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The E-Usual Course of Business: ESI Application to Rule 34 Requirements

By Amanda E. Gordon

As the world has evolved, more and more of the legal industry has become automated. No longer is document collection accomplished by loading filing cabinets onto trucks but by forensically imaging hard drives and backup tapes. Gone are the days of staples or paper clips. These metal tools have been replaced with documents that reflect the parent-child relationships commonly used to logically differentiate electronic documents. In this "paperless" world, most documents are exclusively stored in electronic format rather than in printed form.

The electronic world has grown and with it the ever-present issue of legal discovery costs and how best to balance the burden and expense of producing electronically stored information (ESI). Currently, Rule 34 of the Federal Rules of Civil Procedure allows parties to produce documents in one of two ways: (1) by organizing and labeling them to correspond to the categories in the request or (2) by keeping them as they are in the usual course of business. Producing parties often prefer to provide documents as they are kept in the usual course of business because it is less burdensome and costly. Requesting parties may also want the documents as they are maintained on a day-to-day basis for strategic reasons. But what exactly does the "usual course of business" mean in today's electronic world?

The Evolution of "Kept in the Usual Course of Business"

Traditionally, a party can satisfy the requirements of Rule 34 by either allowing the requesting party to inspect the records where the documents are maintained or producing copies of the records that have been organized, indexed, and labeled in the same manner as the producing party maintains them. Unlike paper documents, however, ESI is not physically stored in file folders, boxes, or cabinets but placed on hard drives or in a storage device and organized and presented to users as needed for specific purposes by computer applications.

There is also a wide variety of ESI, ranging from familiar and easily accessed email and word processing files to less familiar or accessible cloud storage, backup media, or fragmented data on hard drives. Parties can also uniquely produce ESI in a number of forms—portable document format (PDF) or tagged image file format (TIFF) digital image, or in the form it was created and maintained electronically (typically referred to as "native"), to name a few. To further complicate matters, most ESI, unlike paper, is also associated with or contains "metadata" information about the document or file itself that is recorded by the computer to assist in storing or retrieving the document or file.

The Federal Rules

Federal Rule of Civil Procedure 34, added in 1980, was designed to address the concern that parties could deliberately mix critical documents with other documents to make review more

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difficult. For that reason, the rule forbids parties from burying or hiding an important file among several unimportant documents. A party choosing to produce documents as they are maintained in the usual course of business bears the burden of establishing that the documents were so kept.

Rule 34(b)(2)(E) specifies how documents and ESI may be produced:

> (E) *Producing the Documents or Electronically Stored Information.* Unless otherwise stipulated or ordered by the court, these procedures apply to producing documents or electronically stored information:
>
> > (i) A party must produce documents as they are kept in the usual course of business or must organize and label them to correspond to the categories in the request;
> > (ii) If a request does not specify a form for producing electronically stored information, a party must produce it in a form or forms in which it is ordinarily maintained or in a reasonably usable form or forms; and
> > (iii) A party need not produce the same electronically stored information in more than one form.

Some district courts have held that ESI is governed by (E)(ii) only and that (E)(i) does not apply to ESI, while other courts have applied both subsections to ESI. Practitioners are advised to carefully research their district for cases indicating their court's preference. *See*Amanda E. Gordon, "Tips for Organizing ESI per the Document Request," *Business Torts & Unfair Competition*, Winter 2016.

ESI Application to the "Usual Course of Business"
When producing electronic files, the manner of production determines whether the files are properly produced as they are kept in the usual course of business. Because businesses have an incentive to keep their documents to allow ready access, producing documents as kept in the ordinary course of business should permit a systemized retrieval of relevant documents. This requires a party to organize its ESI production in such a way as to enable the requesting party to substantially replicate the system that the producing party uses.

> **Computer forensics.** The most exact replica of ESI as it is maintained in the usual course of business, short of producing the actual devices on which the files are stored, uses computer forensics to produce a copy of the devices on which the files are stored. This, however, is not often required nor necessary in most civil litigation. Forensic collection, the most sophisticated method of ESI collection, involves the employment of experts, which is costly and implicates issues of relevance, burden, privacy, and privilege. There are, of course, instances in which forensic collection and examination may be warranted. For example, if it is important to show ESI usage activity and patterns, forensic collection may be useful. However, baring these special circumstances, the far more common option is for a party to simply produce electronic files.

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Electronic file production. If a party chooses to produce files but not the devices or forensic copies of the devices on which the files are stored, courts have found that the manner of production should preserve the functional utility of the electronic information produced. Courts have recognized that Rule 34 does not explain what it means to produce ESI as it is kept in the usual course of business, and very little case law guides this determination. An examination of the decisions that have addressed this issue, however, shows that Rule 34 is generally held to require (1) preserving the format of the ESI and (2) providing sufficient information about the context in which it is kept and used. *Teledyne Instruments, Inc. v. Cairns*, 2013 U.S. Dist. LEXIS 153497, at *31 (M.D. Fla. 2013).

ESI format. The format for disclosure of ESI as it is kept in the usual course of business depends on the type of electronic data. Production "as kept in the ordinary course of business" typically requires turning over electronic documents in the format in which they are kept on the user's hard drive or other storage device. Some courts interpret Rule 34 to mean that a party producing electronic documents as they are kept in the usual course of business must provide them in native format.

Metadata have been found to be relevant when producing in the usual course of business. A file converted to another format solely for production, or for which the metadata have been scrubbed or altered, has not generally been found to be produced as kept in the ordinary course of business. For example, in *Bray & Gillespie Management, LLC v. Lexington Insurance Co.*, 259 F.R.D. 568, 585 (M.D. Fla. 2009), *quashed in part on other grounds*, 2009 U.S. Dist. LEXIS 123236 (Nov. 16, 2009), the defendant requested that the plaintiff produce data in native format, and the plaintiff did not comply. While the plaintiff converted its native files to TIFF and stored the files' metadata separately, the plaintiff gave the defendant only the TIFFs and held back the metadata. In withholding the metadata, the court found that the plaintiff had not produced documents in the usual course of business as claimed, and the court imposed sanctions while still requiring the plaintiff to produce the metadata.

In requiring metadata, courts have specifically voiced concern that conversion from native format may eliminate or degrade searching and other information processing features. These features, such as copy, paste, search, or sort, may allow a receiving party to identify relevant information in a document much more quickly, greatly enhancing the value of a document. Allowing a party to defeat information processing features undermines the purpose of producing information as it is kept in the usual course of business. For example, stripping embedded formulas or data from files such as Excel spreadsheets can substantially impair the

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functionality of the file and the accuracy of the production as a fair representation of the file as kept and used in the ordinary course of business.

When producing under Rule 34, it is important that all parties have a clear understanding of applicable terms. "Native format," for instance, is often used without a common understanding of what it means in the context of the particular case. Not all ESI may be conducive to production in native format, and some other form of production may be necessary. In the same way, metadata often have no material evidentiary value—frequently, it does not matter what edits were made before the document was finalized or when it was printed. At least one court has found that electronic records were produced in the usual course of business where the records lacked metadata, but the requesting party did not specifically request metadata.*Autotech Techs. Ltd. P'ship v. Automationdirect.com, Inc.*, 248 F.R.D. 556, 559 (N.D. Ill. 2008). Parties are encouraged to use the Rule 26(f) conference to resolve what documents need to be produced and in what format, even in defining "the usual course of business." Because discovery, especially in federal courts, is often a self-managed process, cooperation is necessary for meaningful and efficient discovery.

ESI organization. In addition to producing in a specified format, the producing party must also provide information about where the documents are kept and how they are organized. Generally, courts have found that this means that ESI should be produced, organized, and labeled, and, if appropriate, indexed, just as the ESI is maintained by the producing party. For documents stored on a computer or external storage device, this means providing system metadata indicating at least the file name and path for produced files. The files and system metadata must also be organized in a manner that permits systemized retrieval of files. In other words, the requesting party must be able to search for and readily access files with particular characteristics. For example, a party must be able to search for all PowerPoint files in a particular folder.

The case of *Valeo Electrical Systems v. Cleveland Die & Manufacturing Co.*, 2009 U.S. Dist. LEXIS 51421, at *6–8 (E.D. Mich. 2009), illustrates this point well. The plaintiffs produced over 270,000 pages of documents in PDF files, per party agreement, with two searchable indices describing the origin of all produced ESI. The defendant, expressing concern that metadata were omitted, moved to compel the plaintiff to organize and label the documents according to the production request. The court, although likening the indices to a "magic decoder ring" that would provide no more help than the Rosetta Stone, held that the plaintiff had demonstrated that the documents were kept in the usual course of business and was under no obligation to otherwise organize and label the documents. In so holding, the court noted that there was no indication that any

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document or file names had been modified and all ESI documents were searchable in Adobe or other commercial available litigation search programs.

For emails, the relevant context is somewhat different. A user typically does not view emails in a file browser but in an email client. While the relevant organizational information for files viewed in a file browser is the file name and path, the relevant information in an email client is the date the email is transmitted, the sender and recipients, and the subject line. As a rule, emails are produced in the usual course of business when arranged by custodian, in chronological order, and with any attachments, or when arranged in the same order as found on the hard drive of each document's custodian, with attachments directly following the corresponding email.

For email collection, practitioners should work with the client immediately to identify and preserve any ESI and keep careful records showing where and from whom ESI has been obtained. Practitioners too often allow clients to address these concerns without proper direction. The better course is to take an active role in ESI collection.

Conclusion

The "usual course of business" requirement, once relevant to file cabinets and paper clips, is now infused with concepts that range from forensics and metadata to applications and databases. Discovery requests have become voluminous and the costs of compliance enormous. Although rules regarding electronic discovery are still in their relative infancy, courts have generally turned to the historical reasons underlying Rule 34 to prevent discovery abuses stemming from document production in volume or disarray. Careful planning and cooperation are the best tools to meet your burden when producing ESI in the usual course of business.

Keywords: litigation, business torts, ESI, electronically stored information, e-discovery, usual course of business

Amanda E. Gordon is an associate in the Hartford, Connecticut, office of Robinson + Cole LLP.

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Bank Litigation Arising from Check Fraud Schemes and Client Trust Accounts

By Melissa M. Grand

Check fraud schemes are alive and well. With the explosion of new and advancing technologies, fraudsters have refined their scams with dizzying speed, making them more sophisticated and often believable. Although onlookers may cast the victims of these scams as "desperate, greedy, naïve, gullible, and even dumb," in reality, a wide range of individuals can become prey to check fraud, including attorneys.

The Anatomy of a Check Fraud Scheme

Although there are variations, a typical check scam involves the fraudster soliciting an unsuspecting individual with an offer that is "too good to be true": If the individual deposits a check from the fraudster into the individual's bank account, then transfers a portion of the funds to the fraudster's bank account, the victim can keep some of the proceeds. In other words, the victim gets money for doing virtually nothing. Of course, the check from the scammer turns out to be counterfeit. By the time the fraud is discovered, the scammer has absconded, and the victim is left suffering an often substantial financial loss.

Many check fraud schemes involve fraudulent cashier's checks, which are sometimes (incorrectly) viewed as relatively risk-free instruments. However, cashier's checks are not cash. Cashier's checks have become an attractive means for perpetuating fraud schemes in part because of the misconception that cashier's checks are just as safe as cash. Although the amount of a cashier's check may become "available" quickly upon deposit, the availability is only provisional. It may take days or weeks for a cashier's check to be discovered to be fraudulent. By that time, the scammer has disappeared with funds received from the victim, and the customer is liable to the bank for the full amount of the check deposited.

Risk Allocation under the Uniform Commercial Code

Articles 3 and 4 of the Uniform Commercial Code (UCC) govern a bank's duties with regard to deposit and payment (or nonpayment) of negotiable instruments like checks. The UCC provides that the physical act of presenting a check for deposit to a bank is "presentment." The bank where "presentment" takes place is a "collecting bank." Once a check is presented to it, the collecting bank becomes the agent for its customer (to whom the check is payable).

After presentment, the collecting bank submits the check to the bank housing the account on which the check is drawn, known as the "payor bank." The payor bank then either forwards the funds represented by the check or, upon inspection of the check or the account on which it is drawn (or both), determines the check will not be paid and communicates that decision to the collecting bank. The action of a payor bank deciding and communicating that it will not pay a check is referred to as "dishonoring" that check. Alternatively, the act of a payor bank forwarding the amount of the check is a "final settlement" of the check.

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A collecting bank may also be called on to deposit the funds represented by a check drawn on one of its customer's accounts. A bank that both collects and deposits funds is a "depositary bank." The UCC provides that, pending the act of collection, a depositary bank may provide a temporary credit to its customer's account. The temporary credit is termed a "provisional settlement" of the check. UCC section 4-214 is clear that a depositary bank may revoke a provisional settlement if, at a later date, the payor bank dishonors the instrument (i.e., if "final settlement" never occurs).

Under section 4-202 of the UCC,

> a collecting bank must exercise ordinary care in: (1) presenting an item or sending it for presentment; (2) sending notice of dishonor or nonpayment or returning an item other than a documentary draft to the bank's transferor after learning that the item has not been paid or accepted, as the case may be; (3) settling for an item when the bank receives final settlement; and (4) notifying its transferor of any loss or delay in transit within a reasonable time after discovery thereof. A collecting bank exercises ordinary care by taking proper action before its midnight deadline following receipt of an item, notice, or settlement. Taking proper action within a reasonably longer time may constitute the exercise of ordinary care, but the bank has the burden of establishing timeliness. A bank is not liable for the insolvency, neglect, misconduct, mistake, or default of another bank or person or for loss or destruction of an item in the possession of others or in transit.

Further, the UCC imposes an overriding obligation of good faith. Articles 3 and 4 of the UCC provides that "good faith" requires "honesty in fact and the observance of reasonable commercial standards and fair dealing."

Check Fraud Litigation: Suits Against the Depositary Bank
Not surprisingly, issues related to check fraud scams are highly litigated. Often, the victim of a check fraud scheme will file suit against his or her bank and a bank employee with whom the victim spoke.

In *Simmons, Morris & Carroll, LLC v. Capital One, N.A.*, 144 So. 3d 1207 (La. Ct. App. 2d Cir. June 27, 2014), the plaintiff, a law firm, became embroiled in a check fraud scheme that began with a spam email to the firm. All of the communications in this case between the scammer, "Okei," and the law firm were via email. The fraudster told the law firm that he wanted to retain the firm in a collections matter, and the law firm subsequently received what appeared to be a cashier's check in the amount of $350,000. The check was a foreign check from the Bank of Nova Scotia and was made payable to the law firm. The cover letter sent with the check contained typos and had no return address.

The law firm deposited the check in its client trust account. The bank, not recognizing that the check was a foreign check, processed the check as a domestic item and provisionally credited the

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firm's trust account in the amount of $350,000. When the law firm called the bank to verify that the funds were available, it was told that the check had "cleared." No one at the firm checked the account online to see whether the funds from the check were in the trust account. The law firm subsequently wired $349,175 to Japan Trading Company, as directed by the scammer. By the time the bank's proof department realized that the check was foreign and counterfeit, and reversed the provisional credit on the trust account, the funds had already been wired to Japan.

The law firm filed suit against the bank and the bank's employee for negligent misrepresentation. The Louisiana Second Circuit found in favor of the bank and held that the plaintiff law firm was in the best position to protect itself from the scam:

> [T]he bank had no duty to protect [the law firm] from the particular harm that it would be the victim of a check scam and that [the law firm] was not justified in relying on [the banker's] representations regarding the check when it could have easily accessed its account information and learned that the funds from the check were not in its trust account.

Id. at 1219.

The court found that the plaintiff was not justified in relying on the bank employee's representations and could have easily accessed the account information online and learned that the funds were not in the account. The court explained that that the ordinary relationship between a bank and its customer is that of debtor-creditor; there was no duty on the part of the bank to inform the customer as to whether a check had cleared, and the bank in this case did nothing to breach the ordinary duty of care in the way that it handled the check.

Similarly, in *Greenberg, Trager & Herbst v. HSBC*, 958 N.E.2d 77, 84–85 (N.Y. App. Div. 2011), the plaintiff law firm fell victim to a check fraud scam. The scam began when a partner at the firm received a spam email from a representative of Northlink Industrial Limited, a Hong Kong company, seeking legal representation to assist in debt collection. When the law firm demanded a retainer in the amount of $10,000, the scammer told the firm to take its retainer out of a $197,750 check it would be receiving in the mail. The firm received the check, which of course was counterfeit, and deposited the check into its trust account.

The law firm later called the depositary bank, asked if the check had cleared, and inquired if funds were available for disbursement. The firm was told that funds were "available" and thereafter wired the funds out of the account, in accordance with the scammer's instructions. Subsequently, the check was discovered to be fraudulent, and the amount of the fraudulent check was charged back to the firm's account. The firm then filed suit against the bank.

The trial court dismissed the suit on the grounds that the firm's "reliance on such a misrepresentation does not give rise to an action for negligent misrepresentation barring a fiduciary relationship, [which] did not exist between a bank and its customer" and that the firm

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"was in the best position to guard against the risk of a counterfeit check by knowing its client" and, thus, was estopped from filing suit. *Id.* at 81. Because no liability is attached to the bank on account of its employee having allegedly stated the check "cleared," the law firm had no viable claim against the bank:

> [The firm's] claim is based on the alleged oral statement by [the bank's] representative that the check had "cleared"—an ambiguous remark that may have been intended to mean only that the amount of the check was available (as indeed it was) in [the firm's] account. Reliance on this statement as assurance that final settlement had occurred was, under the circumstances here, unreasonable as a matter of law.

Id. at 84–85.

Numerous other courts have made similar rulings in virtually identical circumstances. *See also Fischer & Mandell, LLP v. Citibank, N.A.*, 632 F.3d 793, 799 (2d Cir. 2011) (statement that funds were "available" insufficient to shift risk from customer to bank); *Stockmen's Livestock Mkt., Inc. v. Norwest Bank of Sioux City*, 135 F.3d 1236, 1242–43 (8th Cir. 1998) (statements that "[w]e'll make [the check] good," "that there was no problem" with check, and that the bank employee "believed the check would be 'good'" did not shift risk of loss from customer to bank); *Moughrabie v. Citibank, N.A.*, 867 N.Y.S.2d 376 (N.Y. App. Div. 2008) (use of term "cleared" and indication that "funds were available" were insufficient to warrant shifting risk from customer to bank); *Keybank Nat'l Ass'n v. Woodham Asset Mgmt.*, 131 Wash. App. 1062, at *4 (Wash. Ct. App. 2006) ("A conversation with a bank employee" does not shift liability to the bank).

Bank One, NA v. Dunn, 927 So. 2d 645 (La. Ct. App. 2d Cir. Apr. 12, 2006), *writ denied*, 937 So. 2d 385 (La. Sept. 22, 2006), presents a particularly bizarre set of facts. In *Dunn*, an electrician met the son of the President of Zaire, Mobutu Sese Seko, while traveling to California in the 1980s. Dunn was invited to visit Zaire and met with President Mobutu. According to Dunn, he was hired as a lobbyist for Zaire in the United States and registered with the Justice Department as a foreign agent. Among Dunn's actions on behalf of Zaire was an attempt to establish a consulate office for Zaire in Shreveport, Louisiana.

According to Dunn, he lobbied for Zaire for about three years. To pay Dunn for his lobbying, Zaire agreed to trade computers to Dunn, who would then sell these computers to Nigeria for $32,100,000. Dunn claimed that he was later contacted by a "Senator Frank" from Nigeria, whom Dunn did not know. Senator Frank told Dunn that he owed back taxes to Nigeria, which had to be paid before Dunn would receive his $32,100,000. Senator Frank offered to send Dunn a check for $315,000 in order to pay these taxes. Dunn apparently provided Senator Frank with the number of his checking account. Senator Frank told Dunn that $315,000 would be deposited into the account.

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Unsurprisingly, the check deposited into Dunn's account was counterfeit. After the provisionally credited funds were debited from Dunn's account, the fraud was discovered, and the check was dishonored. The provisional credit of the funds was revoked, and Dunn's account was severely overdrawn. The bank filed suit against Dunn based on the overdrawn account; in turn, the customer filed a counterclaim alleging that the bank negligently failed to timely determine the check was fraudulent and thus should be liable for the amount of the wire.

The court placed all liability related to falling victim to the scam on the customer himself—not the bank. The court characterized Dunn's argument as suggesting the bank "should have protected him from himself" but that the bank "owed Dunn no such duty." *Id.* Dunn ignored a number of red flags that could have prevented his loss. The court found that Dunn "was simply naive for trusting someone he did not know with his bank account information" but that in any event, the bank "owed no duty to protect Dunn from his notably poor judgment."*Id.*

Complications When Attorneys Are "Duped"
Special considerations arise when attorneys fall victim to check fraud schemes, especially if fraudulent funds are deposited into a client trust account. Under ABA Model Rule of Professional Conduct 1.15,

> [a] lawyer shall hold property of clients or third persons that is in a lawyer's possession in connection with a representation separate from the lawyer's own property. Funds shall be kept in a separate account maintained in the state where the lawyer's office is situated, or elsewhere with the consent of the client or third person. Other property shall be identified as such and appropriately safeguarded.

If an attorney deposits a fraudulent check into a trust account and disburses funds, the fraudulent check being reversed would cause an overdraft on the account, potentially subjecting the attorney to disciplinary sanctions.

If it seems too good to be true, it probably is. Although scammers urge their victims to act quickly, individuals, and especially attorneys, would be well served to exercise extreme caution. Under the UCC's loss apportionment rules, the risk remains with the customer until final settlement of the check. Unless the customer can show that the bank acted in bad faith, the loss falls on the victim of the scam.

Keywords: litigation, business torts, check fraud, scheme, scam, UCC, attorney trust account

Melissa M. Grand is an associate in the Baton Rouge, Louisiana, office of McGlinchey Stafford PLLC.

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The Talk about Shell Companies

By Emily Lehmberg

Events in recent months have attracted attention to the use of corporate vehicles—among them, different forms of companies, trusts, and foundations—that are expressly organized to hold money, usually tremendous sums of money and often in foreign jurisdictions. Upon encountering such an entity, a business litigator can be either emboldened or discouraged, depending on his or her case and objectives. The prevailing perception is that the primary and intended purpose of these entity structures is to facilitate tax evasion or to serve as an instrument of money laundering.

The fact that this negative view is so generally held should be of concern to those who understand the practical applications of employing complex business structures, and foreign corporate entities, for facilitating international business transactions. The use of these structures, and the organization of foreign entities, is a mainstay of global business; entire banking and investment markets have developed in areas of lower regulation and lower taxes, to provide banking, investment, and legal services for these foreign capital holding companies. This isn't a dirty, little secret. Yet, since the media first published the story of the Panama Papers data leak, this has become quite a big deal.

The Panama Papers leak, which is believed to be the largest global information data leak in history—roughly 2.6 terabytes of encrypted internal data from Mossack Fonseca, a Panamanian law firm—was made to a German newspaper by an anonymous source. This information is said to have revealed the existence of at least 214,000 offshore shell companies, mostly tied to individuals—high-net-worth individuals, heads of state, foreign politicians, and corporate executives. Without any direct evidence or admission of impropriety, the media have written story after story implying wrongdoing.

The International Consortium of Investigative Journalists delayed public release of the papers until after it had completed its own granular analysis of the information, and on May 9, 2016, it made available to the public only a fraction of the data. However, even prior to the release of this information, simply being identified as having associations with foreign shell companies has resulted in public scrutiny and criticism so severe that several global leaders—including the prime minister of Iceland and the acting minister of industry, energy, and tourism of Spain—have already resigned from their positions, while many others have been forced to publicly disavow involvement and the law firm and lawyers responsible for facilitating these structures have come under attack. With this scandal has come renewed attention to the practice of American companies using such corporate vehicles to hold profits offshore, primarily in an effort to decrease taxes. This practice has attracted harsh criticism for some time, but it is now also being critiqued by presidential nominees, journalists, and the public.

The use of shell companies is commonly referred to as a "loophole," and the structuring of this entity form has been dubbed "quasi-legal manipulation." Corporations that use these entity forms

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are blamed for growing income disparities and are targeted for not paying their "fair share" of taxes. However, in all the frenzied discussion, there has been little consideration given to the potential merits of these entity structures. And while many recognize these structures are legal, there has been little intelligent discussion of existing laws or practical means of change. Instead, we have seen a leveraging of vocabulary. Perception has become more important than purpose.

Perception blurs the lines between what is legal and what is popular, and places officers and directors of corporations, and the lawyers who represent them, in a difficult position as they struggle to reconcile the fiduciary duties they owe with the potential backlash of popular opinion.

The Structure of Shell and Shelf Companies

A shell company is generally defined as a nonoperational company: a legal entity with no current operations, ongoing business activities, or appreciable assets. This definition makes no mention of impropriety or wrongdoing; however, the classification as a "shell" has created a negative connotation that a company is a "front" or lacks a proper purpose.

Shell companies are commonly used to serve legitimate business and economic functions. This entity structure is often used to facilitate corporate mergers, whereby two merging companies structure the transaction so that they are consolidated under a third, neutral shell company. Similarly, this entity structure is used in joint ventures, whereby a shell company is incorporated in a neutral jurisdiction to ensure neither party to the transaction receives favoritism. Shell companies are also used to organize partnership payments and profit-sharing agreements involving parties from different jurisdictions, potentially to allow for the pre-tax division of revenues and income between shareholders.

The primary mechanism of tax evasion that is orchestrated using shell companies relies on the use of a shell entity to obfuscate the identity of the real owner or owners of the underlying assets, substituting relatives, fictitious individuals, or strawmen in place as owners of record; the owners then fail to report their ownership of the shell entity and the underlying assets to the applicable tax jurisdictions where they have liabilities. They effectively evade their tax requirements by failing to report their ownership in the company that they effectively own and control.

A shelf company is a company that is organized using a standard memorandum or articles and left dormant for the purpose of enabling its sale to another party at a later date. This can provide a buyer an opportunity to avoid delays associated with registering and forming a new business, or allow the buyer to obtain an existing business history, tax history, and credit history for its new business. This is typically viewed as a shortcut, as well as a way to mislead the general public, creditors, and investors about the true history of the business. The primary concern of governments and tax jurisdictions in policing these companies and this structure is the potential for nefarious buyers to purchase shelf companies and never officially transfer ownership to their names. This leads to the conclusion, real or not, that shelf companies provide a direct mechanism for obtaining shell companies for the purpose of obfuscating the owners' identities.

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Ownership, Management, and Duties to Shareholders

In the United States, many jurisdictions permit companies to issue shares in certificate form, as a type of scrip; these shares are known as bearer shares and allow their holders to exercise rights of ownership in the underlying company—this includes applicable rights to payments or income distributions. The bearer share instrument form continues to attract negative attention related to the perception that it is a means of obfuscating business entity ownership, secreting assets, and laundering money. Much of this criticism relates to the ability of holders of bearer share to anonymously transfer ownership through physical delivery of the certificate, person to person, as this has been seen as an avenue for money laundering.

Most jurisdictions, including those in the United States, have implemented policies to require share registration, including immobilization and dematerialization. These measures are implemented to eliminate the bearer instrument quality of being "unregistered"; through immobilization, this is accomplished by requiring that a custodial agent maintain possession of the shares in order to prevent anonymous and unreported transfers of ownership; through dematerialization, this is accomplished by requiring registration of the shares on a company ledger.

These processes eliminate the means for shareholders to legally transfer shares anonymously, person to person, and to do so without recording the transactions; it also effectively passes responsibility for registering shares and maintaining ownership records to the issuing company. This might seem redundant, as most companies issuing shares in this form, or any other form, require the registration of shares by shareholders in order to basically comply with tax accounting and anti-money-laundering compliance requirements, and in order for shareholders to prove ownership as necessary for exercising ownership rights.

It would appear that a significant problem facing regulators is an entity structure that allows individuals or groups to have effective control of an entity and its interests while avoiding registering or reporting their ownership. For this reason, it might seem wise to target the structures that are most fraught with impropriety; however, to engage in this process is a fool's errand because it is not possible to make a determination of wrongdoing, or the intent to do wrong, through a top-down appraisal of an entity vehicle or organization structure. A system that does not embrace a case-by-case approach to examination will likely prove tantamount to a witch hunt.

State codes allow corporations to be formed for any lawful business purpose, and the corporate charters of many large publicly traded corporations describe company purpose in similarly general terms. Corporate case law instills officers and directors with fiduciary duties premised on acting in the "best interest of the company." These broadly worded mandates have encouraged ample debate on when acting in the corporation's best interest includes maximizing profits for shareholders.

It may be true that no fiduciary duty mandates corporate officers and directors to act to maximize

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profits. In fact, corporate boards generally do not have a fiduciary duty to do anything; rather, their duties are centered on protecting entity and shareholder interests. In*Burwell v. Hobby Lobby*, 134 S. Ct. 2751, 2771 (2014), the U.S. Supreme Court that "[m]odern corporate law does not require for-profit corporations to pursue profit at the expense of everything else, and many do not do so." This statement has encouraged advocates of corporate social responsibility to argue for corporations to adopt strategies aimed at achieving social good over maximizing immediate distributions to shareholders. Yet, to be protected by the business judgment rule, decisions of this nature are only justifiable when they are reasonably related to maximizing long-term profits of the corporation and, ultimately, long-term distributions to shareholders.

A bedrock principle of Delaware corporate law is that a corporate board work to promote the value of the corporation for the benefit of its shareholders. And Delaware case law has imposed a duty on a corporate board to maximize profits: "[T]he duty of loyalty [ ] mandates that directors maximize the value of the corporation over the long-term for the benefit of the providers of equity capital. . . . [S]tockholders' best interests must always, within legal limits, be the end." *In re Trados Inc. S'holder Litig.*, No. 1512-VCL, slip op. at 33–34 (Del. Ch. 2013).

Tax Treatment and Resulting Hostility
The growing animosity toward the use of shell companies to hold profits in offshore accounts has seen a corresponding pressure on companies that do so, notably Apple, Google, and Nike, to pay taxes on those profits to the U.S. government. It is estimated that 72 percent of Fortune 500 companies hold profits in offshore shell companies, collectively amounting to roughly $2 trillion.

Current tax law requires corporations to pay taxes on all profits earned in the United States at a rate of roughly 40 percent, the highest corporate tax rate of any developed nation. The law also requires corporations to pay taxes at the same rate on all profits earned outside the United States, but only when those profits are brought back into the country. Corporations use offshore shell companies primarily to avoid paying taxes on profits earned outside the Unites States and, accordingly, hold profits in the same place: outside the United States. For corporations adopting this strategy, shell companies serve as a legitimate method of tax deferral just as an individual retirement account or pension plan.

This is tax avoidance, not tax evasion, and it is perfectly legal. Many individuals, however, are ignorant of the distinction between the two and look at all efforts by corporate boards and wealthy individuals to pay less in taxes as an effort by these parties to avoid paying their "fair share." This, Tim Cook (the chief executive officer of Apple Inc.) has described as "total political crap." Others are quite aware of the distinction but find the practice unethical, immoral, or ultimately injurious to society. Many simply find the secrecy surrounding the practice suspect and look down on the need to hide identities more than the need to hide profits. What has universally been considered fair for taxes, both corporate and personal, is the amount that is owed. As Justice Learned Hand famously said, "No one in the law is required to pay more tax than the law specifies."

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The choice by corporate directors to volunteer or willingly submit to pay a greater rate of tax than a business owes could be accurately viewed as a breach of a corporate board's duty to its shareholders to maximize corporate profits, both immediate and long term. Is it fair to blame corporations for using the laws to their advantage? These entities themselves are completely legal; their owners are simply using them for illegal purposes.

The Role of Legal Counsel

The Panama Papers leak has also brought attention to the role of lawyers in structuring, sheltering, and moving money in offshore corporate vehicles. Like corporate directors, lawyers owe a fiduciary duty to act in the best interests of their clients, within the confines of the law. This includes using the law in creative and innovative ways to develop solutions to client problems. Lawyers, however, face an especially difficult challenge in achieving the lawful goals of their clients when those goals abut ethical considerations. Lawyers face an even greater challenge when the potential exists for their clients to use their services to achieve an unlawful purpose after they have achieved the purpose for which they were hired.

In response to questions from International Consortium of Investigative Journalists about its incorporation services, Mossack Fonseca stated that it "does not foster or promote unlawful acts," adding that there are a number of legitimate purposes for incorporating entities in other jurisdictions. It further stated: "We regret any misuse of companies that we incorporate or the services we provide and take steps wherever possible to uncover and stop such use."

As it applies to the use of corporate vehicles to provide anonymity to certain transactions or hold money offshore, lawyers must apply a rigorous examination of the law and tread lightly to stay within its confines. However, to what extent is a lawyer legally obligated to follow up with his or her clients to ensure that the clients have not used the lawyer's services for an unlawful end?

Keywords: litigation, business torts, shell companies, shelf companies, Panama papers, Mossack Fonseca

Emily Lehmberg is an associate at Bell Nunnally & Martin LLP in Dallas, Texas.

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Why I Love Rule 36—and Why You Should Too

By Fitzgerald T. Bramwell

Requests to admitare the Rodney Dangerfield of pretrial procedure—they get no respect. Even though the Federal Rules of Civil Procedure include requests to admit under the "discovery and disclosures" subsection, some courts have said that they are not technically a discovery device. *E.g.*, *Nat'l Semiconductor Corp. v. Ramtron Int'l Corp.*, 265 F. Supp. 2d 71, 74 (D.D.C. 2003). But even if they are not technically a discovery device, Rule 36 and state law equivalents have a place in the discovery plan.

Unlike interrogatories and document requests that elicit and expound on facts, requests to admit seek to narrow issues for litigation: "[T]he intended impact of an admission is to conclusively establish the admitted fact unless the court permits a withdrawal or amendment of the admission." *Henry v. Champlain Enters.*, 212 F.R.D. 73, 77 (N.D.N.Y. 2003). The procedure under the Federal Rules is fairly simple. One party makes a statement of fact and asks the other party to agree with it. The responding party's principal choices are to admit the allegation or to deny the allegation. Fed. R. Civ. P. 36(a)(4). However, the responding party may also (1) object to the request as beyond the scope of discovery, (2) provide a qualified admission, or (3) explain that it has insufficient information to allow it to admit or deny the allegation. *Id. See also McFadden v. Ballard, Spahr, Andrews, Ingersoll LLP*, 243 F.R.D. 1, 7 (D.D.C. 2007). If a party says it is unable to admit or deny, it must make "a reasonable inquiry" into the allegation and assert "that the information it knows or can readily obtain is insufficient to enable it to admit or deny." Fed. R. Civ. P. 36(a)(4).

Given the above, counsel can be forgiven for thinking that the request to admit is nothing more than a formal request for a stipulation. In reality, it is much more because—at least in the federal system—the rule imposes an obligation to inquire into the truth or falsity of the requested admission. *See Nguyen v. Winter*, 756 F. Supp. 2d 128, 130 (D.D.C. 2010). In other words, opposing counsel cannot simply refuse to agree to a request out of obstinacy: There must be a reason for denying a proper request to admit. A bad-faith denial of a request to admit can lead to discovery sanctions. Fed. R. Civ. P. 37(c)(2). *But see Buzz Off Insect Shield v. S.C. Johnson & Son, Inc.*, 606 F. Supp. 2d 571, 592–95 (M.D.N.C. 2009) (declining to award sanctions where responding party had good reason to deny certain requests to admit).

It is the responding party's obligation to inquire—together with the ability to then serve interrogatories and depose witnesses—that makes the request to admit so useful. Using Rule 36, counsel can ask a party to admit a fact. If the party admits the fact, counsel does not need to spend further resources on the issue—that particular fact is settled. But, if the party denies the request to admit, counsel can use an interrogatory to ask the important follow-up question: Why? Why do you deny this fact? What evidence do you have that contradicts what is obvious to us? Please provide each and every reason you believe that what we have stated is incorrect. While you're at it, please also give us any documents that support your view of the world. These follow-up questions are surprisingly powerful.

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Consider the following hypothetical: An executive is told that he is not performing as required and that he is going to be given a last chance to correct these issues before the termination. The "last chance" letter states that the executive must meet certain minimum performance metrics within the next quarter. (For example, the executive's team may need to ship a certain amount of product during the next quarter or make sure that waste product does not exceed a certain dollar amount.) When the executive fails to meet those metrics, his employment is terminated. A few weeks later, the now former supervisor serves the employer with process, alleging wrongful termination. You represent the employer.

As defense counsel, one of your arguments will be that the former employee was terminated for cause and that termination was therefore proper. To present this defense, you want to show that the employee failed to meet known performance standards. What better source of information than the employee's own words? As soon as discovery opens, you ask the employee to admit that he failed to meet at least one of the minimum performance standards articulated in the "last chance" letter. Not surprisingly, the employee denies having done anything to merit termination, and he denies your request to admit.

After receiving the denial, your next move could be to issue an interrogatory asking the employee to identify each and every performance metric he satisfied. The employee is now faced with an uncomfortable choice. On the one hand, he can retract his denial and admit that he missed some of the metrics, setting himself up to lose on summary judgment. On the other hand, he can continue to lie about his performance and look incompetent (at best) when the employer introduces the metrics as evidence at trial. Alternatively, counsel might raise the issue at the employee's deposition. After showing him the metrics, counsel might ask, "You denied request to admit no. X, which asked you to admit that you missed at least one of the metrics. What metrics were hit?" When the employee answers "I don't know," you may have ammunition for a motion for summary judgment and, potentially, a motion for discovery sanctions.

Much like a boxer's simple jab setting up a knockout combination, the request to admit can be an opening move in a discovery plan that sets the case up for victory. By narrowing the issues for litigation, it can help counsel focus limited interrogatories on key issues. (Recall that Rule 33(a)(1) of the Federal Rules of Civil Procedure limits counsel to 25 interrogatories without leave of court. There is no such limit on requests for admission in the Federal Rules.) And, together with other discovery devices, it can also help counsel force an opponent to explain a position. Given that the Federal Rules do not limit the number of requests a party may serve, there is no reason not to exploit this tool to the maximum extent on the facts of any particular case.

Keywords: litigation, business torts, unfair competition, Rule 36, request to admit, request for admission

Fitzgerald T. Bramwell is the principal at the Law Offices of Fitzgerald Bramwell in Chicago, Illinois.

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PRACTICE POINTS

What You Should Know about the Implied Duty of Good Faith and Fair Dealing

Imagine you're a franchisee of a large chain and, according to your franchise agreement, you owe a monthly franchise fee. To make enough money to pay that fee, you ask the franchisor for help with marketing or to speak to your potential investors. The franchisor, however, refuses to help. As a result, you are unable to pay your franchise fee.

In this situation, the franchisor may be liable to you for breach of the duty of good faith and fair dealing—even though you didn't perform your end of the bargain. This is because every contract contains an implied duty of good faith and fair dealing in the performance and enforcement of the contract. Most executives and companies—and even attorneys—however, do not realize that this duty may require that parties *not interfere with or fail to cooperate in the other party's performance*. This is important because even if your contract does not explicitly require you to cooperate or if your contract does not explicitly state that you must not interfere, the duty of good faith and fair dealing may require you to do so or else you risk breaching the agreement.

This post will explain what the duty of good faith and fair dealing is and how a party can breach that duty by interfering with or failing to cooperate in the other party's performance.

The Duty of Good Faith and Fair Dealing
In general, every contract contains an implied duty of good faith and fair dealing. This duty requires that neither party will do anything that will destroy or injure the right of the other party to receive the benefits of the contract. There is no specific definition, however, of this duty and courts have discretion to determine its scope. When deciding whether the duty of good faith and fair dealing was breached, courts analyze the facts and determine what is fair under the circumstances.

"Good faith" has generally been defined as honesty in a person's conduct during the agreement. The obligation to perform in good faith exists even in contracts that expressly allow either party to terminate the contract for any reason. "Fair dealing" usually requires more than just honesty. It generally requires that a party cannot act contrary to the "spirit" of the contract, even if you give the opposing party notice that you intend to do so.

In general, the duty of good faith and fair dealing means, for example, that parties cannot evade the spirit of the bargain, lack diligence or slack off, perform incorrectly on purpose, abuse their power when specifying the terms of a contract, or *interfere with or fail to cooperate in the other party's performance*. Let's further analyze this last example because, as stated above, most executives and attorneys do not realize that some jurisdictions include it in the duty of good faith and fair dealing.

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Interfering with or Failing to Cooperate in the Other Party's Performance

As stated above, each party to a contract has a duty to do everything that the contract assumes he or she will do to accomplish its purpose. This means that your performance under a contract is excused—or does not need to happen—if your performance is prevented or hindered by the other party to the contract. In other words, your performance in a contract does not need to be completed—and you won't be considered to have breached the contract—if the other party is interfering with or fails to cooperate with your performance. The theory behind this principle is that a party cannot interfere with or fail to cooperate with your performance and then complain about it.

Thus, in the example above, when the franchisor failed to help you with marketing or refused to meet with your investors, the franchisor may have breached the duty of good faith and fair dealing and you may be excused from paying the franchise fees.

Final Thoughts

It is important that you and your business understand what your obligations are under a contract—not just the actual contract terms, however, but also the implicit terms, like the duty of good faith and fair dealing. This is because, during the course of a contract, if the other party asks you for help and you do not provide it because the contract terms do not require you to do so, you may have unintentionally breached the agreement.

Whether you are about to enter into a contract or are already a party to numerous agreements, talk to an attorney to understand what the duty of good faith and fair dealing requires of you and your company.

Keywords: litigation, business torts, unfair competition, contracts, duty of good faith, duty of fair dealing, breach of contract, franchise law

—*Catherine Pastrikos Kelly, Meyner and Landis LLP, New York City, NY*

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