ASSOCIATION OF BUSINESS TRIAL LAWYERS

abtl

NORTHERN CALIFORNIA

REPORT

Volume 3 No. 2

MARCH '94

Letter from the President

THE ABTL of Northern California is now in its third year. Our dinner programs meet a not otherwise easily filled need of business trial lawyers for high quality programs aimed at the litigation skills we need and the challenges we face.

The format of these dinner events allows us to mix the serious business of continuing legal education with a bit of fun. The cocktail hour that precedes the seven o'clock (sharp) dinner and the eight o'clock (sharp) program is a chance to visit with other business trial lawyers and with trial and appellate judges from all over the Bay Area.

Jerome B. Falk, Jr.

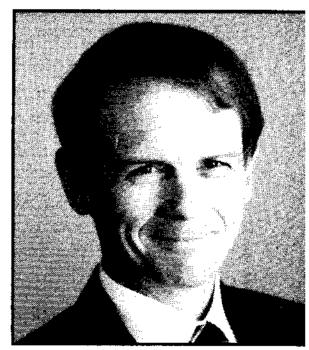
The high level of participation by Bay Area judges makes all this special. I think the high degree of judicial participation and bench-bar socializing occurs not only because of the high quality of the programs that are the centerpiece of these evenings, but also because the ABTL is not an interest group or political organization of the kind that many judges are reluctant to join. ABTL's lawyers represent plaintiffs and defendants in all types of

Continued on Page 12

Also in this Issue

Noncompetition Agreements: Babcock *and Beyond*

BY now most practitioners have noted with passing interest last December's Supreme Court opinion declaring that law firms may withhold from departing partners a reasonable portion of post-departure earnings if the attorneys leaving the firm later compete with it. But the true noteworthiness of *Howard v. Babcock*, 6 Cal.4th 409 (1993), is an astonishingly broad rationale which constitutes a potentially revolutionary development in what law firms may do to discourage competition. The former absolute ban on law firm noncompetition clauses imposed by the Rules of Professional Conduct has now been so circumscribed that firms will surely become a good deal more aggressive in creating a wide variety of disincentives. Noncompetition clauses have now, as a practical matter, been given new life, and the impact upon the economics of our profession in this era of mobility will no doubt be quite significant.



William H.G. Norman

The Babcock Decision

The Plaintiffs in *Howard v. Babcock* were a group of partners who left their firm to set up a competing partnership with the 200 cases they took with them. Several years before they left, however, the partners had signed a partnership agreement which, in Article X, provided that:

> Should more than one partner...withdraw from the firm...and thereafter within a period of one year practice law...within [the] Los Angeles or Orange County court system, said partner or partners shall be subject, at the sole discretion of the remaining nonwithdrawing partners, to forfeiture of all their rights to withdrawal benefits other than capital...

Continued on Page 2

Continued from Page 1

Noncompetition Agreements

The withdrawal benefits in question were substantial, amounting to 82.5 percent of the net profits received for work the departing lawyers had performed for the clients they had taken, and the "old firm" proceeded to withhold them. The defecting partners thereupon sued for their recovery, arguing that Article X violated Rule of Professional Conduct 1-500, which generally forbids members of the bar from entering into any agreement restricting the right to practice law. The trial court rejected the plaintiffs' argument, but the Court of Appeal reversed on the grounds that Article X was unenforceable under Rule 1-500.

The Supreme Court reversed the appellate court, relying heavily on Business & Professions Code § 16602, which generally permits agreements that restrict competition by former business partners. The Court reasoned that if the Legislature had intended to make an exception for law firms it would have said so, and it didn't.

What about Rule 1-500? Invoking its broad supervisory powers over ethical issues in the legal profession, the Court declared that Rule needed to be harmonized with § 16602 so as to protect the legitimate economic interests of law firms. The Court went on to conclude Article X was essentially a departure tax rather than a true restriction on the practice of law as contemplated by Rule 1-500. The case was remanded to the trial court to determine whether the tax was reasonable.

The Court's Far-Reaching Rationale

Anticipating a number of points raised in Justice Kennard's dissent, the majority opinion set forth a rationale which is so broad as to be quite instructive of what further restrictions on competition might be found acceptable in the future.

For example, Justice Kennard's vigorous dissent pointed out that Rule 1-500 was unambiguous in its prohibition of restrictions on law firm competition and that an 82.5 percent forfeiture could hardly be interpreted as anything but a restriction. Anticipating this semantic point and acknowledging that courts in seven other states had struck down similar clauses as forfeitures, Justice Mosk explained the majority's view of the distinction as follows:

> [A]n agreement that assesses a reasonable cost against a partner who chooses to compete with his or her former partners does not restrict the practice of law. Rather, it attaches an economic consequence to departing partners' unrestricted choice to pursue a particular kind of practice.

This distinction seems to be a stretch. Although one can argue that a substantial monetary penalty may or may not be effective or outcome determinative in any given case, it seems difficult to conclude that it couldn't theoretically impose at least a minor restriction, and Rule 1-500 prohibits any kind of restrictions at all.

Six Justices were, however, willing to make that stretch, and so it must be regarded as driven by a deep wellspring of concern about the trend towards "portable books of business." As the Court put it, there is a need to address "one of the important changes rocking the legal profession...the propensity of withdrawing partners in law firms to 'grab' clients of the firm and set up a competing practice." Justice Mosk articulated the majority's concerns by observing:

> The firm has a financial interest in the continued patronage of its clientele...the firm's capital finances that development of a clientele and the support services and training necessary to satisfactorily represent the client...in earlier times, this investment was fairly secure because the continued loyalty of partners and associates of the firm was assumed. But more recently lateral hiring of associates and partners, and the secession of partners from their firms has undermined this assumption....

The dissent further noted that the legal profession should be held to a higher standard than other businesses because of its position of trust, its fiduciary duties, and its enjoyment of special protections for client communications. Justice Kennard argued that a client's right to an unfettered choice of counsel is therefore paramount and it becomes threatened by the substantial economic disincentives contained in clauses such as Article X.

Once again anticipating the argument, Justice Mosk stated:

> It seems to us unreasonable to distinguish lawyers from other professionals such as doctors or accountants, who also owe a high degree of skill and loyalty to their patients and clients. The interest of a patient in a doctor of his or her choice is obviously as significant as the interest of a litigant in a lawyer of his or her choosing.

But wouldn't a substantial penalty or "tax" act to discourage clients from following their chosen lawyer if he or she left? The majority answered with a resounding "No":

> In fact, it has been argued that a noncompetition agreement, or a penalty for competition, may actually serve clients as well as the financial well-being of the law firm. Without such an agreement, "[t]he culture of mistrust that results from systemic grabbing is very likely to damage, if not destroy, the law firm's stability. It is clear that when law firms dissolve, work on behalf of clients is undeniably disrupted. But even where a law firm does not self-destruct, it is easy to comprehend the disastrous impact on clients." (Citations omitted.)

Analogizing Article X to a kind of liquidated damage clause, ("an accepted fixture in other commercial contexts"), Justice Mosk approved of the approach taken by the Second District in *Haight, Brown & Bonesteel v. Superior Court,* 234 Cal.App.3d 963 (1991). He declared:

> [A] contractual provision specifying damages for breach of contract is valid only if it represents a result of reasonable endeavor by the parties to estimate a fair average compensation for any loss that may be sustained. An amount disproportionate to the anticipated damages is termed a penalty. A contractual provision imposing a penalty is ineffective.... *Under this standard, a partnership agreement to pay former partners...an amount that at the time of the agreement is reasonably calculated to compensate the firm for losses that may be caused by the with-*

Continued on Page 3

Continued from Page 2

Noncompetition Agreements

drawing partner's competition with the firm would be permitted. (Emphasis supplied.)

Where Do We Go From Here?

The majority's rationale suggests plainly that the Court will go to great lengths to protect law firms from defections, and it seems to announce a willingness to approve a variety of economic sanctions provided they are grounded in a reasonable attempt to measure the future economic impact of departures. That could logically include some extremely onerous disincentives if the departing partners represented a sufficient loss of income.

For example, if a firm's biggest rainmaker departs with clients representing 50 percent of the firm's revenues, and it is reasonably estimated in advance that replacing that business would likely take four years, could the partnership agreement establish a sinking fund of four years of income and provide that the departing partner forfeits all of it? Could a partner's capital be declared part of such a fund?

Good draftsmanship might also be employed to weave into a noncompetition clause still further monetary disincentives relative to the expected adverse economic consequences of the use of proprietary information by a departing partner. For example, recitals could be inserted to the effect that client lists, office forms, research, software, marketing plans, and manuals are all firm property developed with firm resources and do not belong to individual partners even if they helped develop the information. See *Courtesy Temporary Services v. Comacho,* 222 C.A.3d 1278 (1990); C.C. § 3426.1; and *Loral Corporation v. Moyes,* 174 C.A.3d 268 (1985). Therefore, the agreement might go on to provide, any departing partner's use of them would damage the firm, according to the parties' best current estimate, in an amount significantly greater than if a partner merely left without attempting to use these resources later. (Of course, a cause of action for damages and injunctive relief might already exist, but an automatic forfeiture of a sum already held by the firm might be quicker, easier and less cumbersome than a lawsuit.) In any event, carefully worded with the kinds of recited details which liquidated damage clauses required, could such a provision pass muster?

Other Employees

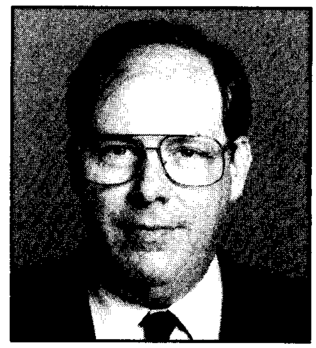
It can be argued too that proprietary information also includes employment relationships with employees and associates because of the substantial investment firms often make in training their personnel. Would a forfeiture be upheld if it became triggered by a former partner's post-departure hiring of legal assistants or office managers, especially if that activity relied upon inside knowledge about the attitudes, salary, tastes, and competence of firm personnel? (A penalty on post-departure hiring could be useful because while the partners' fiduciary duties to each other prohibit the solicitation of old firm personnel before the departing partners leave, they might

Continued on Page 8

When Bankruptcy Collides With Settlement Hopes

So you finally settled that monster piece of unfair competition litigation and you are just about to send off the settlement documents for signature when your client calls. She tells you that there is a rumor running around the industry that one of the parties in your case has just filed bankruptcy in Texas. She asks you to confirm it and give her a call back advising of the effect of that bankruptcy on your settlement. After a few calls, you verify the bankruptcy has not yet been filed but will be filed in a day or two. When you call your client back, what do you tell her?

What you need to worry about depends largely on what role your client will play in the settlement. If your client will receive money or property, your worry is making sure the client does not have to give it back in the event of a bankruptcy. If your client is paying for a release, you need to make sure you will get it. And if future performance by another is part of the settlement, protecting your client against nonperformance because of bankruptcy is your concern.



Mike C. Buckley

Who Owns the Claim?

Regardless of what role your client plays, assuming that the settlement will not be actually signed and consummated until after a bankruptcy petition is filed, you may not be dealing with the right parties. Following the filing of a bankruptcy petition under Bankruptcy Code Section 541, all of the rights and property of the debtor, including contingent claims such as those asserted in a lawsuit, become part of the bankruptcy estate. Even personal injury claims, which may not be assignable under state law, are transferred by operation of the Bankruptcy Code to the bankruptcy estate, a separate legal entity created upon the filing of the petition. Who controls the estate depends upon what kind of bankruptcy case has been filed. In a so-called Chapter 7 liquidation, the bankruptcy estate is managed by a court-appointed bankruptcy trustee. All action with respect to the assets of the estate are taken in the trustee's name. Thus, any claims owned by the estate belong to the trustee and can be resolved only by agreement with the trustee.

It is not uncommon that an individual with a pending lawsuit may fail to list the lawsuit in his bankruptcy petition. After all, in his mind it is still just a contingent claim which he may even regard as a long shot. If his bankruptcy lawyer does not discover the pending suit, it may not be listed in the petition and the trustee may never administer it. Later, when the case is up for settlement, it suddenly comes to light that the plaintiff went

Continued on Page 4

Continued from Page 3

When Bankruptcy Collides With Settlement Hopes

through bankruptcy, perhaps even before the lawsuit was filed, but after the claim originally arose. Since the claim or suit actually transferred to the trustee at the time the petition in bankruptcy was filed, you should be settling with the trustee rather than with the plaintiff. Even if the debtor was discharged or the bankruptcy estate was "closed" by the trustee, the claim still belongs to the estate and should be handled by the trustee. Closing the estate does not revest any unadministered assets in the debtor. Moreover, the trustee is not deemed to have abandoned the asset even if the asset went unadministered; abandonment requires a noticed motion and court approval.

On the other hand, if the debtor files under Chapter 11 or Chapter 13, so-called reorganization cases, the asset belongs to the bankruptcy estate but is administered by the debtor acting as a debtor-in-possession. The debtor-in-possession has the authority to make a settlement agreement and, in our original scenario, you can reassure your client that you are dealing with the right people. This would certainly be true where the reorganization case has resulted in a confirmed plan of reorganization, which typically returns the ownership of assets back to the debtor.

Of course, all settlements with a bankruptcy estate, whether managed by a trustee or a debtor-in-possession, require Bankruptcy Court approval following notice to creditors and other parties in interest. Settlement agreements with such debtors should be made expressly contingent upon such approval.

For claims not settled prior to the filing of a bankruptcy petition, bankruptcy has the effect of dividing the treatment of claims the debtor has against third parties from the claims third parties have against the debtors. While the bankruptcy estate may be willing to settle to obtain payment for claims it has against your client, it may not be willing to be similarly generous with respect to claims your client may have against it. General unsecured creditors usually will not receive a substantial percentage of their claims. Thus, the debtor may try to take the position that its claims should be honored against your client at 100 cents on the dollar while your client will receive a much smaller pro rata share of the debtor's estate on any cross-claim. Principles of set off may apply to protect you, but not in all cases.

Effect of Bankruptcy on Prior Settlements

If your client has already entered into a settlement agreement and perhaps partially performed some of his obligations prior to the bankruptcy case being filed, you have a different set of problems. You probably made the settlement with the right people, but now the settlement may be unenforceable as originally envisioned. On the simplest level, if the settlement agreement requires future payments or performance by a now bankrupt party, your client will only be entitled to what it will receive as a general unsecured creditor in bankruptcy. If you had the foresight to obtain some sort of security interest in the assets of the debtor, you may be treated as a secured creditor who has the opportunity to pursue the collateral in the bankruptcy.

A settlement agreement which still has provisions to be performed on both sides, such as periodic payments for an intellectual property license with the requirement to make new technology available, will be deemed an executory contract under Bankruptcy Code Section 365. The debtor has the right to reject most executory contracts that are a burden on the estate. The disappointed party's claim for losses caused by the rejection is a probably unsecured creditor's claim in the bankruptcy case.

Avoidable Transfers

One significant feature of a bankruptcy filing is the effect of Bankruptcy Code Sections 547 and 548, which allow the bankruptcy trustee or debtor-in-possession to set aside certain "transfers" made prior to the filing of the bankruptcy petition. The retroactive impact of the preference rules in Section 547 permits a trustee or debtor-in-possession to sue for and recover payments made by an insolvent debtor to its creditors within the 90 days preceding the filing of the bankruptcy petition where the payment is made on account of a preexisting obligation and enables the creditor to receive more than he would receive in a regular bankruptcy liquidation. Thus, if a debtor pays your client a settlement amount in the 90 day period, the trustee or debtor-in-possession may be able to recover it and effectively set aside the settlement agreement even if no further performance is due. Similarly, even if security is obtained for the settlement obligations, if the security interest is perfected within the 90 days preceding bankruptcy, the perfection of the security interest itself will be deemed a transfer for preference law purposes.

It is less likely that a true settlement will run afoul of Bankruptcy Code Section 548's prohibitions on fraudulent transfers, but under some circumstances a fraudulent transfer might be asserted. A fraudulent transfer is a transfer made by the debtor without substantial consideration. The bankruptcy trustee or debtor-in-possession may set aside those transfers if they occurred up to three years prior to the filing of the bankruptcy petition. In the business litigation context a fraudulent transfer argument is most commonly asserted when a group of related entities settles a case but the bulk of the consideration comes from one entity, though the benefit is to all the related entities. Thus, a group of individuals and their controlled corporation might settle a case by having the corporation pay most of the settlement. If the corporation subsequently goes into bankruptcy, the trustee might challenge the settlement on fraudulent transfer grounds, inasmuch as the corporation may not have received much benefit for its payment, apart from the piece of mind accorded its shareholders or officers. Your client's peace of mind may be disturbed, however, if the payment he received in settlement was a fraudulent transfer.

Drafting Suggestion

While no settlement can be made impervious to attack as a result of the bankruptcy of one of the parties,

Continued on Page 5

Continued from Page 4

When Bankruptcy Collides With Settlement Hopes

several things can be done to improve the chances of avoiding disappointment. Once again what to try to put into documents depends on the role of your client.

If your client is receiving payment and if the settlement does not involve any future executory performance, the primary object of attention should be to frame the deal and describe the factual setting so as to guard against attack as a preference or fraudulent transfer. Several elements of a preference attack may be undercut by good draftsmanship in the settlement documents. Since a preference can occur only if the transferring party is insolvent at the time of the transfer, you might require a representation of solvency and do whatever is necessary to ascertain its truth at the time the settlement is consummated. Moreover, transfers are subject to preference attack only if they are in satisfaction of a preexisting, past due indebtedness. To the degree the settlement is based upon contemporaneous obligations, the agreement should so specify. Perhaps a stipulated judgment or an unopposed summary judgment could be entered and then promptly settled. The judgment is arguably a current obligation even if it is based on preexisting obligations. Make sure the agreement specifies where funds are coming from and why a party supplying

Continued on Page 8

VeriFone *Clarifies Securities Fraud Litigation*

IN November 1993, the Ninth Circuit affirmed Judge Vaughn Walker's 1992 dismissal of a securities fraud class action against VeriFone, Inc., several of its officers and directors, and the underwriters of VeriFone's public stock offering. *In re VeriFone Sec. Litig.*, 11 F.3d 865 (9th Cir. 1993).

The Ninth Circuit's *VeriFone* decision was the fourth consecutive Ninth Circuit decision during 1993 affirming dismissal of a securities fraud suit. *See In re Lyondell Petrochem. Co. Sec. Litig.*, 984 F.2d 1050 (9th Cir. 1993); *In re GlenFed Sec. Litig.*, 1993 U.S. App. LEXIS 24439 (9th Cir. 1993), petition for rehearing and suggestion for rehearing *en banc* pending; and *Neubronner v. Milken*, 6 F.3d 666 (9th Cir. 1993). On December 29, 1993, the Ninth Circuit issued its only 1993 published decision reversing dismissal of a securities fraud action. *In re Wells Fargo Sec. Litig.*, [Current Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 98,007, at 98,250, 1993 U.S. App. LEXIS 33818 (9th Cir. 1993).

Paul T. Friedman

The *VeriFone* opinion addresses several significant and recurring issues in federal securities litigation, including: (1) the district court's proper role in deciding a Rule 12(b)(6) motion; (2) the ability of the district court to evaluate the actual text of allegedly misleading statements; (3) a corporation's duty to disclose projections; (4) claims based on independent analyst reports; and (5) alleged violations of SEC or stock exchange rules.

VeriFone, a designer and manufacturer of transaction automation systems for credit card and check verification and other transactions, undertook an initial public stock offering in March 1990. Following the offering, VeriFone's stock rose to a high of over $25 a share in July, then declined to a low of just over $7 a share following VeriFone's announcement in mid-September of disappointing quarterly results. Immediately after the announcement, plaintiffs filed suit for securities fraud under sections 10(b), 11, 12(2), and 20A of the federal securities laws, principally alleging that VeriFone withheld from the market information concerning its business prospects.

The district court granted VeriFone's and the underwriter defendants' motions to dismiss the complaint under FRCP 12(b)(6) for failure to state a claim, and under FRCP 9(b) for failure to plead fraud with particularity.

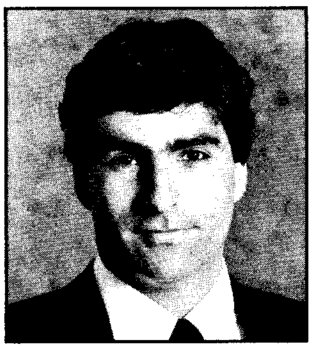
Continued on Page 6

Continued from Page 5

VeriFone *Clarifies Securities Litigation*

Noting that plaintiffs did not allege that any of VeriFone's public statements were literally untrue, Judge Walker found that plaintiffs must therefore establish "as a threshold matter" that defendants withheld from the market not just relevant information, but information that they had "a legally cognizable duty to disclose." *In re VeriFone Sec. Litig.*, 784 F. Supp. 1471, 1480 (N.D. Cal. 1992). Relying upon the Ninth Circuit's decision in *In re Convergent Technologies Sec. Litig.*, 948 F.2d 507 (9th Cir. 1991), the court reiterated that a corporation has no duty to disclose internal forecasts of its financial performance, and held that plaintiffs failed to state a claim for allegedly withholding such information.

The district court further held that a listing of customers in VeriFone's prospectus did not imply that the company had current orders with the customers. Finally, the court held that statements in independent analyst reports did not support a claim because plaintiffs failed to show that the defendants "knew that [the statements] lacked a reasonable basis" when made. *VeriFone*, 784 F. Supp. at 1486-87.



Jordan Eth

Deciding a Rule 12(b)(6) Motion

The Ninth Circuit's *VeriFone* decision clarifies the proper approach for a district court considering a motion to dismiss under Rule 12(b)(6). In opposing motions to dismiss, plaintiffs have argued that the court must draw all inferences in plaintiffs' favor. The *VeriFone* court clarified, however, that "[c]onclusory allegations of law and unwarranted inferences are insufficient to defeat a motion to dismiss for failure to state a claim." 11 F. 3d at 868. *VeriFone* thus makes clear that, although the court must accept all *reasonable* inferences from the alleged facts, the court need not accept *unwarranted* inferences solely because plaintiffs advocate them. Nor must the court deny a motion to dismiss because of conclusory assertions that the defendants have violated the securities laws.

The *VeriFone* court also independently examined the complaint's specific allegations, and did not simply accept the plaintiffs' characterizations in their complaint. Despite plaintiffs' contention that the defendants "concealed adverse facts in order to complete VeriFone's public offering," the court held that the "alleged nondisclosures are, *in substance*, failures to make a forecast of future events," which defendants had no duty to disclose. *Id.* at 869 *(emphasis added)*.

Independent Evaluation of Allegedly Misleading Statements

Besides finding that the court need not accept plaintiffs' characterizations in their complaint, *VeriFone* reinforces the principle that, on motions to dismiss, district courts can and should evaluate independently the text of the purportedly misleading statements. *See also Branch v. Tunnell*, 1944 U.S. App. LEXIS 409 at *13 (9th Cir. 1944). The court noted that the district court had considered "all of the documents in which the allegedly false and misleading statements were contained." The Ninth Circuit went on to review each of the statements and, based on that review, concluded that the complaint did not "adequately allege a material misrepresentation or omission." *Id.* at 868 n.2, 869. For example, the court held not actionable an allegedly misleading list of customers after reviewing for itself the full text of the document and the context in which it appeared:

> [Plaintiffs] argue that the list was misleading, in that VeriFone failed to disclose an actual fact, that it did not have current orders with these customers. However, we read the listing, which appears in a discussion of VeriFone's historical marketing strategy, as simply a compilation of past and current customers that connotes nothing material about the status of existing or prospective orders.

Id. at 870.

Thus, like decisions in other circuits, *VeriFone* affirms the principle that courts faced with a motion to dismiss should perform an independent review of the allegations in the complaint and the allegedly misleading statements. This approach is consistent with courts' historic function of reading and interpreting the substance of documents that are referred to by a complaint. The method also provides a tool for early review of the substance of a complaint, before the costs of full-scale litigation escalate.

No Duty to Disclose Internal Projections

The *VeriFone* court also held that VeriFone had no duty to issue projections of its future performance. The defendants allegedly "failed to disclose projected or potential changes in VeriFone's product market." *Id.* at 867. Echoing the district court, the Ninth Circuit wrote that plaintiffs were essentially complaining that "VeriFone omitted to state the 'fact' that future prospects may not

Continued on Page 10

COMING EVENTS

April 12, 1994	MCLE Dinner: *Topic to be announced* Sheraton Palace Hotel Cocktails at 6:00 p.m. Dinner at 7:00 p.m.
October 21-24, 1994	Annual Program: *Lawyer Misconduct and Liability* Four Seasons Hotel, Maui

Call Phyllis Montoya (415) 434-1600 for tickets or information.

ZELA G. CLAIBORNE

On CONSTRUCTION

ALTERNATIVE Dispute Resolution (ADR) in the construction field has moved beyond dispute resolution to dispute prevention. Owners, contractors, construction managers, design professionals, and their counsel now look to "Partnering," a broad term which refers to a variety of dispute avoidance techniques, as the newest way to avoid the cost of litigation. Partnering draws on the principles of total quality management (TQM) and is a method of encouraging the parties involved in a construction project to work together in an atmosphere of goodwill and cooperation to produce a quality project on time and within budget. Any disputes which may arise are resolved quickly as work progresses or can be assigned to later ADR. Although partnering techniques have been developed in the construction field, they are easily adaptable to other kinds of business and are now being used in a variety of fields.

Because of the success of various partnering efforts, the American Arbitration Association (AAA) currently is developing a program to assist parties in their efforts to establish dispute avoidance procedures. To begin the process, the AAA suggests that the following language be included in a partnering agreement to be entered into by the key participants in the project:

> In order to complete this contract most beneficially for all parties, the parties to this contract agree to form a partnering relationship. This partnering relationship will draw on the strengths of each party in achieving a quality project. Within ____ days of the date of execution of this contract, the parties will request from the American Arbitration Association the appointment of a neutral facilitator for the partnering retreat. The partnering retreat will take place as soon as is practicable, but in any case within ____ days of the date of execution of this contract. The parties to this contract agree to good faith participation in such partnering retreat. Individual participation in such partnering retreat shall be agreed upon by the parties, but shall include at least the following project personnel:
>
> [list personnel names here]
>
> The cost of administering the partnering retreat and the fees and expenses of the partnering facilitator shall be borne equally by the contracting parties.

After the partnering agreement and the usual contracts are executed, the AAA will assist by appointing a neutral facilitator or, for a very large project, more than one facilitator to assist the parties during construction. Then, the decision makers for all of the key players attend a retreat to be held over several days before the start of construction at a neutral location away from the parties' places of business. At the retreat, the facilitator assists the parties with their common goal of creating a sound working relationship, including open communication, trust, and a willingness to work together to solve problems. Also, the parties may explore innovative ideas for cost saving or value engineering, provide for periodic review of progress toward meeting partnering goals, and agree on appropriate methods to resolve disputes before they escalate into costly lawsuits. Generally, the participants agree to use mediation or arbitration to resolve any disputes which cannot be resolved promptly during construction.

At the partnering retreat, the parties may agree on appropriate on-the-job dispute resolution methods. Sometimes, they may decide to use AAA review boards or "instant" arbitration to resolve disputes as they arise during construction. As part of the partnering agreement, the parties may agree on qualifications for potential neutrals, select individual neutrals for the project, and decide on procedures to facilitate timely dispute resolution, such as discovery and time frames for hearings and decisions. The goal is to develop dispute avoidance and resolution mechanisms appropriate to a specific project. The process can be loose and flexible or formal and structured, depending on the needs of the project.

Zela G. Claiborne

While partnering may add some cost to a project, the expense to any one party is minimal because it is shared by all. Clearly, this cost is justifiable if partnering results in a high quality project which is completed without substantial delays and cost overruns and without the extended litigation which now arises from most construction projects of any substantial size and complexity. If the decision makers for the key parties are committed to this "win-win" approach, all participants will benefit from the success of the project. Such efforts also should result in good long term business relationships among those involved. Partnering will not replace ADR, but should result in a reduction of the number of disputes sent to mediation or arbitration.

In essence, however, partnering is simply a method of achieving what already is required of contracting parties, both by good business practice and by the law. Unfortunately, the construction business has been so plagued by litigation that parties and their counsel have lost sight of applicable legal principles like the covenant of good faith and fair dealing. Further, the legal profession has been blamed – and sometimes justifiably so – for the growth of construction litigation and the resulting adversarial atmosphere which pervades many projects. In response, some construction consultants claim that project tensions develop when parties turn over their rights and responsibilities to lawyers out of fear of litigation. As a solution, these consultants offer their own project management and partnering services.

Experience has shown that partnering is an effective way to assure the success of a project. Lawyers who are trained in negotiation, business counseling, and ADR techniques are extremely well qualified to serve as neutrals and facilitate the partnering process. Perhaps it is time for the construction bar to put more energy into these efforts and less into urging clients to "paper" the file and prepare for litigation.

Ms. Claiborne is a partner in the firm of Bronson, Bronson & McKinnon.

Continued from Page 5

When Bankruptcy Collides With Settlement Hopes

funds or other consideration is doing so. If multiple parties or an insurance carrier and a litigant together are contributing to a settlement, their respective portions should be set forth. That part of the consideration supplied by third parties or the carrier is not a preferential transfer should an individual litigant go bankrupt.

To guard against a claim of fraudulent transfer, the settlement agreement should establish the values inherent in the bargain. In settlements parties are usually reluctant to describe in detail why they are settling or the relative strengths and weaknesses of their positions, but a carefully drafted description of the facts and an estimate of the value of the things each party is giving as part of the settlement will go a long way toward blunting a fraudulent transfer attack.

Insuring Future Performance

If future performance by the other side is an issue, even if the settlement does collapse as a consequence of the bankruptcy, your client may still be paid from another source. Obtaining a guarantee by third parties who are not likely to go bankrupt, such as the principals of a corporation, an insurance carrier or a financially secure party who is a co-defendant with a financially troubled defendant, will enable your client to seek compensation from them in the event he has to surrender what he received from the bankrupt party.

Make certain that your settlement documents provide that, if a bankruptcy is filed and the consideration your client received or anticipates receiving is recovered by the bankruptcy estate, then the original obligations sued upon are revived in the original amount requested and in the original character sued on, not just for the balance due under your settlement as a contract claim. One way of doing this is to make any release ineffective until full performance has been received. The comfort you can give the debtor in the meantime is a covenant not to sue so long as performance is timely tendered under the terms of the settlement agreement. Of course the settlement agreement should specifically revive the claims if needed.

Certain kinds of claims are not dischargeable debts in bankruptcy under Bankruptcy Code Section 523. In cases where the defendant's initial liability would not be dischargeable, consider trying to make his settlement obligations similarly nondischargeable. A defendant may be willing to admit that the original offending conduct gave rise to a nondischargeable debt, but he will probably not in most cases. At a minimum try to preserve the original character of the claim with an agreement that if the original claim is revived due to nonperformance because of a bankruptcy, the original claim that the character of the debt is nondischargeable can be pursued in the bankruptcy case. At least your client will be no worse off than before settlement.

Co-defendants' Bankruptcy

When a settlement involves future obligations by a party on the same side of the case as your client, failure to perform these obligations may result in your client having to pay more than originally anticipated to preserve the settlement. Make sure appropriate language is included in the settlement agreement to give your client the option but not the obligation to do so in the event of a bankruptcy. Also provide the right to assert a claim against the co-party's bankruptcy estate to recover the excess amounts paid and damages including attorney's fees. If possible make your client's obligation a separate one which is not joint and several. Most plaintiffs will not accept that result, however, and if you represent more than one party an attempt to do so will present an ethical issue for counsel. Finally it would be desirable to have a lien on the co-defendant's assets as protection for your client's contingent right to recover excess payments.

Settlements are inevitably placed in jeopardy by the filing of a bankruptcy case. Careful forethought about the possible impact of a bankruptcy can greatly minimize the effects of bankruptcy filings on hard won and hard negotiated settlement results.

Mr. Buckley is a partner in the firm of Crosby, Heafey, Roach & May.

Continued from Page 3

Noncompetition Agreements: *Babcock* and Beyond

otherwise be free to commence hiring after they left.) While such a post-departure hiring ban might be vulnerable under BPC § 16600, which forbids restrictions on a person's right to engage in a trade, a future Court might uphold it on the grounds that it is directed against potential solicitors rather than the employees themselves.

In the final analysis, resolving the questions posed above can be answered only in the context of particular situations (and indeed it should be stressed that the Supreme Court did not even uphold Article X itself, just its potential reasonableness). But the Court's liquidated damages clause analogy will alert those drafting or revising future partnership agreements to a need to become extremely detailed in their explanations of how the forfeited amount is the result of a good faith effort to approximate future losses which are extremely difficult to fix. Though Civil Code § 1671 creates a presumption of validity for liquidated damages clauses, disguised penalties will be struck down and the parties' conclusionary statements alone will not be binding. Nonetheless, if the parties' damage estimate was reasonable at the time the agreement was executed, it may be held valid. *See Farthing v. San Mateo Clinic* (1956) 143 CA2d 385.

Details aside, however, it seems plain that *Howard v. Babcock* has created opportunities for law firms, both large and small, to fortify their partnership agreements with protections against the risks of future catastrophic defections.

William H. G. Norman is a partner in the firm of Bronson, Bronson & McKinnon.

MICHAEL A. JACOBS

On PATENTS

YOUR client has received a letter asserting he is infringing a patent. The patent-holder demands that Client cease infringement and pay compensation for past damages.

Client explains he doesn't make anything like the patented invention, and the only device he is using that could possibly infringe was purchased from his equipment supplier. Will the UCC warranty against patent infringement cover Client? If so, Client could tender defense of the claim to his supplier and relax.

Section 2-312(3) of the Uniform Commercial Code provides:

> Unless otherwise agreed a seller who is a merchant regularly dealing in goods of the kind warrants that the goods shall be delivered free of the rightful claim of any third person by way of infringement or the like but a buyer who furnishes specifications to the seller must hold the seller harmless against any such claim which arises out of compliance with the specifications.

Except in cases where the buyer has designed the product and provided the specification to the supplier, this provision allocates intellectual property risks to the seller. The theory underlying the provision is obvious: a seller who regularly deals in a product is likely to have superior knowledge of intellectual property issues – or lower per unit costs in acquiring that knowledge – than the occasional buyer of such a product.

Of course, Section 2-312(3) permits parties to contract around its allocation of risks, and many do: increasingly, contractual intellectual property warranty and indemnification provisions are heavily negotiated. But if Client's sales contract does not materially vary the UCC's approach to IP risk allocation, it would seem that Client should be protected against infringement claims.

However, several authorities suggest that the question is more complicated than one might suspect.

Delivery

Commentators and courts have noted that the UCC addresses only *delivery* of goods free of a claim of infringement. If a patent-holder alleges a violation of its exclusive right to *use* the patented invention, it could be argued that the language of 2-312 does not protect the buyer. White & Summers, 1 *Uniform Commercial Code* ¶ 9-12, at 490 (1988) (emphasis added).

Indeed, that is what the court held in *Motorola, Inc. v. Varo, Inc.*, 656 F. Supp. 716 (N.D. Tex. 1986). Varo sought to hold its photoresist supplier liable under the UCC for having induced it to use the product in a way that allegedly infringed Motorola's patent. "This sort of allegation," said the court,

> that the buyer was induced by the seller to purchase the good and then use it to infringe a process patent is wholly outside the language of ¶ 2.312. The delivery of a good is warranted to be free of all claims of infringement. There is no warranty that a buyer's use of the good will be free of all infringement. *Id.* at 718.

Knowledge

A UCC comment indicates that the seller must see that no claim of infringement "*will* mar the buyer's title." Pre-UCC caselaw, however, "indicates that no such warranty arises in the absence of specific knowledge on the part of the seller" of an intellectual property claim "at the time of sale." Duesenberg & King, *Sales & Bulk Transfers Under the Uniform Commercial Code* ¶ 5.04[4], at 5-27 (1993). Does it matter whether client's seller knew of the infringement claim prior to delivery of the devices in question?

The court in *Chemtron, Inc. v. Aqua Products, Inc.*, 830 F. Supp. 314 (E.D. Va. 1993) said it does. The decision concerns components – detergent dispensers and plastic caps – that were installed in a way that allegedly infringed a patent covering a dishwashing detergent dispenser. The defendant sued the component supplier for indemnification under the UCC. Granting the supplier's motion to dismiss, the court said the UCC warranty only covers the goods at the time of sale, and at the time the goods were delivered, they were "free from any third party complaints against infringement." *Id.* at 316.


Michael A. Jacobs

As *Chemtron* itself forecast, a narrower basis for the ruling was available, focusing on whether the components were infringing:

> [A] buyer, such as Aqua, should not be entitled to purchase goods for a seller, such as Viking, which are not subject to any infringement action, use the non-infringing component goods in an infringing device and incur liability to a third party patentee, Chemtron, and then turn around and attempt to impose liability on the original seller of the component parts.

Id. at 315.

The *Chemtron* court went on to state that reading the UCC the way Aqua wished would likely be unconstitutional "as an infringement upon Congress's monopoly of legislation as to patents." The court did not explain why this was so, and the implications of this conclusion are striking. What if parties contract to broader indemnification provisions than those the *Chemtron* court read from the UCC? Contracts, like the UCC, are creatures of state law. Would enforcing them run afoul of federal preemption in the patent field?

There is thus some uncertainty about the applicability of the UCC non-infringement warranty. Some solace may be had in good business practices: what supplier wants to leave its customers on the hook for patent infringement? And a few 2-312 cases are more straightforward: *see, e.g., Golden Trade v. Jordache*, 143 F.R.D. 504 (S.D.N.Y. 1992); *Dolori Fabrics, Inc. v. Limited, Inc.*, 662 F. Supp. 1347 (S.D.N.Y. 1987). Still, as one commentator noted, "the courts...have hardly been inundated with 2-312(3) cases." White & Summers, *Uniform Commercial Code* at 490. Caveat emptor!

Mr. Jacobs is a partner in the firm of Morrison & Foerster.

Continued from Page 6

VeriFone *Clarifies Securities Litigation*

be as bright as past performance." *Id.* at 869. Following prior decisions in *Lyondell*, 984 F.2d at 1053, and *Convergent Technologies*, 948 F.2d at 516, the Ninth Circuit held that a corporation has no duty to predict the future or to disclose its internal projections. *VeriFone*, 11 F.3d at 869-70. The allegedly withheld projections did not, by definition, consist of "existing" or "material, actual facts," and thus, as a matter of law, could not and "did not render other statements that were made misleading." *Id.* at 869.

Projections in Analyst Reports

The Ninth Circuit also addressed whether projections contained in analyst reports could support a claim against VeriFone and the underwriters. The court reiterated the well-established principle that "[t]he fact that the prediction proves to be wrong in hindsight does not render the statement untrue when made." *Id.* at 871. Instead, plaintiffs must show that defendants were aware of undisclosed facts that would tend to seriously undermine the prediction. Using the same analysis that it employed in reviewing whether any of VeriFone's public statements were actionable, the Ninth Circuit concluded that the allegedly undisclosed "facts" consisted of the same type of information the court had already concluded did not constitute "actual facts" because such information amounted to internal forecasts that VeriFone had no legal duty to disclose. *Id.* at 871. In other words, *VeriFone* establishes that plaintiffs cannot state a claim by alleging that a forecast disclosed to the market turned out to be "wrong," while another less favorable and undisclosed forecast turned out to be "right."

SEC Regulations and Stock Exchange Rules

Many securities fraud lawsuits include an allegation that defendants violated disclosure provisions in SEC regulations or stock exchange rules, and allege that such violations support a Rule 10b-5 or other securities fraud claim. The *VeriFone* court, following *Lyondell* and *Convergent Technologies*, held that Item 303 of SEC Regulation S-K does not require corporations to issue predictions. The *VeriFone* court also held that alleged violations of stock exchange rules cannot support a Rule 10b-5 claim. "It is well established that violation of an exchange rule will not support a private claim...[Plaintiffs'] argument that a violation of those rules violates § 10(b) or Rule 10b-5 amounts to the same thing." *Id.* at 870 (citations omitted).

This reasoning of *VeriFone* applies with equal force to any alleged violation of an SEC regulation or other regulatory rule. If there is no private right of action for violation of a particular regulation, district courts should not permit a 10b-5 claim that "amounts to the same thing."

In affirming the district court's dismissal of the securities fraud suit in *VeriFone*, the Ninth Circuit reinforces the proper role of district courts in scrutinizing securities fraud complaints on motions to dismiss, and clarifies several significant and recurring issues in securities fraud litigation. In light of the Ninth Circuit's guidance, district courts likely will dismiss more securities fraud complaints at an early stage.

Mr. Friedman and Mr. Eth are partners in Morrison & Foerster's San Francisco office which served as counsel to VeriFone *in the case discussed in this article. Michael Dicke, an associate at the firm, assisted in developing and writing this article.*

It's Maui in October! Mark Your Calendar

THIS year's ABTL Annual Program is scheduled for October 21-24 at the Four Seasons Hotel in Maui. The Annual Program, a combined effort of the Northern and Southern California branches of the ABTL, attracts many judges and the best legal talent in the state.

This year's program will involve issues of lawyer misconduct and liability. A legal malpractice trial provides the setting for exploring the shifting standards governing the profession – as well as rapidly evolving changes in client expectations.

The hallmark of all ABTL programs is the combination of active judicial participation with live demonstrations by respected practitioners. Numerous prominent federal and state judges attend. This year will be no exception, with Justice Anthony Kennedy joining us at the Maui seminar.

The '94 program will take place at the beautiful Four Seasons Hotel in Maui. Golf, tennis, hiking (to the Maui volcano and waterfalls), swimming, and snorkling are just a few of the recreational activities that will be available. The ABTL has reserved a limited number of rooms at the resort. Based on attendance at the last two annual programs, it is likely that the program will be a sellout. We expect to begin taking reservations within the next several months, so mark your calendars.

Robert Fram is this year's Northern California Program Chair. He welcomes questions and suggestions at (415) 772-6160.

STEPHEN OROZA

On CREDITORS' RIGHTS

CREDITORS' attorneys are familiar with the difficulty of arguing cases involving the one-action rule of CCP §726 and the anti-deficiency protections of CCP §580d. These statutes, passed to protect mortgagors from abuse by creditors and limit their exposure to declines in real estate values, have a valid function in any humane body of secured lending law. Courts consistently point out that the statutes were passed as a result of "the Great Depression and the legislative abhorrence of the all too common foreclosures and forfeitures [which occurred] during that era for reasons beyond the control of the debtors." *Western Sec. Bank v. Sup. Ct.*, 21 Cal. App. 4th 156,168 (1993).

Against this background, avoiding application of the statutes is an uphill battle, even when the debtor's position is unsympathetic and application of the statutes to the facts is only weakly supported by their underlying policies. Accordingly, creditors often lose even apparently strong cases. While there are a number of sound legal and policy criticisms of the appellate decisions in these areas, these criticisms are of little practical assistance to the creditors' bar. Instead, creditors' counsel should fashion arguments addressed to the real problem – judicial and legislative concern for debtors.

The Background

CCP §726 provides that the only legal action available to enforce a debt secured by real property is an action for judicial foreclosure of the security. Section 580d bars the collection of any deficiency judgment if the creditor proceeds by the more expeditious and economical means of a nonjudicial foreclosure. The consequence of a violation of §726 can be the loss of the creditor's real property collateral or, in some circumstances, a possible discharge of the underlying debt.

The protections of the statutes cannot be waived when the loans are made. Until recently, it was generally thought that the protections of the statutes could be waived post-default. A recent case, however, suggests in dictum that *any* waiver of §726 rights might be unenforceable as a matter of public policy. *O'Neil v. Gen. Sec. Corp.*, 4 Cal. App. 4th 587, 598-99 n. 6 (1992).

If the Court of Appeal decisions concerning the statutes were clear and consistent, creditors might have little complaint. Unfortunately, appellate decisions concerning these statutes are uncommonly arbitrary, harsh and counter-intuitive, a fact the courts have themselves noted. The California Supreme Court described the result reached by the Court of Appeal in one such case as a "gross injustice to the bank," violative of "simple morality" and "so harsh as to be punitive." *Sec. Pac. Nat'l Bank v. Wozab*, 51 Cal. 3d 991, 1005-06 (1990).

Against this background, creditors' lawyers should assume that neither the soundest technical argument nor arguments concerning the practical effect of such decisions on creditors will likely have much impact on most judges. They should also acknowledge that the most influential commentators in this area advocate seemingly endless expansion of the coverage of these statutes. How, then, does the creditor's attorney argue these cases?

A Modest Proposal

Try focusing on the current realities of the real estate market and the effect on *debtors* of overzealously applying these rules. Most judges see the debtor as a person who, through no fault of his own, must suffer the loss of his property and then, adding injury to insult, face personal liability. Courts are unlikely to respond to any argument which they think increases the likelihood of this result, especially when they are supported by the commentators.


Stephen Oroza

The reality today, however, is that debtors face almost no practical risk of personal liability for real estate loans. Contemporary debtors try to persuade creditors to enter into workout arrangements which defer or eliminate the tax consequences of foreclosure and promise some possibility of upside participation for the debtor if the property can be turned around. To convince creditors to work out these loans, debtors offer concessions in exchange for voluntary write-downs of the debt and restructuring of payment terms. The arrangements are by and large arms-length commercial transactions with real benefits for both the lender and the borrower.

The consideration which the debtor offers to the creditor, however, is of limited value if the creditor cannot be certain that the courts will enforce the workout agreement. Thus, a creditor who accepts a letter of credit in a loan workout is faced with the possibility that the debtor and the issuing bank will later claim, successfully, that drawing under the letter is prohibited by §580d. *Western Sec. Bank, supra*. Likewise, the creditor who works out a voluntary arrangement to allow collection and application of rents post-default must ask whether this conduct will be alleged to violate §726. Since a vio-lation of §726 risks both the collateral and the debt, few creditors will accept a workout which poses this risk.

If courts continue to expand the reach of §§726 and 580d based upon an emotional and intellectual paradigm which bears no relation to contemporary reality, the effect will be to limit the flexibility which lenders and borrowers need to achieve the most economically, legally *and* emotionally satisfying resolution of the latest epidemic of real estate loan defaults. While pointing this reality out to courts might not ultimately alter the scoreboard, creditors have little to lose by trying.

Mr. Oroza is a partner in the firm of Lillick & Charles.

Continued from Page 1

Letter from the President

commercial cases, so judicial participation in ABTL programs and events does not link judges to any particular point of view. As a result, ABTL dinner programs are a comfortable place for judges and lawyers to meet and mingle.

Anyone who comes at 7:00 p.m., just in time for dinner and the program, is missing a chance for a good bit of fun of the kind that our hectic professional lives offer too rarely.

Speaking of our hectic professional lives, a frequent topic of conversation when trial lawyers or judges gather is that litigation is getting to be an unnecessarily rough business. Sanctions, "rambo litigators," disruptive behavior during depositions, noticing major proceedings during the adversary's vacation, accusations and counter-accusations – we've all experienced it, and most of us don't like the slow decline into the world of Gratuitous Hardball. To be sure, the Bay Area is still a relatively pleasant place to practice law, and the worst horror stories I've heard come from other legal communities (no names mentioned here). But if there is a trend – and I think there is – it's not a positive one.

One response has been for the judiciary to become more involved in regulating the conduct of, and relations between, lawyers. The increasing imposition of sanctions are a manifestation of that. A number of courts have issued codes or guidelines intended to regulate the conduct of lawyers and, presumably, to be enforced by sanctions or even discipline.

I don't blame the judiciary for attempting to deal with the problem of unprofessional or uncivil behavior, but if there is another way to deal with the problem that does not involve more sanction motions, surely most of us would embrace it gladly. Moreover, if it means anything for the Bar to be a self-regulated profession, as we often proclaim it to be, then we ought to take this problem in hand ourselves rather than wait until a judge is so exasperated that sanctions are imposed. Finally, sanctions are rarely imposed for anything but the most extreme bad behavior. Can't we as a profession set standards of professional behavior that are a good deal higher than the way-below-the-line level that draws sanctions?

Prodded by such thoughts, I began with a modest experiment in my own firm, which adopted an internal code of ethical and professional conduct. The discussion in the preparation of that internal code was a fascinating and lively one, because there is at the outer margins a tension between the laudable goals of zealous advocacy and professional behavior. To pick just one example: should one postpone a key deposition because of an adversary's competing family obligation or force a less well-prepared and capable junior attorney to cover it? My firm debated these and other fascinating questions, had what diplomats call a "frank exchange of views," compromised with one another a bit, and ultimately agreed upon a set of principles.

I believe that something along these lines – not necessarily the precise code that my own firm adopted – would be embraced after thoughtful analysis and reflection by virtually all Bay Area law firms. It would also be embraced with enthusiasm by knowledgeable clients, who presently pay the fees that are generated by unnecessary lawyer squabbling.

And so I presented to the ABTL Board the question of whether our organization might craft a code of professionalism that ABTL would commend to its member lawyers and law firms. A Board committee, chaired by Steve Brick, studied extensive materials collected for a recent Ninth Circuit Judicial Conference discussion of the issue. At our February meeting, the committee recommended that the ABTL proceed with this project, and the Board agreed. The committee is now engaged in preparing a draft of that code of professionalism for consideration by the Board in the very near future.

The goal here, I want to stress, is for something that is voluntary in all respects. It is, moreover, entirely separate from the whole business of sanctions that some view as a plague and some as a necessary evil but that none of us much likes. Rather, the purpose is to agree upon a set of professional standards that will allow us to continue zealously representing our clients while maintaining correct and even friendly relations with our lawyer adversaries. I also hope that we will be able to develop an informal process by which a law firm embroiled in needlessly unpleasant conflict with another law firm that also subscribes to these ABTL standards will be able to approach a responsible person in the other firm and begin a constructive dialog rather than fire off yet another sanction motion.

Stay tuned.

Mr. Falk is a member in the firm of Howard, Rice, Nemerouski, Canady, Robertson, Falk & Rabkin.

ASSOCIATION OF BUSINESS TRIAL LAWYERS
abtl
NORTHERN CALIFORNIA

Three Embarcadero Center, 7th Floor
San Francisco, California 94111
(415) 434-1600