

US litigation risk

Recent developments

Owen C Pell and Michelle Dean of White & Case LLP examine recent developments that affect US litigation risk for non-US businesses.

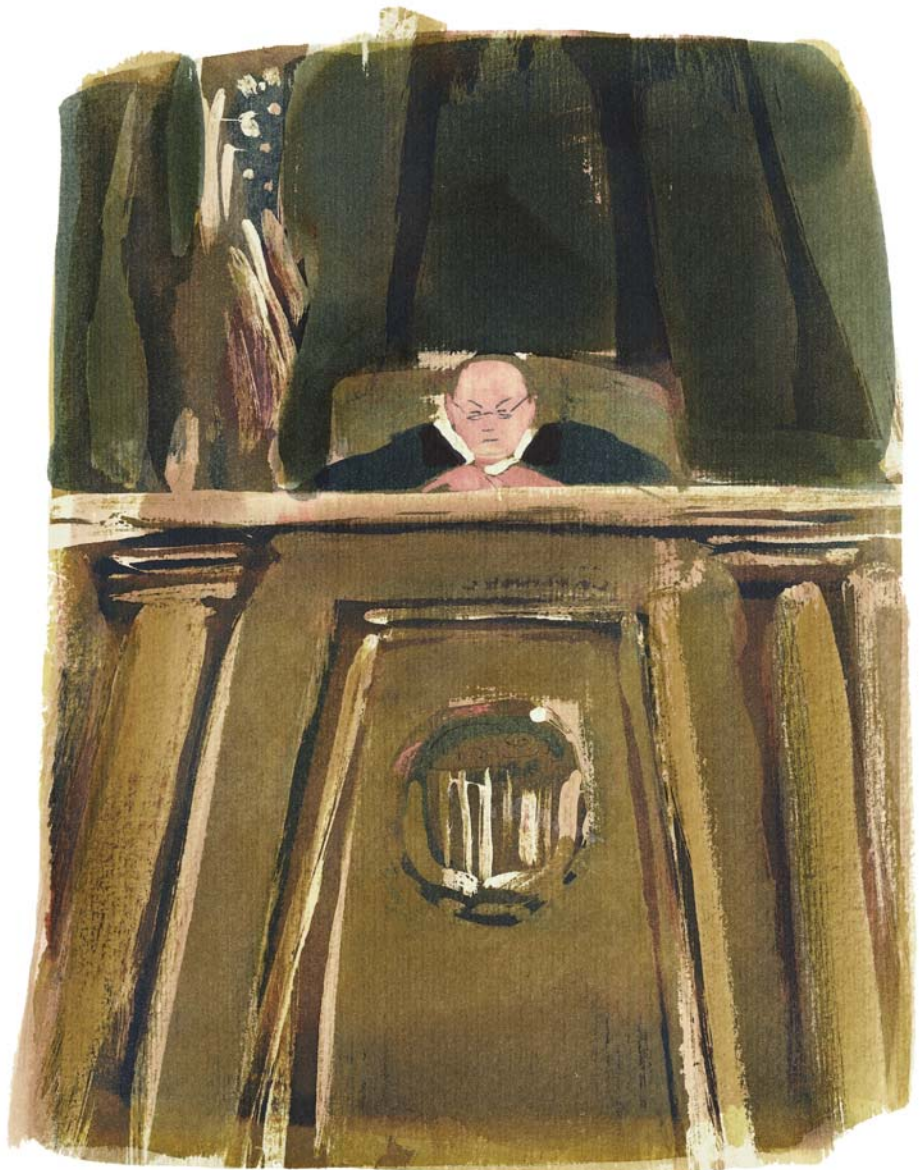
The US legal system has long been overshadowed by its reputation for excess. Not only is the US the most litigious society in the world, Hollywood courtroom dramas have reinforced the impression that US courts rule by emotion rather than logic. For non-US businesses, the task of managing this process may seem daunting.

The real-life idiosyncrasies of US civil procedure tend to reinforce, rather than dissipate, those concerns:

- US courts have taken a broad view of their jurisdiction and applied US law to disputes that have little, if any, connection to the US.
- Complaints filed in US courts often make sweeping allegations that do not specify how the alleged loss was caused by the alleged facts.
- The breadth of pre-trial discovery in US proceedings (and the resulting cost and degree of management attention required) is unlike that of any other legal system.

A number of recent developments have signalled that US courts may be attempting to rein in the extraterritorial application of US law, and to tighten pleading standards. Nevertheless, recent amend-

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ments to the federal court procedural rules relating to electronic information, as well as the significant duty to preserve documents that arises as soon as litigation begins, mean that the US discovery process remains a significant challenge for any party involved in US litigation.

EXTRATERRITORIAL APPLICATION

For non-US businesses, one of the more irritating aspects of the US legal system is the extent to which US courts apply US law to disputes between non-US parties, even when they arise from events occurring mostly, or wholly, outside the US (extraterritorial application). In fact, US laws generally are not supposed to have extraterritorial application, unless the US Congress has clearly and expressly indicated otherwise.

Ambiguous statutory language should not confer extraterritorial effect. For example, in *EEOC v Arab American Oil Co.* the Supreme Court found that, because the US laws regulating employment practices were ambiguous in relation to extraterritorial application, US employment laws should not be applied outside the US (499 US 244, 248 (1991)). The increasingly international nature of business has nonetheless made it more common for plaintiffs to attempt to bring non-US defendants into the jurisdiction of the US courts for conduct occurring wholly outside the US.

Tests for extraterritorial application

US courts have developed two tests to determine whether commercial disputes are within the subject matter jurisdiction of US courts: the conduct test and the effects test.

Conduct test. The conduct test asks whether the plaintiff has alleged conduct occurring in the US that is both material to the claims asserted, and a direct and foreseeable cause of the loss allegedly suffered by the plaintiff (*North South Fin. Corp. v Al-Turki*, 100 F 3d 1046, 1051 (2d Cir 1996)). “Conduct” refers to the core activities that are material to the asserted

claims. Acts taken merely in preparation for the relevant conduct are immaterial to the jurisdictional analysis.

In *Europe & Overseas Commodity Traders SA v Banque Paribas London*, the plaintiffs were non-US investors who alleged that they were defrauded by non-US defendants operating outside the US (147 F 3d 118, 129-31 (2d Cir 1998)). The court held that a series of telephone calls made by the defendants into the US, and an order to purchase securities in the US, were not enough to support the subject matter jurisdiction of the court because the core fraudulent activities were conducted outside the US.

Effects test. The effects test asks whether the plaintiff has alleged conduct (whether occurring inside or outside the US) that has a material effect within the US. The definition of materiality may differ depending on the substantive law at issue.

In *Hartford Fire Insurance Co. v California*, there was an alleged boycott of a group of US insurers for their non-use of certain forms by another group of insurers (509 US 764 (1993)). The alleged boycotters included some London insurance firms. As the substantive law at issue was the Sherman Act (the US anti-trust statute), the Supreme Court held that US law could reach this non-US conduct because the conduct was intended to have an anti-competitive effect within the US market.

In a later case, the Supreme Court ruled that the effect in the US must give rise directly to the plaintiff’s claim. If the US effect only gives rise to some other person’s claim, that effect is not sufficient to support subject matter jurisdiction over the plaintiff’s claim (*F. Hoffman-La Roche, Ltd v Empagran SA*, 542 US 155 (2004)).

RICO

The potential extraterritorial jurisdiction of US courts is particularly significant in cases concerning the US Racketeer Influenced and Corrupt Organizations Act (RICO) (18 USC, 1961-68).

RICO is a federal criminal statute that also provides a civil remedy to private plaintiffs for injuries to business or property by reason of a violation of specified “predicate acts” that must be part of a pattern of racketeering activity conducted by an enterprise (that is, an entity beyond a single defendant). The predicate acts include federal criminal laws, such as the federal mail and wire fraud statutes. A successful RICO action can entitle a plaintiff to attorneys’ fees and treble damages, making it an appealing option for plaintiffs.

RICO suits lend themselves to multinational claims, due to RICO’s broad scope and the need to plead patterns of activity among multiple defendants. Plaintiffs are increasingly asserting RICO claims, often premised on some type of alleged fraud (to come within the mail or wire fraud laws as predicate acts) in commercial disputes that have little connection with the US.

In the *North South* case, a non-US company asserted RICO claims against two French investment banking groups for an alleged scheme to depress the price paid by the defendants for a French bank being sold by the plaintiff. The plaintiff asserted that the defendants had prepared false financial reports to support the lower price and that, among other things, those reports were sent to an accountant in New York.

There are strong arguments that RICO was never intended to reach such a dispute:

- The provisions governing private remedies available under RICO are silent as to any extraterritorial application (18 USC, 1964(c)).
- RICO’s remedial provisions do not provide guidance for foreign service of process or venue over non-US entities (18 USC, 1965).
- The legislative history of the RICO statute provides no mention of extraterritorial effect.

Although in *North South* the Second Circuit affirmed the decision of the lower court to dismiss for lack of subject matter jurisdiction, the court did not decide whether subject matter jurisdiction in all RICO cases should be governed by the conduct or effects test because the plaintiff had only focused on the effects test. Using cases drawn from the anti-trust area (which the court found comparable to the types of claims asserted under RICO), the court held that none of the events material to the fraud claim occurred in the US. The alleged US activities only facilitated a fraud that, at its core, was perpetrated, executed and had an effect in France.

Recently, in *Norex Petroleum Ltd v Access Industries Inc.*, a New York federal court reached a similar result using both the conduct and effects tests (540 F Supp 2d 438 (SDNY 2007)). Norex was a Cypriot company doing business from Canada and alleged that:

- A Russian company had engaged in a series of illegal acts in Russia that had resulted in Norex losing its controlling interest in another Russian company.
- Many of the acts carried out in Russia were directed from, or planned in, the US.
- The takeover of Norex's interest in a Russian company was part of a broader scheme, involving passing money through US banks, to gain control over the Russian oil industry and defraud the Russian government and investors other than Norex.

In dismissing the case for lack of subject matter jurisdiction, the court held that any conduct that may have taken place in the US was only preparatory or peripheral to the alleged scheme, which was centred and carried out entirely in Russia. As a non-US company, Norex could not use its loss of control over a Russian company in Russia, or the alleged harm suffered in the US by other (non-plaintiff) in-

Rule 19

Rule 19(a) lists factors under which a party is deemed to be “required,” and includes parties without whom a court cannot grant complete relief.

If required parties cannot be joined, for example, because they are beyond the court's jurisdiction, Rule 19(b) lists factors to be considered when determining whether the case should proceed without them.

vestors, to show a direct US effect. Any harm caused to Norex in the US was, at best, indirect. *Norex* (which is currently on appeal to the Second Circuit) is a good example of how a subject matter jurisdiction challenge may be used to defeat a RICO action.

The required parties rule

It has become increasingly common for US claims to be brought against one or more non-US defendants, including defendants that are owned by, or related to, foreign governments. However, where plaintiffs cannot successfully invoke the jurisdiction of the US court over some of the defendants, the claim against all of the defendants may be dismissed under the required parties rule.

The required parties rule is enshrined in Federal Rule of Civil Procedure 19 (Rule 19) and provides that, where not all of the parties materially interested in an action are joined to the action, the entire case may be dismissed (*see box “Rule 19”*). The purpose of Rule 19 is to ensure that parties materially interested in the subject of an action are joined to the action, so that they may be heard, and the court can render a complete disposition of the case.

Under Rule 19, any defendant (whether or not they are within the US court's jurisdiction) can bring a motion regarding the effect of absent parties, and can argue that parties that the plaintiff has omitted from its complaint are required for the action to proceed. As this may ultimately result in dismissal of the claim, Rule 19 can be a very effective tool for a defendant to defeat the entire action brought against it.

Rule 19 motions can also be useful in providing defendants with a powerful argument against the start of pre-trial discovery. A defendant (particularly a non-US defendant) should not be subjected to the cost and burdens of US discovery until it is clear that the action will survive. The US Supreme Court recently provided guidance on the procedural requirements surrounding required parties in *Republic of Philippines v Pimentel* (128 S Ct 2180 (2008)) (*see box “The Pimentel case”*).

TIGHTENING PLEADING STANDARDS

For a defendant, a particularly difficult aspect of US litigation is the extent to which plaintiffs plead seemingly innocent facts from which they make broad claims of fraud, breach of duty, or harm. Under US procedural rules, a court considering a motion to dismiss must assume that factual allegations are true. Therefore, a successful motion to dismiss must show that, even if all the facts in the complaint were true, the defendant would still win as a matter of law. Under these circumstances, it is often difficult for defendants to challenge the sufficiency of complaints.

Recent US Supreme Court rulings have raised new hurdles for plaintiffs seeking to plead claims, and have created new opportunities for defendants seeking to dismiss those claims.

Short and plain statement

Rule 8(a)(2) of the Federal Rules of Civil Procedure (Federal Rules) requires that a complaint include:

- The basis for the court's jurisdiction.

The *Pimentel* case

Republic of Philippines v Pimentel began as a class action suit filed by victims of alleged human rights abuses by the Marcos regime in the Philippines (the class) (*128 S Ct 2180 (2008)*). The class was awarded \$2 billion in damages. In search of assets to satisfy the judgment, the class sought control over the shares of Arelma SA, a company formed by the Marcos regime. The shares were held by Merrill Lynch as a broker.

At the same time, separate proceedings were being held in the Philippines (the Philippine proceedings), where the Philippine government and a government commission (the sovereign parties) were also trying to obtain control over Arelma's shares to recover assets allegedly looted by the Marcos regime. Merrill Lynch, wanting only to deliver the shares to the correct party, began an interpleader action, asking a federal court to determine who should get the Arelma shares. The interpleader action included the class and the sovereign parties.

The sovereign parties asserted sovereign immunity. They argued that under the required parties principle, the US action could not proceed without them due to their claims to the Arelma shares in the Philippine proceedings (*Federal Rule of Civil Procedure 19*) (Rule 19). While recognising that the sovereign parties were immune from US jurisdiction, the district court did not dismiss the interpleader action, holding that the lawsuit could proceed without them, and awarding the shares to the class. In affirming this decision, the Ninth Circuit Court held that, because the sovereign parties' claims to the shares under Philippine law were unlikely to succeed, the lower court did not have to consider whether they might be prejudiced by the decision in the interpleader action.

The Supreme Court reversed this decision. It held that, under Rule 19, the interpleader action should have been dismissed because the lower courts did not give proper weight to the importance of the sovereign parties' immunity, and the prejudice to the sovereign parties when the lower courts made findings on the likely merits of their claims in the Philippine proceedings.

It was not disputed that the sovereign parties were "required parties" under Rule 19(a) because, without them as parties, their interests in the Arelma shares could not be protected. Joining them in the case was impossible, however, because of their sovereign immunity. Therefore, the Supreme Court had to determine whether, under Rule 19(b), the interpleader action should move forward without them. The court stressed that the test under Rule 19(b) is a flexible one, to be determined on a case-by-case basis. On the facts, the court held that, in equity and good conscience, the case could not move forward.

The Supreme Court also held that, by focusing on the merits of the sovereign parties' claims, the lower courts had infringed their sovereign immunity. The sovereign parties' claims arose from events of historical and political significance and they had a unique interest in resolving the status of the Arelma shares in Philippine courts under Philippine law.

In addition, the Supreme Court held that, in assuming that the sovereign parties had weak claims, the lower courts had ignored the interests of the sovereign parties and the dignity of, and comity due to, the Philippine proceedings. The interests of the class and Merrill Lynch in resolving the status of the shares did not outweigh the significant interests of the sovereign parties. Based on the outcome of the Philippine proceedings, the court found that the sovereign parties might have non-frivolous claims to the shares held by Merrill Lynch.

Pimentel is significant for the weight it accords the interests of absent foreign sovereign parties under Rule 19. This decision could be useful to companies and sovereign entities that want to limit the reach of US court proceedings that overlap with non-US legal proceedings involving foreign sovereign entities. *Pimentel* could also be useful when defendants outside of a US court's jurisdiction are involved in arbitrations that may touch on issues in dispute in US litigation. After *Pimentel*, the respect due to non-US proceedings may be enhanced, making it harder for any US action to proceed if it could conflict with that non-US proceeding.

- The relief sought.
- A short and plain statement of the claim showing that the pleader is entitled to relief.

The Federal Rules require a higher standard of pleadings in certain types of claims. For example, under Federal Rule 9(b), any fraud claim asserted in a US fed-

eral court must be asserted with specificity, including detailed facts regarding how, when and through whom the fraud occurred and supporting the assertion of fraudulent intent.

The US securities laws expressly require greater specificity in pleading securities fraud actions (*Private Securities Litigation Reform Act of 1995, 15 USC §78u-4(b)(1)*).

Where a claim is not supported by the appropriate level of factual detail, it may be dismissed for failure to state a claim on which relief can be granted (*Federal Rule 12(b)(6)*). This dismissal may occur before discovery, saving considerable time and cost. Therefore, where possible, motions to dismiss based on a failure to state a claim are very common at the outset of US proceedings.

The notice standard

US courts have puzzled over the appropriate means of testing whether a complaint has provided enough information to the defendant regarding the plaintiff's claim. In *Conley v Gibson*, the Supreme Court explained that the purpose of the short and plain statement rule is to give the defendant fair notice of what the claim is, and the grounds on which it rests (355 US 41 (1957)). Over time, that standard came to be known as the "notice" standard of pleading.

Courts would test whether the defendant could understand what kind of claim was being asserted by reading the complaint. Therefore, under the notice standard, the courts could deny a motion to dismiss if the facts asserted could support any type of relief, even if that meant reading into the complaint. As the Supreme Court put it in *Conley*, the ample scope of discovery means that only a cursory version of the facts is necessary at the time of pleading; the parties can flesh out the details later.

A move away from the notice standard

Recent case law has shown that the US courts are moving away from the more lenient idea of the notice standard of pleading, and requiring plaintiffs to provide greater specificity in their complaints.

The first decision of note was *Dura Pharmaceuticals Inc v Broudo* (544 US 336 (2005)). *Dura* was a securities class action in which the plaintiffs alleged that misrepresentations about the impending government approval of the defendant's product had artificially inflated the purchase price of the defendant's securities. *Dura* had announced disappointing earnings and its stock price dropped, but recovered within a week. *Dura* then announced that its product had not received government approval, and the share price did not change.

The trial court dismissed the case, holding that simply alleging that the share price was inflated was not enough to establish the required causal link to the

failed governmental approval. The Ninth Circuit Court of Appeals reversed the dismissal, but the Supreme Court agreed with the trial court, holding that the complaint failed to meet the notice standard. The court made it clear that the mere implication that a misrepresentation caused an inflated purchase price was not enough to give the defendant notice of the claim. The plaintiffs had not pleaded the facts in a way that showed the alleged misrepresentation had caused the price inflation.

The case of *Bell Atlantic Corp v Twombly* confirmed that *Dura* signalled a move away from the more lenient pleading standard (127 S Ct 1955 (2007)). *Twombly* was an anti-trust action brought by consumers alleging that their local phone companies had conspired to reduce competition. The complaint alleged facts about how each of the companies had priced certain services, and cited examples of company executives stating publicly that competition could drive down profits. However, the complaint did not allege any facts supporting the existence of an actual agreement to limit competition.

The lower court dismissed the case, but the Second Circuit reversed that decision, holding that one possible inference that could be drawn from the facts alleged was that defendants had indeed conspired to reduce competition. The Supreme Court reversed the decision again, holding that none of the facts alleged in the complaint constituted illegal conduct (parallel conduct by competitors, without more, is not an anti-trust violation), and that the plaintiffs were required to plead "plausible grounds to infer" an agreement to limit competition. The court noted that this "plausibility" standard means that the facts must be sufficient to raise a reasonable expectation that discovery would reveal evidence of illegal agreement.

Twombly is significant not only because plausibility is a higher standard than simple notice, but also because the lower

courts are no longer required to give plaintiffs the benefit of the doubt. Plaintiffs must now plead a plausible claim, based on the facts set out in the complaint. *Twombly* also highlights the idea that plaintiffs should not be able to use discovery to find their claim; they must plead a valid claim to justify the costs and burdens of US discovery.

In *Tellabs Inc et al v Makor Issues & Rights Ltd et al*, the Supreme Court confirmed that the courts are not bound to infer all the facts in the plaintiffs' favour, and should consider plausible opposing inferences in evaluating the strength of a plaintiff's allegations (127 S Ct 2499 (2007)). *Twombly* is also consistent with other recent Supreme Court rulings that have stressed the importance of plaintiffs, in fraud or other business tort cases, properly pleading facts showing that they were directly harmed by alleged misconduct (*Bridge v Phoenix Bond & Indemnity Co* 128 S Ct 2131 (2008); *Anza v Ideal Steel Supply Corp* 126 S Ct 1991 (2006)).

The Second Circuit recently expressed some discomfort with *Twombly*, arguing in *Ashcroft v Iqbal* that the Supreme Court had not intended to heighten pleading standards, but to make them more flexible by requiring, in certain instances, more particularity to create a plausible claim (490 F 3d 143 (2d Cir 2007)). It is not entirely clear how the Second Circuit reached this conclusion, and it is worth noting that the Supreme Court recently agreed to review *Iqbal*, so the meaning of *Twombly* is likely to be clarified further. It is nevertheless apparent that the notice standard of pleading is evolving into a higher and more challenging standard for plaintiffs.

In assessing any US lawsuit, defendants should give careful consideration to the pleaded facts and whether the plaintiff has met the relevant standards. If not, a motion to dismiss should be considered, which could also provide strong grounds for opposing the start of pre-trial discovery. As the Supreme Court noted in

Twombly, a poorly pleaded complaint can create significant burdens for the defendant because the plaintiff is likely to use the wide scope of the claim to frame a broad discovery request. The court also stated that poorly pleaded claims should not be allowed to justify costly and burdensome litigation or discovery that is intended simply to pressure parties into settlements.

MANAGING DISCOVERY

It is well known that US discovery is much broader in scope, and therefore significantly more onerous, than in other jurisdictions, such as the UK. In addition to the greater burden of US pre-trial discovery, non-US businesses should be aware of the recently amended procedural rules about electronically stored information (ESI) and the duty to preserve information. Any failure to comply with these rules could leave a party open to sanctions, including monetary fines, adverse findings of fact, or even the dismissal of claims.

Electronically stored information

The idea that ESI is subject to discovery in US litigation is not new. For years, model document requests have included within the definition of “documents”, all forms of electronic media in which documents may be created and stored. The recent amendments to the procedural rules mean that terms like “metadata”, “emergency backup tapes”, and “deleted e-mail protocols” are now part of most judges’ vocabulary (*see box “What is metadata?”*).

Under the new rules, the parties to a federal case should meet early on to generate a discovery plan that, among other things, must state any issues about disclosure or discovery of ESI, including the form or forms in which it should be produced (*Federal Rule 26(f)(3)(C)*). ESI issues will also be addressed in the court’s pre-trial scheduling order (*Federal Rule 16(b)(3)(B)(iii)*).

It is now essential that, as soon as possible after litigation is contemplated or commenced, counsel should meet with a

What is metadata?

Metadata is information that is created and stored automatically when a document is created. It can provide a drafting history of a document, such as when a document was created and by whom, how many times it has been revised and by whom, who made which revisions to a document and the sequence of revisions or additions made to a document, as well as other information. Generally, when documents are converted to image formats (that is, pdf, gif or tif formats) it is possible to eliminate metadata.

client’s information technology (IT) personnel. These meetings should focus on a range of issues, including:

- How the client’s computer network is set up.
- How the e-mail network is set up.
- When and how information is stored, backed-up and deleted.
- To what extent employees store information off the network, including the use of internet data rooms. (An issue that often arises here is the extent of employees’ rights in personal information stored on their employer’s computer network. This can be a serious issue, especially in Europe where privacy rights in ESI are being increasingly protected.)
- The types of archives or disaster recovery systems that exist to preserve ESI (including information the client may have thought had been deleted or destroyed).
- Whether the client has any system in place to clean metadata from documents.
- The written or other procedures that exist for the use of the client’s computer network and the storage or destruction of information, and whether those procedures are generally followed.
- What happens to ESI relating to employees who no longer work for the client.
- How ESI relating to specific employees or departments will be isolated for preservation, collection and review.
- Whether data on a client’s computers or network may be searched to identify relevant information that should be preserved or reviewed further.
- Whether there are electronic libraries or collections that may contain relevant information.

Using the information collected, counsel should devise a discovery plan that covers the client, adverse parties, and any third parties who may have useful information. The plan should consider what information needs to be preserved, and how that information will be collected, sorted and reviewed.

Depending on the answers to the above questions and the scope of the claims in the US litigation, early consideration should be given to the use of an outside electronic evidence expert. It has become routine to include electronic evidence experts on litigation teams to help clients and counsel manage the discovery process more efficiently and save significant sums of money (*see box “Why use an electronic evidence expert?”*).

Duty to preserve information

Anyone facing US litigation (whether as a plaintiff or defendant) must focus immediately on the duty to preserve relevant data in any form. The duty arises as soon as litigation begins, even if a defendant plans on making motions to dismiss that may postpone, or eliminate the need for, discovery.

This is an extremely important issue because, given that the potential scope of US discovery is so much broader than in other nations (allowing discovery of any information that may lead to the discovery of relevant information), non-US parties could innocently delete e-mails or other information. This would create a significant issue in US proceedings (the range of potential sanctions is set out in Federal Rule 37(b)).

In one of a series of seminal opinions, the New York federal court in *Zubulake v UBS Warburg (Zubulake IV)* held that the obligation to preserve information is triggered when a party has notice that the evidence is relevant to litigation, or when a party should have known that the evidence may be relevant to future litigation (220 FRD 212, 216 (SDNY 2003)). As soon as a complaint has been filed and served on a defendant, both parties will be on notice. A plaintiff is likely to know of impending litigation much earlier than the defendant, of course, although it is much less clear what constitutes notice prior to the filing of a complaint, due to the limited case law on the subject.

Once a business is on notice that information must be preserved, it must take reasonable steps to inform directors, officers and employees of the need to preserve information. This has led to the standard use of “litigation hold” memos that:

- Outline what information must be maintained and by whom.
- Direct the suspension of normal document destruction policies for information that must be maintained.

Why use an electronic evidence expert?

An electronic evidence expert can serve at least four important functions:

- Minimise the stress and demands on busy IT personnel, who can then continue to carry out their everyday activities.
- Support counsel by testifying how a client preserved electronically stored information (ESI) or otherwise complied with discovery requests, perhaps eliminating the need for the client’s IT personnel to testify.
- Work with counsel to ensure that local privacy laws and regulations are observed in the ESI collection and review process.
- Assist counsel in conducting discovery against others, for example, by helping to ensure that other parties comply with their duties of information preservation and production.

- Expressly warn against the loss or destruction of information.

In the ordinary course of discovery, an adversary will usually enquire into the steps that were taken (and when those steps were taken) to preserve information and ESI from intentional or accidental deletion or destruction (*Doe v Norwalk Community College*, 248 FRD 372, 231 Ed Law Rep 292 (D Conn 2007) and *In re NTL Inc Securities Litigation*, 244 FRD 179, 68 Fed R Serv 3d 1145 (SDNY 2007)). It is not unusual for clients to consult with counsel on the content, scope and circulation list of litigation hold memos to ensure that appropriate and timely steps are taken to comply with the duty to preserve information.

The amended Federal Rules provide a so-called “safe harbor” for ESI destroyed in the ordinary course of client’s business

(*Federal Rule 37(f)*). The availability of that safe harbor depends on a party’s good faith in meeting its information preservation obligations. Where information is destroyed or lost, the court will assess, among other things, the offending party’s actions in complying with the duty to preserve when deciding whether to impose a sanction and the severity of that sanction.

For example, in *Google Inc v American Blind & Wallpaper Factory Inc*, the court imposed monetary and evidentiary sanctions on the defendants because they had displayed a willful indifference to their obligation to preserve potentially relevant e-mails (2007 WL 1848665 (ND Cal June 27, 2007)).

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