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Courts Set Limits on SEC's Aiding and Abetting Authority

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Two recent decisions have rejected the SEC's argument that aiding and abetting liability may be based on "recklessness," holding instead that the SEC must prove that the defendant "knowingly" assisted in a violation of the securities laws. If followed by other courts, these decisions could affect the scope of the SEC's enforcement program against secondary actors, such as lawyers, accountants, bankers and non-management directors.

The Supreme Court Clarifies Who Decides Whether an Agreement Containing an Arbitration Clause Is Valid

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The U.S. Supreme Court's recent *Buckeye Check Cashing* decision clarifies that issues of illegality of a contract containing an arbitration clause are for arbitrators, rather than courts, to determine.

European Commission Seeks to Facilitate Private Actions for Money Damages in European Antitrust Cases

By David I. Gelfand *Page 13*

The European Commission has issued a "Green Paper" on how the Commission might facilitate private actions for money damages in European antitrust cases. This may signal a shift in Europe toward U.S.-style litigation, although any changes in Europe will almost certainly fall well short of a wholesale adoption of the U.S. model.

Is There a First Amendment Discovery Privilege for Lobbying Communications?

By Sara D. Schotland and Patrick Bock *Page 19*

As both state and private plaintiffs have increasingly sought corporate and associational correspondence relating to the petitioning of government agencies and legislators, the question whether the First Amendment protects businesses from discovery of such correspondence arises with increasing frequency. There is authority for a First Amendment privilege in this context.

Courts Set Limits on SEC's Aiding and Abetting Authority

By David E. Brodsky and Timothy M. Haggerty

Two recent decisions from the Southern District of New York have imposed limits on the SEC's power to bring enforcement actions for aiding and abetting securities fraud. Rejecting the SEC's argument that aiding and abetting liability may be based on a defendant's "recklessness," the decisions held that to prove an aiding and abetting claim, the SEC must demonstrate that the defendant "knowingly" assisted in a violation of the securities laws. These decisions highlight, and have the potential to resolve, more than a decade of uncertainty in the law of aiding and abetting. If followed by other courts, the decisions could affect the scope of the SEC's enforcement program against secondary actors, such as lawyers, accountants, bankers and non-management directors.

I. The Roots of the Debate: Implied Aiding and Abetting Liability

Aiding and abetting liability under § 10(b) of the Securities Exchange Act of 1934 was a judicial innovation. The broad language of the statute, combined with its remedial purpose, led courts to conclude that § 10(b) prohibits aiding and abetting as well as primary acts of fraud. The authority of the SEC to bring aiding and abetting actions under § 10(b) dates back five decades, *see S.E.C. v. Scott Taylor & Co.*, 183 F. Supp. 904, 909 n.12 (S.D.N.Y. 1959), while the authority of private litigants to bring such claims dates back to the sixties, *see Brennan v. Midwestern United Life Ins. Co.*, 259 F. Supp. 673, 680-81 (N.D. Ind. 1966).

The SEC has used its authority to bring aiding and abetting claims against a wide variety of so-called "secondary actors": lawyers, bankers and accountants who "enabled" the primary violators, as well as corporate insiders who played subsidiary roles in the fraud. In at least one case, the SEC brought an aiding and abetting claim against the *customer* of a primary violator, alleging that the customer helped the primary violator, a software vendor, structure a software sale in a manner that allowed the vendor to improperly recognize revenue from the transaction. *S.E.C. v. Steckler,* No. C-03-0467-JW (N.D. Cal. 2005).

II. The Debate: Recklessness or Knowledge?

While the authority to bring aiding and abetting claims seemed firmly established, courts disagreed over what was required to satisfy the scienter element of those claims.[1] The debate centered on a simple question: would a showing of recklessness satisfy the plaintiff's burden?[2]

Defendants have long argued in favor of a standard that required a showing of actual knowledge of the fraud. Their argument grew out of the language of § 10(b), which prohibits "the use or employ[ment] . . . [of] any deceptive or manipulative device or contrivance." Defendants have argued that allowing reckless conduct to support an aiding and abetting claim would trespass the express limits of § 10(b), by reaching actors who do not actually use proscribed devices or engage in deceptive conduct. Further, they have contended, it would reach beyond the common law and criminal law boundaries of aiding and abetting, as described most famously by Judge Learned Hand in *United States v. Peoni*: "[a defendant must] in some sort associate himself with the venture, that he participate in it as in something he wishes to bring about, that he seek by his action to make it succeed. All the words used—even the most colorless, 'abet'—carry an implication of purposive attitude towards it." 100 F.2d 401, 402 (2d Cir. 1938).

Plaintiffs, including the SEC, have replied that recklessness suffices to support an aiding and abetting action. Specifically, they have noted that recklessness is sufficient to support a *primary* violation of § 10(b) and have argued that requiring a more stringent standard for aiding and abetting would effectively sanction securities fraud because of the difficulty in satisfying the higher burden. The Second Circuit showed sympathy for that argument in *Rolf v. Blyth, Eastman Dillon & Co.*, stating that the higher burden "would for all intents and purposes disembowel the private cause of action under § 10(b)." 570 F.2d 38, 47 (2d Cir. 1978). Moreover, plaintiffs have argued that, under the common law, recklessness is actually a species of knowing conduct. *Id.* at 45.

Splitting the difference without ending the debate, most courts adopted a sliding standard, under which the plaintiff's burden varied with the circumstances. Different circuits articulated this sliding standard in different ways. In the Second Circuit, recklessness would satisfy the scienter requirement when the defendant owed a fiduciary duty or a duty to disclose relevant information to the injured party. *See, e.g., Mishkin v. Peat, Marwick, Mitchell & Co.*, 658 F. Supp. 271, 273 (S.D.N.Y. 1987). Otherwise, "the scienter requirement scales upward – the assistance rendered must be knowing and substantial." *In re Laser Arms Corp. Sec. Litig.*, 794 F. Supp. 475, 491 (S.D.N.Y. 1989), *aff'd*, 969 F.2d 15 (2d Cir. 1992) (internal quotation marks and citations omitted). In the Fifth Circuit, the plaintiff's scienter burden shifted with the nature of the defendant's conduct — more "substantial" assistance yielded a less demanding scienter requirement. *Akin v. Q-L Invs., Inc.*, 959 F.2d 521, 531 (5th Cir. 1992). In a third twist, the Sixth Circuit held that the burden of the scienter element depended on whether the defendant assisted the fraud through action or inaction. *S.E.C. v. Coffey*, 493 F.2d 1304, 1317 (6th Cir. 1974).

This unsettled state of the law seemed poised for resolution in 1993 when the U.S. Supreme Court granted certiorari in *Central Bank of Denver, N.A. v. First Interstate Bank of Denver, N.A.*, 511 U.S. 164 (1994).

III. The Debate Refocused: *Central Bank* and the PSLRA

In *Central Bank*, the Court granted certiorari to consider whether recklessness, in contrast to actual knowledge, is sufficient to satisfy the scienter element of aiding and abetting liability under Section 10(b). This was actually the third time a case raising the issue had risen to the Supreme Court, the Court having dispensed with the earlier cases on other grounds, without reaching the scienter question.[3] In *Central Bank*, the Court took the unusual step of asking the parties to brief a separate and more fundamental question than the scienter requirement — whether § 10(b) supports the right of a private party to bring an action for aiding and abetting at all.

By answering the second question in the negative, the Court obviated the need to answer the scienter question. As the dissent in *Central Bank* noted, the Court answered a question that no one asked, with an answer that no one expected.[4] Indeed, the existence of a private right against aiders and abettors had been accepted by all Courts of Appeals that had considered the question. No court had ruled otherwise.[5]

While ostensibly a victory for defendants, the Court's *Central Bank* decision actually initiated a new period of uncertainty regarding liability for secondary actors in both private and SEC enforcement proceedings. Private plaintiffs have sought to sidestep *Central Bank*'s prohibition on aiding and abetting claims by recasting defendants' conduct as primary violations of the securities laws. In making these claims, plaintiffs accepted the Supreme Court's assertion that secondary actors could still be liable under the securities laws, "assuming *all* of the requirements for primary liability . . . are met." *Central Bank*, 511 U.S. at 191 (emphasis in original). Predictably, plaintiffs have advocated wide-ranging theories of primary liability while defendants have argued that such theories are disguised aiding and abetting claims of the sort proscribed by *Central Bank*. Attempts to define the conduct that exposes a secondary actor to primary liability after *Central Bank* have left lower courts divided.[6]

On the enforcement side, *Central Bank* not only left the scienter issue unresolved, but it threw into doubt the SEC's continued authority to bring actions based on an aiding and abetting theory. Although the majority expressly limited its ruling and analysis to private causes of action, the dissent asserted that "[t]he majority leaves little doubt that the Exchange Act does not even permit the SEC to pursue aiders and abettors in civil enforcement actions under § 10(b) and Rule 10b-5" and that the decision threatened to eliminate "an important part of the SEC's enforcement arsenal." *Central Bank*, 511 U.S. at 200.

The SEC's amicus brief in *Central Bank* had made the same point, supporting its position with statistics and public policy. The SEC stated that 15% of its § 10(b) cases included aiding and abetting allegations and that "[e]limination of such liability would sharply diminish the effectiveness of Commission actions." For these reasons, the SEC argued that "the rationale for permitting aiding and abetting liability in [enforcement] actions is somewhat different from (and even stronger than) the rationale in private damages actions." The SEC argued that whatever the Court's decision regarding private aiding and abetting claims, the SEC's authority to bring the claims should be maintained.

Despite the SEC's arguments, the majority's opinion made no express reference to a continued (or extinguished) right to bring enforcement actions for aiding and abetting. The dissent's suggestion that the majority opinion foreclosed enforcement actions based on aiding and abetting violations was the most authoritative pronouncement of the implications of the ruling for the SEC. The SEC, however, did not immediately accept the dissent's conclusion — SEC General Counsel Simon Lorne said that the Commission believed that *Central Bank* would not apply to its enforcement actions and joked that the dissent must be wrong because it was a dissent. However, less than a month after the *Central Bank* decision, SEC Chairman Arthur Levitt announced that the Commission would not devote "substantial resources to litigate the question" whether the *Central Bank* decision applies to Commission enforcement actions, instead reserving that argument for "one or more selected cases." Later, Levitt retreated further, concluding that the *Central Bank* decision did, in fact, preclude the SEC from bringing aiding and abetting actions.[7]

Congress came to the SEC's rescue when it passed the Private Securities Litigation Reform Act of 1995, which included a provision expressly authorizing the SEC to bring enforcement actions based on an aiding and abetting theory. Specifically, § 104 provided:

> Prosecution Of Persons Who Aid And Abet Violations — For purposes of any action brought by the Commission under paragraph (1) or (3) of section 21(d) of this title,[8] any person that *knowingly provides substantial assistance to another person in violation of a provision of this chapter,* or of any rule or regulation issued under this chapter, shall be deemed to be in violation of such provision to the same extent as the person to whom such assistance is provided.

15 U.S.C. § 78t(e) (emphasis added).

Since *Central Bank* and the PSLRA, most courts have reverted to the scienter analysis that pre-dated those two events, concluding that the PSLRA simply "restore[d] the pre-*Central Bank* status quo." *S.E.C. v. Fehn*, 97 F.3d 1276, 1288 (9th Cir. 1996); *S.E.C. v. PIMCO Advisors Fund Mgmt. LLC*, 341 F. Supp. 2d 454, 468 (S.D.N.Y. 2004) ("Recklessness is sufficient scienter to satisfy the knowledge element of aider and abettor liability in this case, where . . . [the defendant] owed a fiduciary duty to those who were defrauded by the misleading disclosures."); *S.E.C. v. Penthouse Int'l, Inc.*, 390 F. Supp. 2d 344, 355 (S.D.N.Y. 2005) (stating that "reckless is sufficient" and citing pre-*Central Bank* precedent as well as post-*Central Bank* cases that relied on pre-*Central Bank* precedent). Other courts have acknowledged that the "knowingly provides" language of the PSLRA raises a "reckless vs. knowing" issue, but concluded that resolving the issue was unnecessary because the SEC's evidence was sufficient to satisfy the more demanding "knowing" standard. *See, e.g., S.E.C. v. Lybrand*, 200 F. Supp. 2d 384, 399 (S.D.N.Y. 2002), *aff'd on other grounds*, 425 F.3d 143 (2d Cir. 2005).

In two recent cases, however, courts have concluded that the PSLRA imposes new limits on the SEC's authority to bring aiding and abetting claims.

IV. The Debate Resolved?

In *S.E.C. v. KPMG, LLP*, 412 F. Supp. 2d 349 (S.D.N.Y. 2006), Judge Denise Cote squarely rejected the SEC's contention that a showing of recklessness would satisfy the scienter element of an aiding and abetting claim. Instead, Judge Cote held that the defendant could only be liable for aiding and abetting a § 10(b) violation to the extent he had actual knowledge of the primary unlawful conduct.

In *KPMG*, the SEC brought claims against five KPMG partners for their roles in the firm's audits of Xerox Corporation between 1997 and 2000. Xerox had recently restated its earnings for those periods, reducing reported equipment revenues by $6.1 billion and pre-tax earnings by $1.9 billion — at the time, the largest financial restatement in U.S. history. The SEC alleged that the KPMG partners had known throughout that time that Xerox was using improper accounting practices in order to report distorted financial results. Of the KPMG partner-defendants, four were engagement partners during the time in question and one, Thomas J. Yoho, was a concurring partner.

All five defendants moved for summary judgment on the § 10(b) claims, arguing that they did not make misleading statements for which primary liability could attach. The court's decision turned on the roles played by the audit partners, as defined by the KPMG internal guidelines and the American Institute of Certified Public Accountant standards. For the engagement partners, the court concluded that because they held "ultimate authority" for the audit opinions, they could be liable for misstatements in the opinions. However, the court concluded that the KPMG guidelines and the AICPA standards did not give a concurring partner sufficient authority over the opinions such that Yoho could be considered a primary violator under § 10(b).

Thus, Yoho's summary judgment motion would turn on his liability for aiding and abetting. The SEC argued that recklessness would satisfy the scienter element of its aiding and abetting claim; Yoho argued that the SEC must show that he had actual knowledge of the primary violations.

Judge Cote's analysis followed the analytical framework of the Supreme Court's opinion in *Central Bank* by closely hewing to the statutory text, "[t]he starting point in every case involving construction of a statute." *Central Bank*, 511 U.S. at 173 (internal quotations and citations omitted).

- First, Judge Cote noted that "knowingly," the term used in § 104, is defined as actual knowledge in another section of the PSLRA. Even though Congress did not include such a definition in the aiding and abetting provision, Judge Cote suggested that the same term would not carry two different meanings in the same legislation. *KPMG,* 412 F. Supp. 2d at 382-83.
- Next, Judge Cote examined the legislative history of § 104 of the PSLRA, especially the rejection of a proposed amendment that would have imposed aiding and abetting liability for reckless conduct. The rejected amendment's sponsor said that without it, the provision "effectively eliminates the ability of the [SEC] to proceed against reckless professional assistors." *Id.* at 383 (quoting 141 Cong. Rec. S9032, S9083 (daily ed. June 26, 1995) (statement of Sen. Bryan)).
- Finally, the court rejected the SEC's argument that Section 104 merely codified a pre-existing standard of aiding and abetting liability, in which recklessness could support a claim. The court noted that the law on this issue was not settled at the time of the PSLRA's passage. To the contrary, the issue had risen to the U.S. Supreme Court, where it was not resolved. *Id.*

Judge Cote held that Yoho could be liable only to the extent he had actual knowledge of the fraud. The court reasoned in the alternative that even under the pre-*Central Bank*/PSLRA sliding-scale standard, a showing of recklessness would not satisfy the SEC's burden as against Yoho because he did not have a fiduciary relationship with the injured Xerox shareholders. And, the court rejected the suggestion that "an auditor's awareness that the general public will rely on its audit opinion is sufficient to import the recklessness standard into an aiding and abetting claim." *Id.* at 384. Judge Cote did not dismiss the aiding and abetting claim against Yoho, but held that he could be liable only if the SEC proved he had knowledge of the fraud.[9] *Id.* at 392.

In the second case, *S.E.C. v. Cedric Kushner Promotions, Inc.*, 417 F. Supp. 2d 326 (S.D.N.Y. 2006), Judge Thomas P. Griesa cited Judge Cote's *KPMG* decision when he granted a defendant's summary judgment motion on aiding and abetting claims under § 10(b).

In *Kushner*, the SEC had brought claims against several directors of Cedric Kushner Promotions, a boxing promotion company, based on their role in the filing of an annual report that contained fraudulent information and forged affirmations. Only the claims against one of the directors, Steven Angel, were at issue in the summary judgment motion.

The SEC tried to resurrect the sliding-scale standard for scienter, arguing that, as a director with fiduciary duties to injured shareholders, Angel's recklessness was sufficient to trigger aiding and abetting liability.[10] Despite this fiduciary relationship (which was not present in the *KPMG* case), the court rejected the SEC's position and held that "knowing misconduct must now be shown" in order to trigger aiding and abetting liability. *Kushner,* 417 F. Supp. 2d at 335.

V. Conclusion

The impact of these cases remains to be seen. At least one district court outside New York has followed the *KPMG* and *Kushner* approach. In *S.E.C. v. Sandifur*, No. C05-1631C, 2006 WL 538210, at *11 (W.D. Wash. Mar. 2, 2006), the court held that it "must determine whether the SEC has sufficiently alleged that Defendants . . . had actual knowledge that they were providing substantial assistance." On the other hand, the SEC has continued to pursue aiding and abetting claims based on recklessness. *See, e.g., S.E.C. v. Hopper*, No. Civ. A. H-04-1054, 2006 WL 778640, at *15 n.25 (S.D. Tex. Mar. 24, 2006) (stating that "the SEC contends that severe recklessness is sufficient," but finding that "the minimum level of required scienter need not be considered here").

The ultimate resolution of this issue has more than academic significance. In recent years, the SEC Staff has stated that using an aiding and abetting theory to pursue so-called "enablers" of fraud — secondary actors such as lawyers, accountants, bankers, and non-management directors — is an important part of its enforcement program.[11] If the *KPMG* and *Kushner* decisions take root, the SEC will have to limit its pursuit to those it can prove actually "knew" of the fraud they enabled.

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1 Under the most frequently adopted rubric, aiding and abetting liability required a showing of three elements: a primary violation, scienter, and substantial assistance. The Second Circuit formulation is typical: a plaintiff must show: "'(1) the existence of a securities law violation by the primary wrongdoer; (2) knowledge of the violation by the aider and abettor; and (3) proof that the aider and abettor substantially assisted in the primary violation.'" *S.E.C. v. PIMCO Advisors Fund Mgmt. LLC*, 341 F. Supp. 2d 454, 467-68 (S.D.N.Y. 2004) (citations omitted). Other circuits apply somewhat different formulations. The Fifth Circuit, for example, requires a plaintiff to show: "(1) a securities violation by a primary party; (2) that the aider and abettor had a general awareness of its role in the violation; and (3) that the aider and abettor knowingly rendered substantial assistance in that violation." *S.E.C. v. Morris*, No. Civ. A H-04-3096, 2005 WL 2000665, at *8 (S.D. Tex. Aug. 18, 2005).

2 Most courts define recklessness as, "at the least, conduct which is 'highly unreasonable' and which represents 'an extreme departure from the standards of ordinary care … to the extent that the danger was either known to the defendant or so obvious that the defendant must have been aware of it.'" *Rolf v. Blyth, Eastman Dillon & Co.*, 570 F.2d 38, 47 (2d Cir. 1978) (quoting *Sanders v. John Nuveen & Co.*, 554 F.2d 790, 793 (7th Cir. 1977)).

In the securities context, this means "not merely simple, or even inexcusable negligence, but an extreme departure from the standards of ordinary care, and which presents a danger of misleading buyers or sellers that is either known to the defendant or is so obvious that the actor must have been aware of it." *Hollinger v. Titan Capital Corp.*, 914 F.2d 1564, 1569 (9th Cir. 1990) (quoting *Sundstrand Corp. v. Sun Chem. Corp.*, 553 F.2d 1033, 1044 (7th Cir. 1977)). In circumstances where the aider and abettor encountered "red flags" or "'there was a danger so obvious that the defendant must have been aware of [it],'" the D.C. Circuit has looked for conduct evincing "extreme recklessness." *Howard v. S.E.C.*, 376 F.3d 1136, 1143 (D.C. Cir. 2004) (quoting *Graham v. S.E.C.*, 222 F.3d 994, 1006 (D.C. Cir. 2000)).

3 *See Ernst & Ernst v. Hochfelder*, 425 U.S. 185, 193 n.7 (1976) (finding that "we need not consider whether civil liability for aiding and abetting is appropriate under [§ 10(b)] and Rule [10b-5], nor the elements necessary to establish such a cause of action"); *Herman & MacLean v. Huddleston*, 459 U.S. 375, 379 n.5 (1983).

4 The dissent noted: "[I]nstead of simply addressing the questions presented by the parties, on which the law really was unsettled, the Court *sua sponte* directed the parties to address a question on which the petitioner justifiably thought the law was settled." *Central Bank*, 511

U.S. at 194-95. The Court split 5-4 in the *Central Bank* decision. Justice Kennedy wrote the majority opinion, joined by Chief Justice Rehnquist and Justices O'Connor, Scalia and Thomas. Justice Stevens wrote the dissent, joined by Justices Blackmun, Souter and Ginsberg.

5 The Seventh Circuit, however, had questioned the "propriety of implying such a cause of action" and noted that the Supreme Court had twice reserved rulings on the issue. The Court of Appeals concluded that, "[o]ur recognition of aider and abettor liability is rooted in 20+ years' precedent . . . and we stand by this decision until the Supreme Court tells us otherwise." *Robin v. Arthur Young & Co.*, 915 F.2d 1120, 1123 (7th Cir. 1990).

6 *Compare Wright v. Ernst & Young LLP*, 152 F.3d 169, 175 (2d Cir. 1998), *with In re Software Toolworks Inc. Secs. Litig.*, 50 F.3d 615, 628-29 & n.3 (9th Cir. 1994). *See also In re Enron Corp. Secs., Derivative & ERISA Litig.*, 235 F. Supp. 2d 549, 581-94 (S.D. Tex. 2002).

7 *See* Interview with Arthur Levitt, NewsHour with Jim Lehrer, July 15, 2002, *available at* http://www.pbs.org/newshour/bb/business/july-dec02/business_7-15.html.

8 This section empowers the SEC to enjoin or seek monetary penalties for securities law violations.

9 In the end, Yoho agreed to entry of an SEC administrative order finding that he failed to exercise sufficient due care in his concurring audit duties. *See* SEC Litigation Litigation Release No. 19573, *available at* http://www.sec.gov/litigation/litreleases/lr19573.htm.

10 Angel's conduct consisted of largely ministerial tasks related to the preparation of the fraudulent documents. He did not prepare or review the portions of the documents containing false or misleading statements.

11 *See* Speech of SEC Enforcement Director Stephen M. Cutler, The Themes of Sarbanes-Oxley as Reflected in the Commission's Enforcement Program (UCLA School of Law, Sept. 20, 2004), *available at* http://www.sec.gov/news/speech/spch092004smc.htm.

The Supreme Court Clarifies Who Decides Whether an Agreement Containing an Arbitration Clause Is Valid

By Jonathan I. Blackman and Inna Reznik

Early this year, the Supreme Court addressed the perennial question whether the arbitrator or the court should rule on a claim that a contract containing an arbitration clause is invalid. In *Buckeye Check Cashing, Inc. v. Cardegna*, __U.S. __, 126 S. Ct. 1204 (2006), two consumers brought a putative class action in Florida state court alleging that Buckeye charged usurious interest rates and that a "Deferred Deposit and Disclosure Agreement" they had entered into with Buckeye violated Florida lending and consumer protection laws. The Agreement contained a broad arbitration clause covering "[a]ny claim, dispute, or controversy . . . arising from or relating to this Agreement . . . or the validity, enforceability, or scope of this Arbitration Provision or the entire Agreement." *Id.* at 1207. Buckeye moved to compel arbitration under this clause.

The trial court denied Buckeye's motion to compel arbitration, holding that the court must first decide whether the contract is illegal and therefore void. The District Court of Appeal of Florida reversed, holding that the question of the contract's legality should be decided by the arbitrator because the plaintiffs did not challenge the arbitration clause itself but rather claimed that the entire contract was void. The Florida Supreme Court again reversed, agreeing with the trial court. Buckeye appealed to the United States Supreme Court.

The Supreme Court first distinguished between two kinds of challenges to the validity of an arbitration agreement — specific challenges to the validity of the agreement to arbitrate and general challenges to the contract as a whole. The Court found that the consumers' claim was of the latter type because the "crux of the complaint is that the contract as a whole (including its arbitration provision) is rendered invalid by the usurious finance charge." *Id.* at 1208.

The Court then reviewed the state of the law on this subject. In the seminal case, *Prima Paint Corp. v. Flood & Conklin Manufacturing Co.*, 388 U.S. 395 (1967), the Court held that a federal court may proceed to adjudicate a claim of "fraud in the inducement of the arbitration clause itself" because that is "an issue which goes to the 'making' of the agreement to arbitrate" as understood in section 4 of the Federal Arbitration Act,[1] but the "statutory language does not permit the federal court to consider claims of fraud in the inducement of the contract generally." *Id.* at 403-04. In a later case, *Southland Corp. v. Keating*, 465 U.S. 1 (1984), the Court held that "the substantive law the [FAA] created was applicable in state and federal court." *Id.* at 12.[2]

The Court in *Buckeye* summarized *Prima Paint* and *Southland* as establishing the following three propositions:

> First, as a matter of substantive federal arbitration law, an arbitration provision is severable from the remainder of the contract. Second, unless the challenge is to the arbitration clause itself, the issue of the contract's validity is considered by the arbitrator in the first instance. Third, this arbitration law applies in state as well as federal court. 126 S. Ct. at 1209. Applying these propositions to the facts of the

> *Buckeye* case, the Court held that "because respondents challenge the Agreement, but not specifically its arbitration provisions, those provisions are enforceable apart from the remainder of the contract. The challenge should therefore be considered by an arbitrator, not a court." *Id.*

The Court in *Buckeye* also clarified several issues regarding the interplay between state and federal law in this area. First, it rejected the notion that the severability doctrine turns on the distinction between void and voidable contracts. The Florida Supreme Court had ruled that because Florida contract law rendered illegal contracts void, no part of the contract (including the arbitration clause) could be severed. The Court in *Buckeye*, after noting that neither *Prima Paint* nor *Southland* even addressed the issue of whether the claims of invalidity raised there would have rendered the contract void or voidable under state law, stated, "we cannot accept the Florida Supreme Court's conclusion that enforceability of the arbitration agreement should turn on Florida public policy and contract law." *Id.* (quotation marks and citation omitted). Second, the Supreme Court clarified that the rule of severability applies in state court just as in federal court. In reaching this conclusion, the Court dismissed plaintiffs' contention that an agreement void under state law is not a "contract" under section 2 of the FAA, and therefore an arbitration provision in such an agreement is not enforceable. Rather, the Court read "contract" in section 2 to include "putative contracts" as well. *Id.* at 1210.

The first footnote of the Court's opinion is instructive as well. Here, the Court signaled that certain other types of challenges to a contract's validity might be appropriate for adjudication by a court rather than an arbitrator:

> The issue of the contract's validity is different from the issue of whether any agreement between the alleged obligor and obligee was ever concluded. Our opinion today addresses only the former, and does not speak to the issue decided in the cases cited by respondents (and by the Florida Supreme Court), which hold that it is for the courts to decide whether the alleged obligor ever signed the contract, whether the signor lacked authority to commit the alleged principal, and whether the signor lacked the mental capacity to assent.

Id. at 1208 n.1 (citation omitted). The *Buckeye* decision certainly forecloses the argument that a contract's illegality renders its arbitration clause unenforceable. But armed with this footnote, litigants wishing to avoid arbitration might very well focus their efforts on arguing that their challenge to the contract's validity concerns whether an agreement "was ever concluded" and therefore should be decided by a court. Citing the specific examples in the footnote would certainly present the strongest case, but perhaps the lower courts also will consider other types of "formation" challenges to be akin to a claim that a contract never existed in the first place. *See, e.g., Sphere Drake Ins. Ltd. v. All Am. Ins. Co.*, 256 F.3d 587, 591 (7th Cir. 2001) ("Lack of consideration has historically made the promise unenforceable in court . . . . [Thus,] a claim of missing consideration will be heard by a court and, if the agreement is not supported by consideration, the dispute will not be sent to arbitration.").

One important precedent not cited in the *Buckeye* opinion is *First Options of Chicago, Inc. v. Kaplan*, 514 U.S. 938 (1995). The *First Options* case does not address the issue of who has the power to decide whether an arbitration agreement is valid, but rather the issue of who has the power to decide whether the parties agreed to arbitrate the merits of their dispute. In *First Options*, a securities clearing firm commenced arbitration against an investment company and its individual owners arising out of certain disputes over a "workout" agreement. The investment company had signed a document containing an arbitration clause and accepted arbitration, but the individuals had not personally signed any document with an arbitration clause and on that basis, submitted written objections to the arbitral panel arguing that their dispute with the securities clearing firm was not arbitrable. The panel disagreed and proceeded to arbitrate the dispute and issue an award. The individuals then sought to vacate the award in court and the securities clearing firm requested the award's confirmation. The district court confirmed the award, but the Court of Appeals for the Third Circuit reversed. The Supreme Court granted certiorari to address whether the Court of Appeals was correct in stating that "courts should *independently* decide whether an arbitration panel has jurisdiction over the merits of any particular dispute." *Id.* at 941 (quotation marks and citation omitted) (emphasis in original).

In analyzing what it characterized as a "fairly simple" question, the Court in *First Options* started with the proposition that "[j]ust as the arbitrability of the merits of a dispute depends upon whether the parties agreed to arbitrate that dispute, so the question 'who has the primary power to decide arbitrability' turns upon what the parties agreed about *that* matter." *Id.* at 943 (citations omitted) (emphasis in original). But, before determining that the parties have agreed to submit the arbitrability issue to arbitration, a court must have "clear and unmistakable" evidence of such an agreement. *Id.* at 944. This evidentiary hurdle at first glance seems to run contrary to the ordinary presumption that any doubts concerning the scope of arbitrable issues should be resolved in favor of arbitration. However, the *First Options* opinion explains that the law treats the question of who should decide arbitrability differently from the question of whether a particular merits-related dispute is arbitrable, because the former is a "rather arcane" question that a "party often might not focus upon." *Id.* at 944-45. The Court ultimately concluded that the individuals did not clearly agree to submit the question of arbitrability to arbitration, and therefore, that question was subject to independent review by the courts. *See id.* at 947.

Although the *First Options* case did not offer much insight into what would constitute "clear and unmistakable evidence" of the parties' intent to arbitrate arbitrability, some lower courts have done so. In *Shaw Group Inc. v. Triplefine International Corp.*, 322 F.3d 115 (2d Cir. 2003), the Court of Appeals for the Second Circuit held that the parties manifested a clear intent to arbitrate arbitrability (in that case, whether a particular breach of contract claim was arbitrable) because (1) the arbitration clause was broad, and (2) the arbitration was governed by the rules of the International Chamber of Commerce (the "ICC"), which allow the arbitrators to determine their own jurisdiction. *See id.* at 121-23; *see also Terminix Int'l Co. v. Palmer Ranch Ltd. P'ship*, 432 F.3d 1327, 1332 (11th Cir. 2005) (by incorporating American Arbitration Association ("AAA") rules into contract, "parties clearly and unmistakably agreed" to have arbitrator decide arbitrability).[3]

Judge Easterbrook of the Seventh Circuit has said that *Prima Paint* "sits uneasily alongside" *First Options. Sphere Drake*, 256 F.3d at 590. Does *Buckeye* occupy a similar position? Should the Court in *Buckeye* have followed the principles set forth in *First Options* and left it to the arbitrator to decide whether the parties intended to arbitrate the issue of the agreement's validity? After all, the arbitration clause in *Buckeye* was as broad as can be. On the other hand, there is no indication of what arbitral rules the parties in *Buckeye* had agreed to. More fundamentally, it appears that the Court in *Buckeye* did not address the *First Options* argument because Buckeye just did not raise it. Thus, for a party who prefers to arbitrate, but is faced with the kind of challenge to the validity of an agreement cited in *Buckeye*'s footnote 1, the lesson might be to argue, under *First Options* and its progeny, that the parties intended to submit the arbitrability issues to the arbitrators.

In the world of complex commercial transactions, arbitration clauses are broadly drafted and are merely small parts of much larger contracts. With this context in mind, and the recent clarifications by the Supreme Court in the *Buckeye* case, the question of "who decides" can be synthesized as follows. It is for the court to decide whether an arbitration agreement exists, and this includes deciding whether the parties ever even concluded a contract containing an arbitration agreement. It is for the arbitrator to decide the scope of the arbitration agreement and any issues relating to the contract as a whole.

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1 Section 4 of the Federal Arbitration Act, which gives a party the right to petition a federal court for an order to compel arbitration, provides in part, "[t]he court shall hear the parties, and upon being satisfied that the *making of the agreement for arbitration* . . . is not in issue, the court shall make an order directing the parties to proceed to arbitration . . . . If the *making of the arbitration agreement* . . . be in issue, the court shall proceed summarily to the trial thereof." 9 U.S.C. § 4 (emphasis added).

2 In *Southland*, the FAA provision at issue was section 2, which provides in part, "[a] written provision in any maritime transaction or a contract evidencing a transaction involving commerce to settle by arbitration a controversy thereafter arising out of such contract or transaction . . . shall be valid, irrevocable, and enforceable, save upon such grounds as exist at law or in equity for the revocation of any contract." 9 U.S.C. § 2. The Court in *Buckeye* stated that section 2 "embodies the national policy favoring arbitration and places arbitration agreements on equal footing with all other contracts." 126 S. Ct. at 1207.

3 Article 6(2) of the ICC Rules of Arbitration provides, "if any party raises one or more pleas concerning the existence, validity or scope of the arbitration agreement, the [ICC] may decide . . . that the arbitration shall proceed if it is *prima facie* satisfied that an arbitration under the Rules may exist. In such a case, any decision as to the jurisdiction of the Arbitral Tribunal shall be taken by the Arbitral Tribunal itself." (Rules *available at* www.iccwbo.org/court.) Rule R-7(a) of the Commercial Arbitration Rules of the AAA provides that the "arbitrator shall have the power to rule on his or her own jurisdiction." (Rules *available at* http://www.adr.org/RulesProcedures.) *See also* Article 15(1) of the AAA's International Dispute Resolution Procedures ("The tribunal shall have the power to rule on its own jurisdiction . . . .").

European Commission Seeks to Facilitate Private Actions for Money Damages in European Antitrust Cases

By David I. Gelfand

In December 2005, the European Commission released a "Green Paper" discussing various aspects of private damages actions for violations of Europe's antitrust laws and soliciting comments from interested parties.[1] This document is noteworthy both because of what it might mean for future antitrust cases and because of its potential to encourage greater European acceptance of U.S.-style litigation in other fields. Any company with operations in Europe that might be subject to future lawsuits there should take note.

The Green Paper is the latest effort by the Commission to encourage private enforcement of the antitrust laws as a complement to governmental enforcement activities,[2] just as private treble damages litigation has been a key element of the U.S. enforcement regime since passage of the Clayton Act in 1914. As the Commission noted, "Facilitating damages claims for breach of antitrust law will not only make it easier for consumers and firms who have suffered damages arising from an infringement of antitrust rules to recover their losses from the infringer but also strengthen the enforcement of antitrust law."[3]

Historically, Europe has not had a litigious culture and the procedural rules of the national courts are generally not hospitable to plaintiffs. Among other things, little formal discovery is available to the parties, class actions are not generally allowed, cases are decided by judges rather than juries, contingency fees are disfavored or disallowed, and losing parties must pay their adversaries' fees. Europeans (like many Americans) tend to view the U.S. civil litigation system as a free-for-all in which plaintiffs often bring frivolous lawsuits or overreach in lawsuits that may have some legitimate basis, and rely on the expense and risk of litigation to coerce settlements from defendants with deep pockets.[4]

The Commission has concluded that some change in Europe is necessary: "While Community law … demands an effective system for damages claims for infringement of antitrust rules, this area of the law in the 25 Member States presents a picture of 'total underdevelopment.'"[5] But it is also clear that the Commission wishes to proceed cautiously: "The Commission wants to use the debate to find ways to better compensate for antitrust injuries and increase deterrence, while avoiding the situation where defendants settle simply because litigation costs are too high. The ultimate objective should be to foster a competition culture, not a litigation culture."[6]

It is not clear what will come out of this exercise, as the Commission does not have the authority to prescribe the rules that govern civil litigation in individual countries. But the Commission can issue guidelines, model rules, or other recommendations that might influence national lawmakers and national courts, especially if national competition authorities support the Commission's conclusions. Therefore the Green Paper should be viewed as a first step toward possible reforms at the national level that could have significant repercussions.

Three issues addressed in the Green Paper – discovery, damages, and collective actions – are of particular interest to any U.S. company that might confront a future claim in Europe and are issues on which the Commission can be expected to draw heavily from the U.S. experience.[7]

A. Discovery

Perhaps no other aspect of U.S. litigation is viewed more suspiciously abroad than the generous discovery rights afforded to litigants under the Federal Rules of Civil Procedure and similar state rules. The national court systems in Europe do not come close to providing the breadth of discovery that is available to U.S. litigants. There are typically no counterparts to interrogatories and depositions. European litigants generally do not have the right to request broad categories of documents from their adversaries, nor can they compel the production of documents from third parties. Litigants are largely left to their own devices in building a case and developing evidence to support it.[8]

Notably, the first question asked in the Green Paper is, "[s]hould there be special rules on disclosure of documentary evidence in civil proceedings for damages under [European antitrust law]? … If so, which form should such disclosure take?"[9] This question reflects the Commission's view that antitrust cases involve complex sets of facts and can be litigated effectively only if parties (primarily plaintiffs) are given access to documents in the possession of their adversaries. "The particular difficulty with this kind of litigation is that often the relevant evidence is not easily available and is held by the party committing the anti-competitive behaviour."[10]

The Commission sets out three options for defining the obligation of parties to produce documents in antitrust cases, each of which is significantly less intrusive than document discovery in U.S. cases but more generous than that permitted by the current rules in Europe.[11] Under the first option, the disclosure of documents would occur only after the opposing party "has set out in detail the relevant facts of the case and has presented reasonably available evidence in support of its allegations."[12] Even then, disclosure would be "limited to relevant and reasonably identified individual documents and should be ordered by the court."[13] The requirements of fact specific pleading and that the court enter an order requiring disclosure would appear designed to avoid what many see as a fundamental flaw in the U.S. system, *i.e.*, parties seeking massive volumes of discovery to coerce the other side or simply to conduct an unwarranted fishing expedition in hopes of finding incriminating evidence.[14]

The second option also would require specific fact pleading as a predicate to disclosure but would allow the court to order mandatory disclosure of entire "classes" of documents. The third option would still require fact specific pleading, but would oblige each party to give the other a list of relevant documents in its possession. These proposals may seem quite modest by U.S. standards, but they would represent a real departure from current practice in many European countries.

The Commission also raises a question about how to deal with documents that have been provided to a competition authority such as the Commission itself.[15] Antitrust cases – especially those alleging horizontal cartels to fix prices, rig bids or divide markets – often follow governmental investigations, where a violation has been found after the competition authority collects documents. These documents may be relevant to a plaintiff's claim alleging the same violation. The Commission clearly wishes to facilitate the production of these documents.

Public comments on the Green Paper can be expected to provide a range of views to the Commission about document discovery. The plaintiffs' bar undoubtedly will argue that the suggestions in the Green Paper do not go far enough, but any attempt to persuade the Commission to adopt the U.S. litigation model wholesale is certain to be futile. The defense bar and companies that have experienced the burdens associated with U.S. antitrust litigation will inform the Commission about instances of abuse and the frequent failure of the system to limit the parties to relevant evidence. For its part, the Commission appears already convinced that some degree of document discovery is essential to private antitrust litigation. Perhaps the more important question is whether it will be able to so persuade the national authorities and courts.

B. Damages

The Green Paper raises several important questions about damages in antitrust cases.[16] It asks whether damages should be awarded with reference to the loss suffered by the plaintiff or with reference to the illegal gain earned by the defendant; whether double damages should be available for horizontal cartels; whether prejudgment interest should be awarded to plaintiffs; and whether damages should be calculated using complex economic models or using simpler methods.[17] How the Commission answers each of these questions will make a real difference in financial exposure for future antitrust defendants.

As for the first question, it seems likely that the Commission will adopt the U.S. model – that damages should be assessed with reference to the loss suffered by the plaintiff – which has effectively encouraged private enforcement. In a typical antitrust case, plaintiffs seek damages for overcharges they paid to the defendants. In some cases, they might seek damages for lost business opportunities or perhaps being put out of business altogether. Using any of these methods, the loss to plaintiffs is likely to be equal to or greater than the gain to the defendant from those plaintiffs. Using plaintiffs' loss as the reference point also aligns incentives for bringing an action with the parties most affected by the defendant's conduct and avoids issues about how to allocate the defendant's gain among multiple plaintiffs. It also avoids litigation over whether the defendant lost sales or incurred additional costs – both of which might reduce its gain – as a result of its violation.

Whether to allow double damages in antitrust cases is a much more controversial issue for the Commission. U.S. law has long provided for the automatic trebling of damages in all cases in which a violation of the federal antitrust laws is found.[18] Many in the United States view treble damages as an essential element of effective antitrust enforcement. Treble damages deter violations and compensate for violations that go undetected. Others, however, view treble damages as excessive. They encourage plaintiffs to bring lawsuits that lack merit and, except where hardcore violations like price-fixing are concerned, they can deter conduct that may be pro-competitive.

The Green Paper suggests that the Commission might like to see Europe move toward the U.S. model, with some type of damages multiplier. At the same time, the Green Paper proposes double damages rather than treble damages, and it proposes double damages only in cases involving horizontal cartels. The Green Paper also holds out the possibility that awarding a multiple of actual damages might be left to the discretion of the court, whereas trebling is automatic in U.S. antitrust actions.

The debate about whether to impose double damages on antitrust defendants might be academic in some European countries, however, as punitive damages of any kind are often viewed as contrary to public policy. As noted by the Commission Staff Working Paper, "It should be borne in mind that most Member States exclude exemplary or punitive damages as contrary to their public policy. For that very reason, those Member States may refuse to recognize and to enforce decisions providing for such damages."[19]

If the Commission rejects double damages as a model for antitrust cases, it seems likely that it would endorse prejudgment interest as an alternative. Prejudgment interest compensates a plaintiff for loss of use of funds between the time it is injured and the time it receives compensation, so it seems like a logical component of a regime that seeks fully to compensate victims of antitrust violations. Conversely, if double damages were allowed, a prevailing plaintiff would usually be more than compensated for its injury even in the absence of prejudgment interest.[20]

The Commission's interest in whether to base damages on complex economic models or simpler methods also bears on the availability of discovery. Most practitioners would agree that simple methods of calculating damages are often inaccurate and unfair. For example, a method that simply compares pricing before and after an antitrust violation might fail to consider relevant factors other than the antitrust violation, such as costs or changes in demand. To analyze the true effect of the antitrust violation, it is often necessary to use techniques like multivariate regression. Using simpler methods carries the risk of awarding a windfall to plaintiffs who are not damaged or allowing defendants who cause substantial injury to escape liability.

While complex modeling techniques are well known and generally accepted in the economic community, they are only as good as the data that goes into them and the expert who uses them. Reasonable discovery may be necessary to obtain the input data, to assess the work of the opposing expert, to cross-examine the other expert's techniques, and to ensure that this type of evidence has validity. Without discovery, it is doubtful that these techniques can be used in a manner that is fair to the parties. Courts might appoint experts to carry out the damages analysis, but this solution would deprive the parties of the benefits of the adversary system and would carry its own risks of bias and inaccuracy. And even with a court-appointed expert, parties would still need a means of obtaining the necessary input data.

C. Collective Actions

The Commission has raised the question whether procedures should be adopted to allow consumers to bring collective actions. As the Green Paper notes, "[i]t will be very unlikely for practical reasons, if not impossible, that consumers and purchasers with small claims will bring an action for damages for breach of antitrust law . . . . Beyond the specific protection of consumer interest, collective actions can serve to consolidate a large number of smaller claims into one action, thereby saving time and money."[21]

It is unclear how collective actions for antitrust violations would work in Europe. The Green Paper speaks of consumer associations with a possible registration or authorization system.[22] The Commission appears sensitive to leaving consumers free to pursue their own cases if they wish, much as class members can opt out under U.S. law.[23] The model suggested in the Green Paper differs from the U.S. model, however, in that consumer associations rather than representative plaintiffs would pursue the lawsuit on behalf of their members.

The Commission's suggestions regarding collective actions raise a wide range of additional questions. For example, if collective actions were to become accepted across Europe, standards like those in Rule 23 of the Federal Rules of Civil Procedure – numerosity, commonality, typicality, adequacy of representation, predominance of common issues – would have to be developed to limit such actions to cases in which the benefits of collective action outweigh the risks. Similarly, the role of courts in overseeing the management of such actions, ensuring fair notice to affected parties, approving settlements and attorneys' fees, and so forth would have to be defined. Decisions also would have to be made about whether collective actions should be reserved for consumer claims or whether they should extend, as U.S. class actions often do, to collective groups that include large companies as the claimants. Europe would also face challenges should the Commission seek to extend collective actions across national boundaries and bind the citizens of multiple countries through a proceeding in one national court.

As with discovery and damages, it appears that the Commission is trying to move Europe in the direction of the U.S. model for collective actions, but will stop well short of adopting the U.S. model *in toto*.

D. Conclusion

The Green Paper is an important development. Depending on one's view of the matter, the paper is either the first step toward U.S.-style litigation and greater compensation of antitrust victims in Europe, or it is an opportunity to stop such changes before the excesses of the U.S. system can be unleashed in Europe.

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1 Commission of the European Communities, Green Paper: Damages Actions for Breach of the EC Antitrust Rules, Brussels (Dec. 19, 2005), SEC (2005) 1732, *available at* http://europa.eu.int/comm/off/green/index_en.htm ("Green Paper"). "The purpose of this Green Paper and of the Commission Staff Working Paper [that accompanies it] is to identify the main obstacles to a more efficient system of damages claims and to set out different options for further reflection and possible action to improve damages actions both for follow-on actions (*e.g.*, cases in which the civil action is brought after a competition authority has found an infringement) and for stand-alone actions (that is to say actions which do not follow on from a prior finding by a competition authority of an infringement of competition law)." *Id*. at 4.

2 Council Regulation 1/2003, which came into force on May 1, 2004, encouraged greater enforcement of European competition law by national authorities and national courts. For example, Article 6 of Regulation 1/2003 gave national courts the power to apply Articles 81 and 82 of the EC Treaty, which are the principal non-merger competition laws of Europe. *See* Commission of the European Communities, Commission Staff Working Paper, Annex to the Green Paper: Damages Actions for Breach of the EC Antitrust Rules, Brussels (Dec. 19, 2005), COM(2005) 672, at 11, *available at* http://europa.eu.int/comm/competition/antitrust/others/actions_for_damages/sp_en.pdf. ("Staff Working Paper").

3 Green Paper at 3.

4 As noted by the Commission, "The US system is often perceived as encouraging unmeritorious or vexatious litigation. … The protection of rights deriving from Community competition law is important, but it is also important to keep excessive litigation in check and to try to achieve some form of moderation in the enforcement system." Staff Working Paper at 15.

5 Green Paper at 4 (citation omitted). In reaching this conclusion, the Commission relied on a recent study of the effectiveness of private litigation in Europe, which it had commissioned. "The conclusions of the Study were that not only is there '*total underdevelopment*' of actions for damages for breach of EC antitrust rules, but there is also '*astonishing diversity*' in the approaches taken by the Member States." Staff Working Paper at 12 (emphasis in original).

6 Staff Working Paper at 8.

7 The Green Paper also addresses issues of fault requirements, the passing-on defense and standing of indirect purchasers to bring suit, awarding costs of actions, coordination of public and private enforcement, jurisdiction and applicable law, whether courts should appoint experts when needed, rules for suspending limitation periods, and causation requirements. Green Paper at 6-11.

8 "It has been generally acknowledged that the difficulty for the claimant of obtaining evidence of the alleged antitrust infringement constitutes one of the major obstacles to damages actions." Staff Working Paper at 18.

9 Green Paper at 5. The Green Paper does not propose the adoption of interrogatories or depositions.

10 Green Paper at 5. U.S. courts have similarly observed that evidence of antitrust violations is often found only in the hands of the parties who have violated the law. *See, e.g.*, *Poller v. Columbia Broad. Sys., Inc.*, 368 U.S. 464, 473 (1962) ("in complex antitrust litigation … the proof is largely in the hands of the alleged conspirators").

11 The Green Paper also suggests that a party might be sanctioned for destroying documents it is obligated to turn over, or might be required to preserve evidence even before a case begins if the court enters a preservation order upon demonstration of a *prima facie* case for such an order. These measures are taken for granted in the United States. The fact that the Commission considers this to be an open issue itself reveals how reluctant Europeans may be to embrace the U.S. model of discovery. Green Paper at 5.

12 *Id.*

13 *Id*.

14 *See, e.g.*, *Twombly v. Bell Atl. Corp*., 425 F.3d 99, 115-17 (2d Cir. 2005) (acknowledging "a well-founded concern" that antitrust plaintiffs might "condemn defendants to potentially limitless 'fishing expeditions' — discovery pursued just 'in case anything turns up,'" but concluding that, if these problems are to be fixed, "it is Congress or the Supreme Court that must do so") (citation omitted).

15 Green Paper at 6.

16 Green Paper at 7.

17 *Id.*

18 Since its enactment in 1914, Section 4 of the Clayton Act, 15 U.S.C. § 15, has provided for treble damages.

19 Staff Working Paper at 36.

20 Under U.S. law, antitrust plaintiffs are entitled to prejudgment interest only from the filing of the lawsuit. 15 U.S.C. § 15(a). It is discretionary with the court, which is supposed to consider such factors as whether the defendant has engaged in dilatory litigation tactics. With the availability of treble damages for winning plaintiffs, however, prejudgment interest is usually not considered a significant element of antitrust recovery in the United States.

21 Green Paper at 8.

22 *Id.* at 9.

23 *Id.* (mentioning "cause of action for consumer associations without depriving individual consumers of bringing an action").

Is There a First Amendment Discovery Privilege for Lobbying Communications?

By Sara D. Schotland and Patrick Bock

Review of Moore's Civil Procedure suggests a panoply of potential privilege claims, including attorney-client privilege and attorney work product, but no consideration of First Amendment privilege claims, outside the narrow context of journalist's privilege. The question whether the First Amendment protects businesses from discovery materials relating to lobbying of Congress, state legislators, or federal and state regulators is important and arises with increasing frequency. Both private plaintiffs and government enforcers often seek discovery of business documents related to political advocacy in tort, antitrust, and other actions.

The topic is especially timely in light of a ruling by a Minnesota state court that certain lobbying material was not required to be disclosed because the potential chilling effect of the communication outweighed relevance to a state attorney general's antitrust action.[1]

A. The First Amendment Concern

In *NAACP v. Alabama*, 357 U.S. 449 (1958), the U.S. Supreme Court blocked a discovery order requiring extensive disclosure of NAACP membership lists, because of First Amendment concerns. While the potential physical reprisal against members of a political and advocacy organization, as was true in that case, presents an especially compelling case for First Amendment scrutiny, the First Amendment also protects the political expression of business entities. Political expression is protected under the First Amendment regardless of whether the underlying agenda of the individual, company or association seeking protection is economic or political.[2]

As the Supreme Court stated in the landmark campaign finance case *Buckley v. Valeo*, 424 U.S. 1, 14 (1976), the First Amendment seeks "'to assure unfettered interchange of ideas for the bringing about of political and social changes desired by the people'" (citation omitted). Furthermore, a "major purpose of that Amendment was to protect the free discussion of governmental affairs."[3] In the context of campaign finance laws, the Court applied the *NAACP* "exacting scrutiny" standard and required that the government show an important state interest to justify incursion on First Amendment rights through discovery.[4] "[C]ompelled disclosure, in itself, can seriously infringe on privacy of association and belief guaranteed by the First Amendment."[5]

Courts have recognized not only the Constitutional right of citizens to express their political views, but also the value that Congress and administrative agencies can derive from input by the regulated community. Meaningful public participation in legislation and rulemaking from all interested parties is encouraged because it permits administrative agencies to inform themselves about the impact of regulation and to afford adequate safeguards to private interests.[6]

B. The First Amendment Balancing Test

Where compelled disclosure of information implicates First Amendment interests, a number of courts have applied a balancing test to determine whether intrusion passes constitutional muster. The courts consider whether the information sought is truly relevant and goes to the heart of the lawsuit; whether the information sought is overbroad; and whether alternative means have been sought to obtain the requested information.[7]

Once a party makes a *prima facie* showing of entitlement to the First Amendment privilege, the burden shifts to the party seeking disclosure to demonstrate "a compelling need" for the requested information.[8] The "litigant seeking protection need not prove to a certainty that its First Amendment rights will be chilled by disclosure. It need only show that there is some probability that disclosure will lead to reprisal or harassment." *Black Panther Party v. Smith*, 661 F.2d 1243, 1267-68 (D.C. Cir. 1981), *vacated as moot*, 458 U.S. 1118 (1982).[9] In *Black Panther*, the D.C. Circuit stated that protected information may not be disclosed "unless the information goes to '*the heart of the matter*,' that is, unless it is crucial to the party's case. Mere speculation that information might be useful will not suffice; litigants seeking to compel discovery must describe the information they hope to obtain and its importance to their case with a reasonable degree of specificity." *Id.* at 1268.

Whether the balancing test results in an order requiring disclosure will of course depend on a case- and document-specific analysis. A showing of compelling need by the propounding party can trump the First Amendment interest.[10]

C. Relationship of First Amendment Discovery Privilege to the *Noerr-Pennington* Doctrine

The well-known *Noerr-Pennington* doctrine immunizes collective lobbying activity from the antitrust laws. *Eastern R.R. Presidents Conference v. Noerr Motor Freight, Inc.*, 365 U.S. 127, 136 (1961). In *Noerr*, the Supreme Court found that "the Sherman Act does not prohibit two or more persons from associating together in an attempt to persuade the legislature or the executive to take particular action with respect to a law that would produce a restraint or a monopoly." *Id.* In light of the constitutionally guaranteed right to petition, a contrary conclusion "would raise important constitutional questions" *id.* at 138. The *Noerr-Pennington* doctrine has been applied not only in the antitrust context, but also in cases where plaintiffs have sought to base product liability, business tort, and libel claims on defendants' lobbying and petitioning activities.[11]

Noerr, however, does not provide a shield against discovery. The Fourth Circuit explained that, "*Noerr-Pennington* is by definition an exemption from antitrust liability, and not a bar to discovery of evidence." *North Carolina Elec. Membership Corp. v. Carolina Power & Light Co.*, 666 F.2d 50, 53 (4th Cir. 1981).[12]

The fact that *Noerr* does not immunize lobbying documents from discovery, however, should not undermine a party's ability to withhold them as First Amendment privileged in the appropriate circumstances. Where the First Amendment privilege applies and where discovery of the documents requested would chill the respondent's First Amendment rights, nothing in *Noerr* prevents a court from applying a balancing test to weigh the propounding party's need for the documents against the chilling effect on the respondent's petitioning rights.

D. Applicability to Government Enforcement Actions

The issue of discovery of lobbying documents is particularly timely because state attorneys general have increasingly joined private plaintiffs in seeking discovery of private, corporate and associational lobbying correspondence in aid of *quasi* legal, *quasi* political investigations.

Several cases have applied a balancing test and upheld the First Amendment privilege against a government subpoena. In one case, the D.C. Circuit wrote that, "before a state or federal body can compel disclosure of information which would trespass upon first amendment freedoms, a 'subordinating interest of the State' must be proffered and it must be 'compelling.'"[13] That court vacated enforcement of a subpoena issued to a "draft-Kennedy" organization by the Federal Election Commission under President Carter. The court expressed special concern that the subpoena attempted to gather information on a group that was politically opposed to re-election of the President. A subpoena calling for internal documents related to *political activities*, however, is assessed under a heightened standard because such discovery goes to the very heart of First Amendment concern.[14] Where a government subpoena seeks *commercial or corporate data*, however, enforcement will be denied only if the subpoena is too indefinite, over-broad, or unauthorized by statute.[15]

E. Associational Privacy

Courts in California and Washington have analyzed First Amendment privilege under the rubric of associational privacy. In *Britt v. Superior Court*, 574 P.2d 766, 771-72 (Cal. 1978), the California Supreme Court reversed a discovery order seeking information on the associational activities of plaintiff homeowners in a suit against an airport for diminution of property values. The court applied a test requiring a showing of compelling need for the disclosures sought and noted the risk that discovery into associational activities could chill protected activity. The precedent emphasizes the requirement that discovery orders which trench on associational activities should be narrowly drawn to avoid infringement of First Amendment rights.[16]

Practical Suggestions

- Given the increase in discovery requests targeting lobbying activity, government affairs representatives and company employees involved in regulatory/legislative lobbying or trade association activity should be cautioned to be especially prudent in formal and informal communications. Most lobbying activity will not fall under attorney-client privilege protections.
- Unlike attorney-client privilege, First Amendment privilege is subject to a balancing test in which the plaintiff's need for the document may trump the privilege. Therefore, employees should be cautioned that such communications will not be protected as they might expect in the context of attorney-client privilege.
- In some instances, litigants will produce documents relating to petitioning activity but seek their confidential treatment. Where such production is anticipated it is important that the definition of confidentiality in the protective order be as broad as possible or reference any state statutory provisions that recognize privacy as a basis for confidentiality claims.
- When lobbying documents are sought in discovery, care should be taken not to assert First Amendment privilege excessively. The designation should be limited to truly confidential documents, disclosure of which would have a chilling effect. Certainly, not every summary of a legislative bill or a hearing should be designated as First Amendment privileged.
- In formulating objections to discovery requests, litigants should be mindful that courts will be sympathetic to an argument that overbreadth in a discovery demand is especially offensive where discovery trenches on First Amendment concerns.

- Affidavits in support of privilege are important. A logical affiant may be a government relations employee who can testify to the chilling effect of disclosure of government petitioning or lobbying documents.
- Review *in camera*, which is common in claims of journalist privilege, may help convey to the judge the delicate nature and merit of the claims.
- The parameters of First Amendment privilege and associational privacy are hardly well-defined. For example, it is unclear whether and to what extent courts will tolerate instructions not to answer deposition questions that trample on protected communications. The law on these privilege issues is developing, and practitioners would do well to stay abreast of developments.

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If you are interested in more information on this topic, please contact Mrs. Schotland in Washington at 1 202 974 1550 (sschotland@cgsh.com) or Mr. Bock in Washington at 1 202 974 1746 (pbock@cgsh.com).

1 *In the matter of GlaxoSmithKline plc*, No. MC 03-15992 (Dist. Ct. Henn. County July 13, 2004) (order after *in camera* review). Cleary Gottlieb represented the respondent in this case.

2 *Britt v. Superior Ct.*, 574 P.2d 766, 771-72 (Cal. 1978) (concern about the "chilling effect of compelled disclosure[s]" is not limited to members of "organizations espousing unorthodox or unpopular views"). *See also NAACP*, 357 U.S. at 460-61 ("[I]t is immaterial whether the beliefs sought to be advanced by association pertain to political, economic, religious or cultural matters, and state action which may have the effect of curtailing the freedom to associate is subject to the closest scrutiny.").

3 *Buckley*, 424 U.S. at 14 (quoting *Mills v. Ala.*, 384 U.S. 214, 218, 86 (1966)).

4 *Id.* at 64-65.

5 *Id.* at 64.

6 *Action for Children's Television v. FCC*, 564 F.2d 458, 471-73 (D.C. Cir. 1977).

7 *See Black Panther Party v. Smith*, 661 F.2d 1243, 1267-68 (D.C. Cir. 1981), *vacated as moot*, 458 U.S. 1118 (1982); *Int'l Union v. Nat'l Right to Work Legal Defense & Educ. Found., Inc.*, 590 F.2d 1139, 1152 (D.C. Cir. 1978); *Silkwood v. Kerr-McGee Corp.*, 563 F.2d 433, 438 (10th Cir. 1977); *Int'l Soc'y for Krishna Consciousness v. Lee*, No. 75 Civ. 5388 (MJL), 1985 U.S. Dist. LEXIS 22188 (S.D.N.Y. Feb. 28, 1985); *Adolph Coors Co. v. Wallace*, 570 F. Supp. 202, 208 (N.D. Cal. 1983).

8 *NAACP*, 357 U.S. at 463; *see also Grandbouche v. Clancy*, 570 F. Supp. 1463, 1466-67 (10th Cir. 1987).

9 *See also Adolph Coors Co.*, 570 F. Supp. at 210 (quoting *Black Panther Party*, 661 F.2d at 1267-68); *Australia/Eastern USA Shipping Conference v. United States*, 537 F. Supp. 807, 811 (D.D.C. 1982).

10 *E.g.*, *P&B Marina, Ltd. P'ship. v. Logrande*, 136 F.R.D. 50 (E.D.N.Y. 1991) (applying balancing test and allowing disclosure), *aff'd*, 983 F.2d 1047 (2d Cir. 1992).

11 *See, e.g.*, *Senart v. Mobay Chem. Corp.*, 597 F. Supp. 502, 506 (D. Minn. 1984); *Keller v. VonHoltum*, 568 N.W.2d 186, 192-93 (Minn. Ct. App. 1997).

12 *Barnes Found. v. Twp. of Lower Merion*, No. 96-CV-372, 1996 WL 862451, at *3 (E.D. Pa. Dec. 23,1996).

13 *Fed. Election Comm'n v. Machinists Non-Partisan Political League*, 655 F.2d 380, 389 (D.C. Cir. 1981) (quoting *NAACP*, 357 U.S. at 463).

14 *Id. See also Australia/E. U.S.A. Shipping Conference*, 537 F. Supp. 807 (applying a balancing test in an antitrust investigation); *Grandbouche*, 825 F.2d at 1465; *Ealy v. Littlejohn*, 569 F.2d 219, 229 (5th Cir. 1978); *Int'l Action Ctr. v. United States*, 207 F.R.D. 1, 4 (D.D.C. 2002); *United States v. Garde*, 673 F. Supp. 604 (D.D.C. 1987); *Britt v. Superior Ct.*, 574 P.2d 766, 777 (Cal. 1978).

15 *Fed. Election Comm'n*, 655 F.2d at 385.

16 The *Britt* analysis was followed in *Adolph Coors Co. v. Wallace*, and in *Snedigar v. Hoddersen*, 786 P.2d 781, 785-87 (Wash. 1990).

Cleary Gottlieb Wins Conversion of Refco Capital Markets Chapter 11 Reorganization Case to Chapter 7 Liquidation

Cleary Gottlieb, on behalf of a financial intermediary client which held a large securities account in Refco Capital Markets, Ltd., an offshore unregulated subsidiary of Refco, Inc., after a five-day trial, won a motion in the Bankruptcy Court in New York to convert the case from a Chapter 11 Reorganization to a Chapter 7 Stockbroker liquidation. The case is the first decision to address the status under the Bankruptcy Code of an offshore unregulated entity that engaged in the securities business. Judge Robert Drain issued a preliminary bench ruling on March 14, 2006 finding that Refco Capital Markets is a stockbroker and that it had at least one customer – namely, our client. As a result of the decision, securities customers will be able to share in a fund of customer property and thereby obtain a substantial preferential return on their claims. The decision affects customers who collectively hold about $2.75 billion in claims.

Cleary Gottlieb Wins Dismissal of HealthSouth Stockholder Class Action Securities Law Claims Against Citigroup Entities

Cleary Gottlieb won dismissal of all claims against Smith Barney Inc., Salomon Brothers Inc. and Salomon Smith Barney Inc. in the HealthSouth stockholder class action pending in the United States District Court for the Northern District of Alabama. The stockholder plaintiffs alleged that these Citigroup entities had violated sections 10(b) and 20(a) of the Exchange Act through their participation in several private placements of HealthSouth notes totaling approximately $2 billion, their advice to HealthSouth on various mergers, and the issuance by their equity analysts of research reports about HealthSouth. District Judge Karon O. Bowdre reasoned that plaintiffs had failed to allege any actionable misconduct within the relevant limitations period.

Cleary Gottlieb Wins Permanent U.S. Residency for Abused Children from Sierra Leone

Cleary Gottlieb successfully represented pro bono clients A. S. and M. T., children from Sierra Leone, in their application for permanent residency in the United States.

A. S. and M. T. were brought to the United States as minors by a Sierra Leonean diplomat at the United Nations, who fraudulently held them out as his children. He physically abused the children and often deprived them of food, shelter, and other necessities. Following a particularly brutal assault, which resulted in A. S.'s hospitalization with severe burns, the Administration For Children's Services removed the children and placed them in foster care.

After initially filing asylum applications on behalf of A. S. and M. T., Cleary Gottlieb persuaded an adjudication office of the U.S. Immigration Service that the children qualified for permanent residency under the Special Immigrant Juvenile category, specifically carved out by Congress for minors under the age of 21, determined to be dependent on the family court and eligible for long-term foster care.

Cleary in the Courts

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