Governance Lessons from the Disney Litigation

By H. Stephen Grace Jr. and John E. Haupert

The smoke has cleared and the dust has settled on the corporate governance “case of the century”—the shareholder derivative litigation in connection with Walt Disney Company’s hiring and subsequent termination of Michael Ovitz. After lengthy and costly litigation, both the Chancery Court and Delaware’s Supreme Court found in favor of the defendant directors. However, the insightful comments of the court’s chancellor and the complex issues raised during the litigation keep the focus on this governance case of the century. Corporate governance seminars will continue to examine aspects of the case for years to come.

H.S. Grace & Company, Inc., in its role as the consultant to the primary D&O carrier and its counsel, had the opportunity to examine Disney’s corporate governance structure and its workings in connection with the hiring and the termination of Ovitz, and we believe there are many valuable insights and lessons to be learned from Disney. This current article builds on and extends our findings in two prior articles, and sets our belief that Disney offers practical insights to boards, senior management, and their counsel regarding compensation cultures, board minutes, and ongoing vigilance by corporate boards. In the first of those articles (Directors Monthly, August 2008, “An Insider Revisits the ‘Disney Case’” http://hsgraceco.com/images/stories/articles/Article4.pdf), we discussed the practices and processes Disney had actually employed, pointed out what we perceived as the flaws in the Disney plaintiffs’ allegations, and noted that “The ongoing criticisms [of the Delaware courts’ decisions] basically represent a continued acceptance of the plaintiffs’ charges, with the critics failing to recognize the serious flaws in these allegations, which became clear during the trial.”

In our second article (the New York State Bar Association Journal, July/August 2009, “Plaintiff Expert Reports: An Insider Revisits Disney” http://hsgraceco.com/images/stories/articles/Article1.pdf), we asked the question “…whether an examination of the report of the plaintiffs’ compensation expert offers insights that actually support the courts’ decisions for the defendants. Do the issues the expert chose to examine and those he chose not to examine speak to the factual issues of interest to the courts? Do the analyses undertaken reflect on the strengths and weaknesses of the plaintiffs’ allegations?” In other words, did the plaintiffs’ expert avoid performing certain analyses which would have confirmed the acceptability of Disney actions?

Based on our examination of Disney’s compensation culture, which formed the framework for Disney’s negotiations with, hiring of, and termination of Ovitz, we believe its compensation culture and its governance practices and processes offer valuable insights to boards and their compensation committees. Further, we believe that the Disney litigation offers interesting insights into the challenging issue of the determination of what and how much to include in corporate board and board committee meeting minutes. A third lesson the Disney matter confirms is the importance of ongoing vigilance on the part of both boards and senior management. We address each of the areas in the following sections.

The Disney Compensation Culture

The plaintiffs’ allegations regarding Disney’s compensation culture were very provocative. The plaintiffs’ Second Amended Consolidated Derivative Complaint (Complaint) allegations included these charges:

- Michael Eisner, the CEO of Disney, recruited Ovitz as a result of their personal friendship;
- The hiring of Ovitz was facilitated by Irwin Russell in his role as chair of the compensation committee;
- The compensation committee “inadequately investigated the proposed terms of the Ovitz employment agreement (OEA),” and the compensation committee and the old Board paid insufficient attention to the terms of the OEA; and
- At the September 1995 compensation committee meeting, more time was spent on Russell’s additional compensation for handling the negotiations than on the terms of the OEA.

Additional allegations regarding Disney’s compensation culture and the actions of Eisner and the Disney Board are seen throughout the Complaint. At first blush, these allegations paint a picture of ineptitude and conflicts of interest by the CEO and board. However, Chancellor Chandler’s opinion, various trial-related information, and public documents point out the serious issues in the plaintiffs’ allegations. These
findings properly take into account the well-recognized risks associated with business investment decisions, including the hiring or promotion of senior executives; the factors at work that may have influenced Disney’s decision to seek the services of Ovitz; the company’s hiring process; the terms of the OEA; the performance of Ovitz; the termination process; and the termination agreement. Disney’s compensation culture formed the framework within which the business investment decision of seeking to hire Ovitz was conducted.

It is well understood that sign-on bonuses, stock, restricted stock grants, stock options, periodic bonuses, and lucrative back-end payments are often components of the contracts entered into by firms seeking the services of capable CEOs, COOs, and other executives who possess special talents. Table I compares key compensation components for five well-known senior executives (Five Executives) with those received by Ovitz: Michael Armstrong on his joining AT&T, Carly Fiorina on her joining Hewlett-Packard, Gary Wendt on his joining Conseco, Robert Nardelli on his joining Home Depot, and Larry Johnston on his joining Albertson’s. Section 2 of Table I reflects the various forms of front-end compensation paid to the Five Executives and that paid to Ovitz. The Five Executives all received various forms of front-end compensation. Ovitz received no front-end consideration in spite of the high level of compensation he was foregoing by departing from Creative Artist Agency (CAA), along with the power and perks associated with his ownership position at CAA. Other than salary and the potential for a shareholder oriented performance based bonus, Ovitz received a single stock option grant for the five-year-employment term from which he would benefit only if the shareholders benefitted. Disney did not pay any other forms of front-end compensation. It is remarkable that, even though Ovitz’s prior compensation package at CAA far exceeded that of the Five Executives and there was pressure at Disney to find a replacement for Frank Wells who had died, Disney stayed with its compensation culture. Certain proxy comments regarding executive compensation forfeited at prior companies for the Five Executives and Ovitz are shown in Table II. The distinctiveness of Disney’s culture is evidenced by these proxy comments.

Each of the Five Executives received stock options which vested over time. Ovitz also received stock options which vested over time. However, unlike the Five Executives who were guaranteed annual bonuses or grants of stock options or restricted stock within their compensation agreements, the OEA did not guarantee such annual grants. The employment agreement of each of the Five Executives incorporated termination provisions, which included cash compensation, removal of restrictions on restricted stock, the vesting of part or all of stock options or other equity based awards and other considerations. Ovitz’s termination provisions included only cash compensation and the vesting of his initial stock option grant of 3 million shares. The cash compensation and the vesting and/or removal of restrictions on restricted stock assured the Five Executives of financial consideration should they be terminated, along with other consideration such as immediate forgiveness of any outstanding loan principal. Ovitz’s only assured consideration at termination was the cash component, which declined over time to a minimum of $10 million by the end of his five-year term.

In summary, the Five Executives received a number of forms of compensation, many of which insured the Five Executives of benefits regardless of whether there were concomitant benefits to shareholders. Disney’s employment agreement with Ovitz stands in sharp contrast to those of the Five Executives. The fact that his back-end package was largely influenced by the value of his stock options insured that Ovitz would benefit only if the Disney shareholders likewise benefited. This was the case, as Disney’s share price rose from approximately $57.00 per share to $71.00 per share during Ovitz’s tenure.

Disney’s conservative compensation culture is further reflected by the fact the Ovitz’s compensation was not excessive when compared with other Disney executives. Option grants were provided to Eisner under his 1989 contract for 2 million shares (which subsequently became 8 million shares in 1995 as a result of the four-for-one stock split declared in April 1992). So, by the time of Ovitz’s hiring in October 1995, the decision by the board to grant Ovitz 3 million shares does not appear to be out of line with Eisner’s 8 million shares. Similar to Eisner, Frank Wells (Wells) whom Ovitz succeeded, under his 1989 contract was granted 750,000 shares and, as a result of the four-for-one stock split, theses options were equivalent to 3 million shares, equaling the grant of shares to Ovitz. The second option grant to Ovitz did not occur until Ovitz had been at Disney for five years, and was cancelled in the case of a non-fault termination. These actions support the fact that Ovitz’s compensation was not unusual nor overly generous within the Disney business parameters.

The hiring process itself was well structured with an important role being played by the compensation committee. Initial discussions with Ovitz involved Russell, Disney’s compensation committee chair, Eisner and, later, Raymond Watson, the former Disney chairman and a member of the compensation committee. Having the chair of the compensation committee and a long-term board member head the negotiations insured both compensation committee awareness and board awareness of the flow of these negotiations. Watson had been the chairman of Disney at the time Eisner and Wells joined. A highly creditable consultant, Graef Crystal, was quickly involved in assisting Russell and Watson. The negotiations were lengthy and required tough bargaining. Ovitz’s contract terms changed considerably during the course of these negotiations and the changes favored Disney.

The Ovitz deal was arm’s length. Ovitz’s advisors were capable and independent of Disney, while the individuals leading the negotiations for Disney were “informed buyers of talent” who had a clear understanding of the compensation parameters within which a compensation package with Ovitz had to be structured. An examination of what occurred among and between the parties negates the plaintiffs’ allegations. Disney’s compensation culture framed the negotiations with Ovitz, which was quite remarkable given the extent of Ovitz’s earning power in his previous employment, but Disney did not bend from its
compensation culture. The compensation committee not only adequately investigat-
ed the terms of the OEA, but was deeply involved in the Ovitz negotiations as a result of Russell’s and Watson’s leadership of the negotiations.

We believe that Disney’s compensation culture and the role it played in the negotiations with Ovitz may offer useful lessons today. Disney put a compensation culture in place that took into account the interests of their shareholders. They stuck with it notwithstanding their need for a senior executive and notwithstanding Ovitz’s significant earning power at CAA.

Their use of the compensation culture in the Ovitz negotiations was a sound move, as was the power given to the compensation committee that was enhanced by a compensation expert.

**Board and Board Committee Meeting Minutes**

The challenge of recording board and board committee minutes is well understood. There is always a struggle to determine what and how much to include. The Disney case shows the complexity of recording board and board committee minutes and offers some insight into how to deal with it.

There has been, and continues to be an evolution of thought regarding the composition of board and board committee meeting minutes. In the past the thinking might have been summarized as “less is better.” However, in light of the tidal wave of litigation, much of which attacks CEO’s and boards, a school of thought has developed advocating more comprehensive minutes, providing more detail about what actually occurred at the meetings. The interesting dilemma is “how much is enough?”

The Disney case hits this issue head on. The plaintiffs alleged that the compensation committee “... inadequately investigated the proposed term of the OEA...” and pointed to the fact that at the September 26, 1995, compensation committee meeting, more time was spent on discussing additional compensation for Russell’s handling the negotiations than was spent on the terms of the OEA, which was recommended to the board for ap-

The plaintiffs used the brief minutes of the committee meeting as a platform for attacking Disney’s actions.

The information developed during discovery and the information presented at trial reveal a much different picture than the allegations. Compensation committee members Russell and Watson, both of whom understood the Disney compensation culture, actually led the negotiations with Ovitz and his advisors. Furthermore, Russell and Watson wisely employed a compensation expert, Crystal, to assist in the negotiations with Ovitz and his team which were lengthy and contentious.

The September 26, 1995, meeting of the compensation committee did not need to address the terms and provisions and the remaining open items to be resolved in the negotiations, as Russell and Watson had been directing the negotiations. Since Russell and Watson were satisfied with the state of the negotiations, the package was ready to present to the entire board for its review and approval. The only remaining issue to discuss was Russell’s compensation.

The interesting question here, and a question that has no clear answer, is whether it would have been appropriate to include in the compensation committee meeting minutes a detailed description of what had gone on regarding the origins and the conduct of the negotiations with Ovitz. Had the involvement of Russell and Watson and their familiarity with and understanding of these negotiations and the OEA been detailed in the minutes, would this information have seriously, if not fatally, damaged the plaintiffs’ allegations regarding the alleged inadequacies of the Disney Board’s actions? We believe it would have but others take the position that confidentiality, competition and privacy discourage including too much.

Whatever position is taken it would benefit both sides to have discussions about how to properly convey the work that has been done leading up to board or board committee recommendation or decision.

**Vigilance**

Nations have recognized that “The price of peace is ongoing vigilance.” These words may be paraphrased for consideration by boards as follows, “The price of good govern-

ance is ongoing vigilance.” The facts in the Disney case speak directly to the challenge of boards exercising proper diligence. Chancellor Chandler’s opinion and the documents from the case speak not only to Disney’s decision to seek the services of Ovitz, but also to the manner in which Disney sought these services and, in particular, the roles of Eisner and of board members serving on the compensation committee.

Despite Chancellor Chandler’s positive finding for the defendants, his observations regarding weaknesses in the process are insightful and suggest that the lack of board vigilance could have resulted in a different outcome. Regarding the termination of Ovitz, Chancellor Chandler again points to the importance of not only the authority to undertake an action, but the process by which an action is undertaken.

Chancellor Chandler’s thoughtful insights point to the need for “ongoing vigilance” on the part of boards. Given that opportunities may arise for a firm which must be addressed in a brief window of time, given the sensitivity of employment at senior levels and the fact that boardroom discussion of feelings regarding the CEO or other senior management may not be workable given the difference in feelings of various board members, and given numerous other issues, boards must not only insure that there are proper assignments/delegations of authority, but also must insure that the associated processes are supportable.

Interestingly, Disney’s circumstances offered an additional challenge to board vigilance. Disney’s success under Eisner and Wells in the period 1984–1995 was spectacular. Ten thousand dollars invested in Disney stock in September 1984 was worth approximately $160,000 by July 1994, while $10,000 invested in the S&P index over this period would have an approximate value of $56,000. Given Eisner and Wells dedication and success, it could be expected that the Disney board’s respect and trust for the two of them grew over that period. Given significant levels of confidence and comfort in the firm’s management team, it can certainly be understood that a board could perhaps become slightly more relaxed in the way they were addressing their responsibilities. Notwithstanding what may have actually happened
at Disney regarding the relationship between the board and Eisner, Chancellor Chandler’s comments point to the risk of a board perhaps relaxing in the addressing of their responsibilities. It may be that, regardless of the extent of a relationship or the depth of trust and respect that is developed over the course of that relationship, a board, and senior management, must continue to be vigilant in addressing their respective responsibilities.

Disney had a well thought out shareholder orientated compensation culture and negotiated the Ovitz arrangement within the framework of its compensation culture and in a form that was consistent with the compensation of other members of Disney senior management. Yet these positives were weakened by the court’s views of Eisner and the board as set out in Chancellor Chandler’s opinion. The Chancellor’s insights point to the need for continual consideration and observation of board and management practices and processes.

The authors agree, not only based on their own executive experience and that of their colleagues, but also based on their involvement in numerous complex commercial litigation matters covering a broad range of industries and business organization structures. Again and again, as in Disney, the Delaware courts, and others, have focused on board and management roles, responsibilities, practices and processes, and whether these have been addressed in an acceptable manner.

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The authors benefited from the comments of Sheryl Hopkins, also a member of the Grace & Co. Board of Advisors.

**TABLE I**

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<tr>
<td><strong>1. Key compensation components at date of hire:</strong></td>
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<tr>
<td>Signing bonus</td>
<td>$2,050,000</td>
<td>$3,000,000</td>
<td>$45,000,000</td>
<td>$0</td>
<td>$1,230,000</td>
<td>$0</td>
</tr>
<tr>
<td>Restricted stock or stock options - which vests upon hire or which cannot be forfeited even on a termination for cause (value of restricted stock based on stock price at date of hire and value of stock options based on Black-Scholes)</td>
<td>$0</td>
<td>$22,260,000 (7)</td>
<td>$34,052,000</td>
<td>$3,546,000</td>
<td>$0</td>
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<td>Restricted stock - vests over time (valued at date of grant)</td>
<td>$14,900,000 (8)</td>
<td>$65,600,000</td>
<td>$0</td>
<td>$24,450,000</td>
<td>$17,439,000</td>
<td>$0</td>
</tr>
<tr>
<td>Stock options - vests over time (valued at date of grant based on Black-Scholes)</td>
<td>$9,000,000</td>
<td>$24,400,000</td>
<td>$13,840,000</td>
<td>$63,920,000</td>
<td>$3,858,000</td>
<td>$110,000,000</td>
</tr>
<tr>
<td>Guaranteed bonuses, stock or restricted stock over life of employment contract</td>
<td>Est. $4,200,000</td>
<td>$1,616,000</td>
<td>$8,000,000 to $50,000,000</td>
<td>$72,500,000 (10)</td>
<td>Est. $87,050,000</td>
<td>$0</td>
</tr>
<tr>
<td>Other key components</td>
<td>$704,000 (11)</td>
<td>$0</td>
<td>$0</td>
<td>$10,000,000 (12)</td>
<td>$0</td>
<td>$0</td>
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<tr>
<td><strong>Total</strong></td>
<td>$30,854,000</td>
<td>$94,616,000</td>
<td>$89,100,000 to $131,100,000</td>
<td>$224,922,000</td>
<td>Est. $113,123,000</td>
<td>$110,000,000</td>
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**2. Non-Fault Termination Provisions:**

Cash compensation, full vesting of stock options, removal of restrictions on restricted stock and supplemental pension benefits shall fully vest.

**Notes:**

(1) AT&T Proxies filed 3/26/98 and 3/19/99. Part of his restricted stock (224,561 units), which vest on 10/1/03 have a floor of $10 million. (Proxy filed 3/26/98, p. 39.)

(2) Hewlett Packard Proxy filed 1/14/00.

(3) Conseco Proxies filed 4/30/2001, 4/30/2002 and 10-Q 6/30/00. Wendt employment agreement dated 6/28/00. In addition to the compensation of Mr. Wendt, Conseco issued a warrant to GE to purchase 10,500,000 shares of Conseco common stock at a purchase price of $5.75 per share (estimated value - $21.0 million). (Source 10-Q 6/30/00).

(4) Method of valuing warrant not disclosed.

(5) Home Depot Proxies filed 4/23/01, 4/19/02, 2002 10-K and Mr. Nardelli’s employment agreement.

(6) Albertsons’ Proxy filed 5/2/2002.

(7) Proxy filed 2/25/97 and Graef Crystal letter to Irwin Russell dated 8/12/95.

(8) Amount for Mr. Wendt includes $18.8 million of restricted stock which cannot be forfeited upon termination for “just cause” prior to June 30, 2002. The remaining amount includes the value (using Black-Scholes) of stock options that vested immediately on the grant date.

(9) Under certain time based circumstances, Mr. Armstrong’s agreement provided a floor of $10 million on his restricted stock units (Proxy filed 3/26/98, p. 39.)

(10) Representatives of additional compensation for Mr. Wendt based on stock price two years after hiring date. (Proxy filed 4/30/01, p. 6.)

(11) For Nardelli, represents guaranteed annual bonuses of $15.0 million and estimated present value of annual stock options of $57.5 million.

(12) Estimated value by AT&T of Mr. Armstrong’s supplemental pension was $704,000 (Proxy filed 3/19/99, p. 62.)

(13) Represents a loan to Mr. Nardelli made at the date of grant, which was to be forgiven ratably over 5 years. (Proxy filed 4/19/92, p. 18.)

Notes:

- **Non-fault termination provisions**: Cash compensation, full vesting of stock options, removal of restrictions on restricted stock and supplemental pension benefits shall fully vest.

- **Cash compensation**: Cash compensation, full vesting of restricted stock and restricted stock units and 50% vesting of unvested stock options.

- **Cash compensation, vesting of 4 million options**: Cash compensation, immediate vesting of unvested equity-based awards, granting of additional stock option awards, if applicable and immediate forgiveness of outstanding loan principal.

- **Cash compensation and vesting of 60% of his stock options**: Cash compensation and vesting of 60% of his stock options.

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<table>
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<tr>
<th>Proxy Comments on Executive Compensation Forfeited at Prior Companies</th>
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<tr>
<td><strong>AT&amp;T</strong> Mr. Armstrong</td>
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<tr>
<td>“To address certain forfeitures experienced when Mr. Armstrong left his previous employer, the Company paid a premium of $2,050,000 to purchase a split-dollar survivorship insurance policy insuring Mr. Armstrong and his spouse.” (AT&amp;T Proxy, filed 3/19/99, p. 50.)</td>
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<td>“Mr. Armstrong was also granted AT&amp;T Restricted Stock, AT&amp;T Restricted Stock Units and AT&amp;T Stock Options under the 1997 LTIP to replace similar grants forfeited from his prior employer and to provide strong incentives to create shareholder value for AT&amp;T shareholders.” (AT&amp;T Proxy, filed 3/19/99, p. 51.)</td>
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<tr>
<td><strong>Hewlett Packard</strong> Ms. Fiorina</td>
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<td>“The Board of Directors approved Ms. Fiorina’s employment agreement after an extensive search had been conducted by the Board, the Organization Review and Nominating Committee and an Ad Hoc Committee established in connection with the CEO search, with the assistance of an executive search firm. In determining the final compensation amounts, we focused on the importance of hiring a president and chief executive officer with an outstanding business and leadership record. We also reviewed Ms. Fiorina’s compensation package in comparison with the compensation packages of CEOs of selected large industrial companies, with particular emphasis on CEOs who had been hired externally and received packages intended to compensate them partially for amounts forfeited from their former employers. In setting total CEO compensation, we believe that it is especially relevant to review companies that are not a part of the S&amp;P High Tech Index because of the possibility that a company outside of one industry may recruit a CEO from another industry. We also considered the fact that HP does not have a Chief Operating Officer and therefore Ms. Fiorina would assume the additional responsibilities usually associated with that position. Finally, we recognized the need to consider Ms. Fiorina’s compensation at her previous employer, as well as the value of benefits under various plans of her employer that would be forfeited upon her resignation.” (Hewlett Packard Proxy, filed 1/14/00, p. 42.)</td>
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<tr>
<td><strong>Conseco</strong> Mr. Wendt</td>
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<tr>
<td>“Pursuant to the [employment] agreement Mr. Wendt received a cash payment of $45,000,000 at signing, which amount was partial compensation for benefits he was forfeiting from a prior employer.” (Conseco Proxy, filed 4/30/01, p. 6.)</td>
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<tr>
<td><strong>Home Depot</strong> Mr. Nardelli</td>
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<tr>
<td>“The Company believes it is essential that a large portion of our executive officers’ total compensation is tied to stock performance, which more closely aligns their interests with the long-term interests of stockholders. To reflect this belief and in recognition that Mr. Nardelli forfeited substantial equity ownership rights provided by his former employer, Mr. Nardelli received two stock option awards.” (Home Depot Proxy, filed 4/23/01, p. 16.)</td>
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<tr>
<td><strong>Albertson’s</strong> Mr. Johnston</td>
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<td>“In negotiating the terms of Mr. Johnston's employment agreement, the Board sought advice from outside legal counsel and independent compensation consultants, and considered such factors as the competitive levels of Chief Executive Officer compensation at other companies of comparable industry and size, the Company's internal executive compensation practices, and the level of compensation deemed necessary to induce Mr. Johnston to accept the Company's offer of employment and restore amounts forfeited by him upon leaving his former employer.” (Albertson’s Proxy, filed 5/2/02, p. 24.)</td>
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<td><strong>Disney</strong> Mr. Ovitz</td>
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<td>“Prior to entering into the agreement, the Company negotiated with Mr. Ovitz extensively regarding its terms, with particular emphasis on establishing a total compensation package which would, within the framework of the established policies of the Company, induce Mr. Ovitz to relinquish his significant earning power and the substantial value of his ownership interest in CAA. In those negotiations, the Company declined to pay Mr. Ovitz any signing bonus or to grant him any restricted stock or other form of compensation not dependent solely upon future growth of the Company. Instead, in order to induce Mr. Ovitz to relinquish his ownership position at CAA, the agreement included a number of provisions (described further below) concerning compensation payable to Mr. Ovitz in the event of certain types of early termination of his employment by Company.” (Disney Proxy, filed 1/9/97, p. 14.)</td>
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On April 27, 2011, the Supreme Court issued its (now widely-reviewed and critiqued) decision in AT&T Mobility LLC v. Concepcion, 563 U.S. __ (2011), holding that the Federal Arbitration Act (the FAA) preempted a California state-law rule that invalidated most class-action waivers in consumer contracts on grounds of unconscionability. Concepcion affects cases not only in the Ninth Circuit and California where it was pending, but also in any jurisdiction that has singled out class-action waivers for special treatment. In addition to confirming the general enforceability of arbitration provisions containing class-action waivers, Concepcion compels even the most reluctant jurisdiction to recognize the enforceability of arbitration provisions that are very likely to be found in the consumer finance contract at issue in your client’s active case (or cases).

Although pre-dispute agreements to arbitrate are commonplace in consumer contracts, courts in many jurisdictions have shown hesitation, if not outright unwillingness, to enforce arbitration clauses in consumer contracts. Typically, arbitration clauses have been invalidated in the context of the savings clause of section 2 of the FAA, which permits courts to invalidate arbitration agreements only upon “generally applicable contract defenses, such as fraud, duress, or unconscionability.” Concepcion, however, is a game-changer, and with it the question becomes not whether a state rule can be contextualized as a generally applicable defense but, instead, whether the rule’s effect is to obstruct the accomplishment of the FAA’s objectives. No matter the jurisdiction, courts are now taking a fresh look at arbitration provisions in consumer contracts of all types, thus affording your client the potential opportunity to enforce its arbitration provision.

The Concepcion Case

Concepcion involved a dispute between consumers (the Concepcions) and AT&T Mobility (AT&T) over sales taxes charged to the Concepcions by AT&T for a cellular phone advertised as free. The parties’ agreement contained an arbitration provision requiring all claims to be brought in the parties’ individual capacity and not as a class action. Despite the arbitration provision, the Concepcions sued AT&T in federal court. AT&T moved to compel arbitration. The federal district court in California denied AT&T’s motion, relying upon California Supreme Court’s decision in Discover Bank v. Superior Court, 36 Cal. 4th 148 (2005) to find that the arbitration provision was unconscionable. In Discover Bank, the California Supreme Court held that class waivers in consumer arbitration agreements are unconscionable if the agreement is in an adhesion contract, disputes between the parties are likely to involve small amounts of damages, and the party with inferior bargaining power alleges a deliberate scheme to defraud (the so-called “Discover Bank Rule”). The Ninth Circuit affirmed the denial of AT&T’s motion to compel arbitration, finding that the Discover Bank Rule was not preempted by the FAA.

The United States Supreme Court reversed, holding that the Discover Bank Rule was preempted by the FAA. The Supreme Court stressed that the principal purpose of the FAA is to ensure that private arbitration agreements are enforced according to their terms. It stated that “[t]he point of affording parties discretion in designing arbitration processes is to allow for efficient, streamlined procedures tailored to the type of dispute.” The Court found that the Discover Bank Rule interfered with FAA and was, therefore, preempted. Specifically, the Supreme Court held that the Discover Bank Rule was preempted because it “stands as an obstacle to the accomplishment and execution of the full purposes and objectives of Congress.” The Supreme Court further noted that “parties may agree to limit the issues subject to arbitration . . . and to limit with whom a party will arbitrate its disputes . . . .” Under Concepcion, “states cannot require a procedure that is inconsistent with the FAA, even if it is desirable for an unrelated reason.” The Supreme Court held that the FAA preempts state laws that run counter to its goals, stating, “Although §2’s saving clause preserves generally applicable contract defenses, nothing in it suggests an intent to preserve state-law rules that stand as an obstacle to the accomplishment of the FAA’s objectives.”
**Concepcion Applied to Enforce Arbitration Provisions**

Concepcion verifies that prior holdings that invalidate arbitration agreements because they contain class-action waivers under state law doctrines, such as unconscionability, are preempted by the FAA. Now, Concepcion may be deployed as a tool to avoid problematic jurisdictions not just in recently filed cases but also in cases that are already pending. And there can be little doubt that the Supreme Court did not view its decision in Concepcion as an immediate paradigm shift, as the court granted certiorari, vacated, and then remanded several cases “for further consideration in light of AT&T Mobility LLC v. Concepcion . . . .” Litman v. Celloco P’ship, 131 S. Ct. 2873 (U.S. 2011); Mo. Title Loans, Inc. v. Brewer, 131 S. Ct. 2875 (U.S. 2011); Sonic Auto., Inc. v. Watts, 131 S. Ct. 2872 (U.S. 2011). Litman, Brewer, and Watts had invalidated arbitration agreements with class action waivers as being unconscionable.

On remand, only the Litman court has issued an opinion. In its decision, the Third Circuit held: “Because the United States Supreme Court’s decision in Concepcion holds that state law . . . requires the availability of classwide arbitration . . . is inconsistent with the FAA[,] we now endorse the District Court’s decision to reject New Jersey law holding that waivers of class arbitration are unconscionable, and we will affirm the District Court’s order compelling individual arbitration of the appellants’ claims.” Litman v. Celloco P’ship, 2011 U.S. App. LEXIS 17649 (3d Cir, N.J. Aug. 24, 2011). The Litman court’s decision adopted a “broad and clear” understanding of Concepcion: “a state law that seeks to impose class arbitration despite a contractual agreement for individualized arbitration is inconsistent with, and therefore preempted by, the FAA, irrespective of whether class arbitration is desirable for unrelated reasons.” Litman, 2011 U.S. App. LEXIS 17649, 2011 WL 3689015, at *5 (quotations omitted).

The Eleventh Circuit has likewise adopted a “broad and clear” understanding of Concepcion. In Cruz v. Cingular Wireless, LLC, 2011 U.S. App. LEXIS 16811 (11th Cir. Fla. Aug. 11, 2011), the court, citing Concepcion, held that a class action waiver in the plaintiffs’ arbitration agreement was enforceable under the FAA. The plaintiffs in Cruz argued on appeal that the class action waiver in the arbitration provision of their wireless service agreement was unenforceable because it “hindered the remedial purposes” of the Florida Deceptive and Unfair Trade Practices Act by insulating the defendant from liability for unlawful business practices, which, the plaintiffs argued, was a “violation of public policy.” The Eleventh Circuit dismissed the public policy argument. Relying upon Concepcion, the Cruz court held that the Florida law that the plaintiffs relied upon was preempted by the FAA to the extent it would require class-wide arbitration “simply because the case involves numerous small-dollar claims by consumers against a corporation, many of which will not be brought unless the Plaintiffs proceed as a class.”

Most recently, on August 31, 2011, the United States District Court for the Eastern District of Pennsylvania applied Concepcion broadly when it granted a defendant’s motion to compel arbitration. In King v. Advance Am., 2011 U.S. Dist. LEXIS 98630 (E.D. Pa. Aug. 31, 2011), the court considered a motion to compel arbitration in two related class-actions seeking damages for high-interest-or-fee “payday loans.” The plaintiffs resisted arbitration by asserting that the arbitration clauses were unconscionable under Pennsylvania law. The King court concluded that “the FAA preempts Pennsylvania law,” specifically stating that the “defenses can be disposed of with only a brief discussion in light of Concepcion.

Actions commenced when the Discover Bank Rule or a similar rule would have prevented arbitration raise the question whether the defendant can move to compel arbitration now or is barred from doing so under the doctrine of waiver. In Villegas v. US Bancorp, No. C 10-1762 RS (N.D. Cal. June 20, 2011), the United States District Court for the Northern District of California ordered arbitration and enforced a class action waiver in a case that had been pending for more than a year. The court rejected the plaintiff’s argument that the defendant’s motion to compel arbitration was untimely, holding that prior to Concepcion, a request to compel arbitration would have been futile. In Villegas, the plaintiff made no claim that the arbitration agreement would generally be unenforceable on any state law ground. The sole issue was whether the defendant bank had waived the right to arbitrate due to its failure to enforce the agreement until approximately 13 months after the complaint was filed. In ordering the parties to arbitration, the Villegas court specifically notes that the “law did not permit defendants to compel arbitration of the class claims until recently,” recognizing that but for Concepcion, a previous motion to compel would have been futile.

**Not So Fast**

Not every court has been so willing to view Concepcion as a mandate requiring the enforceability of arbitration provisions. In the In Re Checking Account Overdraft Litigation pending in the U.S. District Court for the Southern District of Florida, the court held that bank customers with debit cards attached to checking accounts are not compelled to use arbitration rather than class action lawsuits because the subject arbitration agreements are “unconscionable.” In the Checking Account Overdraft Litigation matter, Judge James Lawrence King considered renewed motions to compel arbitration in a class-action suit brought on behalf of account holders at a variety of banks claiming damages from excessive overdraft fees. The court denied earlier-filed motions to compel arbitration in May 2010. After the bank defendants appealed, the Eleventh Circuit Court remanded the case for consideration in light of the Concepcion ruling. On remand, the court noted that the parties had each “argued for an extreme interpretation of Concepcion.” The plaintiffs argued that Concepcion had no effect; on the other hand, the defendants argued that Concepcion eliminated unconscionability as a defense to the enforceability of an arbitration agreement. According to the Checking Account Overdraft Litigation court, a “case-by-case analysis of the ap-
Applicable state law doctrine of unconscionability” may be applied to an arbitration agreement to find that it is unenforceable. *Concepcion*, the court stated, “has not relieved courts from their obligation to scrutinize arbitration agreements for enforceability on a case-by-case basis where one party resists arbitration . . . *Concepcion* provides guidance as to what courts may consider when fulfilling that obligation.” Ultimately, the *Checking Account Overdraft Litigation* court conducted a complete and thorough unconscionability analysis to the five arbitration contracts at issue and found that they were each unconscionable for a variety of reasons. *Checking Account Overdraft Litigation* shows that *Concepcion* will not be considered a mandate to enforce every arbitration agreement. Rather, state law defenses such as unconscionability will remain available to plaintiffs so long as they do not “stand as an obstacle to the accomplishment of the FAA’s objectives.”

**Now What?**
The post-*Concepcion* cases cited above demonstrate the potentially powerful impact that *Concepcion* may have on consumer financial cases. When your client is served with a new complaint, should you consider a motion to compel arbitration? If a case has been pending for a while, a previously futile request to the court for an order requiring arbitration may now be viable. For cases on appeal or soon to be appealed, your client now has an additional argument: Under *Concepcion*, should your case have been compelled to arbitration in the first instance? While there are limits to the scope and applicability of *Concepcion*, a broad reading of the Supreme Court’s decision provides an option to defendants facing challenges by consumers (individually or on a class basis) in financial services litigation. Some commentators have called *Concepcion* a “devastating blow” to consumers, while others have heralded it as a “rational and fair” approach to the management of class-wide dispute resolution. Regardless of your view, *Concepcion* presents an opportunity to review its arbitration options.

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Clients use their websites to tell the world about their products and services, and what used to be printed on paper now exists only in electronic form. This also applies to the contracts of clients, such as their terms of sale. A business lawyer would ask if those terms of sale are legally enforceable against the world if they were simply posted on the client’s website.

The answer is not as simple as it may seem. Enforceability will always depend on the facts, the parties, and the jurisdiction examining the question. However, as technology develops and businesses and customers find innovative ways to contract, both on paper and electronically, new lines of case law are emerging, combining technical realities and traditional contract principles, which instruct the practitioner how to incorporate web-based terms of sale by reference into a client’s contracts.

The terms of sale under which goods or services are sold are critical to both seller and buyer. The terms of sale set forth the contract rules, for example, relating to methods for acceptance of the offer, price, payment, delivery, risk of loss, credit and collection, warranty, limitations on liability, indemnification, choice of term, choice of venue, period for making claims, and so forth. A well drafted set of terms of sale should be customized for the client’s situation and the interests of the client that need legal protection.

A decade or so ago, the terms of sale always appeared on paper—somewhere. Usually, they were printed, in small font, grayed-out, on the reverse side of the seller’s order acknowledgement or invoice form. Sometimes, they were a five-page appendix stapled to the contract for services. Today, though, it is possible to simply post the terms of sale on the client’s website.

Posting terms of sale on the client’s website has several advantages. For example, doing so allows for universal accessibility by the client’s customers. This is certainly true if the client sells only business-to-business, since virtually all businesses can be expected to have web access, and over time will also apply to individual consumers. Also, a client may not desire—or even be able—to print order acknowledgments or invoices with an extensive listing of the terms of sale on the reverse side. This may be especially difficult for a client whose orders come in via e-mail, PDF, or electronic data interchange. For clients who sell only through their website, the only option is to post the terms of sale there. Finally, posting the terms on the client’s website might allow the client to change the terms of sale as needed in the future for either current or future customers. This idea makes too much sense to ignore. This article seeks to determine the best ways that it can be done.

Are Web-based Terms Enforceable?

As website-based contract terms are a specifically modern development, case law has only begun to address the issue of their enforceability and application. The first situations addressed by courts were those in which contract terms were posted on a seller’s website, but without explicit reference to the terms within the contract itself. Is it enough for a client to post its terms of sale on its website, without more? Does doing so make them automatically binding on anyone buying the client’s goods or services?

The answer is no. In E.J. Rogers, Inc. v. UPS, 338 F. Supp. 2d 935 (S. D. Ind. 2004), a customer sought to ship a loose diamond via UPS. When UPS lost the package, it refused to reimburse the customer based on a tariff containing terms of service which stated that UPS would not be liable for any packages containing articles of “unusual value,” such as precious stones. The tariff had been posted on the UPS website, but no reference to it was included in the paper airbill received by the customer. The court held that the terms of the tariff were not enforceable because there was no reference in the airbill to the tariff or any other documents. In the end, the lesson from E.J. Rogers is that some reference must be in the contract that the customer actually sees. Just putting the terms of sale on the client’s website is not enough.

How Much of a Reference is Needed?

In Manasher v. NECC, 2007 WL 2713845 (E. D. Mich. 2007), a telecommunications service provider sought to enforce an arbitration provision contained in a “disclo-
sure and liabilities” agreement, which was posted on the web. The reference to the agreement on the paper invoice stated the following:

NECC’s Agreement “Disclosure and Liabilities” can be found on-line @ www.necc.us or you could request a copy by calling us at (800) 766-2642.

The Manasher court held that the disclosure and liabilities agreement was not enforceable because the clause in the paper invoice did not indicate a clear intent that the provisions would be considered part of the agreement between the parties. The court explained that there was no explicit indication that the disclosure and liabilities agreement applied to the service contract between the parties. Also, there was no indication that the parties intended it to be incorporated into the agreement. Cases like Manasher instruct that the plain text of the contract must do more than simply state the existence and location of similar “disclosure and liabilities” sections intended to be incorporated by the sellers. Rather, the reference in the contract must clearly show that both parties intend to be bound by the web-based terms.

In Affinity Internet, Inc., v. Consolidated Credit Counseling Services, Inc., 920 So.2d 1286 (Fla. Dist. Ct. App. 2006), an arbitration clause contained among a list of terms of sale posted on a website was not enforced when the paper contract stated this:

This contract is subject to all of SkyNetWEB’s terms, conditions, user and acceptable use policies located at http://www.skynetweb.com/company/legal/legal.php.

Surprisingly, even the statement that the contract was “subject to” web-based terms was insufficient to bind a customer to the terms of sale. The Affinity Internet court, in reaching its decision, said that no clear language was present evidencing an intention by the parties to incorporate the website terms, despite the “subject to” language used. In addition, the court considered that the customer was not given a paper copy of the website terms and that in a page displaying three hyperlinks, all of which were found by the court to be incorporated by reference. The court found these to be enforceable because the external documents were described with the requisite specificity, and the parties’ intent to be bound by the terms was clearly expressed.

A Formula for Enforceability?
In seeking a formula that makes web-based contract terms enforceable, begin with basic contract law principles. According to the Restatement (Second) of Contracts, a contract may consist of several writings if one of the writings is signed and the writings clearly indicate that they relate to the same transaction. (Restatement (Second) of Contracts §132 (1981)). The comments to this section indicate that explicit “incorporation by reference” is not necessary, but if the connection is dependent on external evidence, the evidence of the connection must be clear and convincing. Due to the relative difficulty of establishing clear and convincing evidence of a connection from external evidence, the clearest path to enforceability is the “incorporation by reference” doctrine.

Most attorneys are familiar with the incorporation by reference doctrine, and there is case law from virtually every state upholding its application. It is often used, and in many different legal contexts. Perhaps the most familiar is the incorporation by reference treatment afforded American Institute of Architects Form A201, General Conditions of the Contract for Construction. This form, which is not even meant to be signed, is made legally binding on owner and contractor by incorporating it by reference in the dozen or so AIA construction contract forms that are signed by owner and contractor.

Signed Contracts
The clearest cases for enforcing website terms of sale are those with a signed paper contract. In International Star Registry of Illinois v. Omnipoint Marketing, LLC, 2006 WL 2598056 (N. D. Ill. 2006), the disputed paper contract stated:

by my signature below, I certify that I have read and agree to the provisions set forth in this invoice and to the terms and conditions posted at http://www.omnipoint.marketing.com/gen terms.html.

The court found a choice of venue clause in the website’s terms of sale to be enforceable. The clause was contained in a page displaying three hyperlinks, all of which were found by the court to be incorporated by reference. The court found these to be enforceable because the external documents were described with the requisite specificity, and the parties’ intent to be bound by the terms was clearly expressed.

Clickwrap Agreements
Clickwrap agreements are those in which a customer must evidence affirmative assent to viewable contract terms in order to gain access to a licensed product, typically through the use of “Agree” and “Disagree” buttons. In Hugger-Mugger, LLC v. NetSuite, Inc., 2005 WL 2206128 (D. Utah 2005), the court held a customer to be bound to a choice of venue clause contained in web-based terms of service by affirmatively agreeing to exactly this type of clickwrap agreement. The agreement in dispute stated:

. . . In consideration of the license fee paid by Customer [Hugger-Mugger] and subject to the terms of this agreement and the Terms of Service posted at www.netsuite.com, or successor Website, NetSuite grants Customer . . . a . . . license . . .

This Agreement and Incorporated Terms of Service represent the entire agreement of the parties and may not be modified unless expressly agreed to in writing by both parties.

The court noted, in addition, that whether the customer actually read the terms was irrelevant. Later courts have reinforced the binding quality of terms of sale incorporated by clickwrap agreements. In Appliance Zone, LLC v. Nextag, Inc., an online merchant using an online registration process selected a box stating “I accept the Nextag Terms of Service” by clicking that box on the web page next to a hypertext link to the terms. 2009 U.S.
Dist. LEXIS 120049 (S.D. Ind., 2009). The court held that a choice of venue clause within the terms of service were binding on the merchant, whether or not the terms were even viewed by the merchant. The lesson from clickwrap agreements is that simply clicking on a button indicating assent, which courts treat as a written signature, will be enough to bind a customer to web-based terms, so long as those terms meet the standard for incorporation by reference.

**No Signed Contract or Clickwrap**

When there is no signed contract or clickwrap-type assent by which web-based terms are clearly incorporated, as in the above cases, courts will generally look at other factors, such as the adequacy of notification to the customers affected. A contract for services can be formed when an offer is accepted by using the services. In *Conference America v. Conexant Systems, Inc.*, 508 F. Supp. 2d 1005 (M.D. Ala. 2007), two parties had previously had an ongoing contractual relationship entered into a series of unilateral contracts formed when the customer requested services and the provider solicited them. Upon the termination of the initial contractual relationship, the service provider had sent a termination letter stating:

Any services used or requested by Conexant [Customer] after termination will be made available only on and subject to Conference America’s [Provider’s] standard terms, conditions, and prices effective at the time the services are rendered . . . Terms & Conditions is available at www.yourcall.com.

The issue was whether the customer was required to pay a deactivation fee contained in the web-based terms of sale. The court found the terms of sale to be successfully incorporated into each subsequent unilateral contract between the two parties. In addition to this, the court noted that any terms of sale posted on the website before the formation of any of the unilateral contracts was irrelevant to the particular contract formed upon the performance of services by the provider; the terms of sale existing on the date of services governed.

It is possible to bind a customer to incorporated terms of sale through notification from other sources, such as a telephone conversation. In *Greer v. 1-800-Flowers.com, Inc.*, 2007 WL 3102178 (S. D. Tex. 2007), a customer placed a telephone order for flowers for his girlfriend, at which time he inquired about the company’s privacy policy. Privacy seemed important to this customer. The vendor directed the customer to the company’s website, which stated:

Privacy Policy is part of the Terms of Use, which governs your use of 1-800-Flowers.com.

The girlfriend received the flowers. Shortly afterward, 1-800-Flowers, attempting to show good customer service, sent a thank-you-for-ordering note for the flowers to the customer’s wife. The customer sued for a violation of the privacy policy. The court held that a choice of venue clause, which was contained in the terms of use, was enforceable against the customer. Since the customer sued under the web-based privacy policy, this meant the customer was bound by the broader terms of use, of which the privacy policy was but one part, even if the customer had not even visited the terms of use, or in fact even visited the website at all.

Incorporation of web-based terms will not be effective unless there is proof of direct affirmative assent. In *Feldman v. UPS*, 2008 WL 800989 (S. D. N. Y. 2008), the shipper of a diamond ring was forced to print his own shipping label on a computer at the UPS store. There was proof that the customer clicked a “Print” button, but not an “Agree” button. The court ruled there was a triable dispute as to whether the customer had been given adequate notice of the UPS tariff limited the company’s liability, since there was no proof that the tariff was accessible on the UPS computer or present at the store in paper form.

**Website Changes**

Web-based terms of sale can be changed by a seller with a single mouse click. If a seller does so, are all of its customers bound to the new terms? In *Douglas v. United States District Court for the Central District of California*, 495 F.3d 1062 (9th Cir. 2007), a customer alleged that his phone provider had changed the terms of his service contract without notifying him. The provider countered that it had posted the changed terms on its website. The court held that the mere posting of revised terms on the company website was insufficient notice. The court distinguished the situation from other cases in which service providers had notified customers of changes to web-based terms of service by written notice. In contrast, in *Conference America*, the court noted that where a series of unilateral contracts existed, the terms of service present on the website at the time services were rendered were the only relevant terms; anything posted prior was irrelevant. Thus, the service provider in *Conference America* could change the terms of sale, and enforce the changed terms on future sales of services.

Changing web-based terms of sale can become complicated. Clients who seek to change the terms must retain a record of the terms that were posted at their website at the time of execution of any contract. In addition, having a separate URL for each successive amended terms of sale, or coding the website to allow a user to reference a complete set of terms by particular date, would lead to a multitude of forms, seemingly undermining the entire purpose of having a standard contract form in the first place. If a client is seeking to alter its terms of sale of sales on a regular basis, it may not be feasible for the terms of sale to be solely web-based.

**How to Do It**

In summary, there are several things to remember in seeking to make terms of sale posted on a client’s website enforceable. First, the contract should make a specific reference to the terms of sale in the contract document itself. If possible, it is always helpful to obtain either a manual signature or to obtain customer consent by using a clickwrap-style “I Agree” button. Also, it is vital to state that the terms of sale are “incorporated by this reference and made a part of the agreement between the parties.” Finally, remember that it is
insufficient to simply refer to the terms of sale, or just provide the website reference, or even to make the transaction “subject to” the terms of sale.

Here is a sample clause applying the preceding principles:

This sale is subject to the Client Products, Inc. Terms of Sale effective on the date the purchase order is received, which are incorporated in full by this reference. The Terms of Sale are available at www.client.com/terms, and also will be sent by mail or fax to the purchaser upon request. Client Products, Inc. limits acceptance to the Terms of Sale, and objects to any other additional or different terms in the purchaser’s purchase order or acceptance.

Here are two final cautions to consider. First, some clients may not want their terms of sale to be disclosed to all the world. For example, a client may include pricing formulas or special warranties in a set of terms of sale, which are to be made available to certain customers but not to others, and certainly not to its competitors. Second, since courts will examine the parties’ notice of the terms of sale and intent to be bound, conclusions on the enforceability of web-based terms of sale are less certain when applied to sale of consumer goods or services, as opposed to a business-to-business sale. In a business-to-business sale, it can be presumed that the purchasing business has a computer with web access to view the terms of sale. According to recent surveys, however, only about 60 percent of the American public has usable access to the web. Several of the cases cited in this article enforce website terms of sale against consumers. But suppose a court were asked to enforce a warranty disclaimer posted on a website for a consumer product like, for example, oven cleaner, against a poor person who could not afford a computer. If the injured consumer lacked web access, it is unlikely that a court would enforce the disclaimer.

**Conclusion**

A client can post its terms of sale on its website and make them enforceable using the traditional contract doctrine of incorporation by reference, so long as it is tailored to the medium of the contract, be it on paper or electronic. The key issue is whether the customer received adequate notice of the existence or changes of the terms.

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Over the past decade, consumers affected by data breaches have asserted both common law and statutory claims in state and federal courts against businesses that are potentially responsible for the breaches. However, common law claims based on negligence and contractual theories generally fail to survive the pleading stage due to lack of actual damages sustained by the consumer. Because the courts are quick to dismiss these claims based on lack of actual damages, there has been little or no incentive, at least from the court system, for businesses holding personal information and/or data to adopt stronger security safeguards to protect personal information. However, in Claridge v. RockYou, Inc., 2011 U.S. Dist. LEXIS 39145 (N.D. Cal. 2011), a federal district court has recently created an exception to the general trend by allowing contract and negligence claims to survive a motion to dismiss filed by the defendant. In doing so, the RockYou court also recognized an ascertainable “value” inherent in a consumer’s personally identifiable information (PII).

For affected consumers, the primary hurdle for seeking damages and other relief through the American courts has been the lack of standing to sue when the only injury to the consumer is emotional harm, increased risk of identity theft and/or future credit monitoring costs. Absent evidence that breach resulted in actual injury, the courts have generally found the potential risk of future identity theft, or the mitigation of that risk, does not satisfy the “injury in fact” requirement imposed by Article III of the United States Constitution. Other courts have dismissed data breach claims as a matter of law for various other reasons, all of which also relate to the speculative nature of the injury or the lack of actual damages. Regardless of the specific language or reasoning, courts have been unwilling to assign value or allow for damages related to PII which resulted in large numbers of dismissals at the pleading stage.

Resnick v. AvMed is a good recent illustration the types of unsuccessful claims brought in data breach cases and the reasoning relied upon by the court in denying the relief sought. In Resnick, laptops containing unencrypted medical and personal information for over one million individuals were stolen. The affected individuals brought suit alleging (1) negligence; (2) breach of contract; (3) breach of implied contracts; (4) restitution/unjust enrichment; (5) violation of a state consumer fraud and deceptive trade practices statute; (6) negligence per se; (7) breach of fiduciary duty; (8) breach of implied covenant of good faith and fair dealing; and (9) invasion of privacy. The defendant brought a motion to dismiss based on the plaintiffs’ failure to state a cognizable injury. After quoting the Seventh Circuit Court of Appeal’s decision in Pisciotta, 499 F.3d at 639–40 (“Without more than allegations of increased risk of future identity theft, the plaintiffs have not suffered a harm that the law is prepared to remedy”) and noting similar judicial treatment of such cases, the court dismissed all nine claims. The court found that the complaint alleged nothing more than a “mere specter of injury: a heightened likelihood of identity theft.”

Claridge v. RockYou, however, reached a different result with respect to PII. The defendant, RockYou, is a company that develops and publishes online applications for social networking sites. Customers sign up by providing a valid email address and registration password, which RockYou then stores in its database. Many customers are also required to provide their Facebook or MySpace usernames and passwords in order to use RockYou’s applications. Although RockYou promised on its website that it used “commercially reasonable physical, managerial, and technical safeguards to preserve the integrity and security of your personal information,” the company did not use encryption to prevent hackers from “easily” accessing users’ PII. The failure to encrypt this information had led to the publication of the contents of RockYou’s database on underground hacker forums.

The plaintiff filed a putative class action suit against RockYou alleging a plethora of statutory and common law claims. The first amended complaint also alleged that plaintiffs’ user information has inherent value. The so-called “value” is created
when advertisers are attracted to RockYou’s platform because it has access to user’s personal information.

The attorneys for RockYou brought a motion seeking to dismiss all of the class plaintiffs’ claims, particularly, the common law contract and negligence claims, based on the plaintiffs’ alleged failure to plead actual damages required to maintain a claim. The motion called plaintiff’s theory of recovery “speculative” and “an incomprehensible theory.”

In opposition to the motion to dismiss, the plaintiffs’ mainly argued that the class “paid” RockYou for products and services that they “buy” from the defendant by providing their personally identifiable information, here, e-mail accounts and social network logins. Thus, the plaintiffs argued that their PII represented “valuable property” that was exchanged “not only for defendant’s products and services, but also in exchange for defendant’s promise to employ commercially reasonable methods to safeguard the PII that is exchanged.” The named plaintiff further argued that he has already suffered an injury in fact because of RockYou’s failure to secure his PII, which itself is his personal property. The plaintiff’s counsel conceded in his brief that their theory on damages is a novel one and supporting authority for it is scarce.

Though the court dismissed most of the plaintiffs’ statutory claims and some its state law claims, it denied RockYou’s motion to dismiss with respect to the common law contract and the negligence claims. The court noted, “At the present pleading stage, plaintiff has sufficiently alleged a general basis for harm by alleging that the breach of his PII has caused him to lose some ascertainable but unidentified “value” and/or property right inherent in the PII.”

Although the court declined to hold at this juncture that, as a matter of law, “plaintiff has failed to allege an injury in fact sufficient to support Article III standing,” the court emphasized that it “has doubts about the plaintiff’s ultimate ability to prove his damages theory in this case.” It is unclear, at this moment, whether the complaint will survive summary judgment or another dispositive motion by defendant RockYou. It is also unclear as to whether the “value” recognition in RockYou will be adopted by other courts in class action data breach litigation if defendant’s business platform is different from that of RockYou.

It should be noted that less than a month after the RockYou ruling, a class action lawsuit has been filed against Sony in the Northern District of California on behalf of potentially 12.3 million users who had their credit card numbers stolen off of its Playstation network. It remains to be seen whether RockYou has any impact on the Sony class action. One online commentator, David Navetta, has already noted the RockYou case “may be a sign of an evolving judicial atmosphere and approach concerning data breach lawsuits.”

In conclusion, even with the court’s cautionary language, the RockYou decision should not be dismissed by businesses that hold and/or transact personal information/data. The RockYou breach resulted in part due to a lack of encryption of the PII. By allowing data breach claims to survive at the motion to dismiss stage, the RockYou court has increased the chance a defendant business being held liable for damages due to data breach. There are also additional legal fees and costs associated with written and oral discovery, and preparation of dispositive motions. The RockYou decision may incentivize and encourage relevant businesses to further invest in stronger and tougher security measures to reduce security breaches.

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Additional Information

78065 (D. Conn. 2009) and Belle Chasse Auto. Care, Inc. v. Advanced Auto Parts, Inc., 2009 U.S. Dist. LEXIS 25084 (E.D. La. 2009) (both holding that plaintiffs have not stated a claim upon which relief can be granted); Melacon v. La. Office of Student Fin. Assistance, 567 F. Supp. 2d 873 (E.D. La. 2008) and Kahle v. Litton Loan Servicing LP, 486 F. Supp. 2d 705 (S.D. Ohio 2007) (both holding that such damages are purely speculative and don’t amount to actual losses); Forbes v. Wells Fargo Bank, N.A., 420 F. Supp. 2d 1018 (D. Minn. 2006) (alleged injuries are “solely the result of a perceived risk of future harm”).
The U.S. Department of Justice (DOJ) has provided a jarring reminder of the penalties for dishonesty in Hart-Scott-Rodino (HSR) filings. On August 15, the DOJ announced that Nautilus Hyosung Holdings Inc. (NHI) agreed to plead guilty to criminal obstruction of justice for altering documents submitted with an HSR filing. NHI agreed to pay a $200,000 fine, but the DOJ can still pursue criminal prosecution—and potential incarceration—of an NHI executive.

Companies must make HSR filings with the DOJ and Federal Trade Commission (FTC) and observe a waiting period before closing to enable the agencies to evaluate the likely impact of the transaction on competition. Item 4(c) of the HSR notification form requires parties to provide copies of “all studies, surveys, analyses and reports which were prepared by or for any officer or director . . . for the purpose of evaluating or analyzing the acquisition with respect to market shares, competition, competitors, markets, potential for sales growth or expansion into product or geographic markets.” Such “4(c) documents” provide the agencies with their first insight into the potential impact of a transaction on competition.

NHI, a manufacturer of automated teller machines (ATMs), made a filing in August 2008 in connection with its proposed acquisition of Trident Systems of Delaware (Trident), a rival ATM manufacturer. According to the plea agreement filed in the U.S. District Court for the District of Columbia, an unnamed NHI executive altered 4(c) documents to “misrepresent and minimize the competitive impact of the proposed acquisition on markets in the United States and other statements relevant and material to analyses . . . by the FTC and DOJ.”

Despite the altered documents, the DOJ initiated a merger investigation and requested additional documents from NHI, including copies of preexisting business plans and strategic plans relating to the sale of ATMs for the years 2006–2008. The company submitted the requested materials in early September 2008. According to the plea agreement, an NHI executive altered the business and strategic plans to misrepresent statements concerning NHI’s business and competition among vendors of ATMs.

In early 2009, NHI told the DOJ that an executive had altered 4(c) and other documents produced to the government. NHI and Trident abandoned the proposed transaction shortly thereafter. According to the plea agreement, NHI provided substantial cooperation with the DOJ’s obstruction of justice investigation.

According to the DOJ, the recommended fine of $200,000—$100,000 for each count—takes into account the nature and extent of the company’s disclosure and cooperation. NHI could have faced a maximum fine of up to $500,000 per count of obstruction of justice under 18 U.S.C. § 1512(c). The plea agreement reserves the DOJ’s right to pursue criminal prosecution of the executive involved in the alterations.

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While most law firm corporate attorneys first encountered the legal complexities of the Troubled Asset Relief Program (TARP) when advising multi-million dollar for-profit businesses, several dozen attorneys from around the country recently donated their time and expertise to help community credit unions acquire the tail end of TARP funds to benefit low-income communities. This fast paced, significant pro bono legal project was coordinated by Lawyers Alliance for New York, the leading provider of business and transactional legal services for nonprofit organizations that are improving the quality of life in New York neighborhoods.

Last fall, Lawyers Alliance and its network of volunteer law firms took an active role in enabling nonprofit organizations to receive loans from the U.S. Treasury Department CDFI Fund. The program, called the Community Development Capital Initiative (CDFI), made returned TARP funds available to CDFI-certified community development credit unions and community development banks, but had its own requirements and regulations relating back to TARP. Confronted with a major set of loan documents and a limited amount of time, the pro bono attorneys helped secure vital loans for credit unions serving low-income communities across the country.

The CDFI Fund’s mission is to expand the capacity of community development financial institutions (CDFIs) to provide credit, capital, and financial services to underserved populations and communities in the United States with the overall goal of promoting economic revitalization and community development. This recent round of loans (CDFI) was funded through TARP. The CDFI Fund awarded a total of $104.9 million, the largest ever regular appropriation round, to 180 CDFIs around the country, including $12.4 million to CDFIs based in New York state.

During September 2010 the CDFIs, including dozens of low-income designated community development credit unions (CDCUs), closed on their long-term, low-interest secondary capital loans. Participating CDCUs had to demonstrate financial viability and a focus on serving their respective communities. Applicants were subjected to rigorous review by the National Credit Union Administration and the Treasury Department.

Lawyers Alliance worked with the National Federation of Community Development Credit Unions (the Federation), whose members are CDCUs, to help pair 45 of the CDCU recipients in and outside New York with pro bono counsel from 15 law firms. Pro bono counsel guided the CDCUs through the complex loan closing process, including due diligence, negotiation and documentation of loan agreements, and required legal opinions. These awards ranged from $8,000 to more than $8 million. Additionally, the attorneys helped the CDCUs to appreciate and comply with applicable TARP regulations and understand the obligations under the documentation governing the financing.

Says Joel Rappoport of Kilpatrick Townsend & Stockton LLP’s Washington, D.C., office, “My firm places a high value on pro bono service, but it can be challenging to find opportunities in my area of corporate and banking expertise. So when I heard, through our collaboration with the Pro Bono Partnership of Atlanta, of the need for assistance for community development credit unions, I had no problem finding volunteers on our financial institutions team willing to pitch in. Our team was able to represent six credit unions notwithstanding fairly intense time pressures. Our experience representing credit unions, as well as our experience with the Treasury’s comparable TARP capital purchase programs for banks, gave us a big head start in analyzing and addressing the complex issues involved. I know that all the attorneys and paralegals involved found the experience very rewarding on a personal level.”

“Anyone who worked on this project knows just how daunting some of the requirements were for CDFI funds,” says Clifford Rosenthal, president and CEO of the Federation. “Many of the program’s regulations were designed with trillion-dollar banks in mind under the original TARP authority and carried over to the CDFI program. This made it especially challenging for many drastically smaller credit unions to comply. I can confidently say that without the assistance provided by the Lawyers Alliance and the pro bono counsel from attorneys nationwide, many
of our credit unions would have been forced to drop out of the program. They literally saved our members hundreds of thousands of dollars in lawyer fees, and helped us bring millions in much-needed capital to low-income communities across the nation.” As part of the follow up, the staff and volunteer attorneys drafted a post-closing compliance memorandum, and the Federation then shared this memorandum with the participating CDCUs.

The CDCUs were grateful for the assistance. “As a smaller-asset-sized institution, we did not have the legal expertise internally to complete the requirements necessary to meet the closing deadline,” says Helen Godfrey-Smith, President and CEO of the Shreveport (Louisiana) Federal Credit Union, which received a $2,646,000 loan from this program. “The Lawyers Alliance for New York was recommended to us by the National Federation of Community Development Credit Unions. The Lawyers Alliance team helped us understand what was required to meet the TARP guidelines.

They aligned us with Shearman & Sterling, which assigned us to a team of legal professionals within the firm to answer all of our questions, prepare all of the closing documents, and assure that our interests were represented before the Treasury. We made the deadline and breathed a huge sigh of relief. We can now expand our services to many more low- to moderate-income families efficiently and effectively because of this partnership.”

To help recruit qualified pro bono attorneys for this project, Lawyers Alliance reached out to business law pro bono providers that serve nonprofits beyond New York, in Atlanta, Boston, Central Florida, Chicago, Connecticut, Detroit, Los Angeles, New Jersey, Philadelphia, San Francisco, Texas, and Washington, D.C.

Says Lawyers Alliance Executive Director Sean Delany, “We believe we do meaningful work here at Lawyers Alliance, but seldom are the fruits of our efforts so immediate and so satisfying. The National Federation is to be commended for spearheading this initiative, and we are proud to have played a vital part in it.”

Elizabeth M. Guggenheimer is the deputy executive director of Lawyers Alliance for New York.