Business Law Section

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Newsletter

Message From the Chair

by Gianfranco A. Pietrafesa

With this message, I would like to report on the state of the Business Law Section at the conclusion of the 2010–2011 term.

The section continued to provide many educational and networking opportunities for its members. We held four free Brown Bag Lunch Seminars, as well as joint meetings with the New Jersey Society of Certified Public Accountants, the Tax Law Section, the Banking Law Section, and the Young Lawyers Division. The section also sponsored the annual Business Law Symposium, as well as a joint seminar on chancery practice at the NJSBA Annual Meeting in Atlantic City. We will be continuing these educational and networking opportunities in the new term.

The section and the New Jersey Office of Legislative Services have made their final revisions to legislation amending the limited liability statute. The amendments are based on the Revised Uniform Limited Liability Act, and will bring a modern, comprehensive limited liability company statute to New Jersey. After considerable time and effort working on the project, it is our hope and expectation that the legislation will be enacted by the end of 2011.

The section experienced an increase in membership. Although modest, the increase is viewed as a positive development, considering the lingering effects of the economy on lawyers and bar association memberships. Also, many of the section's substantive committees have seen an increase in members, including young and diverse members. Finally, the section's board of directors has been increased in size to 21 members, and a number of younger business lawyers have been elected to the board.

A warm welcome to the following new members of the section's board of directors:

Colleen R. Donovan (Day Pitney)–director (2013)
Lori I. Mayer (Nagel Rice)–co-chair, Family & Small Business Committee
Sean Monaghan (Drinker Biddle)–chair, ISRA & Environmental Issues Committee
Jeffrey M. Shapiro (Lowenstein)–director (2013)
Lydia C. Stefanowicz (Edwards Angell)–director (2013)
Denise Walsh (Marcus Body)–co-chair, Business Entities Committee
Seth E. Zuckerman (Saiber)–director (2014)

In the new term, the section will continue to work on behalf of its members, and to seek new members and existing members interested in becoming active. Business lawyers interested in getting involved in the section, in writing for the newsletter, or in speaking at a seminar, should contact me at gpietrafesa@archerlaw.com or 201-342-6000 ext. 269. ■

Notes From the Editors

by John A. Aiello and Richard J. Pinto

There is an increasing demand for business lawyers to provide advice and counsel on a wide range of matters. With that in mind, this edition of the *Business Law Section Newsletter* includes articles that cover a variety of topics of interest. We thank the authors of these articles for providing invaluable assistance to the community of business lawyers in their quest to remain current.

The articles included in this edition of the *Business Law Section Newsletter*, arranged alphabetically by author, are as follows:

- "Home Improvement and the New Jersey Consumer Fraud Act" by Darren M. Baldo;
- "The More Things Change, the More They Stay the Same: Back to Basics of Contracting" by Jane M. Coviello;
- "Intellectual Property Due Diligence Made Easy" by Richard Gearhart;
- "The Risks of Electronic Communications and Social Media Usage in the Workplace" by Galit Kierkut;
- "New Jersey RULLCA" by Ira B. Marcus;
- "Building Energy Performance: The New Frontier of Transactional Due Diligence and Contractual Liability" by Daniel J. Sheridan; and
- "New Developments in Chinese Anti-Commercial Bribery Regime" by Yang Yang.

In closing, we encourage members of the Business Law Section to submit articles for publication in our newsletter. The newsletter has served over many years as an effective vehicle for sharing knowledge focused on practical issues confronted by business lawyers. Please consider submitting an article for our next edition. ■

Home Improvement and the New Jersey Consumer Fraud Act

by Darren M. Baldo

If you represent home improvement contractors or homeowners, you should be familiar with the New Jersey Consumer Fraud Act[1] (CFA) and Home Improvement Contractors Registration Act[2] (CRA).

If a client's home is damaged during work performed by a home improvement contractor, the CFA can provide for both compensatory and punitive damages. Attorneys who represent home improvement contractors have the obligation to inform their clients about how to handle their contracts and the dangers of not performing work properly. New Jersey's Consumer Fraud Act gives homeowners a potent tool against home improvement contractors who breach contracts, perform negligently, cause damage to homes, misrepresent facts and commit fraud. There is a high level of risk for home improvement contractors who violate these laws, and even the otherwise good home improvement contractor is not immune from the reach of the CFA.

HOME IMPROVEMENT

Pursuant to N.J.A.C. 13:45A-16.1, "home improvement" means the remodeling, altering, painting, repairing, or modernizing of residential or noncommercial property or the making of additions thereto, and includes, but is not limited to, the construction, installation, replacement, improvement, or repair of driveways, sidewalks, swimming pools, terraces, patios, landscaping, fences, porches, windows, doors, cabinets, kitchens, bathrooms, garages, basements and basement waterproofing, fire protection devices, security protection devices, central heating and air conditioning equipment, water softeners, heaters, and purifiers, solar heating or water systems, insulation installation, aluminum siding, wall-to-wall carpeting or attached or inlaid floor coverings, and other changes, repairs, or improvements made in or on, attached to or forming a part of the residential or noncommercial property. It does not include the construction of a new residence.

Any contractors who perform any of this work fall within the ambit of the CFA.

LEGISLATIVE INTENT

The CFA was enacted to protect consumers against predatory merchants and home improvement contractors by imposing a broad array of prohibitions and requirements on sellers, advertisers, and contractors. As stated by the New Jersey Supreme Court:

> The [CFA] has three main purposes: [1] to compensate the victim for his or her actual loss; [2] to punish the wrongdoer through the award of treble damages; and, [3] by way of the counsel fee provision, to attract competent counsel to counteract the community scourge of fraud by providing an incentive for an attorney to take a case involving a minor loss to the individual.[3]

As a remedial statute, the CFA's provisions are "construed liberally in favor of the consumer" to accomplish its deterrent and protective purposes.[4] While the CFA originally provided only for enforcement by the attorney general,[5] it now provides a private cause of action.[6]

The remedial section of the CFA provides:

> Any person who suffers any ascertainable loss of moneys or property, real or personal, as a result of the use or employment by another person of any method, act, or practice declared unlawful under [the CFA] may bring an action or assert a counterclaim therefor in any court of competent jurisdiction. In any action under this section the court shall, in addition to any other appropriate legal or equitable relief, award threefold the damages sustained by any person in interest. In all actions under this section, including those brought by the Attorney General, the court shall also award reasonable attorneys' fees, filing fees and reasonable costs of suit.[7]

The CFA includes a multitude of provisions for acts and omissions that constitute violations that fall within the reach of this remedial statute. These violations can be found under the New Jersey Contractor' Registration Act,[8] the Home Improvement Practices Regulations,[9] and the Contractor Registration Regulations[10] (collectively, the CFA).

VIOLATIONS OF THE CFA

Among the long list of possible violations of the CFA, some common violations include:

1. Failure to provide home improvement registration infor-

mation.
2. Failure to provide contractor's insurance information.
3. Failure to have a written contract for home improvement work.
4. Failure to state start dates and completion dates in the written contract.
5. Failure to obtain proper licenses and permits prior to performing work.
6. Seeking payment before it is due under the terms of the contract or before the work is complete.
7. Failure to begin or complete the work within scheduled time or at all without proper reason or cause and a written extension of the time.
8. Substituting materials for lesser quality materials than promised or warranted.
9. Failure to list products in the contract.
10. Attempting to charge additional money without having a written and signed change order.
11. Failure to state homeowner's three-day right to cancel contract in at least 10-point bold type print.
12. Poor workmanship that causes homeowner to repair and/or replace goods and services.
13. Unconscionable commercial practices.

SCIENTER NOT NECESSARILY REQUIRED

Within the strict liability framework of the CFA, contractors are presumed to be familiar with the CFA and its regulations.[11] Moreover, liability under the CFA does not require that the consumer actually be misled or defrauded by a merchant; any violation is enough to create liability.[12] A contractor's actual intent is irrelevant under the CFA.

The New Jersey Supreme Court has stated:

> The capacity to mislead is the prime ingredient of deception or an unconscionable commercial practice. Intent is not an essential element. Since consumer protection is the ultimate goal, the standards of conduct established by the [CFA] and implementing regulations must be met regardless of intent except when the Act specifically provides otherwise.[13]

CAUSATION AND DAMAGES

In order to be eligible to recover treble damages, a party must prove a "causal link between the violation [of the CFA] and damages."[14] To demonstrate a loss, a victim must simply supply an estimate of damage, calculated within a reasonable degree of certainty.[15] It is not necessary to actually expend damages in order to prove damages.[16]

However, to have an "ascertainable loss," the loss must be quantifiable and measurable and not speculative. In *Thiedemann v. Mercedes-Benz USA, LLC*,[17] the New Jersey Supreme Court held that a "future hypothetical dimunition of value" of the property was too speculative to satisfy the ascertainable loss requirement to prove damages. In that case, the repairs to automobiles were performed at no cost because of the fulfillment of an applicable warranty obligation. But the plaintiff did not produce an expert witness to support the inference of loss in value.

The Court's holding in *Thiedemann* can also be applied to the loss in value to a home. If the homeowner cannot prove loss of value through expert witness testimony, then the court may deny the award of treble damages, notwithstanding a violation of the CFA and damages to the home. The homeowner's counsel must show causation and damages through expert witness testimony to be best assured of the application of the treble damages remedy.

FAILURE TO OBTAIN PERMITS PRIOR TO STARTING WORK

Many home improvement contractors violate the CFA by beginning work on homes without obtaining permits or prior to receiving permit approval. N.J.A.C. 13:45A-16.2(a)(10)(i) requires contractors to obtain required permits prior to doing any home improvement work. In New Jersey, building permits are generally required for any project that will involve construction or substantial electrical, plumbing, or mechanical work. This includes building new buildings and altering or remodeling existing buildings. Depending on the town's building regulations, it can also include building decks, fences, sheds, tree houses, detached garages, and other separate structures.

In *Cox v. Sears Roebuck & Co.*,[18] the New Jersey Supreme Court found that a contractor who agreed to perform home improvement work on a consumer's residence engaged in "unlawful acts in violation of the CFA" by failing to obtain necessary permits, with the result that contractors were allowed to perform in a substandard manner with no government supervision or inspection. "Once a permit is obtained, a code inspector will inspect the residence periodically and issue a Certificate of Continued Occupancy to conform to the municipality's inspection process. Because no permit was ever issued for the Cox home, no inspections took place and no certificate was issued."[19]

The Court further stated in *Cox*:

> Had all applicable permits been obtained before Sears began work, the issued permits would have triggered periodic inspections of the renovations. An inspector would have detected any substandard electrical wiring or cabinet work and would not have permitted the work to progress or have issued the required certificates until Sears corrected the deficiencies. Because the inspections did not occur, the wiring remained unsafe, the cabinets remained unattractive and both resulted in a loss measured by the cost of repairing those conditions.[20]

In *Cox*, the plaintiff used expert witnesses to successfully prove causation and damages flowing from the failure to obtain permits and was awarded treble damages.

ATTORNEYS' FEES

Recovery of attorneys' fees is a statutory remedy expressly permitted under the CFA, so long as the party seeking such remedy proves an actual violation of the CFA, notwithstanding lack of proof of actual damages caused by any such violation. According to the Supreme Court:

> a consumer-fraud plaintiff can recover reasonable attorneys' fees, filing fees, and costs if that plaintiff can prove that the defendant committed an unlawful practice, even if the victim cannot show any ascertainable loss and thus cannot recover treble damages.[21]

That rule does not distinguish between "technical," "*per se*," or "substantive" violations of the CFA.[22]

In *Branigan v. Level on the Level, Inc.,* the Appellate Division emphasized:

> Although we think the facts now before us demonstrate the lowest conceivable level of violation under the Consumer Fraud Act, and although we have difficulty seeing how the salutary goals of this Act are furthered by the award of fees, the statute nevertheless supports such an award. The Supreme Court has made it clear that the statute mandates an award of counsel fees and costs for any violation of the Act, *even if that violation caused no harm to the consumer.*[23]

EXPERT FEES

Oddly, the CFA does not provide the same degree of certainty with respect to recovery of expert fees as it does for attorneys' fees. One would think that if one needed an expert to prove causation and damages that the remedy to recover expert fees should be automatic under the CFA; but it's not. Rather, the Legislature either failed to clarify its intent to ensure that expert fees should be part of the remedy or left it to the courts to decide whether recovery of expert fees represents an additional appropriate remedy.

The CFA provides:

> In any action under this section *the court shall, in addition to any other appropriate legal or equitable relief*, award threefold the damages sustained by any person in interest. In all actions under this section, including those brought by the Attorney General, *the court shall also award* reasonable attorneys' fees, filing fees and *reasonable costs of suit.*[24]

According to the language emphasized above, it appears that the CFA delegated sufficient authority to the courts to award expert fees as a remedy, even if the remedy is not explicitly listed. However, such language does not require the courts to award expert fees. Accordingly, expert fees are subject to the decision of the courts.

In *Josantos Construction v. Bohrer*,[25] the court instructed that the phrase "reasonable costs of suit" does not include expert fees as a remedy. In that case, the court denied expert fees as part of the remedy to which the successful party was entitled, notwithstanding the party's proof that the contractor violated the CFA.

The court stated:

> In our view, expert witness fees are not encompassed within the phrase "reasonable costs of suit." The general rule is that litigants bear their own expenses for fees and costs, except where specifically authorized by statute, rule or agreement. *Velli v. Rutgers Casualty Ins. Co.*, 257 N.J. Super. 308, 309, 608 A.2d 431 (App. Div.), *certif. denied*, 130 N.J. 597, 617 A.2d 1220 (1992). Expert fees are not taxable costs under N.J.S.A. 22A:2-8. *Buccinna v. Micheletti*, 311 N.J. Super. 557, 565, 710 A.2d 1019 (App. Div. 1998). Nor do we think the Legislature intended the phrase to encompass expert fees. When the Legislature intends the recovery of expert fees, it is perfectly capable of saying so explicitly. *See, e.g.*, N.J.S.A. 39:6A-34 (expert fees recoverable in de novo trial following rejected automobile arbitration award); and N.J.S.A. 54:51A-22 (expert fees recoverable as litigation costs when taxpayer prevails on certain tax matters). Expert fees are properly classified as litigation costs, as N.J.S.A. 54:51A-22 demonstrates. Thus a general provision allowing recovery of "all reasonable litigation costs" is arguably sufficient to encompass expert fees. *See, Weed v. Casie Enter.*, 279 N.J. Super. 517, 533, 653 A.2d 603 (App. Div. 1995), so indicating in the context of N.J.S.A. 2A:15-59.1, the "frivolous litigation" statute. Accord, *Fagas v. Scott*, 251 N.J. Super. 169, 197-200, 597 A.2d 571 (Law Div.1991). Here the Legislature chose the broader phrase "reasonable costs of suit." We have found no reported case under the Consumer Fraud Act that has awarded expert fees. In our view, they are not intended within the statutory language. We also agree with the trial judge that in this case the vast majority of the expert's testimony did not go to establishing a breach of the Consumer Fraud Act or to calculating damages thereunder.[26]

It appears that the court in *Josantos Construction* denied the recovery of expert fees because the expert witness testimony in that case was not inextricably linked to proving the breach of the CFA or to calculating the damages thereunder. In that regard, perhaps, the court was not sufficiently impressed to award expert fees as "other appropriate legal…relief." Therefore, the prudent approach would be to advise a client that there is a risk that the costs of the expert being used to prove violation of the CFA or damages may not be recoverable unless the expert testimony is successful in actually doing so.

AMOUNT IN CONTROVERSY AND JURISDICTION

Pursuant to New Jersey Rule 6:1-2(a)(1), $15,000 is the jurisdictional limit for amounts in controversy for claims brought in Special Civil Part. Any claims having amounts in controversy over $15,000 must be brought in regular Law Division. When calculating damages to determine the amount in controversy and proper venue, the courts exclude attorneys' fees.

The New Jersey Supreme Court has expressly held that, in determining the amount in controversy, attorneys' fees that may be awarded under the CFA are excluded from calculation of the jurisdictional limit.[27] Among the many reasons given by the Court, it stated that "[w]hat amount of counsel fees will be incurred as a result of the twists and turns of litigation is not ascertainable at that point. Those fees will accrue as the case proceeds and will indeed not even be calculable until the judgment is entered."[28]

However, the Court in *Lettenmaier* stated that "the jurisdictional amount in controversy…can refer only to the monetary damages that a plaintiff claims were sustained as a result of the defendant's actions, plus trebling."[29] Thus, within the Court's *dicta*, it recognized the trebled portion of the damages as part of the amount in controversy. (*See also, Nieves v. Baran*,[30] where the Appellate Division held that treble damages under the CFA were part of the jurisdictional amount in controversy.) Therefore, only the actual damages sustained by the party plus treble damages under the CFA are calculated as part of the jurisdictional amount in controversy for purposes of Rule 6:1-2(a)(1).

CONCLUSION

Violations of the CFA can be prevented by careful compliance with its provisions. Even though there may be good and qualified contractors out there, a number of contractors continue to violate the act. Many need to revise their existing contract forms and practices in order to confirm and promote compliance. Both the homeowners and home improvement contractors ought to try to work together to make sure all of the requirements are addressed early and stated in the written contract to ensure compliance and avoid misunderstandings and litigation.

When violations of the CFA occur, counsel should advise the homeowner to carefully build the case, using expert witnesses where necessary, to prove causation and damages flowing from such violations. On the other hand, attorneys' fees will be awarded so long as a violation of the CFA can be shown. In light of the availability for treble damages and attorneys' fees afforded by the CFA, homeowners should give due consideration to initiating litigation, and contractors should give extra consideration to settling a dispute, even if the amount of damages seems at first glance to be too small to justify a lawsuit. ■

ENDNOTES

1. N.J.S.A. 56:8-1 *et seq*.
2. N.J.S.A.56:8-136 *et seq*.
3. *Lettenmaier v. Lube Connection, Inc.*, 162 N.J. 134, 139 (1999) (*citing Silva v. Autos of Amboy, Inc.,* 267 N.J. Super. 546, 555, 632 A.2d 291 (App. Div. 1993).
4. *Id.*; *Barry v. Arrow Pontiac, Inc.*, 100 N.J. 57, 69 (1985).
5. *See* L. 1960, c. 39, § 3.
6. *See* L. 1971, c. 247, § 7; amended 1997, c. 359.
7. N.J.S.A. 56:8-19.
8. *See* N.J.S.A. 56:8-136 to -152.
9. *See* N.J.A.C. 13:45A-16.1 to -16.2.
10. *See* N.J.A.C. 13:45A-17.1 to -17.14.
11. *See Cox v. Sears Roebuck & Co.*, 138 N.J. 2, 18-19 (1994).
12. *Skeer v. EMK Motors, Inc.*, 187 N.J. Super. 465, 470 (App. Div. 1982), *quoted in Sprenger v. Trout*, 375 N.J. Super. 120, 131 (App. Div. 2005).
13. *Fenwick v. Kay American Jeep, Inc.,* 72 N.J. 372, 378 (1977).
14. *Branigan v. Level on the Level Inc.,* 326 N.J. Super. 24 (App. Div. 1999); *Roberts v. Cowgill*, 316 N.J. Super. 33 (App. Div. 1998).
15. *Cox v. Sears Roebuck & Co.*, 138 N.J. 2, 22 (1994).
16. *Id*.
17. 183 N.J. 234 (2005).
18. 138 N.J. 2 (1994).
19. *Id*. at 19-20.
20. *Id*. at 22.
21. *Cox, supra*, 138 N.J. at 24 (*citing Performance Leasing Corp. v. Irwin Lincoln-Mercury*, 262 N.J. Super. 23, 31, 34 (App. Div.), *certif. denied*, 133 N.J. 443 (1993)).
22. *Czmyr v. Avalanche Heating and Air Conditioning, Inc.*, 2011 WL 519871(App. Div. 2/16/2011) (*citing BJM Insulation & Constr., Inc. v. Evans*, 287 N.J. Super. 513, 517-18 (App. Div. 1996)).
23. 326 N.J. Super. 24, 30-31 (App. Div. 1999) (Emphasis added)(*citing Roberts v. Cowgill*, 316 N.J. Super. 33, 45 (App. Div. 1998)).
24. N.J.S.A. 56:8-19. (Emphasis added).
25. 326 N.J. Super. 42 (App. Div. 1999).
26. *Id*.
27. *Lettenmaier v. Lube Connection, Inc.*, 162 N.J. 134 (1999); *see also Surf Cottages Homeowners Assoc., Inc. v. Janel Assocs., Inc.*, 362 N.J. Super. 70 (App. Div. 2003).
28. *Id*. at 143.
29. *Id*. at 143.
30. 164 N.J. Super. 86 (App. Div. 1978).

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The More Things Change, the More They Stay the Same

Back to Basics of Contracting

by Jane M. Coviello

In this electronic age of emailing, instant messaging, hyperlinking and texting, business communications often have a feeling of urgency that was lacking in the days of paper transactions and snail mail. It is easy to lose sight of the basics of contract formation in such an environment. Despite the fast pace of business and changing methods of communicating offers and/or acceptance, demonstrating the mutual assent of the parties, and defining a 'writing,' the basic principles of contract formation continue to govern whether parties are legally bound.

A binding contract still requires a manifestation of mutual assent to the essential terms of the parties' understanding.[1] In general, demonstrating agreement to essential terms may be accomplished through words that create an express contract, or by conduct that gives rise to a contract implied-in-fact.[2] There are, however, circumstances in which a writing is required as the expression of the parties' agreement.

In New Jersey, the Statute of Frauds[3] identifies some of the types of contracts that must be memorialized in a writing to be enforceable.[4] In circumstances where the subject of the parties' agreement is not governed by the Statute of Frauds or another law that requires a writing, the parties themselves may agree that their contract can only be modified by a signed writing. Although electronic communication methods have not changed these basic underlying legal principles, they have altered, in some cases, how the principles are applied.

Looking back to the beginnings of technology-driven commerce, when software first became readily available to purchasers in CD-ROM format, we saw the advent of software shrink-wrap licenses (so-called because the written license to use the software is found inside the shrink-wrap product packaging). Not unexpectedly, from a practical standpoint the mass appeal and distribution of such products made it impossible for software vendors to follow the traditional practice of obtaining a purchaser's agreement to license terms before receiving payment for their product.[5]

Although this was a new context, the practice of requiring payment before disclosing contract terms is not unusual in other circumstances. In the realm of consumer goods, for instance, warranty information is commonly inserted in the box or packaging with the product. Despite this, many purchasers (and courts) initially treated shrink-wrap licenses as unenforceable because the terms could not be viewed by purchasers before they bought the software.[6]

Given the impracticality of putting an entire license agreement in microscopic print on small CD-ROM packages, courts soon stopped concentrating on the method of presenting the license agreement and looked instead to how traditional contracting principles should be applied. As one court stated, "(n)otice on the outside, terms on the inside, and a right to return the software for a refund if the terms are unacceptable (a right that the license expressly extends), may be a means of doing business valuable to buyers and sellers alike."[7]

Soon after, as software products became downloadable over the Internet, 'click-wrap' licenses were born. The moniker grew out of the method of contract formation—license terms are presented electronically on a viewable webpage and accepted by a mouse click on a dialog box stating "I agree" or "I accept." For such licenses to be enforceable, the software download must not activate until after the mouse click occurs, evidencing the purchaser's affirmative assent to the license terms.[8]

As with the case of shrink-wrap licenses, the enforceability of click-wrap licenses has been determined by courts through application of traditional contract principles. The key inquiries have been whether the software users receive reasonable notice of the license agreement and whether they manifest agreement to its terms.[9] Courts apply the same "inquiry notice" doctrine[10] to click-wrap licenses as they did to shrink-wrap licenses. Where parties are put on notice of the existence of terms and conditions accompanying a product, whether by labeling on packaging or electronically on a webpage, and they acknowledge their assent to those terms and conditions in the manner specified (by using the product, for example, or by an affirmative mouse click), they are bound to those terms and conditions.[11]

The same is true in other contexts as well. In a case where an email contained a link to an external set of terms and conditions, and notified the recipient that clicking the link would constitute acknowledgment of their receipt and an agreement to abide by them, clicking the link created a binding contract that included those terms and conditions.[12] It is commonplace for warranty information and/or technical support guidelines to be referenced in a written contract and located elsewhere, even remotely on a vendor website. As long as the contract provides adequate notice of external terms and conditions and the ability to view them, those conditions will be an enforceable part of the parties' agreement. This approach is no different in legal effect from referencing and incorporating an attached contract schedule or exhibit in a more traditional transaction.

One of reasons courts began accepting as valid contracts and/or external policies that are viewed and accepted electronically is because such electronic information began to be seen as akin to traditional written expressions of the parties' mutual agreement.[13] Treating electronically viewable words as writings allows courts to draw analogies to the world of paper transactions.[14] It also dovetails nicely with the doctrine of inquiry notice, which, although generally applied in more traditional contexts, applies "equally to the emergent world of online product delivery, pop-up screens, hyperlinked pages, clickwrap licensing, scrollable documents, and urgent admonitions to 'Download Now!'"[15]

Under New Jersey case law, materials that are electronically viewed or transmitted satisfy a writing requirement because they are capable of being recorded, stored and printed.[16] In sync with the myriad discussions of click-wrap agreements by the courts, New Jersey enacted the Uniform Electronic Transactions Act (UETA) in 2001.[17] The New Jersey UETA defines a "record" as "information that is inscribed on a tangible medium or that is stored in an electronic or other medium and is retrievable in perceivable form."[18] To the same effect, under the Uniform Commercial Code (UCC) a writing includes "printing, typewriting, or any other intentional reduction to tangible form."[19] The terminology and context may vary, but the concept of what constitutes a writing is consistent.

The New Jersey UETA definition of a record is intended:

> to embrace all means of communicating or storing information except human memory. It includes any method for storing or communicating information, including "writings." A record need not be indestructible or permanent, but the term does not include oral or other communications that are not stored or preserved by some means. Information that has not been retained other than through human memory does not qualify as a record. As in the case of the terms "writing" or "written," the term "record" does not establish the purposes, permitted uses or legal effect which a record may have under any particular provision of substantive law.[20]

The provisions of UETA are intended to be both technologically neutral and subject to substantive law. This opens the door for new and/or novel arguments over whether communication exchanges via emerging technologies constitute writings or manifest assent under traditional contract principles.

This is exactly what happened in connection with click-wrap agreements when courts began looking beyond the medium of expression to the substance of the communication. Such agreements are now well accepted as enforceable.[21] Similarly, email exchanges are now routinely treated as accepted expressions of contractual terms and/or manifestations of assent.[22] They can thus become critically important in a determination of whether parties have formed a binding contract.

Even where a formal, definitive written contract is contemplated by the parties, if their email exchange states the essential terms of their agreement and evidences their mutual manifestation of assent to those terms, a binding obligation may have been created. The intent to sign a formal document later does not avoid the formation of a contract unless the parties have clearly expressed that they will not be bound except by a signed written contract.[23] This is a lesson to be learned for electronic communications in general, especially in a fast-paced business environment where the speed of communications sometimes takes precedence over careful thought and deliberation.

Given the rate at which communications technologies have evolved over the last decade, and the pressure to conduct business at a similar pace, parties must remember the longstanding legal principles that will be applied to their conduct. A decision out of the Southern District of Florida in March of this year illustrates the point. The court there held that an instant messaging conversation was sufficient to modify a written contract.[24]

While the facts of the case are a little murky, it is clear that the parties entered into a binding written agreement they called an insertion order. The litigated dispute revolved around whether the insertion order had been modified through the parties' instant message exchange despite a provision in the insertion order that it could "be changed only by a subsequent writing signed by both parties."[25] The content of the instant messages and the concurrent conduct of the parties were found to demonstrate a mutual assent of the parties to changed contract terms.[26]

The court did not find any legal obstacle to concluding under Delaware common law that the parties were free to substitute a new oral contract without abrogating the written one. The modified insertion order was enforced.[27]

The Florida court did not find it necessary to reach the question of whether the instant messages were writings capable of modifying the insertion order in accordance with its own terms, holding instead that the instant message conversation manifested an intent by both parties to modify the insertion order. As in the situation where email correspondents fail to explicitly state that they will only be bound by a signed writing, the court (applying Delaware law) held that "overt manifestation of assent—not subjective intent—controls the formation of a contract; [and] the 'only intent of the parties to a contract which is essential is an intent to say the words or do the acts which constitute their manifestation of assent';...'the intention to accept is unimportant except as manifested.'"[28]

The court continued by finding "(a) close reading of the instant messages and careful consideration of the behavior of the parties during the conversation indicate clear assent on the part of both parties" to the changed terms.

What does this mean for the future of business communications? Will contracts evidenced by postings on Facebook walls or Twitter tweets be enforceable? What new methods of electronic communication will come into play? As long as new communications methods satisfy the UETA definition of an electronic record[29] and manifest a mutual assent, case law seems to indicate that such communications may indeed be the basis of enforceable contracts.

The establishment of contractual relationships does not depend on the execution of a single document, and can instead be based on an exchange of communications that evidence an agreement on essential terms.[30] We are not limited by the method of communication.

Over a decade ago, the prefatory note to the model Uniform Electronic Transaction Act (1999) (which was drafted and approved by the National Conference of Commissioners on Uniform State Laws for adoption by all 50 states) said it well. The purpose of the law is to

> …eliminate the barriers to the application of traditional legal principles to electronic transactions:
>
> With the advent of electronic means of communication and information transfer, business models and methods for doing business have evolved to take advantage of the speed, efficiencies, and cost benefits of electronic technologies. These developments have occurred in the face of existing legal barriers to the legal efficacy of records and documents which exist solely in electronic media.

The drafters of UETA sought to establish "a clear framework for covered transactions" that would avoid "unwarranted surprises for unsophisticated parties dealing in this relatively new [electronic] media."[31] While many people did not initially see the need for legislation specifically geared to validate methods of electronic commerce and information exchange, the growth of new communications technologies and their use by business over the last decade demonstrates the benefits of such a technologically neutral approach to contracting. As communications technologies continue to develop and evolve over the next 10 years, our job as attorneys will be to remain mindful of the traditional legal principles governing contract formation, and to advise our business clients how those principles may impact their communications cultures. ■

ENDNOTES

1. *Weichert Co. Realtors v. Ryan*, 128 N.J. 427, 435-436 (1992).
2. *See* Restatement (Second) of Contracts § 19(1) (1981).
3. The Statute of Frauds is found at N.J.S. 25:1-5 to -16, but some additional statutory provisions requiring a writing also exist. For example, N.J.S. §§ 12A:1-206 and 12A:2-201 of the New Jersey Uniform Commercial Code also require a signed writing.
4. In most cases where contracts are subject to the Statute of Frauds signed writings memorializing the parties' agreement satisfies the most basic requirements. However, particular statutes may have specific additional requirements in the identified context.
5. *ProCD, Inc. v. Zeidenberg*, 86 F.3d 1447, 1451 (7th Cir. 1996).
6. *See ProCD, Inc. v. Zeidenberg*, 908 F. Supp. 640 (W.D. Wis. 1996), *reversed and remanded by* 86 F.3d 1447 (7th Cir. 1996).
7. New Jersey courts take the same approach as the court in *ProCD, Inc. v. Zeidenberg*, 86 F. 3d 1447, 1451 (7th Cir. 1996). In an unpublished opinion, the court in *In re Samsung Elecs. Am., Inc.*, 2008 U.S. Dist. LEXIS 105199, (D.N.J. Dec. 31, 2008) held that "the law of New Jersey tolerates warranty information included inside product packaging. The law does not require warranties or disclaimers to be printed on packaging, as plaintiffs contend, so that customers can "readily see and consider the terms before purchasing the product." In so saying, the court included a footnote to *ProCD, Inc. v. Zeidenberg*, indicating that it had a similar holding in the context of shrink-wrap licensing.
8. *Feldman v. Google, Inc.*, 513 F. Supp. 2d 229, 236 (E.D. Pa. 2007).
9. In *Specht v. Netscape Communs. Corp.*, 306 F.3d 17, 38-39 (2d Cir. 2002), the court held that "in circumstances such as these, where consumers are

urged to download free software at the immediate click of a button, a reference to the existence of license terms on a submerged screen is not sufficient to place consumers on inquiry or constructive notice of those terms. The SmartDownload webpage screen was 'printed in such a manner that it tended to conceal the fact that it was an express acceptance of [Netscape's] rules and regulations.'"

10. As quoted by the court in *Specht v. Netscape Communs. Corp.*, 306 F.3d 17, 32-33 (2d Cir. 2002), "inquiry notice is actual notice of circumstances sufficient to put a prudent man upon inquiry." *Cal. State Auto. Ass'n Inter-Ins. Bureau v. Barrett Garages, Inc.*, 257 Cal.App. 2d 71 (Cal. Ct. App. 1967).
11. *Caspi v. Microsoft Network*, 323 N.J. Super. 118 (App. Div. 1999), *certif. denied* by 162 N.J. 199 (1999).
12. *First Trenton Indem. Co. v. Forsyth*, 2010 N.J. Super. Unpub. LEXIS 1183 (App. Div. May 28, 2010).
13. Applying New Jersey law, the district court in *Davis v. Dell, Inc.*, 2007 U.S. Dist. LEXIS 94767 (D.N.J., Dec. 28, 2007), at pages 13-15, *affirmed by Davis v. Dell, Inc.*, 2008 U.S. Dist. LEXIS 62490 (D.N.J., Aug. 15, 2008), stated that "(t)he agreement at issue in this case may be characterized as a "clickwrap" agreement, which has been explained by one court as follows: "[a] clickwrap agreement appears on an internet webpage and requires that a user consent to any terms or conditions by clicking on a dialog box on the screen in order to proceed with the internet transaction....Even though they are electronic, clickwrap agreements are considered to be writings because they are printable and storable. Under both New Jersey and Texas law, when a party uses his computer to click on a button signifying his acceptance of terms and conditions in connection with an online transaction, he thereby manifests his assent to an electronic agreement." (Internal citations omitted).
14. *Caspi v. Microsoft Network*, 323 N.J. Super. 118, 125-126 (App. Div. 1999), *certif. denied* by 162 N.J. 199 (1999).
15. *Specht v. Netscape Communs. Corp.*, 306 F.3d 17, 36-37 (2d Cir. 2002).
16. *Davis v. Dell, Inc.*, 2007 U.S. Dist. LEXIS 94767 (D.N.J., Dec. 28, 2007), at pages 14-15, *affirmed by Davis v. Dell, Inc.*, 2008 U.S. Dist. LEXIS 62490 (D.N.J., Aug. 15, 2008).
17. N.J.S. § 12A:12-1, *et seq*.
18. N.J.S. § 12A:12-2
19. N.J.S. § 12A:1-201(46).
20. Comment 10 to Section 2 of the model Uniform Electronic Transactions Act, incorporating portions of the ABA report on use of the term "record," Oct. 1, 1996.
21. *See, e.g., Caspi v. Microsoft Network*, 323 N.J. Super. 118, 122 (App. Div. 1999), *certif. denied by* 162 N.J. 199 (1999); *Feldman v. Google, Inc.*, 513 F. Supp. 2d 229, 236 (E.D. Pa. 2007); *Davis v. Dell, Inc.,* 2007 U.S. Dist. LEXIS 94767 (D.N.J., Dec. 28, 2007), at pages 14-15, *affirmed by* 2008 U.S. Dist. LEXIS 62490 (D.N.J., Aug. 15, 2008).
22. *Malloy v. Intercall, Inc.*, 2010 U.S. Dist. LEXIS 136808 (D.N.J. Dec. 28, 2010); *Luciano v. Cline,* 2008 N.J. Super. Unpub. LEXIS 2187 (App. Div. July 3, 2008). *See also, Union Savings Bank v. White Family Cos.,* 183 Ohio App. 3d 174, 177 (Ohio Ct. App., Montgomery County 2009).
23. *Tangible Value, LLC v. Town Sports International Holdings, Inc.*, 2011 U.S. Dist. LEXIS 19754, 9-11 (D.N.J. Feb. 28, 2011).
24. *CX Digital Media, Inc. v. Smoking Everywhere, Inc.*, 2011 U.S. Dist. LEXIS 29999 (S.D. F., March 23, 2011).
25. *Id*., at p. 30.
26. *Id*., at p. 20.
27. *Id*. at pp. 37-38.
28. *CX Digital Media, Inc. v. Smoking Everywhere, Inc.*, 2011 U.S. Dist. LEXIS 29999, 18 (S.D. F. March 23, 2011).
29. N.J.S. § 12A:12-2. "Electronic record" means a record created, generated, sent, communicated, received or stored by electronic means.
30. *Corestar Int'l PTE. Ltd. v. LPB Communs., Inc.,* 513 F. Supp. 2d 107, 115-116 (D.N.J., Oct. 10, 2007)
31. Prefatory note to the model Uniform Electronic Transactions Act.

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Intellectual Property Due Diligence Made Easy

by Richard Gearhart

How do you help your client get $20 million? Or, how do you save your client $20 million? Simple, just do your intellectual property (IP) due diligence right! Certainly, the value of IP assets is not only in the ideas they protect, but also the value they create for investors, purchasers and licensees.

If your client is buying or selling a business, you, as their attorney, are responsible for ensuring that any intellectual property[1] is properly represented in the case of the seller, and properly understood and reviewed in the case of the buyer. Improper due diligence around IP matters can have significant consequences for the buyer or the seller. This article addresses the sale of assets, but the considerations also apply for license deals and other types of acquisitions or investment transactions.

CONSIDERATIONS WHEN REPRESENTING THE SELLER

If you are representing the seller, your first task is to advise the seller to define the universe of IP that will be part of the transaction. In some cases, it may be all of the seller's assets; in other cases it will only be a part of the portfolio. You should have a careful discussion with your client to understand exactly which IP assets your client will convey. This should be done at an early stage, as you are formulating your agreement, so the definition of the IP estate can be factored into the definitions and schedules used in the agreement. If the transaction involves patents, or your client has retained IP counsel, they should be involved at an early stage in the formulation of these definitions.

If you are representing the seller, you should carefully consider when you will first allow the buyer to review your client's IP. Often the review of IP involves the release of sensitive, confidential information. If the buyer is a direct competitor, you should do your best to ensure that the buyer reviews the IP as late as possible in the transaction and the basic terms have been agreed to by both parties.

You should feel confident that the buyer is reasonably committed to the transaction before granting access to your client's IP. This would, at a minimum, be after a confidentiality agreement and term sheet are executed. It is better to wait until at least one round of draft agreements is exchanged. If your client has IP counsel, then delaying this is also a cost advantage to the seller.

If the confidential information is especially sensitive, special confidentiality agreements can be drafted limiting review of the confidential information on a strict need-to-know basis.

It is not unusual, for example, for the IP to be placed in an electronic data room where access can be controlled. Data rooms allow controlled access for different members of the due diligence team.

As the seller's representative, you should obviously advise your client to take steps to ensure that the IP is in the best possible shape before presenting it to the buyer. Any issues that can be resolved should be resolved; for example, all assignments for patents should be in place, and unresolved issues with inventors should be resolved. If the transaction involves conveying a website, then it should be confirmed that the client is, in fact, the owner of the website. Any unpaid renewals for trademarks should be brought up to date. Summary reports of the IP should be prepared. Any trade secrets should be investigated to make sure that they have not been inadvertently lost. Finally, any know-how should be identified and documented.

If there are any difficult issues in the IP estate, develop a strategy to address them, and present the issues in the best possible light. IP issues only occasionally sink deals, but problems can create a renegotiation of the transaction's value, depending on the criticality of the IP.

If you are representing the seller and you have an issue with the IP asset, disclosure with an explanation is always better than waiting for the buyer to find out independently. I recently represented the buyer during an IP due diligence and found out independently that the key patents in the acquisition were the subject of a validity arbitration. The seller never told the buyer's business team that the patents were at risk. The buyer terminated the transaction the next day, in large part because the seller's non-disclosure created a lack of trust for the buyer.

In all likelihood, you will receive an IP checklist from the buyer to start the IP due diligence. Get ahead of the issue and provide your client with your own, similar IP checklist earlier in the process. This will help you smoke out and resolve any IP issues before the due diligence starts with the buyer, and accelerate the transaction.

CONSIDERATIONS WHEN REPRESENTING THE BUYER

If you are representing the buyer, your job is to evaluate the IP and ensure that it represents good value.

As a first step, do a freedom to operate (FTO) search for the key technologies, business names, trade names and copyrighted materials. This cannot be emphasized enough, even if the business is established. I recently consulted with a businessman who purchased a retail business that had successfully operated in the area for years without a website. His lawyer had not done a FTO search on the business name. After he purchased the business, he put up a website, and almost immediately received a cease and desist letter from a store with the same name in Maryland. The Maryland store owner had a federal trademark registration on the name long before the New Jersey store opened. The Maryland store owner only became aware of the name because the New Jersey store started advertising on the Internet. The Maryland store owner took action against the New Jersey store owner. The New Jersey owner was forced to change the name of his store, and lost much of the goodwill he purchased when he bought the business.

Avoiding the IP of third parties is usually more important to the ultimate success of the transaction than quality of IP assets for sale, as important as the IP of the seller may be. Also, conducting the FTO search first will often identify other third-party IP that can be used when evaluating the strength of the seller's IP. For example, an FTO patent search may reveal patents that are relevant to the seller's IP for purposes of patentability.

You can always ask the sellers if they have done their FTO homework, and if so, if they are willing to share part or all of their findings. They may refuse to disclose this to maintain the attorney-client privilege, but the sellers may be willing to disclose underlying prior art or relevant trademarks without divulging opinions. It's worth a try, and usually the sellers get extra points for providing this type of disclosure.

Identifying the strength of the seller's IP is beyond the scope of this short article, and needs to be completed by competent practitioners. However, the buyer's business counsel can assist by providing a strong set of representations and warranties in the agreement drafts, which will hopefully smoke out at least some IP issues. Consult with the IP counsel for particular clauses that can address particular issues the IP counsel would like addressed.

Finally it is important to investigate origin and ownership of the IP assets. Ownership of trademarks and copyrights needs to be determined. For patents, inventorship needs to be confirmed.

In a recent case,[2] an IBM employee violated her employment agreement by filing patents on inventions she made during her employment and could not prevail in a third-party claim. The court concluded that the patents were the property of IBM as a consequence of her employment contract, and, therefore, the employee lacked standing to sue the defendant. In addition, the court found that the plaintiff also lacked standing because she had made improper assignments of the same patent to different entities at different times. A careful review of the assignments would have revealed the defects.

Careful understandings of the source of the IP and following the chain of title are important tasks to protect the interests of your client. ■

ENDNOTES

1. For purposes of this article, "intellectual property" (or IP) means those assets of the business comprised of patents, trademarks, copyrights, knowhow and trade secrets. "Patents" are government documents (from the U.S. Patent and Trademark Office in the U.S.) granting the exclusive rights to use the inventions or technology in the country in which the patent is issued. "Trademarks" are government certifications granting the owner the exclusive rights to use a name or logo in connection with particular classes of products in the country or state in which the trademark is issued. "Copyrights" protect original works of expression, and may be registered or unregistered. It is not necessary for copyrights to be registered in order for them to be transferred. "Knowhow" is particular practical knowledge that is useful in an industrial process. A "trade secret" is any business secret that gives a competitive advantage.
2. *Picture Patents LLC v. Aeropostale Inc*. (S.D.N.Y 4/15/11).

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The Risks of Electronic Communication and Social Media Usage in the Workplace

by Galit Kierkut

Electronic communications and social media have taken their place at the forefront of the discussions among employment counsel, as we struggle to glean consistency from the rulings and decisions of the courts in this area in the past few years.

What has become clear is that in the absence of effective internal controls and established policies regarding electronic communication and social media participation, companies may find themselves subject to claims of harassment, discrimination, defamation, invasion of privacy and possible government enforcement action, as well as facing the loss of confidential information and trade secrets. Although this risk increased in some measure with the advent of the widespread use of emails, the dissemination through social media is far faster and reaches a far greater audience.

Because social media tends to blur personal and professional lines of behavior, people often give less thought to their postings, and disclose more information than they would in an email or in writing, compounding the risks to employers. As a result, employers must take steps to protect against the legal hazards associated with employee electronic and Internet communication, and specifically, must adopt comprehensive communication polices and codes of conduct. Many of these policies involve some sort of monitoring on the part of the employers; but courts are just starting to delineate the appropriate boundaries for such monitoring.

The first significant decision in the social media area was handed down in 2009, by the New Jersey District Court in *Pietrylo v. Hillstone Restaurant Group*.[1] In *Pietrylo,* two servers at the Hillstone Restaurant Group began an invitation-only MySpace.com group for employees to "vent" about issues at work. The MySpace forum included sexual remarks and used profanity toward company managers.

One employee member of the forum showed the chat group page to a manager. When another manager asked the employee for her password to the forum, she gave it to him (although she later claimed she was concerned about adverse action if she did not comply).

When Hillstone Restaurant fired the servers who founded the forum due to the sexually inappropriate and derogatory content on the site, the servers sued, in part for alleged violation of federal and state stored communications acts.

The jury ultimately found that Hillstone Restaurant's conduct in accessing the employees' password-protected MySpace forum violated the Stored Communications Act[2] because the managers accessed the chat group without authorization from a forum user. The New Jersey District Court denied the company's motions for judgment as a matter of law and for a new trial, concluding that it could reasonably infer that the employee's purported "authorization" (the provision of her password to a manager) was coerced or provided under pressure, and that the manager's review of the site was intentional.

The court's holding in *Pietrylo* establishes that employers face significant liability when using information obtained from password-protected social networking sites to discipline or terminate employees, where that information is obtained without the requisite permission. The question left unanswered, of course, is what level of 'authorization' must an employer have to access employee content on private social networking sites without fear of liability?

The New Jersey Supreme Court has also weighed in on the issue of an employer's right to monitor its employees' use of company owned computers, in *Stengart v. Loving Care Agency, Inc.*[3] The Court addressed whether a company's electronic communications policy gave the employer ownership of emails sent by an employee to her attorney, on a company-owned computer, via a private password-protected Internet-based email account. While the Court determined that Stengart had a "reasonable expectation of privacy in the emails she exchanged with her attorney on Loving Care's laptop," it based the holding on:

1) the steps taken by Stengart to protect the privacy of those emails,

2) the ambiguity in Loving Care's policy as to whether emails exchanged through a private password-protected web-based account via a company-owned computer were subject to monitoring or constituted company property,
3) the failure of the policy to provide adequate notice to employees that such emails were stored on the computer hard drive and could be retrieved, and
4) the importance of the attorney-client privilege.

Again, the question becomes whether the company would have been entitled to review the emails if the policy were more clearly drafted, or whether the addition of the privilege into the analysis outweighed any potential employer interest.

Finally, the United States Supreme Court tackled a similar issue regarding employee's privacy rights in public employment under the Fourth Amendment. In *Quon v. Arch Wireless Operating Company, Inc,.*[4] a member of the police department, Sergeant Jeff Quon, was issued a pager for the purpose of sending work-related text messages. The city paid for the service up to a 25,000-character limit per month. Because Quon and other employees regularly exceeded the city's 25,000-character limit, the department conducted an audit of its employees' text messages to determine if these limits needed to be increased.

The goal of the audit was to determine how many texts were being sent for work-related purposes. In conducting the audit, the department discovered that Sergeant Quon had been using his workplace pager to engage in sexually explicit text exchanges while on duty. Quon was fired for these infractions, and later he and his girlfriend sued the city and the department for violating their Fourth Amendment privacy rights.

The United States Supreme Court granted *certiorari*, and decided the matter on June 17, 2010, in *City of Ontario, California, et al. v. Quon.*[5] Although much anticipated, the Supreme Court's decision in *Quon* unfortunately did not answer the question of whether or not the employees had a reasonable expectation of privacy in their text messages. The decision instead assumed, *arguendo*, the right to privacy, and then focused on the reasonableness of the employer's search. The Court found that the search was reasonable because the employer had a legitimate purpose for it (testing the efficacy of the service plan) and it was limited in scope as it focused on a narrow time period and redacted certain information.

The decision is helpful and consistent with the guidance in all of the cases discussed here, insofar as it holds that a legitimate employer interest can override an employee's right to privacy. What the court did not do, however, is provide the anticipated guidance to employers regarding the limits of what constitutes a legitimate employer purpose, or whether, if employees are given proper notice, employers can lawfully access employees' electronic communications made during work hours and/or while using company-owned equipment *without* a specifically stated purpose.

The only consistent thread in these social media/electronic communications cases is that the courts engage in a balancing analysis to determine the significance of the employer's interest in monitoring or in reviewing, the clarity of the policy, and the significance of the privacy or other interest of the employee. These cases have uniformly held that employer's rights with respect to monitoring and ownership of an employee's personal communications on a company-owned computer are not, in fact, limitless, despite language to that effect set forth in an employee handbook. Rather, each court applied a balancing test and focused on whether the regulated conduct concerns terms and conditions of employment and reasonably furthers legitimate business interests.

Generally, these courts concluded that employers do not have a legitimate business interest in the content of personal communications, but do have an interest in the fact that an employee is spending work hours engaging in business unrelated to the company, and certainly have an interest in ensuring that employees are not conducting illegal activity at the workplace. How the courts apply such balancing remains difficult to predict. What lawyers can learn from this is that they have to impress upon their clients that there is no one-size-fits-all policy, or enforcement of a policy.

Another somewhat unanticipated challenge for employers who want to monitor their employees' use of social media is emanating from the National Labor Relations Board (NLRB). Unions are viewing social media as the new picket line. The NLRB has recently settled its closely watched lawsuit against the Connecticut employee who was fired for making disparaging comments about her boss and work on Facebook.

In *In re: American Medical Response of Connecticut, Inc.*,[6] filed on Oct. 27, 2010, the NLRB filed a complaint against American Medical Response of Connecticut, Inc. (AMR), claiming that the company violated federal labor law when it disciplined and then terminated an employee who posted disparaging remarks about her supervisor on her Facebook page. The employee posted the Facebook comments in 2009, from her home computer, hours after her supervisor said a customer had complained about her work. The expletive-filled posting referred to her supervisor using the company's code for a psychiatric patient. Her remarks at the time drew supportive posts from colleagues. The NLRB sued the company last year, arguing the worker's negative comments were protected speech under federal labor laws. It was the position of the NLRB that the employer's use of social media may violate the employee's rights to engage in "concerted activity" as provided by Section 7 of the National Labor Relations Act (NLRA).[7] The company claimed it fired the emergency medical technician because of complaints about her work.

Under the settlement with the NLRB, American Medical Response of Connecticut Inc. agreed to change its blogging and Internet policy that barred workers from disparaging the company or its supervisors. The company also will revise another policy that prohibited employees from depicting the company in any way over the Internet without permission. The NLRB will clearly be consistently taking the position that such commentary is protected free speech, which should make all companies revisit their own policies.

So, the social media issues that are arising today are not limited to individual employee privacy, but implicate concerted activity rules under the NLRA as well. Company handbooks must be reviewed to ensure that the right to engage in concerted activity is not inadvertently limited by seemingly neutral social media policies.

Whether or not a business has policies regarding all forms of communication and conduct, including social media usage, those policies should be reviewed based on a company's identification of its risks. Once a risk analysis is completed, Internet, email and social media usage policies that establish standards of conduct should be disseminated to employees and reinforced through education over time. Other policies that correlate with communication issues, such as confidentiality, anti-harassment and recommendation policies, should also be updated to account for social media use and communicated and bolstered by employee training.

However, when drafting these policies, the balancing of the employees' interests in privacy and free speech cannot be underestimated, and policies must be carefully drafted to clearly state the legitimacy of the employers' interests and to provide adequate protection to employees. Finally, just like with all employment policies, training, consistency in enforcement and documentation of violations are paramount. ■

ENDNOTES

1. 2008 WL 6085437 (D. N.J., July 25, 2008).
2. 18 U.S.C. § 2701-2712.
3. 2010 WL 1189458 (N.J. March 30, 2010).
4. 529 F.3d 892 (9th Cir. 2008).
5. 130 S. Ct. 2619 (2010).
6. CA-12576 (there was no reported decision as the case was filed and subsequently settled).
7. 29 U.S.C. §§ 151-169.

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New Jersey's RULLCA

by Ira B Marcus

Last year I wrote an article for the *Business Law Section Newsletter* titled "Why New Jersey Should Adopt RULLCA." That article set forth the compelling (hopefully!) reasons why New Jersey should adopt a new limited liability company statute based on the Revised Uniform Limited Liability Act (RULLCA), which was promulgated by the National Conference of Commissioners on Uniform State Laws (NCCUSL) in July 2006. All of the points I made in that article continue to be true, and I urge you to refer to it if you do not have a basic understanding of the benefits that we believe will inure to this state and its lawyers and business people from the passage of the new law.

I am happy to report that the requisite legislation has been introduced and the new law is on its way to becoming a reality. I have attached to this article as an exhibit, the legislative statement that Denise Walsh (who co-chairs the Business Entities Committee with me) and I drafted for attachment to the bill that was introduced.

In this article, rather than rehash the article I wrote last year, I would like to give members of the section more insight into the work the Business Entities Committee has done and the changes we proposed to RULLCA, as proposed by NCCUSL, based on our experience as practicing lawyers in this state.

I must state at the outset that we have been assured by members of NCCUSL's drafting committee that our changes did not detract from the essential benefits to be derived from the adoption of this uniform law. We firmly believe that we will obtain many benefits attendant to adopting a uniform law. These benefits include guidance for our judges and practitioners from the thoughtful analysis of uniform laws by professional journals, law reviews, and the courts of other jurisdictions. New Jersey has already adopted the Uniform Partnership Act,[1] in 1966, and the Uniform Limited Partnership Law,[2] in 1976, both of which were promulgated by NCCUSL and parallel the provisions of RULLCA in key ways.

That being said, here are the principal changes we made to RULLCA as adopted by NCCUSL:

1. Shelf LLCs. From my experience, many clients wish to have a limited liability company formed and a matter of public record before all of the relevant deal points concerning the limited liability company's organization have been agreed upon. For example, the limited liability company may be formed before the precise identity and contributions of the members have been decided. Some of the members of NCCUSL's drafting committee thought that a memberless limited liability company was an oxymoron. Although they conceded that a corporation might be formed before the identity of its shareholders were determined, they deemed the formation of a limited liability company at a time when it had no members philosophically impossible because no agreement could be deemed to exist.

To deal with this issue, NCCUSL's drafting committee seized upon a compromise. A limited liability company could be formed even though it did not yet have any members. However, in such a situation the formation would entail two filings. The first filing would have to contain a statement to the effect that the limited liability company did not have any members. A second filing, which was required to be made no more than 90 days after the first filing, would have to be made at such time as members did exist. Our committee thought that this provision was hyper-technical, unnecessary and unwieldy, and we elected to remove it from our proposal.

2. Deadlock and Oppression. We included in our proposal a more extensive deadlock/oppression section than NCCUSL's modeled on N.J.S.A. 14A:12-7. In this section, we specifically authorized the court to grant certain types of equitable relief. Although equity courts have the authority to order a broad range of remedies other than dissolution, many practitioners in this state feel that the courts are hesitant to do so until specifically authorized by statute. Our proposal, in certain circumstances, expressly authorizes the court to grant remedies such as the appointment of a custodian or one or more provisional managers if it appears to the court that such an appointment may be in the best interests of the limited liability company and its members. The court can allow reasonable compensation to any custodian or provisional manager and reimbursement or direct payment of his or her reasonable costs and expenses by the limited liability company. The court is also authorized to appoint a custodian or one or more provisional managers in a summary proceeding, or to order the sale of all interests held by a member who is party to the proceeding to either the limited liability company or any other member who is a party to the proceeding, if the court determines in its discretion that such an order would be fair and equitable to all parties under all the circumstances of the case.

Our proposal, unlike RULLCA, also expressly authorizes the court to award counsel fees if it determines that a party has acted vexatiously or otherwise not in good faith.

Finally, our proposal makes explicit what RULLCA merely implies—that a party may *seek* a remedy other than the dissolution.

3. Indemnification. My committee's members felt that a major shortcoming of our existing limited liability company statute was that indemnification was authorized but never mandated. N.J.S.A. 42:2B-10 merely says that a limited liability company *may* indemnify and hold harmless a member, manager or other person. Thus, a manager or member has no recourse against a limited liability company for claims made against him or her in the course of serving the limited liability company, except to the extent provided by agency law. In contrast, RULLCA provides that a limited liability company *must* indemnify members and managers for expenses or liabilities incurred in the course of that person's activities on behalf of the limited liability company, so long as the person did not violate his or her duties of loyalty and care stated in RULLCA.

Our committee greatly expanded RULLCA's indemnification section, again following from our corporate statute. It makes clear that "company agents" entitled to indemnification include all persons who are members of a member-managed company; a manager of a manager-managed company; or an officer, employee or agent of the indemnified company or a constituent company absorbed by it. The definition of company agent also includes people who are or were serving as managers, officers, directors, trustees, employees or agents of any "other enterprise," serving as such at the request of the indemnifying company. Other enterprises are defined to include not only corporations, limited liability companies and partnerships, for example, but employee benefit plans as well.

The standard of care under our existing limited liability company statute (as well as our partnership statute) is to refrain from willful misconduct or engaging in gross negligence. NCCUSL drafted RULLCA in the shadow of the Enron debacle, at a time when many felt that the people in charge of organizations should be held to a higher standard. Thus, NCCUSL opted for a standard of ordinary care as appropriate for those in charge of an organization. However, the drafters thought to soften the effects of such a change by subjecting the standard of ordinary care to the business judgment rule to the extent that the circumstances warranted.

Some of us were never fully comfortable with this change. When we learned, rather recently, that as part of the harmonization process NCCUSL is undertaking to rationalize the provisions of RULLCA, the Uniform Partnership Act and the Uniform Limited Partnership Law the gross negligence standard (present in the other statutes) would be incorporated into the latest revision of RULLCA, we opted to make that change in our proposal.

4. Name. We decided that RULLCA's permissive name, "limited company" or "LC" for short, should not be included in our proposal. We think there is already enough confusion regarding these entities, sometimes called limited liability corporations, and that this additional permissive name would add to that confusion.

5. Alternate Names. We added a provision dealing with alternate names. Many states have statutes pertaining to the use of alternate names by different types of business entities. New Jersey does not, so we included such a provision in our proposal. Our provision is similar to N.J.S.A. 14A:2-2.1 in that it does not require an alternate name to include an LLC identifier.

6. Annual Reports. We included a provision (Article 11) that provides for the filing of annual reports.

7. Nomenclature. In consulting with the Division of Revenue, we changed the wording of RULLCA to reflect the current terminology that is used in our statute and by the Division of Revenue. This will save the state the time, effort and money that would be required if such changes were not made. Thus, for example, RULLCA's references to "designated agents" were changed to references to "registered agents;" RULLCA's "certificate of organization" was changed to "certificate of formation;" and RULLCA's references to "certificates of existence" were changed to "certificates of standing."

8. Additional Changes Made In Consultation with Division of Revenue. Our committee worked closely with Jim Fruscione, the director of the Division of Revenue. We tried hard to make changes to RULLCA that would facilitate the efficient running of the Division of Revenue and would not cost the taxpayers money. By way of example, RULLCA contained several provisions requiring that notice be given by certified or registered mail, and that the mailing of notices be to multiple addresses. We deleted such requirements in the interest of administrative convenience and cost savings.

In all cases where the limited liability company is asked to provide the information for a change or amendment filing, we required the limited liability company to provide "such other information as may be required by the filing office to correctly indentify the company." The intent here was to allow the filing office to ask for information like the company's 10-digit ID. We were told this will greatly speed the filing process and increase accuracy. We modified all provisions for filing acknowledgements so that the filling office may direct confirmations and receipts to the submitter. From a practical perspective, we were told that the filing office could not completely or officially determine on whose behalf a filing is submitted. By way of yet another example, we have changed the annual report noncompliance and reinstatement provisions so that they are in line with current filing office practices.

We believe that a modern statute such as RULLCA, as proposed by my committee, is a wonderful replacement for our current outdated statute. The adoption of a new modern statute will help New Jersey resurrect its reputation as a good state to do business in, without any cost to its taxpayers.

EXHIBIT

Statement

This bill, the "Revised Uniform Limited Liability Company Act," repeals the "New Jersey Limited Liability Company Act," and replaces it with a more modern regulatory scheme for the creation and operation of limited liability companies in New Jersey.

The limited liability company (LLC) is a relatively new form of unincorporated business organization that provides corporate-style limited liability to its owners, while affording the owners the partnership-like capacity to structure the entity by agreement rather than as prescribed by statute. LLCs began to be widely used after IRS Revenue Ruling 88-76 upheld the taxation of LLCs as partnerships. If the LLC elects to be taxed as a partnership, the LLC does not pay federal income tax on its profits. Rather, its members are taxed on their share of the LLC's income. As a result, LLCs have become the business entity form of choice for new businesses, and far more New Jersey LLCs have been formed in recent years than corporations and limited partnerships combined.

The "Revised Uniform Limited Liability Company Act" (RULLCA), as developed by the National Conference of Commissioners on Uniform State Laws (NCCUSL), is a significant advancement in this area of the law. It is a comprehensive, fully integrated "second generation" LLC statute that takes into account the best elements of "first generation" LLC statutes (such as the "New Jersey Limited Liability Company Act" (NJLLCA), which was enacted in 1993 and became effective on January 26, 1994) and two decades of legal developments in the field. Similar to the Revised Uniform Partnership Act (RUPA), RULLCA is largely a series of "default rules" that govern the relations among the members in situations they have not addressed in their operating agreement. Under RULLCA, express provisions of the operating agreement prevail over most statutory norms.

RULLCA's structure is similar to RUPA's. Article 1 (General Provisions) contains general provisions, including definitions; Article 2 (Formation; Certificate of Formation and Other Filings) provides for the formation of LLCs and for the filing of the appropriate documents with the Division of Revenue in the Department of the Treasury; Article 3 (Relations of Members and Managers to Persons Dealing with Limited Liability Company) governs the relations of members and managers to third parties; Article 4 (Relations of Members to Each Other and to Limited Liability Company) provides the default rules for the members' relationships with each other and with the LLC; Article 5 (Transferable Interests and Rights of Transferees and Creditors) reiterates the "pick your partner" concept that is fundamental to LLCs and sets forth the rights of transferees; Article 6 (Member's Power to Dissociate; Wrongful Dissociation) delineates the causes and consequences of an owner's dissociation from the LLC; Article 7 (Dissolution and Winding Up) sets forth the events for dissolution and liquidation of the LLC; Article 8 (Foreign Limited Liability Companies) governs foreign LLCs; Article 9 (Actions by Members) provides for direct and derivative actions by members of an LLC; Article 10 (Merger, Conversion and Domestication) governs domestication, conversion and merger transactions; Article 11 (Miscellaneous Provisions) includes several miscellaneous provisions, including transition rules for existing LLCs.

RULLCA makes meaningful changes in the NJLLCA. Here are some of the more significant changes and innovations in RULLCA as compared to NJLLCA:

- Perpetual duration. RULLCA eliminates the default (and often overlooked) rule that LLCs have a limited life. As is the case with corporations, RULLCA provides for LLCs to have perpetual duration.
- Permissible form of operating agreement. RULLCA permits operating agreements to be oral, written or implied based on the way an LLC has operated. This is consistent with the vast majority of states and in line with the organization of many LLCs formed in New Jersey.
- Profits, losses and distributions. Consistent with RUPA, unless otherwise agreed, allocations of profits and losses under RULLCA are per capita. Distributions also are made on a per capita basis.
- Statements of authority. As is the case under RUPA, RULLCA allows an LLC to file statements of authority with the Division of Revenue in the Department of the Treasury (and in the case of real estate, in the office where real estate records are maintained) authorizing certain people or entities to bind the LLC.
- Dissociation of a member. RULLCA eliminates a major pitfall for the unwary practitioner or layperson forming an LLC in

New Jersey. Under RULLCA, a resigning owner is no longer entitled to receive the fair value of his or her LLC interest as of the date of resignation. Rather, upon resignation, the resigning owner is dissociated as a member and only has the rights of an economic interest holder.
- Remedies for deadlock and oppression. Reflecting case law developments around the country and incorporating some of the best elements of the New Jersey Business Corporation Act, Article 7 (Dissolution and Winding Up) of RULLCA provides remedies for oppressed minority owners. RULLCA permits a member to seek a court order dissolving the company on the grounds that the managers or those members in control of the company have acted or are acting in a manner that is oppressive and was, is, or will be directly harmful to the member. RULLCA also permits a member to seek (or, in its equitable discretion, a court to order in lieu of dissolution) a less drastic remedy such as the appointment of a custodian.
- Domestication and conversion. RULLCA provides enhanced ease and flexibility for domesticating, merging and converting an entity other than a domestic limited liability company, if permitted by the law under which it was formed. Its comprehensive provisions offer streamlined methods for domestication (*e.g.,* allowing an LLC formed under the laws of another state to become a New Jersey LLC) and conversion (*e.g.,* allowing a corporation to become an LLC).

This bill will become effective 180 days after enactment, and will govern all LLCs formed after its effective date. Following the first day of the 18th month following this bill's enactment, it will apply to all New Jersey LLCs, whenever formed. ■

ENDNOTES

1. N.J.S.A. 42:1A-1 *et seq.*
2. N.J.S.A. 42:2A-1 *et seq*.

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Building Energy Performance

The New Frontier of Transactional Due Diligence (and Contractual Liability)

by Daniel J. Sheridan

Experienced transaction counsel know but one constant: nothing stays the same. Be it a new Delaware Chancery Court decision on minority freeze-out procedures, a shift in accounting standards from generally accepted accounting principles (GAAP) to International Financial Reporting Standards (IFRS), or a renewed enforcement initiative from the Department of Justice under the Foreign Corrupt Practices Act,[1] we are challenged on a daily basis with policy developments that often reflect rapidly evolving cultural norms and business needs.

A few years ago, the so-called green building movement made its debut on the legal stage. What may have been considered novel even two years ago has quickly become mainstream. According to a Feb. 17, 2011, press release from the Green Building Certification Institute, "[t]he practice of green building is currently in high demand, *with more than one million square feet of construction space certifying to the LEED rating system every day*."[2] (emphasis added).

Improved building energy performance is one of the major goals of the green building movement. In recent months, there have been several advances in the area of building energy performance, including a variety of state and local legislative initiatives that mandate, among other things, disclosure of a building's historical energy use,[3] as well as responsive solutions from a variety of industry and professional organizations, including the American Society for Testing and Materials (ASTM), and the International Standards Organization (ISO). This article briefly describes these developments, and includes some early observations regarding their potential impact on standard practice in mergers and acquisitions and other deals involving commercial real estate.

The ASTM recently published its much-heralded *Standard Practice for Building Energy Performance Assessment for a Building Involved in a Real Estate Transaction* (E-2797-11) (the standard) in response to the perceived market need for a uniform methodology for evaluating energy efficiency in buildings.[4] The standard defines a careful process through which a "qualified consultant" collects and analyzes "energy use" information, and specifies the format in which various "findings" are reported, the most relevant of which are: (i) "pro forma building energy use" (reported in kilo (10^3) British thermal units (kBtu) per year), (ii) "energy use intensity" (reported in kBtu per square foot), and (iii) "pro forma building energy cost" (reported in U.S. dollars per year and dollars per square foot per year).

The stated (and laudable) objectives of the standard are to:

> (1) define a commercially useful practice for collecting, compiling, and analyzing building energy performance information associated with a building involved in a commercial real estate transaction; (2) facilitate consistency in the collection, compilation, analysis, and reporting of building energy performance information as may be required under building labeling, disclosure, or mandatory auditing regulations; (3) supplement as needed a property condition assessment conducted in accordance with Guide E2018 or an environmental site assessment conducted in accordance with Practice E1527; (4) provide that the process for building energy performance data collection, compilation, analysis, and reporting is consistent, transparent, practical and reasonable; and (5) provide an industry standard for the conduct of a BEPA [building energy performance assessment] on a building involved in a commercial real estate transaction, subject to existing statutes and regulations which may differ in terms of scope and practice.

The standard references, and in some respects parallels, the Standard Practice for Environmental Site Assessments Phase I Environmental Site Assessment Process (E1527), the ASTM's effort to standardize the practices and procedures that satisfy the "all appropriate inquiry" element of the Comprehensive Environmental Response, Compensation and Liability Act[5] (CERCLA) innocent landowner defense. Having witnessed the evolution of environmental due diligence from the mid-1980s through the present, and the concomitant expansion in breadth and depth of contract representations, warranties and indemnities specifically addressed to environmental concerns, I cannot help but wonder when green building and energy efficiency issues will find their way into standard due diligence checklists and definitive agreements for corporate mergers and acquisitions transactions. It likely will not be long.

The standard, together with a variety of other benchmarking tools now (or soon to be) available to the market, have progressed us toward objectively measurable criteria, which in turn facilitates creation of legally enforceable obligations. Among the additional due diligence practices and external factors referenced in Section 13.1 of the standard are a number of protocols adopted by the American Society of Heating, Refrigerating and Air-Conditioning Engineers (ASHRAE), the *Capital Markets Partnership Green Building Investment Underwriting Standard, Green Value Score, Environmental Protection Agency's Energy Star Building Labeling Assessment-Statement of Energy Performance, Green Globe's Continual Improvement Assessment for Existing Buildings*, and the *U.S. Green Building Council's Leadership in Energy and Environmental Design (USGBC's LEED®) for Existing Buildings: Operations and Maintenance* (sometimes referred to as *LEED® EBOM*).

Additionally, the International Standards Organization is expected to publish the ISO 50001 *Energy Management Standard* in the third quarter of this year.[6] While this latter effort is geared toward energy management rather than measurement of energy use, the availability of an ISO benchmark signals the urgency with which the market is developing and adopting new tools to assist in the accurate measurement of the environmental impacts associated with the built environment.

As noted above, the rapid evolution in market forces in this arena was not the sole driver for the standard. A meaningful number of municipal and state authorities, most notably the cities of San Francisco, New York and the District of Columbia, have adopted mandatory disclosure requirements related to building energy performance. The illustrative list appended to the standard as Table X1.1 identifies 26 separate state laws or municipal ordinances governing record-keeping and disclosure for various subsets of commercial properties. New York's ordinance also mandates that large commercial buildings undergo energy audits and retro-commissioning on a 10-year cycle. In fact, the deadline for owners of large buildings in New York City to submit the first wave of benchmarking data from covered buildings was May 1, 2011.

To address the obvious "where do I start?" question, at least one software provider has developed an online tool that facilitates the data collection and analysis required under the standard. Sustainable Real Estate Solutions' assessment and benchmarking module[7] is designed to meet the requirements of the standard. It also incorporates other industry protocols, most notably Energy Star and LEED®.

What does this all mean for mergers and acquisitions, environmental and real estate practitioners? Here are some of my initial observations:

- First, we should add facility energy performance and disclosure as a due diligence item for all business and real estate transactions. A check of local law for potential disclosure or other compliance obligations (*e.g.,* reporting of building energy performance) is a must. In this regard, care must be taken to distinguish absolute legal requirements from aspirational standards, as much of the legislative activity in this arena is of the carrot and not the stick variety.
- Second, assuming there are no independent legal requirements that must be satisfied, we must discuss with our clients the advisability and extent of the desired due diligence. For publicly reporting companies, issues of carbon footprint reporting and corporate sustainability policies may prove a stronger catalyst for comprehensive due diligence.[8]
- Following the due diligence discussion and evaluation, we should facilitate our clients' evaluation of the proper context of these issues within the overall 'deal dynamic.' Is there a minimum performance standard (on either a single facility or aggregate basis) which, if not met, would give rise to a claim for damages or indemnity? Or is the intent simply a disclosure exercise that may or may not potentially impact deal pricing?
- Fourth, we of course must draft to accomplish the deal objective. Green lease forms,[9] as well as construction contracts for green projects, may provide a useful starting point for this exercise, but the legal context of these agreements may not necessarily translate well to mergers and acquisitions practice. Alas, we brave pioneers may have to tackle this one without the aid of a form book.
- Finally, we must facilitate understanding. Not only must we surmount our own learning curve, we must teach others. This is just one more area where we, as practitioners, must adopt a legal framework to address a new market reality.

There is no doubt that the green building wave has crested. Learning to address building energy performance in acquisition transactions is but one of many new legal challenges that await us as society continues to wrestle with climate change, environmental stewardship and global sustainability. ■

ENDNOTES

1. 15 U.S.C. §§ 77dd-1 *et seq*.

2. *See* www.gbci.org/org-nav/announcements/11-02-17/New_Online_Tool_Launched_for_LEED_Professional_Credential_Holders.aspx.
3. Most recently, the city of Seattle joined the fray with a "new citywide program designed to help owners and managers assess and improve building energy efficiency and spur the market for building energy retrofits." *See* www.reuters.com/article/2011/05/13/idUS402424029220110513.
4. The standard is available for purchase and download at www.astm.org/Standards/E2797.htm.
5. 42 U.S.C. § 9601 *et seq*. (1980).
6. *See* www.iso.org/iso/pressrelease.htm?refid=Ref1399.
7. *See* www.srmnetwork.com/solutions.
8. *See*, for example, the Securities and Exchange Commission's Guidance Regarding Disclosure Related to Climate Change, 17 CFR Parts 211, 231 and 241, and accompanying interpretive release at www.sec.gov/rules/interp/2010/33-9106.pdf.
9. For a description of a variety of green lease resources that are currently available, *see* http://legallygreenblog.com/green-leasing/leed-ebom-and-existing-leases-%e2%80%93-a-square-peg-in-a-round-hole.

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New Developments in Chinese Anti-Commercial Bribery Regime

by Yang Yang

In China, the distinction between a government official and a non-government official has less importance than in the United States, because Chinese law criminalizes both commercial and government bribery. In particular, the criminal law of the People's Republic of China (PRC) creates criminal penalties for both commercial and government bribery in articles 163 and 387, respectively. As China is making ongoing efforts to promote and maintain fair competition in its 1.3 billion population market, the nation's anti-unfair competition law regime plays a key role in ensuring a healthy marketplace. While crimes of official bribery target abuses of public power, China's anti-commercial bribery regime targets unfair competition.

One law and one set of regulations specifically address anti-commercial bribery in China: the Anti-Unfair Competition Law[1] and the Interim Provisions on Prohibiting Commercial Bribery.[2] These rules impose monetary fines for committing commercial bribery of up to RMB 200,000 (U.S. $30,303). If the bonus amount is significant, the commercial bribery would constitute a criminal offense.

This article is divided into four parts. Part I explains who is subject to the commercial bribery regime. Part II explains the elements of illegal commercial bribery. Part III is an introduction to the liabilities that can be imposed in cases of commercial bribery. Part IV is a case study, and a discussion of the industries that have been the focus of anti-commercial bribery investigations by the government.

PART I: WHO IS SUBJECT TO THE ANTI-COMMERCIAL BRIBERY REGIME?

The Anti-Unfair Competition Law and Interim Provisions on Prohibiting Commercial Bribery prohibit "business operators" from committing commercial bribery. However, the law and regulations do not provide a specific definition for business operators.

Under general Chinese criminal law,[3] employees with corporations or enterprises who do not perform public service would be subject to criminal prosecution for taking or offering commercial bribes. On the contrary, employees who perform public service would be subject to criminal prosecution for taking or offering official bribes. People who perform public service are called "state functionaries." Therefore, business operators would be non-state functionaries, who do not perform public service.

In summary, there are mainly two categories of non-state functionaries who do not perform public service. The first category is employees with privately owned companies. The second category is employees at state-owned companies who do not perform public service.

The Supreme Peoples' Court[4] defines "public service" from the perspective of judicial practice. Public service means duties performed on behalf of state organs; state-owned companies, enterprises, institutions, and people's organizations, including organizing, leading, supervising, managing, etc. According to some commentators, public service duties must involve the use of public power (*i.e.*, state authority) or the management of national property. Under this interpretation, a person engaged in public service must possess some amount of authority or responsibility on behalf of the state; low-level employees, such as those performing pure labor or technical work, would not be engaged in public service. However, the precise boundaries of what duties constitute public service have not been clearly defined by the government authorities.

PART II: ELEMENTS OF ILLEGAL COMMERCIAL BRIBERY

According to the Anti-Unfair Competition Law, Interim Provisions on Prohibiting Commercial Bribery and the general Criminal Law of China, the elements for constituting illegal commercial bribery are: 1) a conduct of unfair competition by offering money or items of monetary value; 2) such offers are under-the-table and not recorded in accounting books; and 3) an effect that the business operators actually gain more business opportunities (*i.e.*, increased sales of products or services) as a result of such conduct.

The China State Administration for Industry and Commerce and its local offices (each is referred to as the AIC and collectively, the AICs) are the primary authorities to identify commercial bribery. Recently, the AICs have been targeting bonus payments made to third parties other than business partners or competitors. Therefore, the money or items of monetary value paid to a third party instead of another business operator falls within the first element of constituting illegal commercial bribery.

Following is a discussion of what payments paid to a third party could trigger AIC investigations and what the differences are between commercial bribes and legal commissions paid to an agent.

What Payments Paid to a Third Party Could Trigger AIC Investigations?

If the bribes to third parties might have indirect effects on achieving more business opportunities (*i.e.*, increased sales of products or services), such bribes usually could trigger investigations. Usually the third parties hold positions of power. Third parties holding positions of power in markets may include, but are not limited to, private entities and their employees who can influence the parties' business decisions.

As an example of the third category, Company A possesses customer information, such as a list of customers who are likely to be the target consumers of Company B's service. An AIC may find that Company A is able to influence its own customers' decisions. Thus, any bonus paid to Company A by Company B might serve as an incentive for Company A to favor Company B over other business operators.

As mentioned above, the anti-commercial bribery regime is intended to protect fair competition in the market. In the example provided above, it would be part of the government's efforts to have business operators compete on the quality of products or services, or more competitive price of the products rather than be influenced by under-the-table payments.

Distinction Between Legal Commission and Illegal Commercial Bribe

A legal commission is a form of payment for actual services rendered by licensed agents or other parties. In addition, such payments must truthfully and accurately be recorded in the accounting books of the receiving parties. Therefore, there are three main elements for a legal commission: 1) the receiving party must actually provide services to the paying party; 2) if providing such services requires a license from the government, the receiving party must possess such a license; and 3) the payments must be recorded in the accounting books of the receiving party.

If an agent without business qualification provides services and accepts a commission, it will be characterized as an "unlicensed operation." An unlicensed operation does not necessarily constitute commercial bribery. However, the AICs tend to apply more stringent scrutiny on such unlicensed operations in determining whether the payment of a commission to the agent would constitute an illegal commercial bribe.

An Intent to Bribe

An intent to bribe also is one of the elements of commercial bribery. Thus, parties could make an affirmative defense that the paying party does not intend to bribe. However, this intent can be implied from specific transactions. For example, the required intent could be inferred if a business operator pays an extra bonus to an agent in addition to the consideration for the actual services provided by the agent and the agent possesses an influential position regarding customers, as discussed above. This implication would be triggered when extra payments are made to the agent. The rational is that even though these agents provide services, the extra payment might act as an incentive for the agent to favor the paying business operator over other business operators.

PART III: POTENTIAL LIABILITY UNDER COMMERCIAL BRIBERY LAW

Under Chinese law, commercial bribery can lead to both fines and imprisonment. Although the fines are relatively small, the prison terms can be substantial.

The Anti-Unfair Competition Law empowers the AICs to impose up to RMB 200,000 (U.S. $30,303) for illegal commercial bribery. In addition, the AIC is empowered to confiscate the bribes.

If the business operators receive RMB 5,000 (U.S. $756) or more, they could be charged with the crime of taking commercial bribes. For paying individual business operators, they could be charged with offering commercial bribes if they offer RMB 10,000 (U.S. $1,515) or more to another business operator. For paying corporate business operators, they could be charged with offering commercial bribes if they offer RMB 200,000 (U.S. $30,303) or more to another business operator.

If the amount of the bonus is significant, taking a commercial bribe could subject the recipient to at least five years in prison. The determination of what is significant is left to the discretion of the courts.

One notable difference between the crime of taking an official bribe and taking a commercial bribe is that there is no death penalty for the crime of taking a commercial bribe, while criminals could be subject to the death penalty if found guilty of taking an official bribe. The court can impose monetary fines in addition to the sentence. Offering a commercial bribe might subject the offeror to up to 10 years in prison.

In 2010, four employees of Rio Tinto, the British-Australian international mining group, including an Australian citizen, were found guilty of accepting millions of dollars in commercial bribes and stealing commercial secrets. Stern Hu, the Australian citizen who served as Rio Tinto's general manager in Shanghai, was sentenced to seven years in prison for commercial bribery and five years for stealing business secrets. But his final sentence was reduced to 10 years for the two crimes. In addition, he received a fine of one million RMB (U.S. $151,515).

The three other charged employees were Chinese citizens, and all of them were found guilty of taking a commercial bribe and stealing commercial secrets. The court sentenced Wang Yong to a 14-year prison sentence and imposed a fine of RMB 5.2 million (U.S. $787,878), Ge Minqiang to an eight-year sentence with a fine of RMB 800,000 (U.S. $121,212) and

Liu Caikui to a seven-year sentence with a fine of 700,000 (U.S. $106,060).

All of them appealed, but the appeals were dismissed.

Another high-profile case involved Pepsi, and was uncovered in September 2009. Guangzhou Pepsi Cola Beverage Co., Ltd., a subsidiary of PepsiCo, was fined for offering commercial bribes of a total of RMB 247,700 (U.S. $37,530) to approximately 47 local supermarkets and chain stores in Guangzhou. The payment was for having the supermarkets and chain stores display the company's Tropicana™ label. Guangzhou Pepsi Cola Beverage Co was fined RMB 700,000 (U.S. $106,060).

PART IV: SOME INDUSTRIES AS EXAMPLES FOR EXPLAINING THE RULES

The explanations of the rules in the following industries apply to all industries.

Auto Financing Industry

Many Chinese automobile sales dealers routinely promote auto financing companies to finance automobile purchases by their customers. Usually, these auto financing companies have a bonus agreement with the automobile dealers. The automobile dealers receive bonuses from the auto financing companies for financing agreements entered into between customers and the financing companies. The interest rates under these financial agreements are higher than the interest rate offered by commercial banks. Many auto dealers were investigated by the AICs, and fined because those dealers intentionally did not disclose this information or inform their customers that they could also apply for lower-rate auto loans from commercial banks.

Medicine

In the medical care industry, the AIC in 2005 issued a notice emphasizing measures to be taken to prevent commercial bribery by hospital employees.[5] The purchase by hospitals of medicine and medical devices must be put out for public bidding. In addition, the bidding is required to be transparent, fair and equal. The AICs are supervisors of the process, and will also provide assistance with information supporting such public bidding.

Tourism

In practice, stores would pay tourist guides bonuses based on purchases made by the tourists. The bonuses acted as incentives for attracting tourists to the paying stores. These bonuses were paid in the name of "parking fees" or "head fees," in order to cover up the real purpose of these fees. The State Administration for Industry and Commerce (SAIC), in 1999, issued a notice directly addressing such payments.[6] According to the notice, these payments violate the Anti-Unfair Competition Law, and would constitute an illegal commercial bribe.

CONCLUSION

The legislative intent of anti-commercial bribery law is to protect a fair and efficient market with fair competition. In practice, the AICs will examine the substance of a transaction, including the intent of the parties, the content of the agreement, and the manner in which the agreement is enforced.

In summary, payments to another business operator may trigger investigations by the AICs if: 1) the payment is made to a third party other than the business partner and the third party does not provide actual services to the paying party; 2) the services to be provided by the third party require a license from the government, but the third party does not possess a valid license; 3) the payments made to a third party exceed the value of the services provided by the third party; 4) the payment made to this party are not recorded properly in the payor's accounting books; 5) the payment made to a business partner is not recorded properly in the payee's accounting books; or 6) the payment exceeds the value of the products or services the business partner actually provides.

Accordingly, counsel representing companies doing business in China should advise that clients strictly avoid all such practices. In addition, companies in industries covered by specific AIC advisory, such as those noted above, should review advisories carefully, to confirm that their business practices fully comply with the law and relevant regulations and policies. ■

ENDNOTES

1. The Anti-Unfair Competition Law of the People's Republic of China was promulgated on Sept. 2, 1993, and became effective on Dec. 1, 1993.
2. Interim Provisions on Prohibiting Commercial Bribery by the State Administration for Industry and Commerce was promulgated and became effective on Nov. 15, 1996.
3. Criminal Law of the People's Republic of China was promulgated by Nat'l People's Congress on March 14, 1997, and became effective on Oct. 1, 1997.
4. "The Announcement on Promulgation of Important Notes on Trials of Cases on Economic Crimes by The Supreme People's Courts" was promulgated and became effective on Nov. 13, 2003.
5. The Notice of the State Administration for Industry and Commerce on Measures Taken to Prevent Illegal Activities in the Medicine Purchase and Sales and Medical Service, was promulgated and became effective on April 6, 2005.
6. The Response by the State Administration for Industry and Commerce on Head Fees, Parking Fees and Etc. to Tourist Guides by the Stores, was promulgated and became effective on June 22, 1999.

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