INTELLECTUAL PROPERTY AND INFORMATION TECHNOLOGY DUE DILIGENCE IN MERGERS AND ACQUISITIONS: A MORE SUBSTANTIVE APPROACH NEEDED*

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I. INTRODUCTION: REASONS FOR A NEW APPROACH

Few decisions have greater consequences for a business than the decision of whether to acquire another business.1 In today’s world, one of the key determinants of a business’s value is the value of its intellectual property (“IP”) and information technology (“IT”).2

However, it appears that with relatively few exceptions, the due diligence (“DD”) processes,3 by which businesses assess the benefits of acquiring a

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* This article was first published in 2008 U. ILL. J.L. TECH. & POL’Y 321 (2008).
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1. Lee Gomes, H-P’s IBM Envy Drives Deal, WALL ST. J., May 14, 2008, at B8 (“Few things a company can do are taken more seriously than a big acquisition. Because that often means betting the farm . . . .”); see, e.g., ROBERT F. BRUNER, DEALS FROM HELL: M&A LESSONS THAT RISE ABOVE THE ASHES 95–340 (2005) (describing in detail the potentially dire consequences of acquisitions gone awry, including large losses and, sometimes, liquidation for companies, such as Penn Central, Revco Drugstores, Quaker Oats, Snapple, Mattel, The Learning Company, and others, as well as the positive consequences from a deal done well); David Enrich, CEOs Grapple with Subprime Beast: Pandit of Citigroup Plots a Turnaround but Not a Breakup, WALL ST. J., May 10, 2008, at B1 (referring to the failure to integrate sixteen data centers following 1998 acquisitions by Citigroup). Many troubled financial institutions find themselves in an acquisition predicament, in part, as a result of acquisitions of other institutions. See, e.g., Dan Fitzpatrick et al., With Wachovia Sale Looking Likely, a Makeover for Charlotte, U.S. Banking, WALL ST. J., Sept. 29, 2008, at C1 (“Wachovia [Bank’s] fall began with its $25 billion purchase of mortgage lender Golden West Financial corp. in 2006.”).

2. Jon Van, Stock Index Values Firms on Basis of Their Patents: Chicago’s Ocean Tomo Ranks 300 Companies, CHI. TRIB., Nov. 15, 2006, § 3, at 1 (“Now, tangible assets make up less than 20 percent of companies’ market value.”). For example, Microsoft Corporation in its 2006 Annual Report to Shareholders, identifies as material risk factors to its business model, problems protecting “intellectual property rights against piracy, infringement of . . . patents by third parties, or declining legal protection for intellectual property” and infringement claims brought by third parties. MICROSOFT CORPORATION, MICROSOFT CORP. ANNUAL REPORT 2006 15 (2006), available at http://www.microsoft.com/msft/reports/ar06/downloads/MS_2006_AR.doc; see also Enrich, supra note 1, at B1 (referring to an example of how poor integration of sixteen data centers adversely impacted Citigroup).

potential target, do not emphasize such matters. Rather, businesses emphasize traditional matters such as minute books, suit papers, credit agreements, and accounting work papers. Although the customary confidentiality of the DD process means that there is no way to perform meaningful empirical analysis to test this conclusion, both the author’s observations and the limited pertinent commentary corroborate this assertion. “Many companies approach due diligence by dotting the i’s and crossing the t’s,” but companies should instead “focus all of [their] time making sure the strategic value is there.”

Frequently, when IP and IT are addressed, the focus is on procedural matters, such as the timeliness of filings and review of suit papers in pending infringement disputes, as opposed to the substance of the IP and the process by which it is developed and used. This Article is intended to explain why additional substantive attention is warranted when reviewing a company’s IP and IT processes, as a result of recent changes in the legal and technological environments and the diverted focus of many practitioners. Additionally, this Article will discuss how to best provide this additional attention to actual transactions. The objective is to provide a conceptual framework to supplement and guide the myriad of steps that are required in this process, as well as guide the development of new steps that will be needed to accommodate the inevitable changes that will occur in the areas of law and technology. This framework involves the critical consideration of the genuine economic and operational value and risks associated with a target’s IP and IT related practices.

More traditional document-based DD was appropriate for many years “due diligence” and construing section 11(b)(3)(A) of the Securities Act of 1933 as referring to the standard of care required of one deemed an “underwriter” in a securities offering.

4. For an example of the traditional approach being applied, as well as the potential impact of merger and acquisition transactions on IP licenses, see Elaine D. Ziff, The Effect of Corporate Acquisitions on the Target Company’s License Rights, 57 BUS. LAW. 767, 786–87 (2002) (surveying several courts’ approaches to determining assignability of patent and copyright licenses). While Ziff provides outstanding guidance to the bar as to the structural considerations impacting license compliance, with emphasis on the need to consider the form of the corporate transaction when crafting a license compliance strategy, the article does not discuss the equally significant need for a substantive analysis of the subject matter of those patents. See generally id.


6. See Geoffrey Groshong & Samantha Pak, Patent Portfolios in Bankruptcy Cases: Protecting and Maximizing Their Value, BUS. L. TODAY, July-Aug. 2008, at 51 (“[P]atent counsel must remain highly vigilant and know the patent rules to ensure that deadlines are not missed.”). This article, which discusses analogous circumstances of a trustee or debtor in possession of an IP holding company in bankruptcy, is intended to provide guidance for those assuming control of bankrupt entities. Id. The article contains some discussion of the need to use relevant professionals to assess the substance of patents as they impact operations, but focuses on procedural aspects of due diligence, with headings such as “List All Patents and Applications,” “File a Power of Attorney,” “Be Aware of Deadlines,” and “Ensure Maintenance Fees are Paid.” Id. at 52. The latter topics are certainly essential, especially for one with a fiduciary obligation to preserve or maximize a company’s value, but must not overshadow the need to fully understand the strategic value of the patents in today’s environment. Notably, the article does not even cite or mention KSR Int’l Co. v. Teleflex Inc., which must be properly applied to understand the current value of a given patent. See generally id. at 51–55. An anecdotal illustration of this approach is found in NAT’L BUS. INST., INTELLECTUAL PROPERTY IN BUSINESS TRANSACTIONS: BEST PRACTICES IN LICENSING AND ACQUIRING IP RIGHTS (2008) (brochure on file with author). Of the five specific topics listed in the “Considerations during Mergers and Acquisitions” segment of the program, three are: Hart-Scott-Rodino Notification Rules, Drafting Non-disclosure Agreements, and Accounting for IP: Statement of Financial Accounting Standards 141 and 142. Id.
when IP and IT were rarely key drivers of business value. However, in today’s world, where hard assets normally play a subordinate role in business success and valuation, and where judicial decisions (and sometimes even the bringing of suit) and legislation have such a drastic impact on economic outcomes, a different approach is warranted. Very recent legal and technological developments include:

- The much more stringent standard for sustaining patents against obviousness challenges brought about by the U.S. Supreme Court’s decision in *KSR International Co. v. Teleflex Inc.*;
- The increased business potential and legal exposure associated with Web-based blogging and interactive marketing possibly leading to claims of secondary infringement of copyrights and trademarks;
- The creation of major legitimate and illegitimate businesses around digital music and movies; and
- The increasing significance of identity theft and related legislation.

These developments compel a detailed, rigorous analysis of the target’s IP and IT in an effort to assess their ultimate value (or detraction from value). Hopefully, this discussion will be helpful not only to the practicing bar pursuing best practices but also to the bench and commentators striving to develop standards of conduct and liability to govern the disputes that will inevitably arise to an increasing extent from IP and IT issues in merger and acquisition ("M&A") transactions.

II. GENERAL CONSIDERATIONS

Of initial interest is what constitutes IP. The term is universally understood to refer to patents, copyrights, trademarks and trade secrets, all of which may be directly owned as a result of purchase, development, or license from a third party. With the notable exception of trade secrets, almost all of

8. *127 S. Ct. 1727* (2007); see Linda Greenhouse, *High Court Puts Limits on Patents*, N.Y. TIMES, May 1, 2007, at C1 (noting that the court’s decision in *KSR* “raise[s] the bar for obtaining patents on new products that combine elements of pre-existing innovations.”).
9. See discussion *infra* Part III.C.2 (noting that with the rise in digital media offerings has come an increased risk of secondary infringement exposure); see, e.g., MGM Studios Inc. v. Grokster, Ltd., *545 U.S. 913, 940* (2005) (noting that Grokster sought profit from secondary infringement, which was significantly different from prior similar case).
10. See generally Grokster, *545 U.S.* at 939–40 (holding that a “peer-to-peer” file sharing network that derived revenue from the illegal sharing of copyrighted music had an “unlawful objective”).
11. See discussion *infra* Part IV.A.
12. See J. May Liang, *Going In-House with Intellectual Property*, BUS. L. TODAY, Mar.-Apr. 1997, at 36 (describing the major element of each type of IP). Each type inherently involves an element of exclusivity or monopoly (the right to exclude others from doing something). *Id.* at 36–41. Such exclusivity is deemed to be in society’s interest by promoting innovation. See, e.g., U.S. CONST. art. I, § 8, cl. 8 ("[T]o promote the progress of science and useful arts, by securing for limited times to authors and inventors the exclusive right to their respective writings and discoveries."); *KSR Int’l*, *127 S. Ct.* at 1746 (noting that giving exclusive rights to ordinary innovation would
the relevant law is federal.13

A. Why Conduct Due Diligence? How Do These Factors Impact IP and IT?

The most basic reason to conduct DD is to determine if it is appropriate to proceed with a particular deal. If the process reveals that the other company (the “target”) is not what it was represented to be, or is a poor “fit” with the acquirer as a result of business philosophy, technological, cultural, or personal incompatibility, the deal may not make sense and should be reconsidered. In many such cases, unless contractually obligated not to, the acquirer should simply walk away. Frequently, a target’s claimed competitive advantage from IP turns out to be nonexistent or exaggerated upon closer evaluation. Similarly, a review of IT process, people, or physical infrastructure may reveal that integration of the companies would be much more difficult or costly than originally contemplated.14

Even if the IP/IT review does not dictate “cratering” the deal, it may dictate pricing adjustments in the acquirer’s plan for the deal. For example, if a patent has less time until expiration than originally contemplated or a device or service is likely to prompt legal challenges of some sort, the acquirer must allow for the unfavorable effects when determining what to pay.15 Less frequently, the process will reveal unanticipated benefits—such as pending registration applications—from the target’s IP portfolio, which justify a price even higher than what was contemplated.

Apart from pricing considerations, IP/IT matters may dictate how a deal is to be structured. Many IP licensing agreements will be breached if the licensee becomes a party to one type of transaction but not to another.16 Prudent legal and business practice dictates close review of license documents before determining the formal structure for a deal.17

DD also impacts the mechanics of a deal. All acquisition agreements will spell out in some form the major “property” and rights or obligations being acquired, such as real estate, inventory (of merchandise for resale, finished goods and raw materials), fixed assets, receivables, employee benefit plans and the like. Customarily, such matters are enumerated in schedules to the definitive agreement—for example, “Target does not own any real property except as indicated on Schedule 4.1.” Identical treatment should be accorded

stifle progress).


14. See Enrich, supra note 1, at B1 (referring to the failure to integrate sixteen data centers following the 1998 acquisitions by Citicorp).


16. See Ziff, supra note 4, at 785 (explaining how the distinction between stock sales, asset sales, and mergers impacting the licensee often determines whether the licensee is in breach of IP licensing agreements that do not expressly enumerate the consequences of acquisitions).

17. See id. at 767 (suggesting that license provisions be reviewed for determinations on transferability and any specific prohibitions).
to IP and IT, both owned and licensed, including pending matters such as registration applications. The DD process must be used to help both parties develop and agree upon the information comprising this IP/IT schedule.18

The information obtained in DD can be quite helpful once the deal is done. It should facilitate and expedite the integration of the two firms by allowing the acquirer’s management to know what it is getting into and how best to use the resources added by the target. Good management organizations will operate on parallel tracks during the acquisition process so that the information they obtain in DD is used for deal pricing, structuring, and documentation, as well as integration planning. While all information obtained in DD is likely to be helpful, the IP and IT information is likely to be among the most helpful material obtained.

The technical information related to IP typically details how a firm runs major elements of its business. For example, a patented process or device that is used by the target means that it functions in some respect differently than comparable firms. Such information will be invaluable to management charged with combining the operations of the two firms by providing insight as to nuances of the target’s operations as they will differ from both prevailing practice and the acquirer’s own practices. A customer or supplier list, protected as a trade secret, provides the same benefits in the pertinent areas and will be extremely important to acquiring management in knowing with whom it will be dealing (and often on what terms).19 The same can also be said for pending or recently granted applications for patents; such items are likely to indicate the short or medium term agenda for the target and allow the acquirer to “hit the ground running.”

While many traditional procedural elements of DD are fairly straightforward and have not changed a great deal in recent years—such as review of contracts, corporate minutes and filings, and papers in pending litigation—IP and IT materials are by their very nature quite complicated and often serve to define the essence of a business’s position in the marketplace. Changes in the marketplace and legal environment20 have greatly increased both the complexity and opportunity associated with IP and IT. These changes necessitate a significant time commitment coupled with the involvement of a variety of people not typically thought of as part of a DD “core” team, which in the author’s experience and observation has relied heavily on lawyers, accountants, and environmental consultants.

18. As is the case with all definitive agreement schedules, the acquirer must review what is proposed by the target prior to executing the agreement, in order to ensure that its contents are consistent with its observations during the DD process.
19. See Illinois Trade Secrets Act, 765 ILL. COMP. STAT. 1065/2(d) (2006) (including a “list of actual or potential customers or suppliers” within the definition of a trade secret).
B. Who Should Participate in the IP and IT Due Diligence Process?

For the most part, DD is the province of transactional lawyers and accountants, with secondary involvement from subject matter experts ("SMEs"), such as environmental consultants, employee benefits specialists, and the like. However, with respect to IP and IT matters, this is not appropriate.

It is necessary to engage SMEs with pertinent technical expertise in the relevant area, be it an electrical engineer to review a patent for items involving transmission of electricity, a physician researcher to review a patent for a drug, or a systems integration consultant to consider a target’s IT environment and its integration with that of the acquirer. Such SMEs should take the lead in the substantive review process, in which the business significance of the various items of IP and the IT infrastructure are absorbed and evaluated. For example, an engineer would advise the DD team of whether the subject matter of a patent is likely to work as advertised, whether it is genuinely a breakthrough for commercial purposes, or whether it would be easy for someone to develop the same capability without infringing on the claims of the patent.

For IP matters, the required types of SMEs will vary greatly depending on the type of IP at issue. Consideration of patents will involve engineers and/or scientists and patent lawyers, while consideration of trademarks will usually be for sales and marketing management, with some input from trademark counsel. Copyright matters will usually require persons with design or literary expertise, although the growing concerns regarding secondary infringements brought about through technological innovations may cause the involvement of engineers or computer scientists, as well. Trade secret issues will likely remain the province of lawyers, with significant involvement from human resources professionals.

IT matters will require discussion between each party’s IT managers, framed by lawyers with some familiarity of the major issues in this context.

21. As opposed to the procedural review process of the filings pertaining to each item of IP—when registered and as maintained through required filings with governmental bodies and infringement claims—where lawyers are likely to play a leading role.

22. Howard B. Rockman, Intellectual Property Law for Engineers and Scientists 98 (2004); see also Markman v. Westview Instruments, Inc., 517 U.S. 370, 387 (1996) (“As it cannot be expected . . . that judges will always possess the requisite knowledge of the terms of art or science . . . it often becomes necessary that they should avail themselves of the light furnished by experts . . .”).

23. David A. Westenberg, What’s in a Name? Establishing and Maintaining Trademark and Service Mark Rights, 42 BUS. LAW. 65, 65 (1986) (“A trademark is a word, symbol, design or device, or any combination thereof, used by a manufacturer or merchant to identify the source of its goods, and to distinguish them from goods manufactured or sold by others.”). It is necessary for those responsible for selling the product(s) at issue to make an assessment of whether their marks are conducive to doing so in the relevant, post-acquisition circumstances. Id. at 66–67.

24. See Grokster, 545 U.S. at 914 (“[T]he argument for imposing indirect liability is powerful.”).

25. See, e.g., Complaint at 7–9, RealNetworks, Inc. v. DVD Copy Control Ass’n (N.D. Cal. 2008) (No. C-08-4548) (alleging that RealNetworks’s program, which allows the copying of DVDs to computer hard drives, violates the Digital Millennium Copyright Act). The outcome of this case may serve to illuminate the meaning of section 501 of this statute. RealNetworks’s explanation may be diluted as a result of its argument that its license with an affiliate of plaintiffs supersedes any statutory prohibitions. Id.
C. What Are We Looking For in the Due Diligence Process?

The IP analysis of the DD team must have a quadruple focus:

- What is the target’s IP worth, now and in the future, in the plant, in the marketplace, and in court;
- How well does it insulate the target’s business from legitimate competition as well as infringement;
- Does the target face a realistic threat of third-party claims for infringement of IP; and
- Does the target take proper measures to minimize the likelihood of involvement in disputes concerning alleged infringement of third-party IP?

This multifaceted approach reflects the need for both an offensive and defensive analysis of the target’s IP posture. It is little consolation for an acquirer to establish that the target has outstanding technical personnel who have developed a valuable IP portfolio, if such portfolio has not been properly defended from misappropriation by competitors. It is even worse to discover that a seemingly valuable IP portfolio is the result of misappropriation or infringement of another party’s IP. Even the likelihood of spurious claims of such activity by the target should give pause to the acquirer in view of their potentially drastic consequences. As is true with all legal claims, one does not want to acquire a lawsuit or the need for one in an M&A transaction. The IP area is particularly susceptible to legal disputes as a result of many of the recently promulgated authorities, which substantially change the legal environment by expanding or limiting various legal theories of interest to practitioners in the area.

Since so much IP is licensed, and so much software used in the IT area is also licensed, DD work must always address not only prevailing legal doctrines in the respective areas—such as patent, copyright, trademark and trade secret—but also obligations contained in the applicable license documents. In many cases, behavior that is clearly permissible or, at worst, arguable under common and statutory law, is the subject of an express contractual provision that either permits or prohibits it. In many copyright

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26. Injunctions or large settlements/damage awards often result from infringement claims and attorney’s fee awards are also fairly commonplace. Large legal fees are certain. The well-known lawsuit involving the patents associated with the Blackberry device—which nearly caused the shutdown of Blackberry service and was settled for over $600 million, despite serious questions about the validity of the patents—is an example of the impact of such claims. Adam Jaffe & Josh Lerner, Innovation and Its Discontents, WALL ST. J., Mar. 21, 2006, at A14.

27. See, e.g., 17 U.S.C. §§ 501, 1201 (2000) (heightening penalties for copyright infringement on the Internet and criminalizing production and dissemination of technology intended to circumvent measures that control access to copyrighted work added as part of the Digital Millennium Copyright Act); KSR Int’l v. Teleflex Inc., 127 S. Ct. 1727, 1740 (2007) (finding that an improvement that is discoverable by a “person of ordinary skill” likely bars patentability); Grokster, 545 U.S. at 919 (holding that one who distributes a product used to violate copyright and promotes its use to violate copyright is liable for the resulting infringement by end users).

cases the contract at issue is not a traditional one on paper but is a so-called “click wrap” or “browse wrap” agreement where users click a button with their mouse to manifest their consent. Inquiry must be made as to whether the target customarily agrees to or tracks the acceptance of licenses covering all relevant products, including those covered by a “traditional” license document and those covered by “click wrap” agreements. Such inquiry should also encompass the use of so-called “open source” software for which the relevant materials are made freely available on the Internet, but are subject to use limitations in a “General Public License” document. Noncompliance with the latter can constitute both copyright infringement and breach of contract.

D. Who Are the Parties? Legal and Operational Implications

For IP licensed to the target, it is worth considering the financial stability of the licensor. If the licensor disappears or encounters major financial problems, this will at least impact the support provided to the licensee for the IP following the execution of the license, which is often referred to as “maintenance,” and is of great significance for software and sometimes (in some form) for patents. Until fairly recently, a licensor’s bankruptcy could also result in a termination of the license by the licensor or its trustee, resulting in devastating consequences for a licensee who needed to continue to use the IP in its business. However, section 365(n) of the Bankruptcy Code now dramatically reduces this risk for all IP except trademarks. A licensee bankruptcy may also be problematic for the licensor—especially if the bankrupt licensee had an exclusive license—and is not governed by a specific IP-oriented statute. At a minimum, as is the case with any contract where a party files for bankruptcy while owing money, there will be an interruption in the payment of royalties and there may be impediments to relicensing the IP to someone else.

Since M&A transactions and macroeconomic turmoil can have a major

33. Id. at 1661–63.
35. See, e.g., In re Catapult Entm’t, Inc., 165 F.3d 747, 748 (9th Cir. 1999) (describing how a licensor may prevent a licensee from reassigning a nonexclusive patent during post-bankruptcy reorganization plans).
impact on the viability of licensors and licensees, it is also prudent to address the termination provisions of any major license agreements to which the target is a party to determine what circumstances allow for termination. For example, if there is a “change of control” of the licensor, or if the licensor’s circumstances drastically deteriorate, or merely for the licensor’s own convenience.

E. Outside the United States

While space considerations dictate that this Article focus on U.S. issues, it must be stressed that to an increasing extent, IP matters are subject to law outside the United States. This means that for both an offensive and a defensive analysis, the acquirer of a target with any material non-U.S. operations must consider foreign IP law and practice. Foreign countries are under increasing pressure from their own commercial communities and the international community to bring their IP laws and practice in line with those of the United States. They are doing so in order to protect their own large companies and avoid World Trade Organization sanctions for tacitly allowing infringement of IP rights of Western firms.

F. Proper Use of Due Diligence Findings

The results of the license compliance and patent strength assessments need to be properly used and managed. A pending lawsuit between software giants Oracle and SAP illustrates what happens when this is not the case. When SAP pursued the acquisition of a company called TomorrowNow (“TN”), its DD review was broad enough to discover that TN was misusing Oracle software but proceeded with the transaction anyway. “Oracle claims that . . . members of SAP’s executive team knew that [TN] misused Oracle’s intellectual property before making the acquisition.” Oracle brought suit against SAP in Federal District Court and included a discussion of the SAP DD team reports in its second amended complaint.

37. See Ziff, supra note 4, at 787–88 (describing an example of changes in contract rights due to a change of ownership).
38. See PATRICK J. WHALEN & PEARL HSIEH, PROTECTING INTELLECTUAL PROPERTY IN OUTSOURCING DEALS 3 (2005) (“Through Article 39 of the Agreement on Trade-Related Aspects of Intellectual Property Rights (TRIPS), the obligation to protect trade secrets has gone global.”). Despite the limitation of the quoted language to trade secrets, the title of the World Trade Organization Agreement speaks for itself with respect to the internationalization of this area. Id.
39. Id. at 7.
40. Id.
41. Complaint at 28–40, Oracle Corp. v. SAP AG, 566 F. Supp. 2d 1010 (N.D. Cal. 2007) (No. 07-7658) (including counts for, inter alia, copyright infringement, breach of contract, and violations of the Computer Fraud and Abuse Act).
42. Second Amended Complaint at 2–3, Oracle Corp. v. SAP AG, 566 F. Supp. 2d 1010 (N.D. Cal. 2008) (No. 07-7658).
44. Id. at B4.
While the outcome of this suit cannot be known at this writing, its existence is certainly a source of expense and embarrassment for SAP. One would hope that SAP properly allowed for such considerations when determining the net value of the transaction. In such situations, many companies would be well served by walking away from the deal, rather than grabbing the proverbial hornet’s nest.

In any case, the fact that outside of the discovery process Oracle obtained reports from SAP’s DD team and quoted them in its complaint indicates that sufficient precautions were not taken to safeguard such materials. When a DD process does turn up adverse material, it must be properly secured to avoid unintentional disclosure, and steps must be taken to preserve whatever attorney-client privilege would otherwise apply to protect it from discovery or admissibility in court. At a minimum, this means minimizing the circulation of the material within the acquirer’s organization.

III. SPECIFIC DUE DILIGENCE TECHNIQUES

There are vast differences in the steps to be taken with respect to each of the topics covered in this Article, but in all cases, it will be necessary to consider both procedural and substantive matters. That is,

- Whether the target has “jumped through the right hoops” regarding the notices and filings that are needed with government and private parties to establish and maintain the particular IP rights at issue (including the content of such materials, as well as its timeliness) or avoid third-party disputes;

46. See, e.g., Worthen, supra note 43, at B4 (explaining that SAP acquired TN to better compete with Oracle but now has to close it after the discovery of some questionable operating practices); Jacqueline Emigh, SAP Could Sell off Its Embattled Division Amid Oracle Suit, BETANEWS, Nov. 20, 2007, http://www.betanews.com/article/SAP_could_sell_off_its_embattled_division_amid_Oracle_suit/1195597861 (describing how SAP admitted that its customer support division TN “improperly and perhaps illegally downloaded materials from Oracle’s Web site by masquerading as one of its customers,” and that selling off TN was the best option).

47. See Oracle Corp., 566 F. Supp. 2d at 1013 (allowing production of grand jury documents).


49. Of course, any efforts to safeguard such materials must comply with obligations under the Federal Rules of Civil Procedure and comparable state law to avoid spoliation of evidence that appears to be germane to pending or anticipated litigation. See, e.g., Zubulake v. UBS Warburg L.L.C., 217 F.R.D. 309, 324 (S.D.N.Y. 2003) (ordering the defendant to supply e-mails stored on backup tapes when no privilege was claimed); Coleman (Parent) Holdings, Inc. v. Morgan Stanley & Co., No. CA 03-5045 AI, 2005 WL 674885, at *9 n.17 (Fla. Cir. Ct. Mar. 23, 2005) (finding a defendant violated numerous discovery orders when it claimed over two hundred documents were privileged, and considering the claims of privilege unfounded).

50. While practices diverge among the states, in federal court, the privilege can be preserved best by limiting dissemination of arguably privileged material to those within a corporation who have a bona fide interest in its subject matter. Upjohn Co. v. United States, 449 U.S. 383, 400 (1981). A commentator summarizes the guiding principle as: “[U]nless you want to risk a waiver, don’t send a memorandum dealing with legal matters to anyone who isn’t working on or involved with the problem.” Michael A. Lampert, In House Counsel and the Attorney Client Privilege, FINDLAW, 2000, http://library.findlaw.com/2000/Oct/1/128767.html.
• Whether the particular contract and property rights, if properly reserved, are sufficient to provide the acquirer with the anticipated business benefit(s); and
• Whether the target is properly respectful of the IP rights of others.

A. Patents

1. Implications of Recent Case Law

Quite surprisingly, given its seemingly arcane nature, this area has become a focal point for many discussions about how best to maintain or enhance the competitiveness of the American economy.\(^{51}\) Many have argued that the patent system has discouraged innovation and creativity by granting many patents for “inventions” that add little to the greater good, but simply serve to enrich their inventors by discouraging legitimate competition that would naturally flow from the existing knowledge base.\(^ {52}\) Issuing patents for so-called business methods was authorized by the Federal Circuit in State Street Bank v. Signature Financial Group in 1998,\(^ {53}\) and has been seen by many as particularly problematic.\(^ {54}\)

Apparently, in response to these concerns, the U.S. Supreme Court has recently acted to scale back the rights of patent holders and patent applicants, making patents harder to get, enforce, and maintain in the face of infringement. Most notably the Court in KSR International Co. v. Teleflex Inc.,\(^ {55}\) raised the bar for demonstrating that the subject matter of a patent is not “obvious” to “a person having ordinary skill in the art” within the meaning of the Patent Act.\(^ {56}\) The Court approvingly cited the district court’s view that obviousness is to be judged from the perspective of someone with a bachelor’s degree in engineering in the relevant field, as opposed to merely a reasonable person.\(^ {57}\)
This will clearly make it harder to obtain a patent and easier to escape liability for infringement, since a defendant in an infringement action may defend on the basis of the patent’s invalidity.

As this Article went to press, in a closely followed case involving a commodity trading strategy, in which thirty-nine amicus briefs were filed, the Federal Circuit, acting en banc, substantially limited the patentability of business methods without a direct physical application. In *Bilski*, the court indicated that it would be insufficient for a method application to be based only on the existence of the “useful, concrete and tangible result,” which was approved by the same court in the *State Street Bank* case. The *Bilski* opinion made clear that it was not promulgating a per se rule barring the issuance of business method patents, but relied upon the U.S. Supreme Court’s decision in *Gottschalk v. Benson* to reiterate that any patent based on a process or method would have to have some genuine, meaningful connection to a machine or transform a particular article into a different state or thing.

In addition, the Supreme Court has limited the remedies available to patent-holders by making clear that even where infringement is established, requests for injunctive relief must be held to the same standard as in any other case, rather than strongly presumed or automatically available for the aggrieved patent-holder.

All of this means that a target’s patent portfolio and pipeline of patent applications is likely to be worth less than it would have been several years ago, especially if it is comprised to any significant degree of business method patents. Existing patents are more likely to be invalidated in infringement litigation and applications are less likely to be granted. Those patents that are granted and upheld will sometimes offer their holders less effective relief from infringement. Conversely, many pending or threatened actions against a target for patent infringement will now fail, and perhaps do so without the need for protracted legal proceedings. Patents and inventions in process must be evaluated in light of these more rigorous standards to determine their genuine viability.

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59. *Id.* at 10 (citing *Gottschalk v. Benson*, 409 U.S. 63, 67 (1972)).
60. *In re eBay Inc. v. Mercexchange, L.L.C.*, the Supreme Court reiterated that before granting equitable relief in a patent case, the court must consider (as in any other case not governed by a contract or statute) whether the plaintiff has suffered an irreparable injury, whether there is adequate relief to be found at law with money damages, the balance of hardships between plaintiff and defendant, whether the burden of an injunction would be disproportionate, and whether the injunction is contrary to the public interest. *eBay Inc. v Mercexchange, L.L.C.*, 547 U.S. 388, 391 (2006).
62. *See generally* Seidenberg, *supra* note 61, at 60–61 (discussing cases that make it difficult for patent holders to obtain certain types of relief).
2. Assessment of Business Value

Assuming the validity of a target’s patent portfolio, the acquirer needs to assess its business value. This means enlisting SMEs with appropriate technical skills and marketplace familiarity who can determine how much the patents advance the target or industry’s ability to introduce commercially successful products to the market. A major part of this process is review of the “claims” included in each patent application. “Claims” refer to the specific technical improvements brought about by the patent application and define the extent of the exclusivity.63 This process should encompass both granted and pending patent applications.

At this stage, transactional lawyers can best serve their client by enlisting and coordinating the input of patent attorneys, engineers, scientists, manufacturing management, and sales personnel to assess the value of the patent portfolio. The same group can also add real value by engaging their target counterparts in a discussion of the target’s patent compliance and patent defense approaches. The discussion must encompass patent searches conducted in anticipation of a proposed new invention or refinement to an existing product where a third party’s patents need to be evaluated in order to minimize the likelihood of infringement. Of course, if the target believes that it is taking a calculated risk with significant business benefits by infringing the arguably invalid patent of another, any potential infringement must be noted and quantified to the extent possible. It is important to note that this may give effect to the possibility of additional damages resulting from the willful infringement. The important thing is to screen out companies who are simply unconcerned about the need to respect the genuine IP of others.

3. Additional Burdens of Licensing

The preceding analysis should be conducted with respect to patents that are directly owned by the target, as well as those that are licensed to it. If great reliance is placed on a licensed patent that turns out to be invalid, adverse business and possibly legal consequences will result.64 It may be more difficult to obtain access to the required information and people if a target has licensed a patent rather than if it owns one, but this information is essential where the licensed patent is material to the target’s business.

With all patents subject to licenses (as both licensee and licensor), it is critical to closely review the infringement indemnification language that allocates responsibility for dealing with third-party infringement claims.65

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64. See Jaffe & Lerner, supra note 26, at A14 (noting that a business was forced to pay a settlement of over $600 million to prevent Blackberry handhelds from going dark, due to a potential injunction resulting from patent infringement litigation).
65. Separate indemnification provisions in the definitive acquisition agreement should cover misstatements by the seller as to IP and other matters, particularly third-party claims arising prior to the closing (and sometimes reflect the desired risk allocation for known, disclosed claims). See generally James J. Widland, Selling the Family Business, BUS. L. TODAY, May-June 2005, at 43, 47 (discussing misstatements within indemnity provisions for preparing purchase agreements for selling businesses). For example, if the
Such provisions usually address responsibility for both defense costs—for example, legal fees—and ultimate settlement or judgment amounts. There are an infinite number of variations of such provisions, dictated by prevailing legal and marketplace circumstances. Key topics where exposure and recourse can drastically differ and which the DD report should address for material items, include:

- Applicability to licensor’s entire patent portfolio or merely those existing when the license is signed;
- Applicability to patents issued in all countries or only those issued by specified countries, such as the United States;
- Requirements for prompt notice of a claim for which an indemnity is sought as a complete defense if not complied with, or only coming into play to the extent of actual prejudice from the delayed notice; and
- Right or obligation of the indemnified party to take control of the defense of a claim.\(^{66}\)

An acquirer should understand the significance of the contingent claims represented by the target’s outstanding indemnification of third parties, as well as potential recourse it may have if it is challenged on account of patents licensed by the target. If infringement disputes are customary in the space occupied by the patents in question, greater value must be attributed to these “contingent” claims than if such disputes are rare in the specific environment at issue. Of course, the financial strength—i.e., the ability to remain in existence and satisfy claims—of any third-party who has provided an indemnity to the target is also relevant to the analysis of its value.

4. Procedural Due Diligence

While this Article argues strongly for increased emphasis on substantive analysis of patents, it must be emphasized that this does not reduce the importance of procedural review. Concurrently with the substantive analysis, counsel should work with its counterpart to address the procedural aspects of the target’s patent portfolio. This procedural analysis may have major implications on the target’s value and will have to be translated into a definitive agreement schedule. Matters that need to be disclosed in the schedule along with corroborating documentation such as patent certificates and applications include:

- Patent (or application) numbers;
- Patent types (design, process, composition, device, or business

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method);

- Ownership of patents including written assignments of ownership from employees67 (if these do not exist, the acquirer should be wary of potential claims by employees and contractors on patents of the target, especially where the patents are of fairly recent vintage);

- Major claims in applications;

- Status (applied for, granted or subject to a provisional patent);68 and

- Filings and fee payments to keep the patent in force.69

Counsel should also conduct appropriate analysis of products being developed for which the target contemplates filing a patent application. These matters should also be included on the definitive agreement disclosure schedule. Such a schedule should also enumerate pending applications for which the target will normally sign a covenant that it will cooperate with the acquirer in connection with patent prosecution.

Pending and threatened infringement claims by and against the target need to be identified, catalogued, and evaluated in the same manner as other litigation, but with appropriate substantive input from patent counsel and scientific or engineering personnel.

Licensed patents (where target is either licensor or licensee) call for separate procedural analysis with the emphasis on not only the nature of the patents involved, as described above, but also commercial issues such as:

- License duration and extension options;

- Use limitations—e.g., type of product, number of units, and geographic limitations; royalty amounts, formulae, and adjustments;

- Compliance audit or verification mechanisms;

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67. There is legal authority providing for automatic ownership by the employer of IP, particularly copyrights, generated by an employee within the scope of their employment. See 17 U.S.C. § 101 (2000) (defining a “work made for hire” as one that is “prepared by an employee within the scope of his or her employment.”). The exact parameters of this authority are somewhat murky, with respect to patents (and even copyrights), and it is far simpler and better to rely on express written assignments or appropriately titled patent applications. Additionally, in many cases when a company is started, it relies upon patents obtained by its founder(s), without providing for a formal transfer of ownership. See Eric J. Moutz & Adrian Eissler, Four Strategies for Controlling Employee-Created IP, 36 COLO. LAW. 31, 31 (2007) (explaining that the best way for a company to establish ownership rights to IP is by getting employee-inventors to sign an employee agreement).

68. A provisional patent requires little documentation but is only good for one year, and it serves as something of a “placeholder” for a patentee who is testing the water to see if it is prudent to incur the expense associated with a full scale application. See 35 U.S.C. § 112 (2000) (specifying the required elements in a claim); see also U.S. Patent & Trademark Office, Provisional Application for Patent, www.uspto.gov/web/offices/pac/provapp.htm (last visited Nov. 18, 2008) (explaining the process for filing a provisional application for patent). If a “traditional” patent is granted, the patentee’s exclusivity relates back to the granting of the provisional patent. Id. During the one year, the applicant can refer to its “patent pending” status. Id.

• Identity of parties, with emphasis on identification of those who are financially unstable or likely to be untrustworthy in a manner that would spawn litigation or compromise the value of the patent;

• Whether or not the license is exclusive vis-à-vis both the licensor and the rest of the world, or whether the licensor is excepted; and

• Assignment or change of control provisions impacting the proposed transaction.70

If the proposed deal or resulting corporate structure conflicts with a material license, then the parties should, depending on the relationship with the other party to the license, either request their consent or reconsider the structure of the deal.71

Additionally, because many infringement suits arise from failed licensing negotiations (initially or with respect to renewal),72 the target should include, on the disclosure schedule, any pending license negotiations and its status as either licensor or licensee.

5. Patent Pools, Trade Regulation, and Other Considerations

Any patent pools—arrangements whereby a group of patent holders allow each member of the group to utilize a specified group of patents developed by its members, with or without payment of a royalty—need to be identified, evaluated, and documented.73 A given patent of the target may have less value than anticipated if it is in a pool where other companies can use it, as well. Similarly, the target may have rectified a gap in its IP and added to the value of its IP portfolio and company by becoming a participant in a pool that gives it access to required technology.

In addition to patent pools, any collaborative arrangement whereby the target contracts with other companies with respect to the use of IP (other than a genuinely nonexclusive license involving IP), such as exclusive territorial provisions and joint research and development or grantback agreements to which the target is a party, also needs to be specifically identified and evaluated from a trade regulation perspective.74 Because IP, by definition,

70. See Ziff, supra note 4, at 785 (describing the Sixth Circuit’s handling of the issue of assignability in patent licenses). To overgeneralize, nonexclusive patent and copyright licenses that are silent on the matter are usually deemed nonassignable, and thus contravened by asset sales and mergers, even without a showing of prejudice, but not contravened per se by stock sales. Id. Trademark license analysis usually involves consideration of actual prejudice to the licensor from the proposed transaction. Id. Express permission or prohibition of M&A transactions contained in licenses are given effect. Id.

71. While Grokster arose in connection with a copyright issue, its teachings are equally applicable to all types of IP and are included in this section because the patent DD process is likely to generate more findings than the process for other IP. MGM Studios Inc. v. Grokster, Ltd., 545 U.S. 913, 915 (2005) (referencing patent law concepts in defining a theory of contributory copyright infringement).


73. 54 AM. JUR. 2D Monopolies, Restraints of Trade, and Unfair Trade Practices § 137 (2008).

involves a limitation of competition, any collaboration among firms involving the shared access to IP requires significant scrutiny. The U.S. Department of Justice and Federal Trade Commission have promulgated “Guidelines” indicating when they will challenge multi-company arrangements involving IP. The Guidelines also contain a safe harbor for arrangements involving companies with under 20% of the relevant market. If a target is a party to any arrangements within the scope of the Guidelines, or if the proposed transaction would negate the safe harbor, consideration should be given to the likelihood and significance of an antitrust challenge.

Where a transaction takes the form of an asset sale or transfer of a patent (or group of patents), a filing is required with the U.S. Patent and Trademark Office (“PTO”). This should be addressed, both for the transaction for which DD is being performed and for any of the target’s previous transactions in which patents were acquired, in order to ensure that it has good title to such patents.

B. Trademarks and Servicemarks

Trademarks and servicemarks can appear in a variety of situations. While the most obvious such situation is a target with branded products, such marks will also appear as a consequence of franchise agreements to which the target is a party, or as corporate logos. Strictly speaking, such marks do not require any governmental filing or registration, but as a practical matter they are not likely to have great value without U.S. federal registration. Preferably, such registration will be on the “Principal Register” instead of the “Supplemental Register.” The registration certificates will have to be examined as part of the procedural DD.

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75. See id. at 2–4 (applying standard antitrust analysis to IP).
76. Id. While these Guidelines are important to businesspeople and practitioners when structuring transactions, they are not binding on private plaintiffs, who are free to sue under the antitrust laws if they believe that they have evidence of a violation. Ill. Tool Works v. Indep. Ink, 547 U.S. 28, 45 (2006). These Guidelines also address “tying” arrangements, whereby one wishing to purchase the patented product must also purchase another, nonpatented product. Id. In Illinois Tool Works, the U.S. Supreme Court directed that such arrangements be evaluated on a case-by-case, rule of reason basis, instead of their prior rule of per se illegality. Id. at 36.
77. U.S. DEP’T OF JUSTICE & FED. TRADE COMM’N, supra note 74, at 22.
78. Id. at 24–25.
79. As of October 1, 2005, the PTO no longer provides a specific form for this purpose but still requires assignments to be recorded in its records. U.S. Patent & Trademark Office, Assignments and Licenses, www.uspto.gov/web/offices/pac/doc/general/assign.htm (last visited Nov. 18, 2008). Pre-October 2005 assignments of mission-critical patents should be verified with the PTO. The assignment “should identify the patent by number and date (the name of the inventor and title of the invention as stated in the patent should also be given),” and the assignment should be notarized. Id.
80. Westenberg, supra note 23, at 69.
81. In contrast to the Supplemental Register, the Principal Register provides several procedural benefits for the holder in infringement litigation and renders the mark incontestable in the face of most challenges after five years. Id. at 70. There is also a fairly new statute providing special protections to “famous” trademarks even without a showing of likelihood of confusion. Trademark Dilution Revision Act of 2006, Pub. L. No. 109-312, § 2, 120 Stat. 1730 (to be codified as amended at 15 U.S.C. § 1125(c)). But its applicability—i.e. what is “famous”?—and significance can not yet be gauged. This statute should be considered if the target owns or is using any marks that are arguably famous.
1. **Substantive Considerations**

Before addressing procedural matters, sales and marketing management, along with trademark counsel for the acquirer, should address the marketplace value of the target’s marks. There is a dichotomy between the legal strength of a mark and its identification with the underlying product or service. The marks that are most defensible in a legal proceeding are those with no apparent connection to the product and which contain fanciful shapes or characters—such as “Exxon” or “McDonald’s.” Marks that on their face refer to a type of good or service are more likely to be easily and legitimately appropriated by competitors. Ultimately, the issue is whether the acquirer is getting what it expects from the target’s trademark portfolio with respect to both marketplace value—distinguishing the goods from those of competitors—and legal defensibility.

A topic related is whether, and how well, the target has “policiced” its marks against persons who use them on counterfeit products or on competitive products. The owner of a mark has a legal incentive to avoid public confusion by taking action against those who use the mark in a misleading manner; inadequate policing of a mark can lead to a loss of trademark rights. Apart from the legal obligation, it is also good business to avoid “dilution” of one’s mark through its use on someone else’s goods, especially if they are inferior to your own:

> Trademarks receive legal protection primarily to prevent buyers from being fooled about the source of goods or services. If a company that owns a trademark fails to control who uses the mark to the extent that the mark no longer indicates a single source of goods or services, the rationale underlying legal protection collapses.

The basic standard for enjoining the use of a mark is whether it is causing or is likely to cause consumer confusion.

The target’s policing practices need to be evaluated to determine if they adequately protect marks to which the acquirer has assigned significant value. If it appears that the target has largely ignored infringing uses, then the

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83. Id.
84. Id.
85. Id. at 85; see also Deborah Wilcox, *Resist Cease and Desist: A Lighter Approach May Work Better with Trademarks*, BUS. L. TODAY, May-June 2006, at 27 (“Taking action to enforce trademark rights against infringers might be a major cost of doing business, but it is required under the law to maintain the integrity of the trademark.”).
86. Westenberg, *supra* note 23, at 85. A failure to police may result in the loss of the mark. *Id.; see e.g.*, Murphy Door Bed v. Interior Sleep Sys., 874 F.2d 95, 101–02 (2d Cir. 1989) (finding “Murphy Bed” to be a generic term and thus no longer a valid trademark in spite of Murphy Door Bed’s unsuccessful attempts at policing the mark).
87. Wilcox, *supra* note 85, at 27.
88. Westenberg, *supra* note 23, at 68. Marks are registered only for specific products or services. The same consequences can also result if a mark becomes synonymous with an entire category of products. *Id. at 83.* Where applicable the target’s efforts to avoid this result should be considered—for example, Xerox running advertisements reminding the public not to use its name as a verb. *See id.* at 85 (noting that a trademark owner in such danger may wish to engage in advertising to request that the public use its mark properly).
acquirer should attribute little or no value to the mark in question.\textsuperscript{89} Policing actions can range from simple letters, to agreements not to use the mark in a manner that causes confusion for the customers of either company, to legal action against infringers for damages and injunctive relief.\textsuperscript{90} Increasingly, legal action against foreign counterfeiters will involve recourse to non-U.S. courts or the World Trade Organization.\textsuperscript{91}

Even meritorious legal action can cause a backlash against the target in the “court of public opinion.”\textsuperscript{92} Alleged infringers frequently respond with not only traditional legal papers but also Internet-based public relations campaigns seeking to depict the mark’s owner as a bully trying to trample on the “rights” of a tiny company or individual.\textsuperscript{93} Whatever the merits of any particular dispute, a company that reflexively responds to alleged infringement with legal demands or filings is likely to offend many potential customers in the marketplace, and may instigate counterclaims, putting its own mark at risk.\textsuperscript{94} Such a situation may have just as much associated risk as doing nothing to police, and should be noted by the acquirer in its evaluation of the target’s marks’ value.\textsuperscript{95} Of course, the possibilities of using such a campaign to respond to a pending infringement claim brought against a target that is a smaller company should also be considered along with the evaluation of traditional legal defenses.

2. Practice Assessment

The target’s use of the mark also needs to be evaluated to better understand its susceptibility to legal attack and whether its marketplace value is being impaired through use by others in a confusing manner on unrelated or inferior goods.\textsuperscript{96} One key indication of the quality of the target’s analysis in this area is whether and to what extent it conducts trademark “searches” with a

\textsuperscript{89} See id. (describing how a trademark owner may lose rights in the mark by the failure to police the trademark).

\textsuperscript{90} See, e.g., Wilcox, supra note 85, at 27 (noting the use of cease and desist letters when seeking to enforce trademarks).


\textsuperscript{92} Wilcox, supra note 85, at 29.


\textsuperscript{94} OMS Investments, Inc. v. TerraCycle, Inc., No. 07-1064 (JAP), 2007 WL 2362597 (D. N.J. Aug. 15, 2007) (discussing how TerraCycle, an alleged infringer, responded to an infringement suit by another well known fertilizer company, with both a large Internet-based public relations campaign against the plaintiff and its own legal claims for false advertising and trademark invalidity).

\textsuperscript{95} Wilcox, supra note 85, at 28–29 (describing potential consequences of sending a cease and desist letter to a party using a company’s trademark without authorization).

\textsuperscript{96} Cf. In re E. I. DuPont DeNemours & Co., 476 F.2d 1357, 1357, 1364–65 (1973) (holding that using trademark “Rally” for an automobile cleaner does not conflict with using “Rally” for an all-purpose detergent).
commercial vendor before pursuing a new mark of its own. Such searches are intended to identify other uses of the proposed mark. If such searches are not done at all or are largely ignored, the underlying marks may well be impaired and the target may be at risk for third-party infringement claims. Copies of recent searches done by the target should be reviewed to get a better idea of competitive activity and the risk associated with the target’s marks.

By the same token, it is useful in the trademark context to apply the same type of analysis discussed above to the target’s respect for the patent rights of others. The acquirer should be comforted by the target’s desire to avoid trademark disputes and its use of trademark search results to avoid potentially problematic activities and generally to mitigate risk of litigation. On the other hand, if such matters are “off the radar screen” of target management, the acquirer should anticipate trademark-based legal challenges, disputes, or litigation.

3. Procedural Considerations

Procedurally, the process should encompass cataloguing the target’s granted and pending federal registrations with attention focused on the types of products for which the mark is registered and compared to the acquirer’s anticipated use. The target’s practice of paying continuation fees and associated calendar entries should also be noted, as should continued use of the mark itself. The same analysis noted above for registration formalities of patents associated with an IP or line of business asset sale is also applicable here. Appropriate use of the ® and ™ symbols should also be addressed.

Trademark license documentation in both directions must also be reviewed, and the effect of the proposed acquisition assessed. If licensees of the target’s marks are noncompliant in their actual use of the mark, as opposed to payment obligations, this may constitute a failure to police that jeopardizes the mark.

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97. Thomson and Thomson, probably the most prominent trademark search firm, advises on its Web site that its “In-Use Investigation Services” program “provide[s] the in-depth intelligence you need to assess potential infringement, to mitigate risk and to plan an effective protection strategy.” Thomson Compumark, In-Use Investigation Services, http://compumark.thomson.com/do/cache/off/pid/100 (last visited Nov. 18, 2008).

98. See, e.g., Am. Ass’n for Advancement of Sci. v. Hearst Corp., 498 F. Supp. 244, 251–52 (D.C. Dist. 1980) (noting that no trademark search was performed prior to adoption of the infringing mark).

99. See supra Part III.A.3 (discussing key elements affecting exposure and recourse when patent infringement occurs).

100. Abandonment is a potential defense to a claim of infringement. That is, if a mark ceases to be used in interstate commerce, it effectively ceases to exist. The same is true of the use of the mark by its owner on inferior goods. See Westenberg, supra note 23, at 83.


102. Westenberg, supra note 23, at 83–84.

103. “Hershey’s lucrative right to sell KitKat chocolate bars in the U.S. reverts to Nestle SA if ownership of Hershey changes, under a licensing agreement between the companies.” Julie Jargon & Aaron O. Patrick, More Sweet Deals in the Candy Aisle?, WALL ST. J., Apr. 29, 2008, at B1. Cf. Ziff, supra note 4, at 770 (suggesting that this analysis may dictate a different structure or request for licensor consent).

104. See generally MCCARTHY ON TRADEMARKS AND UNFAIR COMPETITION § 18:48 (4th ed. 2001) (discussing a licensor’s duty to control and the perils of “naked licensing,” which is equated to trademark abandonment).
As a result of the IP license exception for any trademark material to the
target in section 365(n) of the Bankruptcy Code discussed above, someone
with financial expertise should obtain and review the financial statements of
the target’s licensor to help evaluate the likelihood and effect of a licensor
bankruptcy on the target’s operations. If the licensor appears to be shaky,
either a pricing adjustment or a back-up marketing plan may need to be
considered.

C. Copyrights

For a long time a backwater issue with significance mainly in the literary
and artistic fields, copyrights have gained greater commercial significance as a
result of both the introduction of digital media and the rapidly increasing
significance of Internet-based marketing.

1. Procedural Due Diligence

Few areas of legal and technological change have impacted DD practices
as much as those associated with copyrights. Traditional copyright analysis
involves review and cataloging of the federal copyright registration forms filed
by the target to determine if they are consistent with what has been disclosed
by management. Additionally, there should be discussions as to whether either
party is familiar with third-party duplication of such works (whether or not
they are the subject of a filing). Federal copyright filings are usually quite
short. Similar analysis to that discussed above is also appropriate regarding
the target’s respect for the creative works of others. Appropriate use of the ©
symbol should also be addressed.

A related query is whether the target is in compliance with all of their
copyright license agreements. Even for noncreative firms, there are likely to
be some copyright license agreements for software. Even if a firm complies
with its statutory obligations, it will still face liability if it fails to comply with
its contractual, licensed obligations.

105. See supra, Part II.D (explaining that the bankruptcy code expressly precludes “rejection” of an IP
license by a bankrupt licensor but excludes trademarks from the definition of IP).
106. See 11 U.S.C. § 365(n) (2) (stating that in exchange for the licensor’s retention of its license rights,
the licensor waives certain contract rights).
copyright infringement theory to a file-sharing service); Complaint at 10, Viacom Int’l Inc. v. YouTube, Inc.,
2007 WL 774611 (S.D.N.Y. Mar. 13, 2007) (No. 1:07CV02103) (asserting YouTube profited from infringing
files posted by its users).
109. See U.S. Copyright Office, Form CO — Application for Copyright Registration, available at
http://www.copyright.gov/forms/formco2d.pdf (last visited Nov. 18, 2008) (consisting of a relatively simple
eight-page form to apply for copyright protection).
111. E.g., Wall Data Inc. v. Los Angeles County Sheriff’s Dep’t., 447 F.3d. 769, 781 (9th Cir. 2006)
(holding that using copyrighted software beyond bargained for uses affects the market for the product).
2. “New Age” Substantive Concerns: The Need to Apply New Case and Statutory Law

a. Internal Use

The new capabilities provided by Internet and scanning technologies have opened up not only a wide variety of business opportunities involving copyrighted works (including new forms of copyrighted works, such as digital music and video) but also a wide variety of legal exposure. An organization that freely shares copyrighted reference materials (for internal use) by scanning or similar means may face copyright infringement suits, even though it pays for the materials, because it exceeds the agreed upon usage limits. Likewise a copyright owner that acquiesces to such sharing without proper adjustment of its pricing is likely to miss out on significant revenue that it might have received had it insisted upon the purchase of multiple copies of the material.

In “borderline” cases, where material appears to have been shared in good faith and without an attempt to deprive the copyright holder of revenue, a “fair use” defense may be possible, even though good faith is not sufficient in itself for such a defense. While the literature associated with the fair use defense is voluminous and well beyond the scope of this Article, the four factors comprising such a defense are: 1) the purpose and character of the use, including whether such use is of a commercial nature or for nonprofit educational purposes; 2) the nature of the copyrighted work; 3) the amount and substantiality of the portion used in relation to the copyrighted work as a whole; and 4) the effect of the use on the potential market for or value of the copyrighted work.

b. Secondary Infringement Exposure Under the Digital Millennium Copyright Act

The rise of digital music and movies has facilitated the creation of many businesses that provide hardware, software, and services for such market. It has also prompted Congress to enact the Digital Millennium Copyright Act (“DMCA”) to provide a customized regulatory structure for this market. Many digital media offerings may pose a risk under these provisions, as well as “regular” copyright authority. If the target has operations involving digital music or movies, including the distribution of software that facilitates the copying of such material, the DD process must encompass the implications
of recent (and pending) case law involving the DMCA. Even a company that is arguably not directly infringing a copyright but rather is facilitating someone else’s infringement may face liability for “secondary infringement” of others under the Supreme Court’s recent decision in *MGM Inc. v. Grokster, Ltd.*

For anyone offering a product or service that purports to allow a consumer to avoid the copy protection, often referred to as “digital rights management,” the DMCA makes them at least civilly liable for such action. Any target engaged in such business should be avoided, absent a colorable license claim or other recognized defense. For companies producing devices that may be used in this manner, but that also have genuine lawful uses, the analysis will be more difficult, and reference should be made to relevant legal authorities at the time of inquiry.

More challenging is the situation of a target that allows consumers to share electronic files or to post their own content on an Internet message board for public access. While there is nothing inherently inappropriate about such services, there is the potential for misuse if they are used to disseminate

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118. 545 U.S. 913, 914–15 (2005). For more recent cases, pending and decided, see, e.g., Complaint at 10, Viacom Int’l Inc. v. YouTube, Inc., 2007 WL 775611 (S.D.N.Y. Mar. 13, 2007) (No. 1:07CV02103) (alleging that defendants directly profit from plaintiffs’ copyrighted audiovisual works uploaded by users onto defendants’ Web site); Complaint at 12, Universal City Studios Prod, L.L.P. v. Real Networks, Inc. (C.D. Cal. Sept. 30, 2008) (No. 2008 Civ 06412) (“Real offers to the public, provides, and/or otherwise traffics in a software product – RealDVD – that . . . is designed or produced for the purpose of circumventing CSS or the protection afforded by CSS . . . .”).


120. While the pending RealNetworks case should provide some guidance as to the meaning and application of this section, the fact that it was brought at all, especially given the license of Real to certain relevant technology, should give pause to anyone intending to distribute such a software product. RealNetworks, Inc. v. Streambox, Inc., No. C-08-5448, 2000 WL 127311, at *13 (W.D. Wash. 2000).

121. In *Sony Corp. of America v. Universal Studios, Inc.*, the Supreme Court permitted the production and sale of video recorders that allowed for both legal “time shifting” and prohibited dissemination of copyrighted material, but the language of section 512 of the DMCA arguably impacts this holding. *Sony Corp. v. Universal Studios, Inc.*, 464 U.S. 417, 436 (1984). The Supreme Court in *MGM Studios Inc. v. Grokster, Ltd.*, also shed light on the considerations associated with technology that can be used for legitimate and illegitimate purposes: “mere knowledge of infringing potential or of actual infringing uses would not be enough here to subject a distributor to liability,” but “one who distributes a device with the object of promoting its use to infringe copyright, as shown by clear expression or other affirmative steps to foster infringement, is liable for the resulting acts of infringement by third parties.” MGM Studios Inc. v. Grokster, Ltd., 545 U.S. 913, 936–37 (2005).

122. In fact, it has recently been said that “[o]ne of the new rules of doing business online is that you must create a community where visitors to your Web site can add comments and content, not just consume it.” Posting of Ben Worthen to Wall Street Journal Business Technology Blog, http://blogs.wsj.com/biztech/2008/05/08/ (May 8, 2008 13:54 EST) (commenting on a case where someone posted gyrating images
access to copyrighted content to persons who are not paying for it. Many companies provide such forums in order to encourage feedback about their products, in the form of simple textual comments or more elaborate songs or videos describing customers’ experiences with the products.  

While there are relatively few companies that allow consumers to formally share files, those that do have been the subject of numerous legal challenges by copyright holders, many of which have been resolved in favor of the copyright holders. Most notably, in the Grokster case, the Supreme Court made clear that any such service must demonstrate that it actually provides substantial noninfringing services in addition to its use for copyright infringement: “[W]e hold that one who distributes a device with the object of promoting its use to infringe copyright, as shown by clear expression or other affirmative steps taken to foster infringement, is liable for the resulting acts of infringement by third parties.” A mere theoretical possibility of lawful use will not suffice in the face of large-scale infringement and evidence of wrongful intent.  

The pending case of Viacom International Inc. v. YouTube, Inc. is likely to amplify the meaning of Grokster, the fair use defense, and the relevant sections of the DMCA, for companies allowing users to post their own content on the Internet, some of which will be infringing. In this case, Viacom contends that YouTube’s business model encourages users to post their own content for public consumption while selling advertising on their site. All types of content find their way to the site from perfectly legitimate home videos to infringing movies, television shows, and music. Viacom, a copyright owner alleges both direct and secondary infringement by YouTube, the Web site’s operator.  

Even companies that merely invite public comment on their products, but allow such comments to include more than simple text, may face liability or at
least allegations of liability, if copyrighted content shows up on their site.\textsuperscript{132}

In section 512 of the DMCA, Congress sought to balance the competing interests that come into play when a user’s posting of copyrighted content is unknowingly facilitated by a service provider.\textsuperscript{133} While the exact meaning of the statute is still not clear, the DD process for any company that allows public posts should at least apply the major elements of this section in order to gauge the likelihood of a significant challenge.\textsuperscript{134} In particular, a party that allows public posts and desires to avail themselves of this “safe harbor” must:

- Designate an “agent” to receive complaints from copyright holders and advise the Copyright Office of such person’s name and contact information;
- Not receive a direct financial benefit from the infringing activity;
- Not modify the content posted by users; and
- “Expeditiously” take down, as soon as practicable, content that a copyright holder advises is wrongfully posted.\textsuperscript{135}

The statute does not expressly create a duty of inquiry by the Web site operator into whether the content is infringing, if no objection is received from a copyright holder.\textsuperscript{136} The \textit{Viacom} case, if it is not settled, may provide some guidance as to whether such a duty exists.\textsuperscript{137}

In the meantime, the DD process pertaining to any target that operates a Web site allowing public posts should include inquiries as to both the target’s awareness of and compliance with the DMCA. This should include an inquiry into whether the target obtains any potential direct financial benefit from the dissemination of copyrighted material. If there is a lack of DMCA compliance, the target makes no effort to discourage submissions of copyrighted material, and the target does not use a common sense approach to flag postings of seemingly professionally prepared content—for example, a recognizable clip from a song, television show, or movie—there is reason for concern about potential claims following the closing. While there is no formal
authority to this effect, it seems logical to anticipate the law developing more stringent scrutiny of companies operating sites devoted to sharing user-generated-content as their business model, than for companies operating sites that simply invite comments on the company’s product.

The acquirer should also be aware of developing technology that allows digital “fingerprinting” or “watermarking” of copyrighted material in order to facilitate its identification and restrict unauthorized display. While this technology is still in its infancy, anyone soliciting public submissions should be giving thought to the use of such technology at the appropriate time. If the target is not aware of the existence of such technology, it does not bode well for their compliance posture.

Given the last decade’s radical changes in the legal and technological environments surrounding copyrights and those currently pending in court and in laboratories, for any target having relevant operations an essential element of the DD process is to ascertain, at both a conceptual and a technical level, whether the target has met its obligations under the law.

D. Trade Secrets

1. Legal Source and Summary

Unlike the other types of IP, this area is governed by state law, which makes the target company’s internal practices involving sensitive information relevant and sometimes conclusive. In at least forty states, the governing law is each state’s version of the Uniform Trade Secrets Act and the cases construing it. Thus, questions of whether particular material will be protected need to be addressed with reference to the law of the jurisdiction(s) in question. Also, unlike other IP, there is nothing filed with any governmental body.

Illinois, for example, defines “trade secrets” as:

information, including but not limited to, technical or nontechnical data, a formula, pattern, compilation, program, device, method, technique, drawing, process, financial data or list of actual or potential customers or suppliers, that (1) is sufficiently secret to derive

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139. See, e.g., 765 ILL. COMP. STAT. 1065/2 (2006) (defining a trade secret as being the “subject of efforts that are reasonable under the circumstances to maintain its secrecy or confidentiality.”).


141. Where the target has operations or employees in more than one state, a choice of law analysis must be conducted to determine which state’s law is applicable. See WILLIAM M. RICHMAN & WILLIAM L. REYNOLDS, UNDERSTANDING CONFLICT OF LAWS 147 (2d. ed. 1993) (noting that courts handling disputes implicating different states must chose which state’s law to apply). Even for the handful of states that have not enacted some form of the Uniform Act, there is still a body of statutory and case law to be considered.

142. 765 Ill. COMP. STAT. 1065/2 (defining “trade secret” but not requiring registration); THE TRADE SECRET HANDBOOK: PROTECTING YOUR FRANCHISE SYSTEM’S COMPETITIVE ADVANTAGE 12 (Michael J. Lockerby ed., 2000) (contrasting patent law and trade secret law, including details about the registration system of patent law).
economic value, actual or potential, from not being generally known to other persons who can obtain economic value from its disclosure or use; and (2) is the subject of efforts that are reasonable under the circumstances to maintain its secrecy or confidentiality.\textsuperscript{143}

The Illinois statute also allows the owner to enjoin use by another, or recover damages for such use.\textsuperscript{144} Examples of materials that can qualify for trade secret protection, if properly handled, include:

- Customer and prospect lists;
- Supplier lists;
- Employee lists;
- Product formulae; and
- Production process information or manuals.\textsuperscript{145}

Fundamental to DD analysis and practice in this area is consideration of whether the target has taken appropriate steps under the law to maintain the secrecy of its sensitive business information not otherwise protected by a patent, trademark, or copyright.\textsuperscript{146} Traditional analysis focuses on physical steps taken to maintain secrecy such as keeping putative trade secrets in locked file rooms and cabinets while restricting access to such areas to employees and other persons with a “need to know.”\textsuperscript{147} While this is still the correct starting point, in today’s world of cheap, portable, electronic storage and communication, it is hardly sufficient.

2. Impact of New Technology

Electronic access through flash drives, scanners, camera phones, e-mail and the like can be of far greater significance than physical access to paper files. It is essential to understand how the target secures its sensitive materials from misappropriation through such devices. The acquirer must ask: what material is kept in readily accessible computers, what policies exist regarding use of such devices, what “virtual partitions” exist to keep persons with a legitimate reason for access to one electronic file from getting into another for no good reason, and what intrusion detection devices are deployed to deal with problems at an early stage?\textsuperscript{148}

\begin{flushleft}
\textsuperscript{143} 765 ILL. COMP. STAT. 1065/2.
\textsuperscript{144}  Id. § 1065/3-4.
\textsuperscript{145}  Cf. Minn. Mining and Mfg. Co. v. Pribyl, 259 F.3d 587, 596 (7th Cir. 2001) (stressing that even a compilation of public materials can qualify if it is properly handled).
\textsuperscript{146}  765 ILL. COMP. STAT. 1065/2.
\textsuperscript{147}  See generally Roman A. Klitzke, Trade Secrets: Important Quasi-Property Rights, 41 BUS. LAW. 555 (1986) (discussing the need of the trade secret holder to take affirmative, yet reasonable, steps in maintaining the confidentiality of the trade secret, whether through physical means of restricting access to the secret or limiting disclosure of the contents of the secret). While this article pre-dates the vast technological changes that have occurred in recent years, the legal principles are still applicable but must be extended to encompass both physical and electronic security considerations.
\textsuperscript{148}  Some stress the need for formal policy regarding the use of new media and proper exit interview inquiries and admonitions about downloading, use of sensitive materials, and formal imaging of the hard drives of departing employees with access to the most sensitive materials, in order to trace the activities of
\end{flushleft}
Extremely sensitive material that may be used in identity theft or other fraud must be kept and transmitted in encrypted form at all times. An example of this would be material containing personally identifiable information ("PII") of employees, customers, or employees of customers—for example, social security numbers, credit card numbers, or drivers license information. The DD team must also ask questions such as: To what extent does the target deal with the public, and who is issued electronic devices that can be misused in this manner?

Both formal written policies in dealing with these materials and their application in practice are relevant. Equally relevant is the target’s history in these matters. If the target has experienced several instances of alleged misappropriation that have led to competitive harm or litigation with former employees, consultants, and the like, there is probably something wrong with its practices or policies.

3. Target Human Resources Procedures

The firm’s dealings with its employees are also critical to this analysis in several respects. First, it is essential that employees having anything to do with sensitive material, including the use or development of IP, execute written nondisclosure agreements. These agreements should acknowledge that they are working with company property and, during and after their employment, that they will use it only in furtherance of the company’s interest. Such agreements and employment contracts should also contain an express representation that the employee is not bringing to their new position, and will not utilize in the performance of their duties, any trade secrets or materials that if utilized would infringe upon the IP rights of anyone else.

Organizations can become vulnerable to claims brought by an employee’s former employer. These claims may allege misappropriation of the former employer’s trade secrets by the new employer in addition to the employee. Such cases typically include allegations that the new employer somehow “induced” the individual to breach their obligations to the previous employer and must be enjoined from benefiting from such breach. It is essential that such employees if necessary in litigation. Bradford K. Newman, Protecting Trade Secrets: Dealing with the Brave New World of Employee Mobility, 17 BUS. L. TODAY 22, 25 (Nov.-Dec. 2007).

149. Joseph Periera, Credit-Card Security Falters, WALL ST. J., April 29, 2008, at A9 (describing a major security breach where encrypted customer personal data was stolen, with significant financial losses for a grocery chain).

150. A recent case illustrating the practical consequences of “loose” practice is Al Minor & Associates, Inc. v. Martin, in which an individual had access to the plaintiff’s customer list, did not sign an employment contract or noncompete agreement (and possibly did not sign a confidentiality agreement), left the company and went into competition based solely on his recollection of the customer list. Al Minor & Assoc., Inc. v. Martin, 881 N.E.2d 850, 851 (Ohio 2008). While the Ohio Supreme Court ultimately sided with the employer, the fact that the case got that far indicates the advisability of making explicit what is expected of employees. Id at 855.

151. This would encompass all forms of materials—paper, electronic, or memorized. See id. (indicating that in many (but not all) states, trade secrets can be misappropriated solely through memorization).

the new employer be able to demonstrate its good faith in hiring; obtaining these representations as part of the employment application or contract is one way to do so. If the target’s practices do not include these measures, the acquirer should plan on prompt change during the integration process. For these purposes, human resources management should be part of the DD team.

It is also useful to assess the target’s practices regarding use of nondisclosure agreements when confidential material is shared with anyone, such as customers, prospects, or suppliers. Ignoring the need for confidentiality and discretion in such relationships is likely to be just as problematic as in the employee-employer relationship.

IV. INFORMATION TECHNOLOGY

It is not intuitively apparent why this topic is addressed in the same breath as IP, however, there are two reasons for doing so. First, in practice, it is often the case that some people on the DD team are asked to address both. Second, a great deal of the software used for IT operations is licensed pursuant to agreements of the sort discussed above, so that the compliance analysis is equally relevant.

Whatever the conceptual rationale or DD team assignments, this is a critical area of the DD process. A misstep here—either with respect to evaluation of system compatibility between target and acquirer for integration purposes, or evaluation of target company competence and capability—can doom an acquisition with adverse legal and operational consequences in areas such as sales (if there are problems filling orders, tracking inventory, or securing customer data in order to prevent fraud and identity theft), manufacturing, billing, and financial reporting. Of course, such consequences are likely to be accompanied by major litigation and potential governmental sanctions, not to mention adverse publicity. In addition, a security breach that impacts the integrity of material will also be operationally disruptive. For example, a deletion or corruption of a customer list, inventory schedule, pending accounts receivable, or payable information will disrupt

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153. Many litigated cases in this arena involve and even turn on the availability of equitable remedies, such as injunctions, with respect to which the parties’ good faith or absence thereof is of great significance. Victoria A. Cundiff, Preventing the Inevitable: How Thinking About What Might Happen Can Help Ensure that It Won’t, 947 P.L.U./PAT. 759, 776–79 (2008).


156. E.g., In re TJX Co., No. 072-3055 (F.T.C. Mar. 27, 2008), available at http://www.ftc.gov/os/caselist/0723055/index.htm (ordering TJX to implement or establish an information security system designed to protect the security information collected about customers and a twenty-year consent decree with the Federal Trade Commission, requiring extensive and burdensome third-party monitoring).
operations, even if no third party is impacted and no litigation ensues. 157

A. Information Security

1. Importance

As a result of growing social and legal concerns over individual privacy, this topic has emerged as a strategic priority for lawmakers, commentators, regulators, and enlightened corporate managements. 158 Information security should therefore be the first part of this phase of the DD review. As usual, there should be an informal discussion with target management to understand and evaluate its commitment to the topic and its ability to follow through on such commitment. At such time, a request should be made for any third-party reports or certifications of its practices. The objective of this inquiry should be a so-called “SAS 70” report from a recognized provider such as a major accounting firm. 159 Such reports have come to prominence in response to the Sarbanes-Oxley Act of 2002, and are often used as a key part of the financial audit and internal controls report. 160 If a recent SAS 70 report exists (without material qualification), it should go a long way toward assuring the acquirer that it is not walking into a hornet’s nest. If no such report exists there is reason for concern, especially if the target is of any significant size or has large or public clients. The absence of an SAS 70 report increases the likelihood of customer or employee claims, or the emergence of unhappy customers or employees post-closing. Without a recent SAS 70 report, the acquirer should, at the very least, plan on promptly spending time and money to bolster the target’s practices and infrastructure.

With or without an SAS 70 report, the DD process should also extend to the specific devices and processes that the target uses to maintain security. Special emphasis should be placed on the security of customer or employee

157. See Waste Mgmt., Plaintiff’s Original Petition at 15–18.
158. E.g., Julie E. Cohen, Privacy, Visibility, Transparency and Exposure, 75 U. CHI. L. REV. 181 (2008) (concluding that transparency and exposure both visual and informational, especially in our Internet era, have harmed privacy laws); Richard A. Epstein & Thomas P. Brown, Cybersecurity in the Payment Card Industry, 75 U. CHI. L. REV. 203 (2008) (discussing the tension between the desire for security in protecting against credit card identity fraud and the desire for privacy, such as anonymity in transactions).
160. As described at SAS70.com: “A service auditor’s examination performed in accordance with SAS No. 70 . . . is widely recognized . . . [as] an in-depth audit of their control objectives and control activities, which often include controls over information technology and related processes. . . . [T]he requirements of Section 404 of the Sarbanes-Oxley Act of 2002 make SAS 70 audit reports even more important to the process of reporting on the effectiveness of internal control over financial reporting.” Id. SAS 70 reports come in two flavors, type I and type II, with the type II report involving additional work by the reviewer. Id. The underlying standard used for evaluation of security practices is promulgated by the International Standards Organization in standard 17799, codified and restated in standard no. 27001. See generally ALAN CALDER & STEVE WATKINS, INFORMATION SECURITY RISK MANAGEMENT FOR ISO 27001/17799 (2007) (describing the standards used for evaluation).
personal information, as well as PII. 161 While any company or individual can be victimized by a hacking incident, the problem is most acute with companies with large-scale dealings with the general public or companies that maintain large volumes of employee data. 162 This inquiry should start with evaluation of physical security of facilities, areas where sensitive material is kept (including movement of physical media such as tape cartridges), 163 and individual access rules, but should also extend to more technical matters such as:

- Use of commercial grade, mainstream hardware firewalls, and their settings;
- Encryption of stored or transmitted data, especially when it resides on laptop computers or involves PII. This is especially true where the target is governed by special obligations associated with health care or financial services; 164
- Purging of data when no longer needed; 165
- Use of mainstream antivirus software;
- Special handling for wireless transmissions of PII or other sensitive material;
- Requirement for alpha-numeric passwords of at least six to eight characters and varying cases, for network access, with expirations of no more than ninety days;
- Disaster recovery vehicle with off-site facilities; 166
- Rules and procedures for prompt incident reporting; 167

161. An excellent definition and description of the term “personal information” that is often used interchangeably with “PII” is contained in the FTC’s Order involving TJX. *In re TJX Co., No. 072-3055* (F.T.C. Mar. 27, 2008).


167. See CAL. CIV. CODE §§ 1798.80–1798.84 (West 1998) (illustrating the most prominent and probably the most significant of the many state statutes requiring prompt reporting to the public of any breaches, since it impacts all companies with California operations); Scott Berinato, *CSO Disclosures Series: Data Breach Notification Laws, State By State*, CSO, Feb. 12, 2008, http://www.csomime.com/article/221322/cso_disclosure_series_data_breach_notification_laws_state_by_state (providing a summary of thirty-eight state reporting laws).
• Rules and procedures for meaningful employee background checking for those with access to sensitive material. This is important to screen out persons with a history of identity theft, virus dissemination or other disreputable or fraudulent activity;

• Use of commercial grade intrusion detection products; and

• Rules for disabling of employee/contractor system access upon termination.¹⁶⁸

Special attention must be paid to target Web sites that facilitate public transactions (e-commerce) and that are likely collecting sensitive information. Targets operating such sites should not only have good security in fact but more critically also live up to any public statements that they have made concerning their security.¹⁶⁹ Third-party Web site hosting agreements should be reviewed with an emphasis on initial and ongoing provision of an SAS 70 report for the third-party host.

Material deviations from mainstream practices must be discussed with respect to not only integration but also pricing and whether to proceed at all. Factors such as the target’s exposure to liability, pending or probable major claims against it, or a culture that places too little emphasis on the topic should weigh against deal closure.

Where major functions, such as the entire IT function, are outsourced by the target to offshore providers, it is necessary to focus not only on the contents of the relevant contracts but also on the actual steps being taken to comply. Practical difficulties with enforcement of contracts against non-U.S. entities make it essential to understand the substance of the agreement, as well as the likelihood of successful remedy in the event of a breach—as opposed to merely ensuring that there is a provision providing for appropriate remedy.¹⁷⁰

A public company acquiring a private one needs to be especially cognizant of this issue. The author has observed many capable private company managements that are (justifiably) unfamiliar with the enhanced security obligations of public companies under Sarbanes-Oxley.¹⁷¹ Consequently, many well-run private companies are fundamentally unprepared for public company integration, and will require substantial investment in

¹⁶⁸. While the rapid pace of change in this field means that there is no codification of such requirements, they are based upon not only the author’s interaction with information security professionals in the course of his practice, but also the recommendations of the Canadian Privacy Commission and the excellent Federal Trade Commission handbook for businesses. CPC REPORT, supra note 165; FED. TRADE COMM’N, PROTECTING PERSONAL INFORMATION: A GUIDE FOR BUSINESS, http://www.ftc.gov/infosecurity (last visited Nov. 18, 2008).


¹⁷¹. See Newman, supra note 148, at 26 (stating trade secret practice is a fundamental element of Sarbane-Oxley compliance).
infrastructure, training, and staff to comply with any cited International Organization for Standards (“ISO”) standards, obtain an SAS 70 report, and otherwise function properly in the public arena. It should also be noted that European consumer privacy standards are uniformly more stringent than those of the United States, so that any M&A transaction that will cause a U.S. company to have a significant European consumer presence will require additional scrutiny under European Union standards.

Information security is an area where it is difficult to distinguish best practices and law. With technology—both protective and malicious—changing so rapidly, it is impossible for any legislative or administrative body to spell out in any meaningful way what technical measures are required. Thus, there is only a limited body of “law” in the traditional sense to use when testing target methods and practices.

However, it is clear from cases such as In re TJX Companies, Inc., that after the fact assessment of liability for a problem looks to what technology was available at the time to prevent it. The nature of a useful DD review will change from time to time to reflect changes in technology and will also focus on whether the target understands the flexible and ever-growing nature of its obligations.

B. Other IT Issues, Operational Assessment

A related topic to security, but involving different considerations is system performance. An evaluation of system performance is particularly important with respect to Web-based applications and other public Web sites used as part of the sales or marketing process. The focus of this evaluation should be on whether the target has the required, sufficient hardware and software infrastructure to handle its business with reasonable dispatch, both before and after integration with the acquirer. Web-based products will often slow to a crawl—i.e., take forever to open or move from screen to screen when information is input or the user requests—or “crash” completely in the face of excessive demand and without adequate load-balancing or backup systems.


174. The Canadian Privacy Commissioner noted that while TJX did encrypt customer PII after its collection prior to its wireless transmission, it did so using the older Wired Equivalent Protocol (“WEP”) rather than the more recent standard of Wi-Fi Protected Access, and that the newer approach was not nearly as susceptible to hacking as was WEP. CPC REPORT, supra note 165. The Information and Privacy Commissioner for Alberta stated when such report was released, “[w]hen the technology exists to protect data, we expect companies to move quickly to adapt that technology.” Robert Westervelt, TJX Should Have Had Stronger Wi-Fi Encryption, Say Canadian Officials, SEARCHSECURITY.COM, Sep. 25, 2007, http://searchsecurity.techtarget.com/news/article/0,289142,sid14_gci1273889,00.html.

175. Katherine Nguyen, The Secret’s Out, OC REGISTER, Dec. 4, 2006, http://ocregister.com/ocregister/life/homepage/article_1371295.php (explaining the most famous—or infamous—example being the Victoria’s Secret 1999 Super Bowl commercial, which drove so much traffic to its site that the site “crashed”).
The acquirer’s IT management must closely examine the target’s technical capabilities in relation to its anticipated demand. Some examples of these technical capabilities are Web servers, database and application server software, storage, network bandwidth, load balancing capability, as well as internal practices. A publicly accessible system that crashes amidst a major promotion will undermine the target’s market position for a long time.176 Both lawyers and IT management should review any agreements, including Service Level Agreements (“SLAs”) with third-party service providers that “host” such sites. This review should also include a review the providers’ infrastructure.

A more procedural but equally essential part of the DD review is an assessment of the target’s general IT approach and capabilities to see if they are in accordance with accepted industry practices and the acquirer’s approach without a great deal of retrofitting.177 If the acquirer can live with any retrofitting hardware or software costs that are necessary, then a plan to upgrade the target’s systems should be generated.

Most fundamental, in the author’s experience, is the question of whether the basic hardware and software relied upon by each organization is reasonably current, and how difficult it will be to make the organizations’ computers to talk to each other. If one company relies on a state of the art IBM mainframe or minicomputer (AS-400) hardware and the other on a Sun or even on older IBM hardware, problems may result. Similarly, if one relies on a centralized processing model with most data and applications residing on one or a few servers, while the other uses a more distributed model or relies heavily on “software as a service” with major applications accessed at a third-party vendor’s Web site, integration may be difficult and costly.178

Whatever hardware is in use, attention should also be paid to both software operating systems and application programs. If one organization uses IBM “big iron” or AS-400s with the customary MVS operating system while the other uses UNIX as its main operating system, integration may be more costly. Even at the desktop level, the same considerations apply between Apple and Microsoft Windows applications. Within the Windows world, the process must address which versions of operating systems and applications such as Office are in use. If one firm has upgraded to Windows Vista while the other is still using Windows 98 or 2000, work may not flow smoothly or at all from one “side” to the other.

176. Id. The fact that the Victoria’s Secret 1999 episode was still being discussed online in 2006 is indicative of the lasting effects from such crashes.
178. Vincent Ryan, A Place in The Cloud, CFO, Sept. 1, 2008, at 31 (providing an objective assessment of the pros and cons of such models, sometimes referred to as forms of “cloud computing”). The author explains that potential savings in fixed costs must be weighed against potential performance and security limitations. Id. If a target relies on this model for its basic IT capacity, the acquirer should approach the situation with a very critical eye.
The same analysis is needed for versions of Office and all material applications, including proprietary ones, to ensure that people who will be expected to work together will have the same (or compatible) tools. If one firm intends to install software on the computers of the other, it must ensure that it is technically possible to do so. Philosophies regarding system updates and upgrades need to be compared. Some companies will stick with the tried and true, even if it is ten years old, while others may insist upon being early adopters. Version numbers must be compared and differences evaluated.

Additionally, if the integration of the two companies involves sharing data between companies’ systems—for example with sales or inventory data going into a financial accounting system—it must be determined whether the two systems allow for this, or whether an “interface” program is required.

The acquirer’s IT management must be intimately involved in the DD process and “get their hands dirty” at a level of detail sufficient to determine whether a good fit exists from a technical perspective. More importantly, any advice to the contrary, must be heeded by the ultimate decision-maker(s).

The acquirer’s lawyers should rejoin the process when it addresses the target’s software license compliance approach and status. All licenses must be catalogued and characterized by type. That is, whether they allow the use of the software at one site, multiple sites, without limit within one firm or multiple firms under common control, by named users, by a specified number of users or on one or more specified computers, or are otherwise limited. Once this is done, an inquiry must be made as to known compliance/noncompliance and third-party vendor challenges as well as mechanisms in place to facilitate compliance. Organizations that rely upon “cute” technical practices to avoid or circumvent contractual use limitations can expect to encounter costly consequences. These consequences may involve damages, attorney’s fee awards and even enjoined use. Practices and awareness involving shrink-wrap and open source code should also be assessed.

A software license compliance problem is not usually enough to justify reconsideration of a deal, but it may have pricing implications if there appears to be a good deal of exposure to liability. It may also raise questions about the overall competence and integrity of the target’s organization. On the positive side, this review may also identify duplicative licenses for software or related “maintenance” services, which may be canceled for cost savings.

The software license inquiry should also extend to whether the license agreements contain language under which the acquisition itself may constitute a breach or trigger additional payment obligations, even if the target is

179. John Edwards, *Thumbscrew 2.0*, CFO, Feb. 1, 2008 (discussing how software vendors have started “aggressive policing of current licensing agreements” as part of a program to maximize revenues).

180. See generally Wall Data v. Los Angeles County Sheriff’s Dep’t., 447 F.3d 769 (9th Cir. 2006) (involving a vendor’s successful effort to recover damages and attorney’s fees for the efforts of the Los Angeles County Sheriff’s Department, which licensed a product subject to a limit of about 3,500 users but installed it on about 6,000 computers, with a mechanism to prevent its concurrent use by more than 3,500 users).

181. See discussion supra Part II.C (discussing the General Public License documents that generally limit the use of open source software).
otherwise in compliance. At the minimum, the target may have to provide the vendor with written notice of the transaction.

Unrelated and seemingly mundane but important considerations are the terms of any leases for IT hardware. If such leases are noncancellable or nontransferrable for their stated terms, this may affect any potential short-term savings that might be realized from integration of two firms’ IT functions. Such leases often contain onerous terms governing equipment return, purchase, or lease extension, and can require significant management to make illusory some of the anticipated savings from integration. For these reasons the DD process should also involve a review and cataloging of the target’s hardware leases. The acquirer should have a full understanding of the lease terms, including the nature of the financial commitments, required end-of-term termination notices, end-of-term purchase requirements, and any other required conditions for return.

V. CONCLUSION

While the M&A process always involves significant business risk and its outcome is susceptible to macroeconomic factors that are not subject to mitigation, even by the best practices, good DD will go along way toward shifting the odds in favor of success for those deals that do go forward. Good DD today requires a sophisticated approach to IP and IT matters. It is hoped that this Article can make a modest contribution toward increased sophistication of executives and practitioners in this area.

182 See, e.g., Wells Fargo Bank Minn. v. BrooksAmerica Mortgage Corp., 419 F.3d 107 (2d Cir. 2005) (finding that Bank of America’s contract for a sale-leaseback transaction of computer equipment was noncancellable and held them responsible for all rental payment due under the contract); AT&T Credit Corp. v. Transglobal Telecomm. Alliance, Inc., 966 F. Supp. 299 (D.N.J. 1997) (discussing the breach of lease for telephone equipment by lessee Transglobal and finding them liable for damage in the amount of the lessor’s return including delinquent rental payments and all rental payments due).
Attorneys in general practice are likely to encounter intellectual property issues regularly, whether they represent individuals, businesses, or both, and whether they focus on litigation or transactional work.

For example, even an attorney who represents individuals in litigation matters might be asked how to protect the products of an individual’s “tinkering.” Lawyers who represent businesses in litigation often find that the lawsuit involves ownership claims over the results of developmental efforts and sensitive business information in the face of possibly “unfair” competition.

Family law attorneys might have to grapple with who owns pending research and development work by members of family businesses and consider which protection strategies are best to avoid dissipating the value of such material. Of course, general business lawyers representing inventors and innovators—yes, there is a difference—and early stage companies in general are often faced with similar questions.

In other words, clients of all stripes need advice about whether to file for U.S. patent protection on their efforts or simply treat the material as a trade secret. There is not always a clear answer, but there are a number of factors to consider. While it is always good practice to involve an intellectual property attorney in this analysis, this article presents some threshold issues a generalist should consider when a client needs to

1. While quite important in many cases, non-US patent filings are beyond the scope of this article. Where a client is interested in distribution or manufacturing outside the US, foreign IP specialists must be consulted.
2. In some cases, federal registration of trademarks (i.e., identifying words or symbols) or copyrights (i.e., proclamations of ownership in particular expressions of ideas) will be useful supplements to patent or trade secret approaches. However, they should not be considered their equivalent.

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Should your client file for patent protection, or will simpler and less costly trade secret protection be enough? Here are things to think about when these issues arise for your clients, as they do with surprising frequency.

know if a patent filing is warranted or if trade secret protection will suffice.

**Patent protection pointers**

A patent granted by the U.S. Patent and Trademark Office (“USPTO”) is a way to exclude others from using the invention in question for 20 years. The invention must be a “process, machine, manufacture or composition of matter.” In essence, a patent provides the patent owner with a form of monopoly on the use of the invention.

The issuance of U.S. patents is governed by federal statute and regulations, along with cases decided in the Federal Circuit and U.S. Supreme Court. Until 1998, it was understood that patents could only be issued for traditional inventions with a physical embodiment and not for business processes or methods.

**Business method patents.** However, in that year the Federal Circuit opened the door for business method patents and in so doing created confusion for practitioners with clients interested in patents for non-traditional subject matter. In the opinion of many, such as Justice Kennedy, it also led to a number of “bad” patents that reduced competition without increasing innovation and led to several of the restrictions on patent grant and retention discussed below. Regardless, the America Invents Act (“AIA”) and a 2010 Supreme Court case allow business method patents but subject them to higher post-grant scrutiny and prevent their issuance for subject matter based on a law of nature or an abstract idea.

**Reasons not to seek a patent.** Patents are often seen as an indication of technical prowess and perceived by many to confer a competitive advantage on their holder, which allows both premium pricing and superior access to financing. Witness the use of “patent holder, which allows both premium pricing and superior access to financing. Witness the use of “patent pending” legends on new products.

So why would someone not pursue patent protection? Several reasons come to mind.

• Patent protection may not be available. In very general terms, the patent statute limits patents to subject matter that is said to be “new, useful and non-obvious.” In *Bilski v. Kappos* and *KSR International Co. v. Teleflex, Inc.*, the Supreme Court raised the bar on patentable subject matter and non-obviousness.

• Patent protection may not be available. In very general terms, the patent statute limits patents to subject matter that is said to be “new, useful and non-obvious.” In *Bilski v. Kappos* and *KSR International Co. v. Teleflex, Inc.*, the Supreme Court raised the bar on patentable subject matter and non-obviousness.

For example, the latter case imposes a requirement that the subject matter, even for traditional inventions with a tangible dimension, be non-obvious to someone with a bachelor’s degree in engineering or the equivalent. This is not a trivial requirement and has made it substantially harder to obtain and retain a patent.

Similarly, many business methods that have genuine value will not pass muster under today’s law, including the AIA, or will be difficult and costly to defend even if a patent does issue and an infringement suit is brought. Almost invariably, a defendant in an infringement suit will take the position that the patent is invalid.

• There may be a great deal of uncertainty around patent protection’s availability and/or commercial value prior to a filing, which might make the client uncomfortable with the expense. While a patent con-

**Promptly involving an intellectual property practitioner is essential.**
Taking trade secret protection steps is often helpful even when a patent is available and affordable.

Trade secret protection – the less costly and complicated option

In contrast to a patent, trade secret protection (at present) is strictly a creature of state law and requires no governmental filing. Under the Uniform Trade Secrets Act, a version of which is in force in virtually every state, injunctive relief and economic damages are available for the misappropriation of a trade secret. Protection requires actual or potential economic value for the subject matter and reasonable efforts under the circumstances to maintain its secrecy.

Examples of material eligible for trade secret protection include customer and employee lists, ingredient lists (e.g., the famous Coca-Cola formula), and pricing information. While not technically required, nondisclosure agreements by employees and consultants typically protect trade secrets. Trade secret protection is perpetual, but it cannot stop the efforts of someone who independently develops protection of the subject matter

Taking trade secret protection is a hotly debated topic. Employees who are brazen enough to walk off with boxes of documents or download sensitive material to a flash drive can usually be dealt with under this body of law, but the issue is not so clear with persons who are more subtle or have better memories.

Trade secret protection is much cheaper and faster than patent protection and does not hinge, at least in the first instance, on the decision of a third party. At the client level, the associated steps (e.g., locking file rooms and partitioning electronic data bases to limit access to those with a need to know) are not usually expensive. Even written assignment and non-disclosure agreements typically cost under $2,500 to prepare.

Trade secret protection steps are often helpful even when a patent is available and affordable. For example, ancillary materials such as training manuals that are not patentable themselves (and may not be fully protectable through copyright registration) still have significant value by indicating the patent holder’s competitive posture or facilitating “inventing around” the patent. Judge Pflaum’s seventh circuit opinion in the 2001 case of Minnesota Mining & Manufacturing Co. v. Pribyl provides a good illustration of the use of a trade secret strategy to protect such materials.

Counseling clients

When an inventor seeks advice about protective steps, what should a general practitioner do?

Seek out an IP attorney. Promptly involving an intellectual property practitioner is an essential first step. Patent applications cannot be prosecuted by someone other than a registered patent lawyer or agent, and the massive statutory and common law upheaval in this area during the last few years makes it imperative to engage someone who keeps up to date.

A patent lawyer can arrange for preliminary review to ascertain whether an attorney than a registered patent lawyer or agent, and the massive statutory and common law upheaval in this area during the last few years makes it imperative to engage someone who keeps up to date.

A patent lawyer can arrange for preliminary review to ascertain whether another inventor has beaten your client to the punch through “prior art” and whether the subject matter is likely to meet the statutory criteria.

Move quickly if you seek a patent. Where a patent application is warranted, the AIA’s “first to file” standard for entitlement to a patent (replacing “first to invent”) dictates that an application be filed sooner rather than later.

Explore the trade secret approach. However, the generalist should be advising at an early stage about the merits of a trade secret strategy and its implementation. There are rarely a downside to taking those steps. They are not likely to impede the patent application if it is filed within one year of the first commercial use of the subject matter and are a useful backstop if the patent is not granted.

Note, however, that applications become public 18 months after filing. If granted, it may be a useful complement to protect related, non-patentable materials. Even if this is not the case, the incremental cost of the trade secret approach is not likely to be significant compared to the cost of obtaining the patent.

Use trade secret approach broadly. Use a trade secret protection strategy not only with employees of the client, but also with potential business partners consulted for assistance with product development, distribution, or otherwise. While some large companies may balk at signing trade-secret agreements because they are not contemplated by company policy, they usually have some form of their own to accomplish a similar purpose. If not, advise the client of the potential risks of proceeding without an agreement in place.

Understand the options

Obtaining a patent is often a major milestone for young companies. However, patents are not always available or commercially valuable enough to justify the cost of obtaining one. As a result, practitioners need to thoroughly understand trade secret strategies as well.
PAY + BOARD COMPOSITION + PERSONAL BEHAVIOR ≠ CORPORATE GOVERNANCE:
IN SEARCH OF CONCEPTUAL CHANGE

MARTIN B. ROBINS*

ABSTRACT

Seemingly everyone agrees that our economy requires substantial improvement in corporate governance in order to avoid a reprise of our recent financial collapse and Great Recession. Yet, this is not prompting legislative or private actions which actually facilitate an improvement in decision-making and outcomes of corporate action. Too many “solutions” pertain only to management compensation and board of director composition.

Congress expressly sought to improve governance in 2010 when it enacted the Dodd-Frank law to improve regulation of the financial sector. But the Act’s specific provisions largely missed the mark and perpetuated the status quo of governance law by addressing procedural matters rather than matters of genuine governance. A case can be made for the status quo in the context of “ordinary” firms which do not present systemic exposure to the consequences of risk-taking to the same extent as the large financial firms which, by their risk-taking, led us into the Great Recession. For the latter category of firms, however, a different set of considerations comes into play.

The actions taken in response to Dodd-Frank by the SEC and private actors have had little to do with better strategic decision-making. Instead, they largely address peripheral or procedural matters. Governance law still needs fundamental reorientation to be an instrument facilitating better outcomes than what we have seen from our most systemically important firms.

This Article discusses how Dodd-Frank and its predecessor law are improperly focused and the conceptual changes which are needed. In particular, it calls for a reversal of the pro-director presumption of the business judgment rule for systemically important firms where poor decisions can impose societal costs, if defined adverse events have already occurred. In order to minimize the burden on business and underscore what is important

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such change should be coupled with a drastic relaxation of requirements around management/director compensation and its disclosure.

In support of the new standard, in addition to discussing problematic elements of current legal doctrine, the Article also incorporates very recent commentary on the causes of the Great Recession and discussion of very recent actions of specific companies as illustrations of what this author considers appropriate and inappropriate focus.

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INTRODUCTION

Recent developments in our economy have made clear that substantial changes in our corporate governance model and legal framework are essential. Everyone agrees in principle that better governance is needed, but what is presently considered corporate governance too often involves decisional process instead of substance. Decisional process includes chastising executives on account of their pay and related matters or personal behavior, and seeking to shape the composition of firms’ boards of directors. Yet it ignores directors and the firms’ broader performance. As we have seen too frequently in recent years, poor decisions by major firms can easily drag down the firms, their shareholders, employees, suppliers, customers, and “innocent bystanders” alike. This Article intends to elaborate upon and propose a way to rectify this anomaly, of governance law and doctrine emphasizing seemingly everything except actual governance.

In particular, this Article discusses why recent legislative action
intended to improve governance in ‘too big to fail’ firms will not, and is not, doing so. Also, it will examine where governance law previously fell short and contributed to the 2008 financial meltdown and the resulting Great Recession which prompted Congressional action intended to avoid a recurrence. After a discussion of the nature of the problem and its intended solution, specific changes in governance law and related law are proposed and placed into context with a discussion of recently observed appropriate and inappropriate board responses to governance challenges.

I. WHAT IS CORPORATE GOVERNANCE AND WHY DOES IT MATTER?

The traditional concept of corporate governance promulgated by the internationally renowned Organisation for Economic Co-operation and Development (“OECD”) states: “Corporate governance involves a set of relationships between a company’s management, its board, its shareholders and other stakeholders. Corporate governance also provides the structure through which the objectives of the company are set, and the means of attaining those objectives and monitoring performance are determined.”

This makes sense, as it incorporates as a major element, considerations of “how the company is doing,” i.e., the company’s objectives and performance, which should reduce the likelihood of disastrous management decisions imposing large costs on shareholders and society in the manner we saw during the 2008 financial meltdown. Amidst the financial meltdown, it was acknowledged by the G20 Finance Ministers that better governance was needed to prevent a recurrence. Very recently, the U.S. Financial Crisis

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2 “A year ago, the collapse of Lehman Brothers set off a series of stunning events from which Wall Street is still recovering.” CNNMONEY.COM, Sept. 14, 2009. A separate article on the same website on the same date indicates that the AIG bailout alone cost the government $116 billion and the Troubled Asset Recovery Program cost approximately $372 billion with $90 billion of that going to Citigroup and Bank of America alone. While large amounts of several of these interventions have been recouped, it is still true that the government has incurred large net costs, especially with respect to the AIG bailout. Yet another article enumerates some of the asset write-downs attributable to the events of late 2008 and refers to $29 billion with respect to Washington Mutual, $56 billion with respect to Wachovia and $40 billion with respect to Countrywide Financial. Eavis, Silent Treatment on Bank Write-Downs, WALL ST. J., Sept. 21, 2009, at C10. Of course, this is in addition to the drastic reduction in lending, especially small business lending, and double digit unemployment plaguing the country in the wake of the financial collapses.
3 Available at www.g8.utoronto.ca/g20/2009/banking0905. In their Sept. 5, 2009 Banking Statement they propose a “framework on corporate governance and compensation practices” in an effort to “prevent excessive short term risk taking and mitigate systemic risk.” Among the major steps they suggest are: “corporate governance reforms to ensure appropriate board oversight of compensation and risk, including greater independence and accountability of
Inquiry Commission, which has sought to address the causes of the meltdown, stated in its draft report: “dramatic failures of corporate governance and risk management at many systemically important financial institutions were a key cause of this crisis.” The report also referred to “stunning instances of governance breakdowns and irresponsibility” at major institutions which required government assistance, such as American International Group (“AIG”).  

A blue ribbon forum of private market participants and some regulators recently acknowledged the international economy’s need for improved governance, when they considered what is needed to avert another financial meltdown. The panel included a task force discussing systemically important institutions: the so-called “too big to fail” firms. One of the co-chairs of the task force stated the proposition quite succinctly: “In particular, we came to the view that for those that are systemically important financial institutions, a very much higher standard of governance was needed [to prevent failures].” This author agrees with the corresponding assessment of noted corporate attorneys writing for The Conference Board that “good corporate governance is a means to an end rather than an end in itself” and a board is to “work with management to develop strategies for long-term value.”

II. WHAT IS TODAY’S CONCEPT OF GOVERNANCE?

In recent years, the mainstream concept has moved away from the consideration of results and risk-taking to focus on various peripheral matters. These matters are detrimental to the economy insofar as they divert attention from the quality of decision-making within firms. This conceptual shift is epitomized by the Dodd-Frank law enacted in 2010 to improve regulation of the financial sector.

While Congress rightly recognized the need for improved governance to forestall new financial crises, its actions in enacting the Dodd-Frank law

board compensation committees.” As discussed, infra, equating governance and compensation is fundamentally flawed.

4 Quoted in McKinnon & Jackson-Randall, Panel: Fiscal Crisis was Avoidable, WALL ST. J., Jan. 26, 2011.

5 Statement of Ken Costa, Chairman of Lazard International, in Fixing Global Finance: Too Big to Fail, WALL ST. J., Dec. 14, 2009, at R5. The highest priority recommendation of the task force published in a sidebar to the article was: “Hold systemically important institutions to higher standards of governance.” Id.

6 Lipton et al., Director Notes: Some Thoughts for Boards of Directors in 2011, THE CONFERENCE BOARD (Jan. 2011).

have little to do with governance in the OECD sense. These actions require substantial augmentation so that the dialogue and action pertaining to improvement of governance, proceeds in the appropriate context.

UCLA Law School Professor Stephen Bainbridge, in his abstract of a pending article aptly summarizes the corporate governance provisions of Dodd-Frank:

1. Section 951 creates a so-called “say on pay” mandate, requiring periodic shareholder advisory votes on executive compensation.
2. Section 952 mandates that the compensation committees of reporting companies must be fully independent and that those committees be given certain specified oversight responsibilities.
3. Section 953 directs that the SEC require companies to provide additional disclosures with respect to executive compensation.
4. Section 954 expands the Sarbanes-Oxley Act’s rules regarding claw-backs of executive compensation.
5. Section 971 affirms that the SEC has authority to promulgate a so-called “proxy access” rule pursuant to which shareholders would be allowed to use the company’s proxy statement to nominate candidates to the board of directors.
6. Section 972 requires that companies disclose whether the same person holds both the CEO and Chairman of the Board positions and why they either do or do not do so.
7. Section 989G affords small issuers an exemption from the internal controls auditor attestation requirement of Section 404(b) of the Sarbanes-Oxley Act.

Particularly striking about the foregoing items is that none of them directly pertain to actual corporate performance or risk profile or make anyone accountable for it. They focus on board composition and management compensation, and related disclosures — rather than factors which directly pertain to how the firm is actually operated or its results. One can argue that all of these items have an indirect impact on performance, or are desirable otherwise, but they should not be proscriptive. The new law was intended to

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reduce the likelihood of firms blundering into disastrous decisions requiring bailouts and the like. However, it is difficult to see how this laudable objective will be attained without addressing actual results.\textsuperscript{10}

As distinguished an observer as Nobel Prize-winning economist and Columbia University Professor Joseph Stiglitz exhibits similar confusion between governance and pay. Despite acknowledging that poor governance played a major role in the meltdown, he characterizes governance as only “the manner in which incentives and pay get determined.”\textsuperscript{11} In the same vein, it has recently been noted that “The SEC sees compensation as an indicator of the relationship between the board and the CEO — does it have the backbone to stand up to him?”\textsuperscript{12}

Obviously, there is no “clearinghouse” compiling the reasons for bad business decisions. However, this author’s direct experience and observations over several decades of practicing corporate law with clients of all sizes and in many industries along with common sense have provided some insight into such reasons. Bad decisions result partly from skewed pay plans and ‘old boy’ networks on boards. They also stem from factors such as ineptitude, ignorance (sometimes willful, sometimes not) of fact, law, or market reality, hubris, inertia, megalomania, emphasis on speed, and “groupthink” (where faddish practices are slavishly adopted). In this author’s experience, too many decisions of great importance are made for the sole purpose of asserting this authority of the decision-maker.

\textsuperscript{10} A more graphic example of the divided focus of Congress in this regard is found in the requirement of Dodd-Frank that “[r]etailers carrying store-brand products . . . report annually whether the goods contain minerals from war-torn Central Africa.” Jessica Holzer, \textit{SEC Proposes ‘Conflict Mineral’ Report}, \textit{WALL ST. J.}, Dec. 16, 2010, at B9. While it is laudable to seek to reduce demand for minerals which appear to be causing the violent conflicts in Africa, this has nothing to do with financial stability in the U.S., and it seems like a very curious use of the SEC’s time. By the same token, Dodd-Frank also requires the Federal Reserve to limit the transactional fees which debit card issuers may charge merchants. Victoria McGrane et al., \textit{New Debit-Card Fee Rules Hit Hard}, \textit{WALL ST. J.}, Dec. 17, 2010, at C1. Perhaps this benefits consumers and retailers, but has nothing to do with financial stability or the health of the banking sector. In view of the scattershot approach of Dodd-Frank, we should not be surprised that its approach to governance is unfocused. When commenting on another provision of Dodd-Frank, this one addressing creation of a clearinghouse for all derivatives trading, the Wall Street Journal aptly observed in a lead editorial what is true in this area as well: “But Americans have reason to wonder what any of this has to do with avoiding the next financial crisis.” Editorial, \textit{Derivative Rules on ICE: Wasn’t Dodd-Frank supposed to reduce systematic risk?} \textit{WALL ST. J.}, Jan. 7, 2011, at A12.

\textsuperscript{11} \textsc{Joseph E. Stiglitz}, \textit{Freefall: America, Free Markets, and the Sinking of the World Economy} xviii (W.W. Norton & Company, Inc., 2010).

\textsuperscript{12} \textsc{Worth Magazine}, Dec.-Jan. 2011, at 55 (quoting Andrew Liazos, leader of the executive compensation practice at the law firm of McDermott Will & Emery).
III. WHAT GOVERNANCE INITIATIVES ARE WE SEEING?

In the wake of Dodd-Frank, the governance movement and the SEC are not implementing major initiatives to avoid horrible decisions. Instead, they are pursuing measures such as the following:

- New, contested-in-litigation, SEC rules around proxy access for minority shareholders;\(^\text{13}\)
- New SEC rules around ‘whistle-blowers’ encouraging employees to report management wrongdoing\(^\text{14}\) by paying them up to 30% of any recovery of monetary penalty resulting from the wrongdoing alleged by the whistle-blower;
- Governance devotees challenging public companies to require director candidates to obtain the votes of a majority of the outstanding shares for election, instead of a simple plurality;\(^\text{15}\)
- Advisors to major institutional investors pursuing against portfolio companies, efforts to ban reimbursement of management for losses on home sales in connection with relocations;\(^\text{16}\)
- As prompted by Dodd-Frank, the SEC, Federal Reserve and other banking regulators, are addressing whether to require financial firms to defer a large part of their executives’ pay for several years in order to mitigate a perceived short term emphasis on their part;\(^\text{17}\)
- SEC efforts to reduce ‘insider trading’ in stocks\(^\text{18}\) by those not


in management but having access to sensitive information by virtue of some other relationship with a company.\textsuperscript{19}

Speaking in general terms of the impact of Dodd-Frank obligations, former and current members of the Congressional Oversight Panel charged with evaluating the impact of the TARP program, were quite blunt in their assessment: “The government’s efforts inside and outside of TARP have sown the seeds for the next crisis and[,] unfortunately, last year’s 2,319 page Dodd-Frank Act does nothing to fix those problems.” Apart from or, perhaps, prompted by governmental action, we see boards focusing more on management personal behavior than on business policy when evaluating and overseeing management.\textsuperscript{20}

As discussed immediately below, perhaps good policy arguments can be made for these things. However, they have little to do with governance in the sense contemplated by the OECD and advocated by this author — i.e., “how the company is doing and what should it be doing?”

Broader proxy access is favored by this author, who views the legal objections to the rules as weak,\textsuperscript{21} and is seen by some knowledgeable

\textsuperscript{19}Perhaps the most prominent example of this tendency is found in a case where the SEC is pursuing claims against non-management rail yard employees for their purchases of stock in their company based upon their surmise that it would be sold, as a result of their observation of unfamiliar men in business suits in their rail yard. See Andrew Ross Sorkin, \textit{Sorkin: So What is Insider Trading?}, N.Y. TIMES DEALBOOK, Oct. 25, 2010, http://dealbook.nytimes.com/2010/10/25/sorkin-so-what-is-insider-trading/. One struggles to imagine how this sort of suit has any benefit for governance or compliance. An analogous example is found in the hedge fund claims, where the SEC is finding inappropriate so called channel-checking where an analyst seeks to determine distributor interest in and intentions regarding the subject company’s product. See Todd Harrison, \textit{Insider’s Take on the Insider Trading Scandal}, YAHOO!, Nov. 23, 2010, http://finance.yahoo.com/news/Insiders-Take-on-the-Insider-minyanville-3577425135.html?x=0&sec=topStories&pos=2&asset=&ccode (“Channel checks, . . . once considered hard work and due diligence, are now being fingered as proof-positive of wrongdoing.”).

\textsuperscript{20}See the Hewlett-Packard affair discussed \textit{infra} notes 52-57 and accompanying text, which has prompted its own insider trading inquiry by the SEC. See also Ben Worthen et al., \textit{SEC Probe Examines Hurd Exit from H-P}, WALL ST. J., Dec. 21, 2010, at A1; and the Tribune Company ouster of CEO Randy Michaels for maintaining a locker room atmosphere at headquarters but not for leading the company into, but not out of, a protracted bankruptcy proceeding. See David Carr & Tim Arnago, \textit{Tribune Chief Accepts Advice and Backs Out}, N.Y. TIMES, Oct. 23, 2010, at A1. (“The Tribune Company’s board resolved on Friday what had been its preoccupation for most of the week: sealing the fate of Randy Michaels, the controversial chief executive whose boorish behavior and cronyism became a dark sideshow to his bankrupt company’s financial struggles.”) To be clear, this is not to defend or rationalize the revolting behavior, but to wonder why such behavior was needed in the first place to jolt the board to act in the face of disastrous financial performance.

observers as being of great significance. Yet simply changing the composition of boards without changing their roles and responsibilities has at best a tenuous connection to better governance. George Mason University Law Professor Christopher Bruner cogently explains why this is the case:

Offering up proxy access and other forms of shareholder empowerment as a response to corporate governance problems precipitating the financial crisis is absurd. To the extent that excessive risk-taking led to the crisis, reforms like proxy access — aiming to empower the corporate constituency whose incentives are most skewed toward greater risk — simply don’t add up.

Encouraging more whistle-blowing, by paying whistle-blowers, does nothing to prevent wrongdoing. Rather, it may incentivize more wrongdoing by leading those with an opportunity to stop an incipient problem to ignore it until it ripens into a financially cognizable claim. In any event, it has nothing to do with honestly considered — but seriously flawed — business decisions which we saw in most cases with the financial firms.

The governance-related clamor around Apple, one of the world’s most legitimately successful firms in both a product and a financial sense, serves as an example of this problem. The challenge to its director election practices (which require only a majority of votes cast as opposed to a majority of its outstanding shares, which is the approach favored by governance activists)

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22 One prominent corporate lawyer states that this change is “... the biggest change relating to corporate governance ever proposed by the SEC. Period. It gives activists the ultimate vehicle to express dissatisfaction with a board, the ability to replace board members at the company’s expense.” Jeffrey McCracken & Kara Scannell, Fight Brews as Proxy Access Nears, WALL ST. J., Aug. 26, 2009, at C1 (quoting John Finley, Esq., former partner at Simpson, Thatcher and Bartlett, and presently general counsel at Blackstone Group). Similar sentiments are expressed in a less elegant manner by Nell Minow, a well-known critic of current corporate governance who stated, referring to corporate directors: “The only way you’re going to change things is to throw the bums out.” Joe Nocera, Pay Cuts but Little Headway on Larger Goals, N.Y. TIMES, Oct. 23, 2009, at B1. Pay practice is not what matters most, competent performance is; after the fact removal from office does little to enhance performance in office.

23 He supports the hypothesis by looking to the U.K.’s experience with rules similar to what have been adopted in the U.S.: “As I discuss in a recent paper examining U.S. and U.K. corporate governance crisis responses, the fact that the far greater governance power of U.K. shareholders appears to have done little to mitigate the (very similar) crisis over there ought to give pause to those suggesting that augmenting shareholder powers will prevent future crises over here.” Erik Gerding, Proxy Access Forum: Christopher Bruner, THE CONGLERATE, Aug. 26, 2010, http://www.theconglomerate.org/2010/08/proxy-access-forum-christopher-bruner.html.

24 Witness the virtual absence of criminal or civil litigation brought — let alone sustained — against principals of financial firms at the epicenter of the meltdown.
illust rates the gap between today’s concept of governance and that preferred by this author and the OECD. Apple has done superbly by all concerned and has imposed no costs on anyone from poor management, and no one has any reason to believe that this will change in the foreseeable future. For the head of the CalPERS corporate governance office to say, when discussing the Apple matter, that “[t]here is systemic risk when directors are not accountable” trivialis the issue of accountability. When a firm is delivering poor performance, accountability — beyond removal from office — is required. Apple’s management and directors have delivered superb performance, such that it makes little sense to demand anything more from them. Emphasizing the mechanics of board elections in a case like this indicates that today’s concept of governance has little to do with results.

Efforts to curb home loss reimbursements are nothing more than a diversion from the effort to improve governance. They are immaterial in amount and have nothing to do with corporate or executive performance. Deferral of bankers’ pay seems to be a knee jerk reaction to some undeniably poor decisions in that sector. This solution is unsupported by any empirical analysis that has addressed the existence and extent of a link between pay and risk-taking behavior.

As to insider trading, a long time observer of the enforcement landscape notes:

[There has been] a shift in insider trading jurisprudence away from its roots in deterring and punishing those who abuse special relationships at the expense of shareholders and into a murkier area where the S.E.C. is policing general financial unfairness that has traditionally been considered beyond its authority to regulate.

Another commentator writes of this new approach being known as “mosaic theory.” It involves the putative insiders ‘putting together the pieces’ as to corporate performance, rather than being accused of trading on one piece of discrete non-public information. Even assuming it is fairer in some regards, this author can see no meaningful systemic policy benefit when following this approach, in terms of better management or company performance or

25 Lublin, supra, note 15.
26 See infra notes 44-48 and accompanying text. Similarly, the revelations that many executives did not understand what they were doing, infra note 85 and accompanying text, belies the notion that it was their pay plan which caused them to do these things.
27 Joel M. Cohen, partner at Gibson, Dunn & Crutcher, quoted in Sorkin, supra note 19.
avoidance of disasters.

1. Governance, Pre-Dodd-Frank and Now

While its remedial action may be misdirected, Congress was correct in its observation that poor governance contributed to the 2008 financial meltdown, and that the prevailing legal regimen was not well suited for improvement.

This author has noted before the enactment of Dodd-Frank that governance law mainly emphasized matters that have nothing to do with firm performance, viz:

(i) Director independence, understood as decision-making and oversight of management by a financially disinterested board of directors with “undivided loyalty” to the firm: that is, one lacking any direct pecuniary interest in the particular matter on which the director is voting and requiring recusal in the particular case where this is not true. The Sarbanes-Oxley Act of 2002 augments this emphasis on independence with its requirements for detachment from management for the members of public company audit committees; (ii) Officer/director responsibilities in connection with merger and acquisition (“M&A”) situations and other ‘major corporate transactions’.

30 DEL. GEN. CORP. LAW § 141; Loft, Inc. v. Guth, 2 A.2d 225 (Del. Ch. 1938), cited approvingly in In re The Walt Disney Company Derivative Litigation, 907 A.2d 693, 750 (Del. Ch. 2005) [hereinafter Disney]. Corporate governance obligations are dictated by the laws of a corporation’s state of incorporation (and to some extent by the federal securities laws). Delaware is by far the most influential jurisdiction for American corporate governance, as a result of it being the state of incorporation for over 50% of U.S. publicly traded companies and 63% of the largest companies comprising the Fortune 500, according the Delaware Secretary of State. See Delaware Secretary of State, http://corp.delaware.gov (last visited Dec. 30, 2010). This Article emphasizes Delaware authority. The author is not aware of any authority to the contrary of the cited Delaware cases in any other commercially significant states. Cf. Meinhard v. Salmon, 249 N.Y. 458 (1928) (originating, arguably, the “duty of undivided loyalty” of corporate directors to their corporations).
33 See, e.g., Omnicare v. NCS Healthcare, 818 A.2d 914 (Del. 2003) (explaining how acquisition agreements may and may not be structured to encourage or discourage other bids); Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc., 506 A.2d 173 (Del. 1986) (explaining nature of duties to maximize price when change of control is inevitable); Unocal Corp. v. Mesa Petroleum Co., 493 A.2d 946 (Del. 1985) (detailing permissible and impermissible actions in response to a hostile takeover).
(iii) Disclosure to public company shareholders of management remuneration;\(^{34}\) again quite worthy, but unrelated to performance itself;
(iv) Direct limitations on management remuneration;\(^{35}\) and
(v) Procedural and disclosure requirements around proxy contests for board seats and shareholder proposals.\(^{36}\)

Even cursory consideration of these concepts indicates their lack of connection to governance in the OECD sense. As we have seen, just because a director is independent in a financial sense that does not mean that they will be diligent or even competent. Experienced boardroom observers have argued that the emphasis on independence may impair competence:

However, one of the lessons learned from the financial crisis is . . . independence thresholds do preclude the candidacy of insiders with extensive day-to-day knowledge of the company, and also tend to preclude individuals who, in connection with their development of industry expertise, have naturally developed relationships and affiliations in the sector.\(^{37}\)

M&A consideration procedures are certainly a critical topic as they may lead to or prevent disasters. However, they are not alone sufficient, as many poor courses of actions unfold gradually and are not embodied in one particular decision.

Two very recent, well publicized Delaware cases provide a graphic example of this excessive focus. In the first, *Air Products and Chemicals, Inc.*

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\(^{34}\) *See e.g., “Executive Compensation and Related Person Disclosure,”* 17 CFR Parts 228, 229, 232, 239, 240, 245, 249 and 274, Rel. Nos. 33-8732A, 34-54302A; the extent of the discussion of these rules in the Code of Federal Regulations speaks for itself as to their scope and complexity. Their operation is illustrated in the text accompanying infra note 66, which contains excerpts from a recent IBM proxy statement.


\(^{36}\) *See e.g., Securities Exchange Act 17 CFR 240.14a-101. The stayed proxy access rules implemented pursuant to Dodd-Frank, see supra note 7 and accompanying text, are a response to the perceived inadequacy of these rules.*

\(^{37}\) Lipton et al., *supra* note 6. The *Wall Street Journal* illustrates this point by reference to the former Merrill Lynch in an editorial entitled “Independently Incompetent”:

*We’re still waiting for evidence that independent directors yield better financial results . . . . Merrill was a model of trendy corporate governance with a board of esteemed Americans who could offer an unbiased perspective. As it turned out, what Merrill really needed was a board that knew how to manage financial risk. And it would have helped immensely if directors had understood the mortgage-backed securities on which they had unwittingly bet the firm.*

v. Airgas, Inc., et al and In re Airgas Inc. Shareholder Litigation, the Delaware Chancellor in a well-reasoned 158 page discourse containing 514 footnotes, upheld the use of the so-called ‘poison pill’ takeover defense mechanism against a challenge that it infringed upon shareholder rights to decide for themselves whether to accept an above-market bid for their company. In the second, In re Del Monte Foods Company Shareholder Litigation a Vice Chancellor restricted the ability of investment bankers in M&A situations to act both as adviser to the target company and as an agent for the purchaser in connection with procurement of financing for the same transaction. Airgas was explained as follows by Chancellor Chandler:

[T]his case brings to the fore one of the most basic questions animating all of corporate law. . . . That is, when, if ever, will a board’s duty . . . require [the board] to abandon concerns for ‘long term’ values (and other constituencies) and enter a current share value maximizing mode?

Vice Chancellor Laster explained Del Monte as being intended to deal with situations where a financial advisor to a buyout target surreptitiously associates with a potential bidder in order to provide financing, while receiving fees from both: “[A]lthough Barclays’ [the target’s advisor] activities and nondisclosures in early 2010 are troubling, what indisputably crossed the line was the surreptitious and unauthorized pairing of Vestar with K.K.R. [potential bidders]. In doing so, Barclays materially reduced the prospect of price competition for Del Monte.”

This author’s concern is not with the reasoning or outcome in either situation. Rather, it is with the manner in which Delaware jurisprudence has developed, to emphasize such analysis to the exclusion of consideration of the manner in which boards oversee management in situations not involving M&A transactions. One sees constant honing of Delaware law applicable to M&A,
even in cases such as these where neither Airgas nor Del Monte have any systematic importance, but much less focus on the need for strong governance in the ‘ordinary course’. To this author, if the last several years illustrate anything about the need to improve governance, it is that the greatest threat to the economy comes not from these “major corporate transactions,” but from flawed conduct of “everyday” business. Subjecting actors in these relatively minor M&A situations to this sort of intensive scrutiny, while subjecting the Citigroup board to less scrutiny despite the significance of Citigroup to the economic meltdown, sends the wrong message to all concerned.

By the same token, compensation limitations and disclosure requirements, while perhaps desirable in themselves, have nothing directly to do with the ultimate issue of decision-making quality. Rules around board elections are also desirable, but say nothing about what elected directors are supposed to do after their installation. For example, one of the leading corporate governance scholars, who is quoted elsewhere in this Article, has noted that directors give short shrift to the fundamental — for companies in all industries — matter of information technology. This is yet another example of how the lack of emphasis on day-to-day matters can be so detrimental to firms. Focusing on the process around board elections while ignoring the responsibilities of elected directors brings to mind the age old comparison involving deck chairs and the Titanic.

2. Too Much Process, Not Enough Substance

It is hardly a coincidence that the preceding points are the cornerstones of our governance framework and that assessment of results is not. The fundamental element of today’s corporate law is the so-called business judgment rule. The rule effectively immunizes directors from liability for adverse, even catastrophic, results arrived at through impartial exercise of business judgment and appropriate “process”. Directors and officers are subject to a “duty of care” which nominally requires them to use reasonable care in performing their duties even where their impartiality is not at issue. In

have a greater macro-economic impact. See discussion of disregard by directors of information technology matters, infra note 47 and accompanying text.

44 See discussion infra note 47 and accompanying text regarding directors’ lack of attention to matters such as information technology strategy.

45 See infra note 48 and accompanying text.

46 See infra note 47 and accompanying text.

practice, however, it means little other than jumping through the correct hoops, that is utilizing the appropriate process. If they do so, they receive the benefit of a ‘presumption’ in their favor. This presumption requires anyone seeking to establish liability based upon breach of this duty of care leading to poor results, to affirmatively prove that it was not met.

The business judgment rule “is a presumption that in making a business decision the directors of a corporation acted on an informed basis, in good faith and in the honest belief that the action taken was in the best interests of the company.” 48 The burden is on plaintiffs, the party challenging the directors’ decision, to rebut this presumption.49

In practice, given the disparity in access to information between directors and outside shareholders, and the cost of discovery, this is often an insurmountable burden for plaintiffs.50

Facing an effort to hold directors responsible for catastrophic losses on mortgage loans at a major financial institution, requiring a large government bailout, the Delaware Chancery Court very recently proclaimed:

[Where a BOD decision results in financial loss], director action is analyzed under the business judgment rule, which prevents judicial second guessing of the decision if the directors employed a rational process and considered all material information reasonably available. [C]ompliance with a director’s duty of care can never appropriately be judicially determined by reference to the content of the board decision that leads to a corporate loss, apart from the consideration of the good faith or rationality of the process employed. Thus, the business judgment rule is process-oriented and informed by a deep respect for all good faith board decisions.51

This court relied heavily upon the seminal Delaware Supreme Court case of Smith v. Van Gorkom.52 In Smith, the court used the cursory process around the approval of a disastrous merger to hold responsible the directors who approved it. A generation of corporate practitioners and many judges relied upon this case to dictate spending (and demonstrating spending) sufficient time on the discussion of major corporate transactions and engagement of “experts.” For example, using investment bankers to advise on

48 In re Citigroup Inc. Shareholder Derivative Litigation, 964 A.2d 106, 122 (Del. Ch. 2009) [hereinafter “Citigroup”].
49 Id.
50 Id. at 124 (quoting Aronson v. Lewis, 473 A.2d 805, 812 (Del. 1984).
51 Id. at 122 (quoting In re Caremark Int’l. Derivative Litig. 698 A.2d 959 (Del. Ch. 1996) (emphasis added).
them, along with ensuring that meeting minutes reflect the thoroughness of the board’s consideration. That is, it created the emphasis on process which is noted in the Citigroup case and quoted above. Professor Bainbridge again aptly summarizes its effect in an abstract of a paper:

“Smith v. Van Gorkom arguably was the most important corporate law decision of the 20th century. The supreme court of a state widely criticized for allegedly leading the race to the bottom held that directors who make an uninformed decision face substantial personal liability exposure.”

No one would disagree with the insistence that boards be fully informed, but in practice, this author believes that being informed is necessary but not sufficient. There needs to be — but is not in practice — accountability for what is done with the information.

The Citigroup court relied upon, inter alia, a prominent case in the last decade involving the Disney Company. The case stresses that this process orientation, a key element of its jurisprudence, is intended to avoid excessive risk aversion on the part of corporate decision-makers. This is accomplished by absolving them of responsibility for poor results, so long as they acted “intelligently”.

There is little doubt that excessive risk aversion has been avoided, but it is now time to reduce our concern with risk aversion, at least where risk embrace can do serious economic damage.

As if this body of common law is not enough to impede good governance, the Delaware General Corporate Law contains a provision, Section 102(b)(7), adopted soon after the Smith v. Van Gorkom decision. It permits corporations to include in their charters (with shareholder approval) language which exculpates officers and directors for financial liability for breaches of their duty of care, even if such breaches are based upon the use of poor process.

Consistent with the sentiments in Citigroup, Delaware’s Vice Chancellor has stated that “[o]ne of the primary purposes of 102(b)(7) is to encourage directors to undertake risky, but potentially value-maximizing, business strategies, so long as they do so in good faith.”

In practice, all of this has meant something of a ‘check the box’ approach where boards make sure they obtain pertinent ‘expert’ advice and spend sufficient time on the consideration of proposals outside the ordinary

54 Disney, 907 A.2d 693, 748 (quoting Mitchell v. Highland-Western Glass, 167 A. 831, 833 (Del. Ch. 1933) and Smith v. Van Gorkom, 488 A.2d 858, 872 (Del. 1985)). As we have unfortunately seen in Citigroup and elsewhere, this encouragement was wildly successful in places, where, unlike Disney, risk-taking should not have been encouraged.
55 65 DEL. LAWS. C. 289 (1986).
course of business. However, assuming they jump through these hoops, that is the extent of their responsibilities; they are not accountable in any way for using such advice or otherwise if the outcome is highly adverse. It is little comfort to those who have suffered during the financial meltdown and its aftermath that “proper” process was used to vet decisions which led to such catastrophic outcomes.

By the same token, there is little or no authority specifying responsibilities involving process or substance for officers and directors in the conduct of their duties within the ordinary course. This is despite the potential for severe losses resulting gradually if matters are not properly handled or not handled at all — i.e., there is no specific decision to be made on a given transaction, but over time a course of action leads to disaster. One need look no further than the erosion of mortgage lending standards that led to our financial crisis. There was no one event which marked this change, but over 5-10 years, the change certainly had its effect. We need boards to oversee the direction of ordinary course activity to the same extent as extraordinary activity, and speak up if this activity seems to present new risks. There is a high quality jurisprudence in Delaware and elsewhere governing actions outside the ordinary course of business. However, it is time to develop comparable guidance for actions or inactions which are in the ordinary course, but which can still have huge implications.

Noted mutual fund executive and Harvard Business School senior lecturer Robert Pozen has similar observations as to the overemphasis on process and lack of substantive expertise. On why so many large financial firms encountered so many problems, despite the attempt in the Sarbanes-Oxley Act to improve governance, he comments:

I believe the problem is the current structure of corporate boards. In short, they are too big, members often don’t have enough relevant experience, and they put too much emphasis on procedure. . . . Regulators, investors and directors should recognize that we do not need more procedures for corporate boards. Instead, we need more expert directors who view their board service as their primary profession — not an avocation.57

The inadequacy of the current model governing board functioning is summed up by the business journalist Charles Gasparino when speaking of the Wall Street bets on mortgages and mortgage-based securities:

But a special place in the pantheon of irresponsibility belongs to the boards of directors who looked away from the risk

taking; believed the best-case scenarios presented by management when they should have been preparing for the worst; and worst of all, left in charge management that didn’t have a clue how to manage leverage and risk.\textsuperscript{58}

With performance like this in such critical situations, a new model is needed.

To this author, perhaps the ultimate indignity and absurdity of this regimen is presented by the Apple situation, discussed above. Apple, a company which is performing brilliantly by any standard, is being assailed for the mechanical process and standards around its director elections. In theory, perhaps, its process could stand improvement, but theory is irrelevant when the practical results are at such a high level. This concern by governance devotees contrasts sharply with the exoneration of the Citigroup board of any responsibility for its catastrophic losses which caused so much external damage.

3. What Needs to be Done . . . and Stopped: Theory and Practice

Governance law needs to be drastically reshaped to reflect today’s needs. This includes de-emphasizing peripheral matters and process and emphasize what the OECD does, namely meeting of objectives. Governance devotees should also re-prioritize so that reflexive opposition to increases in management compensation and demands for minority representation on proxy ballots and boards are not the focal point of the effort and do not impede efforts to address more substantive considerations.

Both law and observers must emphasize whether officers and directors are in fact bringing about respectable results. They must maintain the viability of the firm and avoid its imposition of costs on society. This means understanding and critiquing firms’ strategy, financial performance, and status in ‘real time’, when it can be changed or otherwise meaningfully addressed. This contrasts with after-the-fact consideration or recrimination in connection with the CEO’s next compensation review.

It is easy to say that at present, corporate governance is off the rails with its focus on peripheral matters. It is considerably harder to specify what needs to be done to improve things and make firms run better. In the first instance, I suggest much less focus on management compensation and personal behavior.

While distinguished economists have argued that compensation and results are inextricably related,\textsuperscript{59} empirical evidence suggests that this is not


\textsuperscript{59} Professor and Former Fed Vice Chairman Blinder posits: “Despite the vast outpouring of commentary and outrage over the financial crisis, one of its most fundamental causes has received surprisingly little attention. I refer to the perverse incentives built into the
necessarily the case. For example, the former CEO of Merrill Lynch, which imploded during the 2008 meltdown, explained that none of its executives even understood the perilous positions that it was taking prior to its downfall. This made it disingenuous to conclude that pay formulae caused irresponsible actions. New York University Stern School of Business Professor David Yermack took a broad look at the situation and concluded: “No evidence whatsoever indicates that errant executive compensation ‘caused’ the financial crisis of 2008.” Other analysts concur: “These studies suggest that bank executives were simply ignorant of the risks their institutions were taking — not that they were deliberately courting disaster because of their pay packages.” An analysis of the actual impact of the post-meltdown rule changes pertaining to pay is to the same effect: “A study prepared for an influential shareholder group (the Council of Institutional Investors) says rule changes meant to revamp Wall Street’s pay culture have been negative, concluding that pay practices at six U.S. banks have ‘worsened’ since the financial crisis.” Simply put, with all due respect to Professor Stiglitz et al., corporate governance is much more than pay or the identity of those doing the governing.

To this author, the endless discussion of compensation and perquisites undermines the credibility of the governance movement by indicating mere jealousy toward “rich executives.” A cursory glance at any substantial public company proxy statement reveals mind numbing verbiage dictated by SEC proxy rules around not only base salary and bonus, but matters such as:

compensation plans of many financial firms, incentives that encourage excessive risk-taking with OPM — Other People’s Money . . . . The source of the problem is really quite simple: give smart people go-for-broke incentives and they will go for broke. Duh.” Alan Blinder, Crazy Compensation and the Crisis, WALL ST. J., May 28, 2009, at A15. Professor Stiglitz makes the same argument that pay practices caused the meltdown, but cites no authority for the causal relationship, but simply notes under the heading “Corporate governance”: “The incentive schemes that produced misaligned incentives did not serve shareholders well, and did not serve the world well.” STIGLITZ, supra note 11, at 149-155.

Story, In Merrill’s Failed Plan, Lessons for Pay Czar, YAHOO! FINANCE TECH TICKER, Oct. 7, 2009, finance.yahoo.com/tech-ticker/article/350268. The text accompanying note 85 contains an eyewitness account indicating that Merrill executives literally did not know or understand what they were doing when they assumed many mortgage-related risks.


Friedman, Bank Pay and the Financial Crisis, WALL ST. J., Sept. 24, 2009, at A21 (referring to very recent studies of the 2008 financial meltdown by Profs. Rene Stulz and Rudiger Fahlenbrach (available at SSRN.com) and Viral Acharya and Matthew Richardson).


See supra note 31 and accompanying text.
- equity based compensation, including the details of grants and vesting;
- retirement plans;
- personal travel on company aircraft;
- company-supplied club memberships;
- company-supplied tax and financial planning;
- company-supplied home security systems and services; and
- company-supplied medical and life insurance.

For example, the IBM 2010 Proxy Statement, which this author considers to be quite straightforward by large company standards, says the following to introduce the subject of director compensation:

**2009 Director Compensation Narrative**

*Annual Retainer:* In 2009, non-management directors received an annual retainer of $250,000. Chairs of the Directors and Corporate Governance Committee and the Executive Compensation and Management Resources Committee received an additional annual retainer of $10,000, and the chair of the Audit Committee received an additional annual retainer of $15,000. Under the IBM Deferred Compensation and Equity Award Plan (DCEAP), 60% of the total annual retainer is required to be deferred and paid in Promised Fee Shares (PFS). Each PFS is equal in value to one share of the Company’s common stock. When a cash dividend is paid on the Company’s common stock, each director’s PFS account is credited with additional PFS reflecting a dividend equivalent payment. With respect to the payment of the remaining 40% of the annual retainer, directors may elect one or any combination of the following: (a) deferral into PFS, (b) deferral into an interest-bearing cash account to be paid with interest at a rate equal to the rate on 26-week U.S. Treasury bills updated each January and July, and/or (c) receipt of cash payments on a quarterly basis during service as a Board member. The Company does not pay above-market or preferential earnings on compensation deferred by directors. IBM had a retirement plan for directors which was eliminated effective January 1996, and the Company credited the PFS accounts with retirement PFS equal to the benefits accrued under that retirement plan. For 2009, all directors made elections under the DCEAP to defer 100% of their annual retainer in PFS. Under the IBM Board Corporate Governance Guidelines, within five years of initial election to the Board, non-management directors are
expected to have stock-based holdings in IBM equal in value to five times the annual retainer initially payable to such director. Stock-based holdings mean (i) IBM shares owned personally or by members of the immediate family sharing the same household and (ii) DCEAP PFS. Stock-based holdings do not include (i) unexercised options and (ii) any amounts credited to the PFS account in connection with the elimination of the retirement plan.66

A footnote to a nearby table elaborates as follows:

Amounts in this column include the following: for Ms. Black: $40,623 of dividend equivalent payments on PFS; for Dr. Brody: $15,000 contributed by the Company under the matching grants program; for Mr. Chenault: $26,189 of dividend equivalent payments on PFS; for Mr. Eskew: $16,234 of dividend equivalent payments on PFS and $18,761 contributed by the Company under the matching grants program; for Dr. Jackson: $13,939 of dividend equivalent payments on PFS and $15,000 contributed by the Company under the matching grants program; for Mr. Owens: $12,754 of dividend equivalent payments on PFS; for Ms. Spero: $17,769 of dividend equivalent payments on PFS and $10,000 contributed by the Company under the matching grants program; for Mr. Taurel: $23,821 of dividend equivalent payments on PFS and $10,000 contributed by the Company under the matching grants program; and for Mr. Zambrano: $18,699 of dividend equivalent payments on PFS.

In case the preceding is overly simple, the same document says the following in a footnote to a table containing officer compensation:

*Other Compensation.* The SEC disclosure rules require that companies include certain items in the Summary Compensation Table column entitled “All Other Compensation.” At IBM, many of these items are available to all employees. In fact, additional programs that are restricted to senior executive participation amount to less than 1% of their total compensation on average. These programs are limited to services with a direct bearing on individual productivity or security. IBM’s security practices provide that all air travel by the Chairman and CEO, including personal travel, be on Company aircraft. IBM does not provide any tax assistance to

66 IBM Proxy Statement, *supra* note 64.
Mr. Palmisano in connection with taxes incurred for personal travel by him on the corporate aircraft. While the cost of corporate aircraft usage varies year to year based on several external factors such as fuel costs, using corporate aircraft for all travel is a prudent step to ensure the safety of the Chairman and CEO given the breadth of IBM’s operations in over 170 countries which includes many emerging markets where security concerns are a reality. Given the personal travel security practice for the Chairman and CEO, family members periodically accompany him on the corporate aircraft. In accordance with tax requirements, income was imputed to Mr. Palmisano for personal travel by his family members on the corporate aircraft. In recognition of his family’s personal travel, Mr. Palmisano has contributed $63,000 to the IBM International Foundation to fund contributions to Columbia University.  

Many of the amounts contained in disclosures of this nature are immaterial; and few, if any, of them give us any insight into how officers or directors approach strategic business decision-making. Why should anyone care about the interest paid to directors on deferred compensation? The word “petty” comes to mind when characterizing requirements for disclosures of this nature. This author is much more concerned with whether someone’s business strategy makes — or ever did make — sense in the present market environment, and how the directors are making such determination, than whether the company is paying their home security service, or whether their spouse used a company plane for a shopping trip.

One sees this taken to absurdity in the effort of institutional investors to stop home loss reimbursements for relocating executives, which are immaterial in amount and totally unrelated to performance. Even the insistence on full disclosure of compensation and perquisites, which appears innocuous on its face, often seems punitive in nature as a result of its burdensome nature and lack of connection to performance and potential for innocent missteps inviting legal challenges.

This is most definitely not a defense of lavish executive compensation. Too many executives are overpaid and doing poor jobs. The same is true for the board members responsible for overseeing them, but doing little of the sort. Instead, the relevant consideration for society should be the poor performance, irrespective of pay. We are not well served by even the gratuitous performance of services by an executive or director of a firm which

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67 IBM Proxy Statement, supra note 64.
68 See supra note 12 and accompanying text.
is being put into, and is putting our public fiscal health into, serious jeopardy.

4. How are Boards Responding in the Wake of Dodd-Frank?

The most prominent example of board scrutiny of management, post-Dodd-Frank is not encouraging in this regard. Hewlett-Packard (“HP”) ousted its CEO, Mark Hurd, in August 2010, as a result of revelations of his involvement with a female company contractor and possible expense irregularities relating to the episode. While there is little reason to commend his behavior or decry his ouster, most striking is that afterward we heard revelations about his flawed business policies, specifically the suppression of capital expenditures jeopardizing HP’s competitive posture. Yet, it appears that the HP board was prompted to act only by the tawdry personal matters, which had little impact on the company’s position in the marketplace. The board did not seem to understand nor care about the much broader strategic matters. Even more suspect is the board’s replacement for Mr. Hurd, Leo Apotheker, who may have been deeply involved in highly questionable conduct involving possible trade secret misappropriation by his former employer, SAP, Inc. This situation resulted in litigation against SAP, resulting in $1.3 billion in damages being awarded. Apparently as a consequence of this situation and the concern about being subpoenaed to testify in the litigation, it was impossible to determine Mr. Apotheker’s

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70 IBM’s CEO, Samuel Palmisano spoke of Hurd’s approach and its effect: “[HP] used to be a very inventive company . . . . Hurd cut out all the research and development.” Ante, IBM’s Chief Thumps Hurd, WALL ST. J., Sept. 15, 2010. To the same effect are recent revelations about HP’s weakness in the markets for software and services, compared to companies such as IBM. Winkler, IBM Shows H-P how to Serve it Up, WALL ST. J., March 8, 2011, at C22. One wonders why the HP board was not discussing any of this with Mr. Hurd.

71 Nocera, A Double Standard at HP, N.Y. TIMES, Oct. 8, 2010, http://www.nytimes.com/2010/10/09/business/09nocera.html (“It takes your breath away, really: the same board that viewed Mr. Hurd’s minor expense account shenanigans as intolerable has chosen as its new CEO someone involved — however tangentially — with the most serious business crime you can commit [i.e., the alleged trade secret misappropriation].”).

72 Tuna, Jury: SAP Ows Oracle $1.3 Billion, WALL ST. J., Nov. 24, 2010, at B1. It appears that the SAP board authorized the acquisition despite having learned in due diligence that the acquired company was in fact engaged in the behavior which prompted the suit:

Did SAP’s executive board know that its new division’s business model depended on stealing Oracle’s code? Stunningly, it did. A crucial piece of evidence in the lawsuit is a presentation made in Jan. 2005 to the SAP board by executives arguing in favor of the purchase. One of the slides acknowledges that TomorrowNow used [a] ‘nonproduction copy’ — i.e., unauthorized copy — of Oracle’s software.

Nocera, supra note 71. While SAP is a German company, the problem is with HP, an American company, disregarding Mr. Apotheker’s involvement in this episode.
whereabouts during the first few weeks after he started his position with HP.\(^{73}\)

To this author, this series of events suggests that the HP board does not see itself as an overseer of management performance and its impact on the company’s position in the marketplace. While Hurd’s alleged misbehavior was unseemly, it did not relate to HP’s dealings with anyone. Apotheker stands accused by at least one commentator of unlawful conduct involving a major transaction squarely on behalf of SAP. The board does not appear to be clearly focusing on protection of their company; rather, it seems blinded by titillating or disgusting peripheral matters.

Even the SEC’s reaction to this affair reflects a skewed focus. It is apparently more occupied with whether Mr. Hurd shared with the female contractor any non-public information on an HP acquisition in 2008, and, to some extent, with his expense reimbursements.\(^{74}\) In addition to its obsolescence and the immateriality of the expense reimbursement issue, the SEC’s involvement reflects a troubling inability to grasp what is important to shareholders and the economy. While slightly less prominent than the HP episode, the Tribune board’s conduct, discussed above,\(^{75}\) reflects seemingly little concern about drastic financial deterioration, and a languishing bankruptcy. Instead — and equally discouraging — it appeared to act only upon revelations of gross personal behavior by the CEO.

In a very recent case, shareholders sought to hold accountable directors and management of a firm which has not experienced major financial reversals, but which has encountered legal compliance problems as a result of product recalls. Specifically, the well-known pharmaceutical firm Johnson & Johnson has experienced a number of product recalls on claims that its drugs were poorly manufactured and were either dangerous or ineffective. Shareholders alleged that its board and top management affirmatively ignored information which put it on notice that there was a significant and worsening problem.\(^{76}\)

In the lawsuit, the shareholders alleged the board of directors ignored a whole host of “red flags,” including warning letters from federal regulators, subpoenas and two criminal plea agreements for violating government regulations that go to the heart of the company’s business: marketing prescription medicines. The complaint states:

\footnote{Madway & Ando, HP CEO Apotheker, sought by Oracle, pops up in Japan, Reuters, available at http://www.reuters.com/article/idUSN091246462010101110 (suggesting that he may have been trying to avoid being served with an Oracle subpoena).}


\footnote{Lublin, supra note 16.}

Defendants were well aware that the consequences of permitting or fostering a culture of legal non-compliance could be catastrophic to J&J’s business. . . . Inexplicably [sic], instead of remedying these drug and medical device manufacturing and marketing violations, the misconducted [sic] continued unabated and in many ways it proliferated.

It must be stressed that the preceding is only an allegation which has not even been the subject of a response by the defendant, let alone any adjudication. However, if true, it reflects the sort of board behavior that must be promptly improved for the betterment of our economy.

5. New Standards Going Beyond Process and Pay

What standards should be made part of a new governance regimen? This author strongly believes that directors and executives must in some sense be financially accountable for severely adverse, but avoidable, business outcomes, especially those having major implications beyond the company and its stockholders. This can take many forms, but must not impinge upon bona fide entrepreneurial risk-taking. We must accept that risk-taking drives our economy and employment, such that we do not punish those who oversaw failed business ventures simply because of the failure.

Rather, we must carefully isolate situations where more than simple poor results are at issue. Even under present law, there is, and will remain, liability for management or director dishonesty or divided loyalties leading to shareholder loss. Our focus for change must be on situations where management and directors acting in good faith without a personal stake and using proper process, made specific decisions or knowingly or recklessly ignored circumstances that could have been dealt with or reversed, and that led directly to large losses extending beyond their organization itself.

The purpose of incorporating such a standard is to deter — not punish after the fact — occurrences such as, but certainly not limited to, the gradual but radical decline in mortgage lending standards which felled and impaired so many of our financial institutions during the last five years, and business acquisitions made without a bona fide understanding of their implications, even if the correct process was used. Process evaluation cannot always be the principal yardstick for governance.

While hindsight is always 20/20, few major institutions heeded warnings from those who spoke out against financial market excesses at a time when at least some consequences could have been prevented.77 These

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77 Professor Stiglitz identifies several prominent economists who spoke up before the onset of the crisis — e.g., Nouriel Roubini, Paul Krugman, George Soros, Stephen Roach, Robert Shiller, and Robert Wescott. STIGLITZ, supra note 11, at 18-19.
institutions blindly relied on the judgment of rating agencies, despite evidence from public accounts of lax underwriting, that such judgments had little or no basis in reality. There must be real consequences for such willful or reckless disregard of gathering storms, especially when credible opposing voices emerged while there was still time to avert at least some of the harms.

Similarly, in the SAP case discussed above, SAP’s exposure arose from the wrongful activity of its target company, TomorrowNow, and top management’s and the supervisory board’s disregard of the activity of which it learned in its due diligence. That is, management was aware of the unlawful activity on the part of the acquired company but went ahead with the deal anyway, and is now enmeshed in major litigation as a direct result. This is unacceptably poor governance.

This author believes and has argued elsewhere that there are certain events which at least presumptively should be considered indicative of poor governance. While observers may genuinely disagree about one or more of these as well as others not on the list, as well as specific levels of loss from them which should trigger consequences, items that should at least prompt discussion about the conduct of management and directors include:

- Criminal or serious civil legal proceedings against the firm (or management/directors with respect to firm business) alleging more than breach of contract or simple negligence and involving financially material amounts (not ‘slip and fall’ cases) which are not summarily resolved;
- Filing for bankruptcy or insolvency;
- Receipt of extraordinary governmental assistance as a result of financial distress;
- Large asset write-downs; or
- Large goodwill write-downs following an acquisition of another business.

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78 STIGLITZ, supra note 11, at 7 (“The ‘market’ badly misjudged the risk of defaults of subprime mortgages, and made an even worse mistake trusting the rating agencies and the investment banks when they repackaged the subprime mortgages, giving a AAA rating to the new products.”); id. at 94 (“In the current crisis and in the East Asian crisis before it, too many people, especially regulators and investors, were outsourcing their responsibilities to the ratings agencies.”).

79 Luchetti, supra note 63; see also supra text accompanying notes 71-72.

80 IBM Proxy Statement, supra note 64.

81 SAP is based outside the U.S. so that new standards in governance for U.S. companies would not impact it. Nevertheless, this is an example of where there needs to be more accountability for an avoidable poor outcome, at least if it impacted those outside the ranks of the company and its shareholders.

82 Robins, supra note 13, at 12.
Even if one disagrees as to these specific items, this author believes that proper guidance requires promulgation of some sort of list of occurrences which may trigger liability. Intentionally omitted from this list are large operating losses. As noted, it is essential that any change in law take heavily into account the need to avoid discouraging new business start-ups and innovation by existing businesses.\(^{83}\) Since both of these things are often associated with large losses, both at inception and when the ‘best laid’ plans fail, it is imperative that no one be punished as a result of their efforts to innovate, even if doing so involved a good deal of risk taking.

6. *To What and Whom Should the Standards Apply?*

One should also question where any new standard should be applied. Should new standards apply only to publicly traded companies or to all companies?\(^{84}\) If applied only to public companies, should there be a size threshold?\(^{85}\) If so, should it involve assets, revenues, stock value, number of employees, number of shareholders or something else?

This author believes that any new standard should be applied to all companies, public or private, that have sufficient connection to the rest of the economy, to the extent that their impending demise would necessitate significant government assistance or would have significant effects outside their shareholders and employees. In a rudimentary effort to be more specific,

\(^{83}\) The author agrees with Professor Stiglitz that it is essential to distinguish between real innovation manifested in new products, and the sort of sophistry which passed for innovation in the financial sector. STIGLITZ, supra note 11, at 114: “The sad truth is that in America’s financial markets, innovations were directed at circumventing regulations, accounting standards and taxation . . . . No wonder then that it is impossible to trace any sustained increase in economic growth (beyond the bubble to which they contributed) to these financial innovations . . . . It is hard to point to any clear link, for instance, between ‘financial-sector innovations’ and increased productivity.”

\(^{84}\) Indeed, there is a real question as to who should enact the new standard. In the U.S. corporate law is almost exclusively state law, so the ideas contained in this Article would need to be enacted by state legislatures, presumably beginning with those in the states of greatest commercial significance, such as Delaware. While one could argue, and a prominent corporate governance authority has argued, for a federal corporation law to expedite this process, Marty Robins, *Require Affirmative Proof in Specified Circumstances of “Too Big to Fail Companies” in Order to Meet the Business Judgment Rule*, CorpGov.net (Apr. 22, 2010), http://corpgov.net/?s=%22marty+robins%22+and+%22outcome-oriented+model%22, there is little reason to believe that this is feasible during the lifetime of any reader of this Article. For such action to make economic sense and not unduly burden the business community, it would need to be coupled with action at the federal level.

\(^{85}\) There is current precedent for distinguishing between public and private companies when setting standards for external conduct, specifically with respect to accounting standards. In Bruce Pounder, *Private-Company GAAP: Setting the Right Goal*, CFO (Dec. 10, 2010), http://www.cfo.com/article.cfm/14544186, there is an extensive discussion of the emerging movement to have different accounting standards for public and private companies and the reasons why this makes sense.
he proposed that this would encompass regulated financial firms and other firms with total assets exceeding $50 billion or total obligations, broadly defined to include notional value of derivative securities based upon its common stock, exceeding $100 billion.86

There is no magic associated with this effort and it is in need of substantial refinement. Significant consideration must be given to the determination of where the new standard should apply, so that we tailor it to those firms which have the most significant interconnections to the rest of the economy. Professor Hal Scott of the Harvard Law School argues persuasively that the extent of interconnectedness is not well known, but likely to exist outside the traditional financial sector:

If large losses by institutional investors and other stakeholders are the real reason why we are concerned with interconnectedness and ‘systemic risk’, then we would have to regulate all large global corporations, not just financial ones, whose failures could trigger similar losses — an impossible task . . . . Clearly we need to know far more about the facts of interconnectedness . . . . Congress, as part of its reform legislation, should mandate the creation of a new expert commission designed to fully investigate the extent and consequences of interconnectedness before any new regulation of systemically important institutions is actually adopted.87

This author disagrees with Professor Scott that it is impossible to impose a new standard outside the financial area. However, he strongly endorses Professor Scott’s call for a proper study to identify where such standard is most needed. Whatever mechanical approach is used, it is important to acknowledge that there are some firms which have such external significance that a pure laissez faire approach to their governance can no longer be justified. Governance luminaries such as James McRitchie, the principal of the renowned governance site corp.gov.net, argue that this approach of targeting enhancements in governance obligations is insufficient,

86 In the Dodd-Frank Act, see supra note 7, Congress provided that bank holding companies with more than $50 billion in assets (and sought to define other systemically important firms) are "systemically important," but actions of the Fed and Financial Stability Oversight Council ("FSOC") have cast doubt on whether such standard is definitive even for banks under Dodd-Frank. Systemically Confused, WALL ST. J., Apr. 12, 2011, at A14. "[N]owhere in the draft rule [of the FSOC] did it say how large is large, how much is too much leverage or what exactly 'interconnectedness' means."

87 Hal S. Scott, “Do We Really need a Systemic Regulator?, WALL ST. J., Dec. 11, 2009, at A21. The regulatory confusion over who is systemically important noted in the preceding footnote underscores the need for the study suggested by Professor Scott.
and that it is needed ‘across the board’. This author respectfully disagrees and invokes the infamous Disney case as an example of where no enhanced obligations are needed.

This case involved a claim by Disney shareholders against former officers and directors. The shareholders alleged that the directors’ actions in entering into and performing an employment agreement and severance contract with a former executive constituted, inter alia, a breach of the duty of care discussed above which was at issue in Citigroup.

Making such a claim superficially appealing is the fact that the executive received an amount of cash and stock exceeding $100 million, despite having worked at Disney for slightly more than one year and not being recognized as a major contributor to the company’s results during such tenure.

The court found in favor of the defendants with respect to all claims involving the duty of care, despite its disdain for the manner in which the situation was handled. The court applied the business judgment rule, with its strong presumption in favor of board decisions to make clear that so long as directors are properly informed and act in good faith, the “content of the board decision” is not subject to review, even if it is deemed to be “stupid,” “egregious,” or “irrational.” This led the court to hold that while the directors’ conduct fell far short of “best practices,” it did not breach the duty of care.

One can argue that the director conduct in Disney cries out for improvement to the same extent as the director conduct which contributed to the financial meltdown. While this may be true, the critical difference is that the extravagant payments did not have any material impact beyond the Disney Company. We simply did not see the sort of interconnection between Disney and anyone else to cause large scale economic fallout of the sort we witnessed in 2008. As such, the result is a good one for this case and there is insufficient justification for new rules applicable to such cases, which may impede the sort of risk-taking which is needed to drive job creation.

Apart from the empirical considerations discussed above, the political obstacles associated with any change of this nature, persuade this author of the merits of targeting any legal changes only to those firms where there exists the
But what behavior is to be targeted? As noted above, the business judgment rule encourages risky behavior by all firms, as a result of its emphasis on process and express disregard for outcomes, as a means of encouraging entrepreneurial activity. This makes sense for firms lacking systematic importance, but not otherwise. Thus, it is suggested that for firms meeting the criteria noted above, the business judgment rule be suspended by state legislative action. This would require that officers and directors be affirmatively presumed to have breached their duty of care, to affirmatively prove otherwise, when any of the specified adverse events occur. Additionally, this would entail reversal of the present strong presumption in favor of such persons when there is a challenge to the manner in which they have carried out their duty of care to the firm. To mitigate the risk aversion associated with such change, it may be sensible to introduce procedural safeguards such as a short statute of limitations, attorney fee shifting for unsuccessful claims of this nature, and limited director/officer insurance.

More importantly, in order to keep the focus on actual corporate decision-making, these changes should be accompanied at the federal level, by substantial relaxation of compensation-related regulation, both with respect to disclosure and recoupment. This would entail among other things, repeal of Sections 951-954 of the Dodd-Frank law and elimination of all SEC proxy rules requiring disclosure of non-cash compensation, and streamlining of those pertaining to stock options and other equity-based items.

If boards and management are properly serving shareholders and other pertinent constituencies, and not creating inordinate risks to the economy, this author’s somewhat radical assessment is that their remuneration is unimportant. However, if the opposite is true, their exposure should go far beyond their pay, but should reflect in some manner the damage they have caused. It is time to abandon the notion that so long as proper process and

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92 See supra notes 48-54 and accompanying text.
93 See supra note 82 and accompanying text.
94 See supra note 48 and accompanying text.
95 Since U.S. corporate law is left to the states, but securities regulation is mainly a federal matter, the actions which are suggested herein would require action at both levels. The modification of the business judgment rule would have to happen in Delaware and other major commercial states, while the repeal of the superfluous provisions of Dodd-Frank would have to come from Congress and the SEC.
disclosure are utilized in the business world, society will be well served. We should acknowledge that our economy is in its current state of affairs because of some truly horrible business decisions made by officers and directors acting in good faith. One way or another, we need to take steps to prevent such bad decisions from recurring.

When Congress, acting in the immediate aftermath of the financial meltdown, does nothing about governance other than address executive pay and board composition and, as noted in the Citigroup discussion, no one who made the horrible decisions is held responsible for them, it sends a message to all concerned — management, investors, employees, legislators — that there is no real accountability. In more practical terms, it also diverts scarce resources of investors, advisors, and companies from addressing the ultimate issue of performance, to the peripheral matters of justifying, disclosing and contesting remuneration. One can make a strong case for the part of Dodd-Frank that allows proxy access for minority holders as being part of improved governance, in that it facilitates the removal of poorly performing directors. However, the other provisions which purport to fit in this genre are misguided. Perhaps it is a heretical notion, but if someone is doing a good job of running their firm and avoids the risks that have laid low our economy for so long, there is no reason to begrudge them or even concern ourselves with their pay. If someone is doing the opposite and puts our society at risk of disaster, it is of no comfort to this author that their pay is “in line with the companies’ peer group” or even zero. There must be a way and an incentive to stop the problematic behavior before it manifests itself.

V. RE-ENGAGING BOARDS — REAL GOVERNANCE

To render these changes meaningful, boards need to ensure they understand and intelligently evaluate and where necessary, object to, business strategy long before making personal behavior an issue. This is not to condone sexual harassment or similar behavior, but is to state that it does not present the economic or social risk that a flawed business strategy would, and that scrutinizing personal behavior must not be a high priority of boards. In order to do this, directors must possess the appropriate body of knowledge about the firm, its industry, and economics and finance in general before they are elected.

This means that we must consign to the economy’s trash heap those ‘old boy boards’ (where a principal qualification is having a golf handicap higher than that of the CEO or having children in the same school as the CEO’s children). Yet, it also means that directors installed through the new

96 See supra note 48 and accompanying text.
97 Although doing so after the fact and without financial consequences, dilutes the benefit.
proxy access rules must have real business expertise. They should not view themselves as the voice of labor, the downtrodden, the environmental movement or some other limited constituency. It likely requires formal training in many cases.\(^98\)

This also means that boards must be engaged with management on an ongoing basis to see if ‘ordinary course’ activity is taking on a different connotation, despite there not being on the table any M&A activity, major financing or the like.

More importantly, they must take some action when they have reason to believe that something is seriously amiss. Of course “some action,” whether simply a raised eyebrow in a board meeting, an off-the-record chat with the CEO to express concerns over the strategy being pursued, voting ‘no’ when the matter comes on for formal consideration, removing the CEO, or resigning if none of these things is possible or effective, depends on the circumstances.

To be sure, we are only addressing situations where there is a risk of grave harm to the organization with material external implications as well. However, even then, it would rarely make sense to demand that the most onerous alternative be immediately pursued. From this author’s own experience, there are many situations when well meaning managements have lost perspective, and are likely to recover it and reverse course, with a gentle nudge from their colleagues or superiors.

Where this is not the case, more drastic action would be required. Even where it is taken, it may be ineffective at preventing the harm, but those who have taken it — e.g., board members voting ‘no’ or firing a miscreant CEO — would avoid liability if they can demonstrate they took the action at a time which was reasonable under all existing circumstances.\(^99\)

No legal standard will ever avoid all harm. However, what must change is the passivity of boards and officers which we have witnessed in recent years in the face of decisions and courses of action which were palpably questionable at the least. Observers ranging from Professor Blinder to New York Governor (and formerly Attorney General) Andrew Cuomo have lamented the need to overcome this passivity. Professor Blinder succinctly notes: “Quite plainly, many [boards] were asleep at the switch, with disastrous consequences.”\(^100\) Governor Cuomo, when speaking of the Merrill Lynch

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\(^98\) See Martin B. Robins, Directors Elected through Proxy Access, CORPGOV.NET (July 1, 2010), http://corpgov.net/?p=2276 (arguing for formal training for such directors before they are seated); see also supra text accompanying note 46 (arguing that lack of expertise regarding their companies’ business is a major reason why directors are not holding management accountable for poor decisions).

\(^99\) It would be for the trier of fact to determine whether the substance and timing of the response were reasonable under the circumstances taking into account the shifting of the burden of proof as part of the suspension of the regular business judgment rule.

\(^100\) Alan Blinder, Crazy Compensation and the Crisis, WALL ST. J., May 28, 2009, at A15.
episode, said that he “wonders broadly where the boards were in this financial crisis and whether [Bank of America] directors ‘protected the rights of shareholders, were they misled, or were they little more than rubber stamps for management’s decision-making?’”\(^{101}\)

A close observer of the realpolitik of Wall Street, Charles Gasparino of Fox Business News and formerly of CNBC, was quite blunt about the inadequate role of boards in Wall Street firms which were at the epicenter of the financial meltdown. Of Lehman Brothers and its CEO, Richard Fuld, he said: “His board of directors remained silent as his risk taking grew.” Of Bear Stearns and its CEO, James Cayne: “… the board barely debated the firm’s risk taking . . . .” And his assessment of Merrill Lynch and its CEO, Stanley O’Neal: “His board was clueless.”\(^{102}\)

An eyewitness to the Merrill episode, John Thain, who was Merrill’s CEO at the time it was forced to combine with Bank of America, explains the role of ignorance in creating its plight: “There is no chance that pretty much anybody understood what they were doing with these securities. Creating things that you don’t understand is really not a good idea no matter who owns it.”\(^{103}\) Such ignorance by management and its disregard by boards can no longer be tolerated. Boards must understand material strategies themselves and ensure that managements have done likewise or take meaningful action.

Given the need for substantial change in boards’ historical passivity, any new rules which are adopted should give the benefit of the doubt to boards when evaluating the behavior of boards who do take meaningful action where they do have reason for concern. As noted, we must always be cognizant of avoiding excessive risk aversion which will inhibit employment. In view of the current culture of passivity, this means not letting our desire for a perfect response overshadow a ‘good’ response which fails to prevent the harm. Of course, even if a board is deemed to have properly discharged its duty of care in unsuccessfully addressing flawed business policy pursued by management, this would not absolve those in management who directly pursued such policy from any liability which otherwise exists.

VI. PROPER DIRECTOR BEHAVIOR

Some boards seem to ‘get it’ as to their role and focus. An example of


a board engaging with a CEO on the appropriate level is found in the case of MPG Office Trust Inc. (formerly known as Maguire Properties). In this case, the company’s CEO left the company as a result of disagreements with the board over strategic issues such as “raising equity, selling properties, and whether the company should be put on the block,” prompting the CEO to state in a letter that there was no shared “common vision for the strategic direction” of the company.104 While it is obviously inappropriate to comment on the merits of either side on these issues, it is clear that the board was looking at the right things in order to determine whether the CEO was on the right track. It is quite revealing to contrast this level of engagement with the concern with tawdry CEO behavior, instead of strategic issues, we saw from the HP and Tribune boards.

Another recent example of proper director engagement is found in the resignation of a Chiquita Brands International director, Durk Jager. In his resignation letter he stated:

The Company faces declining revenues, deteriorating profits, and a severe drop in its stock price. I have lost the confidence that we have the strategies and plans that can reverse this situation. Chiquita also lacks the capabilities to address basic operational requirements for a sound business.

The fact that Management did not want or could not respond to a request for a realistic 2011 forecast six weeks prior to the start of the new fiscal year is simply one such illustration.105

Again, there is no way to know for sure who is right on the merits, but Mr. Jager is motivated by the appropriate concerns. One wonders why he is seemingly the only Chiquita director acting in this manner.

While it appears that these boards were engaged at the appropriate level, it is essential that if the new standards are adopted in any form, that boards resist the urge to become overly involved with genuine day to day matters, not presenting significant systemic risk.106 Even today, this author has encountered several notable examples of boards undermining management by engaging with subordinates and addressing routine business matters, where the company is clearly not at risk of implosion. If a board feels that management is not capable of keeping the company out of serious trouble or generating appropriate returns on capital, it needs to install new management.

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104 A.D. Pruitt, Dispute with MPG Board Preceded CEO Exit, WALL ST. J., Nov. 24, 2010, at C6. The subheading of this article is also instructive: “Conflict was Focused on Best Way to Improve Embattled Company’s Fortunes.”


106 See Pozen, supra note 57, at A15 (“[T]he board is not supposed to get involved in day-to-day company management.”).
— not look over the shoulder of existing management every day. Even where a board or board member has reason to doubt the wisdom of a particular decision, intervention to reverse it will be counterproductive. This wastes time and undermines management authority, and is counterproductive unless the matter truly is of dire import. The standards which are suggested here are intended to be used judiciously to forestall catastrophe, and not to change the historical roles of directors and management.

Congress, like Professor Stiglitz, was correct in its recognition that poor governance has done serious damage to our economy and that corrective action is needed. It was correct to make the topic a key part of the Dodd-Frank law. However, the law which was enacted skirts around the periphery of the topic. It is at best, irrelevant, to the need for better decisions, and, at worst, detrimental to this cause if it causes people to believe that no further action is needed.

CONCLUSION

What we see in the wake of the law, with the SEC and boards going off on tangents involving pay, personal behavior, identity of decision-makers and insider trading, while ignoring fundamental matters, confirms the fear that we have not actually improved governance and prompts these sentiments. Knowledgeable observers can and should disagree about appropriate steps needed to augment Dodd-Frank in the governance area, but it is past time to begin that discussion. To do so, we need real dialogue about the genuine nature of governance.