract ideas on the other, the Federal Circuit was able to complete its analysis by finding that Claim 3 of the patent in suit “is drawn to an unpatentable mental process – a subcategory of unpatentable abstract ideas.” (Slip. Op. at 9; see *id.* at 10-14.)

Claim 2, as the court observed, is a so-called “Beauregard claim,” namely a claim to a computer readable medium such as a disk or a hard drive that contains program instructions for a computer to perform a particular process. (Slip. Op. at 14, citing to *In re Beauregard*, 53 F.3d 1583 (Fed. Cir. 1995).) But the process or method that Claim 2’s medium contains instructions to perform is simply the same mental process for fraud detection recited in claim 3, which the court had already found unpatentable (Slip. Op. at 16) despite *CyberSource*’s assertion that reciting a “manufacture” (a computer readable medium containing program instructions) brought the claim within Section 101. “Regardless of what statutory category ... a claim’s language is crafted to literally invoke,” the court said, “we look to the underlying invention for patent-eligibility purposes.” (Slip. Op. at 17.) Here, the invention underlying both claims 2 and 3 is “a method for detecting credit card fraud, not a manufacture for storing computer-readable information” (*id.*), and to find otherwise would, as in *In re Abele*, 684 F.2d (CCPA 1982), exalt form over substance. (*Id.*)

CyberSource still leaves uncertainty and room for argument, however, because of its closing note that *CyberSource*’s patent claims were entirely unlike cases where, “as a practical matter” (Slip. Op. at 20, emphasis added), a computer is required to perform the claimed method. (In *SiRF Tech., Inc. v. Int’l Trade Comm’n*, 601 F.3d 1319, 1331-33 (Fed. Cir. 2010), for example, the court noted that it had found that claims to “a method for calculating an absolute position of a [Global Positioning Satellite] received and an absolute time of reception of satellite signals” were patent-eligible because “there was ‘no evidence ... that the calculations could be performed entirely in the human mind’” and it “was ‘clear that the methods at issue could not be performed without the use of a GPS receiver.’” (Slip. Op. at 21.) Similarly, in *Research Corp. Techs. v. Microsoft Corp.*, 627 F.3d 859, 868 (Fed. Cir. 2010), the Federal Circuit had affirmed the patentability of a claimed method for rendering a halftone image of a digital image by comparing the digital image, pixel by pixel, against a blue mask. (*Id.*)

How and where to draw the line between “business methods” that can be performed entirely in the human mind and those that cannot is obviously the kind of question that invites litigation on a case-by-case basis. But that is what the courts are for, and just as in other areas like copyright or commercial transactions, the law will evolve as technology (and the human mind) do – if the Federal Circuit continues to have the patience. Perhaps, however, it does not.

Classen Immunotherapies v. Biogen

For in *Classen Immunotherapies, Inc. v. Biogen Idec* (Fed. Cir. Aug. 31, 2011), barely two weeks after the Federal Circuit decided *CyberSource*, not only could a panel of the same circuit not offer a unanimous decision, but also Chief Judge Rader wrote separately to suggest that the court is tired of trying to determine what is patentable subject matter and what is not.

In a case reminiscent of both *Prometheus* and *CyberSource*, patent holder *Classen Immunotherapies* asserted infringement of three patents based on the



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discovery that the timing of infant immunization for infectious diseases can affect later occurrences of chronic immune-mediated disorders. (The obvious conclusion from this observation is that “immunization should be conducted on the schedule that presents the lowest risk with respect to such disorders,” but that is the essence of the claimed invention. (Slip Op. at 5.))

Representative Claim 1 of one of three patents in suit claims an immunization method consisting of essentially two steps: (1) screening and (2) immunizing. Step (1) involves two sub-steps: (a) identifying at least two groups of mammals that have been immunized according to different schedules and (b) comparing the effectiveness of the schedules in protecting against or inducing a chronic immune-mediated disorder. Step (2) then involves immunizing a subject based on the immunization schedule that seemingly produces the best results.

According to the inventor, a health care provider infringes claims of the patent when the provider reads the relevant literature and selects and uses an immunization schedule “that is of lower risk for development of a chronic immune-mediated disorder.” (Slip Op. at 7.) This is true regardless of whether the provider makes any change in the immunization schedule and regardless of whether the one who reviews relevant information produces vaccines, provides health care, or is simply “a concerned parent.” (*Id.* at 7-8.)

The district court found on summary judgment that the asserted claims merely claimed an abstract idea and the Federal Circuit, pre-*Bilski*, readily affirmed that the claims were not patentable. Following remand after the Supreme Court’s decision in *Bilski*, a two-judge majority (Judges Rader and Newman) concluded that only one of the three patents in suit (the ‘283) failed to satisfy Section 101. Although the other two patents (the ‘139 and the ‘739) included a mental step, the fact that they also included the physical step of immunization meant that they were

directed to a “specific, tangible application” and therefore directed to patentable subject matter. (Slip Op. at 18.) In dissent, Judge Moore expressed her frustration that although “the precise line ... between patentable subject matter and abstract idea is quite elusive, ... this case is not even close.” (Dissent at 6.) In her view, all three patents are limited to abstract subject matter (the principle that changing immunization timing may change the incidence of chronic immune mediated disorders) and the immunization step of the ‘739 patent is nothing more than the “post-solution activity” previously held unpatentable in *Parker v. Flook*, 437 U.S. 584 (1978). (Slip Op. at 9.)

Judges Rader and Newman then wrote separately to suggest that, for policy reasons, the Federal Circuit should in the future decline to accept invitations to restrict subject matter eligibility. (Rader, additional views at 2.) Among those reasons is the observation that “eligibility restrictions usually engender a healthy dose of claim-drafting ingenuity,” which “add to the cost and complexity of the patent system and may cause technology research to shift to countries where protection is not so difficult or expensive.” (*Id.* at 3.)

Conclusion

It is obvious in the wake of *Bilski* that patent subject matter eligibility in the information age will continue to plague inventors, established businesses, lawyers, and judges for many years to come. The Supreme Court did no one any practical favors by leaving matters open-ended in *Bilski*, despite the judicial policy reasons for doing so. Most especially, it did no favors for the Federal Circuit, which has now made manifest in *Classen Immunotherapies* its confusion and frustration in the wake of that decision.

So you think you have a patentable idea? In the wake of *Bilski*, *Prometheus*, *CyberSource*, and *Classen*, you just might!

Fellow, Litigation Counsel of America, and Chair of the Intellectual Property Practice Group at the Chicago Law Firm of Williams Montgomery & John Ltd.

Cross-Cultural Competency: A Non-Negotiable Skill for Lawyers Involved in International Commerce

By: Robert L. Gegios and Stephen D. R. Taylor

Kohner, Mann & Kailas, S.C.

Washington Building, Barnabas Business Center
4650 N. Port Washington Road
Milwaukee, Wisconsin 53212

414.962.5110 phone

414.962.8725 fax

skailas@kmksc.com

staylor@kmksc.com

kmksc.com

Businesses of all sizes are selling more to foreign buyers, sourcing from foreign suppliers, entering into ventures with foreign partners and investing directly in foreign businesses or infrastructure. Since businesses rely on legal advice, documentation and advocacy throughout the lifecycle of a business undertaking, lawyers are increasingly being asked to provide counsel relating to transnational business transactions and disputes. Such advice is frequently critical to the successful outcome of a client's initiative. Legal input shapes risk assessments and strategic choices, influences the direction of negotiations and the form of joint ventures, and provides management with the groundwork for moving forward.

Yet transnational commerce inherently crosses cultural boundaries, raising the question of whether domestic assumptions that underpin traditional legal reasoning travel effectively. The answer is that, more often than not, such assumptions do not translate well, and the result is that sound advice in one culture may be far from beneficial in another. To be effective, legal counsel must be able to develop legal support for negotiations, transactions and operational management that is accepted by the

counterparty and enforceable in the relevant localities. The absence of such capabilities in counsel can be disastrous. At the outset, flawed risk assessments may result and strategic decisions may be based upon erroneous assumptions. Cultural miscomprehension can alienate or confuse employees, partners, suppliers, customers, and key local constituencies. Needless misunderstandings or minor disagreements may be created or existing ones escalated into major crises resulting in significant costs and, sometimes, more lasting damage to future prospects.

The scale of this challenge is significant. Differences in business culture may represent a greater obstacle to successful outcomes than even language differences.¹ "Cultural differences are the most significant and troublesome variables ... the failure of managers to fully comprehend these disparities has led to most international business blunders."² General Motors has stated in court briefs that "cross-cultural competence is the most important new attribute for future effective performance in a global marketplace."³ Microsoft has acknowledged past losses resulting from an inability to identify and bridge international cultural divides. Microsoft's response, in common with large sections of the business community,



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has been to invest heavily to establish and broaden cross-cultural skills. The amount of attention devoted by the business media to cross-cultural management tools and techniques reflects the international business community's recognition that developing cross-cultural competence internally is essential to international business success. It should be no less important to ensure that both in-house and outside counsel possess the same cross-cultural capabilities. This is particularly so given the economic and political rise of areas of the world that do not share European-derived commercial or legal traditions or the cultural characteristics from which these developed.

Why are Cultural Differences So Significant?

Our culture shapes the way we see the world.⁴ How we see the world shapes what we regard as proper, or important, and, hence, how we organize our society and evaluate the propriety of actions, in everyday life, in business and at law. Where cultural values differ, the same comment, concept, text or act may be understood completely differently. For this reason, the ability to appreciate cultural differences is essential to successful international commerce, and to the provision of legal services that support it.⁵

Culture is the “set of distinctive spiritual, material, intellectual and emotional features of society or a social group and ... encompasses, in addition to art and literature, lifestyles, ways of living together, value systems, traditions and beliefs.”⁶ Unfortunately, visible manifestations of cultural differences—such as fine arts, literature, drama, music, pastimes, cuisine and dress—are of little practical help in predicting how cultural differences will affect notions of proper business conduct and the enforcement mechanisms that underpin business certainty.⁷ The visible manifestations of cultural difference have been compared to the tip of an iceberg, since they represent only a tiny fraction of the whole and are noticeable only because of the existence of the much larger body of unseen influences, as illustrated by the following diagram.⁸

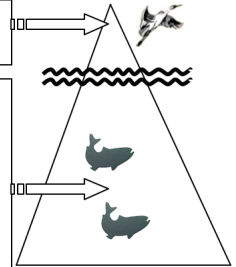
THE ICEBERG METAPHOR FOR CULTURE

Visible Indicators of Cultural Differences

Fine arts, Literature, Drama, Classical music, Popular music, Folk-dancing, Games, Cooking, Dress, Segregation of activities by group

Hidden Influences on Cultural Difference

Notions of modesty, Conception of beauty, Rules of descent, Patterns of superior/subordinate relations, Definition of sin, Courtship Practices, Conception of justice, Motivation to work, Notions of Leadership, Tempo of work, Priority of work versus family, Notion of family, clan or other defining grouping, Patterns of group decision-making, Attitudes to the dependent, Approaches to problem solving, Conceptions of status mobility Implications for status of age/sex/class/occupation/kinship/ etc., Nature of friendship, Conception of “self,” Patterns of visual perception, Role of non verbal communication, Notions about logic and validity, Patterns of handling emotions, Conception of past and future Ordering of time Preference for competition or cooperation, Conception of physical space, Etc.



Business practices reflect cultural sensitivities and objectives, and hence are not universal. For example, in the United States, profit is seen as a legitimate goal, success in business can be measured empirically, and the work ethic is highly developed.⁹ For the Japanese, the focus may not be on the pursuit of profit alone, but on human efficiency; the group is superior to the individual. In France, there may be more of an emphasis on moderating one's own freedom of action in order to avoid harming the interests of others, often expressed as a social compact.¹⁰ This is not to say that a French or Japanese person does not seek to make profit. It is simply that they may not necessarily see true return on investment as measurable solely by bottom-line financial gain, but rather as an amalgam of profit, long-term market position, and the welfare of all stakeholders in the venture, including the workforce, and even the local community.

As commerce is shaped by culture, so is law. Legal systems that have developed organically over time fundamentally reflect the belief system that spawned and upholds them. Indeed, “the rule of law is the very bedrock of our civilization.”¹¹ It is not surprising, therefore, that cultural divergence is, if anything, more pronounced in law than in commerce. As Professor Charles W. Wolfram observed in his treatise *Modern Legal Ethics*, “the practices and philosophies of lawyers practicing in other



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legal cultures very often bear little resemblance to those of lawyers in the U.S.”¹² This goes to the heart of legal reasoning and practice:

[T]he Anglo-American lawyer [tends] to evaluate the importance of code provisions, of decisions of higher courts ... and underestimate treatises or commentaries The continental lawyer in contrast will usually find himself at a loss among the innumerable precedents which are binding, but yet can be distinguished out of existence ... and will vaguely look for precise concepts among the legal synonyms, loosely phrased decisions and unsystematic text books.¹³

One of the then most senior English Law Lords, Lord Templeman, acknowledged the practical difficulties posed by trans-system practice in commending an English text for “grappl[ing] manfully with the different problems of construing English and [European] Community legislation.”¹⁴

However, the conceptual divide between established European civil and common law systems is far narrower than that between the traditional systems of many major trading nations.¹⁵ Both legal paradigms are primarily the product of Christian Western European peoples. For all the differences between them they have far more in common than regulatory mechanisms developed in other parts of the world. Other distinct legal traditions include Sharia law, Hindu law and various forms of cultural “law,” such as the *guanxi* system of relationships in China, or *giri* in Japan. To complicate matters, many modern societies operate a fusion of systems, such as Egypt, which has elements of civil, common, and Sharia law, and South Africa, where common law is blended with uncodified civil law. Many emerging nations have imported statute law or civil law code, yet this written law alone often seems not to be predictive of legal outcomes, at least as interpreted without overlaying an understanding of local values and practices inherent to indigenous practitioners.

Contract Law as an Illustration of Divergent Cultural Priorities

Generally, commercial law, or its equivalent in a given culture, performs two functions: the creation of certainty in business transactions, and the resolution of disputes.¹⁶ Where there is trade, some mechanism will have developed

to foster certainty in transactions and disputes resolution. However, this may not be legalistic. Cultural rules may be unwritten or may operate by changing the meanings of written law in ways that reflect the traditional values of the culture. Sometimes, the mechanism operates in the absence of enforced law, or outside of its structures. Dispute resolution may be based on the application of moral codes or interpretations of religious teachings. In such circumstances, transactional undertakings or litigation conducted on the basis of written law alone are unlikely to produce the desired outcome.

Dispute resolution and commercial regulation are outgrowths of what is important to a society. In a culture where an agreement is defined by the language in which it is expressed, interpretation on the basis of the language is not only logical, but also essential to establishing certainty in the marketplace. Yet, in many cultures, commercial accommodation requires trust, which can be created only by the gradual building of a relationship.¹⁷ In such societies, a written contract is not always seen as a final embodiment of the accommodation.¹⁸ The idea that words on paper could replace trust built through mutual understanding may appear ludicrous. Breach of obligations under a relationship duly grounded in trust may carry infinitely more severe consequences than a breach of contract. For the same reasons, culture goes to the heart of whether a party will view a business opportunity as worthy of investigation, the terms on which it will do so, and the likelihood that the relationship will be lasting and mutually beneficial. It shapes the conception of what has been entered into and perceptions of why each party has done so, and hence can legitimately expect as a result. Not surprisingly, therefore, it also plays a role in the emergence of disagreements and misunderstandings, whether these escalate into disputes, and whether and how such disputes can be resolved.

The profound impact of such cultural differences is illustrated by considering the differences in the concept of operation of contract between the relatively closely-related Western European civil and common law traditions. Under common law, a contract is not binding unless consideration of at least nominal value is exchanged. Consideration is “an inducement given to enter into a contract that is sufficient to render the promise enforceable in the courts.”¹⁹ In civil law, the critical element is cause, which does not necessarily



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require any flow of consideration. Thus, gratuitous promises may form the basis of a binding arrangement, and, as a result, contracts in favor of a third party can be recognized and enforced despite no consideration having been tendered for the benefit. “With regard to bilateral contracts, the [cause] of one party is the correlative obligation. In the case of gratuitous contracts, the [cause] amounts to the spirit of liberality of the donor.”²⁰ Consequently, there is no equivalent to the common law concept of privity (under which, as a general rule, only a party to a contract can sue to enforce).²¹

The notions of when a contract can be revoked or is breached differ equally markedly. In common law, an offer can be revoked until acceptance, even if the language suggests otherwise (unless consideration has been exchanged in return for what is perceived as a separate contract to keep the offer open for a given period). This is far from the case in civil law, where once made, an offer is binding for any period specified, or for a reasonable time beyond its making, if accepted within that period. If breach occurs, the concepts applied to determine damages also diverge. Common law holds breach of contract to be a strict liability issue, and consequently, it is enough that a material breach has occurred: no intent or fault is necessary to enable the aggrieved party to recover damages. However, an award of damages under civil law requires a finding of fault. Even if performance is not timely, at civil law, notice must be given to the potential defaulter, who must also be given a reasonable time to remedy the situation. At common law, the contract is deemed to provide adequate notice of conditions and duties, and generally no notice is required to enable damages to be sought.

In “most legal systems outside of the common law world, the law of obligations recognizes and enforces an overriding principle of good faith” as applied to the making and application of contract.²² Common law applies no such rule, rather allowing equitable principles to address unconscionable dealings.²³ However, “only where the contract is unconscionable as might arise from situations of unequal bargaining power between the parties, should the courts interfere with agreements that parties have freely concluded.”²⁴ In other words, the common law acknowledges the potential for abuse of power at

creation of a contract. In contrast, the civil law duty of good faith applies to pre-contractual negotiations as well as performance: good faith is presumed and the party alleging otherwise bears the burden of proof.²⁵ The different philosophy of the civil law approach is illustrated by the determination that good faith required debt revaluation by courts in periods of hyper-inflation because it was contrary to good faith for the creditor to be deprived of actual value by the debtor.²⁶ A similar principle is at play in Quebec civil law, under which a party who exercises a contractual right in a manner that would not be expected of a “prudent and reasonable individual” may be subject to an action to recover damages incurred as a result, even if there was no malicious intent.²⁷

The timing of passing of title is another area of conceptual difference that can cause significant problems. Under common law, the contract, as representative of the desire of the parties, determines when title to goods transfers. However, traditionally, under French law, title passes the moment the nature of the goods and the price to be paid are agreed: delivery and payment are of no consequence.²⁸ German concepts evolved differently from the French: not only must there be agreement, but the goods must also be delivered.²⁹ Taken together, the result is that a secondary buyer may, in certain jurisdictions, acquire the contractual rights of the first buyer for goods not yet delivered, without the need to consult the original seller. Such concepts are directly contrary to the common law precept that parties can contract for risk (unless utterly unforeseeable) and that if parties fail to do so there is no basis for the courts, absent duress, to step in and apply a higher principle of good faith.

Different Cultural Priorities Result in Dramatically Different Approaches to Disputes

Cultural differences affect every aspect of commercial activities, not merely the process of entering into an arrangement. The concept of dispute resolution differs just as profoundly. Consider the approach to evidence in European-derived civil and common law traditions. The principal characteristic of civil law systems is “full exchange before hearings of documents on which each party intends to rely.”³⁰ Judges in civil law countries



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bear the bulk of the responsibility for bringing out the facts of the case. Pre-trial is neither distinguished from trial, nor clearly understood as a concept.³¹ The whole American discovery process is frequently viewed as fishing for cause, and as distasteful in the extreme, and often as contradicting fundamental rights of privacy and confidentiality.³² “Never underestimate foreign fear and loathing of American Discovery Practices.”³³ This is so even in common law England, where disclosure (discovery) is generally only available from parties, and then only of identified documents for which relevance can be justified in advance. Depositions, essential to the American process, are regarded as little more than exercises in intimidation and entrapment, to the point that they are almost unheard of in international arbitration. Notions of privilege also vary greatly, in large part because the privilege is the result of a different policy concern. In the United States, the aim is to foster full and frank communication, generally safe from discovery. In civil law, the object is to protect professional confidences as a right of the lawyer, who determines what constitutes such a confidence.³⁴ On the other hand, American privilege extends to employees consulted by in-house counsel, whereas civil law privilege generally will not.³⁵ Together, these differences over evidentiary rights provide excellent examples of a potentially determinative differences arising directly from different cultural perceptions of privacy.

Such contracts reflect fundamental differences in the rights of the participants, the objective of the judicial process and the manner in which it is conducted. Arguably, the difference goes to the very core of the concept of the position of the individual. The common law focus on these rights of an individual as the basic unit of law is not the same as the civil law concept of an individual as a member of a wider society. Put another way, compare the state-determined balance of constitutional rights expressed in the German Basic Law: “favoring dignity over freedom of speech, and favoring the preservation of democracy over the exercise of free speech with the statement that “all men are created equal, that they are endowed by their Creator with certain unalienable Rights” from the United States’ Declaration of Independence.³⁶ Just as in conceptions of contract, there are many “largely unbridgeable conceptual

chasms between common and civil law” in the areas of pleading, testimony, discovery and the proper time for production of written argument.³⁷ “Counsel should be wary of their own – and their colleague’s culturally conditioned conceptions” and the behavior that springs from these.³⁸

The above differences demonstrate fundamental conceptual divergences between these systems. The starting rationale and burdens placed on the parties are fundamentally different conceptually, resulting in a “difficulty finding even a common starting point for lawyers in the two systems.”³⁹ Cumulatively, these and other differences shed some light on the different notions of the role of contracts in society, on the approach to resolving disputes and the proper limitations on a person’s ability to establish and enforce rights and obligations through a contract. Obviously, the optimal language and structure of any documentation reflecting a given, hypothetical agreement to transact will look very different depending on whether a civil or a common law legal system applies. What is often overlooked is that the ability to enforce agreements and the impact of external events may also differ significantly.

Cultural differences deeply impact the concept of an acceptable contract document. For example, the prototypical American conception of contract is an all-encompassing document that is the exclusive record of the respective rights of the parties expressed in a detailed writing. One word may alter the interpretation of the whole contract, rendering precision essential. Therefore language is necessarily specific and direct regarding obligations. The result is a detailed, sequential document intended to address all potential eventualities that may arise over the term of a contract in explicit language. In contrast, in European civil law jurisdictions, contracts are traditionally “relatively straightforward and brief” since major contractual principles are implied as a result of their being enumerated in applicable civil code.⁴⁰ In other parts of the world, the divergence in the conception of contract is often greater. In such circumstances, practical considerations are paramount. The length, breadth and subject matter appropriate for a contract should both facilitate the intended commercial activity and provide certainty in the event of a dispute arising. In many cultures, an American-style detailed exposition may alone be sufficient to prevent the other party’s ratification of an otherwise



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acceptable agreement. Alternatively, signature may be effectively valueless, since contracts in such form are either unenforceable under local law, or at best only offer the potential for a pyrrhic victory. As a result, very careful consideration should be given to whether to include and how to fashion dispute resolution clauses, and the manner that these can be beneficially invoked in a cross-cultural setting.

To Achieve Cross-Cultural Competence, One Must First Comprehend the Problem

To appreciate the perspective of another culture, one must understand that even the most fundamental tenets of one's own culture may not be recognized, let alone understood, in another. Such appreciation entails not only an ability to appraise the fundamental values of others, but to realize that such fundamental concepts as freedom, transparency and individual rights may not be shared, and that this difference critically impacts business transactions and notions of law.

Acquiring the ability to operate effectively across different cultures is a process that requires an individual to question fundamental personal and professional assumptions before he or she can acquire the skills to assess the differences in terms of practical consequences. Only then can a viable approach to a particular legal or business objective be identified and pursued. This is not a sudden process, but a skill that requires time to acquire. For most people it also requires a catalyst to create awareness of the existence of the problem.

Businesspeople with experience in international commerce have often learned all too well that simply being part of the same company does not ensure efficient cross-cultural cooperation. If a corporate connection was sufficient to promote cross-cultural competence, most international cultural problems would disappear or have been solved long ago. In contrast, international businesses increasingly encourage, and often require, senior appointees to have had extensive experience of working not just with people from different parts of the globe, but as leaders of business units and teams physically located in different cultures—staffed by and transacting with people and businesses that are part of that culture. In addition, many industries are investing heavily to develop cross-cultural awareness and competency among their personnel.

Lawyers appear to be more insulated from exposure, perhaps in part because lawyers typically focus on their domestic environment. This is supported by the fact that international law firms have, for the most part, been slow to acknowledge the need to invest in such skills.⁴¹ Some international firms are on record as believing that cross-cultural awareness is unnecessary, because they have so many offices in so many nations, or because such issues can be adequately addressed informally, or as an adjunct to domestic sensitivity training.⁴² This appears to confuse international diversity with cross-cultural understanding, and contrasts with the approach of many major businesses that retain such firms. Others may be more candid: “Some lawyers said law firms don’t invest in cross-cultural training because it can’t be linked to billable hours.”⁴³ For others the issue seems to equate to business etiquette—surely the very tip of the cultural iceberg. “[I]t’s not terribly effective to have a workshop or a course that will tell you how to receive business cards,” notes the head of one multinational law firm,⁴⁴ suggesting that some law firms have yet to become appreciative of the impact of culture. Perhaps the reason is the lack of direct exposure of most attorneys to a catalyst.

Some writers, such as Milton Bennett and Mitchell Hammer, believe that without such exposure, the natural inclination of lawyers and businesspeople alike, is to refuse to recognize that differences exist, and when forced to do so, dismiss their significance or insist on American practice.⁴⁵ One of the most fertile sources of cultural blunders occurs when businesses from developed countries assume their strong belief in the correctness of their domestic operational principles and practices upon operating units located in emerging economies.⁴⁶ According to Bennett and Hammer, even when it becomes apparent that different peoples possess divergent but nevertheless valid and complex world views, there may be problems in coming to terms with the validity of the practices that reflect the underlying cultural differences. The inescapable conclusion is that true cross-cultural competence requires significant time and experience to develop to a point where an individual can grasp different cultural realities and identify means to achieve objectives in a manner that finds support within all the cultures involved.



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Identifying Cross-Culturally Competent Counsel

The risk of false cultural confidence is genuine, as are the potential consequences. As a result, prudent business decision-makers give cross-cultural expertise significant weight in evaluating potential legal counsel for transnational matters, even where they have had a long and productive relationship with prospective counsel in domestic activities.

There is no miracle test. If available, the assessment should involve individuals within the client organization who have real experience verifying and implementing transactions and operations in other cultures, ideally in close geographic proximity. Whether such resources are available or not, asking the right questions of potential legal counsel at the outset is critical. The following are a few suggestions for developing questions to evaluate prospective counsel. If one can address the client's potential impact in relation to a business or project, then one has, at a minimum, established awareness and some potential to develop appropriate solutions. If such responses are lacking, the client may wish to look elsewhere. While far from comprehensive, these suggestions may shed light on whether counsel has an awareness of obstacles and will be able to address how such issues can be accommodated in practice.

In General Dealings

1. Is the individual the rightful focus, or the community, or other group, and to what degree?
2. Is communication direct, or is nuance preferred?
3. Is deference to superiors expected, and to what extent?
4. What are the sources of superiority?
5. Is linear negotiation favored?
6. What is the attitude to devolved decision-making?
7. What is the real source of business certainty?
8. Is there great focus on the past, or is past practice viewed as something to be continuously improved upon?
9. How important is decisiveness (or the public appearance thereof)?
10. What are local attitudes to gender, age or overt sexuality?

In Relation to Resolving Disputes

1. Is the dispute as expressed likely to be the true source of contention?
2. What is the attitude to public conflict?
3. Is "face" a significant concern?
4. Which is most valued: visible affluence or demonstrable contribution to the community?
5. Is there a black or white view of conflict, or one of shades of gray?
6. Is conciliation a tenet of the society, or is there a win-lose approach?
7. Is the proper scope of consideration limited to parties or properly inclusive of all stakeholders?
8. Are contracts viewed as final expressions, loose guides, or agreements to agree, etc?
9. Is profit motive accepted as the prime purpose of business?
10. Can disputes impact prospects beyond the scope of the parties to the dispute?

In Relation to Successful Advocacy

1. What are the attitudes to, and bounds of, privilege?
2. Is lawyer contact with witnesses viewed as tainting?
3. What is the concept of privacy? Does this conflict with domestic evidentiary principles?
4. In a deferential society, which sources of evidence attract particular deference?
5. Is the goal to punish wrongdoing or to find the solution offering the least harm to interested parties?
6. Is truth validated by rational, dispassionate investigation, or by live test under cross-examination?
7. Is cross-examination seen as ineffably hostile?
8. Is oral testimony or written evidence seen as more dispositive?
9. Is aggression in advocacy indicative of conviction and right, or improper intimidation?
10. Is precedent seen as an inhibition on the ability of a decision-maker's scope of action?

The above provides a starting point for further research into linguistic abilities, political issues and, most critically, individual background and experience. Detailed knowledge of the laws of a particular nation is not a pre-requisite. Rather, the search is for evidence of a lawyer's awareness and knowledge of the nature and scale of the cultural



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difference issue, combined with insight into how differences can be identified and addressed to secure effective business and legal advantage.

Businesses with cross-cultural business understanding and experience should expect as much from their counsel. For those companies less experienced in international dealings, advice from peers in the business community on the realities and pitfalls of transnational commerce can help in creating a basis for evaluating potential counsel. The stakes are high: cross-cultural competence can mean the difference between success and failure in matters crucial to a client's long-term business prospects as well as short-term profits.

- ¹ Horwitz, F. M., Anderssen, K., Bezuidenhout, A., Cohen, S., Kirsten, F., Mosoeunyane, K., Smith, N., Thole, K. & Van Heerden, A., “*Due diligence neglected: managing human resources and organizational culture in mergers and acquisitions.*” South African Journal of Business Management, Vol. 33(1), pp. 1-10 (2002).
- ² David A. Ricks, *BLUNDERS IN INTERNATIONAL BUSINESS*, 3rd Ed. Blackwell (2000) ISBN: 0631217762.
- ² *Amicus Curiae* Brief, filed in *Gratz v. Bollinger*, 122 F.Supp.2d 811 (E.D. Mich. 2000).
- ⁴ Cultures are not coterminous with nationality, but tend to be ethnically, and sometimes religiously, defined. See, Convention on the Protection and Promotion of the Diversity of Cultural Expressions (2005) Art. 2(3), available at http://portal.unesco.org/en/ev.php-URL_ID=31038&URL_DO=DO_TOPIC&URL_SECTION=201.html.
- ⁵ Culture evolves over time and as a result of outside contact, but significant change generally occurs on a generational time scale. See, John Hewko, “*Foreign Direct Investment in Transitional Economies: Does the Rule of Law Matter?*” East European Constitutional Review, Fall 2002/Winter 2003, p. 78.
- ⁶ UNESCO definition (2002). Source: http://www.unesco.org/education/imld_2002/unversal_decla.shtml#1. Individuals within a culture will vary in the degree to which they reflect cultural generalizations due to differing exposure to divergent cultural traditions and differences in the personality of individual members of societies and cultures.
- ⁷ See, Robert L. Gegios & Stephen D. R. Taylor, “*Cross-Cultural Understanding: An Essential Skill in International Advocacy,*” in *INTERNATIONAL MEDIATION & ARBITRATION FROM THE PROFESSIONALS PERSPECTIVE*, Anita Alibekova & Robert Carrow eds., Yorkhill Law Publishing (2007) ISBN: 978-1-4303-2526-0.
- ⁸ Adapted from *INTERCULTURAL LEARNING T-KIT*, Silvio Marinelli, ed., Council of Europe Publishing (2000). ISBN 92-871-5364-7, p. 21, attributed to “*AFS Orientation Handbook,*” Vol. 4 p. 14, New York: AFS Intercultural Programs Inc. (1984).
- ⁹ P. Poirson, “*Personnel Policies and the Management of Men,*” École Supérieure de Commerce de Lyon, Trans. Thierry Devisse. (1989), p. 6. cited in DEREK TORRINGTON & LAURA HALL, *PERSONNEL MANAGEMENT: HRM IN ACTION*, Prentice Hall, 3rd Ed. (1995), ISBN 0-13-149543-7, p. 117.
- ¹⁰ See Torrington, et al., *supra* n.9, p. 117.
- ¹¹ Margaret Thatcher, “*Follow the Leader*”, American Outlook, Hudson Institute, Spring 2000, at 23.
- ¹² West Publishing Co. (1986), ISBN 0-314-92639-9.
- ¹³ C. SZLADITZ & C. GERMAIN, *GUIDE TO FOREIGN LEGAL MATERIALS: FRENCH*, 2nd Ed. Oceana (1985) at ix.
- ¹⁴ The Rt. Hon. Lord Templeman MBE, Lord of Appeal in Ordinary (1982 to 1994), Foreword to JAMES A. HOLLAND & JULIAN S. WEBB, *LEARNING LEGAL RULES*, Blackstone Press, 4th ed. (2001), ISBN 1-85431-889-6, at vii.
- ¹⁵ For more on these divides, see Stephen D. R. Taylor & Robert L. Gegios, “*The Ability to Bridge Cultural Differences: A Prerequisite for Good Counsel in International Transactions,*” *COMPARATIVE LAW YEARBOOK OF INTERNATIONAL BUSINESS*, VOL. 32, Kluwer Law International (2010) ISBN: 90-411-3361-5.
- ¹⁶ The fundamental purpose of commercial law is “to maintain the commercial harmony, integrity, and continuity of society.” Source: <http://www.commonlawvenue.com/Glossary/GlossaryA-D.htm>.
- ¹⁷ “*Seven Disciplines for Venturing in China,*” Deloitte Research (2005), p. 4 col. 1.
- ¹⁸ The Japanese have sometimes been characterized as averse to all-controlling written contracts. Rather, certainty comes from “*giri*,” a system of intertwining social and moral obligations. “In the event that parties under *giri* should fall into a dispute, then they will adopt a conciliatory and flexible concessionaire approach. The presence of *giri* might be incompatible with the nature of litigation and operate to inhibit a resort to legal resolution of disputes.” Masayuki Yoshida, “*The Reluctant Japanese Litigant: A New Assessment,*” available at: <http://www.japanesestudies.org.uk/discussionpapers/Yoshida.html>.
- ¹⁹ Encyclopædia Britannica online, available at <http://www.britannica.com/EBchecked/topic/133519/consideration>.
- ²⁰ Dr. Aron Mifsud-Bonnici, “*The requirement of a lawful consideration in the law of obligations (section 987 [of the Italian Civil Code]),*” available at: <http://www.mifsudbonnici.com/lexnet/articles/causa.html>.
- ²¹ See, Australian Contract Law website available at <http://www.australiancontractlaw.com/law/scope-privy.html>. As a general rule, under common law, a contract cannot confer rights or impose obligations on persons who did not assent to the agreement that the contract records.
- ²² *Interfoto Picture Library Ltd v. Stiletto Visual Programmes Ltd* [1988] 1 All ER 348, 352-53, Bingham L.J.
- ²³ *Id.*
- ²⁴ *Hunter Engineering Company Inc. et al v. Syncrude Canada Ltd. et al* [1989] S.C.R. 425, 426
- ²⁵ HOLLAND, et al., *supra* n.14, pp. 308-09.
- ²⁶ *Id.* at 309.
- ²⁷ *Banque Nationale du Canada v. Houle* et al ([1990] 3 S.C.R. 122, 155; Article 7, Civil Code of Quebec (“No right may be exercised with the intent of injuring another or in an excessive and unreasonable manner which is contrary to the requirements of good faith”).
- ²⁸ Ceslav Pejovic, “*Civil Law and Common Law: Two Different Paths Leading To The Same Goal,*” [2001] VUWL Rev 42, III. A. at III H, citing Article 1583 of the French Civil Code.
- ²⁹ *Id.* at III H, citing Article 929 of the German Civil Code.
- ³⁰ W. LAWRENCE CRAIG, WILLIAM W. PARK & JAN PAULSSON, “*INTERNATIONAL CHAMBER OF COMMERCE ARBITRATION,*” 3rd Ed. Oceana Publications, Inc. (2000), ISBN: 0-379-21392-3, p. 418.



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- ³¹ Glen P. Hendrix, in “*Ten Rules for Obtaining Evidence from Abroad*,” in “INTERNATIONAL LITIGATION STRATEGIES AND PRACTICE,” Barton Legum, ed., ABA Section of International Law (2005), ISBN 1-5903-544-8, p. 105, cites examples for emphasis, including a declaration of a staff attorney at the Russian High Commercial Court that pre-trial discovery enables a party to obtain documents even before a complaint is filed, to facilitate the filing.
- ³² Javier H. Rubinstein, “*International Commercial Arbitration: Reflections at the Crossroads of the Common Law and Civil Law Traditions*” CJIL, Vol. 5 No. 1, (2004), p. 2.
- ³³ Glen P. Hendrix, in Legum ed., *supra* n.31, p. 105, Rule 1.
- ³⁴ Javier H. Rubinstein & Britton R. Guerrina, “*The Attorney Client Privilege in International Arbitration*,” 18 J. Intl Arb. 587 (2001), p. 591-99.
- ³⁵ *Id.*
- ³⁶ *The Unanimous Declaration of the thirteen united States of America, in Congress, July 4, 1776.*
- ³⁷ Cliff Hendel, “*Transnational Litigation and International Arbitration: Cross-Cultural Reflections*,” International Law News, Winter 2006, p. 8.
- ³⁸ *Id.*
- ³⁹ HOLLAND, et al., *supra* n.14. p. 311.
- ⁴⁰ Sara McLaughlin Mitchell and Emilia Justyna Powell, “*Legal Systems and Variance in the Design of Commitments to the International Court of Justice*,” Shambaugh Conference, University of Iowa, October 12-14, 2006. Available at: saramitchell.org/mitchellpowellcmps.doc.
- ⁴¹ As one business performance consultancy to law firms notes: “North American lawyers, in particular, may be surprised to learn that styles and behaviors that work well at home may produce unintended negative effects among lawyers and staff in other countries.” Source: <http://www.walkerclark.com/articles.html>.
- ⁴² See, e.g., Vesna Jaksic, “*The Culture Gap: Firms going global study client customs*,” The National Law Journal, May 11, 2007, available at: <http://www.law.com/jsp/llf/PubArticleLLE.jsp?id=1178787890511&rss=newswire>.
- ⁴³ *Id.*
- ⁴⁴ *Id.* (quoting the managing partner of one of the world’s largest law firms).
- ⁴⁵ See “The Development Model of Intercultural Sensitivity,” Milton Bennett and Mitchell Hammer (1998), available at <http://www.intercultural.org/pdf/dmis.pdf>.
- ⁴⁶ Ahlstrom, D. & Bruton, G., INTERNATIONAL MANAGEMENT: STRATEGY AND CULTURE IN THE EMERGING WORLD, Cengage Learning, ISBN-10: 0324406312 (2010).

Robert L. Gegios, Kohner, Mann & Kailas, S.C.
rgegios@kmksc.com

Robert Gegios chairs the Litigation Department of the Milwaukee law firm of Kohner, Mann & Kailas, S.C. He has more than 25 years of experience representing public and private companies and individuals in a wide range of legal matters, including general business and commercial litigation and counseling, securities, antitrust and trade regulation, dealership and franchise law, intellectual property, RICO, employment disputes, insurance coverage, and international controversies. His clients have spanned a broad array of industries and occupations, and he has represented their interests in disputes across the United States, as well as in foreign settings. His many accomplishments include winning one of the largest jury verdicts in a business case in the State of Wisconsin in recent years and obtaining winning dismissals of numerous multi-million dollar class and individual actions brought against both public and private companies.

Stephen D. R. Taylor, Kohner Mann & Kailas, S.C.
staylor@kmksc.com

Prior to becoming an attorney with Kohner, Mann & Kailas, S.C., Stephen Taylor was a businessman and venture capitalist who focused on business strategy, in particular the development and expansion of international markets. Mr. Taylor advises businesses on how to manage electronic information to protect their interests in the event of litigation, and on the conduct of electronic discovery. He also provides transactional and strategic support to businesses involved in trading across international and cultural boundaries and in identifying effective dispute resolution strategies arising out of such activities. An American attorney, Stephen also holds an MBA and Bachelor’s degrees in both International Trade and Politics & International Relations from British universities.

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Customs Audits and Compliance

By: Wesley K. Caine

Law Offices of Stewart and Stewart

2100 M Street, N.W., Suite 200
Washington, DC 20037
United States

202.785.4185 phone
202.466.1286 fax

wcaine@stewartlaw.com
stewartlaw.com

Introduction

Washington, D.C. (September 2, 2011)—U.S. Customs and Border Protection radically changed its enforcement strategy after the passage of the Customs Modernization Act in the mid 1990's. Previously, Customs normally determined the accuracy of declarations in entry papers at the time of importation, inspecting both the imported goods and paperwork submitted with the entry. Customs thereby determined whether the importer accurately represented the classification of the imported goods, declared correct dutiable values, indicated correct quantities, correctly identified countries of origin, actually qualified for claimed preference programs, and accurately represented other key facts relevant to determining the correct duties owing. As imports increased exponentially, however, and as Customs moved to the electronic entry system, Customs switched to post-import audits for its primary method of enforcement. Nowadays, imports normally flow through a port with little immediate Customs involvement; instead, the agency relies on subsequent audits to test the accuracy of past declarations. Therefore, importers must be able, after the fact, to demonstrate that prior representations were correct.

The reality is that customs audits can be elaborate affairs. For one thing, they can last for more than a year and require major commitment in terms of time and personnel. Moreover, the consequences of “failing” an audit can be painful and expensive. Failures can result in penalty proceedings and hefty penalties being assessed, and Customs will likely give closer attention to the importer's future importations. Therefore, all importers are well-advised to be aware of audit procedures, have compliance programs in place, and maintain appropriate recordkeeping systems.

Themes Typically Pursued in Audits and the Need for Appropriate Recordkeeping Systems

Customs' ultimate objective in audits is to determine whether the importer paid all lawful duties owing on an entry-by-entry basis. The agency also assesses risk. It ascertains whether the importer presents a risk of future violations.

Specifically, the amount of customs duties owing on particular imported goods depends on several critical



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Customs Audits and Compliance

considerations. The U.S. Harmonized Tariff Schedule classifies imports into thousands of tariff provisions, each with its own designated duty-rate. It is therefore critical that the importer correctly classify its imported goods at the time of importation so that the correct rate is applied. Equally important is dutiable value because duty rates apply to that value. Customs rules of valuation are complex, and many importers are unfamiliar with all elements constituting value. Also, many importers claim the benefit of so-called preference programs providing for reduced rates of duty or even duty-free treatment on goods imported from certain locales, NAFTA being a familiar example. Each program has rules controlling eligibility. In audits, Customs ascertains whether the importer has met all standards in regard to past importations. Quantities are another critical factor to which auditors give careful attention, because understated quantities can seriously understate duties that are owed. These are just some of the concerns in a typical customs audit.

Auditors also ascertain whether the importer has and employs an effective recordkeeping system and a customs-law compliance program. These go to the questions of risk and likelihood of customs violations. Importers with effective systems are more likely to comply with the law and probably have fewer past violations, while those without them present greater risk. Obviously, this is an enormous incentive for importers to adopt and employ good systems.

Types of Audits and Audit Procedures

There are three basic types of audits, each increasing in intensity.

Quick Response Audits (“QRAs”). Introduced in 2006, QRAs are single-issue examinations of very limited and narrow focus. Customs has described the proceedings as “designed to address a specific objective within a short period of time.” Possible subjects of QRAs include the classification or value of certain goods, eligibility for particular preference programs, origin issues, transshipment of goods, and any other issues of concern. If Customs initiates a QRA, it issues the importer a questionnaire or makes specific data requests, and the importer must quickly provide the information. Any failure to satisfy Customs

can result in Customs deciding to initiate more extensive proceedings. It can also initiate penalty proceedings if the importer has violated the law.

Customs initiates QRAs if it has reason to believe or suspect that the importer presents particular risk regarding the particular issue of concern. Customs reaches these conclusions based on available information. Sometimes import specialists at the port make observations or receive information, and provide the auditing office with facts suggesting possible non-compliance. Other times, the product in question, the exporting country, or other intelligence sources prompt the suspicion.

Normally, QRAs proceed rather swiftly, taking six or fewer months. If the importer quickly allays concerns, this can bring the matter to an end. However, if Customs discovers a violation or otherwise suspects additional problems, the agency might initiate a so-called Focused Assessment (“FA”). This is a much more extensive type of audit.

The Focused Assessment Program in General. This program embodies two segments. The first, the Pre-Assessment Survey (“PAS”), allows Customs to identify the subject importer’s areas of risk through an evaluation of its organizational structure, internal controls, and import procedures. The second, Assessment Compliance Testing (“ACT”), is a full-scale substantive audit to ascertain the extent of non-compliance and unpaid duties owed. Customs will not conduct an ACT if the PAS successfully indicates that the importer is an acceptable risk.

Pre-Assessment Surveys, in Particular. The PAS normally involves questionnaires, interviews, and limited testing. The objective is to ascertain the degree of care the importer exercises in making entries and declarations. Thus, Customs evaluates the methods and procedures the importer employs to classify goods, determine and report dutiable values, identify origins, and the like. It also examines the company’s books and record and electronic data processing system to determine whether the records and system generate accurate information from a customs point of view. It further examines the company’s methods of internal communication to see whether all personnel



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generating or possessing relevant information communicate the facts to others in charge of making customs entries or providing information to brokers. It frequently happens that companies fail to communicate effectively, often because relevant individuals do not know the customs significance of the information they possess. Auditors also ascertain whether the subject company keeps abreast of developments in customs law and whether it faithfully monitors its entries after they are submitted to Customs to be certain that brokers have not made errors. Customs does all of this, and more, to assess the risk of possible violations and to judge whether the importer has likely underpaid lawful duties.

It is important to note that during the process – the same is true in QRAs – the importer has the legal option of voluntarily disclosing violations and paying any unpaid duties (with interest) before Customs discovers them itself. In the process known as “prior disclosure,” the importer can make these disclosures and thereby avoid penalties. This procedure is discussed further below.

Assessment Compliance Test, in Particular. ACTs are comprehensive audits wherein Customs selects a large sample of entries from a universe covering multiple years and analyzes each for accuracy, with all issues typically examined. Customs tests all declarations and the importer must demonstrate compliance with the law by reference to company books and records and other relevant information. These can be long and expensive proceedings, sometimes taking years to complete. Audit teams typically include Customs accountants, product specialists, computer experts, and other personnel.

The Informed Compliance and Compliance Programs

The Customs Modernization Act requires importers to exercise “reasonable care” when making customs entries. Referred to as “informed compliance,” this includes an affirmative obligation to bring appropriate expertise to bear when making declarations at the time of importation. Merely having good intentions is not a defense to a penalty claim if the importer makes erroneous assertions and has failed to exercise reasonable care.

There are numerous ways importers bring customs expertise to bear. Typically, they rely on customs attorneys, customs brokers, or customs consultants (often former Customs personnel), either in-house or from the outside. It is critical, however, that experts apply their expertise to the relevant facts. Merely using a customs broker to prepare and file routine entries (perhaps at a minimal fee) without fully disclosing all facts relevant to the declarations made does not constitute “reasonable care.” Customs routinely dismisses the excuse that the importer relied on its customs broker to make appropriate declarations, when the importer only engaged the broker to prepare and file entry papers on the basis of the importer’s instructions. In the case of classifying merchandise, for example, the analysis sometimes requires applying complex rules of statutory construction, reviewing prior Customs Rulings where Customs may have addressed certain issues, and even considering court decisions of the U.S. Court of International Trade. The same is true for dutiable value, origin claims, and other declarations.

Importers should also implement and follow effective customs compliance programs to exercise reasonable care. No single program fits all, but any program must include meaningful managerial involvement, access to customs expertise on an ongoing basis, methods for ascertaining relevant facts for potential use in making declarations, and an appropriate recordkeeping system. Ultimately, a company officer should be responsible for administering and enforcing the program, even if staff or other personnel perform the day-by-day operations. A compliance program should also provide for effective channels of communication among all relevant personnel so that all offices or departments possessing and/or generating relevant information communicate relevant facts to those who deal with customs brokers and/or Customs itself. Customs attorneys are often helpful in developing these programs and recordkeeping systems.



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Customs Penalties

Finally, importers should be aware of the scheme for customs penalties, as provided for in Section 592 of the Tariff Act of 1930, as amended.

Briefly, without regard to whether the United States is deprived of any lawful duty, no importer or other person, by means of fraud, gross negligence, or negligence, may enter or attempt to enter any imports on the basis of erroneous representations or omissions of material fact. Clerical errors are not violations, but patterns of such errors can reflect negligence.

If Customs finds a violation – perhaps during an audit proceeding – it will assess a penalty the size of which depends upon the degree of culpability. The statute contemplates three such degrees – fraud, gross negligence, and mere negligence. Thus, if Customs finds gross negligence, for example, the maximum penalty will be the lesser of the domestic value of the imported goods or four times the amount of duties lost by reason of the violation, if the violation affected duties. If the violation did not affect duties, the statute then provides a maximum of 40 percent of dutiable value. The maximums are less for mere negligence because of the lesser culpability. In cases of customs fraud, however, the monetary penalty can be severe and Customs can also refer the matter to the U.S. Attorney for criminal prosecution. In cases of negligence

and gross negligence, penalties are subject to mitigation, i.e., reduction from maximum amounts. Mitigating factors include, among others, contributory Customs error, cooperation in the investigation, taking immediate remedial action, and a good prior record.

As noted in the discussion of audits, the statute provides for “prior disclosures.” If an importer calls Customs’ attention to a past violation before the agency discovers it itself and initiates a penalty investigation, Customs will not assess a penalty. It will only require the importer to pay any customs duties owing together with appropriate interest. The availability of prior disclosure constitutes an incentive to importers to review their practices and situations and to ferret out and disclose violations– violations that could be discovered by Customs in an audit. Importers frequently engage customs attorneys to review their practices with this in mind.

Conclusion

Importers have every reason to become familiar with the customs laws, adopt customs compliance programs, and be prepared for possible audits. Audits are normally time-consuming and expensive, and customs penalties can be severe.

Wesley K. Caine (wcaine@stewartlaw.com) is an international trade attorney and partner at the Law Offices of Stewart and Stewart, 2100 M Street, N.W., Washington, D.C., 20037, www.stewartlaw.com, tel: (202) 785-4185.

Navigating Trade Remedy Rules in a Complex Global Market

By: Elizabeth J. Drake

Law Offices of Stewart and Stewart

2100 M Street, N.W., Suite 200
Washington, DC 20037
United States

202.785.4185 phone
202.466.1286 fax

edrake@stewartlaw.com
stewartlaw.com

Washington, D.C. (September 2, 2011)—Within a country’s market, a complex web of national laws and regulations regulate competition among firms. But those rules – antitrust laws, patent and trademark protections, trade secrets rules, and many others – only work well if the parties affected take an active role both in pursuing enforcement and in ensuring that enforcement is transparent and even-handed.

The same is true when that competition is coming from across, rather than within, our borders. A distinct set of laws and regulations – trade remedies – exist specifically to ensure the fairness of cross-border competition. But it is up to the companies affected by this competition to make sure these rules are enforced when needed, to participate when cases arise, and to advocate for appropriate outcomes.

What Is “Unfair” Trade?

For more than a century, countries have used trade remedy laws to combat trading practices that distort the global marketplace. The right of countries to shield their producers from unfair trade practices has been recognized under international law for over sixty years. In 1947, the major

trading nations signed the General Agreement on Tariffs and Trade (“GATT”), a multilateral trade agreement designed to regulate global commerce. The agreement confirmed the right of countries to impose trade remedies to offset certain unfair practices, and established certain obligations for countries when exercising those rights. Those rights and obligations have been renegotiated over the decades, and continue to be an integral part of the successor to the GATT, the World Trade Organization (“WTO”).

One form of unfair trade is international price discrimination, or “dumping.” This occurs when a producer or exporter sells a product in a foreign market for a price that is below the price charged for the same good in the seller’s home market (or, sometimes, a third country market). In some situations, dumping exists where the price charged in the export market is below the producer’s cost of production. The GATT states that dumping is to be “condemned.” If dumped imports are causing material injury to a domestic industry, the domestic industry may petition for relief under its home country’s antidumping law.

Certain forms of government subsidization can also distort international commerce. WTO rules recognize that



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many governments support their producers in a variety of ways, and such support does not always amount to an “actionable” or “prohibited” trade practice. However, government subsidies that are contingent on an industry’s export performance or on the recipient’s use of domestic over imported goods are considered per se trade distorting and are prohibited under WTO rules. In addition, when government benefits are targeted to a specific industry or group of industries, and when such subsidies reach a level that causes harm to foreign competitors, the industry affected may have recourse under its nation’s countervailing duty laws. Remedies are also available under the WTO dispute settlement system for certain subsidy practices – such cases are government-to-government disputes, with the private sector often participating only in an advisory role.

Many countries, including the U.S., also make trade relief available when imports violate intellectual property rights, when surges of imports cause serious injury or market disruption, and when imports threaten national security. Each type of case is governed by its own investigative processes and legal thresholds, and each offers the prospect of different forms of import relief.

China’s Growing Role

In recent years, many trade remedy cases around the world have focused on imports from China. China has also become a more frequent user of trade remedies. In part this is due to the country’s rapid ascent to become the world’s largest exporter and a major importer. Trade frictions also arise due to the unique nature of China’s economy – the state continues to play a large role in the market, which can lead to distortions that in turn affect global competition.

In recognition of this fact, when China joined the WTO in 2001 other WTO members preserved the right to treat China as a non-market economy in antidumping cases for a transitional period which ends in 2016. This means that countries may determine the “fair value” of goods sold in China by reference to external values (in U.S. cases, external values for inputs and the actual quantities of

inputs used by Chinese producers), and compare this fair value to export prices from China. The manner in which antidumping laws apply to goods from China varies from country to country.

Another area of increasing concern has been the generous subsidies bestowed by the government of China on many of its producers. Such subsidies include grants, tax breaks, discounted land, concessional loans and debt forgiveness from state-owned banks, export credit financing at below-market rates, and access to low-cost inputs from state-owned suppliers. Indeed, the U.S. Department of Commerce has found industries ranging from tires to paper and chemicals to steel products are subsidized by the Government of China, and the U.S. has imposed countervailing duties on more than twenty distinct products from China since 2008. Similar cases have been brought in the European Union and in Canada.

State-owned banks have been one important conduit for subsidies to Chinese industries. Since 2009, for example, Chinese producers of wind and solar power equipment received more than \$40 billion in financing from China’s state-owned banks, much of it believed to be at below-market interest rates. A particularly trade-distorting form of such lending is concessional export credits. China provides upwards of \$100 billion a year in export credits, more than three times that available to U.S. exporters from the U.S. Export-Import Bank. China’s export financing is provided on terms that undercut the minimum thresholds established in the OECD’s arrangement on export credits, thus providing Chinese exporters with a significant competitive advantage compared to U.S., European, and Japanese exporters whose own export credit agencies are members of the OECD arrangement. That’s why the U.S. government and other major developed trading nations are attempting to get China to become a member of the OECD export credit agreement.

These subsidies appear likely to grow in the near future. Earlier this year, China announced it was planning to invest \$1.5 trillion over the next five years to spur growth in seven “strategic and emerging industries”: biotechnology, new materials, next generation of information technology, high-end equipment manufacturing, energy saving and



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environmental protection, “new energy” equipment such as wind and solar power equipment, and electric and hybrid vehicles. The support is aimed at helping these industries grow by 35 percent each year. China’s goal is to become the world leader in each of the seven industries by 2030. As China shifts its resources to support higher value-added products in the coming years, new industries may find themselves looking for relief under their domestic trade remedy laws.

Trade Remedies around the World

While trade remedies only affect a small portion of trade (only about one percent of U.S. imports; small amounts in most other countries as well), they have continued to play an important role as countries have liberalized their tariff and quota barriers and as competition has become increasingly globalized. From the largest multinational corporation with operations spanning the globe to a small family-owned manufacturing firm, whether and how trade remedy laws are enforced can determine whether a company is able to access a new market, maintain sustainable pricing levels, invest in a new facility, or stay in business at all.

Over the past ten years, nearly three dozen countries have imposed more than 1,500 separate antidumping and countervailing duty measures. Users of trade remedies include important home markets for many producers as well as key export markets in Asia, Latin America, and elsewhere. In 2010, the ten nations imposing the greatest number of trade remedy measures were, in descending order: India, Turkey, China, Argentina, the United States, Brazil, Canada, the European Union, Israel, and Australia.

Under WTO rules, each nation’s trade remedy laws may vary to a certain extent. We examine below some of the practical details of trade remedy cases in the U.S. as an illustrative example.

The U.S. Trade Remedy System

In the U.S., petitions for import relief may be filed by domestic manufacturers, farmers, ranchers, and/or workers. When a petition is filed, investigations proceed at two different agencies – the U.S. Department of Commerce and the U.S. International Trade Commission. The Commerce Department is charged with determining whether dumping and/or subsidization of goods exported to the U.S. is indeed occurring, and at what rates. The Commission, on the other hand, investigates to determine whether those imports are causing, or threaten to cause, material injury to a domestic industry.

If both agencies make affirmative determinations, duties are imposed on the goods concerned. If, for example, it were determined that a good was being dumped at 20 percent below the price charged in a producer’s own home market, the additional duty would be equal to 20 percent of the U.S. import price. If the benefit of government subsidies granted to a foreign producer equals 10 percent of the producer’s sales revenue, the additional duty will be 10 percent of the U.S. import price. If both dumping and subsidization are occurring, both duties may be imposed – in the examples above, the combined duty would be 30 percent.

Once a petition is filed, provisional relief can be available in as little as 85 days in subsidy cases and 160 days in dumping cases. This provisional relief consists of a bonding requirement for importers equal to the preliminary margins of dumping and/or subsidization that have been found. A final order imposing the duties can issue in about 7 months from petition filing in subsidy cases and nine-and-a-half months in dumping cases. The deadlines are often extended, but nearly all investigations are completed in a maximum time-period of 13 to 14 months. When an antidumping or countervailing duty order is imposed, importers of subject merchandise must post cash deposits equal to the amount of dumping or subsidization found to exist on entries of goods that are made on or after the date of the order.



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Once an order is imposed, imports from the country concerned remain subject to potential duties until the order is revoked. Upon a party's request, an order may be reviewed on an annual basis to ensure the duty rates accurately reflect the extent of dumping or subsidization occurring during later time periods. The U.S. system encourages elimination of the unfair trade practice by returning to importers cash deposits that exceed the amount of dumping or subsidization found in such a review (with interest). Conversely, an importer will owe any shortfall between what was posted as a cash deposit and what is actually owed (with interest) if a review reveals that dumping or subsidization has increased. Every five years, orders are subject to a mandatory review to ensure they are still warranted to redress unfair trade and to prevent injury to the domestic industry from continuing or recurring.

Conclusion

While pursuing a trade remedy case involves time and investment from a petitioning firm, an affirmative result can restore a level playing field for domestic producers facing foreign government largesse or international price discrimination from foreign competitors. When an exporting firm finds itself the subject of a trade remedies case,

defending the company's interests and ensuring a sound outcome also require time and resources. If an exporter refuses to engage, however, the result can sometimes be prohibitive duties that make participating in the market no longer commercially feasible.

Outside counsel can assist a firm in weighing the costs and benefits of becoming involved in a case – either as a petitioner or a respondent – to provide a sound basis for justifying the level of activity. For firms large and small, whether importers, exporters, or focused exclusively on the domestic market, the ability to effectively navigate trade remedies both at home and abroad can be key to success in a constantly shifting global marketplace.

Elizabeth J. Drake (edrake@stewartlaw.com) is an international trade attorney and partner at the Law Offices of Stewart and Stewart, 2100 M Street, N.W., Washington, D.C., 20037, www.stewartlaw.com, tel: (202) 785-4185.

2011 International Trade Overview

By: Amy S. Dwyer & Patrick J. McDonough

Law Offices of Stewart and Stewart

2100 M Street, N.W., Suite 200
Washington, DC 20037
United States

202.785.4185 phone
202.466.1286 fax

adwyer@stewartlaw.com
pmcdonough@stewartlaw.com
stewartlaw.com

Washington, D.C. (September 2, 2011)—As the global economy continues to fight off the effects of the financial crisis and recent recession, a number of significant trade-related developments continue to hinder that progress. The following overview identifies a few key issues that are likely to draw the attention of domestic and foreign companies and policymakers over the course of the next year. Outside counsel can assist firms with the early identification, analysis, and resolution of trade-related issues that are likely to affect their particular interests in the global marketplace.

The Rise of State Enterprises as Global Competitors

Global rules and disciplines are needed to effectively establish the competitive neutrality of state-owned enterprises (“SOEs”) and state-supported enterprises (“SSEs”) in global trade. The role and impact of SOEs and SSEs in global trade is a topic of widespread interest and concern at present. The problem posed by the rise of SOEs and SSEs as global competitors is that free market competition is distorted when foreign governments favor

SOEs and SSEs (e.g., national champions) through measures such as favorable regulations, subsidies, preferential purchasing mandates, below market policy lending, and other forms of preferential financial support.

Last May, Robert Hormats, Under Secretary of State, summed up the issue that faces the U.S. and other nations as “not whether SOEs or SSEs are inherently good or bad, but whether governments give SOEs preferable finance or regulatory treatment, or provide them discriminatory access to government procurements or domestic markets at the expense of their competitors. This is our concern – and that of other nations as well.” See *Ensuring a Sound Basis for Global Competition: Competitive Neutrality*, <<http://www.state.gov/e/rls/rmk/2011/163472.htm>>.

While many countries have SOEs and SSEs, there are, at present, no effective international rules and disciplines aimed at mitigating or neutralizing the anti-competitive impact that SOEs and SSEs can have in the marketplace. The U.S. has been attempting to address the problem of SOEs/SSEs both bilaterally (e.g., bilateral investment treaty (“BIT”) negotiations and free trade agreements





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(“FTA”)) and multilaterally (e.g., OECD; Trans-Pacific Partnership negotiations). The OECD discussions have resulted in SOE corporate governance guidelines that recommend the establishment of “competitive neutrality” frameworks, which aim at reforming the market environment so that SOEs and private entities compete under the same conditions, with SOEs having no net competitive advantage based solely on their government connection.

Recent and ongoing BIT, FTA, and Trans-Pacific Partnership negotiations provide the opportunity to promote the adoption by member countries of multilateral obligations so that their SOEs and SSEs act according to principles of competitive neutrality and effective disciplines are available to enforce these obligations.

While there are WTO Agreement provisions that require national treatment of goods and services (GATT Article III; GATS Article XVII), and that address state trading (GATT Article XVII), import monopolies (GATT Article II:4), and subsidies to and by SOEs (ASCM), no WTO rules effectively deal with or discipline the broad anti-competitive market problems caused by SOEs and SSEs. Thus, the on-going bilateral and multilateral efforts to address SOEs and SSEs should also be extended to reach an agreement that obligates WTO Members to adhere to the principles of competitive neutrality in the operations of their SOEs and SSEs.

Export Restraints on Natural Resources

A government’s imposition of restraints on the country’s exports of particular products would seem to be counterproductive in this age of globalization and the U.S. desire to double exports by 2015. Yet, the problem of export restraints has existed for decades. Governments have relied on various forms of export restraints to ensure that their own domestic industries have stable supplies of reasonably priced in-puts. Export restraints that benefit domestic industries, however, can cause serious problems for competing industries in other countries seeking the benefits of international trade based on comparative advantage. For that reason, countries have drafted multilateral trade rules to check abusive export restraints.

In 1947, Contracting Parties to the GATT adopted Article XI:1, which prohibits export bans or restrictions other than duties, taxes, or other charges. In 1994, Article XI:1 became part of the 1994 WTO Agreement. The prohibition contained in the WTO Agreement, however, is subject to a variety of limited exceptions, including exceptions related to the conservation of exhaustible natural resources. The preamble to the WTO Agreement likewise encourages trade relations that allow for the “optimal use of the world’s resources in accordance with the objective of sustainable development, seeking both to protect and preserve the environment and to enhance the means for doing so....”

Today, most countries impose few if any export restraints, which are typically short-term. While even those types of actions can cause problems for the world trading system, the expansion of long-term use of such restraints on input materials threatens the basic structure of global trade relations in entire sectors of the economy. For example, trading partners were so concerned about China’s use of export restraints that they obtained specific commitments during its WTO accession process to limit such practices. Despite such commitments, China has in recent years expanded the scope and depth of the export restraints that it imposes, creating significant concerns in the business community and among governments of the trade distortions being created globally. Indeed, China’s 2011 export duty schedule applied export duties to 337 items – more than four times the number permitted in its WTO Protocol of Accession. China’s imposition of export restraints on raw materials has already resulted in an adverse WTO panel decision on July 5, 2011. Although China’s appeal is pending, the panel found that China had failed to justify its reliance on export restraints by asserting that its export restraints were imposed to address critical shortages, were related to the conservation of exhaustible natural resources made effective in conjunction with restrictions on domestic production/consumption, or were necessary to protect human health.



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According to a 2010 WTO report, there has been a sharp rise in world exports of natural resources since 2003. The report further identified the increasing tension between rising demand for natural resources due to population and income growth and their scarcity and exhaustibility. The immediate concern is that resulting tensions will be reflected in international trade conflicts and disputes, as has already been the case with China, unless greater effort is made to heighten international cooperation with respect to trade in natural resources.

Indigenous Innovation Policies of Emerging Economies

In-country technological innovation has been an important driver of economic growth in developed countries. The 1994 WTO TRIPs Agreement acknowledges the economic benefits flowing from access to technology and specifically requires developed countries to provide incentives to their enterprises and institutions for the purpose of promoting and encouraging the transfer of technology to least developed countries.

In recent years, however, some “emerging economies,” like those in China, India, and Brazil, have adopted “indigenous innovation” policies to encourage their own in-country innovation. The policies explicitly favor domestic companies and products that rely on domestically-owned intellectual property. Through those policies, emerging economies hope to encourage domestic innovation and reduce dependence on foreign technology and the consequent payment of royalties to foreign companies for intellectual property rights. For example, China has implemented indigenous innovation policies pursuant to its 2006 blueprint in the areas of government procurement, technical standards, competition policy under the antimonopoly law, taxation policy, and IPR protection and enforcement.

Indigenous innovation policies, however, have been a significant source of tension over the last year or so and have been criticized on both legal and practical grounds. Legally, the WTO Agreement contains a fundamental requirement applicable to all 153 Members not to

discriminate against imported products in favor of domestic products, except for, *inter alia*, measures governing the procurement of products purchased for governmental purposes. The so-called “national treatment” requirement extends to procurement decisions made by WTO Members that have signed the Government Procurement Agreement (“GPA”). GPA signatories are generally allowed to prefer domestic R&D but not domestic products unless they carve out an exception. China, India, and Brazil, however, have not signed the GPA.

Practically, foreign investors view indigenous innovation policies as posing a significant threat to future profits because the policies discriminate against them. Some argue that it is the stimulation of domestic R&D through the procurement process, not the stimulation of demand for particular domestic products through indigenous innovation requirements, that really encourages innovation in a particular sector. Others believe that foreign direct investment can be a disincentive for domestic companies to invest in R&D at all. The policies are also viewed as being fundamentally inconsistent with the integrated, globalized R&D systems relied on by multinational companies that produce and patent innovations created by engineers in a variety of countries.

Indigenous innovation policies in China have reportedly been implemented in the automobile (including electric vehicle), renewable energy, nanotechnology, civil aviation, and health care industries. Recognizing the growing problem, the U.S. and E.U. business communities and governments have been particularly outspoken and have repeatedly raised the issue in media outlets, conferences, and government hearings. The efforts appear to have prompted the Chinese government to respond by promising to treat foreign businesses in China fairly and terminating, effective July 1, 2011, three 2007 national measures that included explicit links to indigenous innovation and government procurement. Recent reports point out, however, that business communities are still concerned that the policies in China will continue at provincial or municipal levels.



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Government Intervention in Currency Markets

Currency “misalignment” is another problem in international trade that needs to be addressed. Currencies can become misaligned for various reasons. Of systemic concern is when governments intervene in currency markets to artificially undervalue their currency vis-à-vis other currencies. In the past 30 years, China, Japan, Korea, and other countries have periodically intervened in exchange markets to keep their currency undervalued. For example, many economists believe China’s currency is undervalued by at least 25 percent. Undervaluation creates artificial incentives and advantages to stimulate production or exports, distorts real market signals, reduces efficiencies, gives exporters an un-fair competitive advantage, and diminishes gains from trade liberalization and trade based on comparative advantage.

The U.S. Congress has repeatedly said that a principal U.S. negotiating objective is the development of international rules and mechanisms to address global current-account imbalances. Both the WTO and International Monetary Fund (“IMF”) Agreements appear to provide some authority for Members to try to remedy the problem. Existing WTO and IMF disciplines recognize the interdependence of international trade and exchange markets and limit somewhat the ability of governments to take exchange action. WTO rules address certain “multiple currency practices,” currency retention schemes, or exchange actions that otherwise frustrate the intent of certain GATT provisions, while IMF rules aim

more specifically at exchange rate manipulation to gain an unfair competitive advantage. However, both sets of rules have proven, to date, to be inadequate to address current exchange rate problems, and neither the IMF nor the WTO has effectively responded to repeated instances of intervention by Members in exchange markets or the resulting adverse effects on trade and the global economy.

Given the amount of international friction this issue has generated since 2001 in particular, it is time for WTO (and IMF) Members to negotiate improvements to existing rules to ensure an effective remedy to currency misalignment. The global trading system would benefit from a clarification of rights and obligations under the WTO Agreement so that WTO Members would know the appropriate steps to take when exchange rates are viewed as manipulated or interfered with to the detriment of home country businesses.

On the national stage, among various proposals to address currency misalignment, there are ongoing efforts in the 112th Congress to pass legislation that expressly authorizes the Department of Commerce to find that fundamentally undervalued currency may constitute a countervailable export subsidy under U.S. countervailing duty law. *See, e.g., H.R. 639 and S. 328.* In addition to action on clarifying international rules, legislation of this kind would provide tools for injured industries to seek help at least at the national level.

Amy S. Dwyer (adwyer@stewartlaw.com) and Patrick J. McDonough (pmcdonough@stewartlaw.com) are international trade attorneys and Of Counsel to the Law Offices of Stewart and Stewart, 2100 M Street, N.W., Washington, D.C., 20037, www.stewartlaw.com, tel: (202) 785-4185.

Leasing of Commercial Premises in the Netherlands

By: Jan Dop

Russell Advocaten

P.O. Box 87400, 1080 JK Amsterdam
Reimersbeek 2, 1082 AG Amsterdam
Amsterdam, NL 1082
The Netherlands

+31 20 301 55 55 phone
+31 20 301 56 78 fax

jan.dop@russell.nl
russell.nl

Introduction

Dutch Law distinguishes two categories of commercial premises. Depending on the type of premises or the purpose for which it is used, they are referred to as:

1. so-called “290-premises”. This category includes shops, restaurants, hotels and other premises that all have in common that they are open to the public;
2. so-called “230a-premises”. This is a separate category for premises that do not qualify as 290-premises or as (private) residential premises. Offices, for example, are 230a-premises.

The numbers 230a and 290 refer to the articles of the Dutch Civil Code in which these premises are defined. Tenants of 290-premises (shops, hotels etc.) enjoy more protection than tenants of 230a-premises (e.g. offices). The reason for this is that tenants of 290-premises are largely or fully dependent on (the location of) the premises to earn their income, for example because of the clientele they have built up.

This article describes the practical implications of

leasing real estate in the Netherlands and deals with the following questions: Can a landlord evict a tenant from leased commercial premises just like that? Is a tenant allowed to remodel rented property without the approval of the landlord? Can a landlord change the rent during the lease term? What happens with the lease agreement if the franchise agreement is terminated? And is there such a thing as turnover rent in the Netherlands?

Dutch Real Estate Law

Real estate leases are governed by the provisions of Book 7, title 4 of the Dutch Civil Code. The majority of the provisions applicable to 290-premises are referred to as ‘semi-binding’. This means that the contracting parties can deviate from them in their lease agreement, provided that the deviation does not limit the tenant’s statutory rights. A deviation that reduces the tenant’s right is only valid and thus enforceable if the district court has approved it. In this matter the district court will (actively) assess whether the interests of the tenant are not harmed disproportionately compared to the interests of the landlord. Only if the interests of the tenant are sufficiently safeguarded the





Leasing of Commercial Premises in the Netherlands

district court will approve the proposed deviation. If a deviation is not court approved and a conflict arises, a tenant is allowed to set aside the agreement and to refer to the original provision of the law. The fact that parties have mutually agreed to deviate from a particular provision makes no difference!

In paragraph 3, examples will be given of situations in which a deviation with court approval is advisable.

Practical issues

This paragraph covers the most important tenants' rights, their practical implications and in what situation deviation with court approval is advisable. The following subjects will be discussed:

- making changes to the premises (3.1);
- the termination of the lease of 290-premises (3.2);
- coinciding franchise and lease agreements (3.3);
- adjustment of the lease price (3.4);
- turnover rent (3.5), and;
- short leases of 290-premises (3.6);
- the (binding) right of substitution (3.7).

3.1 Making changes to the premises

The right to make changes is laid down in the general provisions of Dutch real estate law and is applicable to both 290- and 230a-premises.

Tenants are allowed to make minor changes to the leased premises without prior approval of the landlord. Examples of minor changes are paintjobs or the fitting of a wall with mirrors. In case a tenant wishes to make major changes, such as the installation of the store chain's standard façade or the renovation of the kitchen of the restaurant, the tenant needs to get the landlord's approval. However, if the landlord refuses to approve a certain change, the tenant can appeal to the district court to give him permission instead. The district court will sustain such a request if the change is necessary for the tenant to efficiently exploit his business. A new façade for example can help attract new customers and a state-of-the-art kitchen can be necessary to serve

more meals. Only in exceptional cases in which the landlord can prove that the change will be damaging the (structure of the) premises a request will be rejected. In practice, these situations are rare, therefore, most requests to make changes are sustained.

Usually, lease agreements contain extensive regulations regarding changes to the premises. They also contain regulations as to what is allowed and as to who will bear the costs of these changes (this can be an important issue at the end of the lease term).

3.2 Termination of the lease

290-premises

Leases for 290-premises are entered into for 10 years. This period is divided into two terms, of, in most cases, 5 years each. Tenants are free to terminate the lease at the end of each term. A landlord, however, can only terminate the lease at the end of the first term if he is able to convince the district court that he urgently needs the premises for his own personal ventures or that the tenant mismanages his business. In practice, this right is sometimes used by business rivals who are in close competition. In this situation, one of them buys the premises that is rented by the rivaling other. On certain conditions, he can terminate the lease to use the property for his own business purposes. This way he has effectively eliminated his competitor. At the end of the second term, the landlord can terminate the agreement based on one of the abovementioned conditions but also if he can prove that his interests in terminating the lease outweigh the interests of the tenant in continuing the lease. In case the landlord wishes to terminate the lease, he has to notify the tenant at least one year in advance. If the tenant does not accept the termination, the landlord has to request the district court to decide whether there is a valid ground for termination and to set a date on which the lease ends and by which the premises has to be vacated. This is important because without such a court intervention the lease stays in effect.



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230a-premises

Tenants of 230a-premises enjoy less protections than tenants of 290-premises. Based on the law, the lease of indefinite time of a 230a-premises can formally be terminated one month in advance. The tenant, however, has the right to ask the district court to postpone the date of eviction for a maximum of 1 year. After this first request the district court can postpone the date of eviction two more times with a maximum of 1 year each. A request will only be granted if the tenant can prove that his interest in continuing the lease outweighs the interest of the landlord in evicting the tenant. The burden of proof here is transferred from the landlord (as is the case with 290-premises) to the tenant.

Mutual consent

The lease of 230a- and 290-premises can also be terminated by mutual consent or if one of the parties violates the terms of the lease agreement. If the tenant, for example, fails to pay the rent, the landlord is allowed to terminate the lease.

3.3 Coinciding franchise and lease agreements

(290-premises)

In the Netherlands, the franchisor is often also the franchisee's landlord. If the franchisor wishes to terminate the franchise agreement, he probably wishes to terminate the lease agreement as well. However, as described above, this can only be done after the second lease term. In case the franchisor does not want to wait this long (up to a maximum of 10 years!) it is advisable to deviate from this particular provision in the lease agreement. The parties could for example, include a clause that permits the landlord to terminate the lease agreement at the same time the franchise agreement is terminated. As described in paragraph 2, this deviation has to be approved by the district court to become enforceable.

3.4 Adjustment of the lease price

290-premises

At the end of each fixed lease term, or at least every 5 years, both the tenant and the landlord have the right to request the district court to adjust the lease price, apart from the annual increase of the rent. If for example, in recent years, the lease prices in a particular shopping mall have gone up due to investments of the landlord, the landlord can ask the district court to adjust the price of an existing lease upwards. A tenant of a run-down shopping mall on the other hand, can request the district court to adjust the lease price downwards. The district court compares the 'requested lease price' with the lease prices of similar premises in similar location. If there is a significant difference, the district court will sustain the request and adjust the lease price accordingly. In order to enable the district court to make this comparison, an expert opinion has to be attached to the request. Without such expert opinion the request is not admissible.

230a-premises

Dutch Law provides no right to request adjustment of the lease price for tenants of 230a-premises. The parties will have to come to a mutual agreement regarding the lease price.

3.5 Turnover rent (290-premises)

Turnover rent has been introduced to lease agreements in the Netherlands only recently. These days, tenants of, for example, the shops in the departure hall of Amsterdam Airport Schiphol pay a lease price that is (partially) based on their turnover. Turnover rent however, still is no common practice and has no (legal) basis in Dutch Real Estate Law. The consequence is that, although parties are free to include turnover rent in their lease agreement, they cannot be sure that the district court will maintain it if one of them requests an adjustment of the lease price. The district court then, as mentioned above, compares the 'requested lease



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price' with other lease prices. In practice, district courts find it very difficult though to compare lease prices that are based on turnover rent with normal (fixed) lease prices. Therefore, some district courts have replaced a lease price based on turnover with a fixed lease price.

To be protected against such unpleasant surprises it is advisable to exclude the right to request an adjustment of the lease price in the lease agreement. Exclusion of this right is possible because it is laid down in a semi-binding provision. To make this deviation enforceable the district court has to approve it according to the specific position of the tenant. For this reason each lease agreement in which turnover rent is included has to be approved separately.

3.6 Short leases of 290-premises with a maximum term of two years

A special category of leases are formed by the leases of 290-premises that are entered into for a term of less than two years. Because of this short term, the abovementioned procedure for the regular termination of 290-premises is not applicable. Instead the agreement expires on the fixed date. This category of leases is popular with tenants that need a temporary 290-premises for their business. The right of substitution mentioned in the following is applicable though.

3.7 Substitution

If a tenant wants to transfer his business to a third party, he can request the landlord to acknowledge this third party as the new tenant for the remainder of the lease term. If the landlord refuses to do so, the tenant can request the district court to appoint the third party as such. The district court will only reject such a request if the landlord can prove that it is almost certain that the third party will not be able to meet the obligations of the lease agreement. In practice this hardly ever happens, therefore most requests to replace the tenant are sustained.

The provision containing the tenant's right of substitution is binding. It is therefore not allowed to deviate from this provision. The right of substitution originates from the idea that a tenant should be free to sell his business whenever he pleases. To make this possible he should have the possibility to transfer his business along with the right to lease the premises. The consequence of this right is that the landlord has no influence on the person or entity of the tenant. In practice this has led to the situation that some businesses are only bought because the buyer wants to use the location for his own business purposes.

Dutch Law provides no right of substitution for tenants of 230a-premises. For this group of tenants substitution is thus only possible with the approval of the landlord.

Conclusion

Dutch Law offers tenants of 290-premises (shops, restaurants hotels etc.) a lot of protection. Especially the tenant's right of substitution is far-reaching. The rights of the tenants of 230a-premises (offices) on the contrary, are much less protected. Because tenants of 230a-premises cannot call on the law they have to negotiate and assess the terms of the lease agreement carefully. The specialist lawyers at Russell Advocaten have years of experience in assisting and advising international clients in matters relating to commercial premises. Our high-quality service is much appreciated: This year we have won both the World Finance award Best Real Estate Firm 2011 in the Netherlands and the Corporate INTL Global Award 2011 for Real Estate Law Firm of the Year in the Netherlands.

Recent Developments in U.S. Export Controls and Economic Sanctions

By: Alan M. Dunn

Law Offices of Stewart and Stewart

2100 M Street, N.W.
Suite 200
Washington, DC 20037
United States

202.785.4185 phone
202.466.1286 fax

amdunn@stewartlaw.com
stewartlaw.com

Washington, D.C. (September 9, 2011)—U.S. businesses need to be aware of the frequently changing landscape of U.S. export controls and economic sanctions and must exercise care in complying with these legal regimes. With respect to export controls on products and technologies, the U.S. government currently is engaged in an effort to overhaul the U.S. export control system, which could significantly change the way the system operates. In addition, new economic sanctions are being imposed almost every week by the U.S. (as well as the UN and European Union) in response to political turmoil and humanitarian crises in Libya and Syria. Iran also is the subject of increasing economic restrictions by the U.S. and other countries. For the most part, these new sanctions target specific individuals and government entities, but, in the case of Syria, the U.S. President issued a sweeping new Executive Order in August prohibiting virtually all sales of products and services.

Because the penalties for even inadvertent violations of U.S. export control and economic sanctions laws are so severe, U.S. persons and businesses must be sensitive to the rules governing transactions with a non-U.S. person or entity and alert for frequent changes to these laws.

Export Control Reform Initiative (ECR Initiative)

In August 2009, President Obama announced his Administration would undertake an extensive review of the U.S. export control system. U.S. export controls have long been seen as overly complicated and not particularly effective in focusing on the country's key national security priorities. The current Administration's determination to address these problems was driven by concerns in the U.S. business community that the U.S. export control regime creates an undue burden on U.S. exporters by being overly broad and complicated, as well as complaints from allies that the system complicates defense alliance cooperation.

As a result of this review, the Administration launched the Export Control Reform Initiative (ECR Initiative) to identify the problems and streamline the export control regime. This streamlining is intended to allow the U.S. to focus its controls on the most critical items – i.e., items that are essential to the military and that could result in significant national security implications if obtained by U.S. adversaries. Defense Secretary Gates referred to these crucial items and technologies as America's "Crown





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Jewels.” The stated goal in reducing the number of items controlled was to ensure that U.S. monitoring and control resources are spent more effectively monitoring the movements of items and technology that are specialized for military use and/or that could contribute significantly to threats such as terrorism or nuclear proliferation.

The reforms pursuant to the ECR Initiative are to be implemented in three phases. Phases I and II focus on the unifying definitions and reconciling other aspects of the export control regulations and policies so that, in Phase III, the U.S. government can implement the reform goals it has characterized as the “four singularities”:

1. a single control list,
2. a single licensing agency,
3. a unified information technology system, and
4. a single export enforcement coordination center.

In the recently completed Phase I, the Department of Commerce and the State Department solicited comments from the public on ways to address inconsistencies among definitions in the Export Administration Regulations (EAR), which are administered by the Bureau of Industry and Security in the Department of Commerce, and the International Traffic in Arms Regulations (ITAR), which are administered by the Directorate of Defense Trade Controls in the State Department. These agencies also sought comments on how to implement a tiered control system so that the most crucial technologies had the most stringent controls.

The export control reform process is now in Phase II, and the government is starting to unveil changes to the control lists. For example, in July 2011, the Administration released a list of items it had determined no longer needed to be controlled under the United States Munitions List (USML), which is set forth in the ITAR.

Another example of change under Phase II was the Department of Commerce’s implementation of a new license exception under the EAR in June 2011, called the Strategic Trade Authorization (STA) License Exception. The STA allows for the export and re-export of certain items without first securing an export license, if the items are

exported to designated countries that are deemed to pose a low risk to U.S. national security concerns. Although the EAR’s General Prohibitions still apply to all exports and re-exports that are subject to the EAR, and items that are controlled for certain reasons (such as short supply (SS), missile technology (MT), or chemical weapons (CW) related reasons) are not eligible for the new STA license exception, there is, nonetheless, a core group of 36 countries where items that are subject to EAR license controls for any of multiple reasons (e.g., national security (NS), nuclear nonproliferation (NP), regional stability (RS), chemical or biological weapons (CB)) are allowed to be exported without first securing an export license by using the new STA license exception. These 36 countries include many European countries as well as Argentina, Australia, Canada, Iceland, New Zealand, and South Korea. There are an additional 8 destinations that are eligible for use of the STA license exception if the item to be exported is only controlled for national security (NS) concerns. These additional countries include Albania, Hong Kong, India, Israel, Malta, Singapore, South Africa, and Taiwan.

A second initiative under Phase II is change to the monitoring and reporting requirements that will streamline procedures used to facilitate and regulate international trade in dual-use items by ceasing practices that are duplicative or unnecessary. While this is a welcome effort for U.S. companies dealing with civil use items that also have military applications, the streamlining efforts have been relatively minor in scope so far. (For example, in July 2011 the State Department proposed an ITAR amendment to simplify the process of securing International Import Certificates (IIC) by ceasing its current practice of requiring the submission of a duplicate Form DSP-53 upon importing controlled items into the United States. These ICC certificates often held up shipments because foreign exporters, in an effort to comply with U.S. law and international agreements, would require a U.S. importer to obtain an IIC from the U.S. government as a prerequisite for delivery to the U.S.)



Recent Developments in U.S. Export Controls and Economic Sanctions

New Economic Sanctions Regimes Against Libya and Syria

In response to government violence and human rights abuses arising out of the “Arab Spring” in Syria and Libya, the United States and the European Union have issued a series of sanctions over the last several months directed at the Libyan and Syrian governments and members of the governing regimes. Notably, both the U.S. and the EU have frequently expanded the scope of their sanctions to increase pressure on these regimes and respond to humanitarian concerns. The UN also has imposed sanctions against Libya through Security Council Resolution 1973 (2011), although it recently signaled that it might ease sanctions in response to reports of a shortage of medical and other essential supplies. By contrast, the U.S. recently imposed much broader sanctions against Syria, and momentum could build for additional restrictions by the U.S. and/or EU if clashes between Syrian citizens and security forces continue.

The scope of economic sanctions often is difficult to understand upon first reading and there are complicated exceptions to the restrictions. Thus, special care and sometimes considerable experience is needed to ascertain exactly what transactions are and are not prohibited.

Sanctions on Libya

As a result of the clashes between the Libyan government and its people, President Obama issued Executive Order 13566 on February 25, 2011, which prohibits all transactions involving property and interests in property of certain persons and entities on a specific list of “blocked” parties or “Specially Designated Nationals” (SDNs). The first iteration of that list included:

- Colonel Muammar Qadhafi and members of the Qadhafi family;
- The Libyan government, including the Central Bank of Libya; and
- Senior officials in the Libyan government.

Since February, the Office of Foreign Assets Control (OFAC) has released four additional lists of individuals and entities falling within the scope of the President’s order. These sanctions apply to people and entities in the United

States as well as to United States persons and entities overseas. Importantly, there is, as yet, no general exception for humanitarian items like food and medicine. In the wake of these sanctions, all export licenses were suspended, and no further transactions were permitted pursuant to active licenses. Despite its goal of halting all transactions involving Libya, the U.S. has carved out several exceptions to prevent overly burdensome restrictions on financial institutions and to allow the sale of oil by the Libyan opposition. Additional exceptions will likely follow in the wake of the U.S.’s formal recognition of the opposition-controlled Transitional National Council as the legitimate government of Libya on July 15, 2011.

Businesses with operations in Europe should note that economic sanctions regimes are coordinated to a significant extent between the U.S. and the EU. For example, three days after the U.S. imposed sanctions against Libya, the EU followed suit and issued sanctions through Council Decision 2011/137/FSP. The decision placed an arms embargo on Libya and froze the assets of Muammar Qadhafi, members of his family, and 20 other individuals responsible for the repression of internal dissent. And, like the U.S., the EU has, since its original imposition of sanctions, issued several additional regulations that extend the scope of its assets freeze to cover additional members of the Qadhafi regime, members of the Libyan oil and gas sector, ports under the control of the Qadhafi regime, and certain Libyan banking institutions.

Sanctions on Syria

Similar to the Libyan example, President Obama issued Executive Order 13572 in April of 2011 prohibiting all transactions involving property and interests in property of certain listed parties that fall under the scope of the Order, and has added more persons and entities to that list by subsequent executive orders. In addition to the specific Syrian citizens and entities named in these executive orders, under a more recent Executive Order issued by the President on August 17, 2011 (E.O. No. 13582), all U.S. individuals or entities are prohibited from providing



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“any services to Syria,” making any investments in Syria, or engaging in any petroleum-related transactions or most forms of financial transactions with Syria. Moreover, comprehensive sanctions against the export to a wide range of Syrian persons and entities of goods containing more than 10% U.S.-manufactured component parts have been in place since the enactment of the Syria Accountability Act in 2004.

Also similar to the case of Libya, the EU issued in May 2011 a Council Regulation (EU) No 442/2011 imposing sanctions shortly after the U.S. Executive Order issued in April. The EU Council Regulation places an embargo on the export to Syria of arms and equipment that could be used for internal repression. It also freezes the funds of 13 members of the Syrian government and ruling elite. The EU also has issued additional sanctions in June (EU) Regulation No 611/2011, which extended sanctions to additional Syrian officials and four Syrian firms with ties to the armed forces. The European Union has deeper ties with Syria, and its sanctions will have a wider impact on the business community.

Conclusion

It can be seen from the above that there is a constantly shifting range of U.S. laws governing exports of U.S. products, services and technologies and that these laws change for a wide variety of reasons, often in unpredictable ways. For these reasons, vigilance is required in all transactions with non-U.S. persons to ensure compliance with these laws.

For questions or more information on any of the issues discussed above, please contact Alan M. Dunn or Terence Stewart.

Alan M. Dunn (amdunn@stewartlaw.com) is an international trade attorney and partner at the Law Offices of Stewart and Stewart, 2100 M Street, N.W., Washington, D.C., 20037, www.stewartlaw.com, tel: (202) 785-4185.

New Economic Sanctions Introduced In Response to Libyan and Syrian Crackdowns on “Arab Spring” Require Vigilance by Businesses to Avoid Violations

By: Alan M. Dunn

Law Offices of Stewart and Stewart

2100 M Street, N.W.
Suite 200
Washington, DC 20037
United States

202.785.4185 phone
202.466.1286 fax

amdunn@stewartlaw.com
stewartlaw.com

Overview

In response to government violence and human rights abuses arising out of the “Arab Spring” in Syria and Libya, the United States and the European Union have issued a series of sanctions over the last several months directed at the Libyan and Syrian governments and members of the governing regimes. The U.S. and the EU have frequently expanded the scope of their sanctions to increase pressure on these regimes and respond to humanitarian concerns. (See e.g., OFAC Press Release, 5/5/2011 and Council Regulation (EU) No 572/2011.) The UN also has imposed sanctions against Libya in Security Council Resolution 1973 (2011), although it recently signaled that it might ease sanctions in response to reports of a shortage of medical and other essential supplies. The UN has not yet taken action against Syria, but momentum for sanctions could build if clashes between Syrian citizens and security forces continue. Due to the rapidly changing environment, companies doing business overseas should be careful not to run afoul of sanction laws in applicable jurisdictions.

Libya

U.S. Sanctions

On February 25, President Obama issued Executive Order 13566. The order prohibits all transactions involving property and interests in property of parties that fall under the scope of the order, which includes:

- Colonel Muammar Qadhafi and members of the Qadhafi family
- The Libyan government, including the Central Bank of Libya
- Senior officials in the Libyan government

These sanctions apply to people and entities in the United States as well as to United States persons and entities overseas. Importantly, there is, as yet, no general exception for humanitarian items like food and medicine. In the wake of these sanctions, all export licenses issued pursuant to the Export Administration Regulations and the International Traffic in Arms Regulations have been suspended, and no further exports may be made pursuant to active licenses.





New Economic Sanctions Introduced In Response to Libyan and Syrian Crackdowns on “Arab Spring” Require Vigilance by Businesses to Avoid Violations

Since February, the Office of Foreign Assets Control (OFAC) has released four additional lists of individuals and entities falling within the scope of the President’s order. Sanctions now apply to Libyan oil production and exploration companies, major Libyan banks and investment corporations, and Libya’s state broadcasting company.

Exceptions

Despite its goal of halting all transactions involving Libya, the U.S. has carved out several exceptions to prevent overly burdensome restrictions on financial institutions and to allow for the sale of oil by the Libyan opposition. Additional exceptions will likely follow in the wake of the U.S.’s formal recognition of the opposition controlled Transitional National Council as the legitimate government of Libya on July 15. These exceptions are set out in five general licenses issued by OFAC, which authorize:

1. All transactions with financial institutions that are controlled by the government of Libya but organized under the laws of a country other than Libya (amended Jun. 21).
2. The provision of goods or services in the United States to the diplomatic missions of the government of Libya to the United States and the United Nations (Mar. 1).
3. The provision of legal services to the government of Libya, its agencies, or any other person whose property and interests in property are blocked pursuant to the President’s order (Mar. 9).
4. The continuation of normal operations by investment funds holding any interest of the government of Libya or any blocked person (Apr. 8).
5. U.S. persons to engage in transactions involving Qatar Petroleum or the Vitol group related to oil and gas exported from Libya under the auspices of the Transitional National Council (Apr. 26).

Despite the issuance of OFAC’s general licenses, the businesses should be aware of the possible ramifications of these sanctions. A number of concerns for the U.S. business community were outlined in a letter to Adam

Szubin, the Director of OFAC, from the National Foreign Trade Council’s President, William Reinsch, which was published by Foreign Policy’s Josh Rogin. For example, there is no general license available for making deposits to banks in Libya, even if a company has local employees and contractors. Specific license requests are available, but the process can be time-consuming and burdensome. There are also concerns about the collection of payment for goods and services that have already been delivered, and how to treat oil-related transactions that were underway before the effective date of U.S. sanctions.

EU Sanctions

Three days after the U.S. introduced its sanctions, the EU responded with its own sanctions in Council Decision 2011/137/FSP. The decision places an arms embargo on Libya and a freeze on the assets of Muammar Qaddafi, members of his family, and 20 other individuals responsible for the repression of internal dissent. Since then, the EU has issued several additional regulations that extend the scope of its assets freeze:

Date	Regulation	Description
June 16, 2011	Council Regulation (EU) No 572/2011	Imposed an asset freeze on ports under the control of the Qaddafi regime, including: <ul style="list-style-type: none"> • Port Authority of Tripoli • Port Authority of Al Khorns • Port Authority of Brega • Port Authority of Ras Lanuf • Port Authority of Zawia • Port Authority of Zuwara
April 12, 2011	Council Implementing Regulation (EU) No 360/2011	Amended Annexes II and III of Regulation 204/2011 to include a number of Libyan entities in the oil and gas sector.
March 25, 2011	Council Regulation (EU) No 296/2011	Amended Regulation 204/2011 to include new language on the transfer of funds and the provision of technical assistance.
March 23 2011	Council Implementing Regulation (EU) No 288/2011	Amended Annexes II and III of Regulation 204/2011 to include additional members of the Qaddafi regime.
March 21, 2011	Council Implementing Regulation (EU) No 272/2011	Amended Annex II of Regulation 204/2011 to include the Sahara Bank, the Qaddafi Int’l Charity, and other entities.
March 10, 2011	Council Implementing Regulation (EU) No 233/2011	Amended Annex II of Regulation 204/2011 to include the Libyan investment Authority, the Central Bank of Libya, and other entities.
March 2, 2011	Council Implementing Regulation (EU) No 204/2011	Implemented UN Security Council Resolution 1970 (2011), establishing an arms embargo against Libya.



New Economic Sanctions Introduced In Response to Libyan and Syrian Crackdowns on “Arab Spring” Require Vigilance by Businesses to Avoid Violations

Syria

U.S. Sanctions

On April 29, President Obama issued Executive Order 13572. Like the U.S. sanctions against Libya, the order prohibits all transactions involving property and interests in property of parties that fall under the scope of the order, which includes:

- The Syrian General Intelligence Directorate
- The Islamic Revolution Guard Corps – Qods Force
- Mahir Al-Al Asad (Brigade Commander in the Syrian Army’s Fourth Armored Division), Ali Mamluk (director of the Syrian General Intelligence Directorate), and Atif Najib (former head of the Syrian Political Security Directorate for Dar’a Province)

On May 18, the President responded to ongoing repression in Syria by issuing Executive Order 13573, which added seven senior officials in the Syrian government, including President Bashar al-Assad, to the list of blocked parties.

In addition to the specific Syrian citizens and entities named in these executive orders, comprehensive sanctions against the export of goods to a range of Syrian persons and entities containing more than 10% U.S.-manufactured component parts have been in place since the enactment of the Syria Accountability Act in 2004. Because sanctions were already in effect, limited commercial activity took place between the U.S. and Syria prior to the issuance of the current orders. The European Union has deeper ties with Syria, and its sanctions will have a wider impact on the business community.

EU Sanctions

On May 9, 2011 the European Union issued Council Regulation (EU) No 442/2011. The regulation places an embargo on the export to Syria of arms and equipment that could be used for internal repression. It also freezes the funds of 13 members of the Syrian government and ruling elite. On June 24, the EU issued Council Implementing (EU) Regulation No 611/2011, which extended sanctions to additional Syrian officials and four Syrian firms with ties to the armed forces. The firms include Bena Properties and Al Mashreq Investment Fund, which are both controlled by Rami Makhoul, a cousin of President Al-Assad with ties to companies across all sectors of the Syrian economy.

Conclusion

Businesses should remain vigilant in their dealings abroad in light of the rapidly changing situation. Penalties for violating OFAC regulations, EU regulations, or sanction laws in other applicable jurisdictions can be hundreds of thousands of dollars. Before engaging in transactions that may be covered by these or other regulations, businesses must be sure to obtain authorization from the relevant government agencies.

If you have any questions about these sanctions and how they may affect your business or specific transactions, please contact Alan Dunn at +1 202-785-4185.

Alan M. Dunn (amdunn@stewartlaw.com) is an international trade attorney and partner at the Law Offices of Stewart and Stewart, 2100 M Street, N.W., Washington, D.C., 20037, www.stewartlaw.com, tel: (202) 785-4185.

Compendium of the Principles of Incorporation of a Joint Stock Company in Turkey

By: Serap Zuvin, Melis Oget Koc, Pelin Ecevit

Beybi Giz Plaza, Maslak Mahallesi, Meydan Sokak No: 1

Kat: 31 Daire: 121, Maslak, Sisli

Istanbul, TR 34398

Turkey

+90-212-2807433 phone

+90-212-2781911 fax

szuvin@zuvinlaw.com.tr

zuvinlaw.com.tr

I. Introduction

The Republic of Turkey occupies a strategic geographical presence between the Europe and Asia, creating different investment opportunities for foreign investors. The Turkish economy has welcomed foreign capital by liberalizing the investment laws since the 1980s and foreign investors have made many investments in Turkey leading them to accumulate large profits. Over the last thirty years, the Turkish workforce has developed rapidly by becoming more skilled, multilingual, and highly educated.

Turkish laws contain many different types of companies available for both local and foreign investors to join as shareholders or partners. These companies include: (i) general partnerships (*Kollektif Sirket*), (ii) limited partnerships (*Adi Komandit Sirket*), (iii) partnerships limited by shares (*Sermayesi Paylara Bolunmus Komandit Sirket*), (iv) joint stock companies (*Anonim Sirket*) (“AS”), (v) limited liability companies (*Limited Sirket*) (“LS”) which are listed under the Turkish Commercial Code¹ (the “TCC”); (vi) cooperative companies (*Kooperatif*) which are listed under the Law on Cooperative Company², and ordinary

partnerships (*Adi Sirket*) which are listed under the Turkish Code of Obligations³ (the “TCO”). If preferred so, it is possible to establish a branch or liaison office of a foreign entity in the Republic of Turkey.

The most preferred company types by foreign investors in Turkey are joint stock companies and limited liability companies. Pursuant to the Regulation on Implementation of Direct Foreign Investment⁴ (“Regulation on Foreign Investment”), foreign investors may incorporate or participate in any and all kinds of companies, which are available to local investors in accordance with the equal treatment principle.

The sections set forth in this compendium will explain the comparison between ASs and LSs, structure of a Turkish AS and the establishment procedure of the same. It must be noted that the establishment of banks, insurance/reinsurance companies, and independent auditing firms are subject to the approval of Ministry of Industry and Commerce (“Ministry”).



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Compendium of the Principles of Incorporation of a Joint Stock Company in Turkey

II. Important Similarities and Differences Between AS and LS

- Both AS and LS are limited liability corporations in which the liability of shareholders are limited to their respective capital commitments in the respective companies.
- The minimum number of shareholders required to establish an AS is five (5), whereas such requirement is two (2) for LS. The LS may not have more than fifty (50) shareholders, however, such limitations are eliminated in new Turkish Commercial Code issued in the Official Gazette dated February 14, 2011 and coming into force on July 01, 2012, ASs and LSs will be able to be established and operated even by one (1) shareholder.
- Under the TCC, the minimum capital required for establishing a LS is five (5) thousand Turkish Liras which is approximately US \$ 2,825 whereas a minimum capital of fifty (50) billion Turkish Liras which is approximately US \$ 28,250 is required for the incorporation of an AS⁵.
- An AS is managed by its board of directors. On the other hand, a LS does not have a board of directors and is managed instead by its managers. All or certain of the authorities of the shareholders relating to the management of a LS may be granted by them to the manager(s) or one of the shareholders of the LS.
- An AS is required to hold general assembly meetings every year. Also, in the AS there has to be a statutory auditor. A LS with less than twenty (20) shareholders does not need to comply with the procedural requirements applicable to the AS in relation to conducting of general assembly meetings of its shareholders. It also does not need to have statutory auditors, unlike an AS. In such case, the shareholders of the LS are empowered to review and approve the accounts of the company.
- The shares of a LS, unlike those of an AS, cannot be issued and represented by negotiable share certificates, i.e. shareholding is represented by shares and not by share certificates. In order to be valid and effective, any transfer of shares in a LS must be approved by the shareholders representing three quarters (75%) of the capital of the company and the share transfer document must be notarized by a Turkish Notary Public and registered with the Trade Registry Office and then be published in the Turkish Trade Registry Gazette. A share transfer in an AS does not require such formalities to be accomplished.
- An AS is particularly preferred by its founders when shareholders with potentially conflicting interests come together, such as in a joint venture, since it is possible to establish classes on the shares of AS with different rights. Although the AS is far more common, a LS may be preferable when the sole objective is to establish a wholly owned subsidiary of a foreign parent company with minimum capitalization and administration requirements.

III. The Structure of a Turkish AS: The Board of Directors, Shareholders' Assembly, and the Statutory Auditor(s)

The Board of Directors, Shareholders' Assembly and the Statutory Auditor(s) are contemplated as the mandatory bodies of a joint stock company. Therefore, if any of the bodies disappears/ becomes none existent and such deficiency is not cured, then the AS dissolves.

The Board of Directors of an AS consists of at least three (3) directors who are also required to be shareholders in such joint stock company. The directors may be appointed under the Articles of Association ("AoA") of the AS or may be elected by the general assembly of shareholders of the AS in a general assembly meeting. The directors are responsible both for managing and representing the AS. The Board of Directors of an AS represents and commits the company with their acts. They are also responsible for maintaining the company books properly.

Under Turkish law, the Shareholders' Assembly is named as the General Assembly in ASs. The general assembly appoints the directors and statutory auditors, approves the accounts, and distributes the profits of the company. The shareholders are in charge of controlling the board of directors and auditors. Additionally, the general assembly has the authority to decide on amendment of the AoA, increase or decrease the capital, appointment and dismissal of the members of the Board of Directors and the Statutory Auditor(s) and issuing bonds and preferred shares (*imtiyazli pay senedi*).



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An AS must also have Statutory Auditor who may consist of between one (1) to five (5) auditors. The statutory auditors must submit a report to the General Assembly at the end of each business year stating the current estates and debts of the respective company. The conformity of the balance sheet and profit and loss accounts with the Turkish Laws and AoA of respective AS shall also be stated in the same. In addition to such report they are required to check the accounts every three (3) months and to investigate the commercial books of the AS every six (6) months.

IV. Steps to be taken for the Incorporation of an AS in Turkey:

The procedures for incorporating both ASs and LSs in Turkey are very similar. The information below outlines the establishment procedure of an AS in Turkey and is applicable by analogy to LSs as well.

1. Before the Execution of AoA of the Company

1.1. Execution of Lease Contract

It is mandatory to state the address of the head office of a company to be established in its AoA in accordance with Article 279 of the TCC. Certain official authorities, including relevant municipalities and tax offices, must be provided with the copies of lease contract of the company to be established. Therefore, execution of a lease contract for the registered office of the company is required before its establishment.

1.2. Board of Directors (“BoD”) Resolutions

In order to establish the Company in Turkey, a BoD resolution must be adopted for each legal entity founder relating to (i) its participation to the Company as a shareholder, and (ii) appointment of its representative(s) to represent them in the Company.

1.3. Capital

Twenty-five percent (25%) of the subscribed capital of an AS, must be paid within three (3) months following the incorporation of the respective AS, and the remaining portion of the subscribed capital must be paid within three (3) years following such incorporation.

2. Execution of the AoA of the Company

2.1. Company Name

Pursuant to the Communiqué on the Incorporation and Amendment of the Articles of Associations of Joint Stock Companies and Limited Liability Companies⁶ (the “Communiqué”), it is required that the determined trade name of the AS to be established has not previously been registered with any Trade Registry Office. Use of the words of “Turkish”, “Turkey”, “National” and “Republic” in the company name is subject to the Council of Ministers of Turkey issuing a decree to such affect.

2.2. Passport Copies

All of the Turkish official authorities that are involved in the company establishment process; such as tax office, trade registry, notary public etc., must be provided with the passport copies of the real person shareholders of the company to be established and if any, of the Managers of the Company.

2.3. The AoA of the Company

Article 279 of the TCC provides that the AoAs must be in writing and signed by each of the founders (or their duly authorized representatives) and such signatures must be certified by a Turkish Notary Public.

2.4. Legal Books

Under Turkish law, maintaining certain company books is compulsory. The legal books which are required to be kept for an AS are the Decision Book (*Karar Defteri*), Share Lodger (*Pay Defteri*), Journal Book (*Yevmiye Defteri*), Ledger Book (*Defter-i Kebir*) and Inventory Book (*Envanter Defteri*).

3. Registration with the Local Chamber of Commerce and Trade Registry

In order to get established, the AS must be registered with the relevant Trade Registry where its head office is located, and such registration must be published



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and announced in the relevant Trade Registry Gazette to put third parties on notice of such establishment. The Company shall gain its legal entity status upon its registration with the relevant Trade Registry.

3.1. The Documents to be submitted to Local Trade Registry

Pursuant to the Communiqué, the following documents must be attached to the application letter filed with the relevant Trade Registry to establish the AS: (i) Incorporation Notice Form (ii) Notarized AoA, (iii) Signature declarations of the each director and duly authorized representatives of the Company to be drafted by the Turkish Notary Public, (iv) Letter of Undertaking signed by duly authorized representative of the Company, (v) Original of the receipt of Halk Bankasi evidencing that the 0.04 % of the capital of the AS to be established has been deposited to the account of Competition Board Fund, (vi) copy of the identity card or passport copies of each shareholder and duly authorized representatives, (vii) the original and the notarized translations of the “certificate of activity” and “registry records” for each foreign legal entity shareholder to be issued by the industrial and/or trade registry with which such shareholder is registered or by the competent courts in notarized and apostilled form.

The BoD is the authorized body of an AS for representation and commitment of the same before the third parties. The BoD of an AS can transfer such authority to (i) one or more members of the BoD; or (ii) the managers who are not required to be the shareholder of the AS. In order to accomplish such transfer, the legal representatives of an AS may be appointed either under a temporary article of the AoA to such affect or by a separate resolution as rendered by the BoD. In any case the contents of the representation and duty assignment must be explicitly stated under the temporary article of the AoA; since such duty assignment constitutes the basis of signature circular of such AS.

If the representatives will be appointed upon a resolution to be rendered by the BoD following the establishment of the AS; then such resolution is required to be notarized before a Turkish Notary Public and then be registered with the relevant local Trade Registry. The announcement of such representation and duty assignment with the Trade Registry Gazette also needs to be made; in order to inform the third parties of such fact.

3.2. Further Documentation

In addition to the above-mentioned documents, following documents must be submitted to the local trade registry:

(i) Chamber Registration Statement (*Oda kayıt beyannamesi*), (ii) If the founding shareholder of the company is a legal entity, decision regarding the participation to the company, (iii) The tax identity numbers of the shareholders and representatives of the company to be established.

If the founding shareholders of the Company are legal entities and their head offices are not located in Istanbul, certain additional documents may be requested to be filed by the Trade Registry.

4. Notification to the Foreign Investment General Directorate of the Undersecretariat of Treasury of the Republic of Turkey (the “FIGD”)

Subsequent to the enactment of the Law on Direct Foreign Investments⁷ (“Foreign Investment Law”), foreign investments in Turkey are no longer subject to the approval of the FIGD. Elimination of such authorization/approval system is to the favor of foreign investors because the purpose of the Foreign Investment Law is to encourage direct foreign investment, protect the rights of the foreign investors, and to ensure compliance with international standards and definitions of investment and investor.

There are no approvals and/or authorizations required for a foreign investor in addition to the ones required for a local company in establishing a company or participating to an existing one in Turkey.



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Pursuant to Article 4 of the Foreign Investment Law, foreign investors are merely required to give statistical information on their respective investments in Turkey in compliance with the provisions of the Regulation on Foreign Investment upon the request of FIGD. Therefore, a filing will be made to the FIGD by the relevant Trade Registry only after the submission of registry documents in order to notify the same of the foreign investment.

5. Further Procedural Steps

Upon the registration of the AS with the relevant Trade Registry, it gains the legal entity status. Subsequent to the registration and announcement of the AS; next steps to be taken for its operation are as follows:

- i. A withholding tax number, value added tax number, and a tax identification plaque must be obtained from the local tax office at which the head office of the Company is located.
- ii. A social security number must be obtained from the relevant Social Security Administration and the employees of the Company must be registered with the same.
- iii. A registration number for the relevant workplace of the respective company must be obtained from the relevant Labor Office before the employment of any employees.
- iv. The ASs must apply to the local municipality where the head office is located and must obtain a business license (*i yeri çalışma ruhsatı*).

V. Other Company Types under Turkish Law

1. Ordinary Partnership (*Adi Sirket*)

Ordinary partnerships can be established by two (2) or more persons, with or without executing a written partnership agreement. An ordinary partnership does not contain a legal entity status independent from the identities of the partners who own the same. Ordinary partnerships' assets are jointly owned by its partners. Similarly, the partners of an ordinary partnership are jointly, severally and unlimitedly liable against the creditors of the partnership.

2. General Partnership (*Kollektif Sirket*)

General partnership is the partnership of two (2) or more real persons established for the purposes of operating a commercial enterprise under a trade name, containing a legal status and all the partners being under several and unlimited liability against the creditors of the partnership.

3. Limited Partnership (*Komandit Sirket*)

The limited partnership differs legally from the general partnership, since at least one (1) partner (who is called the "general partner") is unlimitedly liable for all debts and obligations of the partnership against third parties. The other partners (called "limited partners") are not liable for the debts and obligations of the partnership which exceed the amounts contributed by such limited partners.

4. Partnership Limited by Shares (*Sermayesi Paylara Bolunmus Komandit Sirket*)

The partnership limited by shares contains the characteristics of both the AS and the limited partnership. Its capital is divided into shares and, depending on how it is agreed under its bylaws, one or more partners are jointly, severally, and unlimitedly liable to the creditors of the partnership similar to the "general partner" as described above.

5. Cooperative Companies (*Kooperatif*)

The cooperative company is an association of an indefinite number of real and legal persons, the main purpose of which is the furtherance or safeguarding of a defined economic interest of its members by their mutual efforts. The capital of the cooperative company is not fixed in advance and such company's liability is limited to its own assets, unless otherwise agreed in its AoA.

VI. Branch Office in Turkey

Establishing a branch office is an alternative available to foreign investors who want to operate in Turkey.

Establishment of branch offices is subject to the approval of the Ministry. In addition, the branch offices must be represented by an authorized person residing in Turkey.



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After receiving the approval of the Ministry for the establishment of the branch office, the following documents must be attached to the application letter to be submitted to the relevant Trade Registry: (i) Incorporation Notice Form, (ii) Notarized AoA, (iii) Notarized Power of Attorney issued in favor of the duly authorized representative(s) of Turkish branch office, (iv) The approval letter issued by the Ministry, (v) The declaration (“*muzeyyel beyanname*”) and the announcement issued by the Ministry, (vi) Signature declarations of the representatives of the branch office, (vii) Letter of Undertaking, (viii) copy of the identity card or passport copies of the representative(s) of the branch office, (ix) Chamber Registration Statement (*Oda kayıt beyanname*) and (x) The tax identity numbers of the duly authorized representatives of the branch office.

VII. Liaison Office in Turkey

Unlike the branch offices, liaison offices can not engage in commercial activities. The liaison offices are established in practice merely for conducting the local market research, seeking for commercial opportunities and providing parent company of the same.

The establishment of a liaison office is subject to the permission of the FIGD. The parent company must appoint a representative for its liaison office by rendering a resolution in order to authorize such person for the

management of liaison office. It is provided under Article 6 of the Regulation on Foreign Investment that the FIGD must render a resolution on the establishment or extension applications of liaison offices within five (5) days following such application, provided that all the documents required for such filing are submitted by the applicant. In general, such approval of the FIGD is issued within two (2) or three (3) business days. The liaison offices are not registered with any Trade Registry. In any case, annual notifications to the FIGD regarding the operations of the liaison office in Turkey must be made.

- ¹ Turkish Commercial Code; dated June 29, 1956 and numbered 6762 and published in the Official Gazette dated July 9, 1956 and numbered 9353.
- ² Law on Cooperative Companies; dated April 24, 1969 and numbered 1163 and published in the Official Gazette dated May 10, 1969 and numbered 13195.
- ³ Turkish Code of Obligations; dated April 22, 1926 and numbered 818 and published in the Official Gazette dated May 8, 1926 and numbered 366.
- ⁴ Regulation on Implementation of Direct Foreign Investment; published in the Official Gazette dated August 20, 2003 and numbered 25205.
- ⁵ On the basis of the Turkish Central Bank exchange rates of September 09, 2011, US\$ 1.00 is equivalent to TL. 1.77.
- ⁶ Communiqué Concerning Incorporation and Amendment of the Articles of Associations of Joint Stock Companies and Limited Liability Companies; published in the Official Gazette dated July 25, 2003 and numbered 25179.
- ⁷ Law on Direct Foreign Investments; dated June 05, 2003, numbered 4875 and published in the Official Gazette dated June 17, 2003 and numbered 25141.

The Arbitration Trap

By: Raymond A. Fylstra, Esq.

Kubasiak, Fylstra, Thorpe & Rotunno, P.C.

Two First National Plaza
20 South Clark Street, 29th Floor
Chicago, IL 60603
United States

312.630.9600 phone
312.630.7939 fax

rfylstra@kftrlaw.com
ftrlaw.com

Arbitration is a popular way to resolve many kinds of disputes, especially business disputes. Arbitration offers many advantages. Arbitration is private. The parties have flexibility to customize the process to fit the nature of the dispute. The arbitrator is selected with input from both parties. Arbitration awards are not published and are not precedential. Arbitration awards are also extremely difficult to overturn in court. Arbitration may also be quicker and less expensive than court, though this is not necessarily so. (See, article “Pitfalls of Arbitration” at our web site, [www.kftrlaw.com/Media/Pitfalls of Arbitration.pdf](http://www.kftrlaw.com/Media/Pitfalls%20of%20Arbitration.pdf).)

One of the principal drawbacks to arbitration is that the arbitrator does not have the powers of a court and the arbitration award is not directly enforceable. If a respondent refuses to pay an award, the claimant will have to go to court anyway to enforce it. Another related drawback is that the court’s jurisdiction to review arbitration awards can be lost inadvertently. Imagine the mortification of winning an arbitration only to discover that the court won’t enforce the award. Here’s how it happened in the Land of Lincoln.

An arbitration clause in a contract normally will specify the place where the arbitration hearing will occur. Under

the Uniform Arbitration Act, the agreement to arbitrate in a particular state confers jurisdiction in the courts of that state to review the arbitration award. Sometimes, however, the specified venue will turn out to be inconvenient for the parties, or the venue may be unsatisfactory due to the location of the key witnesses. In such situations, the parties may be tempted to move the arbitration hearing someplace else. In several cases, however, the Illinois courts have held that holding the arbitration hearing in a venue not specified in the written arbitration agreement deprives the court of jurisdiction to either confirm or vacate the arbitration award. If the court will not act at all, a successful claimant could be left with an unenforceable award, or an unsuccessful respondent could be left with no chance whatsoever to appeal, even if the arbitrator was corrupt, or exceeded his or her powers or deprived the party of due process.

The trend in Illinois traces back to an Illinois Supreme Court ruling in *Chicago Southshore & South Bend R.R. v. Northern Indiana Commuter Transp. Dist.*, 184 Ill. 2d 151, 703 N.E.2d 7 (1998), which held that the Illinois court lacked jurisdiction to confirm an arbitration award entered in a proceeding which was required by the arbitration



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agreement to be held in Indiana, even though both parties waived the venue clause and arbitrated in Illinois. Soon thereafter, in *CPM Productions, Inc. v. Mobb Deep, Inc.*, 369 Ill. App. 3d 369, 742 N.E.2d 393 (1st Dist. 2000), the Illinois Appellate Court reversed a judgment entered by the circuit court confirming an arbitration award. The Appellate Court instead vacated the award because the arbitration had occurred in Illinois, while the arbitration agreement called for arbitration in New York. The appellant succeeded in vacating the arbitration award even though the jurisdictional issue was raised for the first time on appeal. *See also, Valent Bio Sciences Corp. v. Kim CI, LLC*, 2011 Ill. App. (1st Dist.) 102073, decided on June 1, 2011 (an Illinois court was not the proper tribunal to review an arbitration award where the arbitration occurred in California and no written agreement specified otherwise).

Several lessons may be drawn from these cases. First, when negotiating or drafting an arbitration agreement, always include a venue clause, not just a choice of law clause. Identify specifically the state in which the arbitration hearing is to be conducted, and understand that you are giving that state exclusive jurisdiction to review any arbitration award.

Second, if you have an actual dispute, don't just informally agree or acquiesce to move an arbitration to another venue not specified in the agreement (unless you think you're going to lose and want to try to prevent the court from confirming the award).

Third, though this strategy is untested, the parties may be able to avoid the *Chicago Southshore* rule by agreeing in writing before the arbitration hearing begins to formally amend the arbitration agreement and change the agreed venue. The Uniform Arbitration Act, does not state that the agreement to arbitrate has to precede the dispute. To the contrary, section 1 of the Act explicitly provides that agreements to submit to arbitration "any existing controversy or any controversy thereafter arising between the parties" are enforceable. 710 ILCS 5/1 (2011). Therefore, it would seem unlikely that a court would find that it had no jurisdiction to review an arbitration award simply because Illinois was not the originally specified venue. But again, there is no judicial precedent to rely upon at this time.

Raymond A. Fylstra is managing partner at the law firm of KUBASIAK, FYLSTRA, THORPE & ROTUNNO., P.C., the Chicago, Illinois based firm of the Primerus Business Law Institute.

Japanese Dispute Resolution Bodies

By: Genta Irie

Hayabusa Asuka

4th Floor, Kasumigaseki Building 3-2-5

Kasumigaseki, Chiyoda-ku

Tokyo, JP 100-6004

Japan

+81-(3)-3595-7070 phone

+81-(3)-3595-7105 fax

genta.irie@halaw.jp

halaw.jp

We are providing some comments below with respect to (i) international disputes to be resolved by Japanese dispute resolution bodies and (ii) international disputes to be resolved by foreign dispute resolution bodies.

Dispute Resolutions in Japan

The main international dispute resolution bodies in Japan are (i) courts and (ii) arbitration organizations. To which body a case should be taken might be a concern, and is determined by the intention of the parties and various other factors. If Japanese courts are chosen to be the dispute resolution body, a party whose mother tongue is not Japanese has to bear tremendous cost and time for translation since Japanese courts only accept Japanese. In addition, even when a party wins a case in court, the court decision might not be executed in some countries. The possibility of a decision by a court in Japan being executed in another country is one factor that one must take into account when deciding the forum.

As for arbitration organizations, it is said that they are an inexpensive and quick dispute resolution body. In order to use the arbitration procedure, however, it is necessary for there to be a prior agreement indicating that the parties intend to use the arbitration procedure in the event of a dispute. Therefore, whether or not such an agreement existed often becomes an issue. Also, it is important to note that, unlike a court procedure, one cannot appeal an arbitral award made by an arbitration organization.

International Disputes Outside of Japan

When resolving a dispute outside of Japan, it necessarily involves the law of the country in question. The matters of language can be an issue, and securing an execution of the judgment or award in such country or in Japan will have to be carefully analyzed. Moreover, sometimes parties are not familiar with the foreign legal system. For example, Japanese people are not so familiar with the broad scope



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of discovery or the punitive damage system in the United States. Therefore, obtaining advice from attorneys with knowledge and experience in the foreign country in question will be very valuable.

Conclusion

In cases involving international disputes, the parties may have to bear tremendous cost and time. Therefore, using Japanese attorneys and attorneys of their own country from the initial stage of the business (for example, entering into a contract) might turn out to be a very good way to save potential costs associated with the international dispute.

Employee or Independent Contractor: What you do not know might result in an unpleasant surprise.

By: Dan Block

Robinson Waters & O'Dorisio, P. C.

1099 18th Street, 26th Floor
Denver, CO 80202
United States

303.297.2600 phone
303.297.2750 fax

dblock@rwolaw.com
rwolaw.com

Particularly during the past year, business owners and managers have been surprised by a notice from the Internal Revenue Service or a state government agency informing them that an individual's status as a former independent contractor of the business is being questioned—and ultimately, the government agency reclassifies that worker, and maybe others, as an employee. Typically, this event occurs after an independent contractor relationship ends, and the worker files for unemployment benefits. Then, the business has to pay back taxes, premiums, interest, and possibly penalties.

Upon receiving the notification from the IRS or the state agency, the business owner/manager may think that the matter will be easily resolved, and favorably to the business. He or she might expect that simply by responding that the worker was treated by the business as an independent contractor, and not an employee, that the worker was paid as an independent contractor, rather than being paid via payroll checks—and that both the management of the business

and the worker understood that was the relationship among the parties—that will result in a determination by the agency that the worker was an independent contractor. Unfortunately, the parties' intent is not determinative.

Instead, whether a worker is an employee or an independent contractor depends on whether his or her situation fits into a definition of an “employee” under the applicable laws. Complicating this matter is the fact that several federal and applicable state laws have definitions of “employee,” and related to those laws, multi-factor tests as to whether an individual is an employee or independent contractor—and different definitions and tests exist among the various federal laws and the among the various state laws. Additionally, under some federal and state statutes, a common law test, subject to change by the courts or differing among federal courts in various jurisdictions, applies to the definition; rather than a statutory test.

This article applies to workers in Colorado; but most of the information below also applies to workers in other states.





Employee or Independent Contractor: What you do not know might result in an unpleasant surprise.

The Basic Elements of Independent Contractor Status

The basic, generic, test for whether a worker is an employee or independent contractor, which applies to the various federal and state statutes, contains two elements: (1) is the worker free from direction and control in performance of the services for that business; and (2) is the worker engaged in an independent trade, occupation, profession, or business related to those services? Unless the answer is “yes” to both elements, the worker is an employee, not an independent contractor, of the business for which the worker is performing services.

Those two elements of the basic test are vague and subjective; although the Colorado Court of Appeals has created a more objective standard for one element of that test, as discussed below.

Multi-Factor Tests of Independent Contractor Status

The multi-factor tests provide some guidance to help a person make the assessment of whether the worker is free from direction and control, and whether the worker is engaged in an independent trade, occupation, profession, or business.

The best, most comprehensive, test is the test utilized by the IRS. It is a 20-factor test. The IRS will evaluate the relationship among the business and the worker to see how many of the 20 factors weigh in favor of independent contractor status and how many of the factors weigh in favor of employee status.

Definitions of “employee” appear in three Colorado statutes (the Wage Act, the Workers Compensation Act, and the Employment Security Act). Two of those statutes have a nine-factor test (which is the same under each statute) that can lead to a presumption of independent contractor status if specified conditions are met; but those conditions differ slightly in the those statutes. Most of the nine factors in the test are similar to some of the factors in the IRS test.

The determination of whether someone is an independent contractor under certain federal and state statutes is made based on one of the common law tests, which typically contain six or fewer relatively vague factors.

The tests under federal and state law include factors tending to show or not show direction and control, and

factors tending to show or not show that the individual is engaged in an independent trade, occupation, profession, or business.

While the tests typically state that no one factor is determinative, common important factors under federal and state law to establish independent contractor status include the following:

1. The contractor is paid a fixed rate (such as a commission rate) or a project rate; not paid a salary or hourly rate.
2. No benefits are provided by the business to the contractor.
3. The business cannot terminate the work during the contract period unless the contractor violates the terms of the contract or fails to produce a result that meets the specifications of the contract. In addition, the contractor cannot end at any time its relationship with the business for which the services are performed, other than for a breach of the agreement by the business, without incurring liability.
4. The business does not pay the contractor personally; i.e., checks are not be made payable to an individual. Instead, checks are made payable to a business entity or to a trade name of a sole proprietorship owned by the worker.
5. No employee of the business closely supervises the contractor. For example, the business should not specify the hours of work each day. Also, no employee of the business should be giving ongoing instruction to the contractor.
6. No continuing relationship exists or is contemplated, unless it is at irregular intervals.
7. Unless the contract is for a short period of time (e.g., six months), with no expectation of extension of the contract, the contractor also performs more than a minimal amount of work for at least one other business during the same time period in which the contractor is providing services to that business.

Typically, not all factors in the tests need to be present to establish an independent contractor relationship, and which factors are most important may depend on the circumstances of the relationship.



Employee or Independent Contractor: What you do not know might result in an unpleasant surprise.

That Misguided “Method of Pay” Requirement

Among the factors above, the one that most often seems to be absent from purported independent contractor relationships is that the contractor be paid a fixed or contract rate; not paid a salary or hourly rate. This factor is based on the idea that employees are typically paid a salary or hourly rate, but an independent contractor can set some other method of payment. However, it is often the case, and particularly when the worker is a computer technician or programmer, or other information technology contractor, that it is the worker who requires payment on an hourly basis—even though the business owner/manager would prefer to pay the contractor on a project or other set fee basis. Thus, requiring that the contractor be paid on some basis other than a salary or hourly rate may take away some independence from the contractor, and it often does not indicate direction or control by the business. In other words, this “method of payment” factor is usually not a valid factor in the assessment of whether a worker is independent of the business to which he or she is providing services. Therefore, this factor should be eliminated from the tests of independent contractor status.

If the contractor insists on payment on a salary or hourly rate basis, or if the parties cannot establish or agree upon a commission, project fee, or other fixed contract rate, the business owner/manager should be sure the relationship of the parties can meet all, or at least almost all, of the other factors in the various tests indicating independent contractor status.

In Most Situations, Independent Contractors Must Work for More Than One Business

In deciding whether a worker is an “employee” under the state unemployment benefits statute, the Court of Appeals in Colorado established the following misguided rule: If a worker does not do more than occasional work, and more than an “insubstantial” amount work, for at least one business besides the one trying to establish the independent contractor relationship, that worker is an employee of the business asserting an independent contractor relationship. In addition, the services performed by the worker for each business must be similar. It does not matter if other indicia of the worker being engaged in an independent trade,

occupation, profession, or business exist. And, it does not matter if all the other factors showing independent contractor status exist.

That rule raises the following question: How does the individual starting his or her own business initially qualify as an independent contractor, given that he or she will likely have only one client, at least initially? It also puts the business in an unreasonable situation, as follows: The business owner/manager may have initially, and correctly, thought that the worker qualified as an independent contractor, only to have the worker reclassified many months later because the worker was unable to attract other clients or lost his or her other clients.

An exception to the rule established by the Colorado Court of Appeals is if the worker entered into a contract with the business for only a short period of time. In that situation, the worker can work solely for one business and be an independent contractor if the other factors weigh in favor of independent contractor status.

That All-Important Written Agreement

Businesses engaging independent contractors should always have written agreements with the contractors. Besides describing the terms of the relationship among the parties, independent contractor agreements need to address the independent trade, occupation, profession, or business requirement. In addition, at least with contractors in Colorado, the agreements should provide for the ability of the business to verify that the contractor is engaged in an independent trade, occupation, profession, or business. To help establish a presumption of independent contractor status, the agreements should follow all statutory requirements.

Dan Block is a shareholder of Robinson Waters & O’Dorisio, P. C. in Denver, Colorado. He specializes in employment law and other areas of business law. You can contact him at 303-297-2600 or at dblock@rwolaw.com.

Important Judicial Ruling – Variable Compensation and Setting of Objectives

By: Montaine Guesdon Vennerie and
Marie Sylvie Vatie

Vatier & Associés

12, rue d'Astorg
Paris, FR 75008
France

+33153431555 phone
+33153431578 fax

montainegv@vatier-associes.com
ms.vatier@vatier-associes.com
vatier-associes.com

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We would like to draw your attention to a recent ruling by the Chambre sociale de la Cour de Cassation which may have serious implications for employers.

For the Cour de Cassation, if an employer fails to set an employee's annual objectives which determine the variable portion of that employee's compensation, the employee may unilaterally terminate the employment contract for breach by the employer.

The Cour de Cassation issued its June 29, 2011 ruling with respect to the following circumstances:

- the employment agreement provided that the variable portion of compensation would be paid if certain objectives, set each year by the employer, were met;
- the employer failed to set these objectives for the employee in years 2003, 2004 and 2005, considering that the objectives set for 2002 continued to apply, and the employee having failed to meet them had no right to the variable portion of compensation.

The Cour de Cassation; in consideration of the fact that the employment agreement expressly indicated that

the objectives would be set each year in a letter ruled that the employer should have renewed the 2002 objectives in writing at the beginning of each year if the employer intended them to continue to apply, and since the employer did not, the employer was in breach of contract, and the employee was therefore entitled to consider the employment agreement terminated for breach by the employer.

According to the Cour de Cassation, the notification by the employee that he deems the contract terminated for breach by the employer has the same consequences in law as an unjust termination by the employer (licenciement sans cause réelle et sérieuse) and the court therefore required the employer to pay not only contractual notice and severance, but in addition compensation for unjust termination, which, because the company employed more than 11 persons and the employee had over 2 years seniority, must be no less than 6 months of salary.

It is therefore extremely important to document appropriately annual objectives in the context of variable compensation arrangements, and to do so on a timely basis, each year and prior to commencement of the period in which they are to apply.



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The most important provisions of the new draft Hungarian Labor Code

By: Dr. Szabolcs Hargittay and Dr. Zolt Füsthly

Füsthly & Mányai Law Office

Lajos u. 74-76
Budapest, BU H-1036
Hungary

+(36 1) 454 1766 phone
+(36 1) 454 1777 fax

shargittay@fusthlylawoffice.hu
zfusthly@fusthlylawoffice.hu
fusthlylawoffice.hu

The review of the main concept of the Hungarian Labor Code (hereinafter referred to as LC) has been on the agenda for years but no real progress was made. In the middle of June, the draft of the new act (hereinafter referred to as Proposal) was published on the website of the Ministry of National Economy.

The aim of the new LC is admittedly the flexibility of employment and the improvement of competitiveness. In line with these objectives, the Proposal increases the possibilities of the employer to support his market and production needs.

The Proposal changes the regulatory approach: many guarantee elements will lose their guarantee nature; divergence will be allowed through collective agreements or other agreements between the parties, while the current regulations allow changes only to the benefit of the employees and most of the provisions are mandatory.

This article collects the 10 most important and interesting changes that are the following:

1. Termination of employment relationship by the employer becomes easier

Under the current LC the reason for an ordinary dismissal by the employer must be real (objectively true), clear (should unambiguously reveal the reason of the dismissal) and reasonable (the reason of the dismissal must be linked to the fact that the work of the employee is not needed any longer). In the event of a dispute, the employer must prove the authenticity and substantiality of the reason for dismissal.

Pursuant to the Proposal, the reasoning must be clear, but the Proposal does not mention the employer having the burden of proof, therefore in case of a dispute the employee will have to prove that the dismissal was unfounded.





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2. Legal consequences of wrongful termination of employment relationship

Under the current regulations the legal consequence of a wrongful dismissal by the employer is the obligation of recovering the employment relationship, recovering unpaid wages with a deduction of the income from other sources and the recovery of losses and damages. Should the employee not request the recovery of his/her employment relationship or should the court not order it on the request of the employer, the employee is entitled to receive further 2-12 months' average wages.

Pursuant to the Proposal, in case the court decides that the termination of the employment relationship by the employer was wrongful, the employer will only be obliged to recover a payment for maximum 18 months' absence. The general principle does not allow the request for recovering the employment relationship; the reemployment of the employee is only mandatory if the termination of the employment relationship breached the requirement of equal treatment or if the employee is a trade union functionary, a member of the works council or the supervisory board.

3. Protection against dismissal is abolished

Under the current LC the employer must not terminate the employment relationship by ordinary dismissal, e.g. during the following periods:

- incapacity to work due to illness;
- for the period of sick leave for the purpose of caring for a sick child;
- during pregnancy, for three months after giving birth, or during maternity leave;
- leave of absence without pay for the purpose of nursing or caring for children.

Pursuant to the Proposal, the employer has the right to notify the employees on their dismissal during these periods too, and the notice period starts on the day after the end of the abovementioned periods.

4. Legal protection of employees in/close to retirement age is abolished

Under the current LC an employer is allowed to terminate the employees' employment relationship within the five-year period preceding the date of old age pension by ordinary dismissal only in particularly justified cases. The severance payment for such an employee increases by 3 months' average wages.

Pursuant to the Proposal, the employment relationship of employees in retirement age can be terminated without particularly justified reasons, as well, and the amount of severance payment is 1-3 months absentee pay in function of the active years.

5. The rules of extraordinary work duty are changed

Under the current LC an employee may be ordered to work in extraordinary work duty not more than two hundred hours in any given calendar year; or three hundred hours under collective agreement.

Pursuant to the Proposal the upper limit of extraordinary work duty is increased to 300 hours/year. According to the Proposal, with an annual leave of 4 weeks, 6.25 hours/week will be allowed for overtime.

6. Working time schedule

Under the current LC, unless otherwise provided by collective agreement, the work schedule shall be for at least one week and shall be made known at least seven days in advance.

Pursuant to the Proposal the working time schedule of a given day can be changed by the employer at least three days ahead in case of unforeseen events in production or operation.

7. Employer's liability for damages changes positively for employers

Under the current LC employers shall be subject to full liability for damages caused to employees in connection with their employment, regardless of accountability. An employer shall be relieved from liability if able to prove that the damage was caused by an unavoidable event outside his field of operations or solely by the unavoidable



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conduct of the aggrieved party. No liability shall apply for the portion of damage caused by the employees' negligence. The employer's field of operations shall particularly include the causes arising from the conduct related to the activities pursued by the employer in the course of his duties and from the characteristics, properties, movement and operation of the materials, equipment and energy involved.

Pursuant to the Proposal, the employer is relieved from liability if he can prove that the damage was caused by an event beyond his field of control, he did not have to predict and he was not expected to avoid the damaging condition or the damage. This will decrease the employer's liability, e.g. in case of work accidents.

8. The employee bears full liability for damages

Under the current LC employees shall be subject to liability for any and all damages caused by violation of employment-related obligations. In the event of causing damage by negligence, the amount of liability shall not exceed fifty per cent of the employees' average wages for one month. The employment contract and the collective agreement may specify the amount of liability as no more than one and a half months and no more than six months' average wages, respectively; no deviation from this provision shall be considered valid. Employees shall be subject to full liability for damages caused willfully.

According to the Proposal the employees bear full liability for the compensation of damages in case he/she does not proceed as generally expected, except in case the damage was not to be foreseen or if it was caused by wrongful behavior of the employer, or if the employer did not fulfill his duty to mitigate loss.

9. The supplement called „wage supplement for shift work” will disappear

Under the current LC employees shall be paid a fifteen per cent wage supplement for working in night shift. Employees working in alternating shift or in continuous shift shall be entitled to a 15 % afternoon or 30 % night shift supplement. Employees working in continuous shifts shall be entitled to an additional five per cent shift supplement for afternoon shifts, and an additional ten per cent shift supplement for night shifts.

From the regulations currently in force only the supplement for night shift will be retained as a 15 % supplement.

10. Break-time shall not be part of the working time

According to the proposal break-time shall not be part of the working time even if the collective agreement or the parties agree otherwise. This will result in an increase of the time to perform work and in an income loss through a decrease of the contracted working time and a potential proportional decrease of wages.

Summing up the foregoing the main goal of the Proposal is definitely to increase the flexibility of employment and the improvement of competitiveness. In our opinion this goal is achieved by the Proposal, however, there is a strong resistance against some of the rules of the Proposal in lots of spheres of the Hungarian society.

10 Basic Principles for Your Company's Social Media Policy

By: Noël P. Goudreau, Esq.

Kubasiak, Fylstra, Thorpe & Rotunno, P.C.

Two First National Plaza
20 South Clark Street, 29th Floor
Chicago, IL 60603
United States

312.630.9600 phone
312.63.07939 fax

ngoudreau@kftrlaw.com
kftrlaw.com

Social media is here to stay. Its pervasive nature means that even if your company chooses not to allow its employees to use social media or networking websites while at work or for work related purposes, your company will still need a policy in place to address issues which may fall within the social media domain, such as employees' personal use of social media. Such a policy is an absolute "must have" in this social media saturated environment. The policy should be company specific (i.e., not just off-the-shelf), contain specific definitions and examples, and detail what is, and what is not, permissible use by employees. This article discusses some basic principles which should be covered in your company's social media policy. Even if your company already has a policy in place, it may be worth reviewing your policy to see if it covers all the following principles.

1. Because your company's overall attitude towards social media usage will drive your social media policy, your company first needs to determine its social media philosophy. Management should meet to discuss the pros and cons of social media usage, what limitations

the company wants to impose on its employees, and the steps that would be necessary to monitor employees' usage. Once your company understands its philosophy, you can begin to formulate its social media policy.

2. Your company's policy should specifically define what constitutes "social media" or "social networking," so that there is no employee confusion about which activities the policy applies to and which it does not. It is generally best to define social media and networking as broadly as possible, encompassing all use of internet-based tools to interact with other people through text, images or sound. The policy should give some examples of what would be deemed social networking tools, such as Facebook, Flickr, LinkedIn, Twitter and YouTube.
3. Your policy should also state the parameters of employees' use of social media and networking sites, both at work and when representing the company online. If your company decides to disallow the use



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of specific websites during work time, the policy should list those sites, but make clear that any access to current websites is always subject to change at your company's discretion. The policy should include specific examples of acceptable and unacceptable usage, and should be updated regularly to address new technologies and websites. Your company should also retain the right to demand that employees retract communications and remove posts or comments which violate the policy.

4. The policy should clearly state whether an employee is allowed to identify herself as a representative of the employer. Your company should consider whether an employee should be prohibited from listing her affiliation with your company on social networking sites unless that employee is engaging in such networking for specific job related purposes. (These prohibitions, of course, need to be weighed against employees' rights under applicable laws, such as labor laws which protect an employee against retaliation and other unfair labor practices.) The policy should also provide which employees, if any, are allowed to create social media accounts on behalf of your company. If so allowed, then the policy should provide that all such accounts require pre-approval and possibly the use of disclaimers. The policy can also provide for content parameters or an approval process. If your company allows certain employees to create social media accounts on behalf of the company, you should seriously consider providing for employee training and education regarding the social media policy. Your company should periodically require these employees to affirm compliance with the company policy.
5. Many social sites allow for recommendations, referrals or testimonials. (This would include "liking" something on Facebook or choosing to "FAV" (favorite) someone's tweets.) If an employee who is representing your company online gives a recommendation, referral or testimonial, it may give the appearance that your company endorses the individual or product being discussed. This could create potential liability for your company if someone acts on an employee's recommendation, referral or testimonial, and is subsequently damaged by such action. For that reason, many policies prohibit employees from making recommendations, providing referrals or giving testimonials.
6. Your company relationships with its clients and customers are valuable assets which need to be protected. You don't want these relationships damaged by a negative comment or disclosure by an employee. For that reason, your company's policy should prohibit the disclosure of clients' and customers' names and the nature of those relationships, and should further prohibit employees from making references to clients or customers without first getting their consent.
7. Even if the company has other policies which address the disclosure of confidential or proprietary information, your company's social media policy should expressly prohibit the disclosure of such information (both yours' and your company's clients and customers). Employees must be warned against inadvertently disclosing such information, such as through a personally directed tweet or post. Employees must also be warned of the fact that any such confidential or proprietary information published on a third party's site may cease to be owned by the company, or may cause the company to be in breach of its own confidentiality obligations.



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8. Your company's social media policy should require that employees comply with all applicable laws, regulations and terms of usage. Employees should be made aware of copyright issues, libel, privacy matters and specific laws which may be applicable to your company's business.

9. Your policy should specifically address employees' misuse of social media and possible disciplinary measures, which should include termination. The disciplinary measures must be strictly enforced. Your company may wish to consider prohibiting employees who have disciplinary issues from using social media on behalf of the company.

10. Finally, the policy should make it very clear that employees have no privacy rights in any social media or social networking conducted at work, on company equipment or on behalf of the company.

Your company should regularly and actively monitor its employees' usage of social media and networking websites. Monitoring social media sites can be as simple as conducting a search and viewing content on the websites, or as involved as searching an employee's personal account if that account is accessed and/or stored on the company's computers or network.

A good social media policy will educate employees regarding permissible social media and networking usage, will influence employees to use social media and networking responsibly and thoughtfully, and will provide your company with a basis for enforcement against employee misconduct and with a defense against liability for online wrongdoing by employees.

Noël P. Goudreau is a partner at the law firm of KUBASIAK, FYLSTRA, THORPE & ROTUNNO., P.C., the Chicago, Illinois based firm of the Primerus Business Law Institute.

The Silver Bullet to Avoid Class Actions

By: Olivia Goodkin

Rutter Hobbs & Davidoff Incorporated

1901 Avenue of the Stars, Suite 1700
Los Angeles, CA 90067
United States

310.286.1700 phone
310.286.1728 fax

ogoodkin@rutterhobbs.com
rutterhobbs.com

One of the worst economic threats to companies today is the class action lawsuit. Class action lawsuits provide employees and former employees with a weapon for aggregating small individual claims into a large lawsuit that plaintiffs' lawyers are eager to pursue. These lawsuits are expensive to defend, and are rarely covered by employment practices insurance. Furthermore, until recently, agreements by employees to waive the right to bring class actions---and to instead arbitrate their individual claims---were against the law in several states, including California.

On April 27, 2011, the U.S. Supreme Court issued its opinion in *AT&T Mobility v. Concepcion*. The case discussed whether a consumer's arbitration agreement with a company such as AT&T could properly include a waiver of class-wide arbitration or lawsuits. The Court found that existing California law was preempted by the Federal Arbitration Act (FAA) and that, if an arbitration agreement subject to the provisions of the FAA was otherwise valid, a consumer could be forced to arbitrate his or her individual dispute without the benefit of the class action arsenal.

How can the AT&T Mobility decision affect employers?

The big question for employers is whether AT&T Mobility applies to arbitration agreements between employers and employees. Since I believe that it could, if the arbitration agreement otherwise meets all of the legal requirements in the governing state, this article explores how to best insulate a company from class action lawsuits, in addition to individual plaintiff lawsuits.

What are the advantages of arbitration?

For employers, the biggest advantage of binding arbitration is that a wrongful termination or discrimination case will not be decided by a jury of the employee's peers, but rather by a presumably less emotional and more sophisticated retired judge or experienced lawyer serving as an arbitrator. As a result, the decisions tend to be pro-employer. Even when employers lose in arbitration, the awards typically reflect realistic damages that may have been suffered by employees, rather than potentially larger jury verdicts. Furthermore, now that the Supreme Court has blessed





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the viability of a class-action waiver in an arbitration agreement, such an agreement has the ability to completely change the landscape of employment law, preventing “bet the company” type cases involving large groups of employees.

In addition, the arbitration and the proceedings leading up to it are private and out of the public spotlight. Arbitrations are scheduled at the parties’ convenience, in contrast to the scheduling of court cases, which are often continued from date to date according to the court’s ever-changing schedule. Finally, the cost of an arbitrated dispute typically is less than a litigated dispute, because there tends to be less discovery, fewer hearings, and no needless continuances of the trial date.

What are the disadvantages of arbitration?

The primary and significant disadvantage of binding arbitration is the lack of judicial review. If either party dislikes the award rendered by the arbitrator, by law a court can only review the decision on limited grounds. For example, a party may move to set aside the arbitrator’s decision if it comes to light that the arbitrator had a conflict of interest, or the process was tainted by fraud. The inability to appeal the award is critical, dissuading some employers from offering arbitration agreements to their employees.

Moreover, although the initial arbitration process is private, either party may seek judicial confirmation of the award. For instance, if the employee wins an award of damages, and the employer does not immediately pay the award, the employee may petition the court to convert the arbitrator’s decision into a judgment that can be enforced like any other judgment. Once a motion to enforce the arbitration award is filed, the privacy enjoyed by the employer during the arbitration process is eliminated.

Another potential disadvantage is the limited discovery that may be permitted. In certain cases, it is preferable to have a full breadth of discovery methods available. Finally, it may not be possible in an arbitration proceeding for an employer to move for summary judgment, which is a request that the decision maker find that the employee’s case does not state a claim under the law, even assuming there is no dispute as to the facts of the case. A motion for summary judgment in favor of the employer ends the case before the trial or arbitration.

What are the requirements for enforceable arbitration agreements?

An employer cannot require that every dispute be arbitrated. To be valid, arbitration agreements must be neither procedurally nor substantively unconscionable. The Supreme Court’s decision in *AT&T Mobility* did not change this requirement.

The law of the state in which the arbitration agreement is governed will dictate whether the agreement is unconscionable. In California, the legal requirements for enforceable employment arbitration agreements were set forth in the seminal California Supreme Court case of *Armendariz v. Foundation Health Psychcare Services, Inc.* Arbitration agreements in California must include five provisions:

1. The agreement must be mutual, meaning that both the employer and employee agree to arbitrate any disputes. Agreements that force the employee, but not the employer, to arbitrate are illegal. In addition, it is illegal for the agreement to allow only the employer to use the court system for obtaining injunctive relief, such as a temporary restraining order. Any “carve-out” from mandatory arbitration must be mutual.
2. The employer must pay for all arbitration costs that exceed any court fees the employee would have incurred. In essence, the employer must agree to pay the arbitration fees.
3. The arbitration agreement cannot cut off the right to discovery. The parties must have the right to conduct at least limited discovery, such as depositions of key witnesses and document productions.
4. The arbitrator must issue a written award that includes his or her essential findings and conclusions.
5. The arbitration agreement must allow the employee to be able to recover the same kind of damages that are available in court on the same legal claim. In other words, if the employee states a claim that would include a right to treble damages in court proceedings, then that remedy must be available in arbitration as well.



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It is likely that if an arbitration agreement includes the above safeguards against unconscionability, courts in most states would enforce the agreement. Additionally, employers should heed other court holdings and provide arbitration agreements in “stand alone” documents (rather than as part of an employee handbook), clearly labeling the agreement as an arbitration agreement and unequivocally stating that the employee is agreeing to mandatory and binding arbitration and waiving the right to a jury trial.

Finally, given that AT&T Mobility holds that class action waivers in arbitration agreements governed by the FAA are valid, in order to ensure the enforceability of such a waiver, your arbitration agreement must include a provision stating that the agreement is subject to the rules of the FAA.

Are some claims still not subject to arbitration?

Employers usually cannot require arbitration of claims for workers’ compensation benefits, unemployment insurance, or administrative charges (including harassment and discrimination claims) filed with certain state or federal agencies, such as the National Labor Relations Board.

Moreover, arbitration provisions cannot bar parties from filing a lawsuit in court seeking injunctive or declaratory relief to enforce trade secret agreements or enjoin unfair competition.

Final thoughts on arbitration agreements

Because resolving disputes by arbitration reduces litigation costs and exposure to major jury verdicts, we often recommend that employers have arbitration agreements with their employees. However, this advice is far from one-size-fits-all and some employers are reticent to put their fate in the hands of one decision maker with no right to appeal. Courts are beginning to grapple with the applicability of AT&T Mobility in the employment context, but there are few helpful opinions yet. If the decision is made to proceed with an arbitration agreement, make sure that both procedural and substantive requirements are addressed so that the agreement is enforceable.

Technology in the 21st Century: Protecting Confidential Information

By: Frank E. Melton

Rutter Hobbs & Davidoff Incorporated

1901 Avenue of the Stars, Suite 1700
Los Angeles, CA 90067
United States

310.286.1700 phone
310.286.1728 fax

fmelton@rutterhobbs.com
rutterhobbs.com

Technology's effect on how people work and communicate is making it increasingly difficult for employers to protect their vital, confidential information. The proliferation of PDA's, laptops, telecommuting, zip drives and social media makes confidential information readily accessible to employees virtually anywhere, anytime. As a result, employers must focus more than ever on what information is important, and act diligently and vigilantly to protect it.

The following key tips will help employers to protect their information in today's mobile society:

Be tactical and focused. No company has the time or resources to monitor and track the actions of every current and former employee with respect to the use of confidential business information. The challenge of protecting vital information is even greater for middle market and smaller employers. Company leaders should determine what types of information are most important to protect, and then develop and implement a strategy with IT, HR and legal counsel focused on those employees who have access to that information.

Have clear, enforceable agreements. It is not enough to have a general policy on confidential information in your employee handbook or, even worse, to fail to define what you consider to be confidential, proprietary or trade secret information. Employers should have signed agreements with employees – and all consultants and independent contractors – specifically stating what information and categories of information are to be protected. Enforcement mechanisms, such as injunctive relief and recovery of attorneys' fees and costs for the prevailing party, should also be addressed. Consider including narrowly-drafted restrictive covenants prohibiting departing employees for a reasonable period (such as a year) from using confidential information to solicit customers and/or employees. While non-competition covenants are illegal and unenforceable in California except in the context of a sale of a business, they may be enforced outside of California if considered reasonable under laws of the state where the employee works.



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Technology in the 21st Century: Protecting Confidential Information

Communicate with your employees. Employees should not have any real doubt as to what data or documents they are barred from taking upon termination of employment. You should have clear written policies and conduct meetings or trainings from time to time to protect your company's confidential information. In many instances, employers also need to take actions to protect private or proprietary information of their customers, clients or business partners. As an example, many non-profits fail to communicate with employees about the importance of protecting confidential or private information about donors, plans and strategies, and the people they serve.

Be proactive. Employees are increasingly purchasing their own mobile devices, such as I-phones, for combined business and personal use. Companies should address whether to access business data on such devices when employees leave, especially when some information may not be preserved on the company servers. The same holds true for employee-owned computers and home printer memory cards that may contain vital business data when an employee leaves the company. Where feasible, employers should limit access to especially sensitive business plans or data to those key employees with a real need to know this type of information, and reiterate to those employees the confidential nature of the information.

Adhere to strong exit procedures. Problems commonly arise when employers do not take proper steps at the time employees exit. Employers should meet with each terminating employee to review an exit checklist, ideally including an inventory and check-in of the electronic devices and property with which the employee has been entrusted. Employees should be required to certify in writing that they have returned all property and confidential information, and to re-affirm that they will abide by their agreement with the company to preserve and not use the company's confidential information in the future.

Strategic post-termination actions. In the event of a real suspicion or concern about the theft or misuse of company data, employers should be savvy and tactical about their follow-up actions post employee termination. Cease and desist letters are commonly an initial step. The likelihood of success, effects on customer relationships, expense, and other business and legal issues should be considered before filing a lawsuit, which commonly proceeds quickly through expedited discovery to a motion for a preliminary injunction. Using a quality and reasonably-priced computer forensic firm to discover what information was improperly taken and used may be invaluable in assessing whether to file the lawsuit and in gathering evidence for such an action.

Employers can benefit greatly from the convenience and far-reaching range of mobile communication, but must take the necessary precautions to prevent confidentiality and privacy breaches from outweighing the advantages of such technology.

US Supreme Court Ruling Likely to Further Increase Retaliation Claims

By: Keith Sieczkowski

Branscomb, PC

802 N. Carancahua, Suite 1900
Corpus Christi, Texas 78470

361.888.9261 phone

361.888.8504 fax

ksieczkowski@branscombpc.com

branscombpc.com

Employers face increased exposure to retaliation claims in the wake of another recent U.S. Supreme Court ruling expanding which employees are protected under Title VII's retaliation provisions.

Title VII prohibits employers from discriminating on the basis of race, color, sex, national origin and religion. It also prohibits employers from retaliating against "employees or applicants ... because [the employee or applicant] has opposed any ... unlawful employment practice ..., made a charge, testified, assisted, or participated in any manner in any investigation, proceeding, or hearing under this subchapter."

Based on this language, courts have limited Title VII retaliation claims to only persons who actually engage in one of the enumerated protected activities found in the statute. Consequently, if an employee experienced some negative action by an employer because of his/her relationship with someone who engaged in protected activity, a claim of retaliation was often disallowed because the aggrieved employee did not actually participate in any

enumerated protected activity. This is the situation reviewed in the recent decision of *Thompson v. North American Stainless, L.P.*, 131 S. Ct. 863 (2011).

Thompson and his fiancé both worked for the same employer. Shortly after Thompson's fiancé filed a charge alleging sex discrimination against their joint employer, Thompson was fired, allegedly in retaliation for his fiancé's protected activity. The district court and the court of appeals dismissed Thompson's retaliation claim because, although Thompson may have suffered an adverse employment action, he did not engage in any of the protected activities enumerated in the statute. That is, the retaliation was not because he opposed any practice, filed a charge or assisted in any investigation.

The Supreme Court reversed. The Court concluded there is no doubt that if the facts as alleged are true, Thompson was a victim of retaliation because of his fiancé's protected conduct. More importantly, the Court determined that retaliation claims are not limited to those who actually engage in the protected conduct. Instead, so long as the person allegedly retaliated against is within the "zone



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of interest” with respect to the person who did engage in protected activity, he or she may establish a claim of retaliation under Title VII as a “person aggrieved.”

Absent from the decision is any clear guidance as to what the “zone of interest” is for asserting retaliation claims. Instead, the Court announced that “any plaintiff with an interest “arguably [sought] to be protected” may be able to assert a retaliation claim. On the other hand, if a person’s interests are “so marginally related to or inconsistent with” the statute, he or she will be outside the zone of interest for protection.

Although these precise parameters will undoubtedly be the subject of refinement by courts, it appears that nearly any co-employee with a relationship to a person who engages in protected activity may be able to claim retaliation for an adverse employment decision, even if he or she never engages in any of the activities listed in the statute. Effectively, a person who engages in protected activity cloaks those with whom he or she has a relationship within Title VII’s protective shield.

The *Thompson* decision marks the second recent decision of the U.S. Supreme Court expanding retaliation claims under Title VII. In *Burlington N. & S.F.R. Co. v. White*, 548 U.S. 53 (2006), the Court held that retaliation can take many forms and is not limited to “ultimate employment” decisions. Instead, any action that might dissuade a reasonable worker from making or supporting a charge could be considered retaliatory. After *Burlington*, the number of retaliation claims expanded significantly.

As a result of both of these cases, employers must be vigilant to ensure all employment-related decisions are supportable against claims of discrimination or retaliation.

Keith Sieczkowski is the senior labor and employment lawyer at Branscomb, PC, a Corpus Christi-based law firm providing solutions for businesses, executives and families with tax, real estate, oil and gas, estate planning, probate, corporate, employment and litigation matters.

Japanese Labor Update

By: Genta Irie

Hayabusa Asuka

4th Floor, Kasumigaseki Building 3-2-5

Kasumigaseki, Chiyoda-ku

Tokyo, JP 100-6004

Japan

+81-(3)-3595-7070 phone

+81-(3)-3595-7105 fax

genta.irie@halaw.jp

halaw.jp

I. “Abuse of Dismissal Right” Principle

Under Japanese labor law, an employer does not have the freedom to dismiss employees at will. An employer must have “objectively reasonable grounds which are approved by the society as a proper act, in order to dismiss an employee whose contract term is unfixed.” Otherwise, the dismissal will be considered an abuse of the employer’s right of dismissal and therefore be invalid. This principle is called the “abuse of dismissal right” principle.

II. Transfer as Alternative to Dismissal

In order to ensure the quality of their management conditions, many corporations prefer to dismiss employees with poor performance. However, dismissal on the sole basis of a person’s poor performance is not valid under the “abuse of dismissal right” principle.

When an employer cannot dismiss an employee, the employer might then consider utilizing the employee in other departments, branches, subsidiaries or affiliates, if available. In view of the restrictions on freedom of dismissal in Japan, such “transfer” tends to be considered acceptable under the law.

III. Contract as not Employment

As little flexibility is allowed at the termination stage as mentioned above, employers often seek flexibility at the stage of entering a contract. Since the “abuse of dismissal right” principle only applies to an “employee,” employers prefer to obtain labor by contracts that are not “employment contracts”; namely, by hiring persons through other types of contracts. However, if the actual nature of the relationship is that of an employment relationship in reality, the court could view such contract as an “employment contract.”

IV. Conclusion

In these recessionary times, we have been involved in many complicated cases which need careful consideration. Since social conditions are becoming more complicated, employers should definitely consider consulting legal professionals at an early stage. This will be the most effective way for employers to achieve their labor



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Why a “Double Dip” Threatens More Than “Double Trouble” for Unwary Businesses

By: Stephen D. R. Taylor

Kohner, Mann & Kailas, S.C.

Washington Building, Barnabas Business Center
4650 N. Port Washington Road
Milwaukee, Wisconsin 53212

414.962.5110 phone
414.962.8725 fax

ckailas@kmksc.com
kmksc.com

We have all heard the uncertain economic news over the recent weeks, including talk of the possibility of a “double dip” recession. “That is when the economy slips back into a recession while still trying to recover from the last one.” Stephen Gandel, “*Is a Double Dip Becoming More Likely?*” Time, June 8, 2011. Though it is too early to tell whether we are in another economic downturn, many organizations are following accounts receivable policies that appear to be a gamble that we are not. This article explains why *this may be a big mistake in view of the true significance of the stakes involved*.

In addition to the turmoil in global markets and sovereign debt ratings, recent domestic economic news has not been positive. The consensus appears to be that the housing market is already experiencing a “double-dip” decline in prices. The market values of residential properties have returned to those of 2002, their lowest level in a decade. 2011 is on target to be the worst year for home sales since records began. Unemployment claims, recently a bright spot, have risen again. On average, joblessness now lasts more than nine months and is longer than at any time since recordkeeping began in 1948. Manufacturing

activity in the upper-Midwest has unexpectedly declined and consumer confidence ratings have been falling. Results from a recent survey of expectations conducted by the Philadelphia Federal Reserve Bank were consistent with a second recession, lasting into 2012.

“Double-dip” recessions produce perils and dangers for businesses. Investopedia cites a “double-dip” as being “a worst-case scenario.” The brief period of growth between “dips” means that most businesses and consumers will not have the time to replenish their reserves. Few will doubt the impact of the recent recession. A renewed period of austerity can further strain the already depleted resources of many businesses and their customers.

The sucker punch is the legacy of the brief positive spell before the renewed downturn. When businesses see a potential upturn, they tend to start expanding inventory and investing in equipment and labor. After all, one cannot take advantage of rising demand without the means to satisfy it. If a double dip does strike, such businesses are left with increased accounts payable and overhead, and depleted reserves, but without the necessary ability to generate sales and profits.





Why a “Double Dip” Threatens More Than “Double Trouble” for Unwary Businesses

The result is that business debt increases and becomes delinquent, and debt recovery rates fall. In such circumstances, the early bird gets the worm. Businesses that allow customers to extend payment periods risk extending delinquencies into dangerous waters. When reserves are down and liabilities are up, only those creditors that enforce payment of delinquencies get paid. Since business creditors themselves owe debts to others, if their receivables erode, so does their working capital, along with their ability to service their own obligations, all of which perpetuates the cycle of decline.

It is concerning that the debt liquidation industry is reporting that too many businesses have neglected and relaxed their focus on debt collection because the economic news briefly brightened somewhat at the beginning of 2011. Many continue to delay acting to recover on delinquent accounts, despite recent poor economic news. Though double dip recessions are rare (the last occurred in the early 1980s), most analysts hold that the balance of probabilities is that the current problems reflect the prospects of a slowdown in growth, if not a return to actual shrinkage of the economy. Nobody knows for certain, *but a prolonged slowdown could prove as perilous for businesses as a “double dip.”*

To preserve the value of the strategic business capital represented by outstanding delinquent accounts receivable, businesses should act with dispatch whenever a customer is not reasonably servicing payment of an account balance.

Stephen D. R. Taylor, Kohner Mann & Kailas, S.C.
staylor@kmksc.com

Prior to becoming an attorney with Kohner, Mann & Kailas, S.C., Stephen Taylor was a businessman and venture capitalist who focused on business strategy, primarily in the information technology field. Mr. Taylor advises businesses on how to manage electronic information to protect their interests in the event of litigation, and on the conduct of electronic discovery. He also provides transactional and strategic support to businesses involved in trading across international and cultural boundaries and in identifying effective dispute resolution strategies arising out of such activities. An American attorney, Stephen also holds an MBA and Bachelor's degrees in both International Trade and Politics & International Relations from British universities.

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Founded in 1937, KMKSC is a business and commercial law firm. KMKSC provides quality legal expertise across the areas of law encountered by businesses in the course of their operations and growth. Our services range from high-profile appellate representation and international business issues to ensuring that critical everyday needs, such as debt recovery, are fulfilled efficiently and expertly. Our purpose is to deliver excellent results for our clients, whether the issue is advice on the avoidance of legal disputes, closing a transaction, protecting assets or winning in court. KMKSC is continually advancing the interests of its clients in negotiations, transactions, litigation and alternative dispute forums across North American and beyond. We help U.S. companies address the legal issues raised by trading across international borders and provide legal support and advice to foreign companies operating in American markets.

Leniency Policy in Competition Law

By: Christopher C. Kailas and Stephen D.R. Taylor

Kohner, Mann & Kailas, S.C.

Washington Building, Barnabas Business Center
4650 N. Port Washington Road
Milwaukee, Wisconsin 53212

414.962.5110 phone

414.962.8725 fax

ckailas@kmksc.com

staylor@kmksc.com

kmksc.com

Recovering debt from commercial creditors located in the United States is supposedly particularly problematic. This is an odd notion when one considers that U.S. businesses recover debt every day. Unfortunately, overseas creditors are often unaware of the solution that many U.S. businesses choose.

The Source of Confusion

The U.S. comprises 55 distinct legal systems: the federal system and those of each state and territory. Attorneys are admitted to practice by a state bar, which does not grant the right to practice in other states; most attorneys are admitted in only one state. Federal jurisdiction is limited in scope, with state law determining many issues, including contracts, even if federal jurisdiction is available.

Bankruptcy, however, is a federal matter. The result can be a bewildering choice of venue, law and procedure, and the choices made can significantly impact the cost and likelihood of success. Sometimes a dispute can require action in state and federal courts, and actual recovery may require recognition by another jurisdiction where assets are located.

Common Responses

Four alternatives are often considered by creditors outside the U.S.:

- Submit a claim to a collection agency for collection, but write off the debt if amicable collection fails.
- As above, but allow the non-lawyer collector to select a lawyer licensed in the place(s) where suit must be brought.
- Personally engage individual collection lawyers in each jurisdiction where representation becomes necessary.
- Retain a mega law firm with offices and attorneys throughout the U.S.

Unfortunately, each of these has drawbacks:

- Writing off debt whenever non-lawyer collection fails produces unnecessary losses.
- Relying on a collector to choose local counsel entrusts complex, strategic legal choices of venue, law and other critical issues to non-lawyers.





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- Retaining law firms across the U.S. on an ad hoc basis is both time consuming and costly to manage.
- Large law firms typically have a cost base that filters through into higher fees.

The Alternative: National Practice Commercial Law Firms

U.S. law firms that focus on liquidating debt are called commercial law firms. In loose terms, these are hybrid law-and-collection operations. Hybrid firms differ from most law firms in that they handle large volumes of claims and employ non-lawyer collectors in addition to dedicated collection attorneys and commercial litigators. Significantly, they offer success-related fee options, allaying the cost fears overseas companies often associate with U.S. law firms.

Such firms represent a one-stop resource able to manage all commercial debt recoveries in the U.S., for both creditors and collection houses. Despite typically having few offices, hybrid firms have acquired a multistate capacity to collect delinquent debts through the following:

- A long-established network of local collection counsel across the United States.
- A strong record of collection recoveries throughout the U.S., with and without legal action.
- A U.S.-wide client base.
- A significant practice in associated areas of business litigation and transactional law, including bankruptcy.

While these firms often secure out-of-court resolutions, regular activity in multiple jurisdictions supplies the current knowledge essential to making the best decisions on issues that can be dispositive should court action be required.

What to Look For

Before obtaining verifiable client references, look for evidence of the above characteristics. In addition, remember that good U.S. lawyers are expected to publish, so review websites for articles related to collection, contract documentation and enforcement, and the differences between U.S. practices and those of other legal systems. Transnational legal advice needs to identify and address such differences if costs and misunderstandings are to be avoided.

Christopher Kailas heads the attorneys and collectors of KMK Collections, a division of Kohner, Mann & Kailas, S.C. He leads the recovery of commercial debt and assets from debtors located throughout North America. He manages a network of over 150 local associate counsel throughout North America and coordinates the sharing of legal information and tactical insights within the network.

Stephen Taylor is a British national with nearly two decades of experience in business and financial management, including establishing operations, markets and revenues in the United States. An attorney, he holds a diploma in international trade from the UK Institute of Export and an MBA from the University of Surrey. His practice with Kohner, Mann & Kailas, S.C. focuses on international business and transactions.

IRA Investment in Real Estate

By: Stephen L. Smith

Horack, Talley, Pharr & Lowndes, P.A.

2600 One Wachovia Center
301 South College Street
Charlotte, NC 28202
United States

704.377.2500 phone
704.372-2619 fax

ssmith@horacktalley.com
horacktalley.com

Introduction

As it has become obvious in the last few years that we cannot depend on social security and investments in the stock market for our retirement, I have become more interested in IRA investment in real estate. Even if investment in real estate is not totally the answer for you, it at least provides some diversification from investments in the stock market. The same general concepts also apply to 401(k) plan account investments in real estate but with some additional complications and opportunities.

Allowable Investments in your IRA or Other Qualified Plan

What Can I Invest In?

Given the ups and downs of the stock market and a growing concern about whether individuals will have enough to retire comfortably on, the question naturally arises as to what a person's 401(k), IRA, SEP, or other qualified plan can be invested in. The question is particularly pertinent because

many of us have such a large portion of our savings in IRAs and qualified plans of one sort or another.

The way the rules are laid out, the real question is what can I not invest in rather than what can I invest in because the answer is your IRA or qualified plan can invest in anything with three specific exceptions. There is not any specific rule in the Internal Revenue Code as to what an IRA or qualified plan can invest in. Rather you will only see rules specifying what they cannot invest in. IRS Publication 590 provides some help, but it is by no means clear.

What Can I Not Invest In?

There are three specific items in which you cannot or should not invest your IRA, as follows:

1. A life insurance policy on the life of the IRA owner.
2. Collectibles, with certain exceptions.
3. Subchapter S corporation stock.





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Each of these three items is discussed below.

What is the Limitation on Investment in Life Insurance?

Code §408(a)(3) specifically provides that no part of an IRA's funds will be invested in life insurance contracts. Code §408(e)(5) also deals specifically with investment in endowment contracts and provides that any life insurance element in an endowment contract is to be treated as distributed to the IRA owner.

While the prohibition on investments in life insurance does not carry over to qualified plans, often plan documents do not allow for investment in life insurance or will allow for only limited investment in life insurance. Moreover, the content of the prototype plan documents must be approved by the IRS, so as a practical matter, you may be restricted on investment in life insurance in qualified plans as well. You will need to check your plan documents or consult with your trustee or custodian.

What are Collectibles and What are the Consequences of Investing in Them?

Code §408(m)(2) provides the following are collectibles: works of art, rugs, antiques, metals (except as provided below with respect to certain coins), gems, stamps, alcoholic beverages (e.g., vintage wines), musical instruments, historical objects (such as document or clothes), most coins (see below), and other items of tangible personal property that the IRS determines are collectibles. Code §408(m)(3) provides an exception allowing investments in one, one-half, one-quarter, or one-tenth ounce U.S. gold coins or one ounce silver coins minted by the Treasury Department as well as certain platinum coins and certain gold, silver, palladium, and platinum bullion.

Code §408(n)(1) provides that an investment in a collectible is regarded as being distributed to the IRA owner at its fair market value in the year of the investment. This can mean ordinary income arises in an amount equal to the fair market value. In addition, if the IRA owner is under age 59½, Code §72(t)(1) subjects the "deemed distribution" to a 10% additional tax based on the value of the collectibles. Code §408(m)(1) extends this prohibition on investments in collectibles into the qualified plan area.

What is the Issue on Investment in Subchapter S Corporation Stock?

There is not actually a prohibition against your IRA investing in the stock of a S corporation. However, if you do invest the IRA in S corporation stock, the corporation will be disqualified under Subchapter S and will become a taxable corporation under Subchapter C, because only certain types of trusts can qualify to own S corporation stock. An IRA does not qualify as an allowable trust. See Code §1361(c)(2), and Revenue Ruling 92-73. While this may not impact you, particularly if the only stock in the corporation you hold is through your IRA which is generally exempt from income tax (with the exception of unrelated business taxable income as discussed elsewhere), the other stockholders will be likely to be very unhappy if your IRA's investment terminates the qualification for Subchapter S status for all of them.

Code §1361(c)(6) provides that §401 qualified plan trusts are eligible to hold Subchapter S corporation stock. However, because plan administrators usually have little interest in investing in closely held companies, the ability of a 401(k) plan to invest in stock of S corporations may be more theoretical than real.

Can I Invest in Real Estate?

Because real estate is not on the list of three things you cannot or should not invest in, absolutely you can invest in real estate. You can not only invest directly in various types of real estate, but also in debt obligations secured by real estate or in entities (such as a limited liability company) investing in real estate. The only caution here is that you need to be aware of the prohibited transaction rules, the taxability of unrelated debt financed income and the Plan Asset Rules, which are discussed below.

Why Have I Not Heard About This?

The simple answer is that most of the traditional trustees and custodians of IRAs and other qualified plans are banks, brokerage firms and similar institutions which do not traditionally focus on real estate investments. It has always been easier for them to recommend stock, bond and mutual fund investments rather than dealing with real estate investments. We also understand from several of the companies that do provide services as custodians allowing your IRA to invest in real estate that having to handle the



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necessary paperwork to allow for real estate investments is simply less profitable for the custodians and trustees so they tend to stay away from talking to you about those possible investments.

Conversion to Roth IRA

As you doubtless have heard, regular IRAs (as well as 401(k)s) of even high wage earners can now be converted into Roth IRAs. This article does not discuss such conversions because much has been written about it, but clearly the conversion option available for IRAs and 401(k)s heightens the interest in real estate investment as an alternative to traditional investments available to IRAs and 401(k)s.

Prohibited Transactions and Disqualified Persons

The purpose of these rules is essentially to keep you and various persons related or affiliated with you from doing business with your IRA or other qualified plan to the advantage of either you (or the affiliated person) or the IRA or qualified plan. The IRS's concern is that you somehow gain a personal advantage by reason of the participation by your IRA or other qualified plan in an investment that is regarded as a prohibited transaction. Conversely, the IRS is also concerned that your IRA or qualified plan is benefiting from your efforts in a way that the IRS would argue is an excess contribution to your IRA or qualified plan.

What if I Benefit my IRA?

While the main thrust of this section is the prohibited transaction rules where you or some other disqualified person benefit from doing business with your IRA or qualified plan, you also need to be aware of the reverse side of this. That is, if you are doing things that benefit your IRA or qualified plan investments, your efforts (even if not compensated) may be regarded as excess contributions because you are adding value to the investments that would have to be paid for by your IRA or qualified plan absent your efforts. Moreover, your providing services that benefit your IRA would constitute a contribution to the IRA other than cash, which is prohibited.

While the Internal Revenue Code contains fairly liberal self correction options for excess contributions to an IRA,

those involve a withdrawal of the excess contribution before the due date (including extensions) for the filing of the IRA owner's tax return for the year of the excess contribution, as well as a distribution of the excess amount and any earnings together with a requirement that the excess contribution not be deducted on the IRA owner's tax return. The problem with indirect benefits to the IRA is that the owner may have no idea that he or she has made an excess contribution for a particular taxable year until years later when the IRA is looked at for some other reason. In that case, the usual self corrective procedures which may be relatively painless are no longer available. See Code §408(d)(5) for the general rule on distribution of excess contributions.

Why Should I Care About the Prohibited Transactions Rules?

The reason you should care is because the consequences of violating the prohibited transaction rules are fairly drastic. Code §408(e)(2) provides that if you or your beneficiary engage in a prohibited transaction with respect to your IRA or qualified plan, you risk disqualifying the IRA or qualified plan, which would mean that the fair market value of all of the plan assets would become taxable to you immediately. In addition, if you are under age 59½, Code §72(t)(1) provides an additional 10% tax on the deemed distribution.

Moreover, if it is a disqualified person other than you violates the prohibited transaction rules, there will be penalties imposed on that person. Code §4975(a) provides for a 15% tax on the amount of the prohibited transaction, and Code §4975(b) provides a further 100% additional tax if the prohibited transaction is not corrected. Code §4975(c)(3) provides that the IRA owner and its beneficiaries are exempt from the tax on prohibited transactions if by reason of the transaction the IRA ceases to be qualified with the results described in the prior paragraph of an immediate distribution of the entire value of the IRA.

In a worst case scenario, your causing your IRA to enter into a prohibited transaction with some other disqualified person can result not only in your IRA being disqualified and your having to pay tax on the "deemed distribution" of your IRA to you (together with possibly the 10% additional tax if you are under age 59½), but also the other person being subject to the 15% and possible 100% additional taxes.



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The historic response to these issues has been for the IRA or qualified plan to invest in an LLC or other entity that then acquires the desired investment asset. The theory was that it was only the ownership interest in the entity that was an asset of the plan, and that the entity's investing in real estate could avoid many of these rules because you would be doing business with the entity rather than with your IRA or qualified plan. While under 29 C.F.R. §2510.3-101(h)(3) it is clear that if your IRA owns 100% of an entity you cannot do business freely with the entity, it was often thought that if the ownership was less than 100%, you could use the LLC or other entity to avoid many of the restrictive prohibited transaction rules, at least if the entity were regarded as an operating company. However, this approach has its own set of issues as discussed below in the section captioned "Investing through Entities: The Plan Asset Rules and Rollins and Its Offspring." In other words, simply entering into an investment through an LLC or other entity in which your IRA or qualified plan owns less than 50% of the ownership interest is not a cure all with respect to the prohibited transactions rules.

Who Are Disqualified Persons?

The following is a list of persons who are generally disqualified persons:

1. You, under Code §4975(c)(3) and §4975(e)(2)(A) and by reason of the IRA owner being a disqualified person as a fiduciary. See Department of Labor Opinion Letter, 2000-10A. Although this is not totally clear, the IRA owner is a disqualified person because he or she is regarded as a fiduciary with respect to his or her Plan.
2. The beneficiary of your IRA or qualified plan under Code §4975(c)(3);
3. Various persons related to you, including your spouse, your parents and other ancestors, your children and other descendants and the spouses of your children and other descendants under Code §4975(a)(2)(F) and §4975(e)(6);
4. The trustee, custodian or other fiduciary of your IRA or qualified plan under Code §4975(e)(2)(A);
5. Your employer under Code §4975 (e)(2)(C);
6. A 10% or more partner in your employer if your employer is a partnership which maintains the plan under Code §4975 (e)(2)(I);
7. An officer, director, 10% or more shareholders or a highly compensated employee of your employer under Code §4975(e)(2)(H);
8. A person providing services to your IRA or plan under §4975(f)(2)(B); and
9. Under Code §4975(f)(2)(G), a corporation, partnership, trust or estate in which you or any other disqualified person owns directly or indirectly at least 50% of the following, as applicable:
 - (a) The total voting stock or the value of all stock of a corporation;
 - (b) The capital interest or profits interest in a partnership; or
 - (c) A beneficial interest in a trust or estate.

That is a fairly broad net, but does not pick up your brothers and sisters or persons who are truly unrelated to you and your plan. Because the consequences of violating the prohibited transactions rules are so significant, transactions with disqualified persons must be avoided.

What Are Prohibited Transactions?

Code §4975(c)(1) provides that the following transactions between you or some other disqualified person and your IRA or other qualified plan are prohibited transactions:

1. Borrowing money from the plan;
2. Selling property to the plan;
3. Buying property from the plan;
4. Leasing property to or from the plan;
5. Receiving unreasonable compensation for managing the plan;
6. Using the plan assets as security for a loan;
7. Lending money to the plan;
8. Furnishing goods, services or facilities to the plan;
9. Buying property for personal use with plan funds;
10. Self dealing with the plan assets by any fiduciary of the plan;
11. The receipt of consideration by a fiduciary or any party dealing with the plan in connection with a transaction involving the assets or income of the plan (i.e., a kick-back).



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Code §4975(c)(2) and ERISA §408 provide a handful of exemptions from these rules. While many of them are not very helpful in the real world, a few of them might apply:

1. There is an exemption if you or a disqualified person receive a benefit to which you are entitled as plan participant or beneficiary, as long as the benefits are determined and paid under the same terms as for all other participants and beneficiaries.
2. Loans from a 401(k) or other qualified plans are exempt if they (i) are payable to all participants and beneficiaries on a reasonably equivalent basis, (ii) are not made available to highly compensated employees, officers or shareholders in an amount greater than that made available to other employees, (iii) are made in accordance with specific provisions set forth in the plan document; (iv) bear a reasonable rate of interest and (v) are adequately secured.
3. A reasonable arrangement made with a disqualified person for office space or legal or accounting or other services necessary for the establishment or operation of the plan if no more than reasonable compensation is paid.

The bottom line is that any transaction between your IRA or qualified plan and the whole myriad of disqualified persons listed above risks running afoul of the prohibited transactions rules, which can have drastic consequences.

Investment Through Entities: The Plan Asset Rules and Rollins and Its Offspring

What if I do Business with an Entity Owned by the Plan?

All of the prohibited transactions rules literally deal with transactions between you or some other disqualified persons and the assets of your plan. If the plan assets include, for example, ownership of less than a 100% interest in a limited liability company (“LLC”) which in turn owns a real estate asset, the question may arise whether you can do business with the LLC since it is only the ownership interest in the company that is the asset of the plan, not the underlying assets of the LLC.

Unfortunately, there is a set of rules dealing with this general subject called the “Plan Asset Rules.” The plan asset rules are set forth in 29 Code of Federal Regulations §2510.3-101, which is referred to as Department of Labor Regulation §2510.3-101. All references herein are to provisions of 29 CFR §2510.3-101, which are regulations issued by the Department of Labor pursuant to the Employee Income Security Act (“ERISA”).

In addition to the IRS rules, there are Department of Labor rules promulgated under Title I of ERISA. Although IRAs are not literally subject to ERISA, there is a DOL opinion letter that states that IRAs are subject to the Plan Asset Rules. Everyone now accepts that IRAs are subject to such rules.

What Are the Plan Asset Rules?

The Plan Asset Rules are convoluted in that they state that the assets of an entity in which a qualified plan invests are not viewed as assets of the plan itself. However, the rules carve out an exception that basically provides that if a qualified plan invests in an equity interest of an entity, and that interest is neither a publicly held security nor a security issued by an investment company registered under the Investment Company Act of 1940, the plan’s assets include both the equity interest and an undivided interest in each underlying asset of the entity unless (i) the entity is an operating company, or (ii) equity participation in the entity by plan investors is not significant. See §2510.3-101(a)(2)(ii). Since most of the investments we encounter are not investments in publicly held securities or securities issued by an investment company registered under the Investment Company Act of 1940, these two exceptions from the general rule are crucial.

Unless you fall within one of these two exceptions to the Plan Asset Rules, your IRA or other qualified plan will be regarded as owing a pro rata percentage of the underlying assets of any entity in which the plan invests. For example, if you are subject to the Plan Asset Rules and your IRA owns a 25% interest in an LLC owning a shopping center, your IRA will be treated as owning 25% of the shopping center. If you or some other disqualified person does business with the LLC with respect to the shopping center (such as someone taking a commission on the sale of the center), you and your IRA will violate the prohibited transactions rules.



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What is the Exception for Participation Not Being Significant?

Equity participation in the entity by benefit plan investors will not be significant under §2510.3-101(f) if your IRA or other qualified plan together with other benefit plan investors own less than 25% of any class of the entity's equity interests. "Benefit plan investors" include virtually any sort of employee benefit plan, whether or not covered by ERISA, including IRAs. The Pension Protection Act of 2006 modified the definition of benefit plan investors but basically only excludes certain foreign plans and government plans so it has very little practical effect on normal IRA or 401(k) plans. In calculating this 25%, §2510.3-101(f)(1) eliminates from the total ownership of the entity any interest held by a person who has discretionary authority and control of the assets of the entity. Clearly if you are a manager of an LLC in which your plan owns an interest, you get picked up by this rule. You also would likely get picked up by this rule if you were simply a member of an LLC in which your plan is also a member with some voting rights or have some practical control over the entity.

For example, if you are an investor in an LLC and your IRA together with other benefit plans own 24% of the membership interests in the LLC and you own 20% directly, the participation by benefit plan investors is significant because the 24% held by the plan investors represents 30% of the value of the class exclusive of the 20% you own directly (i.e., 24% of 80%), which exceeds 25%. This rule aggregates the ownership interests of all benefit plan investors even if the investors are unrelated to each other.

What is the Exception for an Operating Company?

If you do not fall within the exception for participation not being significant, you have to look at the exception for an operating company. Under §2510.3-101(c), there are three types of operating companies:

1. A basic operating company, which is an entity primarily engaged, directly or through majority owned subsidiaries, in the production or sale of a product or service other than the investment of capital. This exception is unlikely to apply in most cases.
2. A venture capital operating company, which must satisfy two requirements:
 - First, at least 50% of the entity's assets (valued at cost) must be invested in venture capital investments or derivative investments; and
 - Second, the entity must actually exercise management rights in connection with one or more of its operating company investments.This exception also probably does not apply to most situations.
3. Third, a real estate operating company, which is an LLC or other entity that meets two conditions:
 - First, at least 50% of its assets (valued at cost) must be invested in real estate that is managed or developed and with respect to which such entity has the right to substantially participate directly in the management or development activities; and
 - Second, the entity must be directly engaged in real estate management or development activities in the ordinary course of its business.

There are a great many rules for this exception together with a number of examples in the DOL Regulations.

Why the Concern with the Rollins Decisions and DOL Opinion 2006 01A?

Many people had assumed that as long as an IRA or qualified plan owns less than 50% of an entity, it is permissible for the plan owner to do business with the entity as long as it did not fall within the Plan Asset Rules. However, in *Joseph R. Rollins v. Commissioner*, TC Memo 2004-260, the court took a substance over form approach to state that regardless of any of the percentage interest ownership or other rules, if the owner of an IRA or plan was involved with an entity owned in part by the plan or the IRA, and the plan or IRA was benefited, a prohibited transaction occurred. While many commentators believe that Rollins may not be good law, it further illustrates the danger of doing business with your IRA or qualified plan.



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Moreover, in DOL Opinion 2006-01A, the analysis seems generally to disregard the plan asset operating company exception from the Plan Asset Rules. Given these decisions, even if you think you fall within one of the exceptions, there may be little security in that position.

Unrelated Business Taxable Income

Why Should I be Concerned About This?

While unrelated business taxable income (“UBTI”) does not cause your IRA or other qualified plan to lose its exempt status, your IRA or qualified plan is taxable on such income. Generating some taxable income certainly is not fatal to any investment you are considering, but the tax consequences of a potential investment should be a factor in your evaluation of it.

What Constitutes UBTI?

The UBTI rules were put in place to keep tax-exempt organizations from competing with for-profit taxpaying businesses. Therefore, the most obvious intent was to tax an otherwise exempt organization on the income it receives from running a business in competition with taxable business entities.

However, in keeping with the goal of preventing tax-exempt organizations from having a competitive advantage over taxable businesses in operating an active business, passive income is generally not UBTI. Under Code §512(b)(1) and §512(b)(3), included within passive income are interest and dividends as well as rent from real property as long as the rent is not based on the income or profits of the property. Also, under Treas. Reg. 1.512(b)-1(c)(5) there cannot be an excessive rendering of services in connection with the real estate investment or the income can be regarded as active and no longer exempt from UBTI. Finally, gain from the sale of property is not UBTI unless it constitutes stock in trade or property held primarily for sale to customers in the ordinary course of a trade or business. However, all of these rules go by the wayside if you have debt-financed income.

Debt-Financed Property

Who Needs to be Concerned About These Rules?

Under Code §512(b)(4), operating income as well as possibly gain or loss on the sale of a property becomes taxable to the extent there is acquisition indebtedness with respect to the property. As to who should be concerned about these rules, it is very clear that IRAs are subject to the tax on debt-financed income. Most qualified plans, including 401(k)'s, are not subject to the tax on debt-financed income so long as the indebtedness qualifies under certain rules as is discussed below.

What Income is Subject to Tax?

Basically, a certain amount of the operating income with respect to a property with respect to which there is acquisition indebtedness becomes taxable. In addition, a certain amount of the gain or loss on the sale of property with respect to which there has been acquisition indebtedness during the twelve months prior to its sale is taxable.

How Bad is it to be Subject to the Debt-Financed Income Rules?

Unlike the drastic consequences for violating the prohibited transaction rules, nothing terribly bad happens to your IRA if it has acquisition indebtedness other than that a portion of the operating income and possibly the gain on the sale of property becomes taxable. You simply need as part of your analysis of a potential property acquisition to take into account the income tax cost of the investment. In many cases you will find that even after paying the tax, the investment still makes very good sense. Accordingly, do not dismiss an investment out of hand simply because it may generate debt-financed income.

What is Acquisition Indebtedness?

Acquisition indebtedness is debt incurred to either purchase or improve property. Code §514(c)(1) is to be read literally such that debt which is not incurred to either improve or purchase property is not acquisition indebtedness. Therefore, if there is a debt that is incurred in part to purchase or improve property and there is other debt that is incurred by the IRA for some other purpose, only the



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percentage of the total debt that is acquisition indebtedness causes the income and gain to be taxable to the IRA. For example, if an IRA purchases a property and borrows \$100,000 to purchase and/or undertake improvements to the property, and then later borrows an additional \$100,000 secured by the property but unrelated to the purchase or improvements, only a maximum of 50% of the income and gain with respect to the property is subject to the tax on debt-financed property.

How Much of the Gross Operating Income is Subject to Tax?

If you determine that you have acquisition indebtedness with respect to a piece of real property, a percentage of the income from this property becomes taxable annually. Under Code §514(a) and Treas. Reg. §1.514(a)-1(a)(1), the percentage equals the average acquisition indebtedness divided by the average adjusted basis.

Average Acquisition Indebtedness:

Under Treas. Reg. 1.514(a)-1(a)(3), you take the amount of acquisition indebtedness as of the first day of each month during the taxable year in which the IRA owns the property, add those up and then divide by the total number of months during the year the IRA owned the property (i.e., if the IRA owns the property for the whole year, then you add up the acquisition indebtedness on the first day of each of the twelve months of the year and then divide the sum by 12).

Average Adjusted Basis:

To compute this, under Treas. Reg. 1.514(a)-1(a)(2) you add the basis on the first day of the tax year the IRA owned the property and the basis on the last day of the year (or the last day the IRA owns the property during the year) and divide that by 2.

You then apply this percentage to the gross operating income from the property to determine the amount of the gross income from the property that is potentially subject to tax that taxable year. You then need to take into account the allowable deductions summarized below.

What Deductions are Allowable?

In computing the net amount taxable, certain deductions from gross income are available:

1. Only deductions directly connected with the debt-financed property are deductible from the allocated gross income. The normal sorts of deductions that you would incur with respect to any real estate investment such as insurance, taxes, interest and maintenance expenses are deductible.
2. If the property is depreciable, depreciation must be computed on a straight line basis.
3. Once you determine the allowable deductions and straight line depreciation amount, only the percentage that corresponds to the gross income percentage calculated above is allowed as a deduction.
4. Finally, the IRA is allowed a \$1,000 per year specific deduction. Since the IRA's income is exempt other than that with respect to debt-financed property, the income attributable to the debt-financed property should constitute the full amount of the IRA's taxable income.

What are the Tax Rates That Apply to the Net Debt-Financed Income?

The income of the IRA is subject to tax at the normal trust tax rates, which climb fairly steeply.

How is the IRA's Gain From the Sale of the Property Taxed?

If your IRA sells a property that is subject to acquisition indebtedness or was subject to acquisition indebtedness at any time during the 12 months prior to its sale, the gain or loss from the sale becomes taxable in accordance with the normal tax rules. The amount of the gain or loss that is subject to tax is a percentage equal to the highest acquisition indebtedness to cost basis ratio during the prior 12 months. In other words, the percentage of the gain on the sale of the property is based on the amount of the acquisition



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indebtedness in relation to the tax basis of the property.

Debt-Financed Property Rules as they Apply to 401(k)s and Other Qualified Plans

As discussed briefly above, most qualified plans, including 401(k)s, are not subject to tax on debt-financed income so long as the indebtedness qualifies under Code §514(c)(9) as follows:

- The acquisition price for the property is fixed as of the date of purchase.
- The debt is third party debt and not financing by the seller, a person related to the seller, or a person related to the plan. If any of these people do provide financing, it must be on “commercially reasonable terms.” Because of that vagueness, it probably best to stay away from seller or related party financing.
- Payments on the debt are not based on income or profits from the property.
- The property is not leased back to the seller or a person related to the seller.
- The property is not leased to a person related to the plan.
- The purchaser is not a partnership in which the plan is a partner together with taxable persons where the allocations are designed to avoid tax.

Most real estate acquisitions by 401(k) or qualified plans can avoid these exceptions and therefore avoid the tax on unrelated business taxable income related to acquisition indebtedness. This generally means that only IRAs must be concerned about the debt-financed property rules. If you have a 401(k) plan or other qualified plan, you need to analyze each real estate investment that involves debt to make sure it is not subject to these rules, or, if it is, to calculate the cost to the plan.

What is the Bottom-Line on Debt-Financed Income?

The bottom line is not to dismiss properties out of hand because they may result in debt-financed income. You need to do a careful analysis in assessing whether it still makes sense to go ahead with the purchase even though it may result in debt-financed income. This is particularly true if you have a plan to pay down the acquisition indebtedness prior to your IRA selling the property.

Mr. Smith is a partner with Horack, Talley, Pharr & Lowndes, P.A. in Charlotte. He recently completed a book entitled *IRA and 401(k) Investment in Real Estate: For Syndicators, Other Real Estate Professionals and the Rest of Us*. Mr. Smith has personally invested his IRA and his wife's 401(k) account in an interest in a small strip shopping center and a rental condominium.

Big Problem Small Budget – A reasonable lawyer can get the result you want, without a huge bill.

By: Bettie Kelley Sousa

Smith Debnam Narron Drake Saintsing & Myers, LLP

4601 Six Forks Road, Suite 400
Raleigh, NC 27609
United States

919.250.2000 phone
919.250.2211 fax

bsousa@smithdebnamlaw.com
smithdebnamlaw.com

We've all seen the beast -- a \$30,000 dispute that is likely to cost even more in legal fees to resolve. Do you drop it? Do you, with eyes wide open and nose held tightly closed, proceed on principle? Or, do you let it fester in your A/R report, give it a sigh, and kick the can out another month?

Here's what you do. First, let's assume that this is money that your company is entitled to receive. In other words, wearing your reasonable person hat, you still think it's a good claim. Second, let's assume that the debtor/lessee/defendant, let's call him "Cheatin'SOB, Inc.," is located somewhere else.

Consider these steps:

Reach out. Talk to a lawyer in Cheatin's state. Your Primerus directory is a great starting place. Right out of the chute, tell the lawyer you got his or her name from Primerus. Since all the Primerus attorneys have a vested interest in the network, you'll be sure to hear us at our best. Don't be afraid to lay it all out -- the good, the bad, and the ugly. Don't overstate your claim, and don't understate Cheatin's lying, cheating ways.

Assess. Get the local lawyer to help you assess whether it is worth hiring him or her to do anything

about the claim. Stress your concern that fees not exceed a certain amount. Ask about the cost for an initial demand and some local investigation, such as a public records search including a judgment index. You'd be surprised how much a local lawyer may know about Cheatin' already. Cheatin' may be a serial debtor, already in bankruptcy mode, suffering from a management implosion, or it may be a well-respected company just having a tough year. Even if Cheatin's spirit is willing to pay, is its flesh weak, its coffers bare?

Firm up. Before committing to any course of action, be sure to get an estimate as to what actions will be performed and what will be charged. Consider imposing a cap on fees. Consider suggesting a fee basis that is a part contingency or a flat rate. While fees post-suit may be difficult to estimate, pre-suit actions and fees can be kept under control fairly easily.

What will the lawyer do? The days of "Lawyers Gone Wild" with ridiculous numbers of hours spent and insane fees charged for cases involving comparatively few dollars are gone. Maybe, maybe a large corporation has a case or





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two a year, which are sent to a law firm with the instruction: do whatever it takes. But, these are few and far between; and, if they exist, those cases are sent to specialty firms -- with those specialty firm rates.

The reasonable lawyer today knows that a job well done for a reasonable fee will be a better harbinger of other, similar work from a client. And, in this day of networking and relationship building, the reasonable handling of a case stands a better chance of bearing fruit year after year. So, how does the reasonable lawyer act reasonably with this \$30,000 beast? There are a lot of tools for early action. Here are a few:

- **Demands.** Sometimes, getting a local lawyer to make contact can elevate a claim to squeaky wheel status. Street-wise debtors like Cheatin' know that a call, letter, or even suit from another state translates to a problem to be faced -- down the road.
- **Pre-suit negotiations.** Remember that not only will you spend money suing, but Cheatin' will have to defend or cave. Often, Cheatin' lands in between by hiring a lawyer to defend, then delaying-not-paying, then caving. Your reasonable lawyer can spell this scenario out to Cheatin' or its lawyer and come up with a payment plan, a Confession of Judgment for a compromised sum, or at minimum additional information that can help you decide whether to sue.
- **Out of court mediations.** There is no requirement that the parties to a dispute be in litigation to mediate. And, since you can't buy a skinny latte these days without running into a mediator or two, your lawyer knows plenty of them. Qualified and hungry, mediators get more cases by successfully mediating the ones they handle. A successful mediation is a matter that is settled -- no one leaves happy, but all can live with the result. Your Primerus lawyer can persuade Cheatin' to mediate. If you don't settle, you'll know more about your claim and about Cheatin's defenses and finances.

- **Econo-discovery.** Even if you have to sue, you haven't lost complete control of the beast. One of the biggest variables in your bill is discovery. If you have dealt with a car wreck, you know that each witness will be deposed by the defense counsel. But, those lawyers are being paid by insurance companies, which would rather pay lawyers than claims. Trust me, a deposition can be an easy gig for a lawyer. But, here's the truth. Most cases never go to trial. I'll say it again -- most cases never go to trial. So, while there may be lots of good reasons to take (or threaten to take) depositions of Cheatin's officers, going the "econo route" and limiting discovery to some good, ole fashioned interrogatories and document requests can work just fine. And, instead of hiring a forensic computer expert, send out a request for production. If you ask for all emails since Cheatin' got on the computer, you're begging for a legal battle over objections. Get your lawyer to ask for any emails or documents that mention your client, this dispute, or your product. In other words, keep it simple and you can keep it inexpensive.

Don't let the \$30,000 beast cause you heartburn. There are plenty of reasonable lawyers with reasonable solutions for your company.

Bettie Kelley Sousa of Smith Debnam Narron Drake Saintsing & Myers, LLP has been practicing law with the firm since becoming licensed in 1981. She has a wealth of experience in state and federal courts, including bankruptcy courts, at both trial and appellate levels. She represents mostly businesses -- both large and small -- in a variety of matters, including contract drafting and disputes, and employment issues.

A reasonable lawyer, Bettie is a member of Primerus' Business Law Institute, Commercial Law group. Bettie earned her J. D. from Wake Forest University School of Law and received her A.B. from the University of North Carolina. Since 1993, she has been certified as a Creditors' Rights Specialist by the American Board of Certification (ABC). In addition to her extensive list of professional and community involvement, Bettie currently serves as President of the ABC.

Frack or Fiction

By: Kara A. Batey

Branscomb, PC

802 N. Carancahua, Suite 1900
Corpus Christi, TX 78401
United States

361.886.3800 phone
361.888.8504 fax

kbatey@branscombpc.com
branscombpc.com

Hydraulic fracturing (commonly referred to as “fracing” or “fracking”¹) has received substantial attention by the media, oil and gas industry, environmental groups and landowners since the onset of the “shale” boom across the United States. If you live in a state where oil and gas aren’t produced, you may not be familiar with this method frequently used in hydrocarbon recovery. If you live in a state where oil and gas are produced, particularly where non-traditional shale plays are located and hydraulic fracturing is frequently used in hydrocarbon recovery, you have likely been exposed to some truths (referred to herein as “FRACK”) and some misconceptions about the process.

FICTION: *Hydraulic fracturing is a new method of hydrocarbon recovery being used by oil and gas operators in non-traditional shale plays. Because the technology is new, operators or service companies cannot fracture a well with any reasonable degree of certainty about the outcome.*

FRACK: Hydraulic fracturing has been used in the recovery of oil and gas since the 1940s and can be used on both conventional vertical wells and horizontal wells.

After a well is drilled, a fracturing treatment is performed. The treatment consists of pumping water and fracturing fluids (including sand and chemicals) down the well bore at extremely high pressures, the fracturing fluids permeating tightly compressed rock and releasing the trapped hydrocarbons. Technology has substantially improved and been refined in recent years, reducing costs and allowing more operators to utilize the technique in their recovery operations. Hydraulic fracturing has proven particularly useful in non-traditional shale plays where horizontal drilling is used extensively (if not exclusively) to extract hydrocarbons embedded in and between formations of tightly compressed rock.

FICTION: *Operators generally do not disclose the contents of the hydraulic fracturing fluids they use in treatments. The chemicals used in the fluids are extremely hazardous and no one is regulating what goes into a well that is hydraulically fractured.*



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FRACK: Some operators in oil and gas producing states voluntarily participate in the hydraulic fracturing chemical registry website of the Ground Water Protection Council and the Interstate Oil and Gas Company Commission located at www.fracfocus.org. It is likely that participation in this chemical registry by operators will increase as the general public and landowners with wells on their land seek out information about the hydraulic fracturing process. According to www.fracfocus.org, 98% - 99.5% of the fluid used in hydraulic fracturing is comprised of water and sand. Commencing in 2012, all operators in Texas utilizing hydraulic fracturing in their operations will participate in the chemical registry.

During the past legislative session, Texas became the first state to pass a law requiring operators to disclose the composition of hydraulic fracturing fluids. Section 91.851 of the Natural Resources Code, effective September 1, 2011, directs the Railroad Commission of Texas (the "Commission"), the agency that regulates oil and gas operations in Texas, to adopt rules consistent with the statutory guidelines set forth therein. As of the writing of this article, the proposed rule is still in the comment period. Since the proposed rule is subject to change, we will only consider the substantive disclosure aspects of the instructive legislation. However, it is worth noting that the preamble for the proposed rule includes the Commission's estimate that 85% of wells drilled in Texas in 2010 were hydraulically fractured.

Under the new rule, an operator will be required to complete the form posted on the hydraulic fracturing chemical registry website described above at www.fracfocus.org. The disclosure by the operator will include, along with general details about the well, (1) the total volume of water used in the fracturing treatment; (2) each chemical ingredient that is subject to 29 C.F.R. Section 1910.1200(g) (2), which contains the Occupational Safety and Health Administration's requirements for Material safety data sheets; and (3) all other chemical ingredients intentionally included in the fracturing treatment.

An exception to the disclosure requirement is provided for in the event that the party performing the fracturing treatment asserts that the identity or amount of a particular additive is protected as trade secret information. However, a limited class of parties will be able to challenge a trade secret claim, including the landowner of the property where the well on which the fracturing treatment is performed is located, an adjacent landowner, or a state agency with jurisdiction. In addition, an exception to the trade secret claim will be made to permit disclosure to health professionals and emergency responders consistent with the above OSHA regulation.

Other states will likely follow Texas' example and pass similar disclosure laws in order to alleviate fears about the contents of hydraulic fracturing fluids. In addition, voluntary participation in the chemical registry may also increase as such disclosures become common industry practice.

FICTION: *When a hydraulic fracturing treatment is performed, groundwater is exposed to and contaminated by the chemicals used in the fracturing fluids and the hydrocarbons being recovered.*

FRACK: The claim that groundwater contamination is an inevitable outcome of hydraulic fracturing is not based on fact. Fracturing a well by the method generally described above does not pose a substantially greater danger to groundwater than do operations in wells that are not fractured. Groundwater protection is an issue in conventionally drilled wells that are not hydraulically fractured. At present, there are state and federal regulations already in place specifically for the purpose of protecting groundwater.

Numerous studies have established that over the last 60 years hydraulic fracturing can and has been performed without contaminating groundwater. However, despite evidence to the contrary, a recent New York Times article² focused on a report by the Environmental Protection Agency ("EPA") published in 1987, documenting a single case where fracturing fluids used on a gas well contaminated a water well 600 feet away.³ The article is misleading in



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that it focuses on hydraulic fracturing as the origin of the contamination rather than addressing the probable origins of the migrating fluids, namely faulty casing in the well bore.

Multiple strings of steel casing are cemented into place to protect groundwater and other subsurface strata from being exposed to fracturing fluids and all other substances put down or recovered from a well bore. The best way to picture this is to visualize a telescope going into the ground. Surface casing is cemented into place at the uppermost part of the well bore, providing a barrier between groundwater and fracturing fluids. Typically, multiple additional strings of pipe are cemented inside the surface casing, providing additional layers of protection from groundwater contamination. If the casing, or the cement behind the casing fails, groundwater is potentially exposed to any fluid flowing through the well bore, including fracturing fluids.

The protection of groundwater has clearly been a longstanding regulatory objective in Texas. For example, the Commission provides for operators to set surface casing to protect all useable water in the specific area, as defined by the Texas Commission on Environmental Quality.⁴

In addition to regulations regarding the depth to which the surface casing must be run, additional specifications exist regarding the quantity and quality of cement used to hold the casing in place.⁵ Regulations exist for each type of casing run down the well bore and each regulation is intended to promote the safety and efficiency of oil and gas production.

The national hydraulic fracturing conversation is going to continue as the development of non-traditional shale plays booms in many places in the county. It will be interesting to see whether FRACK or FICTION prevails.

¹ See <http://www.bizjournals.com/pittsburgh/blog/energy/2011/08/the-f-word-business-times-invites-k-frac.html?page=all> for one of many internet discussions about the spelling of the word that is short for “hydraulic fracturing.”

² Urbina, Ian. “A Tainted Water Well, and Concern There May Be More.” *New York Times* 3 Aug. 2011: n. page. Web. 9 Aug. 2011.

³ The complete EPA report is available on the New York Times website as background for the Urbina article.

⁴ See 16 T.A.C. §3.13.

⁵ *Id.*

Kara A. Batey is an oil and gas attorney at Branscomb | PC, a law firm with offices in Austin and Corpus Christi, Texas, providing solutions for businesses, executives and families with tax, real estate, oil and gas, estate planning, probate, corporate, employment and litigation matters.

What Every Manufacturer Needs to Know (and Think About)

By: Bradley C. Nahrstadt

Williams Montgomery & John Ltd.

233 South Wacker Drive, Suite 6100
Chicago, IL 60606
United States

312.443.3200 phone
312.630.8500 fax

bcn@willmont.com
Willmont.com

In 2008, Congress passed the Consumer Product Safety Improvement Act of 2008 (CPSIA). Section 212 of the CPSIA amended the Consumer Product Safety Act and required the Consumer Product Safety Commission to establish and maintain a searchable product safety information database that was available to the public. On May 7, 2010, the CPSC gave notice of its proposed regulations establishing a publicly accessible and searchable database. On December 9, 2010, the CPSC published in the Federal Register its Final Rule establishing the Publicly Available Consumer Product Safety Information Database (the Database). This Database went live on March 11, 2011 (although, according to the Database, reports of harm will not be available for public review until the beginning of April). The database can be found at <http://www.saferproducts.gov/Default.aspx>.

Some have suggested that the Database is long overdue and will serve to inform the public fully of problems associated with consumer products. Others have voiced their concern that such a “crowd-sourced” website will be bloated with bogus, inaccurate, and misleading reports. Still others have argued that the Database will be used

by consumer advocate groups and plaintiffs’ attorneys to manufacture evidence to be used in class action lawsuits. All of these claims may be true—but one thing is certain: product manufacturers and labelers must be intimately familiar with the Database and take certain steps to make sure that they are prepared to respond to reports of harm that are submitted to the CPSC for inclusion in the Database.

What Is the Database?

The Database allows individuals to submit reports of harm for all types of consumer products, as well as other products or substances regulated by the CPSC (reports regarding food, drugs, cosmetics, cars, and firearms will not be posted in the Database). Not only are individuals allowed to submit reports of harm, they are able to conduct searches: for categories of products, for products produced in a particular state, or for specific products and manufacturers. The Database will collect reports on manufacturers of consumer products, importers of consumer products, and owners of a brand or trademark of a consumer product that bears a private label.





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The Database consists of two separate portals: the consumer portal and the industry portal. The consumer portal contains two main tools: one that allows users to post details of a product safety-related incident quickly and easily, and one that allows users to search previous incidents easily and quickly. The industry portal allows authorized and registered manufacturers and labelers to comment on incident reports submitted via the consumer portal. According to the CPSC, appropriate security and user-interface components will be used to isolate companies and segregate internal data. Manufacturers and labelers will be authorized to use only sites and data that are necessary for their contributions and will be restricted from viewing other firms' data.

What Is the Report of Harm?

The Database is intended to serve as a repository of reports of harm relating to the use of consumer products. Reports of harm can be submitted by any consumer, including the user of the product, as well as any family member, guardian, friend, or observer of the use of the product. In addition, reports of harm can be filed by "others," including:

- local, state, or federal government agencies
- health care professionals
- child service providers
- public safety professionals
- attorneys
- consumer advocates.

The individual who submits the report of harm does not need to have firsthand knowledge of the alleged harm caused by the product; no evidence or proof of injury, illness, or death is required to be submitted. Reports of harm can include not only actual injury, illness, or death, but also what the consumer or submitter perceives to be a "risk" of injury, illness, or death (about the only thing that cannot be included in a report of harm are complaints about the quality of the product or the price of the product). Users of the Database may enter reports of harm regardless of when the incident occurred. As a result, some submitters

may file reports of incidents that occurred long before the Database was created and years after any opportunity to investigate the incident has passed. To make matters even worse, users are allowed to submit reports of harm for products that they bought new or used.

Reports of Harm can be submitted online, via e-mail, by written submission, or via telephone. Internet, e-mail, and written submissions must use the incident report form available at <http://www.saferproducts.gov/>. Telephone submissions will utilize a CPSC call center that enters information taken over the phone into the electronic incident form.

A report of harm must meet certain threshold criteria in order to be published in the database. All publishable reports of harm must contain:

- the incident date
- the category of submitter
- a description of the consumer product (according to the regulations the description can be as short as "a word or phrase sufficient to distinguish the product")
- the identity of the manufacturer of the product
- a description of the harm related to use of the product
- contact information for the person submitting the report (at a minimum the submitter's name and address)
- verification by the submitter of the truth and accuracy of the information submitted
- the submitter's consent for inclusion of the report in the Database.

16 C.F.R. §1102.10(d). If this information is not included in the report of harm, the report is ineligible for publication in the Database. Indeed, the pertinent regulations require that "[a]ny information received by the Commission...that does not meet the requirements for submission or publication will not be published." 16 C.F.R. §1102.10(h).

The submitter is not required to submit the name of the "victim." Although the submitter's contact information will not be published, it is a requirement of submission—anonymous reports will not be included in the Database.



What Every Manufacturer Needs to Know (and Think About)

Submitters may also include a variety of optional information as part of the report of harm. That optional information may include the name of the product, the product brand name, the model number, the serial number, where the product was purchased, the date of manufacture, the location of the incident, a description of the severity of the injuries, and an indication of whether the submitter has contacted the manufacturer about the alleged incident. The submitter may also upload photographs or videos of the product or the injuries sustained, as well as copies of the injured party's medical records. The CPSC requests, but does not require, that the submitter retain the product for 30 days in order to allow a CPSC investigator the chance to inspect the product.

What Does the CPSC Do Once a Report of Harm Is Filed?

Within five days of receiving a report of harm, the CPSC must, "to the extent practicable," provide the report of harm to the manufacturer or private labeler identified in the report. A report likely will not be transmitted in a timely fashion when the manufacturer is out of business, the submitter mistakenly identifies a manufacturer, the report contains incorrect contact information, or the CPSC cannot locate the correct contact information for a manufacturer.

If a manufacturer or labeler is registered to receive reports of harm, the CPSC will send notice of reports of harm to the registered account user and any other designated recipients (notification can even be made via text message if the manufacturer selects that method to receive reports). If a manufacturer or labeler is not registered with the CPSC, reports of harm will be sent via U.S. mail to the principal place of business.

The notification sent to manufacturers and labelers will contain all information provided in the report of harm, except for the name and contact information of the submitter, photographs, and medical records. The submitter can consent to the release of this information to the manufacturer. If express written consent is provided,

this consumer information may not be used or disseminated to any other party for any purpose other than verifying the details of a report submitted to the Database (identity of the subscriber, identity of the product, a description of the incident and a description of the harm or risk of harm).

What Can the Manufacturer Do Once It Receives Notice of a Report of Harm?

A manufacturer or labeler who receives a report of harm from the CPSC has 10 business days from the date on which the CPSC transmitted the report to submit comments about the report of harm. It should be noted that the CPSC is required to publish a report of harm that includes the minimum required information set forth above no later than 10 business days after the date on which the CPSC transmits the report of harm to the manufacturer—whether the manufacturer comments on the report or not. 16 C.F.R. §1102.28.

Manufacturer comments can be submitted via regular mail, electronic mail or online through the business portal. Comments that are submitted within the 10-day window will be published in the Database at the same time as the report of harm, provided that certain minimum requirements are met. In order to meet the minimum requirements set forth in the regulations, the comment must specifically relate to the report of harm, contain a unique identifier assigned to the report, been verified by the manufacturer or labeler, and affirmatively request and consent to publication. Companies may submit comments about reports of harm at any time; however, comments received more than a year after notification of a report of harm may be excluded from publication if the CPSC determines that it is not in the public interest to publish the comments. Leta E. Gorman and Lisa Grimm, "The CPSC's Consumer Database Officially Launches in March 2011: Are Your Clients Ready?" IADC Product Liability Committee Newsletter, p. 3 (February 2011), <http://www.iadclaw.org/default.aspx>.

In a nutshell, if a manufacturer wants the CPSC to review its comments (including any assertions that the report of harm contains confidential or materially inaccurate information), and publish those comments at the same



What Every Manufacturer Needs to Know (and Think About)

time the report of harm is posted, the manufacturer has a maximum of 10 business days to accomplish all of the following:

- Investigate the report
- Decide whether to respond with comments
- Draft the comments, including any assertions that the report contains materially inaccurate or confidential information
- Receive any required approval of comments from upper management, in-house counsel, or outside counsel
- Submit the comments to the CPSC
- Request that the CPSC publish the comments.

How Can Confidential Information Be Protected?

If a manufacturer or labeler believes that a report of harm contains confidential business or trade secret information, it may, “in a timely manner” before the expiration of the 10-day window for submission of comments, request a confidential designation of such information. 16 C.F.R. §1102.24(d). Such requests must be conspicuously marked. The burden of proof with regard to confidentiality rests with the manufacturer or labeler. A request for confidential designation must include (1) the specific information claimed to be confidential; (2) whether that information has ever been released to anyone who is not an employee or in a confidential relationship with the manufacturer; (3) whether the information is commonly known in the industry or readily ascertainable by outside persons with a minimum of effort; (4) the relationship (if known) between the manufacturer and the person submitting or the subject of the report of harm and how that person came to be in possession of the information; (5) how the release of the information would cause substantial harm to the manufacturer and (6) whether the person submitting the request for confidential treatment is authorized to make such a claim. 16 C.F.R. §1102.24(b).

If the CPSC agrees with the manufacturer that the identified information is indeed confidential, it must redact the information before publishing the report in the Database. 16 C.F.R. §1102.24(f). If additional time is

needed to make a determination as to the confidentiality of the designated information, the CPSC will redact the information and continue with publication of the report of harm until a final determination can be made. If the CPSC does not agree with the confidential designation, it must notify the manufacturer of its decision to include the information in the report to be published in the Database. 16 C.F.R. §1102.24(g). The manufacturer may, if it chooses, bring an action in the “district court of the United States in the district in which the complainant resides, or has its principal place of business, or in the United States District Court for the District of Columbia, to seek removal of the information from the database.” 16 C.F.R. §1102.24(h).

Identifying “Materially Inaccurate Information”

Anyone reviewing a report of harm or a manufacturer’s comment may notify the CPSC of his or her belief that the report or comment contains “materially inaccurate information.” 16 C.F.R. §1102.26(b). “Materially inaccurate information” is defined as “information that is false and misleading, and which is so substantial and important as to affect a reasonable consumer’s decision making about the product....” 16 C.F.R. §1102.26(a). With respect to a claim of materially inaccurate information in a report of harm, the information must relate to (1) the identification of the consumer product; (2) the identification of the manufacturer; (3) the harm or risk of harm related to the use of the product; or (4) the date or approximate date on which the incident occurred. 16 C.F.R. §1102.26(a)(1). With respect to a manufacturer’s comment, the claimed materially inaccurate information must pertain to (1) the description of the product; (2) the identity of the entity responsible for importing, manufacturing, distributing, or selling the product; (3) the harm or risk of harm related to the use of the product; (4) the status of a CPSC or manufacturer investigation; (5) whether the manufacturer is engaging in any corrective action and whether such action has been approved by the CPSC; or (6) whether the manufacturer has taken, or promised to take, any other action with regard to the product. 16 C.F.R. §1102.26(a)(2).



What Every Manufacturer Needs to Know (and Think About)

Requests for removal of materially inaccurate information can be made either before or after publication of a report of harm. The requester bears the burden of proof. Requests for expedited review can be made if the request is less than five pages long. Although expedited review is available, the CPSC has discretion to withhold a report from publication or to publish it before making a final decision about the claimed material inaccuracy. In short, a manufacturer cannot be sure that a claim of material inaccuracy will be resolved prior to publication of a report of harm; accordingly, information considered by the manufacturer to be materially inaccurate may be available for public viewing for some time prior to its ultimate removal.

Any person making a request that the CPSC correct or exclude materially inaccurate information must provide the CPSC with the following information:

- the unique identifier assigned to the report of harm or manufacturer's comment
- the exact portion or portions of the report or comment claimed to be materially inaccurate
- the basis of the claim of material inaccuracy
- evidence to support the claim of material inaccuracy
- whether the requester seeks exclusion of the entire report or comment, redaction of specific information or addition of corrective information
- whether and how the alleged material inaccuracy may be corrected without excluding the entire report or comment
- whether the requester is authorized to make the claim of material inaccuracy.

16 C.F.R. §1102.26(b).

If the CPSC determines, after conducting an investigation, that the report of harm or manufacturer's comment does contain materially inaccurate information, then, within seven business days of making that determination, the CPSC must do one of the following three things: (1) decline to publish the report in the Database or, if already published, remove the report from the Database; (2) correct the information and publish a corrected report of harm or manufacturer's comment, or (3) add information to the report of harm or comment in order to correct it. 16 C.F.R. §1102.26(b).

Efforts to Delay Implementation of the Database

Earlier this year, Representative Mike Pompeo, Republican of Kansas, introduced a bill that would block the CPSC from spending any money to operate the Database. In an interview, Pompeo said the Database needs to be revised so that the Commission—and manufacturers—can better vet reports before they are posted to ensure accuracy. Pompeo believes that the current version of the Database allows for the easy posting of bogus reports that can lead consumers astray. Although the House approved Pompeo's legislation on February 18, 2011, Senate Democrats are seeking to remove the provision from the House-approved budget package. On March 4, 2011, Democrats on the Senate Appropriations Committee released their own version of the budget that specifically called for restoring funding of the CPSC Database.

The National Association of Manufacturers has also been involved in efforts to delay the implementation of the Database. Rosario Palmieri, Vice President, Infrastructure, Legal and Regulatory Policy for the NAM, recently sent a letter to the CPSC requesting at least a three-month continuance in the "soft launch" of the Database. In his letter, Mr. Palmieri identified numerous problems with the Database discovered by those manufacturers who have been participating in the soft launch phase of the Database rollout, including the following:

- Manufacturers with different divisions and brands among different product lines have indicated an inability on the part of CPSC staff to timely register multiple parties within such corporations. According to Palmieri, the difficulty in registering by brand/product line/division and the slow or incomplete response by the CPSC to registration raises troubling questions about the promised flow of information between the CPSC and registered companies.
- A number of manufacturers, importers and private labelers have reported that reports not directly involving "harm" have been posted to the Database. Some manufacturers have reported that as many as 30 percent of the complaints forwarded were not adequately scrubbed to assure that they involve "harm" as defined by the regulations.



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- Licensors have indicated that they have received reports that are materially inaccurate since they involve products for which they are not the manufacturer, importer or private labeler.
- Manufacturers, importers or private labelers have indicated that they have received reports of harm identifying an incident involving their product that did not in fact involve their product and they advised CPSC of that fact. These entities have not received return affirmative confirmation that the CPSC will not publish such false claims in the Database.
- Registrant businesses have reported that the completed complaint form they received often omitted data necessary to identify the products alleged to have been involved in the harmful incident. That absence of such data, such as the model, serial number, date of manufacture or date/tracking codes (required by law to be contained on many products) makes the reports almost impossible to verify.
- The CPSC's decision to define the term "consumer" very broadly appears contrary to the intent of Congress and will result in the potential for multiple reports of harm involving the identical incident.

As noted above, despite the perceived flaws announced in Mr. Palmieri's letter, and a request that the launch of the Database be postponed, the Database went live on March 11, 2011.

Manufacturers Must Be Proactive Towards Database Reports About Their Products

Proactive planning is the key to responding quickly and effectively when trying to balance the ability to meet the tight deadlines imposed under the CPSIA with protecting both the company and consumer safety. While it will be difficult to prepare procedures for dealing with reports of harm that might be so varied as to content, source, reliability, or seriousness of complaint, planning for how one reacts to them is probably time well spent versus simply reacting to them upon receipt.

Manufacturers cannot control certain things about the database: whether the consumer identifies the correct manufacturer and the correct product; whether the consumer omits important facts or misunderstands what caused the alleged injury; whether CPSC satisfactorily verifies the accuracy of the report prior to posting it; what others will do with the publicly available information. However, advanced planning can help manufacturers control what can be controlled: receiving notice of an incident report as quickly as possible by registering contact information with CPSC; responding within the deadline; providing the CPSC with additional information that identifies material inaccuracies or confidential information in the incident report; making the company's position regarding the incident publicly viewable along with the incident report.

Register

One of the first things all manufacturers and labelers must do is select a Database incident report coordinator or team. The company must make sure that these individuals are registered with the CPSC to receive notice of reports of harm. More than one person from the company should be registered (although steps must be taken to ensure that there is a clear delineation of who is responsible for responding to the report of harm and in what order—in order to avoid a report falling through the cracks). The CPSC should be provided with e-mail addresses and text message addresses in order to facilitate prompt delivery of reports of harm.

Develop Procedures for Handling Incident Reports

It is imperative that every manufacturer and labeler determine a protocol for thoroughly investigating any report of harm posted to the Database. Although the protocol will vary depending on the manufacturer, the type of product manufactured, the sophistication of personnel, the geographic reach of the company, and other factors, any proposed protocol should include an initial assessment to decide if the report:

- identified the correct product;
- identified the correct manufacturer;



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- stated a causal connection between the product and a harm that is implausible if not impossible;
 - requires an immediate designation of material inaccuracy filed in time to accompany any publication of the report of harm to the Database before the CPSC decides the designation;
 - requires an immediate designation of confidential information to protect company trade secrets and proprietary data in the report before it is published;
 - requires comment on the submitter's data about the product or the related incident;
 - requires reporting under Section 15, particularly given that the CPSC has already seen and processed a report concerning the incident (the CPSC has made it very clear that the report of harm, either alone or when added to pre-existing data, needs to be assessed for 15(b) reporting obligations and it cannot be assumed that an event that the agency already knows about through the Database need not be subjected to reporting obligations within the CPSA, including Section 15(b));
 - presents an opportunity to provide a remedy to the reporting product user.
- Will the company draft a unique response every time or use form responses?
 - What level of investigation must be completed, if any, prior to commenting?
 - What will trigger the need for involvement of upper-level management, in-house counsel, or outside counsel?
 - Will the company always have comments published or will it sometimes submit them without seeking publication in the database?
 - Will other manufacturers' comments regarding similar incidents or products affect how your company comments?
 - Who must approve comments prior to submission to the CPSC?
 - What safeguards are in place to make sure that the company considers previously submitted comments when drafting new comments?

Mark A. Kinzie, "The Publicly Accessible Database: Four Things to Know About New CPSC Regulations," *In-House Defense Quarterly*, p. 41 (Fall 2010). In addition to the foregoing, every manufacturer or private labeler must implement a calendaring and notice system to track the 10-day deadline and make sure key employees are aware of the deadlines associated with database reports and comments.

Develop a Policy for Submitting Comments

There are several factors that companies will want to consider when developing a policy for submitting comments:

- Will the company respond to every incident report or only certain kinds of reports?
 - What will determine whether the company will respond, e.g., the type of product, seriousness of the injury, number of related or similar reported incidents?
- Does the company undertake to investigate a report of harm that has attribution for the reporter and who should conduct that task and under what circumstances?
 - Are reports of harm filed by third parties (law enforcement personnel, lawyers, social services providers, "witnesses" to incidents, etc.) to be investigated and if so, to what extent?
 - Are reports of harm to be integrated with general field experience records, which may be considered to be producible during the discovery process?
 - Should outside counsel be utilized to develop the methods of investigation and follow-up (including comments of a manufacturer)?

Other Important Considerations

In addition to developing procedures for handling incident reports and developing a policy for submitting comments, companies should give careful consideration to some other important considerations. Some early thinking needs be given to the following:



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- What role should outside attorneys play in advising manufacturers on the subject of whether receipt of reports of harm need to be considered to be “notice” and worthy of investigative effort by the subject company and how that might be best approached within the limitations of anonymity for “reporters” and restrictions on manufacturer contacts with consumers?
- Is this a system of outsider review and reporting that has similarity to consumer reviews on general websites such as Amazon.com, Wal-Mart, etc. that bring such new volume, content and consequence that they should be dealt with collectively for their importance in a marketplace whose activities are increasingly driven by electronic communications and data storage?

Barring a complete about-face on the perceived need for a “consumer” driven database, or the death of all funding to operate it, the Consumer Product Safety Commission Database is here to stay. As a result, product

manufacturers and labelers need to become intimately familiar with the Database requirements, the timeframes applicable to reporting and commenting, and the ways to protect confidential information from disclosure and to identify materially inaccurate information. In addition, manufacturers must be proactive in their efforts to deal with Database reports. Proactively determining and implementing procedures needed to handle reportable incidents and consumer-reported incidents in the Database is a necessary step toward effectively addressing such incidents in a way that protects both the company and consumer safety.

Bradley C. Nahrstadt is a partner of Williams Montgomery & John Ltd., in Chicago. He is a member of the firm’s executive committee, cochair of the insurance coverage practice group, and a member of the product liability, professional liability, and tort defense practice groups. Mr. Nahrstadt focuses his practice on defending product liability, professional liability, premises liability, insurance coverage, and bad faith and commercial matters in state and federal courts around the country, and also has handled a number of matters at the appellate level.

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Product Liability Cases Involving Warnings Claims: Limitations on the Duty to Warn

By: Brian A. Comer, Esq.

Collins & Lacy, P.C.
1330 Lady Street, Suite 601
Columbia, SC 29201
United States

803.256.2660 phone
803.771.4484 fax

bcomer@collinsandlacy.com
collinsandlacy.com

By: John R. Brydon, Esq.

Brydon Hugo & Parker
135 Main Street, 20th Floor
San Francisco, CA 94105
United States

415.808.0300 phone
415.808.0333 fax

jbrydon@bhplaw.com
bhplaw.com

By: Patrick C. Quinlivan (Rick), Esq.

Rick Quinlivan, Attorney at Law
1920 Main St., Suite 1000
Irvine, CA 92614
United States

949.756.0684 phone
866.298.9254 fax

pquinlivan@tldlaw.com
tldlaw.com

Products liability law recognizes many products cannot be made completely safe for use. *See, e.g.*, RESTATEMENT (SECOND) OF TORTS § 402A cmt. k (1965). However, these products may still be useful, desirable and serve a purpose. *Id.* In such cases, if the product is properly designed, manufactured and packaged with accompanying adequate warnings and instructions, then it is not defective and unreasonably dangerous. *Id.*; *see also id.* at cmt. j. Analysis of a products liability case involving warnings claims involves whether there is a duty to warn to being with and whether any warning is adequate. With regard to the duty to warn, products liability law provides certain limitations that can be dispositive in defense of a lawsuit. This article surveys some of those limitations and how they are applied in a warnings case.

A. Sources of Law and Categories of Limitations

Restatement (Second) of Torts § 402A provided the foundation for modern day products liability law, and Restatement (Third) of Torts: *Products Liability* has continued its evolution. *See* David Owen, *Products Liability*

Restated, 49 S.C. LAW. REV. 273 (1998). Generally, states use one of these frameworks as the source of their products liability law. As derived from these frameworks, limitations on the duty to warn fall into six primary categories: food/consumer products involving either common allergies or harm resulting from prolonged/excessive use, the open and obvious risk doctrine, the sophisticated user doctrine, the learned intermediary doctrine, and duties (or lack thereof) arising after sale of a product.

B. Food/Consumer Products: Limitations Relating to Common Allergies

The first exception to the duty to warn deals with common allergies and arises predominantly in the area of consumer and food products. Generally, there is no duty to warn about common allergies or foods that are widely known to be associated with common allergies. “The seller may reasonably assume that those with common allergies, as for example to eggs or strawberries, will be aware of them, and he is not required to warn against them.” RESTATEMENT (SECOND) OF TORTS § 402A cmt. j (1965); *see also* RESTATEMENT (THIRD) OF TORTS: PRODUCTS





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LIABILITY § 2 cmt. k (1998) (“When both the presence of an allergenic ingredient in the product and the risks presented by such ingredient are widely known, instructions and warnings about that danger are unnecessary.”)

However, this exception becomes more problematic when the food product at issue is an ingredient (i.e., as opposed to a stand-alone food). A person with a strawberry allergy may not realize that a Twinkie® has strawberry filling unless the packaging discloses the ingredient and/or provides a warning. Under these circumstances, both versions of the Restatement require a warning. RESTATEMENT (SECOND) OF TORTS § 402A cmt. j (1965); see also RESTATEMENT (THIRD) OF TORTS: PRODUCTS LIABILITY § 2 cmt. k (1998). In addition, the Food Allergen Labeling and Consumer Act (“FALCA”) went into effect in 2006 to require that packaged foods containing milk, eggs, fish, crustacean shellfish, peanuts, tree nuts, wheat and soy must display them prominently in the ingredient list. See 21 U.S.C. § 201 *et. seq.* According to FALCA, these “Big Eight” food allergens account for 90 percent of all food-allergic reactions, and federal law requires their disclosure on packaged foods. *Id.* at § 201(2). Comment j to § 402A of Restatement (Second) provides some of the rationale for this disclosure: a substantial number of the population is allergic to these ingredients, and the consumer may not know if one of the ingredients is in a food product without the disclosure.

C. Food/Consumer Products: Limitations Relating to Prolonged/Excessive Use

Restatement (Second) also allows an exception to the duty to warn if the potential danger of a product relates to its use over a long period of time or in excessive quantities: “[A] seller is not required to warn with respect to products, or ingredients in them, which are only dangerous, or potentially so, when consumed in excessive quantity, or over a long period of time, when the danger, or potentiality of danger, is generally known and recognized.” RESTATEMENT (SECOND) OF TORTS § 402A cmt. j (1965). The comment cites to alcoholic beverages and

foods containing saturated fats as examples of the types of products for which a warning is not required. Restatement (Third) does not include this explicit language, but cases involving excessive consumption of alcohol, tobacco and other comparable food products are categorized under comment j to section 2: “Warnings: obvious and generally known risks.”

There are numerous cases involving application of this limitation on the duty to warn. See, e.g., *Mills v. Giant of Maryland, LLC*, 508 F.3d 11 (D.C. Cir. 2007) (class action brought by lactose-intolerant individuals; “[a] bout of gas does not justify a race to the courthouse.”); *Pelman v. McDonald’s Corp.*, 237 F. Supp.2d 512 (S.D.N.Y. 2003) (“It is well-known that fast food in general, and McDonalds’ products in particular, contain high levels of cholesterol, fat, salt, and sugar, and that such attributes are bad for one.”); *Joseph E. Seagram & Sons, Inc. v. McGuire*, 814 S.W.2d 385 (Tex. 1991) (no duty to warn of danger of developing disease of alcoholism from prolonged and excessive consumption of alcoholic beverages).

D. The Open and Obvious Risk Doctrine

The limitations involving food/consumer products are a narrow application of a broader limitation on the duty to warn. More generally, a seller is not required to warn of dangers or potential dangers that are generally known and recognized by users. Known as the open and obvious risk doctrine, this limitation is supported by multiple comments to section 402A Restatement (Second)¹ and by comment j to section 2 in Restatement (Third).²

The open and obvious risk doctrine is said to have originated in the non-products case of *Lorenzo v. Wirth*, 49 N.E. 1010 (Mass. 1898) and has been applied in hundreds of cases to discharge a seller’s duty to warn. See, e.g., *Anderson v. Green Bull, Inc.*, 471 S.E.2d 708 (S.C. 1996) (threat of electrocution from placing a ladder in close proximity to power lines is open and obvious risk); *Brown v. Sears, Roebuck & Co.*, 667 P.2d 750, 756 (Ariz. Ct. App. 1983) (no duty to warn of risks of a product that are within “the ordinary knowledge common to the community;” “[s] urely every adult knows that if an electrical extension cord



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is cut or frayed a danger of electrical shock is created”). As set forth in comment j to Restatement (Third), warning about open and obvious risks is not likely to provide an additional measure of safety, and including such warnings runs the risk of decreasing the efficacy of warnings generally. If reasonable minds may differ as to whether a risk is obvious or commonly known, then it is generally left to the trier of fact. RESTATEMENT (THIRD) PRODUCTS: LIABILITY § 2 cmt. j (1998).

E. The Sophisticated User Doctrine

The sophisticated user doctrine is another well-known and widely-used exception to the duty to warn. It is applied to plaintiffs who knew (or should have known) of a product’s hazards, thereby making such person a “sophisticated user” and discharging the manufacturer’s duty to warn. If successfully proven, it will also act as an affirmative defense in a warnings case in most jurisdictions. *In re Asbestos Cases*, 543 F. Supp. 1142, 1151 (N.D. Cal. 1982).

The doctrine finds its genesis in section 388 of Restatement (Second) and the “obvious danger” rule (discussed *supra*). Section 388 imposes liability for physical harm resulting from use of a product that the supplier knows, or should know, is likely to be dangerous if the supplier fails to reasonably warn of the danger and “has no reason to believe that those for whose use [it] is supplied will realize its dangerous condition.” However, comment k to section 388 (“[w]hen warning of defects unnecessary”) declares there is no duty to warn when the supplier has “no reason to believe that those who use it will have such special experience as will enable them to perceive the danger[.]” Courts have interpreted section 388 to mean that if the manufacturer reasonably believes a user will or should know about the product’s dangers, it need not warn of such risks. *See, e.g., Martinex v. Dixie Carriers, Inc.*, 529 F.2d 457, 464-465 (5th Cir. 1976); *Bryant v. Hercules Inc.*, 325 F. Supp. 241, 247 (W.D. Ky. 1970). This is considered “especially [true] when the user is a professional who should be aware of the characteristics of the product.” *Strong v. E.I. Du Pont de Nemours Co., Inc.*, 667 F.2d 682, 687 (8th Cir.1981).

While not universally applied, some states that recognize the sophisticated user defense as a bar to warnings claims based on negligence have not extended the defense to strict liability. *See, e.g., Ruso v. Abex Corp.*,

670 F. Supp. 206, 207 (E.D. Mich. 1987); *Menna v. Johns-Manville Corp.*, 585 F. Supp 1178, 1184 (D.N.J. 1984). Courts in other states do not distinguish between negligence and strict liability claims in the warnings context and also apply the defense to strict liability. *See, e.g., Johnson v. American Standard, Inc.* 179 P.3d 905 (Cal. 2008). Whether a plaintiff is a sophisticated user is a question of fact. Nevertheless, the test for making this determination appears to be an objective one – i.e. whether a similarly situated consumer knew, or should have known, of the dangers of the product at the time of the plaintiff’s injury. *Johnson*, 179 P.3d at 119. For example, in adopting the sophisticated user defense, the California Supreme Court concluded:

[T]he sophisticated user’s knowledge of the risk is measured from the time of the plaintiff’s injury, rather than from the date the product was manufactured. The timeline focuses on the general population of sophisticated users and conforms to the defense’s purpose to eliminate any duty to warn when the expected user population is generally aware of the risk at issue.

Id. at 74.

The sophisticated user defense has been widely applied in a variety of toxic tort and other products liability cases. Examples include asbestos (*Triplett v. Minnesota Mining and Mfg. Co.*, 422 F. Supp.2d 779 (W.D. Ky. 2006)), polyurethane (*Swan v. I.P., Inc.*, 613 So.2d 846 (Miss. 1993)), welding rods (*In re Welding Rod Civil Actions Product Liability Litigation*, Cuyahoga County Case # CV-04-545413 (Ohio 2006)), HVAC mechanic’s exposure to phosgene gas in air conditioners (*Johnson v. American Standard, Inc.* 179 P.3d 905 (Cal. 2008)), rigging procedures for scaffolding used by experienced painter (*Antcliff v. State Employees Credit Union*, 327 N.W.2d 814 (Mich. 1982)), natural pipe manufacturer (i.e., no duty to utility or its employees of well-known gas line dangers) (*Strong v. E.I. Du Pont de Nemours Co., Inc.*, 667 F.2d 682 (8th Cir. 1981)), aircraft warning systems (*In re Air Crash Disaster*, 86 F.3d 498 (6th Cir. 1996), and benzene (*Lambert v. B.P. Prod. North America, Inc.*, C/A No. 04-347-GPM, 2006 WL 924988 (S.D. Ill. Apr. 6, 2006)).



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F. The Learned Intermediary Doctrine

Closely related to the sophisticated user defense is the learned intermediary doctrine. Predominantly used in the context of drug and medical device cases, this doctrine provides that manufacturers of prescription drugs and medical devices discharge their duty of care to patients by providing warnings to prescribing physicians. RESTATEMENT (THIRD) OF TORTS: PRODUCTS LIABILITY § 6 cmt. d, reporters' note (1998). The justification for the rule is that consumers cannot buy prescription drugs or medical devices directly from a manufacturer, and therefore the manufacturer discharges its duty to warn by providing the warning to a learned intermediary.

As stated by the Fourth Circuit Court of Appeals in *Talley v. Danek Med., Inc.*, 179 F.3d 154, 163 (4th Cir. 1999):

“Prescription drugs are likely to be complex medicines, esoteric in formula and varied in effect. As a medical expert, the prescribing physician can take into account the propensities of the drug, as well as the susceptibilities of his patient. His is the task of weighing the benefits of any medication against its potential dangers. The choice he makes is an informed one, an individualized medical judgment bottomed on a knowledge of both patient and palliative. Pharmaceutical companies then, who must warn ultimate purchasers of dangers inherent in patent drugs sold over the counter, in selling prescription drugs are required to warn only the prescribing physician, who acts as a ‘learned intermediary’ between manufacturer and consumer.”

(Quoting *Stanback v. Parke, Davis & Co.*, 657 F.2d 642, 644 n.2 (4th Cir. 1981)).

Currently, 34 states and the District of Columbia have adopted the learned intermediary doctrine either by the highest court or by statute, making it a predominant defense in failure to warn claims brought by users of

pharmaceuticals or recipients of medical devices. Posting of “The Closing of the Learned Intermediary Frontier” to <http://druganddevicelaw.blogspot.com/2011/06/closing-of-learned-intermediary.html> (June 2, 2011, 15:46 EST) (containing a list of all jurisdictions and applicable authority).

G. Whether a Jurisdiction Has a Post-Sale Duty to Warn

A product may not be defective in design or manufacture at the time it is made, and the warnings provided may be adequate based on the information known to the manufacturer at the time of sale. Nevertheless, a manufacturer may be exposed to liability for an injury that occurs from later use of that product. Therefore, critical to any warnings analysis is whether a state provides for a post-sale duty to warn. In cases where a state has not adopted a post-sale duty to warn, a practitioner may have an additional defense in a warnings case.

As background, Restatement (Second) did not address post-sale duties relating to warnings. Therefore, for many years practitioners argued there was no post-sale duty to warn in cases involving recalls, later-developed safety devices and other post-sale knowledge, actions and/or omissions. In 1998, the Restatement (Third) included a section devoted to post-sale warning duties. Section 10 sets forth that a seller/distributor is subject to liability after sale or distribution “if a reasonable person in the seller’s position would provide such a warning.”

As a result, the landscape of jurisdictions that do not recognize any post-sale duty to warn has narrowed substantially since the Restatement (Second). In 2004, the Products Liability Committee of the American Bar Association issued a report in which it concluded that “over thirty states have approved, or there is an indication they would approve, some form of this duty.” Kenneth Ross, *Post Sale Duty to Warn: A Report of the Products Liability Committee*, 2004 A.B.A. LITIG. SEC. at 1. Conversely, an October 2008 law firm study of this issue cited to 24 states that do *not* have a post-sale duty to warn (i.e., either expressly or based on a lack of case law to support



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such a duty). W. David Arnold, darnold@rcolaw.com, *A Manufacturer's Post-Sale Duty to Warn*, at <http://rcolaw.com/documents/postsaleduty101708.pdf>, (Oct. 2008).

In any warnings case involving later-discovered dangers, later-developed safety devices, or other post-sale factors, a manufacturer or seller should assess whether the applicable jurisdiction imposes post-sale duties to warn. If the jurisdiction has not adopted section 10 of Restatement (Third) or has otherwise failed to extend liability to the post-sale arena, then this may offer an additional limitation on the duty to warn and defense to a warnings claim.

H. Conclusion

Before addressing the adequacy of a warning in any products liability case, defense lawyers should carefully assess the duty to warn and whether there are any exceptions or limitations that relieve the seller of liability. The tools outlined above can be effective in dispensing with a warnings case at the dispositive motion stage by merely illustrating to the court that there was no duty to warn.

¹ Different courts cite to different provisions of Restatement (Second) of Torts § 402A for this limitation on the duty to warn. Courts frequently cite to the language in comment j to § 402A and omit the portion dealing with overconsumption and prolonged use. In other words, courts use ellipses to omit the language stricken in the following: “But a seller is not required to warn with respect to products, [. . .] ~~or ingredients in them, which are only dangerous, or potentially so, when consumed in excessive quantity, or over a long period of time,~~ when the danger, or potentiality of danger, is generally known and recognized.”

There has been criticism that this stricken language – and the comment in its entirety – illustrates that this limitation applies only in the context of food, cigarettes, alcohol, drugs, and similar products that contain generic risks and require a warning to notify consumers of hidden dangers. David Owen, *The Puzzle of Comment J*, 55 HASTINGS L.J. 1377, 1382 (2004). The criticism is that courts have ignored this context to support a broad open and obvious risk exception to the duty to warn. However, even without this section there is support in Restatement (Second) for the open and obvious risk doctrine. Comment g to section 402A provides favorable language by setting forth that a product is defective under the section only if it is “in a condition not contemplated by the ultimate consumer. . . .” RESTATEMENT (SECOND) OF TORTS § 402A cmt. j (1965) (emphasis added). The rationale for the exception is that the product is not defective or unreasonably dangerous because these dangers are contemplated by the ultimate user.

² “In general, a product seller is not subject to liability for failing to warn or instruct regarding risks and risk-avoidance measures that should be obvious to, or generally known by, foreseeable product users.” RESTATEMENT (THIRD) OF TORTS: PRODUCTS LIABILITY § 2 cmt. j (1998).

“Are We There Yet?” Addressing Medicare Secondary Payer/Set Asides

By: Laura D. Schmidt

Downs•Stanford, P.C.

2001 Bryan Street, Suite 4000
Dallas, TX 75201
United States

214.748.7900 phone
214.748.4530 fax

lschmidt@downsstanford.com
downsstanford.com

Many of us remember the summer family road trip. Kids are arguing in the backseat. The trunk is loaded with suitcases, pillows, camera bags. Mom and Dad are in the front seat discussing when to stop for lunch, and invariably one of the children asks, “Are we there yet?” Which is followed by this exchange: “Not yet.” “When will we get there?” “We’ll get there when we get there!” Sound familiar? That is basically where liability carriers, attorneys, and the Center for Medicare and Medicaid Service are when it comes to the issue of Medicare Set Asides for tort settlements. No, we’re not there yet, and we’ll get there when we get there. Which leaves many attorneys scratching their heads when a client asks how to handle the Medicare Set Aside. This article will address the current status on this issue, options for set asides, and some thoughts on how to protect your client.

The Center for Medicare and Medicaid Service (“CMS”) is the federal agency handling all things related to Medicare and Medicaid. CMS maintains a website at www.cms.gov with links to issues ranging from research, data, employment opportunities, and regulation on Medicare, Medicaid and CHIP. While it is a good resource for many issues, it fails to provide information on Medicare Set Asides (“MSA’s”) for liability settlements.

Background

Medicare is established through the Social Security Act.¹ Medicare does not pay for medical treatment or service that has been, or is expected to be, paid by no-fault, workers compensation, or liability insurance.² In the event a Medicare recipient incurs medical treatment or service that is not promptly paid by another source, Medicare can make “conditional payments,” with the understanding that it will be reimbursed for these payments at the time of settlement. This subrogation/reimbursement right for payments made in the past is nothing new, and is addressed during settlement. While the past payments are easy to determine, looking into the future for treatment or service for the injury is more difficult. Medicare does not want to pay future benefits that are part of a settlement. That is where the MSA comes into play.

In 2007, Congress passed the Medicare, Medicaid and SCHIP Extension Act to address several issues, including better recovery for conditional payments. All post-payment recoveries are now handled through a national Medicare Secondary Payer Recovery Contractor (“MSPRC”). The departments and contacts within the MSPRC can be found





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at http://www.cms.gov/MSPRGenInfo/02_contactMSPRC.asp#TopOfPage.

Part of the 2007 law requires mandatory reporting by certain entities for any claimant receiving Medicare benefits. Liability carriers (including self-insureds), no-fault carriers, and workers compensation carriers or plans are required to report the identity of the claimant, the date of injury, and additional information to the CMS.³ While the implementation for workers compensation carriers has already begun, the mandatory reporting for liability carriers, no-fault carriers, and self-insured entities does not begin until January 1, 2012.⁴ This implementation date has a reach-back period to all settlements made on or after October 1, 2011. To enforce these reporting mandates, the new law imposes monetary penalties for violations, and makes attorneys, claimants, defendants, and insurers all subject to reimbursing Medicare if its interests are not adequately protected.

Current Status for MSA's in Liability Settlements

Regulations are established for settlements of workers compensation claims, but there are none specifically aimed at tort settlements. There are regulations, however, that imply that tort settlements are also subject to repayment for future medicals.

Reimbursement obligations of primary payers and entities that received payment from primary payers.

- (a) A primary payer, and an entity that receives payment from a primary payer, must reimburse CMS for any payment if it is demonstrated that the primary payer has or had a responsibility to make payment.
- (b) A primary payer's responsibility for payment may be demonstrated by—
...
2) A payment conditioned upon the recipient's compromise, waiver, or release (whether or not there is a determination or admission of liability) of payment for items or services included in a claim against the primary payer or the primary payer's insured....⁵

Under this regulation, it appears that if future medicals are part of a liability claim that settles, the carrier/self-insured or the claimant must reimburse CMS.

Ironically, “set aside” does not appear in the Medicare legislation. There are currently no regulations or rules to address MSA's for tort settlements. So why is this even an issue?

It began with a CMS internal memo addressing workers compensation, where it was suggested that set-aside arrangements should be considered, and that CMS could disregard any settlements that did not protect Medicare's past and *future* interests. As a result, procedures were put in place for mandatory review of certain workers compensation settlements.⁶ However, there currently are no procedures, rules, or guidelines for when CMS should review non-workers compensation settlements. But, CMS has indicated through “town hall” meetings and memoranda that it has the authority to review third party liability settlements as they relate to future benefits.

A memorandum dated May 25, 2011 from the CMS Division of Financial Management and Fee for Service Operations, Region VI specifically states that the law requires that Medicare Trust Funds be protected from payment for future services whether it is a workers compensation or a liability case. It further states that there is no requirement for a set-aside in any situation. The MSA is simply the method of choice for the CMS. Also, there is no formal CMS review for a liability settlement as there is for a workers compensation settlement.⁷ The memo, while not a formal statement of policy, recommends that each attorney will need to determine, based upon the specific facts, whether or not the settlement includes funds for future medicals, and if so, how to protect those funds. Region VI covers the states of Arkansas, Louisiana, New Mexico, Oklahoma and Texas. If the Plaintiff is not in one of these states, the appropriate region should be consulted. However, as of September 2, 2011, this CMS memo appears to be the only one on point, and has been referenced in other states and by MSA vendors across the country.



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So, with nothing in the statute, and no rules or regulations addressing liability MSA's, what is a carrier or self-insured entity to do? If you follow the “guidance” of the May 2011 memo, you evaluate each case on its specific facts to determine if a set aside is even needed, and then how to establish one.

Options for MSA's

A statement specifically addressing Medicare's future interests should be included in all releases. (“The parties carefully considered Medicare's interests for future benefits concerning the settlement and do not intend to shift costs to Medicare,” or something similar.) The claimant should also agree to indemnify and hold harmless any of the defendants, attorneys, and carriers in the event it is later determined that Medicare was entitled to protection for future medical. Some of the liability carriers have established model language for inclusion in all settlements, and vendors that specialize in MSA's also have model language for all settlements. After this generic language, the remainder of the settlement and release will be determined by the facts.

The simplest case is a settlement where no one contemplates future medical expenses. A broken arm that heals with no impairment, a sprained lower back that resolved after therapy, etc. In these instances, it is prudent to add language to the release indicating that no claims were asserted for future medical by the claimant, and no payment was made for future medical. However, the facts and nature of the injury must support this. It would not be enough to represent that there are no future medicals on a serious injury with impairment, as CMS would probably consider this a fraudulent representation. Also, check the pleadings to make sure no claim for future medical was pled. Medical documentation should also support this.

Another easy case is where the claimant will not be Medicare eligible within 30 months of the settlement. In these circumstances, setting forth specific facts in the release, as well as the due diligence used to assert the facts, provides protection against exposure.

The remainder of cases fall into the might need/will need future treatment. This is the area where Medicare's interests must be protected. As stated previously, there are no requirements or procedures for CMS to approve tort settlements with MSA's. Until there are, the workers compensation arena has guidelines that can reasonably be used in a liability case.

CMS mandates a review of a workers compensation settlement of \$25,000.00 or more if the claimant is a current Medicare beneficiary. That threshold rises to \$250,000.00 if the claimant has a reasonable expectation of being a Medicare recipient within 30 months of the settlement. A “reasonable expectation” exists when the claimant has applied for Social Security Disability benefits; has been denied Social Security Disability benefits but plans to appeal; is in the process of appealing a denial of Social Security Disability benefits; is 62 ½ years old; or had End Stage Renal Disease but does not yet qualify for Medicare.⁸ If the plaintiff in a liability settlement over \$25,000.00 is a current Medicare recipient, or in a liability settlement over \$250,000.00 and has a “reasonable expectation” of receiving Medicare benefits within 30 months, it is prudent to assume that some type of MSA is required. It is up to the judgment of the attorney in settlements not meeting these guidelines.

Administration and Approval

Once it has been determined that an MSA is necessary, the parties must determine first if the MSA will be administered by the plaintiff, or professionally administered by one of the many vendors who handle MSA's. CMS allows self-administering if the state where the plaintiff resides allows it. Again relying on the workers compensation arena, MSA's can only be used for future medical treatment and prescription drugs, treatment of the injury-related conditions, and treatment or services that are normally covered by Medicare. The funds must be in an interest-bearing account and administered by a “competent administrator.” In self-administered MSA's, the parties are tasked with evaluating the proper amount of funds to be set aside to cover all future Medicare benefits related to the



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injury, unless there is agreement to pay for a professional opinion. In addition, the plaintiff bears the responsibility of monitoring the account and making annual reports to the CMS when the funds are exhausted. According to one source, the overwhelming majority of MSA's are self-administered by the claimant.⁹

The other option is to have a professional entity administer the MSA. Of course, this requires a payment for establishing the amount for the MSA and administrative fees for ongoing services. The payment of the administrative fees cannot come from the MSA, but must be funded separately. The benefit of using a professional MSA company is that it provides a neutral and experienced calculation of the amount for the MSA, which includes a detailed analysis of the past medical records and bills, the diagnoses and prognoses, projected life expectancy, and future items normally covered by Medicare (treatment, equipment, prescription drugs, etc.).

Once the type of administration is established, and the amount of the MSA is known, the parties can opt to move forward without approval, or seek a written review from CMS. Obviously, if CMS approves the settlement terms, the parties have peace of mind that CMS probably will not come back in the future to question the arrangement. (Without rules or guidelines, one can only assume that there will not

be reviews of settlements approved by CMS.) Deciding to forego CMS approval is a judgment call. Again, referring to the guidelines for workers compensation settlements, the parties may elect to forego the review when the amount of the settlement or the Medicare status of the plaintiff do not meet the thresholds.

Until rules, regulations, or other guidelines are established by the CMS, the attorneys and carriers must use their best judgment and hope we “get there” soon.

¹ 42 U.S.C. 1305, et seq.

² 42 U.S.C. §1395y (b). Note that in January of 2011, in the Florida federal case addressing the new health care law, the “Patient Protection and Affordable Care Act,” *Florida v. U.S. Dept. Health and Human Services*, -- F.Supp.2d--, 2011 WL 285683, N.D. Fla. 2011. The court determined that the PPACA was unconstitutional. The act incorporated the Medicare laws, and those could not be severed from the remainder of the new law. As of September 2, 2011, there are 11 amendments to PPACA currently pending in Congress. Regardless of the outcome of the PPACA, it is unlikely that this part concerning Medicare will be affected.

³ Additional information is found on the CMS website, including the claimant's date of birth, address, Social Security number; the reporting entity's information; policy number, claim number, policy limits, etc.

⁴ CMS memo dated December 21, 2010. <http://www.cms.gov/MandatoryInsRep/Downloads/RevTimeline122110.pdf>

⁵ 42 C.F.R. §411.22.

⁶ 42 C.F.R. §411.16.

⁷ *Schnaxnyder v. Scottsdale Insurance Company*, --F.3d--, 2011 WL 3273547, *3, W.D. La. July 28, 2011.

⁸ <https://www.cms.gov/WorkersCompAgencyServices/Downloads/42203Memo.pdf>

⁹ Blackaby, Dean. *Pirates at the Settlement Conference: Settling Cases and Complying with the Medicare Secondary Payer Act, MSP Education Compliance*, 2011.