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

May 2013

- **There's Something Happening Here: Recent Bankruptcy Developments May Give Trademark Licensees Reason to Hope**
  Recent decisions suggest that trademark licensees may have more rights than previously thought when their licenses are rejected in a licensor's bankruptcy.
- **Robocalling and Wireless Numbers: Understanding the Regulatory Landscape**
  Revisions to the Telephone Consumer Protection Act will soon require written consent for certain telemarketing calls and texts to cell phones, and for prerecorded calls to landlines.
- **Guidance from ARIN on Legal Aspects of the Transfer of Internet Protocol Numbers**
  Internet Protocol address numbers are in short supply. The question at hand is what to do about it.

Departments:

- Keeping Current: **Lien "Strip Down" vs. Lien "Strip Off": *Dewsnup v. Timm* Is Still the Law - Isn't It?**
- Keeping Current: **SEC, for the First Time, Uses a Non-Prosecution Agreement to Resolve an FCPA Enforcement Action**
- Delaware Insider: **The Debate on How to Remedy the Problem of Fast-Filing Plaintiffs in Derivative Actions Continues**
- Member Spotlight: **Interview with Mozelle W. Thompson**

Inside Business Law

American Bar Association • Section of Business Law: Practical Resources for the Business Lawyer

BUSINESS LAW **TODAY**

There's Something Happening Here: Recent Bankruptcy Developments May Give Trademark Licensees Reason to Hope

By Robert Eisenbach III

For years, the world of bankruptcy has been a scary place for trademark licensees. Long-standing case law held that a licensor-debtor's rejection of a license cut off the licensee's rights to the intellectual property, and Congress did not come to the rescue of trademark licensees as it did for licensees of other types of intellectual property. However, recent decisions from at least two courts of appeals suggest that trademark licensees may have more rights than previously thought when their licenses are rejected in a licensor's bankruptcy. This article examines these developments, but first we need to look at the treatment of executory contracts in bankruptcy generally, the protections for other intellectual property licenses, and the history of rejection and trademark licenses.

Executory Contracts in Bankruptcy

An executory contract is a contract between a debtor and another party under which both sides still have important performance obligations outstanding. A debtor in bankruptcy (or its bankruptcy trustee) has the option of assuming, rejecting, or assuming and assigning executory contracts, 11 U.S.C. §§365(a)(1) and (f), with its choice governed by the business judgment standard.

Generally, a debtor can assume an executory contract if it meets the requirements of Section 365(b) of the Bankruptcy Code, including curing defaults and providing adequate assurance of future performance. 11 U.S.C. § 365(b)(1) provides:

> If there has been a default in an executory contract or unexpired lease of the debtor, the trustee may not assume such contract or lease unless, at the time of assumption of assumption of such contract or lease, the trustee
> (A) cures, or provides adequate assurance that the trustee will promptly cure, such default ….
> (B) compensates, or provides adequate assurance that the trustee will promptly compensate, a party other than the debtor to such contract or lease, for any ancillary pecuniary loss to such party resulting from such default; and
> (C) provides adequate assurance of future performance under such contract or lease.

If a debtor chooses to assume and assign an executory contract, the proposed assignee will be required to establish that it can provide adequate assurance of future performance. Alternatively, a debtor can choose to reject an executory contract; rejection constitutes a breach of such contract entitling the nondebtor counterparty to file a claim for rejection damages but without the benefit of specific performance. 11 U.S.C. § 365(g).

Intellectual Property Licenses and Section 365(n)

Prior to the enactment of Section 365(n) of the Bankruptcy Code, 11 U.S.C. § 365(n), licensees whose intellectual property licenses were rejected as executory contracts lost their rights under the license. This was the holding in *Lubrizol Enters., Inc. v. Richmond Metal Finishers, Inc*., 756 F.2d 1043 (4th Cir. 1985). The Fourth Circuit held that Lubrizol, a nonexclusive patent licensee whose patent license was rejected as an executory contract in the bankruptcy case of Lubrizol's licensor, debtor Richmond Metal Finishers, could not "rely on provisions within its agreement with [the debtor] for continued use of the technology." According to *Lubrizol*, when Congress enacted Section 365(g) of the Bankruptcy Code, governing the effect of rejection of an executory contract, "the legislative history of § 365(g) makes clear that the purpose of the provision is to provide only a damages remedy for the non-bankrupt party," and no specific performance remedy. The Fourth Circuit held that, as a result, when the debtor rejected the contract, Lubrizol, as patent licensee, lost its rights under the license.

In reaction to *Lubrizol* and the concerns about the decision's potential impact on patent and other technology licensees, Congress enacted the Intellectual Property

Bankruptcy Act of 1988, adding Section 365(n) to the Bankruptcy Code to give licensees special protections. Although you might expect intellectual property to include trademarks, when Section 365(n) was enacted a special, limited definition of "intellectual property" was also added to the Bankruptcy Code in Section 101(35A). This definition includes trade secrets, U.S. patents, patent applications, copyrights, plant variety, and mask works – but not trademarks.

With no Section 365(n) protection, and in the face of the *Lubrizol* decision, trademark licensees have long faced the serious risk of losing all license rights to a trademark if the licensor files for bankruptcy and rejects the trademark license as an executory contract. If the trademark owner decides that the license is now unfavorable and a better deal can be had under a new license agreement with someone else, the trademark owner likely will reject the existing trademark license agreement. Even the enforceability of phase-out provisions, allowing a licensee to continue to use a mark for a limited time period after the license is terminated, is unclear.

Recent decisions have attempted to fill the gap created by *Lubrizol*, Section 365(n), and the Bankruptcy Code's definition of "intellectual property," and offer trademark licensees rays of hope and caution to trademark licensors in bankruptcy. Three decisions in particular warrant further discussion.

The Third Circuit Treats a Trademark License as Non-Executory

In *In re Exide Techs.*, 607 F.3d 957 (3d Cir. 2010), the United States Court of Appeals for the Third Circuit examined a series of agreements, determined to constitute one integrated agreement, pursuant to which Exide Technologies sold an industrial battery business, and licensed certain trademark rights, to EnerSys. Exide filed for bankruptcy in 2002, and the bankruptcy court granted Exide's motion to reject the agreement as an executory contract, a decision that was affirmed by the district court. On appeal, the Third Circuit held that under New York law, which governed the agreement, once a party has substantially performed, a later breach by that party does not excuse performance.

The Third Circuit held that EnerSys had substantially performed by paying the full purchase price and operating under the agreement for 10 years, as well as by assuming certain liabilities related to the business EnerSys purchased when it obtained the trademark license. As such, the agreement was no longer executory. The court also held that EnerSys's obligation not to use the trademark outside of the licensed business was not a material obligation because it was a condition subsequent and, in any event, did not relate to the agreement's purpose – the transfer of the industrial battery business in return for a $135 million payment. Likewise, the Third Circuit concluded that a quality standards provision was minor because it related only to the standards of the mark for each battery produced and not to the transfer of industrial battery business that was the agreement's purpose. An indemnity obligation that had subsequently expired, and a further assurances obligation where no remaining required cooperation was identified, were held not to outweigh the factors supporting a finding of substantial performance.

Judge Ambro wrote a concurring opinion to address the bankruptcy court's conclusion that rejection of a trademark license left EnerSys without the right to use the Exide mark. He analyzed the history of Section 365(n), disagreed that the exclusion of trademarks from its reach created a negative inference that rejection of a trademark license should be tantamount to termination, and stated that courts should be able to prevent the extinguishment of all rights upon rejection. As Judge Ambro wrote in his conclusion:

> Courts may use § 365 to free a bankrupt trademark licensor from burdensome duties that hinder its reorganization. They should not – as occurred in this case – use it to let a licensor take back trademark rights it bargained away. This makes bankruptcy more a sword than a shield, putting debtor-licensors in a catbird seat they often do not deserve.

Eighth Circuit Holds Trademark License Executory

In *In re Interstate Bakeries Corp.*, 690 F.3d 1069 (8th Cir. 2012), a case with facts that appear very similar to *Exide*, the United States Court of Appeals for the Eighth Circuit examined whether a perpetual, royalty-free, assignable, transferable, and exclusive license to use brands and trademarks belonging to Interstate Brands Corporation (IBC), which subsequently filed for bankruptcy, was an executory contract that could be rejected. Although the relevant aspects of the license agreement appeared to be, at first blush, nearly identical to those in *Exide*, the Eighth Circuit found the agreement in *Interstate Bakeries* to be materially different from the one in *Exide* and held that the agreement was executory – a victory for trademark licensors.

Prior to bankruptcy, IBC entered into a $20 million asset purchase agreement and license agreement with Lewis Brothers Bakeries (LBB) whereby IBC sold to LBB certain baking and business operations in the Chicago area. Following IBC's bankruptcy, LBB sought a declaratory judgment that the license agreement was not an executory contract. The bankruptcy court and district court both found that the agreement executory, with unperformed obligations on both sides. The Eighth Circuit affirmed, finding LBB's obligation to maintain quality standards and IBC's obligations of notice and forbearance with regard to the trademarks material and unperformed. The court distinguished *Exide* because there, "the parties had not even contemplated or discussed any quality standards. . . . Here, it cannot be argued the parties did not contemplate any quality standards, as it is an explicit provision of the License Agreement. Moreover, the plain language of the agreement provides a breach of the quality provision would be material."

As of this writing, a petition for rehearing *en banc* in the *Interstate Bakeries* case is pending but not yet decided.

The Seventh Circuit Rejects *Lubrizol's* Holding

In another 2012 decision, in *Sunbeam Prods., Inc. v. Chicago Am. Manuf., LLC*, 686 F.3d 372 (7th Cir. 2012), the United States Court of Appeals for the Seventh Circuit issued a decision hailed as a major victory for trademark licensees. The facts of *Sunbeam* are straightforward. Lakewood Engineering & Manufacturing Co. made various consumer products, including box fans, which were covered by its patents and trademarks. Lakewood contracted with Chicago American Manufacturing (CAM) to make its fans for 2009, granting CAM a license to the relevant patents and trademarks. In recognition of both the investment CAM would have to make to manufacture the fans and Lakewood's own distressed financial condition, the agreement authorized CAM to sell directly any of the 2009 production of box fans that Lakewood did not purchase. A few months after the agreement was signed, Lakewood was forced into an involuntary bankruptcy and a trustee was appointed. The trustee sold Lakewood's assets, including the patents and trademarks, to Sunbeam Consumer Products, which wanted to sell its own fans and not have to compete with CAM's sales. The trustee rejected the CAM agreement and, when CAM continued to sell the remaining fans, Sunbeam sued CAM for infringement.

The bankruptcy court in *In re Lakewood Engineering & Manufacturing Co., Inc*, 459 B.R. 306 (Bankr. N.D. Ill. 2011), decided to "step into the breach," follow Judge Ambro's reasoning in *Exide*, and begin the "development of equitable treatment" of trademark licensees that it concluded Congress had anticipated would occur. It held that despite rejection of a manufacturing and supply agreement that included a trademark license, the licensee could continue to sell trademarked goods as it had been licensed to do.

On appeal, the Seventh Circuit disagreed with the bankruptcy court's analysis but ultimately affirmed its decision. In its opinion, however, the Seventh Circuit took aim directly at the 1985 Fourth Circuit Lubrizol decision and reasoning.

The issue on appeal was the effect of the trustee's rejection of the CAM agreement, and specifically the trademark license, on CAM's ability to sell the fans. The Seventh Circuit's focus on the *Lubrizol* decision was apparent:

> *Lubrizol Enterprises, Inc. v. Richmond Metal Finishers, Inc.,* 756 F.2d 1043 (4th Cir. 1985), holds that, when an intellectual-property license is rejected in bankruptcy, the licensee loses the ability to use any licensed copyrights, trademarks, and patents. Three years after *Lubrizol*, Congress added § 365(n) to the Bankruptcy Code. It allows licensees to continue using the intellectual property after rejection, provided they meet certain conditions. The bankruptcy judge held that § 365(n) allowed CAM to practice Lakewood's patents when making box fans for the 2009 season. That ruling is no longer contested. But "intellectual property" is a defined term in the Bankruptcy Code: 11 U.S.C. §101(35A) provides that "intellectual property" includes patents, copyrights, and trade secrets. It does not mention trademarks. Some bankruptcy judges have inferred from the omission that Congress codified *Lubrizol* with respect to trademarks, but an omission is just an omission. The limited definition in § 101(35A) means that § 365(n) does not affect trademarks one way or the other. According to the Senate committee report on the bill that included § 365(n), the omission was designed to allow more time for study, not to approve *Lubrizol*. See S. Rep. No. 100–505, 100th Cong., 2d Sess. 5 (1988). See also *In re Exide Technologies*, 607 F.3d 957, 966–67 (3d Cir. 2010) (Ambro, J., concurring) (concluding that § 365(n) neither codifies nor disapproves *Lubrizol* as applied to trademarks). The subject seems to have fallen off the legislative agenda, but this does not change the effect of what Congress did in 1988.

Chief Judge Easterbrook's opinion noted that the bankruptcy court had permitted CAM to continue using the trademarks on equitable grounds, but rejected that approach as going beyond what the Bankruptcy Code permits. The Seventh Circuit then directly addressed the *Lubrizol* decision:

> We need to determine whether *Lubrizol* correctly understood § 365(g), which specifies the consequences of a rejection under § 365(a). No other court of appeals has agreed with *Lubrizol* – or for that matter disagreed with it.

The Court turned to the Third Circuit's *Exide* decision, and specifically Judge Ambro's concurring opinion:

> *Exide*, the only other appellate case in which the subject came up, was resolved on the ground that the contract was not executory and therefore could not be rejected. (*Lubrizol* has been cited in other appellate opinions, none of which concerns the effect of rejection on intellectual-property licenses.) Judge Ambro, who filed a concurring opinion in *Exide*, concluded that, had the contract been eligible for rejection under § 365(a), the licensee could have continued using the trademarks. 607 F.3d at 964–68. Like Judge Ambro, we too think *Lubrizol* mistaken.

After observing that outside of bankruptcy a licensor's breach does not terminate a licensee's right to use intellectual property, the Seventh Circuit explained that under Section 365(g), rejection is considered a breach but without the possibility of specific performance:

> What § 365(g) does by classifying rejection as breach is establish that in bankruptcy, as outside of it, the other party's rights remain in place. After rejecting a contract, a debtor is not subject to an order of specific performance. See *NLRB v. Bildisco & Bildisco*, 465 U.S. 513, 531 (1984); *Midway Motor Lodge of Elk Grove v. Innkeepers' Telemanagement & Equipment Corp*., 54 F.3d 406, 407 (7th Cir. 1995).

The Seventh Circuit then described the impact of Section 365(g) and rejection in bankruptcy. "The debtor's unfulfilled obligations are converted to damages; when a debtor does not assume the contract before rejecting it, these damages are treated as a pre-petition obligation, which may be written down in common with other debts of the same class. But nothing about this process implies that any rights of the other contracting party have been vaporized."

Turning to an analogous situation, the court summarized what happens when a lease is rejected:

> Consider how rejection works for leases. A lessee that enters bankruptcy may reject the lease and pay damages for abandoning the premises, but rejection does not abrogate the lease (which would absolve the debtor of the need to pay damages). Similarly a lessor that enters bankruptcy could not, by rejecting the lease, end the tenant's right to possession and thus re-acquire premises that might be rented out for a higher price. The bankrupt lessor might substitute damages for an obligation to make repairs, but not rescind the lease altogether.

The court distinguished rejection from avoidance powers, which might lead to rescission or termination of an agreement, observing that "rejection is not 'the functional equivalent of a rescission, rendering void the contract and requiring that the parties be put back in the positions they occupied before the contract was formed.' It 'merely frees the estate from the obligation to perform' and 'has absolutely no effect upon the contract's continued existence.' Ibid." (Internal citations omitted.)

The Seventh Circuit referenced scholarly criticism of the Lubrizol decision before turning back to the Fourth Circuit's opinion:

> *Lubrizol* itself devoted scant attention to the question whether rejection cancels a contract, worrying instead about the right way to identify executory contracts to which the rejection power applies.
>
> *Lubrizol* does not persuade us. This opinion, which creates a conflict among the circuits, was circulated to all active judges under Circuit Rule 40(e). No judge favored a hearing en banc. Because the trustee's rejection of Lakewood's contract with CAM did not abrogate CAM's contractual rights, this adversary proceeding properly ended with a judgment in CAM's favor.

Intriguing but Unanswered Questions Raised by Sunbeam

The Seventh Circuit's opinion represents the first court of appeals decision in 27 years to challenge *Lubrizol's* view of how rejection impacts an intellectual property license under Section 365(g). The U.S. Supreme Court denied review, leaving in place the circuit split *Sunbeam* created. *Sunbeam* and its potential interplay with Section 365(n) raises a number of interesting questions, including:

- Aside from the right to use the licensed trademarks, does the licensee keep other rights under its agreement, such as exclusivity if applicable?
- Would a liquidated damages provision in favor of the licensee, payable on breach, cut against the licensee's right under *Sunbeam* to continue to use the licensed trademarks?
- How long does the right to the trademarks continue, the full term of the license agreement plus any extensions, or some shorter period?
- If royalties are required under a trademark license, must the trademark licensee continue to pay them post-rejection to use the licensed trademarks, as an intellectual property licensee covered by Section 365(n) is required to do, or can the trademark licensee argue that rejection is a material breach excusing that performance?
- Since under *Sunbeam* rejection does not terminate trademark license rights, does the same analysis apply to intellectual property other than trademarks, including those covered by Section 365(n)?
- Are licensees of patents, copyrights, or trade secrets, otherwise protected by Section 365(n), required to follow Section 365(n)'s statutory scheme to retain their rights, including payment of royalties, or can they rely on the *Sunbeam* decision's analysis of the effect of rejection as an alternative approach?
- How will purchasers of trademarks and other assets react to the potential continued use of the marks by licensees under rejected trademark licenses?

Conclusion

After years in the proverbial bankruptcy desert, trademark licensees got a glimmer of hope from *Exide* and *Sunbeam*. If followed, these two decisions could mark a significant turning point in the treatment of trademark licenses in bankruptcy. Trademark licensees can now argue under *Exide* that a license, especially if part of a completed purchase and sale, is not an executory contract, although they will have to contend with the Eighth Circuit's *Interstate Bakeries* decision. Outside the Fourth Circuit, licensees can advance the *Sunbeam* decision and argue that rejection of an executory trademark license does not cut off the right to use the trademark. On the other hand, trademark owners will continue to argue that *Lubrizol* was correct and the effect of rejection is to deprive a licensee from further ability to use the trademark, at least other than in the Seventh Circuit. Pending future decisions, and absent a Supreme Court decision or amendments to the Bankruptcy Code to address trademark licenses, it remains to be seen whether these new developments for trademark licensees ultimately will prove to be real – or just a mirage.

Robert Eisenbach III is of counsel at Cooley LLP in San Francisco.

American Bar Association • Section of Business Law: Practical Resources for the Business Lawyer

BUSINESS LAW **TODAY**

Robocalling and Wireless Numbers: Understanding the Regulatory Landscape

By Doug Smith and Andrew Smith

Key provisions of the Federal Communications Commission's (FCC) Telephone Consumer Protection Act (TCPA) rule are scheduled to take effect in October of this year. These changes will require written consent for autodialed and prerecorded telemarketing calls and text messages to cell phones, and will require written consent for prerecorded telemarketing calls to landlines.

The TCPA has a private right of action, and recent class actions alleging violations of the law's autodialer provisions have settled for tens of millions of dollars. The filing of TCPA complaints is on the rise, and recent court decisions have complicated the TCPA litigation landscape.

In this article, we discuss the TCPA and the FCC rules, the amendments to the FCC rules under the TCPA, and new litigation developments under the TCPA.

Background to the TCPA

Under the TCPA, it is "unlawful . . . to make any call (other than a call . . . made with the prior express consent of the called party) using any automatic telephone dialing system or an artificial or prerecorded voice . . . to any telephone number assigned to a . . . cellular telephone service." This law was passed in 1991 and reflects the now-obsolete notion that some cell phone users must pay for incoming calls, and "automated" calls should therefore be limited.

The TCPA defines the term "automatic telephone dialing system" or "ATDS" as "equipment which has the capacity – (A) to store or produce telephone numbers to be called, using a random or sequential number generator; and (B) to dial such numbers." It seems clear that Congress intended the law to apply to random sequential dialers and similar devices that dial numbers continuously until they obtain an answer. For example, the legislative history indicates that "automatic dialers will dial numbers in sequence, thereby tying up all the lines of a business and preventing any outgoing calls."

In 2003, the FCC interpreted the term ATDS to include a predictive dialer, where the dialer has the capacity to randomly generate and dial sequential telephone numbers, even if that capacity has not been enabled: "A predictive dialer is equipment that dials numbers and, when certain computer software is attached, also assists telemarketers in predicting when a sales agent will be available to take calls. The hardware, when paired with certain software, has the capacity to store or produce numbers and dial those numbers at random, in sequential order, or from a database of numbers." Many businesses use telephone systems to contact their customers that, if paired with certain software, are capable of generating and dialing sequential numbers at random.

The FCC's TCPA Rule

The FCC has made a rule under the TCPA (TCPA Rule or Rule), which generally prohibits making telephone calls to cellular telephones using an ATDS or a prerecorded message without the prior express consent of the called party. These prohibitions apply to telemarketing calls as well as to purely informational or transactional calls such as flight updates, debt collection calls, surveys, and bank account fraud alerts.

The TCPA Rule also prohibits making a telemarketing call to a residential landline telephone using a prerecorded message without the prior express consent of the called party, unless the caller has an established business relationship with the called party.

Revisions to the TCPA Rule

The FCC has revised its TCPA Rule to require an automated, interactive opt-out mechanism for prerecorded telemarketing messages to both cell phones and landlines. The revision took effect on January 14, 2013.

In addition, effective October 16, 2013, the Rule will be revised to:

- Require *prior express written consent* requirement for telemarketing calls made to cell phones using an ATDS or a prerecorded message, but will maintain the *prior express consent* requirement for non-telemarketing calls to cell phones;
- Require *prior express written consent* for telemarketing calls made to residential landlines using a prerecorded message; and

- Eliminate the established business relationship exception to the obligation to obtain consent for telemarketing calls made to residential landlines using a prerecorded message.

These revisions are intended to maximize consistency with the Federal Trade Commission's (FTC) Telemarketing Sales Rule (TSR).

Automated, Interactive Opt-Out Mechanism

As of January 14, 2013, the TCPA Rule now requires that every prerecorded telemarketing message, whether delivered to a cell phone or a residential landline, provide an automated, interactive voice- and/or key press-activated mechanism for the consumer to request no further telemarketing calls from the seller. The mechanism must be presented, together with instructions on how to use it, within two seconds of the caller's statement of identity at the beginning of the message. When a consumer uses the opt-out mechanism, his or her number must be automatically added to the seller's do-not-call list, and the call must immediately terminate. When the message is left on an answering machine, it must also provide a toll-free number that the consumer may use to connect directly to the automated, interactive voice- and/or key press-activated opt-out mechanism. These new FCC requirements are consistent with those already imposed by the FTC's TSR.

Prior Express Written Consent

Effective October 16, 2013, the TCPA Rule will require *prior express written consent* to deliver an autodialed or prerecorded telemarketing call to a cell phone, and will require *prior express written consent* to deliver a prerecorded telemarketing message to a residential landline. The Rule defines "prior express written consent" as a signed written agreement that clearly and conspicuously discloses to the consumer that:

- By signing the agreement, he or she authorizes the seller to deliver, to a designated phone number, telemarketing calls using an automatic telephone dialing system or an artificial or prerecorded voice; and
- The consumer is not required to sign the agreement or agree to enter into it as a condition of purchasing any property, goods, or services.

The required signature may be "obtained in compliance with the E-SIGN Act," including via an e-mail, website form, text message, telephone key press, or voice recording.

Although these provisions do not apply to purely informational or transactional calls or messages, such as flight updates, debt collection calls, surveys, or bank account fraud alerts, an informational call that includes an upsell – such as a flight update followed by an offer inviting the consumer to upgrade to first class – would require written consent. The FCC has stated that "if the call, notwithstanding its free offer or other information, is intended to offer property, goods, or services for sale either during the call, or in the future, that call is an advertisement."

It is also important to note that because both the FCC and courts consider a text message to be a "call" for purposes of the rules promulgated pursuant to the TCPA, the written consent requirement will apply to the delivery of telemarketing text message campaigns. It is already industry practice for companies to obtain prior express consent to the receipt of such messages; however, the signature requirement and disclosure obligations (described above) are new.

Litigation and Regulatory Actions

The TCPA allows private actions and provides for between $500 and $1,500 in statutory damages for each violation, with treble damages available for willful or knowing violations, as well as injunctive relief. The TCPA also can be enforced by the FCC and state attorneys general.

TCPA litigation has trended upward in recent years, with TCPA suits rising by 63% between 2011 and 2012. Several factors appear to be fueling this trend:

- *Increased consumer use of cell phones as primary phones*: According to a recent Centers for Disease Control and Prevention Semi-Annual National Health Interview Survey, nearly 36% of American households used cell phones only and nearly 16% received all or nearly all of their calls on cell phones even if they also use landline telephones. Additionally, 60.1% of adults between the ages of 25 and 29 live in households that use cell phones only. Companies that rely on autodialers to contact consumers, therefore, are increasingly at risk of dialing numbers in violation of the TCPA's autodialing prohibitions.
- *Increased ease of filing TCPA class action suits*: In *Mims v. Arrow Fin. Servs., LLC*, the Supreme Court ruled that federal and state courts exercise concurrent jurisdiction over TCPA claims, thus weakening arguments that state law governs whether claims may be brought as class actions.
- *Defects in consent*: For calls where only prior express consent is required to use an autodialer, a 1992 TCPA order by the FCC states that "persons who knowingly release their phone numbers have in effect given their invitation or permission to be called at the number which they have given, absent instructions to the contrary." This view of what reasonably evidences prior express consent is reinforced by the TCPA's legislative history. Nevertheless, a lack of robust controls around ensuring, for example, that prior express consent has been obtained to call a number with an autodialer may result in difficulty overcoming individual claims of a lack of consent.

Several recent court decisions have also complicated the TCPA litigation landscape, one of the most notable being the Seventh Circuit Court of Appeals decision in *Soppet v. Enhanced Recovery Co., LLC*, 679 F. 3d 637 (7th Cir. 2012). In *Soppet*, a debt collector used an autodialer to call two cell phone numbers on behalf of AT&T to collect debts owed. The numbers had been provided to AT&T by the debtors, but at the time of debt collection calls they had been reassigned to new subscribers who had not consented to receive autodialed calls. The new subscribers sued the debt collector for violating the TCPA's prohibition on using an autodialer to call a cell phone number without the prior express consent of the "called party." The debt collector argued that the term "called party" meant "intended recipient of the call." The Seventh Circuit rejected this argument, holding that "called party" means the current cell phone subscriber at the time the call is made. The import of the holding is that consent to autodial a cell phone number can no longer be presumed valid day-to-day unless a reliable mechanism is in place for confirming ownership of the number prior to dialing it. At a minimum, the *Soppet* decision should prompt businesses to consider whether to alter their dialing strategies for consumers resident in Seventh Circuit states (Illinois, Indiana, and Wisconsin).

Chesbro v. Best Buy Stores, LP, 697 F. 3d 1230 (9th Cir. 2012), serves as a cautionary tale for businesses seeking to leverage artificial or prerecorded voice robocalls to deliver messages thought to be purely informational. After purchasing a computer from Best Buy, the plaintiff in *Chesbro* began receiving prerecorded phone messages about Best Buy's rewards program. The plaintiff complained to Best Buy on several occasions about the calls and was eventually placed on its internal Do Not Call (DNC) list. Several months later, however, the plaintiff received another prerecorded phone message from Best Buy about its rewards program, which prompted the filing of a class action complaint in Washington State against Best Buy alleging violation of the TCPA's ban on prerecorded message calls that include or introduce unsolicited advertisements or constitute telephone solicitations. The district court granted summary judgment in Best Buy's favor, finding that the calls were purely informational courtesy calls about its rewards program. On appeal, the Ninth Circuit determined that because the calls encouraged the plaintiff to redeem rewards points, the calls were telephone solicitations, reasoning that redemption of rewards points "required going to a Best Buy store and making further purchases of Best Buy's goods . . . [t] hus, the calls encouraged the listener to make future purchases at Best Buy." Perhaps most significantly, the Ninth Circuit found that the TCPA did not require that telephone solicitations explicitly mention a good, product, or service "where the implication is clear from the context" and that "[a]ny additional information provided in the calls does not inoculate them." The upshot of the ruling is that businesses should carefully review any outgoing prerecorded voice messages that are purported to be informational.

Text messaging is another area in which there has been active litigation. As previously noted, the issue of whether text messages constitute "calls" under the TCPA is well-settled, *see, e.g.*, *Lozano v. Twentieth Century Fox Film Corp.*, 702 F. Supp. 2d 999 (N.D. Ill. 2010); *Abbas v. Selling Source, LLC*, N.D. Ill. 2009; *Satterfield v. Simon & Schuster, Inc.*, 569 F. 3d 946 (9th Cir. 2009). Recent cases have tested whether confirmatory texts – i.e., text messages sent to called party confirming the party's choice to opt out of text messaging – violate the TCPA. Here, however, plaintiffs have not had success. As the court in *Ryabyshchuck v. Citibank*, 11-CV-1236 – IEG (WVG) (S.D. Ca. Oct. 30, 2012) noted, "a simple, confirmatory [text message] response to plaintiff-initiated contact can hardly be termed an invasion of plaintiff's privacy under the TCPA. A finding to the contrary would stretch an inflexible interpretation beyond the realm of reason." The FCC, in a declaratory ruling issued in November of 2012, generally agreed with the idea that confirmatory texts do not violate the TCPA, but included some important caveats in its ruling, including that (1) prior express consent to receive texts messages is required; (2) confirmatory texts must "merely confirm the consumer's opt-out request and do not include any marketing or promotional information"; (3) confirmatory texts are to be the only additional messages sent to customers after they opt out; and (4) confirmatory texts should be sent within five minutes of the opt out request, as "the longer [the] delay [in sending confirmatory texts], the more difficult it will be to demonstrate that such messages fall within the original prior consent." Significantly, the FCC did not entertain the petitioner's argument that confirmatory texts do not violate the TCPA if an autodialer is not used to send them. Rather, the FCC implied in its order that obtaining prior express consent to receive text messages means confirmatory texts may be sent with or without an autodialer.

Given the perilous and quickly changing litigation landscape and the new FCC rules regarding consent, businesses are advised to examine their calling and text messaging practices to determine whether any changes to how they operate and obtain consent are necessary.

Doug Smith is an assistant general counsel at Capital One Financial Corporation in Richmond, Virginia, where he concentrates his practice on consumer privacy, unclaimed property, and payments issues. Andrew Smith is a partner at Morrison & Foerster in Washington, D.C., advising banks, insurers, securities firms, credit bureaus, and other financial services providers regarding consumer regulatory compliance, as well as law enforcement actions and transactional matters.

American Bar Association • Section of Business Law: Practical Resources for the Business Lawyer
BUSINESS LAW **TODAY**

Guidance from ARIN on Legal Aspects of the Transfer of Internet Protocol Numbers

By Ben Edelman and Stephen M. Ryan

Every device connected to the global Internet needs a numeric identifier, an "Internet Protocol" address, or simply "IP address." The Internet's continued growth presents a challenge: most IP addresses have already been assigned to networks and organizations, leaving few left for newcomers and growth. In this context, some networks seek to sell the addresses they previously received – sales which can usefully transfer resources to the networks that most need them, but with certain risks that must be handled with appropriate care. As advisors and counsel to the American Registry for Internet Numbers (ARIN), which assigns and manages these numbers in most of North America, we seek to clarify the circumstances in which such transfers are permitted and to set out the legal, contractual, and policy basis for applicable restrictions.

ARIN's Role and Responsibility for IP Numbers

ARIN is the non-profit corporation that oversees the allocation of Internet Protocol numbers and performs other services related to the operation of the Internet in the North American service region, including the United States, Canada, and certain Caribbean islands. ARIN has served in this capacity since 1998, and in many aspects is similar to, but different from, the Internet Corporation for Assigned Names and Numbers (ICANN), which provides overall global coordination for the domain names and numbers used in the Internet.

ARIN carries out duties assigned to it and handed off to it by the U.S. government – duties that had previously been performed by the government. In particular, effective December 1, 1997, the National Science Foundation (NSF) approved the "transfer [of] responsibility for the IP Number assignment . . . to ARIN." NSF recognized that the formation of ARIN, as an industry self-governance body, was necessary to "give the users of IP numbers (mostly Internet service providers, corporations and other large institutions) a voice in the policies by which they are managed and allocated within the North American region." (*See* NSF Press Release, June 24, 1997.)

ARIN's authority is also recognized through ICANN's contracts with the U.S. government and in turn through ARIN's agreements with ICANN. ICANN's relationship with the U.S. government is presented in part in ICANN's Memorandum of Understanding with the Department of Commerce, November 25, 1998, and various amendments thereto. ARIN's contract with ICANN is embodied in ARIN's assent to the Memorandum of Understanding between ICANN and the Address Supporting Organization (October 29, 2004).

To carry out its obligation of coordinating IP number resource policy in its service region, ARIN follows a rigorous, open policy process. Interested ARIN members and the public, including government agencies, can submit policies for consideration by the ARIN community. Policies are discussed both online and via periodic in-person meetings, and policies are only enacted when they enjoy a consensus among ARIN members. This is exactly the type of multistakeholder industry self-coordination which U.S. government policy has sought for Internet resources.

The Importance of IP Address Uniqueness

The Internet Protocol standard requires that each device connected to a network have a unique IP addresses not used by any other device on the network. Organizations may configure their equipment with any IP addresses they wish, just as they may label folders in their file cabinet with any names they choose, and as long as uniqueness is maintained, the system works. But *global* uniqueness is required when communicating with the Internet at large, as most networks seek to do. Specifically, if a network attempted to connect to the Internet using IP addresses already in use by another network, both networks would find their communications unreliable.

The U.S. government established the Internet Registry System to issue unique IP addresses for Internet research, for facilitating Internet connectivity, and for private use. The Internet Assigned Numbers Authority (IANA) assigns large address blocks to the five Regional Internet Registries (RIR), of which ARIN is one. To assure that each address is assigned only once, IANA carefully assures that each RIR receives distinct address blocks. In turn, each RIR also carefully manages its assigned IP address blocks in its portion of the registry, making individual entries assigning ranges of IP addresses to particular networks as requested. Specifically, when the RIR issues an IP address blocks to a network, the RIR labels the entry in the RIR's registry to indicate the organization's name and related contact information. In short, an "IP address block," as the term is commonly used with respect to globally unique Internet addresses, is defined by and inseparable from its uniqueness in the Internet Registry System.

Uniqueness, as assured by the Internet Registry System, is the crux of the value and importance of IP addressing. From one perspective, IP addresses are just numbers; anyone can pick a number, and configure it into their computer to use it. Completely private networks can and do make use of any IP addresses that they wish. But when it comes to communications with the global Internet, the Internet Registry System provides the required coordination – encapsulating and assuring the right of each participating network to uniquely use assigned IP address blocks free from conflict with others participating in the Internet Registry System.

ARIN's IP Address Transfer Policy

As the four billion Internet Protocol Version 4 Numbers (IPv4) began to run low, ARIN members discussed mechanisms to permit voluntary reallocation of IPv4 addresses to networks that most need them. The ARIN policy process culminated in a consensus on a flexible market-based transfer policy that allows a network to receive the definitive right to IP numbers in the registry, subject to a handful of lightweight restrictions: Under current ARIN policy, the recipient must sign a registration services agreement (RSA) for the addresses it receives, and the recipient must demonstrate "need" for those addresses, consistent with the same standards applied to all other ARIN address allocations. ARIN does not require disclosure of the compensation paid between the parties nor does ARIN share in the compensation.

These reasonable restrictions are appropriate to formalize parties' relationships and to maintain longstanding policy principles. An RSA contract is a basic formalization of rights and responsibilities. ARIN has always required RSAs in its transactions with networks, both to protect ARIN's interests and to clarify networks' rights vis-à-vis ARIN. This process is well-established: more than 3,500 ISPs and network operators have signed more than 11,000 RSAs to date.

Meanwhile, the ARIN community has concluded that demonstrating need is appropriate to assure that networks obtain only the addresses they genuinely require. With IPv4 numbers running low, it would be shortsighted for a network to be permitted to obtain more than it needs – and the networks in the ARIN region therefore have created policies that currently do not allow organizations to take more than they genuinely need. Some networks might wish to obtain a long-term or even indefinite supply of IP numbers, but current community policies intentionally disfavor such tactics: the ARIN community consensus is that networks should be moving to IPv6, the next generation Internet numbering system. Indeed, decades of policies from ARIN and predecessors have limited networks to the addresses they demonstrably need, whether during issuance or when being transferred from one network to another. This requirement should surprise no one.

Services for Networks that Flout ARIN Community Policies

From time to time, critics of current IP resource allocation policies encourage ISPs and network operators to ignore ARIN policy, asserting they have an unfettered right to "sell" addresses in any way they see fit. For example, in a November 2012 article in *Business Law Today*, one commentator suggested that IP address holders can "freely alienate their number assets" – selling to anyone they like. We emphatically disagree.

We first note the policy consequences of allowing addresses to be transferred without restriction. For example, limitless rights to "sell" such numbers would permit them to be "sold" to spammers – who constantly need new addresses as their existing IP address blocks develop bad reputations and become blocked by network operators. Limitless sales would also help those who "phish" and engage in identity theft, activities that similarly damage address reputation. Moreover, limitless sales would permit speculators, who don't use the numbers, to buy up numbers and create artificial scarcity. Putting aside the selfishness of such an approach and the real harm it presents to the Internet, it risks forfeiting the valuable benefits that ARIN provides.

Networks' requests of ARIN also provide ample basis for ARIN's restrictions on transfers. Whether requesting new assignments or transferring addresses from another party, a legitimate network is likely to want multiple services from ARIN: WHOIS to list that network as the authorized and exclusive user of the specified numbers in the Internet Registry System; DNS reverse lookup to confirm the domain names associated with various numbers; and, in the future, perhaps resource certification to cryptographically affirm the network's association with those numbers. To date, ARIN has provided these services to all networks in its service region – networks that signed RSAs as they obtained addresses directly from ARIN, early recipients that signed legacy RSAs (LRSAs) to formalize their relationship with ARIN, and also early recipients of IP numbers who that have not signed LRSAs. ARIN intends to voluntarily continue to provide these services to recipients that comply with ARIN policy. But if a network deliberately flouts ARIN policy, it cannot in the next breath demand that ARIN provide it with services, presumably for free. There is no legal or equitable obligation for ARIN to provide services to those who deliberately choose not to follow ARIN policies. To the contrary, ARIN members expect ARIN to withhold services from networks that intentionally and flagrantly violate ARIN policy; that would be a valid exercise of the ARIN policy process, and it should come as no great surprise to networks that ignore the requirements established by the ARIN community through its open policy process.

For addresses associated with RSA or LRSA contract between ARIN and the address holder, the applicability of ARIN's policies is particularly clear-cut: the contract requires such compliance. Separately, critics occasionally raise questions about addresses allocated by ARIN's government predecessors, without the formality of the RSA contracts. Specifically, some have suggested that those early address allocations yield special rights that include the right to transfer addresses without restriction. Here too, we disagree. The following sections present authority for the applicability of restrictions, duly established by ARIN's community and public processes, to early addresses allocations.

Rights and Obligations of Early IP Number Recipients

Early IP number recipients always understood, or should have understood, that their participation in an interconnected network would necessarily entail compliance with reasonable network policies set by the group, including policies yet to be devised. These requirements have flowed through nearly two decades of subsequent U.S. government policy. For example, when the National Science Foundation (NSF) in 1993 passed responsibility for IP addresses management to contractor Network Solutions (NSI), the NSF's Statement of Work required compliance with certain technical specifications called RFCs that are periodically issued by the Internet Engineering Task Force (IETF). Specifically, the Statement of Work required compliance with RFC 1174 which called for following both existing practice in management of IP addresses as well as "documentation to be issued as RFCs" – indicating that new rules and requirements in the management of IP addresses would arise from time to time. (The Statement of Work instructed: "Awardee shall provide registration services in accordance with the provisions of RFC 1174.") RFC 1174 in turn required the IANA and the Internet regional registries to meet and produce documentation of the operational procedures and requirements to be used in operation of the registry system ("documentation *to be issued* as RFCs," emphasis added).

Just as RFC 1174 contemplated, subsequent IETF documents further formalized the obligations of recipients of IP numbers. For example, RFC 2050 (which was issued in November 1996 before ARIN's formation) in Section 3.1 specifically notes the prospect of reclaiming addresses if the recipient's need no longer exists. Then Section 4.7 adds that transfers of existing assignments from one party to another may occur only with registry permission, and further provides that "the party trying to obtain the IP address must meet the same criteria as if they were requesting an IP address from the Internet Registry." These rules were prepared exactly as anticipated by the use of the future tense in RFC 1174 ("documentation *to be issued*," emphasis added), as combined output of the regional registries and the IANA.

In short, recipients of address space under the NSF cooperative agreement were definitely subject to policies developed by the Internet technical community, including policies established after addresses had been allocated.

As the successor in management of the IP addresses in the region, ARIN inherited responsibility for coordinating and implementing these policies. It would have been easy at the handoff for NSF to restrict ARIN's duties with respect to the management of previously-issued number resources. But the contemporaneous documents reveal no reference to such a limitation, and in fact active statements to the contrary.

Importantly, the creation of ARIN included explicit affirmation of the scope of ARIN's authority as to early IP numbers. For example, the NSF's June 24, 1997, press release celebrates the fact that "creation of ARIN will give the users of IP numbers . . . a voice in the policies by which they *are managed* and allocated within the North American region" (emphasis added). The antecedent for "they" is "IP numbers," and notice the lack of restriction or qualifier on that term; the sentence offers no suggestion that only a subset of North American IP numbers (such as numbers to be issued in the future) are subject to management by IP number users via the ARIN process. Thus, the only reasonable interpretation of this contemporaneous NSF statement is that ARIN has authority to set policy for the IP numbers previously issued by the U.S. government or contractors acting for the U.S. government. Furthermore, verb tense confirms the scope of ARIN's responsibility: As of the time of the press release, no IP numbers had yet been allocated by ARIN, but the press release nonetheless instructs that the ARIN process will set the policies by which IP numbers in the region "*are* managed" (emphasis added) – meaning the policies will apply to the numbers already allocated by ARIN's predecessors in the region. Any contrary interpretation would undermine the NSF's stated intent to enable self-governance of IP addresses by the users in the region.

U.S. Government Policy for Early IP Numbers

Some critics seek support in a recent private letter sent by Mr. Larry Rudolph, the general counsel of the NSF, regarding his views as to the supposed rights of early recipients of IP numbers. But Rudolph's letter was written more than some 14 years after the end of NSF's role in policy oversight of IP numbers. Rather, since 1999, the White House Office of Science and Technology Policy (OSTP) and the Department of Commerce's (DOC) National Telecommunications and Information Administration (NTIA), have overseen the U.S. government's interests in Internet infrastructure. If an advisory opinion were needed to clarify the U.S. government's view of rights in early IP numbers, one would expect that opinion to come from OSTP, DOC, or the Office of Legal Policy at the Department of Justice – but not from NSF. Indeed, in a follow-up letter, Mr. Rudolph himself acknowledged that his prior "observations" were not a "legal or policy position on behalf of the U.S. Government."

Rudolf's letter was almost immediately repudiated by the subsequent statement of

USG IP address policy by the NTIA. Shortly after Rudolph's letter began to publicly circulate, NTIA Administrator Lawrence Strickling posted NTIA's reaffirmation of ARIN's role and responsibility in managing the IP address registry in accordance with the policies developed by community in the region. Specifically, the NTIA statement explained: "The American Registry for Internet Numbers (ARIN) is the RIR for Canada, many Caribbean and North Atlantic islands, and the United States. The USG participates in the development of and is supportive of the policies, processes, and procedures agreed upon by the Internet technical community through ARIN." In our view, NTIA's statement is more persuasive, both through its substance (including its explicit reliance on a decade of U.S. government policy) and its source (the agency with current responsibility for these matters).

Protections for Early Address Recipients

Since ARIN processes may permissibly alter policy as to IP numbers issued before ARIN's creation, one might reasonably ask what protects early IP number recipients against arbitrary or otherwise-improper action by ARIN. The answers are several. For one, ARIN must operate in accordance with its articles of incorporation and bylaws which – duly established during ARIN's formation and reviewed by the U.S. government at that time – require reasonable, non-discriminatory treatment grounded in proper technical justification. Furthermore, ARIN must act in accordance with its own procedures, including changes to policy based on community consensus as grounded in the history and tradition of the Internet technical standards process. These protections amply protect early IP number recipients.

ARIN's good faith stewardship of its responsibilities is demonstrated by its generous treatment of pre-ARIN IP number recipients. For the past 15 years, ARIN has provided no-charge WHOIS, reverse DNS, and other services to early IP number recipients. ARIN has offered (but never required) that early IP number recipients sign a Legacy Registry Services Agreement that formalizes the parties' relationship. Current ARIN policies allow early IP number recipients to sell their exclusive right to use IP numbers to others, realizing significant financial gain (potentially a windfall in some cases, since those recipients did not pay the U.S. government for rights to those resources and the effort necessary to free up underutilized IP addresses could be quite modest.) ARIN imposes minimal restrictions on such transfers. In short, early IP number recipients have every reason to be thankful for the services and policies ARIN has put in place.

U.S. and Canadian Bankruptcy Courts' View of ARIN's Authority

A growing number of IP transfers have occurred to date, including some publicized transactions from bankrupt estates. To ARIN's knowledge, in each and every instance sellers have agreed to follow ARIN policy and have in fact followed ARIN policy.

Despite bankruptcy proceedings recognizing ARIN's role, some critics argue that ARIN policies rules do not bind sellers of IP numbers issued before ARIN began operation. Some even argue that a transfer from Nortel's bankrupt estate to Microsoft supports this view, but that case actually stands for exactly the opposite proposition. In bankruptcy proceedings, the U.S. Nortel estate no longer needed IP numbers it had received years earlier, so it sought to sell those numbers to Microsoft. As initially proposed, the sale sought recognition of the IP addresses as property and did not recognize ARIN's inherent role with respect to IP address management. ARIN intervened in the bankruptcy sale. ARIN had the clear support of the Canadian government and other third parties. See Industry Canada's April 13, 2011, filing in the Nortel Networks bankruptcy *(In re Nortel Networks Inc. et al.,* D. Del. Case No. 09-10138 (KG), docket #5253):

> This submission is in support of ARIN's interventions related to the legal underpinnings of the current governance structure of Internet numbers . . . and to bring to your attention substantive governmental and policy concerns that arise from the sale of Internet numbers in the manner and on the terms suggested in the Debtor's Motion. . . Their use in accordance with the policies adopted by ICANN, ARIN and the regional registries provides essential assurances respecting the ultimate identity and accountability of Internet users.

Microsoft and the Nortel estate ultimately agreed to modify the transaction consistent with ARIN's right to review and approve the transaction following ARIN's established policy. Specifically, in *Nortel* docket #5315, the parties modified the transfer agreement as a transfer of rights and interests in the address blocks, and called for a RSA contract between ARIN and Microsoft. After ARIN's investigation confirmed Microsoft's need for the numbers and found that the transfer complied with established policy, ARIN assented and permitted the transfer to proceed. The bankruptcy trustee and bankruptcy judge assented to this arrangement, and Microsoft – a sophisticated multinational corporation – saw that complying with ARIN's policies added value to its intended transaction. In short, *Nortel* offers only a precedent for following ARIN's policies, not ignoring them.

In myriad transactions after Nortel-Microsoft, bankruptcy courts systematically recognized ARIN's role as the registry in the region and required sellers to comply with ARIN policy. For example, the court in *In re Borders Group, Inc.*, 11-10614 (Bankr. S.D.N.Y.) stated:

> Notwithstanding anything herein to the contrary, . . . (i) the [Internet Address] Sale, . . . is conditioned upon ARIN's consent including any terms and/or conditions established by ARIN's transfer policies or any other policies, guidelines, or regulations developed by ARIN and published on its website, as may be amended and supplemented from time to time (collectively, "ARIN's Policies"), (ii) the transfer of the Debtors' interests in the Internet Addresses

> to the Purchaser is subject to ARIN's Policies, (iii) the Debtors and the Purchaser are required to comply with ARIN's Policies before any transfer of the Debtors' rights in the Internet Addresses may be effectuated; [. . .]

Indeed, the court specifically indicated that ARIN need not change its policies in any way:

> (iv) ARIN is not required to take any action in violation of ARIN's Policies in connection with or as a consequence of this Order, the [Internet Address] Sale, or the Agreements, nor shall ARIN be required to apply a different standard to the transfer of the Internet Addresses than it does to the transfer of non-legacy Internet Protocol numbers. Nothing in this Order is intended, nor shall be construed, as exempting the Debtors and Purchaser from complying with the ARIN Policies.

Orders in similar cases are in accord. See e.g. *In re Teknowledge Corporation*; 10-60457 (Bankr. N.D. Cal.) and *Global NAPS, Inc. v. Verizon New England, Inc.*; 02-12489, 05-10079 (D. Mass.), both permitting sales of IP numbers in bankruptcy proceedings only to the extent compliant with ARIN policy.

Validity of ARIN RSA and LRSA Contracts

ARIN has long formalized its rights and obligations to networks via standard Registration Service Agreements (RSA) contracts laying out rights in IP Numbers. These documents are easily available for public review.

One ARIN critic argues that RSAs are "nothing more than illusory contracts" because, he says, "ARIN, as apparent promisor, makes no binding commitment at all and . . . retain[s] an unlimited right to determine the nature or extent of its performance." The plain language of the RSAs says otherwise. For example, RSA Section 2 grants a network the exclusive right to be the registrant of a given set of numbers, to use those numbers in the registry, and to transfer those numbers. Certainly these rights are encumbered by community policy, but this is to be expected because developing and managing IP address policy is a fundamental principle of ARIN's very existence as part of the global Internet Registry system. A network signing an RSA receives valuable rights, including a commitment from ARIN to associate the number resources with that organization alone, and subject only to the exceptions provided in the RSA – ample consideration to support a valid and enforceable contract.

Looking Forward

IPv4 numbers are indeed in short supply. The question at hand is what to do about it. Some of ARIN's critics envision a future where the networks that received addresses early can sell them to the highest bidder, whether a legitimate network, a spammer, a person engaging in online fraud, or someone stockpiling addresses for future sale. Such a theory recognizes no societal needs or Internet community constraints whatever. In contrast, ARIN's current policies allow transfers with only limited restrictions to prevent the worst abuses and provide additional value to the resources. Some early networks probably will sell their rights to underutilized addresses, even reaping windfall profits, and ARIN policies allow them to do so consistent with the community's rules. But networks' right to make these transfers is nonetheless constrained, including by the agreements networks have accepted in receiving these and other addresses, as well as by applicable law and by longstanding U.S. government policy. That is as it should be.

During this transition to the more capacious numbering system of IPv6, the top priority is, and should be, keeping the Internet running smoothly – assuring that the remaining IPv4 addresses are available to those who need them, and managing all number resources in the registry in accordance with the policies established by the technical community via open multi-stakeholder discussion. ARIN's policies and procedures reveal its commitment to that task.

Ben Edelman, PhD. and Esq., is a Harvard Business School professor and an advisor to ARIN. Stephen Ryan is counsel to the American Registry for Internet Numbers and a partner in the international law firm, McDermott Will & Emery. *The authors thank Matthew Martel of McDermott for guidance on questions pertaining to bankruptcy.*

American Bar Association • Section of Business Law: Practical Resources for the Business Lawyer

BUSINESS LAW **TODAY**

Keeping Current

Lien "Strip Down" vs. Lien "Strip Off": *Dewsnup v. Timm* Is Still the Law – Isn't It?

By Christopher Combest

The real estate collapse of 2008 hurt senior mortgage lenders, but it pummeled junior lenders, whose second liens went from above to below water, almost in a heartbeat. Some homeowners, however, saw an opportunity: if a home purportedly had no value above the amount of the senior lender's claim, why not use Chapter 7 of the United States Bankruptcy Code to value the junior lender's secured claim at zero – effectively stripping the junior lien off of the property and leaving the home closer to the water's surface, where the borrower might more easily start re-building equity?

Bankruptcy professionals might have thought they knew the answer to that question. Over 20 years ago, the United States Supreme Court, in *Dewsnup v. Timm*, barred Chapter 7 debtors from stripping a creditor's partially-secured claim down to the value of the collateral securing it.

However, a unanimous panel of the Eleventh Circuit Court of Appeals recently found *Dewsnup* to be irrelevant when applied to a junior lien on collateral of insufficient value to put the second lien holder in the money. The appellate panel instead relied on one of its own pre-*Dewsnup* decisions, a decision some bankruptcy courts thought had been abrogated by *Dewsnup*. Then, by refusing to publish its opinion, the Eleventh Circuit left debtors, lawyers, and judges in a quandary from which they have yet to emerge. (The case is *In re McNeal*, Appeal No. 11-11352, 2012 WL 1649853 (11th Cir. May 11, 2012).)

Under the Bankruptcy Code, an undersecured creditor with an "allowed" claim (that is, a claim that is entitled to be paid out of the bankruptcy estate) really has two claims: a secured claim in an amount equal to the value of the creditor's collateral and an unsecured claim for the remainder. For example, a lender holding a $1 million mortgage claim secured by real estate worth $400,000 would have a secured claim for $400,000 and an unsecured deficiency claim for $600,000. Moreover, the same section of the Bankruptcy Code that provides for bifurcating the lender's claim into secured and unsecured portions also provides that, to the extent a lien secures a claim that is not an allowed secured claim, that lien is void.

Before the *Dewsnup* decision, therefore, a homeowner in bankruptcy might ask the court to value his or her home at less than the full amount owed on the mortgage; if the court did so, the homeowner would then ask the court to void the lien to the extent that the lender's claim exceeded that court-determined value – a procedure informally referred to as "stripping down" the lien. The debtor might then pay that value and extinguish the lien. Of course, if the court had undervalued the property or the property later appreciated in value, the debtor, not the lender, benefited from the additional value.

In 1991, the Supreme Court, in *Dewsnup*, put a stop to lien-stripping in Chapter 7 cases, finding that, so long as an allowed claim is secured by a lien – even one worth less than the full amount of the claim – a debtor could not strip down the lien. Instead, the lien would survive the bankruptcy, and the lender could foreclose it even after the Chapter 7 debtor received a discharge of his or her debts. While the discharge prevented the lender from collecting a deficiency from the former debtor, the lender would, at least, benefit from any increase in the value of the real estate itself, whether by appreciation or as a result of the court's low-ball valuation. At least two considerations weighed heavily in the Court's ruling:

- honoring the bargain between the borrower and the lender that the lien would stay with the property until foreclosure, thereby insuring that increases in property value would benefit the lender; and
- observing the rule, established long before the enactment of the Bankruptcy Code, that liens survive bankruptcy.

The *Dewsnup* opinion may have given comfort to Lorraine McNeal's junior lender. McNeal owed $176,413 to her first mortgage lender and $44,444 to her second, each of which held liens encumbering a home that, the parties agreed, was worth just $141,416 – less than the amount of the first mortgage, leaving the junior lien completely valueless. McNeal argued that, because the lien of the second mortgage holder did not actually secure any allowed *secured* claim – the junior lender's claim was wholly unsecured – that lien was void and should be "stripped off" of her home completely.

Most courts, including bankruptcy courts within the Eleventh Circuit, had held that the *Dewsnup* rule against "stripping down" liens that had some value applied equally to "stripping off" liens that had no apparent value, and the bankruptcy and district courts both held against McNeal, forbidding her from stripping the second lien from her home.

However, the Eleventh Circuit found that *Dewsnup* did not control its decision, and it reversed, holding for the debtor. Without significant analysis, the panel decided that the case of a lien determined to have some value (*Dewsnup*) had no relevance to the case of a lien determined to have no value (*McNeal*), and, instead, applied a pre-*Dewsnup* Eleventh Circuit decision that had permitted a lien to be stripped off of collateral whose value was insufficient to support the second lien. The result is surprising, in part, because it splits from the opposite rulings of the Fourth and Sixth Circuits and departs from the understanding of *Dewsnup* found in opinions of some bankruptcy courts in the Eleventh Circuit. It also departs from the central policy arguments advanced by the Supreme Court in *Dewsnup*, which appear to apply equally to "strip down" and "strip off" cases: that courts should respect the lender's bargain with its borrower and that they should preserve the long-standing practice of leaving liens unaffected by bankruptcy.

Perhaps even more confounding is the fact that the Eleventh Circuit chose not to publish its *McNeal* opinion. Under the Circuit's rules, that means *McNeal* is not binding precedent, but may be cited as "persuasive authority." One might sympathize with bankruptcy courts in Alabama, Florida, and Georgia as they try to determine the degree to which they should be "persuaded" by a unanimous panel decision from their controlling circuit that nonetheless is not strictly precedential. Some practitioners in those jurisdictions report that, where Chapter 7 debtors have filed contested motions to strip second liens off of their homes, the bankruptcy courts are simply holding the motions in abeyance, indefinitely, pending further guidance from the Eleventh Circuit. Meanwhile, debtors in jurisdictions outside the Eleventh Circuit have also sought to strip second liens from their property.

Guidance does not appear to be within ready reach. In January, debtor's counsel asked the appellate panel to publish its opinion in *McNeal* and thereby put to rest the issue of *McNeal*'s authority within the circuit. However, at the time of that request, both lender-appellees had commenced Chapter 11 bankruptcy cases, and, in February, the Eleventh Circuit therefore stayed all proceedings in the *McNeal* appeal, until it is notified that the bankruptcy court has granted relief from the automatic stay in the lenders' cases.

For now, then, debtors with homes worth less than their total mortgage debt have found a friend in the Eleventh Circuit, while home equity lenders may impose stricter loan-to-value requirements as they try to weigh the risks posed by *McNeal*.

Christopher Combest is a partner in the Chicago office of Quarles & Brady LLP, where he practices in the firm's Commercial Bankruptcy, Restructuring, and Creditors' Rights Group.

American Bar Association • Section of Business Law: Practical Resources for the Business Lawyer
BUSINESS LAW **TODAY**

Keeping Current

SEC, for the First Time, Uses a Non-Prosecution Agreement to Resolve an FCPA Enforcement Action

By Mara Senn, Claudius Sokenu, Arthur Luk, and Daniel Bernstein

On April 22, 2013, the Securities and Exchange Commission (SEC) announced its first-ever non-prosecution agreement (NPA) in a matter involving potential violations of the Foreign Corrupt Practices Act (FCPA). The SEC heralded this NPA – which it entered into with Ralph Lauren Corporation (Ralph Lauren) – as an example of the "substantial and tangible" benefits that companies may earn through the SEC Enforcement Division's Cooperation Initiative (Cooperation Initiative). SEC Press Release, "SEC Announces Non-Prosecution Agreement with Ralph Lauren Corporation Involving FCPA Misconduct," (April 22, 2013). However, exactly when a company may be able to secure an NPA from the SEC and exactly what benefits accrue from such a resolution remain to be seen.

Background

Over three years ago, the SEC's Enforcement Division announced its Cooperation Initiative, which expanded the range of options available in resolving enforcement matters. Historically, the Enforcement Division could, on one end of the spectrum, close an investigation by declining to initiate an enforcement action. On the other end of the spectrum, the Enforcement Division could institute an enforcement action and seek relief, including monetary sanctions. The Cooperation Initiative authorized the staff of the Enforcement Division to use new tools such as NPAs and deferred-prosecution agreements (DPAs) to encourage greater cooperation in reporting securities law violations and assisting in investigations. Under these agreements – which were modeled after those long used by the Department of Justice (DOJ) – the SEC agrees not to pursue an enforcement action in exchange for compliance with express undertakings. *See generally* Arnold & Porter LLP, Advisory, "SEC Announces New Guidance for Cooperation with Investigators," (Jan. 2010).

Yet, while the DOJ has entered into dozens of NPAs and DPAs to resolve criminal investigations in recent years, the SEC has rarely used these agreements. The SEC entered its first NPA on December 20, 2010, with children's clothing manufacturer Carter's, Inc., to settle allegations of accounting fraud. The SEC did not impose a monetary penalty against Carter's in light of the isolated nature of the unlawful conduct, Carter's prompt and complete self-reporting, its exemplary and extensive cooperation in the investigation, and its extensive and substantial remedial actions. A year after the SEC entered into an NPA with Carter's, it announced that it was entering into NPAs with both Fannie Mae and Freddie Mac, apparently because of unique circumstances presented by the companies' then financial status. Like the *Carter* settlement, the SEC imposed no fines in the *Fannie Mae/Freddie Mac* NPA.

On May 17, 2011, a few months after the Carter's NPA, the SEC entered into its first DPA with Tenaris S.A. (Tenaris), a global manufacturer and supplier in the oil and gas industry, to settle FCPA allegations. Tenaris, which also entered into a related NPA with the DOJ, secured a DPA with the SEC as a result of the company's voluntary self-reporting, worldwide internal investigation, enhancement of compliance measures, and high-level of cooperation. Since May 2011, the SEC has not entered into any other DPAs.

Ralph Lauren Corporation Enters Into NPAs

Ralph Lauren resolved parallel FCPA investigations actions through an NPA with the SEC and a separate NPA with the DOJ. The FCPA investigations stemmed from bribes allegedly paid by one of Ralph Lauren's foreign subsidiaries to government officials in Argentina. According to the SEC's NPA, between 2005 and 2009, the general manager and other employees of the foreign subsidiary (RLC Argentina) approved approximately $568,000 in payments to a customs broker to bribe Argentine customs officials in order to secure the importation of Ralph Lauren products into Argentina. The customs broker allegedly submitted invoices with charges for "loading and delivery expenses" and "stamp tax/label tax" that were used to disguise bribe payments. Moreover, RLC Argentina allegedly gave gifts worth thousands of dollars to three government officials in order obtain improper benefits in the customs process.

In 2010, Ralph Lauren implemented a new worldwide FCPA policy. After reviewing this policy, RLC Argentina employees raised concerns about the company's customs broker. As a result, Ralph Lauren initiated an internal investigation of the allegations, and within two weeks of uncovering the improper payments and gifts in Argentina, self-reported its preliminary findings to the SEC and Justice Department.

The SEC decided not to charge Ralph Lauren with FCPA violations, citing "the company's prompt reporting of the violations on its own initiative, the completeness of the information provided, and its extensive, thorough, and real-time cooperation with the SEC's investigation." The SEC also credited Ralph Lauren's extensive remedial measures, which included: "(1) an amended anticorruption policy and translation of the policy into eight languages, (2) enhanced due diligence procedures for third parties, (3) an enhanced commissions policy, (4) an amended gift policy, and (5) in-person anticorruption training for certain employees." Furthermore, the SEC acknowledged that Ralph Lauren is in the process of ceasing all operations in Argentina, though it is unclear to what extent the withdrawal from Argentina related to FCPA concerns.

As part of its NPA with the SEC, Ralph Lauren agreed to pay $593,000 in disgorgement and $141,846 in prejudgment interest. To resolve the DOJ's related criminal investigation, Ralph Lauren agreed to pay an $882,000 penalty. Ralph Lauren also agreed to provide the DOJ with periodic reports on its ongoing compliance efforts, without requiring an independent compliance monitor. Department of Justice Press Release, "Ralph Lauren Corporation Resolves Foreign Corrupt Practices Act Investigation and Agrees to Pay $882,000 Monetary Penalty," (April 22, 2013).

Following the announcement of Ralph Lauren's settlements with U.S. authorities, Argentine tax authorities reportedly asked the SEC to supply information, including the names of Argentine government officials supposedly involved in the bribery scheme, to assist a newly launched criminal investigation in Argentina.

Significance

In many ways, the Ralph Lauren case is a typical one under the FCPA: it shows the U.S. government's continued interest in FCPA violations in Latin America. And it highlights the risks associated with the use of customs brokers to interact with government officials.

The Ralph Lauren case also follows the path set by the SEC's Cooperation Initiative. Robert Khuzami, then-director of the SEC's Division of Enforcement, said that the SEC intended to increase its use of both NPAs and DPAs to "dovetail more nicely" with the DOJ's practice of using such agreements. According to Khuzami, "more uniformity of use" of these agreements will result in more "consistency and clarity for the regulated community." *See BNA White Collar Crime Report*, "Khuzami Says Use of NPAs, DPAs Will Become More Uniform Over Time" (Nov. 16, 2012).

Yet the Ralph Lauren NPA only goes so far in providing this desired "consistency and clarity." For example, the NPA does not provide explicit guidance regarding what conduct will lead the SEC to resolve an action with an NPA. Notably, the publicly disclosed facts in the *Ralph Lauren* and *Tenaris* matters appear similar in many respects: (1) both companies self-disclosed alleged misconduct that was discovered as a result of internal investigations, (2) the alleged violations in each case were limited to one country, and (3) both companies also implemented remedial measures on an international scale. One possible distinction that may explain the different dispositions is that the potential violations in *Ralph Lauren* were discovered through the implementation of a new anti-bribery policy, whereas Tenaris discovered the potential violations in response to allegations of bribery by a third party.

Moreover, the SEC's NPA does not address whether Ralph Lauren's agreed-upon disgorgement reflects a discount for the company's cooperation. While the NPA required disgorgement of $593,000, which is the same amount as the total of the improper payments made and gifts given, the agreement does not specify the amount of ill-gotten gains that resulted from the bribes.

Finally, Ralph Lauren needs to provide full cooperation "during the period of cooperation" and to continue to cooperate for an indeterminate length of time. This cooperation includes ongoing obligations to produce non-privileged documents as requested, use its best efforts to make current and former officers and directors available for testimony (even from overseas), and enter into tolling agreements. Ralph Lauren's NPA requires many of the same terms of cooperation as a DPA would, but without the time limits used in DPAs. Accordingly, resolution through an NPA may just be, as the saying goes, "the emperor's new clothes."

Mara Senn, Claudius Sokenu, and Arthur Luk are Arnold & Porter LLP partners in the Securities Enforcement and White Collar practices who regularly represent clients before the SEC and Justice Department. Daniel Bernstein is an associate at Arnold & Porter. *The authors thank Jocelyn Wiesner for her contributions.*

Click to view the latest
Business Law **TODAY**

American Bar Association • Section of Business Law: Practical Resources for the Business Lawyer

BUSINESS LAW **TODAY**

Delaware Insider

The Debate on How to Remedy the Problem of Fast-Filing Plaintiffs in Derivative Actions Continues

By Jason C. Jowers

Over the past several years, both the Delaware Supreme Court and the Court of Chancery have recognized the problem of plaintiffs that rush to file derivative actions without first investigating their claims, usually in multiple forums, following the announcement of some corporate trauma. Typically, there is a race to the courthouse by plaintiffs' firms in an effort to obtain lead plaintiff status. Although both courts acknowledge the problem, a satisfactory solution has thus far proven elusive. On April 4, 2013, in *Pyott v. Louisiana Mun. Police Employees' Retirement System*, __ A.3d __, 2013 WL 1364695 (Del. 2013) ("*Allergan*"), the Delaware Supreme Court reversed a controversial decision last year by the Delaware Court of Chancery that attempted to address the problem of the fast-filing plaintiff. The lower court had denied dismissal on collateral estoppel grounds of a shareholder derivative action alleging *Caremark* claims despite the fact that substantially similar claims brought by other shareholders in an action in California had been dismissed with prejudice. Supporting its decision, the Court of Chancery determined that Delaware's demand futility law, which the court believed should be incorporated into the privity prong of California's collateral estoppel test, could not be met because a shareholder does not become the representative of the corporation until a motion to dismiss for failure to make a demand on the board is denied. Additionally, the Court of Chancery found that the shareholder plaintiffs in the California action were not adequate representatives of the corporation because they failed to investigate their claims before bringing the action. In so finding, the trial court established a presumption that fast-filing plaintiffs who do not seek to inspect a corporation's books and records before bringing *Caremark* derivative claims do not adequately represent the interests of the corporation, but rather represent the interests of the plaintiffs' firms who routinely bring such claims immediately after the announcement of a corporate trauma.

As soon as it was announced, the decision became controversial. Some members of the defense bar feared that the decision would result an infinite number of derivative actions in multiple jurisdictions if a dismissal with prejudice against one shareholder failed to preclude litigation instituted by another on the same issues. Conversely, from the plaintiffs' bar perspective, the decision would have required plaintiffs to slow down and spend resources bringing a books and records actions to investigate their potential claims rather than racing to the courthouse to file *Caremark* claims in an attempt to win lead plaintiff status.

Shortly after issuing its ruling, the Court of Chancery certified its decision for interlocutory appeal, and the Delaware Supreme Court accepted the appeal. Reversing, the Delaware Supreme Court found that the Court of Chancery improperly conflated California's collateral estoppel law with Delaware's demand futility law. Additionally, the Court expressly rejected an "irrebuttable presumption" that shareholder plaintiffs do not adequately represent a corporation when they quickly file a *Caremark* claim without first seeking to inspect books and records. However, the Supreme Court's decision seems to have left open two key questions for practitioners handling derivative actions brought under Delaware law. First, although finding that the Court of Chancery failed to follow California precedent in administering California's collateral estoppel test, the Supreme Court failed to answer the question of whether, for Delaware law purposes, a shareholder becomes a representative of the corporation before there is a finding of demand excusal or demand futility. Second, although rejecting an "irrebuttable presumption" that fast-filing plaintiffs are not adequate representatives of the corporation, the Court seemingly left open the possibility of a *rebuttable* presumption that fast-filing plaintiffs are inadequate representatives.

The Court of Chancery's Decision

In *Louisiana Municipal Police Employees' Retirement System v. Pyott*, 46 A.3d 313 (Del. Ch. 2012), a Delaware corporation specializing in pharmaceuticals, entered into a settlement agreement with the U.S. government following a three-year investigation into its off-label marketing of Botox. As part of the settlement, Allegan agreed to pay $375 million in criminal fines for misbranding and $225 million in civil fines to resolve False Claims Act actions that also dealt with off-label marketing. Following the public announcement of the settlement, various shareholder plaintiffs filed derivative actions in both California and Delaware. One of the shareholder plaintiffs in one of the Delaware actions sought to inspect books and records pursuant to Section 220. The rest did not.

Following the dismissal of the California action, the director defendants in the Delaware action moved to dismiss, in part, on collateral estoppel grounds. The defendants argued, and the court agreed, that the Delaware court was required pursuant to the Full Faith and Credit Clause of the U.S. Constitution to give the same force and effect to a foreign judgment as the foreign court rendering the judgment. In other words, when a Delaware court is asked to dismiss a case pursuant to the collateral estoppel doctrine based on a prior judgment in California, the Delaware court must give the same credit to that judgment as would a California court.

The California collateral estoppel or issue preclusion standard has five prongs. First, the issue sought to be precluded must be identical to that decided in a former proceeding. Second, the issue must have been actually litigated in the former proceeding. Third, it must have been necessarily decided in the former proceeding. Fourth, the decision in the former proceeding must be final and on the merits. Finally, the party against whom preclusion is sought must be the same as, or in privity with, the party to the former proceeding.

Although accepting that California's collateral estoppel standard generally governed the effect of the prior California judgment on the Delaware action, the Court of Chancery held that Delaware law had a role to play in the analysis. While generally applying California's collateral estoppel test, as it must, the court concluded that Delaware law governed whether stockholders of a Delaware corporation were in privity with each other or the corporation under the final prong of the test. According to the court, "[w]hether successive stockholders are sufficiently in privity with the corporation and each other is a matter of substantive Delaware law governed by the internal affairs doctrine." The internal affairs doctrine generally recognizes that only one state, the state of incorporation, should have the authority to regulate a corporation's internal affairs, such as relationships among or between the corporation and its current officers, directors, and shareholders. Disagreeing with both a prior Court of Chancery case and authority from outside of Delaware, the court found that a shareholder who fails to overcome demand excusal on a motion to dismiss is not in privity with the corporation or the other shareholders. The court explained that a derivative action has two components. In the first instance, it is an action by shareholders to compel the corporation to sue. Second, assuming demand is excused or wrongfully refused, it is an action by the shareholders on behalf of the corporation. Until the court denies a Rule 23.1 motion to dismiss or the board of directors determines it will not oppose the derivative action, the shareholder plaintiff is only bringing an action to compel the corporation to sue. Therefore, until a court denies a motion to dismiss or the board does not oppose the derivative action, the shareholder plaintiff does not have authority to carry out the second component of the derivative action, which is to sue on behalf of the corporation to remedy the wrong itself. Thus, because the shareholders in the California action did not survive the motion to dismiss, the court found they never were in privity with the corporation and its other shareholders.

Additionally, rejecting the defendants' request in part because the California plaintiffs did not properly investigate the claims, the court found that "a court in a plenary derivative action such as this one has discretion to address a rush to the courthouse by determining that the plaintiff in the original derivative action did not provide adequate representation for the corporation and declining on that basis to give preclusive effect to a Rule 23.1 dismissal of the fast-filer's complaint." The court went on to explain that "to give preclusive effect to the California Judgment would favor the lawyers who filed hastily, penalize the diligent counsel who used Section 220, and confer a case-dispositive advantage on the defendants at the potential expense of the corporation." Accordingly, the court denied the motion to dismiss based on the presumption that the fast-filing California plaintiffs had not adequately represented the company because they failed to seek books and records before filing. However, the *Allergan* court did not explain what test governed the fast-filer presumption or whether it could be rebutted.

The Court of Chancery certified the defendants' request for an interlocutory appeal, and the Delaware Supreme Court accepted the appeal.

The Delaware Supreme Court Reverses

The Delaware Supreme Court sitting *en banc* unanimously reversed the Court of Chancery. The Court found that the Court of Chancery failed to correctly apply California's collateral estoppel law when it used Delaware law to decide the privity and adequacy of representation prongs of California's collateral estoppel test. In the trial court, the defendants had argued that *LeBoyer v. Greenspan*, 2007 WL 4287646 (C.D. Cal. 2007) controlled. In *Leboyer*, on facts similar to *Allergan*, the defendants moved to dismiss based on collateral estoppel following dismissal of a different shareholder's suit. The *Leboyer* court ultimately found that "differing groups of shareholders who can potentially stand in the corporation's stead are in privity for the purposes of issue preclusion."

The Delaware Supreme Court found that the Court of Chancery erred by not following California law, set forth in *LeBoyer*, when deciding the collateral estoppel issue. According to the Delaware Supreme Court, "the motion to dismiss, based on collateral estoppel, was about federalism, comity, and finality. It should have been addressed exclusively on that basis. Under this Court's precedents, the undisputed interest that Delaware has in governing the internal affairs of its corporations must yield to the stronger national interests that all state and federal courts have in respecting each other's judgments." Emphasizing that *LeBoyer* required dismissal, the Court went on to state: "The Court of Chancery should have applied California law or federal common law to analyze all elements of collateral estoppel. If the Court of Chancery had done so, rather than invoking the internal affairs doctrine to apply Delaware law to the issues of privity and adequacy of representation, the decision in *LeBoyer v. Greenspan* would have compelled it to dismiss the case."

The high court also rejected the Court of Chancery's attempt to apply what the Supreme Court construed to be an irrebuttable presumption that plaintiffs who do not investigate are inadequate representatives of the corporation. Rejecting at least an irrebuttable presumption against fast-filing plaintiffs, the Supreme Court stated:

> Undoubtedly there will be cases where a fast filing stockholder also is an inadequate representative. But, there is no record support for the trial court's premise that stockholders who file quickly, without bringing a § 220 books and records action, are *a priori* acting on behalf of their law firms instead of the corporation. This Court understands the trial court's concerns about fast filers. But remedies for the problems they create should be directed at the lawyers, not the stockholder plaintiffs or their complaints.

Unanswered Questions

The Delaware Supreme Court's decision in *Allergan* leaves two key questions unanswered with respect to fast-filing plaintiffs. First, although finding that the Court of Chancery failed to follow California precedent in administering *California*'s collateral estoppel test, the Supreme Court failed to answer the question of whether, for *Delaware* law purposes, a shareholder becomes a representative of the corporation before there is a finding of demand excusal or demand futility. The Delaware Supreme Court opted not to address this question "because, as discussed, the Court of Chancery should not have applied Delaware law in deciding whether the California Federal Court Judgment must be given preclusive effect." However, the Delaware Supreme Court expressed some skepticism of the argument that shareholders were not in privity with one another until demand was excused, noting that "that numerous other jurisdictions have held that there is privity between derivative stockholders."

Second, although rejecting an "irrebuttable presumption" that fast-filing plaintiffs are not adequate representatives of the corporation, the Court seemingly left open the possibility of a *rebuttable* presumption that fast-filing plaintiffs are inadequate representatives. In the Court of Chancery's decision in *Allergan*, the court was silent as to whether the decision was rebuttable or irrebuttable. The defendants urged in their briefs before the Supreme Court that the Court of Chancery applied an irrebuttable presumption. Similarly, when addressing this issue in its opinion, the Supreme Court found that the Court of Chancery "announced and applied an *irrebuttable* presumption." (Emphasis added). In the portion of its decision reversing, the Supreme Court makes clear that "[w]e reject the 'fast filer' *irrebuttable* presumption of inadequacy." (Emphasis added).

The modification of "presumption" with the word "irrebuttable" is potentially significant. While *Allergan* was being briefed in the Delaware Supreme Court, the same vice chancellor who decided *Allergan* in the Court of Chancery again applied the presumption against fast-filers, but in this second case made clear that the presumption was a *rebuttable* one. In *South v. Baker*, 62 A.3d 1 (Del. Ch. 2012), following the public announcement of lower silver production projections by Hecla Mining Company and the announcement of numerous safety violations by the U.S. Mine Safety and Health Administration after several accidents in Hecla's mines, plaintiffs filed two actions alleging securities law violations in Idaho. The securities cases alleged that Hecla's disclosures relating to its safety procedures had been materially misleading. In Delaware, shareholders of Hecla brought a derivative action alleging *Caremark* claims against the directors of the company for the damages the company has and will suffer as a result of the securities lawsuits.

The plaintiffs in the Delaware action failed to inspect Hecla's books and records before bringing their action, and the directors moved to dismiss. As is often the case with *Caremark* claims that are not investigated before filing, the court found the plaintiffs were unable to allege particularized facts supporting demand futility by showing that a majority of the board faced a substantial risk of liability. Explaining that fast-filers of Caremark claims display disloyalty to the corporation by not first investigating a Caremark claim, the court stated: "A plaintiff who hurries to file a *Caremark* claim after the announcement of a corporate trauma behaves contrary to the interests of the corporation but consistent with the desires of the filing law firm to gain control of (or a role in) the litigation. The natural and logical inference from this recurring scenario is that the plaintiff is serving the interests of the law firm, rather than those of the corporation on whose behalf the plaintiff ostensibly seeks to litigate."

Because the plaintiffs in *South* filed shortly after the public announcements and the filing of the securities actions and failed to conduct a books and records inspection pursuant to Section 220, their actions triggered the fast-filer presumption. However, unlike *Allergan*, the court also concluded that the presumption that the fast-filing plaintiff acted disloyally and was not an adequate representative of the corporation could be rebutted. Delaware Rule of Evidence 301 provides that "a presumption imposes on the party against whom it is directed the burden of proving that the nonexistence of the presumed fact is more probable than its existence." Pursuant to DRE 301, the court found that the party opposing the presumption could rebut it in two ways. First, the party could prove that despite the fast-filer's failure to inspect books and records under Section 220, the shareholder had "conducted a meaningful and thorough investigation." Second, the person attempting to rebut the presumption could prove that the act of filing quickly benefitted the company, and not just the law firm.

The plaintiffs in *South* were unable to rebut the fast-filer presumption. Plaintiffs' counsel admitted to spending only "several hours" investigating the claims. Furthermore, the plaintiffs were unable to offer any reason why they could not have utilized Section 220 to investigate and then bring their *Caremark* claims if the inspection of books and records generated sufficient evidence. Finally, plaintiffs' counsel admitted that he filed the action quickly due to the fear that other plaintiffs might move faster and gain control of the action against the directors.

It remains to be seen whether the rebuttable presumption announced by the Court of Chancery in *South v. Baker*, as opposed to the irrebuttable presumption rejected by the Supreme Court in *Allergan*, will survive. What appears more certain is that the Court of Chancery will continue to attempt to solve the riddle of limiting the problem of the fast-filing plaintiff in *Caremark* derivative actions.

Jason C. Jowers is a partner at Morris James LLP in Wilmington, Delaware, where he practices in the areas of corporate, alternative entity, and complex commercial litigation.

American Bar Association • Section of Business Law: Practical Resources for the Business Lawyer

BUSINESS LAW TODAY

Member Spotlight

Mozelle W. Thompson

In 1997, President Clinton appointed Mozelle W. Thompson as a Commissioner on the Federal Trade Commission where he became a leader in international consumer protection, high technology competition, and online privacy. Previously, Thompson had served in the Treasury Department, overseeing domestic spending and credit policies and creating the Office of Privatization. Before that, he was general counsel of the New York State Finance Agency.

A graduate of Columbia College and Columbia Law School, Thompson has a master's in public policy from Princeton University. After clerking for U.S. District Court Judge William M. Hoeveler in Miami, Thompson began practicing law at Skadden, Arps, Slate, Meagher & Flom.

Throughout his career, he's been active in professional organizations mentoring law students and new attorneys. In addition to serving as a Business Law Advisor to the ABA Business Law Section, Thompson has taught at Fordham, Stanford, and Princeton Universities. He's received many honors, including the Distinguished Service Award from UC Berkeley School of Law.

In 2005, Thompson founded Thompson Strategic Consulting, which provides legal and policy advice to companies like Facebook and the Walt Disney Company. In 2008, Thompson led the Obama/Biden Transition's review of the Securities and Exchange Commission.

What inspired you to attend law school and practice law?

I'm not so sure that I had a particular goal in mind. I was naturally curious and a problem solver. I also thought at some point I'd be interested in public service. So law school seemed like it would provide me with analytical skills and an understanding of how the law worked.

How did you come to specialize in business law?

I didn't start there. Before law school, I thought, "Maybe I'll be like Perry Mason," a criminal lawyer. But in my first year, I found out that it wasn't interesting. At the same time, I had an elective taking tax, and I actually thought that was more interesting than I thought it would be. I was fortunate enough to be involved in a joint degree program in law and public policy so I had a chance not only to study law, but also spend some time understanding things like macro and micro economics and policy analysis and how markets work. I've always been interested in the line between public policy and business.

What were your early years in practice like and how do they compare to the practice for new lawyers today?

I started my career after clerking at Skadden Arps in the 80s. Everybody has read books like *Barbarians at the Gate* and it was that dizzying, exciting, and intense. Companies were fighting for their lives and you were representing them and it was not for the faint of heart. But I had a really interesting bird's eye view of how companies work and, when they're fighting for their lives, you begin to see how people make decisions.

What was the highlight of your work at the FTC?

I got there at a time when we were just beginning to look at something called the Internet. This was the late 90s, early 2000s. Part of the challenge was to take an agency that was crafted to deal with competition issues and bring them to the point where they're thinking about the market for the HP-Compaq merger or what's going to happen to AOL and Time Warner. We dealt with legal principles on competition that were being revolutionized by technology. One of the first things that we were able to do was create consumer guidelines for e-commerce. That was an opportunity not only to look at this new and burgeoning field, but also to talk about how consumers should be treated around the world.

Describe your work now as a strategic consultant, particularly your role with Facebook.

After I left the Commission, I was thinking about what kind of work would best utilize my experiences. I thought that maybe creating my own platform to give strategic advice, not just legal advice, to companies might be an interesting way to proceed. It just so happened that a very good friend of mine who I've worked with over the years had just become general counsel of a new start up in Silicon Valley called Facebook. He called and said, "Look, here's an opportunity for you to not only use your legal talents and expertise, but also to work on a project with a company that has technology that could potentially change the world."

One of the things that I've always talked to students about is that public policy is not just made in the government – it can be made anywhere. You have to look for the opportunities where you can actually help create an environment a public benefit. I saw that Facebook could change the world. It was exciting, looking back on it, how it lived up to my expectations and beyond.

You've been active in professional and civic organizations devoted to diversity. Why is diversity and mentoring young people, people of color, important to you?

Part of it is a reflection of my own experience. But part of it is looking at what the world is going to look like and what the future is going to look like. There are a lot of people who may not come from a place of privilege or are not around people who have been successful and they may not understand how to value what they bring to the table in terms of experience and insight. So I enjoy talking to them and telling them early on that their ideas have value. It's helpful to have someone tell them that you can make as much of a difference as you want and to not be discouraged if you feel you're undervalued or under recognized. Persistence is important and your ideas are important. Someone has to tell them that. You have to empower them. In many instances, some of those important ideas in the world are not by people who are privileged; they're from regular people who want to make a difference.

How do you differentiate your work as a lawyer from your work as a business advisor, a strategist?

There are times when a client comes to me with a specific representation where they need counsel or they need an advocate. Then there are times where clients come to me for different kinds of advice. They are trying to figure out, for example, how they should be looking at the data they collect and what kind of relationship they want to have with the public and the people who participate in their website. They want to know what kind of rules and regulations might apply to them, especially in the online space, that they didn't necessarily foresee. Or how they can take something that's truly innovative and think about how they can educate regulators about the innovation. Those aren't purely legal questions – they have legal implications but they also have larger policy implications.

How do you see the legal profession changing?

The economic downturn has forced clients to think about how they use lawyers and how lawyers provide value and what kinds of things can be taken in-house. That net-value examination is passed down the line; it's forced lawyers to think about the services they provide and how they provide value. It has caused essentially a reset button; the legal profession has changed and it won't go back.

What was the highlight of your work as a Business Law Section advisor?

Working with young people is one. You always have this interesting mix of people. There are elder statesmen who have been very successful in the legal practice. You have younger people who are trying to think about how to walk into this new marketplace and you have existing practitioners who are trying to figure out how to manage the transition. It's important to be able to talk to people about the roles they could take in various stages in their career.

What is a commonality among the most successful business lawyers that you know?

There are a lot of lawyers who walk into a room and say, "Give me the problem and I'll give you an answer." But really great lawyers want to know what you're thinking. Because if the lawyer can understand how you approach your business or how a government agency approaches its mission, they can better be your partner in solving problems, sometimes before they even arise. I consider those lawyers not only smarter but also wiser.

How easy is it for lawyers to reinvent themselves throughout their career?

The question reminds me of something I told a group of lawyers once: think about the things you really care about and the role they play in your life and to remember that your life is not just one dimensional, but you have stages. You should think about how you incorporate the things you are passionate about into what you do.

Let me give you an example. People talk to me about public service all the time because I have been fortunate enough to do a lot of it. They say, "I've been a lawyer in ABC law firm and now I want to be a lawyer in government." They may have worked in finance all their life and think they want to be a lawyer for the Treasury. Then I say, "Have you thought about what you care about? Do you have a great love for the national parks? Are you trying to figure out ways for them to be sustainable? If you're passionate about that, you could give your expertise to people who are trying to figure out how to make the parks sustainable."

So don't just think in the area that you fit it, think about how you provide insight and experience in a wide range of things, and I think that you will find that really fulfilling.

Who is your idol in the legal profession?

There are so many people I respect and admire. But one comes to mind: I clerked for William Hoeveler in Miami. What he did for me is priceless. When I got done with law school, I was a little discouraged about the commercial aspects of the law, about people wanting to make money and wondered whether that was what the law was all about.

With Judge Hoeveler, I learned what I call the majesty of the law: there is such a thing as justice and fairness, and there are people who fight for it, and there are people who want to see justice prevail, and they want to see people in a better situation. That was such as uplifting experience for me because you don't always get that in law school. It colored the rest of my legal career because it told me, it's OK to fight for justice, to fight for the right answers, even if it's not popular or easy. I learned so much from him, things that are not in the textbooks – I learned about the humanity of the law.

Who has been your most influential teacher?

My parents. I don't say that as a platitude. Mine is an American story. My father was an African-American high school dropout and learned to fix airplanes in the Korean War. He was stationed in Japan, where he met my mother. My mother is Japanese, and they met in Tokyo and got married. They came back to the U.S., and my mother didn't speak any English. My older brother was born in January in Tokyo and I was born in December in Pittsburgh.

My father went back to school and then worked at TWA for 48 years as a mechanic. In the meantime, they had four kids. I have an older brother who is an MIT graduate and an engineering professor. My sister graduated from Amherst and works for American Airlines. I have a little brother who went to Harvard and is a brain surgeon in New York.

My parents didn't know anything about college; they didn't know anything about what it takes to attain high positions. But they gave us a couple of important gifts. One, they never told us there was anything we couldn't do. They would say, "Whatever you think you want to accomplish, you can accomplish." That's a real gift.

They also instilled in us an important way to think about competition. So many people think it's you versus the next guy. But my parents taught us, "Look in the mirror – are you the best you?" They talked about how not to leave people behind, that there are people who have not had the advantages or luck that you've had. I think that that's why my older brother is a professor, why I've had a career in public service and why my little brother works at an inner-city hospital. I have to give it to my parents – they started with nothing and when I think about all of the challenges, I frankly don't know how they did it.

What are your interests outside the law and outside of business?

For a long, long time, the choice wasn't about going to law or business; it was whether I would continue to play music professionally. I've spent many years from the time I was in junior high school until I was a second-year law student being a musician in a jazz-rock band.

What do you play?

I did jazz violin for a long time. I was a bass player for a long time. I spent many, many years as a lead singer.

What has been the most fulfilling moment in your work?

I thought it was important for government agencies to have a connection with their communities so in both the Treasury Department and the FTC, we started a program where we would take high school students from inner city Washington, D.C., and bring them on to work with us for the summer. For many of those people, it's the first time that they've ever been in an office, the first time they're in a professional setting.

After I left the Commission, there was one evening that I was at a supermarket and I hear this woman saying, "Mr. Thompson?" I turned around and I saw this young lady and she said to me, "I'm sure you don't remember me, but I was in your first class of interns at the FTC. I just wanted to let you know that last month I started law school. Without your encouragement, my life would be a lot different."

There are times, especially if you're in public service, when you're never quite sure whether the ideas will translate. So that was a great moment.

American Bar Association • Section of Business Law: Practical Resources for the Business Lawyer

BUSINESS LAW **TODAY**

Inside Business Law

Introduction to the Joint Task Force on M&A Litigation

The Joint Task Force on M&A Litigation is a collaborative project between the Business and Corporate Litigation Committee and the Mergers and Acquisitions Committee. Its co-chairs are the Honorable Myron T. Steele, Chief Justice of the Delaware Supreme Court, and Michael A. Pittenger of Potter Anderson & Corroon LLP.

The Joint Task Force was formed to facilitate a better understanding on the part of the Section's transactional lawyer members of various aspects of M&A litigation that affect their practice, to provide the Section's litigator members with a better perspective on deal dynamics, and to assist all in gaining a better understanding of judicial perspectives on Mergers and Acquisitions. The Joint Task Force will foster collaborative projects and programming opportunities on matters of interest to both M&A deal lawyers and litigators.

The Task Force held its first meeting at the Business Law Section's 2013 Spring Meeting. According to Co-Chair Michael A. Pittenger:

> We had a strong and enthusiastic turn out for our kick off meeting in April, and are looking forward to providing many opportunities for deal lawyers, litigators, and judges to collaborate on M&A-related projects. Our first two projects involve grappling with the many problems posed by multi-jurisdictional stockholder class action litigation and providing guidance to M&A deal lawyers about document preservation obligations and spoliation rules.
>
> If you are interested in helping with either project or have ideas for other projections, we would love to hear from you.

Update on the Mergers and Acquisitions Committee

The mission of the Mergers and Acquisitions Committee is to discuss, debate, and educate its members on the legal issues relating to, and to collaborate with law schools, the judiciary, and investment banking and other professionals to establish best practices for M&A and related transactions, including with respect to the process of negotiating, documenting, and bringing these transactions to market. The Mergers and Acquisitions Committee is chaired by Mark A. Morton.

Contemporaneously with co-launching the Joint Task Force on M&A Litigation, the Mergers and Acquisitions Committee presented a program titled "What Deal Lawyers Need to Know About M&A Litigation" at the 2013 Spring Meeting, which addressed issues arising in merger litigation that transactional attorneys can head off or mitigate when negotiating and documenting the transaction.

Both the recording of that panel and the written materials are now available online.

Focus on the Director and Officer Liability Committee

The mission of the Director and Officer Liability Committee is to enhance the understanding of the risks to officers and directors in for-profit companies and to provide tools to assist counsel in managing such risks. To achieve that goal, Lewis Lazarus, the Chair of the Committee, explains that, "We aim to become the site of choice for inside counsel and practitioners seeking to stay current with the latest case law and statutory developments affecting director and officer liability."

In keeping with its mission, the Director and Officer Liability Committee prepared the inaugural edition of the Director and Officer Liability Report in March of this year. The report includes:

> "Important Cases Regarding Director and Officer Liability: 2012," highlighting six key decisions issued by federal courts and Delaware courts addressing director and officer liability in 2012.
>
> "Defending Directors and Officers Against Breach of Fiduciary Duty Claims in Bankruptcy," by Jeffrey Baddeley, addressing the fiduciary duties of directors and officers as a corporation nears insolvency, becomes insolvent, and files for bankruptcy.

The Committee expects to publish a similar report three times annually to supplement the updates of significant decisions or legislation the Committee sends to those on its listserv.

Finally, the Director and Officer Liability Committee has submitted for publication a model indemnification agreement which it expects to be available through the ABA Webstore in the fall of 2013.

Business Law Today Board Members 2012–2013