

## Q&A with the Hon. Douglas F. McCormick By Sabyl Landrum



*[Editorial Note: Before joining the United States District Court for the Central District of California as a Magistrate Judge on August 23, 2014, Judge McCormick served as an Assistant U.S. Attorney in the United States Attorney's Office in Santa Ana since 2001, and as a Deputy Chief of that office since 2007. In 2008, Judge McCormick received an Attorney General's Award for Distinguished Service. Before joining the U.S. Attorney's*

*Office, he worked at Latham & Watkins in Orange County. He received his B.A. in 1991 from the University of California, Irvine, graduating magna cum laude and Phi Beta Kappa, and his J.D. in 1995 from the UCLA School of Law, where he was a member of the Order of the Coif.]*

**Q:** For young attorneys starting out who might have judicial ambitions, do you have any advice for them?

**A:** I don't know if it's advice for just people having judicial ambitions, but I think it's good advice for any younger lawyers in general. There are two things. First, when I was at Latham one of my clients who is also a good friend wrote a personal branding book called "The

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## A Seat at the Table: The Proper Parties in the Hypothetical Negotiation for Reasonable Royalty Patent Damages By Samuel T. Lam

In recent years, a growing concern over abuses of the patent system has intensified into calls for patent reform. The primary target for this concern is the so-called "patent troll," which falls into a general class of patent owners called non-practicing entities (NPEs). NPEs are individuals or corporations who attempt to enforce their rights under their patents, but who do not themselves manufacture products, perform services, or develop products or services based on those patents.

(PricewaterhouseCoopers, 2009 *Patent Litigation Study—A Closer Look: Patent Litigation Trends and the Increasing Impact of Nonpracticing Entities*, at 2 (Aug. 2009).)



In 2009, PricewaterhouseCoopers began reporting that patent infringement awards for NPEs far outpace those for practicing entities, with awards for NPEs being more than double those for practicing entities and the median damages award for NPEs being more than triple that for practicing entities. (PwC Study (2009), at 6-7.) This discrepancy has continued to the present; as PwC reported last year, damages awards for NPEs continue to average "more than double those for practicing entities over the last decade."

(PricewaterhouseCoopers, 2013 *Patent Litigation Study—Big Cases Make Headlines, While Patent Cases Proliferate*, at 5 (June 2013).) And although median damages awards have declined in recent years, the median damage award for NPEs continues to be more than double that for practicing entities. (*Id.* at 7)

There are multiple reasons suggested for this discrepancy. For one, patentees tend to win in jury trials, and NPEs tend to make more use of jury trials than do practicing entities. (*Id.* at 9-10.) Although the margin between the number of jury trials versus bench trials and the margin in NPEs' use of juries have both shrunk over the years, it is clear from the above numbers that NPEs still have the upper hand in patent litigation—often at astronomical cost to defendants. (See, e.g., AIPLA, 2013

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## The President's Message

By Jeffrey H. Reeves



Before I tell you about our upcoming programs, I want to bring to your attention a critical initiative that the ABTL and other bar-related organizations throughout the state have been banding together to promote -- the National Association of Women Judges Informed Voters Project. The IVP is directed at the troubling but indisputable reality that voters are asked to

make crucially important decisions when voting in judicial elections, but they usually are armed with little or no real information about the candidates when they walk into the voting booth. This leads either to abstinence from judicial voting altogether, or even worse, to votes being cast for the wrong reasons or for no reason. This is an entirely non-partisan effort that will have no hand in actually endorsing any specific candidates. I would urge you to visit the NAWJ IVP website at <http://ivp.nawj.org>, and take a look at the public service announcement that can be found at <http://www.youtube.com/watch?v=aTeFLkueTkQ>.

Next, as you all know, the OC Chapter is honored to be hosting this year's Annual Seminar at the JW Marriott Ihilani Hotel on Oahu, October 15 – 19. We are honored to have **Admiral Harry B. Harris, Jr.**, Commander of the U.S. Pacific Fleet, as our keynote speaker. Our theme is "The Science of Decision Making". We have some fascinating topics to address, and some extremely talented speakers lined up to help us address them. Panelists include **Dr. Craig Stark**, Director for the Neurobiology of Learning and Memory, UC Irvine, **Frank Partnoy**, University of San Diego School of Law, Author of "Wait: The Art and Science of Delay", and **Eva Paterson**, President of the Equal Justice Society. And, we have organized a special private evening aboard the U.S.S. Missouri. If you haven't registered already, I'd urge you to sign up right away. The event will be sold out.

Before we head to the islands, we wanted to tell you how delighted we were to have **District Court Judge Andy Guilford** and **Superior Court Judge Peter Wilson** discuss the September 10th evening's topic: "What I Know Now That I Wish I Knew Then." Jones Day partner and ABTL board member **Mark Finkelstein** moderated the program and, by all accounts, it was a wonderful program with a fascinating discussion.

Aloha! Jeff.

♦ *Jeffrey H. Reeves is managing partner at Gibson, Dunn & Crutcher LLP*

ASSOCIATION OF BUSINESS TRIAL LAWYERS

**abtl**

ORANGE COUNTY

8502 E. Chapman Avenue, #443

Orange, CA 92869

Phone: 714.516.8106 E-mail: [abtloc@abtl.org](mailto:abtloc@abtl.org)

[www.abtl.org](http://www.abtl.org)

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## The Ninth Circuit's Post-Concepcion Views on Arbitration Agreements

By Nancy Olson



In 2011, pointing to the Federal Arbitration Act (FAA) and its underlying “liberal federal policy favoring arbitration,” the Supreme Court reminded lower courts that they “must place arbitration agreements on an equal footing with other contracts, and enforce them according to their terms.” (*AT&T Mobility LLC v. Concepcion*, 131 S. Ct. 1740, 1745 (2011) [internal citations and quotations omitted].)

In *Concepcion*, the Supreme Court held that the FAA preempted California’s judicially-created rule that class arbitration waivers in consumer contracts were unconscionable because this rule applied only to and disfavored arbitration agreements. Three years later, this article surveys the impact of *Concepcion* on the Ninth Circuit’s recent interpretations of and willingness to uphold arbitration agreements.

In *Davis v. Nordstrom, Inc.*, the Ninth Circuit held valid an arbitration agreement after Nordstrom added post-*Concepcion* amendments into its employee handbook to prevent employees from filing most class action lawsuits. (*Davis v. Nordstrom, Inc.*, No. 12-17403, -- F.3d --, 2014 WL 2808139 (9th Cir. June 23, 2014).) Instead, the employees would be required to submit to individual arbitration. The court held that, under California law, employers may unilaterally change the terms of employment—including the terms of arbitration agreements contained in an employee handbook—so long as reasonable notice is provided. The court concluded that continued employment after receiving such notice constituted acceptance of the new terms. Although the *Davis* court found that the notice provided was not “the model of clarity,” it concluded that a letter sent to employees followed by a 30-day period of non-enforcement was nonetheless reasonable.

Notwithstanding its willingness to enforce post-*Concepcion* arbitration agreements that waive the right to class action litigation, the Ninth Circuit has cautioned that arbitration agreements may not contain waivers of statutorily-mandated grounds for challenging arbitration awards. Specifically, in *In re Wal-Mart*, the court held unenforceable a non-appealability clause in an arbitration agreement that “eliminates all federal court review of arbitration awards,” including review of an award on the statutory grounds enumerated in § 10 of the FAA. (*In re Wal-Mart*

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## Why Businesses Need to Care About the Future of Data Breach Laws and How Businesses Can Protect Themselves

By Robert T. Matsuishi and Jared De Jong

In 2003, California became the first state to pass a law (A.B. 700) mandating data breach notification to residents. Since then, the majority of states have enacted their own legislation requiring notification of security breaches. Generally, consumers are informed of the security breach when their data is lost or compromised, putting consumers on alert for potential identity theft. Some state laws also include a credit freeze provision that allows a consumer to stop the disclosure of a credit report by a credit bureau. This article addresses recent pending legislation that will require businesses to go even further in the event of a data breach, and discusses some things businesses can do to mitigate their risk, including pursuing insurance coverage for costs associated with data breaches.



### I. The Future of Data Breach Notification Laws

Earlier this year, responding to the recent data breaches at Target, Neiman Marcus, and Michaels stores that compromised the credit and debit card information of millions of customers, lawmakers in Sacramento introduced a bill (A.B. 1710) proposing to make businesses that maintained private consumer data responsible for customers’ financial losses as a result of a data breach. The bill was passed by the State Assembly in May 2014 and is now before the State Senate for consideration. As proposed, this bill, titled the Consumer Data Breach Protection Act, would create stricter time-frames and specific requirements for notification of affected consumers following a data breach incident.



In addition to notifying the owner or licensee of the data, A.B. 1710 would require businesses affected by a data breach to provide mail or e-mail notification to affected individuals, and, if mail or e-mail is unavailable, to post a general notice on their web page and notify a major statewide media outlet. A.B. 1710 would amend the California Civil Code to make businesses liable to the owner or licensee of the information for the reimbursement of expenses incurred in providing notices, as well as the re-

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## **ABTL-OC Partners With NAWJ On Its Informed Voters Project**

ABTL-OC recently decided to partner with the National Association of Women Judges (NAWJ) to promote the Informed Voters Project (IVP), which aims to increase public awareness about how the judicial system works and how to obtain nonpartisan information about judicial candidates. IVP's goal is to ensure that judges are elected based on their integrity, professional competence and experience.

An independent judiciary is critical to our democracy and to the administration of justice. Our system of checks and balances will fail if we allow special interests to gain influence over the selection and retention of judges. Voter education can ensure fair courts and equal justice. ABTL-SD and ABTL-OC is committed to helping NAWJ take this important message into our community.

The ABTL IVP Committee encourages ABTL members to learn more at <http://ivp.nawj.org/> (there is also a link on ABTL's website) and click on the "Get Involved" tab to download Fact Sheets that can be distributed to clients, friends and family. The centerpiece of this important civics education campaign is a public service announcement titled "Fair and Free" featuring former U.S. Supreme Court Justice Sandra Day O'Connor. ABTL-SD Board of Governors' member, Justice Joan Irion, and Presiding Justice Judith McConnell, serve as the NAWJ IVP Co-Chairs and have prepared a strategic outreach plan of action in collaboration with numerous organizations. If you would like to get involved in sharing IVP's key messages please contact ABTL IVP Editorial Board Outreach Chair M.C. Sungaila ([mcsungaila@swlaw.com](mailto:mcsungaila@swlaw.com)).

## ***-Q&A: Continued from page 1-***

Brand Called You." We sort of laughed about it at Latham - the idea of having a personal brand- but I actually think it's a powerful way to think of yourself as having a brand and what your brand is and how people are going to perceive you. It's certainly something that I was cognizant of, practicing here in this small courthouse, that I had an individual brand or reputation with not just the judges in the building but also my colleagues and the defense bar.

The second thing, which goes back to when I started at the US Attorney's Office, I had someone tell me to try to always say yes to projects and opportunities and trials and things that came along. I did try to do that, and I think that if you look at those kinds of things as opportunities rather than burdens, it's a good thing. Of course you don't want to overextend yourself and do a bad job, but opportunities are what are going to give you chance to grow and get better at what you do.

**Q:** Have you observed any changes in civil practice since you worked for Latham as a civil litigator?

**A:** There are two that come to mind, and I think they are related. In my time at Latham it was still the era when court filings were hand delivered to the filing window to be filed. And so you had to know what time the messenger had to leave the office to get there before the filing window closed. So your deadline to finish the document - and as we all know the documents often don't get done until the deadline - was something like 2:30 or 3:00 in the afternoon. Now e-filing enables people generally to file 11:59 p.m., which is a double-edged sword. From my perspective on the bench, it hasn't had any impact 99.9% of the time. But I'm aware of it as an aspect of how civil practice has changed.

The other thing I have mentioned publicly before is that when I was a law clerk, I don't think either of the two federal judges for whom I clerked had had a computer on his desk. Now pretty much every judge's chambers looks my mine, which is not only a computer on the desk, but two monitors and an iPad or some sort of tablet on the side.

**Q:** The district court has a number of consent programs for proceedings where people choose to have their cases heard in their entirety in front of a magistrate judge. What do you consider to be some of the advantages to consenting to a magistrate judge such as yourself?

**A:** The Court has two programs. The first is the direct assignment program through which I get cases directly assigned to me after they are filed and a party can elect whether to consent to me or go back on the wheel and get assigned to a district judge. The second is voluntary consent to a Magistrate Judge by telling the District Judge, "we would like to consent." There is actually a list on the

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Court's website of the magistrate judges who are available to take those cases.

There are many potential reasons to consent. I think the most obvious is that Magistrate Judges' duties and responsibilities tend to be less calendar-intensive in terms of our daily calendars than the District Judges' duties and responsibilities. To put it another way, if you looked at my calendar in the next several months, you would see lots of open days and weeks. If you looked at a District Judge's calendar for the next several months, you would see many trials scheduled almost every week and many other civil and criminal matters. That reduced calendar congestion might be something that some parties might find to be advantageous.

Q: You are the father of three young children and you have a wife who is a highly accomplished attorney and partner at a law firm herself. How do you balance the demands of having a family with your work commitments?

A: It is a day-by-day thing. Five years ago this month my wife and I had these two people come into our lives who changed everything so dramatically and wonderfully. And then a little less than eighteen months later we were joined by our third little guy. And so we went from being a family of two to a family of five in nearly record time. We have both worked full time throughout the last five years. We have both tried cases throughout those five years. My wife has tried cases in northern California and back on the east coast. I tried several cases in my last few years as a federal prosecutor. And during those busy phases we just made a battle plan and leaned on each other and powered through those more stressful times. I do think because we had our kids when we were a little bit older, we had more resources, both tangible and intangible. We had twelve years of marriage under our belt by the time we had kids. I think that helps. We are also a little bit older and maybe a little bit wiser.

*The ABTL thanks Judge McCormick for his time.*

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*Report of the Economic Survey* I-132 (2013) (indicating that in patent infringement cases with more than \$25 million at issue, the mean damages award in 2013 was \$5,911,000).)

Another reason suggested for this discrepancy derives from the posture of many NPE plaintiffs, namely that NPEs often come into litigation having been assigned the patents by predecessor entities. (See, e.g., Michael Risch, *Scratching my Head Over the SHIELD Act*, MADISONIAN.NET (Mar. 10, 2013) (“[M]any NPE patents are assigned to the NPE as the initial assignee. . . . Some of the most highly-litigated, most-litigated patents were originally assigned to the NPE enforcing them now.”).) This fact is highly relevant if and when the parties reach the damages stage of litigation. The vast majority of damages awarded in patent cases are reasonable royalties. (PwC Study (2013), at 11.) NPEs in particular are forced to seek reasonable royalties because, by definition, they do not sell products or services based on their patents and thus are ineligible for lost profits damages. And the established framework for determining a reasonable royalty damages award is the “hypothetical negotiation,” which considers the amount that the then-contemporaneous patentee (as a “willing licensor”) and the accused infringer (as a “willing licensee”) reasonably would have agreed upon had they negotiated a royalty prior to infringement. (*LaserDynamics, Inc. v. Quanta Computer, Inc.*, 694 F.3d 51, 76 (Fed. Cir. 2012) (“[T]he basic question posed in a hypothetical negotiation is: if, on the eve of infringement, a willing licensor and licensee had entered into an agreement instead of allowing infringement of the patent to take place, what would that agreement be?”).)

In the common situation where a plaintiff is a recent owner of the patents in suit, there can be a temptation to place the plaintiff in the position of the then-contemporaneous patentee for the purposes of reasonable royalty damages. This attempt at musical chairs is important because changing the licensor or licensee at the hypothetical negotiation table can dramatically alter the results of the reasonable royalty analysis. (See Katherine L. Parker & Anders T. Aannestad, *An Assignment's Effect On Hypothetical Negotiation*, Law360 (Feb. 7, 2008).) Indeed, a plaintiff may come into litigation with third-party settlement agreements that it has granted under the asserted patent on pain of litigation, as well as enhanced negotiating power due to aggregation with other patents.

This approach, however, conflicts with case law and contravenes the hypothetical negotiation framework. The hypothetical negotiation framework looks specifically to the state of mind of the *original patentee* and the *accused infringer*—not of any other parties. Accordingly, where the plaintiff was not the patentee at the time of the hypothetical

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## **-Royal Patent Damages: Continued from page 5-**

negotiation, it may not take a seat at the negotiation table for the purposes of calculating reasonable royalty damages.

### **The Relevant Patentee at the Hypothetical Negotiation Table**

As explained above, a reasonable royalty is calculated based on a hypothetical negotiation between the patentee and the accused infringer. A “patentee” is defined in the Patent Act as “includ[ing] not only the patentee to whom the patent was issued but also the successors in title to the patentee.” (35 U.S.C. § 100(d) (2012).) Therefore, the question arises: which patentee is the relevant patentee for the purposes of the hypothetical negotiation? Again, although there may be a tendency to seat a patent-infringement plaintiff at the hypothetical negotiation table, even if that plaintiff is not the then-contemporaneous patentee—*i.e.*, the patentee at the time of the hypothetical negotiation—this tendency conflicts with centuries of patent-damages jurisprudence.

It is well established that “the key element in setting a reasonable royalty . . . is the necessity for return to the date when infringement began.” (*Hanson v. Alpine Valley Ski Area Inc.*, 718 F.2d 1075, 1079 (Fed. Cir. 1983).) Based on this principle, the “patentee” for the purposes of calculating reasonable royalty damages is the then-contemporaneous patentee rather than the plaintiff (assuming the two entities are different).

This issue has come up in at least two cases, and the result has been the same in both. In *Nichols Institute Diagnostics v. Scantibodies Clinical Lab., Inc.*, the plaintiff Nichols had obtained rights to a patent from a licensing company Pharis Biotech GmbH. (2006 BL 129651 (S.D. Cal. May 01, 2006).) At trial, Nichols’s damages expert based his reasonable royalty calculation on a hypothetical negotiation that would have taken place between Nichols and the defendant Scantibodies. The court rejected that damages calculation, stating that “[a]s of th[e] date” of the hypothetical negotiation, “Pharis owned the patent. Thus, the parties to the ‘hypothetical’ royalty negotiations were Pharis – not Nichols – and Scantibodies.” (*Id.* at \*5.) The court also rejected Nichols’s contention that Pharis’s subsequent assignment of the patent rights to Nichols constituted a “re-negotiation,” with the court stating that “the Federal Circuit has repeatedly and expressly directed that the date of infringement controls the date of the ‘hypothetical’ license negotiations.” (*Id.* at \*5-6.)

More recently, in *Oracle America, Inc. v. Google Inc.*, the damages expert for the plaintiff Oracle calculated reasonable royalty damages based on a hypothetical negotiation between Oracle and the defendant Google, even though Sun Microsystems—whose patent rights were assigned to Oracle after Oracle’s acquisition of Sun—was the patentee at the time of the hypothetical negotiation. (798 F. Supp.

2d 1111 (N.D. Cal. 2011).) The court rejected the expert’s approach, stating that “[c]ertain assumptions built into this thought experiment [*i.e.*, the hypothetical negotiation] may not be discarded in favor of the parties’ subjective preferences and history.” (*Id.* at 1116-17.) The court emphasized that “the hypothetical negotiation takes place ‘between the patentee and infringer . . . at the time infringement began’” and that “[a]t the time the alleged infringement began, Sun was the patentee, not Oracle.” (*Id.* at 1117.) Accordingly, the expert “erred in hypothesizing a negotiation between Google and Oracle, instead of one between Google and Sun. . . . Injecting Oracle into the bargaining room was wrong.” (*Id.*)

As these cases demonstrate, reasonable royalty damages are to be calculated using a hypothetical negotiation at a time before the infringement began, and the negotiation is one that would have taken place between the patentee at the time of the negotiation and the accused infringer.

Of course, this rule does not mean that non-parties are always and absolutely irrelevant to the hypothetical negotiation construct. To the contrary, certain information of license agreements entered into with third parties after the date of the hypothetical negotiation may be considered in calculating a reasonable royalty, under a doctrine called the “book of wisdom.” (Hon. Martha K. Gooding, *Reasonable Royalty Patent Damages: A Proper Reading of The Book of Wisdom*, 87 Pat. Trademark & Copyright J. (BNA) No. 2159, at 1476 § I-C.) Under this doctrine, certain “ex post” evidence such as license agreements entered into, with, or between third parties after the date of the hypothetical negotiation can be admitted to determine a reasonable royalty. (*Id.*) These non-party agreements, however, are only admissible in a reasonable royalty calculation if they “can be said to be probative of how the parties to the hypothetical negotiation would have valued the patented technology at the time of the negotiation.” (*Id.*) Information known to the plaintiff, but that would not have been known to the patentee at the time of the hypothetical negotiation, including via the book of wisdom, should not be considered. Thus, where a plaintiff was not the then-contemporaneous patentee, but only a subsequent assignee, evidence of the plaintiff’s subsequent licensing or other activities should not inform the hypothetical negotiation.

### **Conclusion**

As always, the burden rests on the plaintiff to prove damages. In patent infringement suits, this includes the submission of evidence that sheds light on what the then-contemporaneous patentee would have considered in arriving at a reasonable royalty at a time before infringement. If the plaintiff is not the then-contemporaneous patentee, which is almost always true with NPEs, the plaintiff cannot take that patentee’s seat at the hypothetical negotiation. Application of this well-established rule is one way in which parties and courts may close the gap between NPE and prac-

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ting-entity damages awards, and thus produce more consistent judgments that are congruent with the Patent Act and case law.

♦ *Sam Lam is an associate in the Irvine office of Jones Day. The views set forth in this article are Mr. Lam's and do not necessarily reflect the views of his firm, his firm's clients, or anyone else.*

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### **ABTL YLD's Busy Year So Far By Shiry Tannenbaum, 2014 YLD Chair**

ABTL's Young Lawyers Division has been busy! Judge John Gastelum hosted a brown bag lunch where he reminded new attorneys to be prepared, be honest, and be courteous.

Our next event, titled the *Art of Cross-Examination*, showcased the skills of Mike Williams and Steve Katzman from Bienert, Miller & Katzman. ABTL YLD thanks Veritext for sponsoring this event.

Judge Nakamura also hosted a brown bag lunch where he touched on a wide range of topics, including his preferences for courtroom demeanor and how young attorneys can establish a positive reputation in his department.

The ABTL YLD's next member mixer will take place on November 20 at Andrei's. Please plan on attending!

*ABTL YLD thanks Jason Caruso for his contributions to this article.*

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### **-Arbitration Agreements: Continued from page 3-**

*Wage & Hour Employment Practices Litig.*, 737 F.3d 1262, 1264 (9th Cir. 2013).) The court noted that § 10 of the FAA grants federal courts the power to vacate arbitration awards where: (1) the award was procured by corruption or fraud; (2) the arbitrators were partial or corrupt; (3) the arbitrators committed misconduct; or (4) the arbitrators exceeded their power. "Although parties may tailor certain aspects of arbitration through private contract," citing mandatory language in the FAA, the court recognized limits on the "freedom to modify judicial review of arbitration awards." (*Id.* at p. 1267.) The *In re Wal-Mart* court further warned that allowing such waiver by contract would frustrate Congress's intention to "ensure a minimum level of due process for parties to an arbitration." (*Id.* at p. 1268.)

Meanwhile, as class action plaintiffs looked for ways around *Concepcion*, the Ninth Circuit showed its intention to remain true to the pro-arbitration principles reinforced by the Supreme Court in that decision. With respect to the enforceability of agreements to arbitrate, in *Ferguson v. Corinthian Colleges*, the Ninth Circuit heeded the Supreme Court's warning that, "[w]hen state law prohibits outright the arbitration of a particular type of claim, the analysis is straightforward: The conflicting rule is displaced by the FAA." (*Ferguson v. Corinthian Colleges, Inc.*, 733 F.3d 928, 934 (9th Cir. 2013).) The *Ferguson* court struck down California's so-called *Broughton-Cruz* rule, which had exempted from arbitration certain consumer actions seeking public injunctive relief under California law. (*Id.* at p. 938.) In doing so, the court acknowledged earlier Ninth Circuit precedent applying the *Broughton-Cruz* rule to prevent arbitration of such claims, but found this decision to be irreconcilable with and therefore overruled by intervening Supreme Court authority, i.e., *Concepcion*. Upholding the agreement to arbitrate, the court concluded that "even where a specific remedy has implications for the public at large, it must be arbitrated under the FAA if the parties have agreed to arbitrate it." (*Id.* at p. 935.)

On the same day, in *Chavarria v. Ralphs Grocery Store*, the Ninth Circuit struck down an arbitration agreement, cautioning that such agreements remain subject to the FAA's saving clause and may be invalidated based on grounds available for the revocation of any contract. (*Chavarria v. Ralphs Grocery Co.*, 733 F.3d 916 (9th Cir. 2013).) Applying this rule, the *Chavarria* court relied upon California state law to strike down an arbitration agreement on unconscionability grounds. Citing § 2 of the FAA, the court noted that "any contract to settle a dispute by arbitration shall be valid and enforceable, 'save upon such grounds as exist at law or in equity for the revocation of any contract.'" (*Id.* at p. 921.) As with other contracts, arbitration agreements may be invalidated based on a finding of fraud, duress, or unconscionability.

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**-Arbitration Agreements: Continued from page 7-**

Looking to California's general rules governing contract unconscionability, the *Chavarria* court first found the underlying agreement to be both procedurally and substantively unconscionable. (*Id.* at p. 922.) Acknowledging that certain generally applicable contract doctrines may still prove problematic under the FAA if such rules frustrate Congress's liberal policy favoring arbitration, the court next considered whether California's unconscionability doctrine could nonetheless be preempted here. First, the *Chavarria* court found that California's procedural unconscionability rules do not disproportionately affect arbitration agreements. (*Id.* at pp. 922-23.) Next, reiterating that "*Concepcion* outlaws discrimination in state policy" only where it "is unfavorable to arbitration," the court found that applying California's substantive unconscionability doctrine to invalidate a one-sided term dictating choice of arbitrators did not *disfavor* arbitration, but rather was used in a way that mandated the arbitration process be fair. (*Id.* at p. 927.) Accordingly, the court concluded that preemption did not apply and the agreement could be invalidated under state contract law.

Six weeks later, the Ninth Circuit used similar reasoning to conclude that the FAA did not preempt Washington state's unconscionability doctrine where the doctrine: (1) does not unduly burden arbitration; (2) is concerned with the contract formation process only (as opposed to how an arbitration should be conducted); and (3) applies to agreements as a whole, not specifically to arbitration clauses. (*Smith v. Jem Grp., Inc.*, 737 F.3d 636, 638 (9th Cir. 2013).) Accordingly, the court affirmed the district court's decision holding that an arbitration clause in an attorney retainer agreement was unenforceable.

Lastly, as a reminder to plaintiffs who commence litigation despite an agreement to arbitrate, the court recently cautioned that plaintiffs making a deliberate choice to litigate in an improper forum must be prepared to bear the costs of such litigation. (*Richards v. Ernst & Young, LLP*, 744 F.3d 1072 (9th Cir. 2013).)

As the foregoing post-*Concepcion* recap demonstrates, the Ninth Circuit has not been shy to rely upon and adhere to the Supreme Court's clear edict: the liberal federal policy favoring arbitration must be honored and state law to the contrary is preempted by the FAA. Notwithstanding, the Ninth Circuit has shown willingness to apply generally applicable defenses to contract formation in the context of arbitration agreements where those defenses do not disfavor or burden arbitration contrary to the purpose of the FAA.

♦ *Nancy M. Olson is an associate in the Orange County office of Gibson, Dunn & Crutcher LLP, where she practices in the firm's Litigation Department.*

**ABTL Volunteers: Habitat for Humanity**

Habitat for Humanity welcomed the ABTL again this year on a new home in Santa Ana. Coordinated by Maria Stearns of Rutan and Tucker, volunteers from seven ABTL member firms participated.

Readers who are curious about what the house looks like will enjoy special treats at the Habitat for Humanity OC website ([www.habitatoc.org](http://www.habitatoc.org)).

We thank the following firms for their time and financial contributions: *Rutan and Tucker; Haynes and Boone; Paul Hastings; Gibson Dunn; Latham & Watkins; Crowell and Moring; and Orrick.*



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placement cost for the credit or debit cards of the affected individuals. Additionally, if the business is the source of the data breach incident, A.B. 1710 would require that business to offer identity theft prevention and mitigation services at no cost to affected individuals for at least 24 months.

If A.B. 1710 is enacted into law, businesses that sell goods or services and accept payments by credit or debit cards would be prohibited from storing payment-related data unless the business stores and retains the data in accordance with a payment data retention and disposal policy that limits data retention to the amount of time required for business, legal, and regulatory purposes. A.B. 1710 would impose further restrictions on the retention and storage of payment authentication data, such as social security numbers, driver's license numbers, and personal identification numbers. The retention of account numbers would be prohibited unless the numbers are retained in a form that is unreadable and unusable by unauthorized persons. In addition, access to payment-related data would be limited to only those individuals requiring access, and the sending of payment-related data over public networks would be prohibited unless the data is encrypted or rendered indecipherable.

Following passage in the State Assembly, A.B. 1710 is now before the State Senate for a third reading. The bill has been amended repeatedly in the past four months, making the final language of the Consumer Data Breach Protection Act that Governor Jerry Brown signs into law far from certain. Whatever the future holds, California businesses will need to take proactive steps to ensure compliance with data breach laws and protect themselves from the inevitable uptick in litigation.

## **II. Why Businesses Need to Care About The Future of Data Breach Notification Laws**

While measures like A.B. 1710 have faced repeated hurdles in Sacramento in the past, every California business needs to be aware that the atmosphere has changed in the past few years. Privacy issues are a growing concern for Americans – especially as the internet has made personal information more accessible and easier to collect, store, and manipulate. High profile data breaches have also resulted in increased consumer awareness of the dangers posed by improperly secured personal information. In this environment, the public is increasingly willing to blame the businesses that maintain the personal information for any costs associated with unauthorized data breaches. In a recent Harris Poll of more than 2,000 online respondents to the “2014 Consumer Reaction to Financial Data Breaches Study,” consumers overwhelmingly agreed that businesses should be re-

sponsible for preventing future data breaches. The majority view (60% of respondents) was in stark contrast to the approximately 13% of consumers who felt that the responsibility for preventing future data breaches should fall on financial institutions.

California businesses should also understand that legislation similar to A.B. 1710 has the potential to gain traction in Washington. Other states are also following the progress of the bill to determine whether A.B. 1710 can set the precedent for similar legislation in other states. As of July 2014, at least 19 states have introduced or are considering forms of data breach legislation.

In response to the growing concern by California businesses, in February 2014, California Attorney General Kamala Harris – in collaboration with the California Chamber of Commerce – published a “Cybersecurity in the Golden State” report, which attempts to offer “specific and straightforward steps that all small businesses can and should take to reduce their risk, as well as effective measures business can take to respond to cyberincidents should they take place.” The Attorney General’s report urges businesses to take common-sense steps to cybersecurity such as encrypting sensitive data and developing an incident response plan to protect against intrusions. To an extent, the report accomplishes the goal of providing practical recommendations that are specifically directed at small to mid-sized businesses that lack the resources to hire full-time cybersecurity personnel.

With the uncertainty of future data breach laws and the increasing cost of claims and litigation, a growing number of businesses are turning to insurance to help absorb some of the costs associated with data breaches, including notification, public relations, legal and liability expenses.

## **III. Data Breach Coverage Under a CGL Policy**

The most common and successful method of transferring risk is through liability insurance. Although it will vary based on the allegations, policyholders will typically look to the following insurance when facing a data breach claim from a third party: (1) an occurrence-based commercial general liability policy (“CGL”); and (2) a claims-made liability policy. In addition, specialized data breach policies are now becoming available to consumers on the insurance market.

CGL policies typically protect against (1) bodily injury, (2) property damage, and (3) personal and advertising injury.

Most data breach claims do not involve allegations of “bodily injury.” And securing coverage as “property damage” can be challenging. CGL policies typically define

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“property damage” as a “physical injury to tangible property” or the “loss of use of tangible property that is not physically injured.” While no California authority squarely addresses whether an electronic data loss constitutes property damage, the cases that have come the closest suggest policyholders may face an uphill battle convincing carriers to acknowledge coverage.

In *Seagate Technology, Inc. v. St. Paul Fire & Marine Insurance Co.*, 11 F. Supp. 2d 1150 (N.D. Cal. 1998), a computer manufacturer was sued for faulty disk drives that caused a claimant to, among other things, lose their customers’ electronic information. (*Id.* at 1155.) In the ensuing coverage litigation, the district court found against the manufacturer. Without explaining why, the court ruled that the loss of this electronic information did not constitute “property damage.”

The *Seagate* decision was favorably cited by the California Court of Appeal when the court denied coverage for a data loss claim under a first-party property insurance policy. In *Ward General Insurance Services, Inc. v. Employers Fire Insurance Company*, 114 Cal. App. 4th 548, 556 (2003), a policyholder submitted a property claim after losing electronic data during a computer crash. (*Id.* at 550-51.) The carrier denied coverage and the policyholder sued. The central issue on appeal was whether the lost data amounted to a “direct physical loss” under the relevant policy language. In deciding that it did not, the Court of Appeal looked to *Seagate* for guidance. The court explained that *Seagate* contained an “unstated conclusion that loss of data, by itself, is not ‘physical damage to tangible property,’” and that there was “no reason to attribute different meanings to ‘direct physical loss,’ as used in first party coverage provisions, and ‘physical damage to tangible property,’ as used in third party coverage provisions.” (*Id.* at 557.) The court noted that “neither phrase describes lost information without a concomitant loss of a tangible storage medium.” (*Id.*)

Two points about the Court of Appeal’s decision in *Ward* are worth noting. First, the court’s discussion of CGL coverage is dicta, since the case concerned property insurance, not liability insurance. Perhaps a different appellate panel, if squarely presented with a third party data breach claim, would view these issues differently than *Ward*. Second, *Ward* does not address whether the loss or misuse of electronically stored data constitutes “property damage” under its alternate definition: “Loss of use of tangible property that is not physically injured.” CGL policies may or may not provide such coverage, but *Ward* does not speak to this issue.

CGL policies also provide coverage for “personal and advertising injury,” which is defined to include a number of specific offenses, including the “[o]ral or written publication, in any manner, of material that violates a person’s right of privacy.” This is where most data breach coverage disputes under CGL policies are focused. Yet the law in this area is unsettled. Courts continue to work out the circumstances under which a data breach claim is covered as an “invasion of the right of privacy.” Two recently-decided cases highlight the issues that policyholders may face when trying to persuade carriers to acknowledge coverage.

In *Zurich American Insurance Co. v. Sony Corp.*, N.Y. Supr. Ct. Feb. 21, 2014, Zurich sued Sony for declaratory relief after Sony was sued for a host of data breach claims brought by customers whose personal information had been hacked from Sony PlayStations. Zurich admitted there had been a “publication” of Sony’s customers’ personal information and that such publication “violates a person’s right of privacy.” However, Zurich maintained there was no coverage because Sony was not the entity that was alleged to have violated the privacy rights of its customers. A New York state trial court agreed with Zurich and ruled against Sony. The court determined that because third-party hackers, rather than Sony itself, had stolen and misused the customers’ information, Sony had not violated anyone’s privacy rights, and there was no potential for “personal and advertising injury” under Zurich’s CGL policy. This decision has been widely criticized, and Sony is currently appealing.

In *Hartford Casualty Insurance Co. v. Corcino & Associates*, 2013 WL 5687527 (C.D. Cal. Oct. 7, 2013), a medical provider sued its CGL carrier, Hartford, regarding coverage for data breach claims based on the medical provider posting the personal information of its patients on a public website. Hartford filed a motion to dismiss the medical provider’s lawsuit. Hartford argued there was no coverage for “personal and advertising injury” due to the following exclusion:

This insurance does not apply to . . . Personal and Advertising Injury . . . Arising out of the violation of a person’s right to privacy created by any state or federal act. However, this exclusion does not apply to liability for damages that the insured would have in absence of such state or federal act.

*Id.* at \*\*2-3.

The *Corcino* court rejected Hartford’s argument and determined that while the patients had sued under California’s Confidentiality of Medical Information Act and Lanterman Petris Short Act, medical records under California

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law “have been considered private and confidential for well over 100 years at common law.” *Id.* at \* 5. In other words, the exclusion did not apply because the statutes simply codified existing law and did not create any new rights. While this was a victory for the medical provider, the *Corcino* order does not address whether the data breach claims against the medical provider involve a publication that violates the patients’ privacy rights and, thus, constitutes “personal and advertising injury.”

While it is this author’s opinion that data breach claims should be covered as “personal and advertising injury” under a CGL policy, it is anyone’s guess how California courts will ultimately resolve these emerging issues. However, even policyholder-friendly rulings will help only policyholders defending claims under existing policies. They may not help policyholders worried about future claims. This is because the insurance industry recently promulgated new data breach specific endorsements designed to eliminate coverage under standard CGL policies. While these endorsements are new, policyholders facing significant data breach risks should closely review their prospective policy forms when purchasing and renewing CGL coverage, both primary and excess. Shopping around may be an option since some carriers may waive the data breach endorsements and others may not use these endorsements at all.

#### **IV. Data Breach Coverage Under a Claims-Made Policy**

Policyholders may also turn to a variety of claims-made policies for coverage. These include directors and officers liability policies (“D&O”), employment practices liability policies (“EPL”), and errors and omissions policies (“E&O”). The applicable policy will depend on the situation. For example, if a data breach claim is directed toward a company’s employees, officers, directors, or the corporate entity itself, D&O insurance is a likely candidate. If the data breach claim involves the mishandling of employee data, EPL insurance might apply. And if the policyholder is providing what might be characterized as a “professional service,” E&O insurance may be triggered. What is important is that policyholders not limit themselves: They should tender early and tender often, and let their insurers explain why a data breach claim may or may not be covered.

Policyholders should also consider several factors when thinking about tendering a data breach claim under a claims-made policy. First, these policies usually include broad grants of coverage. Coverage under a claims-made policy is typically triggered by a “wrongful act,” which is defined as the breach of a du-

ty. Thus, third-party claims based on the mishandling of or the failure to protect electronic data may often fall within these broad coverage grants, assuming no exclusion applies. Second, these policies often exclude coverage for claims that are covered by a CGL policy. These include claims alleging “property damage,” “bodily injury,” or “personal and advertising injury.” By tendering under its claims-made policies, policyholders hedge the risk that their CGL insurer will deny coverage by arguing that a data breach does not fall within the insuring agreement of a CGL policy. If a data breach claim does not allege “property damage,” “bodily injury,” or “personal and advertising injury,” that claim should in theory be covered under a claims-made policy. Third, future claims-made policies may, like CGL policies, contain specific exclusions meant to preclude data breach coverage. Finally, notice is critical. The easiest (and most avoidable) way to lose coverage under a claims-made policy is by not following notice provisions. While it is beyond the scope of this article to discuss proper notice under a claims-made policy, policyholders should immediately seek counsel from an experienced coverage attorney or their insurance broker if presented with information suggesting potential liability (now or in the future) for a data breach.

#### **V. New Insurance Policies Intended to Cover Data Breach**

Lastly, many insurers have developed and are now offering data breach-specific policies that cover a wide variety of third-party claims and first-party losses. From a liability perspective, these policies are intended to protect against risks most commonly associated with data breach claims, like the disclosure of confidential personal or corporate information, failure to guard against internet security threats, related regulatory proceedings, and certain intellectual property claims. Many policies also provide related services, such as crises and reputation management.

As these are new policies, courts have not had occasion to interpret their language or define the scope of coverage they afford. Furthermore, not all insurers currently offer data breach policies. However, for economic reasons, the insurers offering these policies will most likely be the same insurers endorsing their CGL policies with data breach exclusions.

While data breach laws and litigation threaten many California businesses, businesses can take tangible steps to mitigate against the risk of data breach claims and transfer that risk onto third parties.

♦ *Robert T. Matsuishi and Jared De Jong are associates in the Irvine office of Payne & Fears LLP.*

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