



# Side BAR

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## OPENING STATEMENTS

### Message from the Chair William Frank Carroll



As the new chair of the Federal Litigation Section, I hope you enjoy this issue of our award winning newsletter, *SideBAR*. I know you will find the many articles of interest in your daily practice.

I also want to acknowledge the excellent work of my predecessor as chair, Shelline Bennett of Fresno, Calif. Under her leadership during this past year, the section has grown to over 3,000 members and we have continued to expand our informational and educational services to the members of the section and of the Federal Bar Association.

The section leadership has several new activities planned for the coming year. Among the items under consideration are CLE webinars, one all day CLE program and several joint programs with local FBA Chapters. We also plan to continue our CLE presentations at the Annual Meeting and are considering having a section breakfast or dinner at both the Annual and Midyear Meetings.

Of course we will continue to publish *SideBAR* under the excellent leadership of our editor (and section vice chair), Rob Kohn. I would encourage each of you to consider writing an article for *SideBAR*. Please contact Rob if you have an interest in

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### Editor's Notes Robert E. Kohn



Returning to Capitol Hill this spring with other FBA members, we learned that the Administrative Office of the U.S. Courts has requested a budget for court operations in FY 2013 that includes a small increase over FY 2012. The FBA supports this request. We also support the White House and the Senate acting to fill each of the many vacant judgeships throughout the country. But like any case, proving the need for such action requires evidence. Would you please help the FBA's Government Relations Committee to marshal the evidence now? Concrete examples of delay or other problems in the rendition of justice or court services—and the consequences for our business and citizens—are the best evidence. I hope you will share those examples with Bruce Moyer, the FBA counsel for government relations, at [bruce@moyergroup.net](mailto:bruce@moyergroup.net).

Judges in North Carolina will gather on May 31, 2012, to welcome visiting members of the judiciary from across the country who are joining to teach and learn at Duke Law School. The evening will mark the inaugural class of post-graduate legal education, offered exclusively for active bench officers, at the Center for Judicial Studies at Duke. Please save the date of May 31, and watch your inbox for further details.

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## BRIEFING THE CAUSE

### Patent Reform's "America Invents Act" Invents Major Changes for Patent Litigation

By T. Earl LeVere

On Sept. 16, 2011, President Obama signed into law the Leahy-Smith America Invents Act of 2011. The America Invents Act encompasses the broadest and most-substantial revisions to the United States Patent Act in over half a century. While the better part of the changes occasioned by the America Invents Act, and most of the press reporting on them, deal with patent prosecution (i.e., application and registration) issues, the America Invents Act will bring about substantial changes to patent litigation as well. Although it is impossible to address all of these items here, a few revisions merit special mention, insofar as they will impact both the strategy and timing for initiating a lawsuit for patent infringement, and will require patent litigation defendants to revisit their defense practices as well.

Some of the Act's amendments that are most noteworthy from a patent-litigation plaintiff's perspective include: switching from a "first-to-invent" to a "first-to-file" system; creating a nine-month post-issue patent review period; and limiting claims for "false marking." From a defendant's point of view, the America Invents Act accelerates when certain prior art can invalidate a patent, changes in the relevant timing for obviousness determinations, eliminates the "best mode" defense, and extends the "prior commercial use" defense to all types of patents. Obviously, this "plaintiff issue" vs. "defendant issue" distinction is somewhat artificial and offered primarily to organize this discussion. Each of the items discussed here will be extremely relevant to any patent litigant, regardless of the side of the "v." on which it finds itself.

The most widely publicized feature of the America Invents Act is the transition from a "first-to-invent" system to a "first-to-file" (technically, a "first inventor-to-file" system). Historically, and unlike many foreign countries, the United States awarded a patent to the first inventor who filed an application on the technology within the period allowed under the statute. This "first inventor" would secure the patent over another person who had later independently invented and reduced the advancement to practice, even if the later inventor applied for his or her patent before the first inventor. Under the new system, which will take effect in March 2013, as between two individuals who devised the same invention, the inventor who files a patent application first will secure the patent.

Certainly, this change will impact the patent application process more widely and profoundly than it will impact litigation. Nevertheless, the change will also cascade into patentees' litigation practice, insofar as the change will impact the enforceability and validity of the patent at issue. A defendant who can successfully prove that another person first filed an application covering the asserted technology will be able to defeat the plaintiff's patent rights. Most importantly, proving that another person filed a patent application before the plaintiff will be far easier than proving that someone else actually "invented" the technology at issue before the plaintiff.

Additionally, effective September 2012, the America Invents

Act will implement a nine-month "post-grant review" period. During the nine months after a patent issues, any third party may petition the U.S. Patent and Trademark Office to review the patent's validity. The third-party may seek review of the patent on any grounds of patentability, and the Patent Office will grant the requested review if the petitioner demonstrates that if the proffered information "would demonstrate that it is more likely than not that at least one of the claims challenged in the petition is unpatentable."

This "post-grant review" process will impact patent litigation directly and immediately. A patentee asserting a newly issued patent will have to decide strategically whether to commence suit during the nine-month post-grant review window, or wait until after the time expires. Waiting has the clear benefit of avoiding the Patent Office's post-grant review process entirely, and forces a defendant to challenge the validity of the patent either administratively through the also-new "inter partes review" process (which will replace the current *inter partes* reexamination process and standard of review) or in court through traditional invalidity defenses, which the defendant must generally prove with "clear and convincing evidence." Waiting, however, can give rise to laches or estoppel defenses and will most likely preclude the plaintiff from obtaining a temporary restraining order or a preliminary injunction, which, in many cases is a primary objective for the claimant.

Third, the America Invents Act limits a plaintiff's ability to bring a claim for "false marking." Section 292 of the pre-September Patent Act prohibits individuals and companies from intentionally and deceptively marking or advertising a product as "patented" or "patent pending" when it is not patented or when no application for a patent on the product has been filed. Section 292 allows a civil *qui tam* cause of action against anyone who violates the section. Under recent cases, the damage award for the claimant, even after splitting the award with the United States government as required by Section 292(b), can be significant. Finally, under the pre-amendment Section 292(b), "any person" could sue for false marking.

Attacking the cottage industry of false marking claims that emerged as a result of these recent cases, the America Invents Act now only allows competitors, or one who has suffered an actual competitive injury as a result of the false marking, to maintain a claim arising out of the offense. In addition to attacking free-standing suits for false marking initiated by non-competing entities, the amendment also serves to limit and defendant's ability to bring a counterclaim for false marking in a patent infringement suit. Now, only a defendant who has suffered an actual anti-competitive injury as a result of the alleged false marking may maintain the claim. This statutory limitation of the standing to bring false marking claims took effect immediately upon the enactment of the America Invents Act.

From a defensive point of view, the America Invents Act significantly revamps the timing when certain prior art will invalidate a prior art. Specifically, under the amended statute, many items that would only invalidate a patent if they preceded

## ***Historians as Experts, Consultants, and Corporate Designees: Help for Your Litigation*** **By Emily Greenwald, Patrick O'Bannon, and Keith Zahniser**

### ***Historical Methodology***

Historians seek to explain what happened in the past and why. They use a wide range of evidentiary sources, both primary and secondary, which they analyze in relation to one another and in relation to the larger historical contexts in which the sources were produced.

Primary sources are those records created in the past, during the period one is investigating, while secondary sources are written after the events they describe. David McCullough's biography of John Adams is an example of a secondary source, while the letters that John and Abigail Adams wrote to each other are primary sources.

Both types of sources have biases—there is no such thing as a wholly objective, non-biased source. But historians are trained to evaluate sources and identify their inherent biases. Secondary sources may be biased to reflect and support the writer's goals and intentions. They may also be biased in their selective use of sources, or by a lack of sources. Primary sources reflect the same types of biases as secondary sources. Newspapers, a type of primary source, clearly reflect the editorial policies of their owners in terms of their approach to the stories they cover.

Historians generally subscribe to the idea that "the past is a foreign country."<sup>1</sup> They assume that people's attitudes, motivations, and culture change over time, just as technology, politics, and the economy change. To properly understand the documents people left behind, historians must understand how those people viewed the world. Their perceptions, expectations, and biases are embedded in the material they produced, and historians are trained to filter out these biases to get a clearer picture of what actually happened. This requires understanding the culture, politics, and economy of the time period in which the primary sources were produced.

In research for litigation, historians emphasize primary sources. Key categories of primary sources include published and unpublished written sources, visual sources such as photographs or maps, material sources like buildings or the physical landscape, and quantitative sources such as census or production data.

Correlations among disparate sources give historians a higher degree of confidence that they have figured out what happened. Historical methods are particularly valuable for litigation where there are few or no living witnesses or where a present-day legal issue has a "long tail" into the past. But they are also useful for understanding the relatively recent past and can help complement the testimony of fact witnesses.

### ***Benefits of Historical Experts***

In litigation turning on events in the past, trained historians offer skills and experience especially useful for meeting the

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<sup>1</sup>This phrase comes from a 1953 novel by L. P. Hartley. The full quotation is, "The past is a foreign country: they do things differently there."

challenge of thoroughly researching a case. The most important information is unlikely to be online, so someone will have to go to repositories to search for historical records. The National Archives system, for example, holds 10 billion paper records, and they add 1.4 billion records to their collection each year. They have only digitized a minute percentage of these holdings. Simply put, someone has to determine which repositories hold relevant historical records and then conduct research in these collections to ensure that documents pertinent to the case are identified and collected.

Once at a repository, the researcher will need to utilize finding aids (guides and indices prepared by archivists) to locate potentially pertinent records. Finding aids are often incomplete or vague and are almost never uniform across different collections of material. Professional historians are knowledgeable about the organization of archival records and know from experience how to negotiate the gaps in finding aids.

There is a "law of diminishing returns" in historical research. Researchers will often find a lot of information in initial efforts (if they know where to look) but will then reach a tipping point where more and more time is needed to find less and less material. In order to ensure that the research continues to be productive, professional historians use clues from documents already collected to locate other relevant documents, and they understand the need for patience and persistence in conducting a due diligence search.

### ***Key Repositories***

The National Archives, Federal Records Centers, and the Library of Congress are key starting points for historical research for litigation.

The National Archives and Records Administration (NARA) has two main repositories in the Washington, D.C., area, and it has regional branches throughout the country. It keeps records of the federal government that warrant permanent preservation for their historical or legal significance. The records that meet these standards are determined by each federal agency's records retention protocols. Only 1 to 3 percent of records produced by federal government agencies are actually preserved each year. NARA generally receives permanent documents when they are 30 years old or older.

Federal Records Centers (FRCs) are located throughout the country. These repositories act as a halfway house between federal agencies and the National Archives. Unlike the archives, which are open to the public, records at an FRC are still controlled by the sending agency, which means permission must be secured from the sending agency to view them. Records at an FRC have not yet reached their final disposition: they may be recalled by the sending agency, slated for eventual destruction, or be accessioned into the archives and become accessible to the public.

The Library of Congress (LOC) holds an enormous variety of material. Records of particular use for litigation include Sanborn insurance maps, historical city directories, corporate annual reports and other publications, historical newspapers, and trade journals. Corporate financial history—including mergers, subsidiaries, and current viability—may be researched in LOC financial databases,

### *Historians continued from page 3*

credit reference books, and guides to obsolete companies.

Other useful repositories include state archives, state and local historical societies, and county courthouses. State and local archives preserve records created at the non-federal level and are often an invaluable source of information. State and local historical societies hold written histories, documents generated by local government, historic maps and photographs, newspapers, and private and corporate papers. County courthouses hold land records, tax records, and genealogical information.

University libraries can also be valuable for historical research related to litigation. They hold government documents, technical literature, newspapers, and other source material. Their special collections departments often have extensive local history holdings, as well as corporate and private papers.

#### **Proving a Negative**

Historians are sometimes asked to conduct research to prove a negative, to demonstrate that a set of conditions did not exist in the past. It is impossible to prove a negative, since the proof lies in the absence of any information indicating otherwise. For example, to prove that a corporation or its officers did not know at a particular point in time that a specific industrial process generated hazardous materials requires a document from that period stating that they did not know this to be the case. In the absence of such a document, the issue of prior knowledge remains, to some extent, unresolved.

A historian can, however, build a compelling case to prove a negative by assembling a persuasive body of evidence. To do so requires extensive research in a wide variety of sources. The research effort must be directed towards demonstrating that the absence of evidence to the contrary supports the conclusion. This is analogous to searching for a needle in a haystack. Simply rooting around the edges of the stack and not finding the needle does not prove that there's not a needle in the haystack. Searching the whole haystack is a time-consuming process and may be costly, but the effort can pay off by enabling the historian to argue convincingly that the absence of evidence proves the point.

#### **Working With Historical Experts**

When an attorney and a historian begin working together, the

attorney should explain the legal issues at stake. The historian needs to know the attorney's theory of the case in order to be an effective partner in advocacy. This will help the historian to avoid language that might be problematic and to alert the attorney to evidence that supports or runs counter to the attorney's theory.

The attorney should also explain the evidentiary standards the courts have set in that particular area of law. Historians with experience working in that area should already be familiar with these standards, but it is still a good idea to talk about any recent or pending decisions that might be relevant. The attorney and historian should discuss where the case is in the legal process and what deadlines the court has set for discovery, exchange of reports, deposition, and trial. Because historical research can take time, it is beneficial to retain a historical expert at the beginning of the process, rather than waiting until discovery is nearly over.

Historians can support attorneys in ways other than by providing expert testimony themselves. For example, they can prepare historical contexts, legislative histories, policy histories, and other reports that attorneys can draw from when preparing briefs. Historians can also assist experts from other disciplines by collecting relevant records and helping them develop historical narrative for their reports. Finally, historians can help attorneys with the review of opposing experts' reports. A skilled historian can thoroughly vet an opposing expert's use of historical information, identify repositories and information that the opposing expert did not consider, and assess the soundness of secondary sources on which the expert relied. **SB**

*The authors Emily Greenwald, Patrick O'Bannon, and Keith Zahiser are historical consultants who hold Ph.D. degrees in history. Dr. Greenwald is a vice president and manages the history division of Historical Research Associates Inc., a history and archaeology consulting company based in Missoula, Mont. Dr. O'Bannon is the senior manager of the history and architecture group at Gray and Pape Inc., a cultural resources management consulting firm headquartered in Cincinnati, Ohio. Dr. Zahiser heads Historical Research Associates' office in Washington, D.C. The two firms have a joint venture partnership, HRA Gray and Pape LLC, with offices across the country.*

### *Chair continued from page 1*

preparing an article. His email is rkohn@kohnlawgroup.com.

I hope you will also note on your calendar the FBA Annual Meeting and Convention in San Diego (Sept. 20-22, 2012). If you have never attended one of these meetings, I would encourage you to do so. There are always a number of excellent CLE programs available along with opportunities to visit with fellow federal practitioners from across the country.

Finally, I would encourage you to become active in our section's and committees' activities and programs. If you are interested in becoming involved, please contact me at any time at fcarroll@coxsmith.com or 214-698-7828. **SB**

#### **About the Chair**

*William Frank Carroll is a member of the Trial and Appellate Sections in the Dallas, Texas, office of Cox Smith Matthews Inc. He concentrates his trial and appellate practice in the areas of antitrust, class action, securities, white collar criminal, and intellectual property litigation in the federal courts and is Board Certified in both Trial and Civil Appellate Law. He is also an adjunct professor of law at Southern Methodist University, where he has taught Antitrust Law, Federal Courts, Complex Federal Litigation and Trial Advocacy. He can be contacted at fcarroll@coxsmith.com.*



## FEDERALLY SPEAKING

### *The Eastern District of Texas Lays the Ground for More Expansive ESI Discovery Sanctions*

By Krista Fowler Acuña

In the years following the landmark decision of *Zubulake I* in 2004, few would argue that the preservation and discovery of electronically stored information (ESI) is serious (and expensive) business. Since then, we have seen the 2006 revisions to the Federal Rules of Civil Procedures, the eye opening 2008 decision in *Qualcomm*, and more recently in 2010 the “big three” ESI decisions of *Pension Committee*, *Rimkus Consulting*, and *Victor Stanley*. Despite the gravity of these key cases, and the swift development of the law and procedural rules governing ESI preservation and discovery, there remain lessons to be learned by federal practitioners and corporations alike regarding the practices and procedures in place to effectively and seriously address ESI obligations. Further, the nature and extent of sanctions which can be ordered by a court continue to evolve post-*Zubulake*. New on this forefront is the scathingly well written ESI sanctions order by Hon. T. John Ward of the Eastern District of Texas in *Green v. Blitz*, 2011 WL 806011 (E.D. Tex. March 1, 2011), currently on appeal to the Fifth Circuit. It not only reminds us that ESI obligations must be taken seriously— or risk suffering the consequences; but also forges new ground in world of sanctions. What makes *Green* slightly different than the post-*Zubulake* norm, and therefore worth following, is that discovery violations came to light well *after* the case was tried and settled, thereby leaving the court with the task of fashioning appropriate sanctions in a closed case. The lessons to be learned from this case teach us that the end of a lawsuit may not be the end where ESI discovery violations are concerned, and that a court may be able to sanction a party in ways that affect other (even unrelated) pending and future litigation.

The lawsuit involved in *Green* was a garden variety products liability case involving fairly basic ESI discovery—namely emails and electronically stored documents such as company memos. The *Green* lawsuit was one of several that had been filed alleging that a gas can manufactured by Blitz was defective due to the lack of a flame arrester. Blitz’s primary major defense was that a flame arrester was not included on the gas can because flame arresters are ineffective. A jury returned a unanimous verdict against the plaintiff, resulting in a settlement at the low end of a high-low settlement agreement entered into by the parties prior to verdict. The case was subsequently closed in 2008. Nearly a year after the trial, in a related case in the Western District of Texas, counsel for *Green* learned of documents that directly related to the issue of flame arresters but which were not produced in the *Green* case. Plaintiff filed a Motion for Sanctions in February of 2010 (a year and a half after the *Green* case was closed).

An examination of not only the ESI at issue in *Green*, but also Blitz’s internal “procedures” for handling ESI, is important to emphasize how easily significant sanctions can arise from the most basic of failures—failing to take ESI obligations to preserve and produce seriously from the beginning. In fact, *how* Blitz con-

ducted its discovery was the primary failure highlighted by the court. Blitz had a single employee, Larry Chrisco, responsible for searching for and collecting documents relevant to ongoing litigation against Blitz. Chrisco worked in the product development department and was also Blitz’s corporate representative at trial. Chrisco, Blitz’s agent for gathering discovery, was a self-described “face-to-face” guy who admittedly was “about as computer [sic] illiterate as they get.” In carrying out his duties to conduct discovery, Chrisco would educate himself about the types of document that were relevant and then talk to the departments and/or individuals he felt were likely to have those documents. He did not however, institute a litigation hold of documents, do any electronic word searches for emails, or talk with the IT department regarding how to search for electronic documents.

This lack of effort to identify, preserve and produce relevant ESI on flame arresters resulted in 10 indisputably relevant documents being withheld during the *Green* litigation, three of which were the most damning and highlighted by the court. The first was a 2005 memo from the former CEO to Chrisco that discussed developing a device to eliminate flashback from a flame source. The second was an email entitled “flame arrester” in the subject line and discussing its viability. The third was a development team meeting memo noting “exit gas can for 3-5 years, develop other business, and re-enter w/lower liability [sic] and safer CARB product.”

The failure to produce these indisputably relevant documents was found to be a willful violation of the Court’s Discovery Order and a breach of Blitz’s duty to preserve. The court noted several very specific actions and inactions that were deserving of sanctions: (a) failing to institute a litigation hold; (b) IT department head asking and encouraging employees to routinely delete electronic documents during the pendency of multiple lawsuits; (c) rotating backup tapes every 2 weeks such that the old tapes were permanently deleted and deleted emails permanently lost; (d) failing to scrub servers until early 2009, nearly a year after the trial; (e) Chrisco’s failure to consult with the IT department so that the IT department could conduct word searches; (f) counsel’s failure to list certain of these documents on a privilege log in light of assertion at the show cause hearing that some of the subject documents were work product. The court held that all of these acts were reflective of a lack of effort or appreciation of the discovery process in general.

The sanctions instituted against Blitz included civil contempt sanctions, both monetary and non-monetary “purging” sanctions. Specifically, Blitz was ordered to pay *Green* a \$250,000 monetary civil contempt sanction. Additionally, and of particular interest, the court ordered a significant “civil purging sanction” that required Blitz to furnish a copy of the order to every plaintiff in every past lawsuit it had against it, or was currently proceeding against it, for the 2 years preceding the order; and the requirement that for the next five years Blitz file a copy of the order with its first pleading or filing in any new litigation

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in which Blitz appears (even as a non-party). The court's order arguably takes contempt "purging" sanctions to new levels, and for this reason alone makes it an appeal worth following.

The court's determination of the appropriate sanctions for Blitz's misconduct appropriately addressed the nature and extent of the misconduct, and responded to the need to compensate the *Green* plaintiff specifically and ensure that Blitz complied with future discovery obligations, reflecting its concern regarding Blitz's potential conduct in other past, present and future lawsuits. As to the monetary sanction, the court cited to its knowledge of the amount of the confidential settlement between the parties, clearly bringing plaintiff's recovery near or at the amount of the high end of the high-low settlement and as a result neither rewarding plaintiff beyond that which she was willing to take prior to verdict, nor rewarding Blitz for its misconduct. This equitable outcome was also the most efficient alternative to re-opening the case.

In support of the "purging" sanction the court cites solely to *Am. Airlines Inc. v. Allied Pilots Ass'n*, 228 F.3d 574, 585 (5th Cir. 2000), which holds generally that civil sanctions may be issued to coerce the defendant into compliance with a court's order. The sanctions in *Am. Airlines* did not even involve purging sanctions and is relied upon by the *Green* court in support of a general statement of law. Interestingly, however, the *Green* case was closed and there was no pending order in that case for Blitz to comply. The purging sanctions really acted as a double edged sword—coercion for *future* compliance in pending or future litigation, and punishment for potential *past* discovery sins that may have occurred in other cases. In short, the purging sanctions against Blitz in *Green* reflect a reaction to an overall pattern of obnoxious discovery behavior by Blitz that spanned multiple lawsuits (the court noted that Blitz had also been sanctioned with adverse jury instructions in 2 other flame arrester cases). In short, the purging sanctions issued against Blitz in the *Green* case arguably create an expansive "long-arm" type sanction for ESI-related discovery violations that extends well beyond the litigation from which the behavior arises. If the order is affirmed by the Fifth Circuit, practitioners should be aware and counsel clients accordingly that the failure to preserve and produce relevant ESI is a duty that must be taken seriously and addressed effectively from within and in coordination with litigation counsel via concrete processes and procedures. The failure to do so can result in result in sanctions not long after a case ends and just within the confines of related ongoing litigation, but effecting pending and future litigation. The impact on defense costs and litigation strategies for a client would be profound.

There are several basic lessons that should be learned from the errors committed by Blitz and its counsel in *Green*. Not only should Blitz have taken its ESI obligations much more seriously, but its counsel should have had a much more involved interaction with Blitz to guide it through the process and ensure Blitz was responding appropriately. A practical "to do" list to be taken from *Green* includes:

- Appoint the appropriate company representative(s) to liaise with litigation counsel;
- Include the IT department in order to suspend deletion programs, back up existing data, retain backup tapes, and conduct appropriately available searches of emails and documents. These are not the typical responsibilities of non-IT staff, and should not be delegated outside of IT.
- Always issue a litigation hold when litigation is reasonably anticipated. Update and supplement the litigation hold throughout the litigation. If an appropriately thorough job is being done, this will happen several times.
- Ensure not only that all employees receive the litigation hold, but that it is in fact read, understood and that employees are in fact taking action in response to same.
- Both outside counsel and company representatives should meet with IT to question and understand the company's preservation and retrieval systems, and seek IT's input regarding all means available to search for relevant documents and data.
- Counsel and company must work through this process in a detailed and intimate manner. Counsel must never assume the company has searched for documents, but now must understand and know *how* the company went about searching and that it did in fact conduct the searches, before certifying compliance with pretrial orders.
- Simple Lesson—put in the effort and take it seriously.

*Green* could create yet another profound ripple in the *Zubulake* pond, opening the door for broader, long-arm type contempt sanctions. Not only should federal practitioners be familiar with *Green* for the lessons it provides, but it is certainly one worth following on appeal to know if these serious sanctions are upheld.

*Krista Fowler Acuña is a shareholder of Houck Anderson in Miami, Fla.*



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## “Where Angels Fear to Tread”<sup>1</sup>: Electronic Discovery and the Role of the Keyword Mediator

By Daniel Garrie and Siddartha Rao

### I. Introduction

From the routine to the complex, litigation increasingly involves large-scale production of electronically stored information (ESI).<sup>1</sup> Yet electronic discovery is a field few fully understand. As Judge Easterbrook quipped in a related context: “If we are so far behind in matching law to a well-understood technology such as photocopiers ... what chance do we have for a technology such as computers that is mutating faster than the virus in *The Andromeda Strain*?”<sup>2</sup>

Today, the volume and types of discoverable ESI are “mutating faster than the virus in *The Andromeda Strain*.” In this environment, parties and counsel may find themselves unable to grapple with e-discovery obligations, resulting in increased costs and potential minefields for unwary litigants.<sup>3</sup>

Counsel faced with time and resource intensive e-discovery<sup>4</sup> can greatly benefit from keyword mediation, in which a mediator or special master with technological expertise cuts through this e-discovery thicket, reduces litigation costs, and resolves discovery disputes at the early stages. In short, keyword mediation lets counsel focus on litigating their case rather than e-discovery issues ancillary to the merits.

### II. Differences Between ESI and Traditional Evidence

The cost of e-discovery is “simply staggering,” because, “as compared to the old hard-copy days, nothing truly gets

<sup>1</sup>Milberg LLP and Hausfeld LLP, *E-Discovery Today: The Fault Lies Not in Our Rules ...*, 4 FED. COURTS L. REV. 4, 9 (2011) (noting that “it is largely during the last decade that litigators have seen discovery dominated by ESI, creating a veritable data deluge”) (paper presented at Conference on Civil Litigation sponsored by the Advisory Committee on Civil Rules), available at: [www.fclr.org/fclr/articles/html/2010/Milberg-Hausfeld.pdf](http://www.fclr.org/fclr/articles/html/2010/Milberg-Hausfeld.pdf).

<sup>2</sup>Judge Frank Easterbrook, *Cyberspace and the Law of the Horse*, 1996 U CHI LEGAL FORUM 207 (1996).

<sup>3</sup>E-Discovery: Mitigating Risk Through Better Communication, available at: [www.deloitte.com/assets/Dcom-United-States/Local%20Assets/Documents/FAS\\_ForensicCenter\\_us\\_fas-us\\_dfc/us\\_dfc/us\\_dfc\\_e\\_discovery\\_survey\\_final\\_061710.pdf](http://www.deloitte.com/assets/Dcom-United-States/Local%20Assets/Documents/FAS_ForensicCenter_us_fas-us_dfc/us_dfc/us_dfc_e_discovery_survey_final_061710.pdf) (half of survey respondents said their company is only somewhat effective (43%) or not at all effective (6%) in dealing with the challenges of e-discovery today, and more than a third (36%) didn’t know how their legal and information technology departments communicate).

<sup>4</sup>See *Network Computing Services Corp. v. Cisco Systems Inc.*, 223 F.R.D. 392, 396 (D.S.C. 2004) (“this court’s own firsthand observation of discovery expenditures in civil litigation yields the inescapable conclusion that litigants expend enormous amounts of money on discovery in cases that do not even make it to trial.”)

destroyed; everything gets replicated and goes from holder to holder.”<sup>5</sup> In short, digital is different. Unlike traditional evidence, ESI includes “active” data, metadata, system data, off-line archival data, off-line backup or disaster recovery data, and “residual” (erased, fragmented, or damaged) data. It is also distributed across locations, including office computers, network and offsite servers, removable storage devices, fax machines and printers, personal computers, and other devices including cell phones and pdas. In addition, ESI is rarely permanently deleted and exists in greater volume by orders of magnitude.<sup>6</sup> Indeed, a pretrial discovery request today can generate nearly 10,000 times more paper than ten years ago.<sup>7</sup>

### III. E-Discovery Problems and Pitfalls

E-discovery techniques continue to be developed to cut through this morass of types, locations, and sheer volume of ESI. In that regard, it is now “universally acknowledged that keyword searches are useful tools for search and retrieval of ESI.”<sup>8</sup> Yet despite this consensus, confusion persists about the proper application of keyword search, resulting in wasted time and resources, or even sanctions.<sup>9</sup>

Some problems in keyword searching arise from semantic ambiguity in language. For example, the word “bat” is used to describe a ledge or shelf in a ceramics kiln, but is also used in a baseball context, can reference a nocturnal flying mammal, or can be used in idioms, e.g. to bat around some ideas, to go to bat for someone, or to be crazy as a bat.<sup>10</sup>

*Keyword Mediator continued on page 8*

<sup>5</sup>*Managing Electronic Discovery: Views From the Judges*, 76 FORDHAM L. REV. 1, 1 (2007); see also Kershaw, Anne and Howie, Joe, JUDGES’ GUIDE TO COST-EFFECTIVE E-DISCOVERY, at p. i (Electronic Discovery Institute Publication 2010) (“the costs of gathering, reviewing, and producing ESI have reached staggering proportions”), available at [www.ediscoveryinstitute.org/JudgesGuide/EDI\\_JUDGES\\_GUIDEv1.pdf](http://www.ediscoveryinstitute.org/JudgesGuide/EDI_JUDGES_GUIDEv1.pdf).

<sup>6</sup>*Managing Electronic Discovery: Views From the Judges*, n. 6, supra at 2 (citing estimate in the year 2007 that an email sent on January 1 would be copied on average between 27,000 and 28,000 times by the end of the year).

<sup>7</sup>John Bringardner, *Winning the Lawsuit: Data Miners Dig for Dirt*, WIRED 112 (July 2008), available at [www.wired.com/science/discoveries/magazine/16-07/pb\\_lawsuit](http://www.wired.com/science/discoveries/magazine/16-07/pb_lawsuit).

<sup>8</sup>*Victor Stanley v. Creative Pipe*, 250 F.R.D. 251, 257 (D. Md. 2008);

<sup>9</sup>See *William A. Gross Constr. Assocs. Inc. v. Am. Mfrs. Mut. Ins. Co.*, 256 F.R.D. 134 (S.D.N.Y. 2009) (court left in “uncomfortable position” of crafting and imposing its own search methodology); *Nycomed U.S. Inc. v. Glenmark Generics Ltd.*, No. 08-CV-5023, 2010 WL 3173785 (E.D.N.Y. Aug. 11, 2010) (failure to identify and search appropriate electronic databases held sanctionable).

<sup>10</sup>Kershaw, Anne and Howie, Joe, n. 5, supra at p. 4 n. 8. New search methodologies such as Gene Zyrl Ragan’s patented “content-based implicit search query” (patent number 20060271520) mitigate overbroad search results by organizing the results by file type.

### Keyword Mediator continued from page 7

Others arise from technical considerations. For example, few will understand the differences involved in recovering data from an AS400 or an OS390W, the subtle nuances of “proximity search,”<sup>11</sup> “stemming,” “fuzzy logic,”<sup>12</sup> and predictive coding,<sup>13</sup> or how to properly conduct a random sampling.<sup>14</sup> When it comes to these and other topics such as metadata, compression algorithms, artifacts, data fragments, entropy tests, and sub-OS level searches, careful attention must be paid to constructing proper searches which may involve expertise not typically possessed by counsel or the court. Failure to properly construct and test keyword searches can lead to, *inter alia*, privilege waivers,<sup>15</sup> spoliation claims,<sup>16</sup> and sanctions.<sup>17</sup> For example, in the case of *Ross v. Abercrombie & Fitch Co.*,<sup>18</sup> a simple miscommunication regarding search terms led to extended litigation over production of approximately 1.3 million pages of documents.

#### IV. The Need for Cooperation

With the increased complexity and costs of e-discovery also comes litigiousness that courts increasingly bemoan. As one district court colorfully mused: “If there is a hell to which disputatious, uncivil, vituperative lawyers go, let it be one in which the damned are eternally locked in discovery disputes with other lawyers of equally repugnant attributes.”<sup>19</sup> Courts continue to call for cooperative efforts to confront these problems, but adversarial zeal frequently frustrates these attempts.<sup>20</sup>

<sup>11</sup>Google API Proximity Search, Stagger Nation, available at [www.staggernation.com/gaps/readme.php](http://www.staggernation.com/gaps/readme.php).

<sup>12</sup>David C. Blair & M. E. Maron, *An Evaluation of Retrieval Effectiveness for a Full-Text Document Retrieval System*, 28 COMM. OF THE ACM 289 (1985); *The Sedona Conference® Best Practices Commentary on the Use of Search & Information Retrieval Methods in E-Discovery*, 8 SEDONA CONF. J. 189, 215 (2007).

<sup>13</sup>Jason R. Baron, *Law in the Age of Exabytes: Some Further Thoughts on ‘Information Inflation’ and Current in E-Discovery Search*, 17 RICH. J.L. & TECH. 1, 6 n. 23 quoting Survey on Predictive Coding, E-Discovery Inst., 2 (Oct. 1, 2010) (predictive coding is “a combination of technologies and processes in which ... reviewers examine a subset of the collection and ... [their] decisions ... [are] propagated to the rest of the collection.”).

<sup>14</sup>See *In re Vioxx Products Liability Litigation*, 2006 WL 1726675 at \*2 n.5 (5th Cir. 2006) (using random sampling for privilege analysis).

<sup>15</sup>See, e.g. *Mt. Hawley Ins. Co. v. Feldman Prod. Inc.*, No. 09-CV-00481, 2010 WL 1990555 (S.D.W.Va. 2010) (privilege waived as to produced documents).

<sup>16</sup>See *Network Computing Servs. Corp.*, n. 6, *supra* at 400-01.

<sup>17</sup>See *Nycomed U.S. Inc.*, n. 11, *supra*.

<sup>18</sup>2008 WL 4758768 (S.D. Ohio October 27, 2008).

<sup>19</sup>*Network Computing Servs. Corp.*, n. 6, *supra* at 395, quoting *Krueger v. Pelican Prod. Corp.*, No. 87-CV-2385-A, slip op. (W.D. Okla. Feb. 24, 1989).

<sup>20</sup>*Mancia v. Mayflower Textile Servs. Co.*, 253 F.R.D. 354, 361 (D. Md. 2008), citing, *inter alia*, *Board of Regents of the Univ. of Nebraska v. BASF Corp.*, 2007 WL 3342423, at \*5 (D. Neb. Nov. 5, 2007) (recommending “open and forthright sharing of information by all parties”); *Buss v. Western Airlines Inc.*, 738

#### V. Enter the Keyword Mediator

Keyword mediation is an attractive alternative to the litigiousness that usually attends e-discovery because a jointly selected mediator or court-appointed special master can facilitate a cooperative process while adding the intangible value of knowledge of the law and technology.<sup>21</sup> As prominent e-discovery jurist Shira Schiendlin argued in an article plaintively titled “We Need Help,” “[t]he appointment of a special master who fully understands technology ... is invaluable” and “can have a significant impact on the cost of litigation as well as the prompt resolution of the case.”<sup>22</sup>

In selecting a keyword mediator, one note of caution is required. Often a court-appointed or party selected mediator knows the particular business area in dispute but has no more technological expertise than the parties or the court. However, a keyword mediator *must* possess a firm grasp of theory and application in electronic search, including the algorithms by which software searches for information.<sup>23</sup> Such a mediator brings expertise to the keyword selection process that benefits parties their attorneys, the court, and even third-parties and nonparties who may be custodians of ESI.<sup>24</sup>

#### VI. Conclusion

The costs and complexity of e-discovery threaten to subsume judicial and party resources, raise potential problems and pitfalls for unwary counsel, and mire litigious parties in extended e-discovery disputes. Keyword mediation is an effective tool to F.2d 1053, 1053–54 (9th Cir.1984) (“The voluminous file in this case reveals that a vast amount of lawyer time on both sides was expended in largely unnecessary paper shuffling as the parties battled over discovery ... .”); *Flanagan v. Benicia Unified Sch. Dist.*, 2008 WL 2073952, at \*10 (E.D. Cal.2008) (“plaintiff’s ... lack of communication and cooperation with defense counsel in regard to all discovery [] undermine[s] the judicial process”); *Marion v. State Farm Fire and Casualty Co.*, 2008 WL 723976, at \*3–4 (S.D. Miss. Mar. 17, 2008) (demanding “mutual cooperation of the parties”); *Malot v. Dorado Beach Cottages Assocs.*, 478 F.3d 40, 45 (1st Cir.2007) (noting lack of cooperation with discovery schedule); *In re Spoonemore*, 370 B.R. 833, 844 (Bkrtcy. D. Kan.2007) (“Discovery should not be a sporting contest or a test of wills”); *Sweat v. Peabody Coal Co.*, 94 F.3d 301, 306 (7th Cir. 1996) (“It is apparent that the attorneys ... will not cooperate in the discovery process. The people who suffer ... are the parties.”).

<sup>21</sup>Allison O. Skinner, *The Role of Mediation for ESI Disputes*, 70 THE ALABAMA LAWYER 425, 426 (Nov. 2009).

<sup>22</sup>Judge Shira Scheindlin, *We Need Help: The Increasing Use Of Special Masters In Federal Court*, 58 DEPAUL L. REV. 479 (Winter 2009).

<sup>23</sup>See Judge Shira Scheindlin, n. 22, *supra* at 481 (primary considerations in selecting a special master are “(1) time commitment; (2) knowledge and expertise; (3) resources; and (4) neutrality.”)

<sup>24</sup>See generally *Tener v. Cremer*, \_\_\_ N.Y.S.2d \_\_\_, 2011 WL 4389170 (NY First Dept. Sept. 22, 2011) (discussing e-discovery obligations of nonparty custodians of ESI).



navigate this perfect storm. It facilitates a cooperative process guided by a neutral with technical expertise. With less time and resources needlessly devoted to e-discovery disputes, counsel can focus on the merits of their case. **SB**

*Daniel B. Garrie has B.A. and M.A. degrees in computer science, is an e-discovery neutral with Alternative Resolution Center (ARC),*

*and serves as a court-appointed special master. He has been a member of the Sedona Conference since 2007. Siddhartha Rao is an associate in the New York office of Zeichner Ellman & Krause LLP (ZEK), where he concentrates his legal practice on litigation. He graduated from the University of Texas School of Law, where he was a member of the Texas Law Review. The thoughts expressed herein are solely the authors' own and not those of ARC or ZEK.*

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### *Patent Reform continued from page 2*

the date of invention, or if they preceded the U.S. patent application filing date by more than one year (e.g., patents and printed publications anywhere in the world or public knowledge or use in the United States), will now invalidate a patent if they precede the patentee's effective patent application filing date. This change, which becomes effective in March 2013, broadens the scope of invalidating prior art significantly compared to the current regime. Given the frequency with which defendants assert novelty and prior art invalidity challenges, this amendment will likely work in the defendants' favor.

Similarly, the question of whether a patented technology was "obvious" under § 103 in light of the prior art has changed. A finding that the patented invention was "obvious" to a person of ordinary skill in the particular technical field will invalidate a patent during litigation, or preclude its issue during prosecution. Historically, obviousness was determined as of the date the patentee invented the patented item. Under the amendment, however, obviousness is determined as of the date the patentee filed his or her patent application. The patentee's filing date is often significantly later than the date of invention. As a result, this change gives a patent infringement defendant the opportunity to invalidate a patent for obviousness based upon information that arose or became well-known to a person of ordinary skill in the art during the period of time between when the inventor conceived the invention and when she or he applied for the patent, even if the claimed advancement was not obvious when the patentee invented it.

Finally, the American Invents Act "giveth" and "taketh away" with respect to certain traditional patent infringement defenses. The act *giveth* to defendants by broadening the applicability of the "prior commercial use" defense to all types of patents rather than only to business method patents where it currently applies. In contrast, however, the act *taketh away* by eliminating the defense that a patentee/plaintiff failed to disclose the "best mode" for practicing the patented invention.

Given the act's staggered implementation of these amendments, and the pace of most patent infringement lawsuits, the full impact of the America Invents Act on patent litigation will not fully reveal itself for some time. Suffice it to say, however, that patent litigants will be well-served to consider the issues raised by the act's changes, and their possible litigation impacts, sooner rather than later, and adjust their offensive and defensive litigation strategies accordingly. **SB**

*Earl LeVere is a partner in the Intellectual Property Practice Group at Schottenstein, Zox & Dunn Co. LPA in Columbus, Ohio. His practice focuses litigation matters involving patents, copyrights, and trademarks. LeVere can be reached at (614) 462-1095 or by email at elevere@szd.com. As of Jan. 1, 2012, Schottenstein, Zox & Dunn will join Ice Miller LLP, forming a combined firm of more than 300 attorneys, with offices in Ohio, Indiana, Illinois, and Washington, D.C.*

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### *Editor continued from page 1*

The Federal Litigation Section has also proudly offered an informative CLE webinar on "Jurors Tweeting Their Way to Trouble: Social Media, the Internet and Jury Trials." The program was held April 25, 2012. Events like these timely programs enhance the relevance, value, and visibility of the FBA. To suggest other activities that would also benefit our members, please contact the chair of the section, William Frank Carroll, or any board member.

I hope you will find value, too, in the substantive content of this newsletter. As always, this issue of SideBAR benefits from the contributions of the federal litigation bar. I encourage you to write the varied and insightful articles that we members enjoy each time this newsletter is published. Thank you. **SB**

#### **About the Editor**

*Robert E. Kohn litigates entertainment, business, and intellectual property disputes in the Los Angeles area. He also argues appeals in federal and state courts at all levels. A former clerk to Hon. Joel F. Dubina of the Eleventh Circuit, Kohn attended Duke Law School. He is the vice chair of the Federal Litigation Section and co-chairs the committee on Federal Rules of Procedure and Trial Practice. Kohn also serves The Federal Lawyer magazine as a member of its Editorial Board. He can be reached at rkohn@kohnlawgroup.com.*

## APPROACHING THE BENCH

### *Third Circuit Addresses Breach of Fiduciary Duty and Deepening Insolvency Claims Under Pennsylvania Law*

By Mark S. Chehi, Anthony W. Clark and Robert A. Weber

In *Official Committee of Unsecured Creditors v. Baldwin (In re Lemington Home for the Aged)* (3rd Cir. Sept. 21, 2011), the Third Circuit Court of Appeals addressed breach of fiduciary duty and “deepening insolvency” claims asserted in bankruptcy litigation against former officers and directors of a bankrupt Pennsylvania nonprofit corporation. The court’s rulings highlight differences between Pennsylvania and Delaware law.

The Third Circuit’s opinion demonstrates the need for proper corporate governance of financially troubled organizations—and that business judgment rule protection may not be available to officers and directors if facts support allegations that they acted without reasonable care and diligence, or with self-interest. Moreover, the Third Circuit opinion recognizes a deepening insolvency cause of action under Pennsylvania law and states that officer and director duties “are owed not only to the corporation and its shareholders, but also to the creditors of an insolvent entity.”

#### Background

The Lemington Home for the Aged, a nonprofit Pennsylvania corporation (the Home), provided residential elder care services in Pittsburgh, Penn. By 1999, after years of financial difficulties, the Home was insolvent and subsequently received going concern qualifications from its auditors. The Home’s financial records and the board itself were in disarray, and its chief financial officer failed to maintain a general ledger and other financial records.

The board had a history of informal action, did not maintain proper minutes of meetings, failed to fill its required treasurer position and did not provide meaningful oversight of the Home’s financial operations. The board was on notice of numerous nursing home deficiencies and citations; it continued to employ and rely on the Home’s administrative officer after a study recommended that she be replaced with a qualified professional; and the board relied on the advice of the Home’s chief financial officer even after learning that he was not maintaining customary financial records.

Before bankruptcy, the board discussed and documented a plan to transfer the Home’s principal charitable asset (a fund held by a foundation) to an affiliated entity as to which the Home’s directors were simultaneously overlapping directors.

In April 2005, the Home commenced a voluntary Chapter 11 case. The bankruptcy court subsequently approved closure of the Home and authorized the official committee of unsecured creditors (the committee) to commence an action against the Home’s officers and directors asserting breach of fiduciary duties of care and loyalty and for deepening insolvency.

The district court granted the officers’ and directors’ summary judgment motion, finding that the business judgment rule and the doctrine of *in pari delicto* applied to shield the directors and officers from liability on the breach of fiduciary duty claims, and that the committee would be unable to show that there was fraud necessary to support a deepening insolvency claim. The committee appealed.

#### The Third Circuit Decision

The Third Circuit vacated the district court’s grant of summary judgment in favor of the officers and directors and remanded the case for trial. The appellate court determined that material facts remained in dispute on all the claims and held that Pennsylvania’s business judgment rule protection for directors is overcome by evidence of their negligence.

#### Breach of Fiduciary Duty Claims and The Business Judgment Rule

Fiduciary duties of care and good faith owed by directors and officers of a Pennsylvania nonprofit corporation<sup>1</sup> are defined by statute. See 15 Pa. Cons. Stat. Ann. § 5712(a)-(c) (2011). Directors must use “reasonable inquiry, skills and diligence in the performance of their duties.” *Id.* They are “entitled to rely in good faith on information, opinions, reports or statements ... proposed or presented” by corporate officers and employees “whom the director reasonably believes to be reliable and competent” and by counsel, public accountants and others on matters, “which the director reasonably believes to be within the professional or expert competence of such person.” *Id.*

The Third Circuit stated such “fiduciary duties are owed not only to the corporation and its shareholders, but also to the creditors of an insolvent entity.” (Slip Op. at 16, citing *Citicorp Venture Capital, Ltd. v. Comm. of Creditors Holding Unsecured Claims*, 160 F.3d 982, 987-88 (3d Cir. 1998)).<sup>2</sup>

If officers and directors satisfy their fiduciary duties, the business judgment rule protects their decisions from judicial challenge. The business judgment rule is a presumption that insulates officers and directors from judicial intervention and liability in the absence of fraud or self-dealing.<sup>3</sup> Pennsylvania

<sup>1</sup>The Third Circuit’s decision in *Lemington* addressed the statutory fiduciary duties of directors of nonprofit Pennsylvania corporations. The statutory fiduciary duties of directors of for-profit Pennsylvania corporations are similar. See 15 Pa. Cons. Stat. Ann. § 512(a)-(c) (2011).

<sup>2</sup>Under Delaware law, fiduciary duties of corporate officers and directors are not owed to creditors, even when the entity is insolvent. When solvent, only the corporation itself and shareholders may bring claims for breach of fiduciary duties owed to them. See *N. Am. Catholic Educ. Programming Found. Inc. v. Gheewalla*, 930 A.2d 92, 94 (Del. 2007). Upon corporate insolvency, creditors may assert only derivative claims for breaches of fiduciary duties that are owed to the corporation itself. *Id.* at 101

<sup>3</sup>The business judgment rule is a well-recognized legal doc-

has codified the business judgment rule by providing that “[a]bsent breach of fiduciary duty, lack of good faith or self-dealing, any act as the board of directors, a committee of the board or an individual director shall be presumed to be in the best interests of the corporation.” 15 Pa. Cons. Stat. Ann. § 5715(d). See also 15 Pa. Cons. Stat. Ann. § 515(d) (business judgment rule in context of for-profit Pennsylvania corporations).

The Third Circuit observed that “underlying the [business judgment] rule is the assumption that reasonable diligence has been used in reaching the decision which the rule is invoked to justify.” (Slip Op. at 18-19, quoting *Miller v. American Tel. & Tel. Co.*, 507 F.2d 759, 762 (3d Cir. 1974)). It is thus “material whether the directors’ reliance upon the information provided by one or more officers or employees was in ‘good faith,’ and whether there was a reasonable basis for relying upon officers and employees of the corporation. It is likewise material whether the officers have exercised ‘reasonable inquiry, skill and diligence’ in performing their duties.” (Slip Op. at 16).

The Third Circuit identified factors bearing on whether a board has exercised reasonable diligence in making a decision: “whether the board ... was disinterested, whether it was assisted by counsel, whether it prepared a written report, whether it was independent, whether it conducted an adequate investigation, and whether it rationally believed its decision was in the best interests of the corporation.” (Slip Op. at 19, quoting *Cuker v. Mikalauskas*, 692 A.2d 1042, 1046 (Pa. 1997)).

In vacating the district court’s grant of summary judgment the Third Circuit held, “[w]here ... there is evidence to support a rational conclusion that the directors did not exercise reasonable diligence, application of the business judgment rule cannot be decided on a summary judgment motion.” (Slip Op. at 19). The appellate court held that evidence of “gross negligence” is not required to overcome Pennsylvania’s business judgment rule because that state’s law “recognizes directors’ and officers’ liability for negligent breach of fiduciary duty.” (Slip Op. at 19-20, n. 5, citing *Wolf v. Fried*, 373 A.2d 734, 735 (Pa. 1977) (emphasis in original)).<sup>4</sup>

Although the record on appeal in *Lemington* showed that the board was assisted by counsel, conducted several meetings and pursued various options before approving the Home’s bankruptcy filing, the Third Circuit found sufficient evidence

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trine which presumes that directors are duly informed before they act, and that their official acts are in good faith and in the honest belief that such acts are in the corporation’s best interests. See I Edward P. Welch, Andrew J. Turezyn and Robert S. Saunders, *FOLK ON THE DELAWARE GENERAL CORPORATION LAW* § 141.2.2.1 (5th ed., 2011 supp.). “As a substantive rule of law, the business judgment rule provides that there is no liability for an injury or loss to the corporation arising from corporate action when the directors, in authorizing such action, proceeded in good faith and with appropriate care.” *Id.* § 141.2.2.2.

<sup>4</sup>The court distinguished Pennsylvania from Delaware law. See *Aronson v. Lewis*, 473 A.2d 805, 812 (Del. 1984) (holding that “under the business judgment rule director liability is predicated upon concepts of gross negligence”) (overruled on other grounds).

to show that the board breached its duties of care during the pre-bankruptcy period and in approving the Home’s bankruptcy filing. There was evidence sufficient to show that the board “did not have a reasonable basis to believe” that the Home’s officers were “reliable and competent”; there were “numerous red flags” calling into question the officers’ competence and diligence; and the board declined to authorize a “viability study” of the Home’s business. Moreover, evidence of plans to “divert” the Home’s charitable fund to an affiliate was sufficient to support a breach of loyalty claim. (Slip Op. at 17, 19).

Accordingly, the Third Circuit held that application of the business judgment rule could not be decided on summary judgment on the record in *Lemington*. (Slip Op. at 19).

### “Deepening Insolvency” Cause of Action Under Pennsylvania Law

The Third Circuit concluded in *Lemington* that it remained bound by its own precedents to recognize a deepening insolvency cause of action under Pennsylvania law even though Pennsylvania’s high court has not yet spoken on the issue. (Slip Op. at 23, citing *Official Comm. of Unsecured Creditors v. R.F. Lafferty & Co.*, 267 F.3d 340, 349 (3rd Cir. 2001) (predicting that Pennsylvania Supreme Court would recognize cause of action for deepening insolvency) and *In re Citx Corp.*, 448 F.3d 672, 677 (3d Cir. 2006) (deepening insolvency is claim for “an injury to the debtors’ corporate property from the fraudulent expansion of corporate debt and prolongation of corporate life”). The Third Circuit acknowledged that deepening insolvency has been criticized or rejected as a cause of action in other jurisdictions.<sup>5</sup> (Slip Op. at 23, n. 6).

The Court of Appeals confirmed that fraud is a key element of a deepening insolvency claim, and that fraud under Pennsylvania law includes affirmative statements intended to deceive as well as less direct intentional conduct.<sup>6</sup> (Slip Op. at 23-24).

The Third Circuit found sufficient evidence in *Lemington* to support a triable issue as to whether the officers and directors fraudulently deepened the insolvency of the Home. That evidence included the board’s failure to disclose to creditors and the bankruptcy court its decision made in early 2005 to close the Home, cease admitting new patients and file for bankruptcy while delaying the bankruptcy filing by several months in a manner that the committee alleged caused further deterioration of the Home’s finances to the detriment of creditors, as well as the officers’ alleged failure to collect Medicare receivables,

### Fiduciary Duty continued on page 12

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<sup>5</sup>See, e.g., *Trenwick America Litigation Trust v. Billet*, 906 A.2d 168 (Del. Ch. 2006), *aff’d*, 931 A.2d 438 (Del. 2007) (refusing to recognize deepening insolvency cause of action under Delaware law).

<sup>6</sup>“As a general rule, fraud consists in anything calculated to deceive, whether by single act or combination, or by suppression of truth, or a suggestion of what is false, whether it be by direct falsehood or by innuendo, by speech or silence, word of mouth, or look or gesture. It is any artifice by which a person is deceived to his disadvantage.” (Slip Op. at 24, quoting *In re Reicher’s Estate*, 51 A.2d 615, 617 (Pa. 1947)).

### *Fiduciary Duty continued from page 11*

commingling of Home funds with related entities, directing of transfers of Home assets to related entities, and continuing to do business with vendors when the officers knew the Home was insolvent.

#### ***In Pari Delicto***

The Third Circuit also identified record evidence of possible self-dealing by the officers and directors substantial enough to support the “adverse interest” exception to the *in pari delicto* defense asserted by the defendant officers and directors. The *in pari delicto* doctrine is a defense under Pennsylvania law and in other jurisdictions against wrongful conduct claims asserted by or in the right of a corporation if the corporation was “an active, voluntary participant in the wrongful conduct for which it seeks redress” and was at least as responsible as the defendant for such wrongful conduct. (Slip Op. at 20, citing *Official Comm. of Unsecured Creditors of Allegheny Health Educ. & Research Found. v. PricewaterhouseCoopers LLP*, 989 A.2d 313, 329 (Pa. 2010)). The “adverse interest” exception to the *in pari delicto* defense applies and negates the defense if the underlying wrongful conduct benefited the defendant rather than the corporation itself. *Id.* at 21. The adverse interest exception to the applicability of *in pari delicto* applies when an agent of the corporation “acts in his own interest, and to the corporation’s detriment.” *Id.* (citing *PricewaterhouseCoopers*, 989 A.2d at 333-34).

The Third Circuit ruled it was error for the district court to find on summary judgment that the “adverse interest” exception to the *in pari delicto* defense doctrine did not apply because there were genuine issues of material fact. The court determined that the committee had presented sufficient evidence that the directors’ and officers’ alleged breaches of fiduciary duty did not benefit the Home but instead benefited and advanced their own self-interest. (Slip Op. at 21-22). The Third Circuit focused on evidence showing that the officers and directors simultaneously were affiliated with an affiliate of the Home as to which the defendants discussed and planned to transfer the Home’s primary financial asset; that the Home’s chief financial officer served as a trustee of another entity during the time the other entity was being pursued by the board as a possible purchaser of the Home; that the chief financial officer failed to maintain any financial records of the Home during his tenure; and that another officer of the Home resisted a recommendation to replace her.

The Third Circuit’s opinion did not mention that the *in pari delicto* defense generally is not available to officers and directors or claims asserted against them by or in the right of their corporation.<sup>7</sup>

<sup>7</sup>See, e.g., *In re HealthSouth Corp. Shareholders Litig.*, 845 A.2d 1096, 1107 (Del. Ch. 2003) (“because corporations must act through living fiduciaries ... the application of the *in pari delicto* doctrine has been rejected in situations when corporate fiduciaries seek to avoid responsibility for their own conduct vis-a-vis their corporations”); *American Int’l Group Inc. Consolidated Deriv. Litig.*, 965 A.2d 763, 778 (Del. Ch. 2009) (“Under Delaware law, where insiders have a disabling conflict that gives them a reason to hide information from the corporation’s independent directors and stockholders, their knowledge is not imputed to the corporation for purposes of a suit seeking to hold the insiders who

It seems this issue was not raised below or on appeal by the committee.<sup>8</sup>

The decision in *Lemington Home* highlights the importance of best corporate governance practices in the insolvency context. Officers and directors should remain informed, diligent and proactive in their governance, business oversight and management activities. They should seek and rely on the advice of counsel and other independent advisers, undertake adequate investigations as necessary, insist upon good recordkeeping, and avoid transactions that are conflicted by self- or affiliate interests. **SB**

*Mark S. Chehi is a partner in the Corporate Restructuring Group of Skadden, Arps, Slate, Meagher & Flom LLP. He has represented numerous public and private companies in out-of-court restructurings, “prepackaged” bankruptcies, negotiated workouts, traditional Chapter 11 cases, and related transactions, strategy and governance issues. Anthony W. Clark heads Skadden’s corporate restructuring and bankruptcy litigation practice in Wilmington, Del., and represents debtors, creditors and acquirors. He also handles corporate, securities and general litigation matters. Robert A. Weber is a counsel in Skadden’s Corporate Restructuring Group. His practice focuses primarily on complex bankruptcy and commercial litigation matters.*



committed wrongdoing accountable for the harm they caused to the corporation.”); *In re Granite Partners L.P.*, 194 B.R. 318, 332 (Bankr. S.D.N.Y. 1996) (“*In pari delicto* bars claims against third parties, but does not apply to corporate insiders or partners. Otherwise, a trustee could never sue the debtor’s insiders on account of their own wrongdoing.”)

<sup>8</sup>Generally, only arguments raised in a lower court may be heard on appeal in support of reversal. *Seifert v. Commonwealth of Pennsylvania Human Relations Comm’n*, 301 Fed. Appx. 194, 196-97 (3d Cir. 2008) (citing *Flick v. Borg-Warner Corp.*, 892 F.2d 285, 288 (3d Cir. 1990)). See also *United States v. Albertson*, 645 F.3d 191, 195 (3d Cir. 2011) (court of appeals usually refrains from addressing an argument or issue not properly raised and discussed in appellate briefing).



## The Impact of the Janus Ruling on Secondary Liability in 10b-5 Claims

By Liam O'Brien & Alexander Broche

The recent U.S. Supreme Court decision in *Janus Capital Group, Inc. v. First Derivative Traders*<sup>1</sup> has been met with harsh criticism. Some critics have argued that the Supreme Court has given corporations a “license to lie.”<sup>2</sup> Others have called the opinion “a roadmap for fraud.”<sup>3</sup> However, in truth the decision in *Janus* is demonstrative of this Court’s continued resistance to attempts to expand the implied right of action under § 10b-5. It is a reflection of past precedent, and to understand the effect the decision will have on future § 10b-5 actions, a cursory understanding of the cases leading up to *Janus* is essential.

In 1994, the Supreme Court’s decision in *Central Bank of Denver v. First Interstate Bank of Denver* held that private plaintiffs could not assert claims under § 10b-5 against aiders and abettors.<sup>4</sup> The *Central Bank* case involved bond purchasers who brought an action under § 10b-5 against the underwriter for recklessly failing to provide updated appraisals of the real estate assets used to secure the indenture. The plaintiff’s § 10b-5 claim was premised on the notion that the defendant’s inaction aided the primary violator. The Court rejected the aiding and abetting argument but specifically noted:

The absence of § 10(b) aiding and abetting does not mean that secondary actors in the securities markets are always free from liability under the securities acts. Any person or entity, including a lawyer, accountant, or bank, who employs a manipulative device or makes a material misstatement (or omission) on which a purchaser or seller of securities relies may be liable.<sup>5</sup>

The critical link, according to *Central Bank*, for purposes of § 10b-5 is reliance.

The Court revisited these issues in 2008 in *Stoneridge Inv. Partners LLC v. Scientific-Atlanta*.<sup>6</sup> The plaintiff in *Stoneridge* articulated a claim under § 10b-5 for losses arising out of its purchases of Charter Communications stock. Charter Communications allegedly engaged in a variety of fraudulent accounting practices so that its quarterly reports would meet Wall Street’s expectations. Respondents Scientific Atlanta and Motorola (the vendors), suppliers, and customers of Charter, had no role in the preparation or dissemination of Charter’s financial statements, but the plaintiff alleged that they knew and engaged in certain business transactions, the purpose of which was to enable Charter to fool its auditor into approving the false financial statements. At core issue before the Court was whether Scientific Atlanta and Motorola could be held liable in a private action under § 10(b) and Rule 10b-5 for participating in the transactions with Charter. The Supreme Court rejected plaintiff’s so-called “scheme liability” theory, wherein liability would arise out of the plaintiff’s reliance upon both the public statements relating to a security and the transactions that those statements reflect.

The Court concluded that the plaintiff in *Stoneridge* could not “show reliance upon any of respondents’ actions except

in an indirect chain that we find too remote for liability.” It emphasized that, “[i]t was Charter, not respondents, that misled its auditor and filed fraudulent financial statements; nothing respondents did made it necessary or inevitable for Charter to record the transactions as it did.” In explaining why the Scientific Atlanta’s and Motorola’s conduct did not have the “requisite proximate relation to investor harm,” the Court asserted that the transaction “took place in the marketplace for goods and services, not in the ‘investment sphere.’” The Court further noted that the vendors played no role in preparing Charter’s “books,” conferring with its auditor, or preparing and then issuing its financial statements. In such circumstances, investors “cannot be said to have relied upon any [of the vendors] deceptive acts in the decision to purchase or sell securities.” However, the Court emphasized, as it did in *Central Bank* that secondary actors are not immune from private suit, and Section 10(b) “continues to cover secondary actors who commit primary violations.”<sup>7</sup>

Despite *Stoneridge* and *Central Bank* there was continued confusion among the circuit courts as to the scope of primary liability for collateral actors. The two most divergent doctrines which emerged in the circuit courts prior to *Janus* regarding primary liability were the restrictive “bright-line” attribution rule adopted by the Second, Fifth, Eighth, and Eleventh Circuits<sup>8</sup> and the more permissive “substantial participation” doctrine adopted by the Ninth Circuit.<sup>9</sup> The bright-line rule requires the plaintiff to establish that the defendant made a misstatement or omission that is publicly attributable to the defendant at the time of dissemination to the public in order for primary liability to attach.<sup>10</sup> Conversely, the substantial participation doctrine requires only that the defendant’s participation in the creation of the misstatement be sufficiently extensive to make attribution to the defendant reasonable.<sup>11</sup> Recognizing the confusion resulting from these different tests, the Supreme Court granted certiorari to *Janus* so that it could, answer the question of what it means to “make” a material misstatement for purposes of § 10b-5.

### The Janus Case

In *Janus* the plaintiffs, shareholders of Janus Capital Group Inc. (Janus Capital), alleged that the management company, Janus Capital Management LLC (Janus Management), caused Janus Investment Fund (Janus Fund) to issue prospectuses that falsely suggested that the Janus Fund would not allow so-called “market timing” trading.<sup>12</sup> The Janus Fund was a trust that held all of the Janus family of mutual funds, and was created by Janus Capital. Janus Fund had as its investment advisor Janus Management, a wholly owned subsidiary of Janus Capital. Janus Management, as investment advisor to the funds, was responsible for the day-to-day management of its investment portfolio and other business affairs of the funds. Janus Management furnished advice and recommendations concerning the funds’ investments, as well as administrative, compliance and accounting services for the funds. Each of the Fund’s 17 officers was a vice president of Janus Management. Janus Fund had no assets separate and apart from those they hold for shareholders. Janus

*Janus Ruling continued from page 13*

Management employees drafted and reviewed the Janus Fund prospectuses, including language about “market timing.”<sup>13</sup>

Under this corporate structure, Janus Capital used its knowledge of and control over Janus Management and Janus Fund to time the market and make profits. As a result, New York Attorney General Eliot Spitzer and Colorado Attorney General Ken Salazar brought action against Janus Capital and Janus Management for this market timing scheme in 2003. In 2004, Janus settled that lawsuit by agreeing to pay \$50 million in restitution and disgorgement to injured investors, \$50 million in civil penalties, and \$125 million in a reduction of fees charged to investors over a five-year period. As a result of the fraudulent statements in the Janus Fund’s prospectuses, and the settlement of the market timing cases, shares of Janus Capital declined approximately 25%. First Derivative Traders filed a class action on behalf of all shareholders who in 2003 owned shares in Janus Capital. The plaintiffs alleged that the false statements in the Janus Fund prospectuses that the funds would not be used for any market timing or excessive trading schemes misled investors and directly caused the shares of Janus Capital to fall once the market timing complaint by Spitzer was made public. This share devaluation of Janus Capital occurred because many fund investors withdrew their money from the Janus Fund after learning they had been the victims of Janus Capital’s market timing scheme.

Justice Clarence Thomas, writing for the majority, framed the issue as “whether [Janus Management] can be held liable in a private action under Rule 10b-5 for false statements included in [Janus Fund]’s prospectuses.”<sup>14</sup> In order to be liable under § 10b-5, Janus Management must have “made” the material misstatements in the prospectuses. The majority held that it did not. According to the majority:

For purposes of Rule 10b-5, the maker of a statement is the person or entity with ultimate authority over the statement, including its content and whether and how to communicate it. Without control, a person or entity can merely suggest what to say, not “make” a statement in its own right. One who prepares or publishes a statement on behalf of another is not its maker. And in the ordinary case, attribution within a statement or implicit from surrounding circumstances is strong evidence that a statement was made by—and only by—the party to whom it is attributed.<sup>15</sup>

Therefore, even if Janus Management prepared Janus Fund’s prospectuses, it was not the ultimate ‘speaker’ and could not be liable under Rule 10b-5.

The majority analogized the case to that of a speechwriter and a speaker, arguing that “even when a speechwriter drafts a speech, the content is entirely within the control of the person who delivers it. And it is the speaker who takes credit—or blame—for what is ultimately said.”<sup>16</sup> Based on the majority’s opinion, it appears that ultimate control of its statement will fall solely upon the shoulders of its management, and no farther.

The majority disregards the amount of control Janus Management had over Janus Fund, and thus provides an avenue by which corporations can escape § 10b-5 liability. As the dissent notes:

The possibility of guilty management and innocent board is the 13th stroke of the new rule’s clock. What is to happen when guilty management writes a prospectus (for the board) containing materially false statements and fools both board and public into believing they are true? Apparently under the majority’s rule, in such circumstances *no one* could be found to have ‘made’ a materially false statement—even though under the common law the managers would likely have been guilty or liable (in analogous circumstances) for doing so as *principals* (and not as aiders and abettors).<sup>17</sup>

By requiring plaintiffs to attribute the misstatement solely to the person or entity who stated it, the Supreme Court implicitly endorsed the bright-line attribution rule’s espoused by the Second, Fifth, Eighth, and Eleventh Circuits. The majority also explicitly rejected the Ninth Circuit’s “substantial participation” doctrine, finding that those kinds of suits may be brought by the Securities and Exchange Commission but not by private parties.<sup>18</sup>

Justice Stephen Breyer—joined by Justices Ruth Bader Ginsburg, Sonia Sotomayor and Elena Kagan—dissented. The dissent argued that “... depending upon the circumstances, a management company, a board of trustees, individual company officers, or others, separately or together, might ‘make’ statements contained in a firm’s prospectus—even if a board of directors has ultimate content-related responsibility. And the circumstances here are such that a court could find that Janus Management made the statements in question.”<sup>19</sup> The dissent seems to agree with the Ninth Circuit’s “substantial participation” doctrine, and espouses that the definition of “make” depends on the totality of the circumstances.

While the narrow issue in *Janus* concerns the definition of “make” for purposes of 10b-5 liability, the broader issue is what is necessary for a plaintiff to attribute a misstatement to a person or entity. The majority believes attribution is tied to the person/entity with ultimate control over the statement, whereas the dissent believes “[p]ractical matters related to context, including control, participation, and relevant audience, help determine who ‘makes’ a statement and to whom that statement may properly be ‘attributed’ ... .”

**Opening the Door on ‘Implied Statement’ Theory?**

However, the Court may have left open one avenue by which investors can bring a § 10b-5 claim on a collateral party. The argument made in *Janus* was that Janus Management directed the Janus Fund to make material misstatements in its prospectuses, and that the misstatements therein should have been attributed to Janus Management for purposes of § 10b-5. *Janus* thus stands for the proposition that when a party directs another to make a material misstatement, that party cannot be held liable under § 10b-5, because they were not the parties who “made” the misstatement in question. As the majority noted, “There is no allegation that [Janus Management] in fact filed the prospectuses and falsely attributed them to [Janus Fund].”<sup>20</sup> Thus *Janus* specifically left open the question of bringing an action based on an indirect material misstatement.

In footnote the majority stated “We think the phrase [‘indi-

rect'] merely clarifies that as long as a statement is made, it does not matter whether the statement was communicated directly or indirectly to the recipient."<sup>21</sup> This would seem to allow claims based on an implied statement theory.

Under an implied statement theory, a party brings a § 10b-5 action arguing that the collateral actor made an independent statement to investors by visibly and extensively participating in the creation or dissemination of a statement publicly attributed to the primary actor. Thus, through this endorsement of a third party's fraudulent statement, the collateral actor may have independently made a statement of its own, and as a result, defrauded investors by representing that it does not know of any fraudulent misrepresentations or omissions in the statement. Such an independent implied statement may be found to exist when the defendant's conduct is such that investors would reasonably rely upon the defendant in assessing the contents of the statement, and thus may form the basis of a § 10(b) claim if that implied statement is revealed to be fraudulent.<sup>22</sup> Prior to *Janus* only the First Circuit Court of Appeals has outright ruled on the applicability of an implied statement theory, finding it inapplicable. However, the majority's comments *in dicta* would seem to find otherwise, so long as the defendant's actions were public knowledge.

When *Ashcroft v. Iqbal*<sup>23</sup> was decided, many commentators speculated that the Court's decision would result in an overwhelming dismissal of cases in Federal Court; however a recent study proved otherwise.<sup>24</sup> Similarly here, it is uncertain how profound an impact *Janus* will have on private security suits. In short while commentators are quick to predict that this decision will dramatically restrict plaintiff's access to court, the true impact of *Janus* will not be known for some time. **SB**

Liam O'Brien is a partner at McCormick & O'Brien LLP, and has more than 19 years of broad-based experience trying cases as lead counsel in federal and state courts and before arbitration panels. He has successfully argued appeals before the U.S. Court of Appeals for the Second Circuit and the New York State Appellate Division, and he has represented clients in a number of other jurisdictions.



He can be reached at [Lobrien@mcoblaw.com](mailto:Lobrien@mcoblaw.com). Alexander Broche is a summer associate at McCormick & O'Brien, and is a J.D. candidate 2012 at Fordham University School of Law.

## Endnotes

<sup>1</sup>*Janus Capital Group Inc. v. First Derivative Traders*, 131 S. Ct. 2296, 2312 (2011).

<sup>2</sup>Barriers to Justice and Accountability: How the Supreme Court's Recent Rulings will Affect Corporate Behavior: Hearing Before the S. Comm. on the Judiciary, 112th Cong. (2011) (statement of Sen. Patrick Leahy, chairman, S. Comm. on the Judiciary), (Sen. Leahy's statement) available at [judiciary.senate.gov/hearings/testimony.cfm?id=3d9031b47812de2592c3baeba607fb62&wit\\_id=3d9031b47812de2592c3baeba607fb62-0-1](http://judiciary.senate.gov/hearings/testimony.cfm?id=3d9031b47812de2592c3baeba607fb62&wit_id=3d9031b47812de2592c3baeba607fb62-0-1).

<sup>3</sup>Sen. Leahy's statement.

<sup>4</sup>*Cent. Bank of Denver v. First Interstate Bank of Denver*, 511 U.S. 164 (1994).

<sup>5</sup>*Central Bank* at 191.

<sup>6</sup>*Stoneridge Inv. Partners LLC v. Scientific-Atlanta*, 552 U.S. 148 (2008).

<sup>7</sup>*Stoneridge* at 166.

<sup>8</sup>*Regents of Univ. of Cal. v. Credit Suisse First Boston*, 482 F.3d 372, 386-90 (5th Cir. 2007); *In re Charter Commc'ns Inc. Sec. Litig.*, 443 F.3d 987, 992 (8th Cir. 2006); *Ziamba v. Cascade Int'l, Inc.*, 256 F.3d 1194, 1205 (11th Cir. 2001); *Wright v. Ernst & Young*, 152 F.3d 169 (2d Cir. 1998).

<sup>9</sup>*Software Toolworks Inc. Litig.*, 50 F.3d 615 (9th Cir. 1994).

<sup>10</sup>*Wright*.

<sup>11</sup>*In re ZZZZ Best Sec. Litig.*, 864 F. Supp. 960 (C.D. Cal. 1994).

<sup>12</sup>*Janus*.

<sup>13</sup>*Janus*.

<sup>14</sup>*Janus* at 2301.

<sup>15</sup>*Janus* at 2304.

<sup>16</sup>*Janus* at 2302.

<sup>17</sup>*Janus* at 2310.

<sup>18</sup>*Janus* at 2302.

<sup>19</sup>*Janus* at 2306.

<sup>20</sup>*Janus* at 2312.

<sup>21</sup>*Janus* at 2312 n.11.

<sup>22</sup>David R. Allen, *A New Breath of Life for Private Rule 10b-5(b) Litigation After Stoneridge: Sec v. Tambone and Implied Statements by Collateral Actors*, 32 CARDOZO L. REV. 2093, 2128 (2011); *SEC v. Tambone*, 550 F.3d 106 (1st Cir. 2008), *rev'd en banc*, 597 F.3d 436 (1st Cir. 2010).

<sup>23</sup>*Ashcroft v. Iqbal*, 556 U.S. \_\_\_, 129 S. Ct. 1937 (2009).

<sup>24</sup>Joe S. Cecil, George W. Cort, Margaret S. Williams & Jared J. Bataillon, *Motions to Dismiss for Failure to State a Claim After Iqbal* at vii (2011), available at [www.fjc.gov/public/pdf.nsf/lookup/motioniqbal.pdf/\\$file/motioniqbal.pdf](http://www.fjc.gov/public/pdf.nsf/lookup/motioniqbal.pdf/$file/motioniqbal.pdf).



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## Prost v. Anderson: In The Tenth Circuit Non-Existent Crime Doesn't Pay Either

By: Kellen G. Ressmeyer and Carl W. Oberdier

In February, the Tenth Circuit Court of Appeals issued *Prost v. Anderson*, 636 F.3d 578, 2011 WL 590334 (10th Cir. Feb. 22, 2011), ruling that federal habeas statutes provide no relief in many cases where subsequent changes in the controlling law render convicts actually innocent. As a result, federal prisoners in the country's largest geographical Circuit (Colorado, Kansas, New Mexico, Oklahoma, Utah, and Wyoming) will remain imprisoned for non-existent offenses.

Worse yet, the majority in *Prost* was not required to address this issue at all—it did so over the objection of *both* the criminal defendant and the government. See Court-Ordered Response of the United States To Petition For Rehearing *En Banc*, filed Apr. 25, 2011 (United States Response), at 2. The panel unanimously agreed on the narrower issue necessary to resolve the appeal: controlling circuit precedent had not foreclosed Prost's exculpatory statutory interpretation at the time of his first habeas petition, thus he was barred from basing a second habeas petition on the U.S. Supreme Court's subsequent adoption of that interpretation.

The majority, however, reached out to reject the "erroneous circuit foreclosure test," which permits a second or successive habeas petition to go forward if controlling circuit precedent foreclosed the petitioner's innocence claim in the first instance. Although the majority discerned a "circuit split" on this issue, that was only because certain Circuit Courts had adopted an even *more liberal* rule.

Even the government implored the Court to refrain from considering the correctness of the erroneous circuit foreclosure test. United States Response, at 9 ("*Prost's* case did not present, much less require a decision on, the correctness of out-of-circuit precedent embracing the erroneous circuit foreclosure test[.]"). Indeed, in a rare occurrence in criminal appeal, the government joined the defendant in arguing for rehearing of the majority's decision en banc. "[A]bsent en banc review," the United States contended, the majority's "interpretation will bind future panels of this Court and force individuals who have been convicted of nonexistent offenses to languish in jail. Nothing in the text, history, or purposes of Section 2255 supports that extreme result." United States Response, at 5. In an equally-divided decision issued in May, however, the Tenth Circuit declined to hear the case *en banc*.

### Statutory Background

By the mid-twentieth century, habeas petitions were disproportionately crowding courts in areas with large numbers of incarcerated prisoners. At the same time, federal courts nationwide faced a "sea change in federal habeas petitions filed by state prisoners raising new constitutional claims." King, Nancy J., *et al.*, HABEAS FOR THE TWENTY-FIRST CENTURY: USES, ABUSES, AND THE FUTURE OF THE GREAT WRIT 110 (Univ. of Chi. Press 2011).

In response, Congress revised the statutory framework governing federal habeas relief. Under the new regime, 28 U.S.C. § 2225 served as the exclusive vehicle for challenging the validity of a

conviction or sentence, whereas 28 U.S.C. § 2241 was to be used to challenge the execution of a sentence. In other words, "[e]very federal prisoner attacking his conviction or sentence was required to use the new Section 2255 remedy *unless* it was 'inadequate or ineffective to test the legality of his detention,' a statutory phrase that became known as the 'savings clause.'" King, *supra* at 110-11 (emphasis added). If Section 2255 is inadequate or ineffective, then the prisoner can proceed under Section 2241 to attack the validity of his conviction or sentence.

In the absence of a clear directive from the Supreme Court, the U.S. Courts of Appeal have applied varying standards of the "inadequate or ineffective" test. However, "although the precise formulations vary, essentially each test provides that a federal prisoner who is 'actually innocent' of the crime of conviction, but who never has had an unobstructed procedural shot at presenting a claim of innocence," is entitled to proceed under Section 2241. Yackle, Larry W., POSTCONVICTION REMEDIES § 5:7. *Federal prisoners—Section 2241 habeas corpus petitions* (Database updated Aug. 2011). Until now.

### Keith Prost's Case

At issue in *Prost* was whether the U.S. Supreme Court's decision in *United States v. Santos*, 553 U.S. 507 (2008), defining "proceeds" as "profits" (not "gross receipts") for purposes of federal statutes criminalizing money laundering, rendered Prost actually innocent of his 1999 conviction for money laundering.

In 1999, Keith Prost pleaded guilty to conspiracy to launder illegal drug "proceeds," in violation of 18 U.S.C. § 1956(a)(1). In the underlying criminal proceedings, the government provided evidence that Prost had laundered "gross receipts" from drug transactions. The District Court of Missouri sentenced Prost to 168 months' imprisonment.

At the time of Prost's first petition for habeas relief pursuant to 28 U.S.C. § 2255(a), the Eighth Circuit (the reviewing court for the District of Missouri) had not decided whether the term "proceeds" under 18 U.S.C. § 1956(a)(1) included gross receipts.<sup>1</sup> Prost did not raise the argument in his initial habeas petition.

In 2008, the U.S. Supreme Court decided *Santos v. United States*, 553 U.S. 507 (2008), limiting "proceeds" under § 1956(a)(1) to encompass "profits," not gross receipts. In October of that year, Prost filed a second petition for habeas relief before the District of Colorado (as habeas law requires, because he is presently incarcerated in Colorado), arguing that *Santos* rendered him innocent under § 1956. In other words, the conviction for laundering "gross receipts" was not a cognizable offense.

Prost invoked the savings clause before the district court, arguing (a) the statute of limitations barred any successive motion for § 2255 relief; and (b) *Santos* rendered him actually innocent of the crime of money laundering. Thus, he contended, § 2255 was inadequate or ineffective to test the legality of his conviction, and he was entitled to proceed under § 2241.

The Colorado district court dismissed the petition, reasoning (a) "the fact that Prost may be barred from raising his claims in a second or successive motion in the sentencing court pursuant to 28 U.S.C. § 2255, by itself, does not demonstrate that the remedy provided in § 2255 is inadequate or ineffective"; and (b) "Prost

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does not explain with any clarity how the distinction laid out in *Santos* between criminal profits and criminal receipts makes him either legally or factually innocent of the money laundering crime.” *Prost v. Wiley*, 2008 WL 4925667, at \*2 (D. Colo. Nov. 13, 2008). Prost then appealed to the Tenth Circuit.

**The Tenth Circuit’s Decision**

Upon review, the Tenth Circuit unanimously affirmed the lower court’s denial of Prost’s petition, holding that Prost failed timely to present his statutory interpretation argument for actual innocence in his first habeas petition. *Prost*, 636 F.3d at 598 (Seymour J., concurring in part).

But the majority reached out further—rejecting the application of the erroneous circuit foreclosure test. The majority ruled that *even if* the Eighth Circuit had erroneously defined § 1956’s use of “proceeds” as gross receipts at the time of Prost’s first habeas petition (thereby requiring dismissal of a petition based on the argument that “proceeds” meant “profits”), § 2255 would have still been “adequate and effective”. And thus if *Santos* later rendered him actually innocent of the crime of conviction, he would have no recourse. *See Prost*, at 585 (“The ultimate result may be right or wrong as a matter of substantive law, but the savings clause is satisfied so long as the petitioner had an opportunity to bring and test his claim.” (Gorsuch, J.)).

In support, the majority reasoned that the “erroneous circuit foreclosure test” “would require us to address many novel questions of law, a fact [Judge Seymour’s] concurrence fails to acknowledge.” *Prost*, at 595. In rejecting the erroneous circuit foreclosure test, however, the majority ignored its decisive effect on other “novel” questions of law—such as the constitutional considerations governing procedural bars to factual innocence claims.

In response to indictments that *Prost* isolates the Tenth Circuit, the majority was dismissive: “[O]ur decision does nothing of the sort. Long before we arrived on the scene the circuits were already divided three different ways on how best to read the savings clause.” *Prost*, at 594. But, although the Circuits apply varying formulations of an actual innocence test—they *all* agree that habeas relief obtains to prisoners with actual innocence claims previously foreclosed by Circuit law. *Compare Prost*, at 592 (arguing that “the Ninth Circuit has offered a very different test ... . And, ... the Second and Third Circuits have vigorously pursued another test still.”) *with Taylor v. Gilkey*, 314 F.3d 832, 835 (7th Cir. 2002) (“Every court that has addressed the matter has held that 2255 is ‘inadequate or ineffective’ only when a structural problem in 2255 forecloses even one round of effective collateral review—and then only when as in *Davenport* the claim being foreclosed is one of actual innocence.” (citing the Third, Fourth, Fifth, Sixth, and Eleventh Circuits) (emphasis added)); *Harrison v. Ollison*, 519 F.3d 952, 959 (9th Cir. 2008) (a petition meets the requirements of the savings clause where “a petitioner (1) makes a claim of actual innocence, and (2) has not had an unobstructed procedural shot at presenting that claim.”).

In light of this authority, Prost moved for rehearing *en banc*.

The prosecution joined in moving the Court to reconsider its decision. “Rehearing *en banc* is warranted”, argued the Department of Justice, because “the majority’s interpretation of Section 2255(e) is incorrect, employs a faulty mode of interpretation, and will result in the continued incarceration of persons convicted without legislative authorization.” United States Response, at 14.

An equally-divided Tenth Circuit, however, declined to *en banc* the case. The decision may reflect the Court’s commitment to the ultimate conclusion (that Prost’s petition was untimely) more than complicity in the analysis (rejecting the erroneous circuit foreclosure test). Whatever its reasoning, the Department of Justice has observed that under *Prost*’s new rule, “a prisoner with a valid claim of statutory innocence previously foreclosed by circuit law would be afforded an opportunity to seek habeas corpus relief in any of the *other* circuits that has interpreted Section 2255(e)”, United States Response, at 14 (emphasis added), except the Tenth Circuit, where federal prisoners are subject to continued imprisonment for non-existent offenses. **SB**

*Kellen G. Ressmeyer and Carl W. Oberdier are partners in the New York law firm, Oberdier Ressmeyer LLP. Before entering private practice, Ressmeyer clerked for Tenth Circuit judges Stephanie K. Seymour and Robert H. Henry. Oberdier is a trial attorney and litigator who focuses on complex commercial litigation, patent litigation, and arbitration. For questions or comments about this article, feel free to contact the author at kgr@oberdier.com and cwo@oberdier.com.*

**Endnote**

<sup>1</sup>The Eighth Circuit had, however, construed “proceeds” to include “gross receipts” under the Racketeering Influenced and Corrupt Organizations Act (“RICO”). *See United States v. Simmons*, 154 F.3d 765 (8th Cir. 1998).



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