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Claims-Made Class Action Settlements: Financial and Tax Reporting†

Peter G. Robbins

I. Introduction

When a class action is settled, the settlement can be structured in a variety of ways, but the claims-made settlement[1] structure is often the only type of settlement that will satisfy the class representatives and be approved by the court. Claims-made settlements have a distinct disadvantage for the defendant: "the total aggregate payout is unknown and it will not be known until after the deadline for submission of claim forms has passed—after the settlement has become final."[2] The uncertainty stems from the fact that the "take rate"[3] will not be known until members of the class file their claim forms, the forms are reviewed (particularly if fraudulent claims are a possibility), payouts are made, and checks are cashed. Ultimately, the take rate may be smaller than anticipated or if the relief awarded is claimed

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[1] "In a 'claims made' settlement, the defendant agrees to make payments in whatever manner is agreed upon only to class members who do not opt out of the class and who submit a claim form that demonstrates their entitlement to relief." Wystan M. Ackerman, *Class Action Settlement Structures,* 63 Fed'n Def. & Corp. Couns. Q. 35, 39 (2012).

[2] *Id.* at 40.

[3] Take rate is the percentage of the class who files claims seeking the available benefit. *Id.* at 39.

Peter G. Robbins became a partner with CliftonLarsonAllen, LP in November 2011 when his predecessor firm Middleton, Burns & Davis (MBD) merged into CLA. Mr. Robbins was a shareholder at MBD, joining the firm in 1998. Previously, he was employed by Ernst & Young LLP in Milwaukee, Wisconsin and Grant Thornton LLP in Dallas, Texas. Mr. Robbins works closely with individuals, executives, and business owners providing tax compliance and consulting services, representation before the IRS, estate planning, consultation on stock options and other compensation issues, and general business planning. In addition, Mr. Robbins works extensively in the trust and estates arena and with all forms of business enterprises including corporations, S corporations, partnerships, and limited liability companies. Mr. Robbins was an adjunct instructor at Southern Methodist University for eight years and has served as a guest lecturer and instructor for many professional organizations including the American Institute of CPAs, the Dallas Estate Planning Council, and the Boise Estate Planning Council. He has been published in several periodicals including the Independent Banker and the Texas Independent Banker. In addition, he is the author of the bi-weekly tax and accounting question and answer column, Talking Tax, which is published in the Idaho Business Review. Mr. Robbins earned a Master of Science in Accounting degree from the University of Wisconsin-Oshkosh. He is a member of the American Institute of CPAs, the Texas Society of CPAs, the Idaho Society of CPAs, and the Boise and Treasure Valley Estate Planning Councils, as well as the Rotary Club of Southwest Boise.

by the entire class, the payout "could be far more than the defendant would be willing or even able to pay."[4]

The impact of a class action settlement can be devastating for a company not just in terms of the potential financial settlement costs and related expenses, but also in terms of degradation to the financial statements which can affect the company's financial stability, its capital reserves, and its operations. Whether the settlement payout is tax deductible will also have an impact on the after-tax cost of the settlement. To address these risks and the uncertainty they create, companies and their counsel should consider insuring the settlement payout with Class Action Settlement Insurance. This new form of insurance allows the company to "lock in" the costs of the settlement by effectively transferring the take rate risk to an insurance carrier and thereby decreasing uncertainty and mitigating the impact of the settlement on the company's financial statements and reducing the after-tax cost of the settlement.

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[4] *Id.* at 40.

This Article presents a discussion of current financial accounting, disclosure regulations, and tax consequences of claims-made class action settlements. Part II explains the current financial accounting rules and regulations that govern when the amount of a class action settlement fund must be disclosed and accrued on the defendant's financial statements and how the fund amount varies from the actual participation or "take-rate" of claimants. Part II also explains the process and rules for reporting class action settlements to the Securities and Exchange Commission. Part III explains the tax treatment of class actions settlements with a particular focus on when the settlement amount can be deducted as a business expense and when it must be treated as a nondeductible capital expenditure. Part III concludes with a discussion of nondeductible fines and penalties paid to the government and situations where the court directs or authorizes transfer of the civil penalty to settle class action liabilities. Part IV explains the benefits produced by purchasing class action settlement insurance which may minimize the class action settlement's effect on the company's balance sheet and reduce the after-tax cost of the settlement.

II.
Current Financial Accounting Rules and Regulations

Class action settlements typically have a maximum payout established by the parties and approved by the court. Once the settlement is approved, it can take months or even years for the settlement to become final and the claims process to be completed. During this time, the settling company has to carry the full amount of the liability for the claims-made settlement fund on its books. Additionally, the actual claim rate can vary dramatically and create uncertainty as to the actual financial cost of the settlement.[5] That uncertainty may wreak havoc on a company's liquidity and financial planning.

The Financial Accounting Standards Board (FASB) promulgates the accounting regulations for financial reporting which include regulations for class action contingencies. Financial accounting for contingencies is governed by Accounting Standards Codification Topic 450[6] which states that a company's estimated loss from a contingency shall be accrued on the company's financial statements by a charge to income if:

> a. information available before the financial statements are issued or are available to be issued … indicates that it is probable that an asset had been impaired or a liability had been incurred at the date of the financial statements.… [and]
>
> b. the amount of the loss can be reasonably estimated.[7]

---

[5] *Id.*

[6] Fin. Accounting Standards Bd., Accounting Standards Codification 450 (2009) [hereinafter ASC 450]. In 2009, Statement of Financial Accounting Standard No. 5. was codified as ASC 450. FASB Accounting Standards Codification™ and the Hierarchy of Generally Accepted Accounting Principles, Statement of Fin. Accounting Standards No. 168, § 3 (Fin. Accounting Standards Bd. 2009).

[7] ASC 450-20-25-2.

As established by the FASB, Generally Accepted Accounting Principles (GAAP) also mandated that a company is required to disclose any asset impairment or liability incurrence that is considered to be "probable."[8] Since a class action settlement agreement creates a known and probable liability, GAAP requires that the company book the entire settlement and assumes an 100 percent "take rate" participation in order to provide legal and financial transparency to the public regarding the claim. Thus, when a company settles a class action lawsuit and establishes a claims-made process, it has two choices: (1) take a charge on its financial statements for the entire amount of the settlement which may cause a devastating financial position for shareholders and others, or (2) purchase insurance that will cap the company's maximum net liability at the amount of the insurance premium.

Even in the event that the contingent loss cannot be easily estimated or the loss contingency is only "reasonably possible" (*i.e.,* "[t]he chance of the future event or events occurring is more than remote but less than likely"[9]), GAAP requires that a company must still disclose the nature of the contingency.[10] "Disclosure" of the loss contingency generally involves the "nature of the contingency" and, to the extent known, an estimate of the possible loss (or a statement that an estimate cannot be made).[11]

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[8] ACCOUNTING FOR CONTINGENCIES, Statement of Fin. Accounting Standards No. 5, § 8 (Fin. Accounting Standards Bd. 1975).

[9] ASC 450-20-20.

[10] ASC 450-20-50.

[11] ASC 450-20-50-4. In July 2010, the Financial Accounting Standards Board considered revising ASC 450 and issued Financial Accounting Standards Board Proposed Accounting Standards Update, Disclosure of Certain Loss Contingencies an update of ACS Topic No. 450—Contingencies. The proposal recommended that

> [d]uring early stages of asserted litigation contingencies, at a minimum, the contentions of the parties (for example, the basis for the claim and the amount of damages claimed by the plaintiff and the basis for the entity's defense or a statement that the entity has not yet formulated its defense). In subsequent reporting periods, disclosure should be more extensive as additional information becomes available.

EXPOSURE DRAFT—PROPOSED ACCOUNTING STANDARDS UPDATE, CONTINGENCIES (TOPIC 450): DISCLOSURE OF CERTAIN LOSS CONTINGENCIES 11 (June 5, 2008), *available at* http://www.fasb.org/cs/BlobServer?blobkey=id&blobwhere=1175823559187&blobheader=application%2Fpdf&blobcol=urldata&blobtable=MungoBlobs. Comments received in response to the proposal expressed concern "that the enhanced disclosures in the proposed Update would impose significant costs, force an entity to waive attorney-client privilege and work-product protections, and provide prejudicial information to litigation adversaries that would hinder the entity's defense in litigation." FSAB, Disclosure of Certain Loss Contingencies: Comment Letter Summary, *available at* http://www.fasb.org/cs/ContentServer?site=FASB&c=Document_C&pagename=FASB%2FDocument_C%2FDocumentPage&cid=1176157934255. The Board removed the proposal from its technical agenda at its July 2012 meeting. FASB, Minutes of the July 9, 2012 Board, http://www.fasb.org/cs/ContentServer?site=FASB&c=Document_C&pagename=FASB%2FDocument_C%2FDocumentPage&cid=1176160163070.

As consequence of the ASC 450 regulations, a company is generally obligated to provide substantial information regarding a class action settlement and how it originated. The company can be adversely impacted by both the description of the underlying facts giving rise to the class litigation as well as by the GAAP charges for fully booking the settlement on the financial statements. This obligation to report litigation applies to both public and private companies. Further, because a settlement may continue for months or even years, the liability and disclosure requirement can linger. A company may find itself in a position where the negative impact of the settlement must be disclosed over numerous quarters or years.

In addition to the reporting requirements of ASC 450, the United States Securities and Exchange Commission (SEC) also mandates reporting requirements on Form 8-K,[12] which must usually be filed within four business days after the occurrence of the event (*i.e.*, the class action settlement that triggers the filing of the form).[13] Class action settlements must be disclosed on Form 8-K as a "material definitive agreement"—"an agreement that provides for obligations that are material to and enforceable against" the company.[14] When a company enters into (or amends) a material definitive agreement, Form 8-K must include the following information regarding the agreement:

> (1) the date on which the agreement was entered into or amended, the identity of the parties to the agreement … and a brief description of any material relationship between the [company] or its affiliates and any of the parties, other than in respect of the material definitive agreement or amendment; and
>
> (2) a brief description of the terms and conditions of the agreement or amendment that are material to the [company].[15]

The actual settlement agreement does not have to be filed as an exhibit to Form 8-K.[16] However, filing Form 8-K triggers a requirement that the company's next quarterly report

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[12] Form 8-K, 17 C.F.R. § 249.308 (2006), available at http://www.sec.gov/about/forms/form8-k.pdf (last visited June 25, 2013) (hereinafter SEC Form 8-K).

[13] SEC Form 8-K, General Instructions, Section B. "The filing of the Form 8-K may constitute the first 'public announcement' for purposes of Rule 165 under the Securities Act and Rule 14d-2(b) or Rule 14a-12 under the Exchange Act and thereby trigger a filing obligation under those rules." Additional Form 8-K Disclosure Requirements and Acceleration of Filing Date, Release No. 33-8400 (March 16, 2004), 2004 WL 536851, at *7; *see also* SEC Form 8-K, General Instruction A.2.

[14] SEC Form 8-K, § 1, Item 1.01(b).

[15] *Id.* at § 1, Item 1.01(a).

[16] Additional Form 8-K Disclosure Requirements and Acceleration of Filing Date, Release No. 33-8400 (March 16, 2004), 2004 WL 536851, at *7; SEC Form 8-K, General Instruction B.4.

include the actual agreement,[17] which may include the full amount of the class action settlement fund.[18]

The nature of disclosure must be carefully considered by the company. As previously discussed, the requirements of ASC 450 mandate that certain loss contingencies must be disclosed in financial statements if the loss is determined to be probable or reasonably possible. For example, assume Company X is faced with "probable" loss contingencies in the form of a $250 million class action settlement; this amount must be reported as an accrued liability. Furthermore, Company X must provide a detailed explanation of the nature of the claim, the process, and other important aspects of the contingency (including how it will be funded). These important aspects may also include relevant names, issues, or components of the litigation. On Company X's next financial statement, investors will be able to ascertain the fact that a potential $250 million liability is an obligation of the company and review supplemental information regarding the claim. In addition, Company X will be required to continue filing SEC and financial statement reports regarding the status of the claims and any other aspects of the underlying litigation. Failure to properly disclose a contingency in compliance with ASC 450 is classified as "financially unrepresentative" under the Sarbanes-Oxley Act of 2002,[19] and may cause the company's management to be charged criminally.[20] If the loss is deemed to be "reasonably possible," as opposed to "probable," it need not be accrued, but the settlement must be disclosed in footnotes included in the company's financial statements. Footnote disclosures will notify financial statement readers of the potential for loss and economic drain on the company. In either case, the class action settlement will have a significant detrimental impact on the company's financial statements.

III.
Tax Treatment of Class Action Settlements

To determine if a claims-made class action settlement is deductible, the "origin of the claim" must be determined. Generally, if the claim arises out of the ordinary business operations of the company, then the settlement payments and related expenses may be deducted. When the claim originates from the company's acquisition of an asset, such as purchasing the stock of a target corporation from its shareholders, the company may be required to capitalize the settlement amounts paid as an acquisition cost. When a class-action type suit is settled, section 162(f) which prohibits deducting "any fine or similar penalty *paid to a government* for the violation of any law" must also be considered. Statutes such as the Telephone Consumer Protection Act (TCPA), the Video Privacy Protection Act (VPPA), and

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[17] *Id.*

[18] *See*, *generally,* Ackerman, *supra* note 1.

[19] Pub. L. No. 107-204, 116 Stat. 745 (2002).

[20] Sarbanes-Oxley § 302 (codified at 18 U.S.C. § 1350 (2006 ed. & Supp. V)), Sarbanes-Oxley § 906 (codified at 15 U.S.C. § 7241 (2006 ed. & Supp. V)).

the Fair and Accurate Credit Transactions Act (FACTA) provide for both penalties payable to the government as well as private causes of action that may be pursued by consumers in class actions. When planning the best strategy for negotiating settlements of these types of class-actions, it is particularly important to consult with a tax professional regarding the after-tax cost of each option being considered.

A. *Origin of the Claim*

According to the "origin of the claim" doctrine, whether a particular expenditure is deductible or not depends upon the underlying transaction or activity that initially caused the claim. In contrast, "[t]he purpose, consequence, or result of the expenditure is irrelevant in determining the origin of the claim, and therefore, the character of the litigation cost for tax purposes."[21] Thus, even though "[p]ayments made in settlement of lawsuits are deductible [under Internal Revenue Code section 162(a)] if the acts which gave rise to the litigation were performed in the ordinary conduct of the taxpayer's business,"[22] if the claims arise out of the taxpayer's acquisition of a target corporation's stock, rather than out of the taxpayer's ordinary business relationships, then the settlement is not deductible. Instead, it must be capitalized.[23]

B. *Settlements as Deductible Ordinary and Necessary Business Expenses*

Internal Revenue Code section 162(a) allows companies to deduct the "ordinary" and "necessary" expenses they pay or incur in carrying on their trade or business. The word "ordinary" does not mean that the expense must be recurring:

> Ordinary in this context does not mean that the payments must be habitual or normal in the sense that the same taxpayer will have to make them often. A lawsuit affecting the safety of a business may happen once in a lifetime. The counsel fees may be so heavy that repetition is unlikely. None the less, the expense is an ordinary one because we know from experience that payments for such a purpose, whether the amount is large or small, are the common and accepted means of defense against attack. The situation is unique in the life of the individual affected, but not in the life of the group, the community, of which he is a part. At such times there are norms of conduct that help to stabilize our judgment, and make it certain and objective. The instance is not erratic, but is brought within a known type.[24]

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[21] P.L.R. 200649011.

[22] Rev. Rul. 80-211, 1980-2 C.B. 57.

[23] Missouri Pacific Corp. v. United States, 5 Cl. Ct. 296 (1984); Berry Petroleum Co. v. Comm., 104 T.C. 584 (1995), *aff'd* 142 F.3d 442 (9th Cir. 1998) (unpublished table decision).

[24] Welch v. Helvering, 290 U.S. 111, 114 (1933).

The word "necessary" in the section 162 requirements for deducting class action settlements means only that the payment is "appropriate and helpful" to the business. In this regard, the Court has cautioned that courts should be slow to override the judgment of the business owner.[25]

Damages paid whether compensatory or punitive are deductible ordinary and necessary business expenses if they arise out of the ordinary conduct of the defendant's business.[26] Many claims-made class action settlements fall within this rule because they stem from allegedly false statements, defective products, or violations of the law that occur as part of the ordinary operations of the company's business. The fact that a claims-made class action settlement involves establishing a fund that will be used to pay money to class members who file claims; incentive payments to the named plaintiffs; taxes on income earned by the fund before it is disbursed; expenses associated with taxation of the fund's earnings, such as fees paid to tax attorneys and accountants; administrative fees charged by the class action administrator; and attorneys' fees to the attorneys who represent the class does not change the fact the company is incurring an expense related to its business operations.

For example, consider the likely tax treatment of the settlement in *Dennis v. Kellogg Co.* In this case, the plaintiffs in the class action suit alleged that "Kellogg falsely claimed on its Product labels and packages and in its promotional materials and advertisements that ran during the Settlement Class Period that consumption of Kellogg's® Frosted Mini-Wheats cereal for breakfast improved kids' attentiveness, memory and other cognitive functions to a degree not supported by any competent clinical evidence."[27] Although Kellogg denied the allegations in the complaint, it agreed to settle the class action because Kellogg

> concluded that further defense of the Litigation would be protracted and expensive, and that it is desirable that the Litigation be fully and finally settled in the manner and upon the terms and conditions set forth in the Stipulation. Defendant also has taken into account the uncertainty and risks inherent in any litigation. Kellogg, therefore, has determined that it is desirable and beneficial to it that the Litigation be settled in the manner and upon the terms and conditions set forth in the Stipulation.[28]

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[25] *Id.* at 113.

[26] Rev. Rul. 80-211, 1980-2 C.B. 57.

[27] Class Action Stipulation of Settlement at 2, Dennis v. Kellogg Co., No. 3:09-cv-01786-IEG-WMC (S.D. Cal. Mar. 15, 2013).

[28] *Id.* at 5.

The settlement agreement required Kellogg to pay $4 million into an interest bearing settlement fund that would be disbursed as follows:

> The Settlement Fund shall be applied to pay in full and in order: (i) any necessary taxes and tax expenses; (ii) all costs associated with the Class Action Settlement Administrator, including costs of providing notice to the Class Members and processing claims; (iii) any Fee and Expense Award made by the Court to Class Counsel under §VIII(a); (iv) any class representative incentive award made by the Court to Plaintiffs under §VIII(c); and (v) payments to authorized Claimants and any others as allowed by this Stipulation and to be approved by the Court.[29]

The class representative incentive award was $5,000 for each of the two named plaintiffs.[30] Class members who file the required claim will be paid $5 per box of cereal purchased, but not more than $15.[31] The settlement award specifies that if authorized claims exceed the settlement fund, each claim will be proportionately reduced.[32] The settlement agreement also deals with excess funds specifying that

> [i]f after all valid claims are paid, money remains in the Settlement Fund, the remaining amount shall be used to increase pro rata the recovery on each eligible claim, with total recovery on each claim limited to three times the original value of the claim. Any funds remaining thereafter shall be paid to one or more charities consistent with the Ninth Circuit opinion, chosen by the Parties and approved by the Court pursuant to the *cy pres* doctrine. Subject to Court approval, the Parties select Consumer Watchdog, Consumers Union and the Center for Science in the Public Interest as the *cy pres* recipients.[33]

Kellogg should be entitled to deduct the entire $4 million paid to settle this class action under Internal Revenue Section 162(a) as an "ordinary and necessary" business expense. The origin of the claim was an allegedly false advertising claim Kellogg made regarding its product. Because "the acts which gave rise to the litigation were performed in the ordinary conduct of the taxpayer's business," payouts from the settlement fund are considered deductible ordinary and necessary business expenses.[34] Settling such a claim is an ordinary and necessary means of resolving litigation.

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[29] *Id.* at 11.

[30] *Id.* at 19.

[31] *Id.* at 10.

[32] *Id.* at 11.

[33] *Id.*

[34] Rev. Rul. 80-211, 1980-2 C.B. 57.

C. *Expenses vs. Capital Expenditures*

Some class action settlements give rise to nondeductible capital expenditures rather than deductible business expenses. The issue of whether the settlement is deductible or must be capitalized is best illustrated by claims-made class actions involving securities laws. To determine whether a class action settlement is deductible as a business expense under section 162(a) or is a nondeductible capital expenditure under section 263, the tax professional must determine the "origin of the claim" that is being settled.[35] To the extent that the claims being settled originated in the defendant's acquisition of an asset, such as acquiring a target corporation's stock from its shareholders, they are nondeductible capital expenditures. In contrast, if the claim originates from the defendant's business operations, then the settlement may be deductible under section 162(a) as a business expense.

In *Missouri Pacific Corp. v. United States*, the defendant made a public offering to exchange its shares for the target corporation's shares.[36] After the exchange, the target corporation's shareholders filed a class action lawsuit alleging that the prospectus and the letter they received contained false representations regarding the value of the defendant's shares and also understated the value of the target corporation's shares.[37] A settlement was reached and the defendant paid damages to the target shareholders that participated in the exchange.[38] The damages were calculated to compensate the target shareholders for the true value of their shares on the exchange date. Although the defendant claimed that the settlement was a deductible business expense, the court disagreed and held that the settlement was a nondeductible capital expenditure because it represented an additional cost for the shares the defendant acquired.[39]

In *Berry Petroleum Co. v. Commissioner*, the Tax Court found that based on the origin of the claim doctrine, settlement costs for a class action arising out of a merger were a nondeductible capital expenditure.[40] In *Berry Petroleum,* the defendant purchased 80.56 percent of the stock of Norris Corporation from a corporate shareholder.[41] After the acquisition, the remaining shares were widely held by minority shareholders and publicly traded in the over-the-counter market.[42]As part of a freeze-out, exchange of stock merger, Berry formed a subsidiary corporation that merged into Norris and then Berry acquired the remaining

[35] Woodard v. Comm., 397 U.S. 572, 577 (1970); United States v. Gilmore, 372 U.S. 39, 47 (1963).

[36] 5 Cl. Ct. 296, 306 (1984).

[37] *Id.*

[38] *Id.* at 308.

[39] *Id.* at 310.

[40] 104 T.C. 584, 622 (1995), *aff'd* 142 F.3d 442 (9th Cir. 1998) (unpublished table decision).

[41] *Id.* at 601.

[42] *Id.* at 593.

shares of Norris from the public.[43] Later, the former minority shareholders of Norris filed a class action lawsuit against the defendant. According to the complaint, the "breach of fiduciary duty - merger fraud class action … [had] its origins in the June 26, 1987 freezeout, exchange of stock merger, of the public minority shareholders of Norris Oil Corp., a Nevada corporation ("Norris"), by Norris' parent, defendant Berry Oil Corp."[44] The complaint also alleged that Berry overvalued its own stock and undervalued the Norris stock.[45] Additionally, the prospectus misrepresented and concealed the value of Norris, including the value of its Rincon oil field.[46] The class action was eventually settled for $5 million.[47] Defendant claimed a business deduction for the cost of the settlement plus the legal expenses and other costs incurred to defend against the class action. The Service disallowed the deduction claiming that the settlement cost and related expenses where nondeductible capital expenditures incurred to acquire the minority shareholder's shares.[48]

Although the Tax Court agreed that the class action litigation alleged a breach of a fiduciary duty by defendant (which sometimes is considered a claim arising out of the ordinary operations of the company), the court refused to determine the tax consequences of the settlement costs on that basis alone.[49] Instead, defendant's "position as Norris' majority shareholder and acquiror of the Norris minority stock … created its fiduciary duty, which was a necessary element of" the class action lawsuit.[50] Thus, both the material facts and the controlling law "had their origins in the acquisition of Norris stock by [defendant]."[51] The Tax Court held as follows: "Because the [class] litigation had its origins in the process of acquisition culminating in the Norris merger, the costs attributable thereto are not deductible as ordinary and necessary business expenses, but must be capitalized as acquisition costs of the Norris stock."[52] The Ninth Circuit affirmed the Tax Court's decision in an unpublished opinion.[53]

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[43] *Id.* at 598.

[44] *Id.* at 601.

[45] *Id.*

[46] *Id.*

[47] *Id.* at 607.

[48] *Id.* at 617.

[49] *Id.*

[50] *Id.* at 618.

[51] *Id.* Even though the class members consisted of a selling class whose members sold their stock on the open market after the defendant acquired control of Norris and a merger class whose members exchanged their stock for the defendant's stock in the freeze-out merger, the Tax Court held that "the claims of both classes had a common origin in [defendant's] acquisition of the Norris stock" finding that the lower court (and the parties) drew no distinctions between the two classes when certifying the class, deciding motions, or approving the settlement. *Id.* at 621-22.

[52] *Id.* at 622.

[53] Berry Petroleum Co. & Subsidiaries v. Comm., 142 F.3d 442 (9th Cir. 1998) (unpublished table decision).

Missouri Pacific and *Berry Petroleum* are the only court cases addressing whether class action settlements involving acquisitions of corporate stock by purchase or merger are nondeductible capital expenditures or deductible business expenses. Even though in both cases the courts determined that the settlement costs were nondeductible, the Service has distinguished those cases in three private letter rulings that approved business deductions for class action settlements involving violations of securities laws.

In Letter Ruling 200649011, numerous class actions were filed against the defendant corporation and a corporation (Corp. X) following a reverse triangular merger where the defendant formed a subsidiary that merged into Corp. X and then Corp. X became a subsidiary of the defendant. As part of the merger, the Corp. X shareholders became shareholders of the defendant corporation. The class actions were prompted by the defendant's press releases disclosing that after the merger, the defendant discovered that Corp. X may have overstated its revenue due to accounting improprieties. An audit revealed that management of Corp. X had, in fact, engaged in several accounting improprieties over a period of years prior to the merger.[54]

The defendant settled the class actions and also paid attorney's fees and administrative expenses. It then requested (and received) a private letter ruling that amounts it incurred to settle a class action lawsuit, as well as attorney fees and other fees attributable to the lawsuit, could be deducted as ordinary and necessary business expenses under section 162. The Service noted first that

> [g]enerally, amounts paid in settlement of lawsuits are currently deductible if the acts which gave rise to the litigation were performed in the ordinary conduct of the taxpayer's business.… However, if the litigation arises from a capital transaction, then the settlement costs and legal fees associated with such litigation are characterized as acquisition costs and must be capitalized under § 263(a).[55]

After analyzing the facts that prompted the class action litigation in order to determine the origin of the claim, the Service concluded that the settlement and related legal expenses were deductible as ordinary and necessary business expenses because the claims were rooted in ordinary business transactions of the taxpayer and the corporation, and not in the merger transaction. A critical fact in the determination that the settlement was currently deductible was that the claims had their basis in the accounting improprieties that were published in

[54] The accounting improprieties included "the improper booking of revenues before the conditions required for revenue recognition were satisfied, the improper booking of revenues that were contingent on future events, the premature booking of revenue with respect to backdated contracts, and other miscellaneous revenue adjustments relating to the timing of recognition of certain items, expense underaccruals, and the reversal of certain excess accruals." P.L.R. 200649011.

[55] *Id.*

financial statements over several years prior to the merger. Since "[g]enerally, the preparation and publication of financial statements is a common and routine activity in the carrying on of a trade or business … the plaintiffs' claims … ha[d] their origin in the ongoing operation and conduct of Corp X's business."[56] The Service distinguished *Missouri Pacific* and *Berry Petroleum* because the claims in those class actions arose out of the defendants' acquisition of another corporation's stock from the target shareholders. In contrast, according to the facts in Letter Ruling 200649011, "the claim [was] based primarily on fraudulent information contained in financial documents published well before the merger and only republished as a consequence of the merger."[57]

Letter Ruling 200742004 was issued after the defendant settled a class action lawsuit brought by class members who alleged that the defendant made material misrepresentations that caused them to pay inflated prices for the defendant's stock and notes either in the open market or as the result of a securities offering. In the request for the letter ruling, the defendant maintained that "[a]ll of the alleged omissions and misrepresentations made in connection with any offering were also alleged to have occurred in financial reports and SEC filings, and none of the alleged press release omissions and misrepresentations were alleged to have occurred in connection with any of the offerings."[58] For this reason, the defendant/taxpayer stated "that each alleged omission or misrepresentation was alleged to have occurred in connection with Taxpayer's normal business activities of preparing and publishing financial reports, making SEC filings, or issuing press releases related to its business."[59] The Service agreed and again it distinguished *Missouri Pacific* and *Berry Petroleum.* Even though the class members all purchased the defendant's stock or notes pursuant to its offerings, the Service ruled that the settlement costs were deductible business expenses. The Service's reasoning is instructive:

> All of the allegations involve representations which are part of ordinary business activities – i.e., registration statements, financial reports, SEC filings, press releases. Pursuant to the origin of the claim, the transaction or activity from which the taxable event proximately resulted was to settle claims resulting from ordinary business activities. It is irrelevant that the settled claims had some connection to stock and note offerings or that one stock offering was immediately after and a result of a merger. Capital transactions were not the sine qua non of the allegations in the complaint. Rather, the alleged misrepresentations occurred in a number of reports, statements, filings etc. which were produced over a period of time as part of regular business

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[56] *Id.*

[57] *Id.*

[58] P.L.R. 200742004.

[59] *Id.*

> activities. The Complaint does not indicate that the allegations stemmed from any conduct by Taxpayer involving any acquisitive transaction or merger transactions. Rather the claims focus on alleged misrepresentations and omissions occurring over several years while in pursuit of ongoing business activities.[60]

Letter Ruling 200911002 involved a class action settlement of a suit that alleged violations of various securities laws that harmed purchasers of the defendant's stock. There were three claims.

"The first claim alleged violation of Section 10(b) of the Securities and Exchange Act of 1934 pursuant to Rule 10b-5 promulgated under that section and Section 20(a) of the same Act because Taxpayer's officers were controlling persons as to Taxpayer."[61] Noting that "this claim arose as a result of the publication of allegedly fraudulent financial information in various SEC documents concerning Taxpayer's revenues, earnings, profitability, and financial condition," the Service ruled that the settlement costs were deductible because "[g]enerally, the preparation and publication of financial statements is a common and routine activity in the carrying on of a trade or business."[62] Citing cases and a revenue ruling that did not involve a class action, the Service stated that "[b]oth the courts and the Service have allowed taxpayers to deduct the costs of settling and defending claims arising out of fraudulent misrepresentations made in the conduct of their trade or business."[63]

The second claim alleged that defendant violated Section 11 because its Prospectus Supplement contained materially false and misleading statements because it incorporated previously filed SEC reports that contained those statements. Under Section 11 registered security purchasers are allowed to sue when the registration statement includes false or misleading statements.[64] The Service's language approving a section 162 business deduction for settlement costs for this claim is also instructive.

> While the second claim is brought on behalf of purchasers of stock pursuant to a specific stock offering, the allegations involve representations which are part of ordinary business activities, i.e. the SEC filings in which the fraudulent statements occur. Therefore, pursuant to the origin of the claim, the transaction or activity from which the taxable event proximately resulted was to settle claims resulting from ordinary business activities. It is irrelevant that the settled claims had some connection to a stock offering. Rather, the alleged misrepresentations occurred in

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[60] *Id.*

[61] P.L.R. 200911002.

[62] *Id.*

[63] *Id.*

[64] The second claim also includes a violation of Section 15 of the Securities Act of 1933 which imposes derivative liability on those who control those who are liable under Section 11.

> a number of filings which were produced over a period of time as part of regular business activities. Accordingly, we believe that the second claim also arose in the ordinary conduct of the taxpayer's business. This is distinguishable from *Missouri Pacific, supra*, and *Berry Petroleum, supra*, in which the courts determined that the claims originated in the Taxpayers' acquisitions of targets' stock, rather than in their ordinary business operations.[65]

For their third claim, the class members alleged that when the defendant and its officers offered or sold securities using a Prospectus Supplement that included false statements of material facts or omitted statements that were necessary to make the statements in the supplement not misleading, they violated section 12(a) of the Securities Act of 1933. These false and misleading statements were also the result of incorporating previously filed SEC reports containing the misrepresentations and/or omissions in the Prospectus Supplement. This claim was dismissed by the court. Consistent with its ruling regarding the second claim, the Service ruled that "[t]he third claim, like the second claim, involved representations which are part of ordinary business activities, i.e. the SEC filings in which the fraudulent statements occur. Therefore, pursuant to the origin of the claim, the transaction or activity from which the taxable event proximately resulted was to settle claims resulting from ordinary business activities."[66]

Although a letter ruling cannot be cited or relied upon as precedent,[67] Letter Rulings 200649011, 200742004, and 200911002 suggest that the Service's position is that if a class action claim originates from routine business activities such as accounting irregularities when preparing financial statements that are incorporated into SEC filings and press releases, then settlement costs and associated litigation expenses are deductible as ordinary and necessary business expenses. Capitalization under section 263 is not required even if the class members purchased their shares as a result of offerings that included the misstatements since the claims originate from the defendant's routine business activities and not from the acquisition of the class members' shares. "It is irrelevant that the settled claims had some connection to stock and note offerings or that one stock offering was immediately after and a result of a merger. Capital transactions were not the sine qua non of the allegations in the complaint."[68] In contrast, in both *Missouri Pacific* and *Berry Petroleum*, where the courts required class action settlement costs to be capitalized, the cases were rooted in the defendant's acquisition of the class members' shares and thus, the settlement costs for the class action were viewed as part of the defendant's acquisition costs for the shares. Although the

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[65] *Id.*

[66] *Id.*

[67] I.R.C. § 6110(k)(3) (2006).

[68] P.L.R. 200742004.

line between deductible expenses and capitalized costs may sometimes be clear, usually determination of the origin of the claim and the correct tax consequences of a class action settlement is complex enough to warrant obtaining an opinion from a tax professional. Moreover, it is possible that settlement payouts in a single class action lawsuit could relate to both ordinary business transactions and capital transactions, and thus require a bifurcation of the deduction portion of the settlement from the nondeductible, capitalized portion.

D. *Fines and Penalties Paid to the Government*

Notwithstanding the fact that section 162(a) allows a deduction for business expenses, section 162(f) provides that "[n]o deduction shall be allowed under subsection (a) for any fine or similar penalty paid to a government for the violation of any law." Treasury Regulation section 1.162-21(b)(2) states "Compensatory damages … paid to a government do not constitute a fine or penalty."

While a full discussion of the deductibility of fines and penalties paid to the government is beyond the scope of this Article,[69] *Bailey v. Commissioner* directly addresses the application of section 162(f) to a payment made to a class of private litigants.[70] Bailey was an officer, director, and shareholder of Bestline Products, Inc. which was operated as a fraudulent pyramid sales scheme. In 1971, Bailey entered into a consent decree with the Federal Trade Commission in which he agreed to stop operating Bestline in a deceptive and fraudulent manner in violation of federal law. Six years later, the District Court for the Northern District of California determined that Bailey was still operating his business in a manner that violated the consent decree. Pursuant to 15 U.S.C. § 45(*l*), the court fined Bailey $1,036,000 for violating the consent decree. Bailey then requested that "his payment of the $1,036,000 fine be applied as restitution in a settlement of a multidistrict class action against Bestline and its officers pending in the United States District Court for the Southern District of Florida."[71] The California district court agreed to the transfer and wrote it its order that "'the ultimate disposition of these funds in no way shall alter their status as civil

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[69] *See, e.g.,* Allied-Signal Inc. v. Comm., T.C. Memo 1992-204, *aff'd* 54 F.3d 767 (3rd Cir. 1995) (holding that a company that paid an $8 million contribution to an environmental fund to reduce the criminal fine that it otherwise would have been assessed could not deduct the payment because it was still a penalty paid to the government and any purpose to benefit the general public was completely overshadowed by the fact that establishing the trust would reduce the fine imposed against the defendant); Technical Advice Memorandum 200502041 (advising that a settlement under the False Claims Act may consist of an amount that is deductible compensation paid to the government and an amount that is a nondeductible penalty); *see also* Jacob L. Todres, *Internal Revenue Code Section 162(f): An Analysis and its Application to Restitution Payments and Environmental Fines*, 99 Dick. L. Rev. 645 (1995); F. Philip Manns, Jr., *Internal Revenue Code Section 162(f): When Does the Payment of Damages to a Government Punish the Payor?*, 17 Va. Tax. Rev. 271 (1993).

[70] 756 F.2d 44 (6th Cir. 1985).

[71] *Id.* at 46; *see also* Piambino v. Bailey, 610 F.2d 1306, 1316 (5th Cir. 1980).

penalties' imposed under 15 U.S.C. § 45(*l*)."[72] When the tax matter reached the Tax Court, the court, in an unpublished opinion, disallowed Bailey's attempt to reduce his taxes based on the transfer of the payment of the fine to settle the class action. Bailey appealed and the Sixth Circuit affirmed holding that

> [t]he fact that the California district court, upon Bailey's application, permitted him to apply the $1,036,000 civil penalty toward the settlement of his potential liabilities in the multidistrict class action does not change the status of the payment as a civil penalty. The characterization of a payment for purposes of § 162(f) turns on the origin of the liability giving rise to it.[73]

Although fines and penalties paid to the government or redirected by court order to settle potential class action liabilities are not deductible, there may be situations were a complaint filed by the government is resolved with an amount set aside "to create a fund for future private civil claims for compensatory damages arising from the activities alleged in the complaint."[74] This was the situation in the SEC's settlement with Salomon Brothers in 1992.[75] According to the author who reported on this settlement, "[a] deduction for the $100 million paid into the claims fund is highly likely because those funds would clearly not be categorized as a penalty; rather, they are compensatory damages paid to investors."[76] Unfortunately, there is no reported case available to confirm this prediction.

Ultimately, whether a class action settlement yields deductions for the company depends upon a careful analysis of the claims and their origin. Before advice can be given regarding how to report the settlement costs on the company's tax return, consultations and discussions between defense counsel and the company's tax professional will need to occur so that the tax professional has a clear and complete understanding of the facts and laws creating any potential liability to the class and other motivations to settle.

IV.
Insurance: The Risk Transfer Alternative

A company that is entering into a claims-made settlement of a class action lawsuit has only two paths it can take when booking the settlement and preparing its tax return. First, it can adhere to current ASC 450, Form 8-K and other disclosure requirements and take

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[72] *Bailey*, 756 F.2d at 46.

[73] *Id.* at 47.

[74] Manns, *supra* note 69, at 320.

[75] *Id.* at 319-20.

[76] *Id.* at 322.

a GAAP charge for the full amount of the claims made settlement fund[77] and review the facts and circumstances of the settlement to determine the proper tax filing position.[78] This approach can cause shareholders (both present and prospective) to impugn the company's financial stability, which directly influences its capital reserves and operations. In addition, the tax consequence either further harms the company or opens an avenue for scrutiny by the Internal Revenue Service. Alternatively, the company can procure post-lawsuit risk transfer insurance coverage which effectively transfers the settlement liability from the company to the insurer.[79] Purchasing an insurance policy for a specific class action case can help minimize the economic, tax, and investor disapproval exposure and result in more benign financial disclosure as the net liability is represented by the paid and incurred insurance premium.

The specific accounting treatment of the settlement and the insurance touches on numerous provisions under GAAP and must be evaluated on a case by case basis. Generally, with respect to the financial reporting requirements under ASC 720, insured entities recognize a liability for the probable losses from incurred, but not reported claims and incidents if the loss is both probable and reasonably estimable.[80] There is no general rule that eliminates the liability, even if insurance is in place, unless certain requirements are met.[81] Once the insurance is in place, a company would normally continue to present the liability on its balance sheet, but also report an insurance receivable for claims that the insurance contract will pay. The practical effect of this accounting treatment is that the settlement liability is balanced against the insurance asset thereby mitigating the ultimate financial impact of the claims made settlement fund. Assuming the insurance covers 100 percent of the expected loss contingency, the balance sheet will contain both an asset and a liability in the same amount. The net impact on the income statement would be a charge for the cost of the insurance only, rather than the charge for the entire amount of the claims-made settlement fund.

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[77] *See, supra,* Part II.

[78] *See, supra,* Part III.

[79] CAMGA, http://www.classactionmga.com/index.html.

[80] Fin. Accounting Standards Bd., Accounting Standards Codification 720-20-25-14 (2009) [hereinafter ASC 720].

[81] It is possible, however, that the liability can be completely eliminated from the financial statements in certain situations. In order for the liability to be "derecognized" it must be extinguished by one of two means. First, the debtor can pay the creditor in full settlement of the obligation. Alternatively, the debtor can be legally released from being the primary obligor under the liability, either judicially or by the creditor. ASC 405-20-40-1. These stringent rules on derecognition must be carefully considered by the company and the outside auditors in determining the appropriate accounting treatment for class action settlement and the related insurance coverage.

It is not appropriate to directly offset prepaid insurance and receivables for expected recoveries from insurers against a recognized incurred but not reported liability or a liability incurred as a result of a past insurable event.[82] While at first blush it would seem that the liability and insurance receivable could offset and simply be eliminated from the statement, the fact that the liability has not been extinguished or legally released requires making the reader of the financial statements aware of the potential continuing obligation of the company in the event that the insurer is unwilling or unable to honor the insurance contract. Accounting guidance in specific industry arenas reinforces these general rules. For example, the health care specific standards provide that

> the ultimate costs of malpractice claims or similar contingent liabilities, which include costs associated with litigating or settling claims, shall be accrued when the incidents that give rise to the claims occur. The liability shall not be presented net of anticipated insurance recoveries. An entity that is indemnified for these liabilities shall recognize an insurance receivable at the same time that it recognizes the liability, measured on the same basis as the liability, subject to the need for a valuation allowance for uncollectible amounts.[83]

While insurance can be effectively used to eliminate or mitigate the GAAP charges arising out of the settlement, it may also circumvent the complicated issues regarding whether uninsured settlement costs are deductible business expenses, nondeductible capital expenditures, or nondeductible fines or penalties paid to the government even if the fine or penalty is ultimately distributed to class members. Under the terms of class action settlement insurance products currently being offered in the marketplace, the policies provide indemnity benefits for the take rate of the underlying settlement. The insurance premium for class action settlement insurance coverage should be tax deductible because it is an ordinary and necessary business expense under section 162(a) of the Code.[84] If the premium covers a settlement arising out of the defendant's acquisition of stock, the premium may be deductible as a business expense, rather than a nondeductible capital expenditure, if the premium is incurred to transfer settlement liability from the company to the insurer and prevent the potential for default on debt covenants, a downgrading of the company's debt rating, a substantial loss of investor capital or equity, and an uncertain cost of the ultimate settlement that the company is not able or willing to absorb.[85]

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[82] ASC 720-20-45-1.

[83] Fin. Accounting Standards Bd., Accounting Standards Codification 954-20-25-2 (2010).

[84] I.R.C. § 264(a)(1) which prohibits deduction of certain insurance premiums does not apply to class action settlement insurance premiums.

[85] *See* Ackerman, *supra* note 1, at 40.

It is important to distinguish the tax treatment of premiums that cover a risk of loss from the public policy considerations that may prohibit insurance coverage for a risk. Although, punitive damages may not be insurable,[86] punitive damages (unless they are fines or penalties paid to the government) are deductible.[87] Other than section 162(f) which prohibits deductions for fines and penalties paid to the government, section 162(c) which prohibits deductions for illegal bribes and kickbacks, and section 162(g) which prohibits deductions for the two-thirds treble damages in criminal proceedings involving violation of antitrust laws, there is no public policy limitation that applies to deducting ordinary and necessary business expenses, including punitive damages.[88]

Once again returning to Company X, assume the company does not want to take a charge for its $250 million contingency of a class action settlement fund or suffer the full negative impact of the settlement on its balance sheet. The repercussions associated with the GAAP charges and disclosures may result in a default on debt covenants, a downgrading of the company's debt rating, a substantial loss of investor capital or equity, and an uncertain cost of the ultimate settlement that the company is not able or willing to absorb. Depending on the nature of the case, Company X may be able to insure the contingent liability in a manner that, if structured properly, would cover the claim, and in exchange for a fixed premium effectively transfer the contingent liability from Company X's books to the insurer. The key is for the insurance policy to create a GAAP qualified risk transfer that covers the entire claim period and the full value of the settlement fund.

Assuming such a policy is in place, Company X can mitigate the negative impact of the settlement on its financial statements by booking the insurance receivable, or in some cases only reporting the fact that it has an insurance policy to cover the class action settlement. In either case, Company X's net charge to income would only be the cost of the insurance rather than the entire settlement judgment.

By illustration, if Company X can obtain a tax deductible class action settlement insurance premium at a cost of $50 million,[89] the effective after tax charge to earnings is actually

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[86] Lee R. Russ, 7 COUCH ON INSURANCE, § 101:28 (1995).

[87] Rev. Rul. 80-211, 1980-2 C.B. 57. *See* Kimberly A. Pace, *The Tax Deductibility of Punitive Damage Payments: Who Should Bear the Burden for Corporate Misconduct*?, 47 ALA. L. REV. 825 (1996) (arguing that for public policy reasons, Congress should enact a statute prohibiting business expense deductions for punitive damages).

[88] Reg. § 1.162-1(a). "A deduction for an expense paid or incurred after December 30, 1969, which would otherwise be allowable under section 162 shall not be denied on the grounds that allowance of such deduction would frustrate a sharply defined public policy." *Id.*

[89] This is an amount that is for illustration purposes only. The actual amount of premiums would be developed by the insurer after analysis of the actual claim and settlement options.

(assuming a 35% corporate tax rate[90]) $32.5 million. For most companies being able to obtain finality, certainty, and full tax deductibility is a far more preferable choice than taking a $250 million charge to the company's books during the pendency of the settlement claims process and bearing the full impact of the take rate risk.

V.
CONCLUSION

A company faced with a class action settlement must accept the variability of the class action suit and GAAP charges on its financial statements, or obtain class action settlement insurance coverage thereby limiting the company's exposure by fixing its loss to the amount of the insurance premium. Companies need to weigh carefully the financial and investor impact of the charge against earnings, the ultimate take rate risk, the issue of tax deductibility, and the certainty and finality of the insurance alternative in order to determine whether the purchase of insurance will provide the best option to mitigate the financial and tax impact of the class action settlement liability.

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[90] *See* I.R.C. § 11(b) (2006).

Opening Statements: Persuasive Advocacy Without Crossing the Line

Hon. Sanford M. Brook (Ret.)

I.
The Importance of Opening Statements

Ask any trial lawyer what his or her favorite part of a trial is—chances are few, if any, of them will tell you that it is opening statement. When compared to closing argument, there is a perception that opening statements are not very exciting (they do not generate the same adrenalin rush as getting up to deliver a closing argument) and little preparation is needed (you could deliver one in your sleep because there is no real skill required). If that is what you are thinking right now, keep reading—do not make the mistake of underestimating the importance of your opening statements. In fact, the opening statement is arguably the most critical part of any trial. Remember the adage: "You never get a second chance to make a first impression." It certainly applies to opening statements.[1] Commentary on opening statements has claimed that according to jury research, at least eighty percent of jurors make up their minds immediately after hearing opening statements.[2] While published controlled research studies that support this statistic are impossible locate,[3] jury researchers and consultants

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[1] James R. Lucas, *Opening Statement,* 13 U. Haw. L. Rev. 341, 351 (1991).

[2] Tom Riley, *The Opening Statement: Winning at the Outset*, 10 Am. J. Trial Advoc. 81, 82 (1979). "A study by the University of Chicago School of Law found that eighty percent of the time, the jury verdict on the liability question agreed with the jury's initial impression about liability after hearing the opening statement." *Id.*

[3] "For a short time in the mid-1950s, researchers at the University of Chicago were permitted to eavesdrop on several federal juries. But a subsequent congressional inquiry soon led to legislation prohibiting this." Stan V. Smith et al., *Jury Verdicts in Drunken Driving Cases,* 4 Rev. of L. & Econ. 475, 476 (2008) (citing Robert MacCoun, *Inside the Black Box: What Empirical Research Tells Us about Decisionmaking by Civil Juries* in Verdict: Assessing the Civil Jury System 137 (Robert E. Litan ed., 1993); *see also* 18 U.S.C. § 1508 (2006) (prohibiting eavesdropping on jury deliberations).

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advise, based on their observations and experience, that delivering a powerful and credible opening statement is critically important because many jurors do begin to form strong opinions very early on in a trial.[4]
According to one jury consultant,

> [a] recent study of mock juror decision-making at Cornell University showed that 85% of prospective jurors showed "pre-decisional bias" in their decision-making. That is, their interpretations of incoming evidence were biased to support the party they favored early on in the case. Further, the more confident a juror was in their early judgment of which party should prevail, the more bias they showed in interpreting subsequent evidence. General pro-plaintiff or pro-defense attitudes were also predictive of initial verdict leanings, despite the fact that they were instructed not to let their prior beliefs color their interpretations of evidence.[5]

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[4] "[M]any experienced trial lawyers contend, and the available empirical jury studies tend to confirm, that an opening statement is frequently the most critical stage in the trial of a lawsuit, as here the jury forms its first and often lasting impression of the case." Maleh v. Florida East Coast Properties, Inc., 491 So.2d 290, 291 (Fl. App. 1986) (citing Joseph R. Nolen, Trial Practice: Cases and Materials 55 (1981); James W. Jeans, Trial Advocacy § 8.2 (1975)); 75 AM. JUR. 2d *Trial* § 429 (1964).

[5] Harry J. Plotkin, *Open-minded? Jurors make decisions early on in trial, and once made, these decisions are very difficult for attorneys to change, studies have shown,* L.A. Daily Journal, Jan. 18, 2005, at 26; *see* Kurt A. Carlson & J. Edward Russo, *Biased Interpretation of Evidence by Mock Jurors,* 7 Journal of Experimental Psychology: Applied 91, 99-100 (2001).

According to the same jury consultant, "[e]mpirical evidence supports this finding; in our experience conducting mock trials over the past 26 months … we have found that only 12.4% of jurors change their verdicts between the conclusion of opening statements and the end of trial."[6]

Understanding that an opening statement is very important and deserves at least the same amount of preparation as closing argument, if not more, naturally leads to considering how to draft an effective opening statement. You have probably heard more than one person say that you must "tell a story" to the jurors in your opening statement. This is good advice, but it is not always as simple as it may sound. Jurors are human. They don't like gaps or holes in stories; it makes them puzzle over the missing pieces in order to try to make sense of what they are hearing. It is simple human nature to want to fill in those gaps and, if necessary, supply the missing parts of the story from one's own preconceived notions so that the story makes sense and is believable. Better that *you* tell a story in an opening statement, free of gaps, that lays out the case in a way that explains to the jury why you should win and why your adversary should lose.

It is also important to tell your story in an effective manner without engaging in objectionable argument. Finding the right balance for an opening statement is difficult. We are not allowed to argue, but we must persuade. We cannot characterize, but we must present the case in the light most favorable to our client. We cannot draw inferences, yet our goal is that when we sit down, the jurors conclude that our side of the case is the right side. We want the jury to understand our case in the simplest terms. Our objective is to sharpen the jurors' imaginations and have them say when we sit down, "I can't wait to hear your case, and I want to be for you." Through preparation, thought, and good advocacy skills, we can achieve the goal of presenting an effective and compelling opening statement.

This Article addresses the four principal subjects that must be considered prior to and during the delivery of opening statements. Part II discusses ethical considerations. Part III explains the goals that an attorney seeks to achieve with an effective opening statement. Part IV breaks down the "do's" and "don'ts" that must be remembered when formulating an effective opening statement and includes many examples of how these rules can be applied by defense counsel. Finally, Part V discusses whether and when to object during opposing counsel's opening statement.

II.
Ethical Considerations in Opening Statements

Opening statements are not mentioned specifically in the Model Rules of Professional Conduct, but there are a number of provisions that pertain to preparing an opening statement.

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6 Plotkin, *supra* note 5.

Rule 3.3: A lawyer "shall not knowingly make a false statement of material fact."

Rule 3.4(e)(1): A lawyer may not "allude to any matter that the lawyer does not reasonably believe is relevant or that will not be supported by admissible evidence." The lawyer must have an objectively reasonable belief: it is not sufficient that the lawyer hopes the evidence will be admitted, or believes there is a slim chance it will be admitted.

Rule 3.4(e)(2): A lawyer shall not "assert personal knowledge of facts in issue."

Rule 3.4(e)(3): A lawyer may not "state a personal opinion as to the justness of the cause, the credibility of a witness, the culpability of a civil litigant or the guilt or innocence of the accused."

Rule 3.4 also prohibits a lawyer from "knowingly disobey[ing] an obligation under the rules of a tribunal." Although it may sound rather vague, this provision is generally understood to apply when a lawyer intentionally includes in an opening statement anything the lawyer knows would violate legal guidelines. Consequently, a lawyer should not:

- engage in argument,
- appeal to sympathy or prejudice,
- discuss the law,
- exaggerate the evidence or statements of facts and issues outside the scope of the pleadings, or
- engage in attacks or negative comments on his or her opponent's case.[7]

Reversible errors and grounds for a mistrial during opening statement are much more likely in criminal trials than civil trials. Important constitutional rights are at stake and must be protected in criminal trials. In the civil arena, however, it is far more common to find that challenges to statements or conduct during an opening statement are "excused" under the harmless error doctrine. If the error does not undermine the fairness or validity of the trial, a new trial is not required.[8]

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[7] *See* RICHARD UNDERWOOD & WILLIAM FORTUNE, TRIAL ETHICS 309-16 (1988).
[8] FED. R. CIV. P. 61.

Although we all know that argument is not permitted during opening statement, it also is common knowledge that many courts allow trial counsel some latitude during opening statements. If you were to ask a group of trial lawyers how much argument is too much during opening statement, a lively discussion would probably ensue, and you would find a range of viewpoints. Commentators have asserted that "it is not *unethical* to [argue] unless argument violates a standing order of the tribunal. Because it is rarely clear when a statement of facts becomes argument, attorneys may legitimately press onward until halted by the court."[9] However, there is a line that cannot be crossed without consequences. As former United States Chief Justice Burger explained,

> [a]n opening statement has a narrow purpose and scope. It is to state what evidence will be presented, to make it easier for the jurors to understand what is to follow, and to relate parts of the evidence and testimony to the whole; it is not an occasion for argument. To make statements which will not or cannot be supported by proof is, if it relates to significant elements of the case, professional misconduct. Moreover, it is fundamentally unfair to an opposing party to allow an attorney, with the standing and prestige inherent in being an officer of the court, to present to the jury statements not susceptible of proof but intended to influence the jury in reaching a verdict.[10]

During the highly-publicized and controversial trial of Casey Marie Anthony,[11] the defense attorney made comments during opening statement that have been called into question and widely criticized as ethical violations. During his opening statement, Anthony's attorney told the jury that Anthony knew that her daughter Caylee never went missing, but instead had drowned in the family swimming pool. He also said that Anthony's father knew of the drowning and had sexually abused Anthony. However, during the trial itself, this evidence never materialized. Anthony did not testify and her attorney was left to try to support his claims through cross examination of her family members. Unanswered questions, which will likely never be answered, are whether Anthony's attorney knew when he made those remarks in his opening statement that Anthony would not take the stand or whether he had other admissible evidence to support his statements.

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9 Underwood & Fortune, *supra* note 7, at 315 (footnote omitted).

10 U.S. v. Dinitz, 424 U.S. 600, 612 (1976) (Berger, J., concurring).

11 William Morrow, Imperfect Justice: Prosecuting Casey Anthony (2011).

Setting aside for a moment the consequences of engaging in professional misconduct, there is another good reason to avoid argument during an opening statement: it is not the most effective means of establishing credibility and developing rapport with the jurors. Rather, introducing your side of the case to the jury through effective storytelling that relies on the facts to be presented enhances your credibility and your likeability.

III.
The Goals of Opening Statement

What, then, should we focus on accomplishing through our opening statement? There are a number of key goals to keep in mind. We expect to:

- introduce our theme,
- introduce our client in a subtly favorable manner,
- create favorable first impressions of our clients and ourselves,
- build rapport with the jury,
- define important terms and concepts,
- present an overview of the case in a story-telling fashion, and
- help the jury understand and focus on the key facts of our case.

Two simple tests help determine whether something should be said in an opening statement. First, apply the three-question test. Ask yourself the following questions when considering what to say in opening statement:

1. Will what I say be remembered?
2. Will what I say assist in understanding the factual issues?
3. Will what I say assist in setting the scene?

If a particular point will not be remembered, will not assist in understanding the factual issues, or will not assist in setting the scene, then you should not clutter up your opening statement with that point.

The second test we can use to critically assess an opening statement is the “fact test.” The fact test is used to determine whether a piece of data can be classified as “fact.” If a witness can say something on the witness stand, it is a fact and can be used in your opening statement. If a document or some other form of evidence provides information, then the information is a fact. Material that does not pass the fact test should not be included in opening statement.

Finally, remember that it is permissible for a defendant to reserve the opening statement until the beginning of the defendant's case-in-chief. As a general rule, however, this is not an advisable tactic because jurors develop a factual focus and begin to form impressions when they hear an opening statement. With this in mind, it is dangerous to defer your opening statement unless the trial will be brief. There may be other times when defense counsel determines that reserving the opening statement is tactically sound. However, even the most experienced trial lawyers find it impossible to predict what each juror's initial view might be. Thus, delaying an opening statement should only occur when defense counsel is certain that it will not have a prejudicial effect on how the jury will ultimately view or weigh the evidence.

IV.
The Do's and Don'ts of Opening Statements

Trial courts have broad discretion in dealing with the scope and content of opening statements.[12] The court's discretion should never be used as an excuse for a lackadaisical approach to preparing an opening statement. Instead, by heeding the following advice, counsel can deliver an opening statement that is interesting and persuasive while avoiding pitfalls that may cause a trial court judge to interrupt counsel's flow with warnings and admonitions.

A. *The Don'ts*

1. **Don't argue**.

Argument includes urging, comparing, characterizing, giving opinions, and drawing inferences. These are things that are only permitted in closing argument. Our tone of voice, if loud, may also lead to an objection during an opening statement, particularly when our tone of voice sounds like argument. A polished opening statement is not argumentative; it is persuasive because it is the truth.

2. **Don't use a table of characters.**

Opening statements that use a table of characters sound like a stereotypical Russian novel and, they are difficult for listeners to follow. Keep in mind that the jury does not know your witnesses yet, so telling them who is going to testify is not helpful. Do not mention a

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[12] *See, e.g.,* Cox v. Treadway, 75 F.3d 230, 237 (6th Cir. 1996).

> Appellate courts review a district judge's conduct of a trial, including the conduct of opening statement, for abuse of discretion. A district court's supervisory powers over opening statements include the power to interrupt counsel who is presenting argument during opening. An abuse of discretion has been found only in rare cases, such as where the judge interrupted the proceedings more than 250 times. The trial court's conduct in this case was a legitimate attempt to control opening statements and did not deny appellants a fair trial.

Id. (citations omitted).

defense witness whose testimony does tell the story or set the scene. Also, do not present a witness-by-witness synopsis. For example, when defending an employment case avoid an opening statement that sounds like this:

> "Helen Roberts will explain the hiring process at my client's company. After that, Sam Smith will testify about the day the plaintiff was hired. I will then call Millie Miller to the stand and she will testify that she was the plaintiff's immediate supervisor. Ms. Miller will also describe the numerous times when she warned the plaintiff that her behavior on the plant floor was creating a safety issue for the other employees. Next I will call, Allen Cartwright, Barbara Bennington, Carla Coates, and Tony Hill to the stand. They were the plaintiff's co-workers. They will testify as to how each of them had problems getting along with the plaintiff. Finally, Yolanda Yates will testify regarding the exit interview she had with the plaintiff the day she was fired."

A rendition of who will testify and what they will say wastes time and probably will bore the jury. Instead, tell the jury the story they will know when all of your witnesses have finished testifying.

3. **Don't give a course in trial procedure.**

Opening statements are often compared to a road map or a table of contents. Examples of this technique include such phrases as:

- An opening statement is only a preview of what the evidence will show.
- The opening statement is a road map of where the case will go.

Avoid using this analogy when conceptualizing an opening statement. During opening statements, time is too precious to explain or discuss direct and cross examinations, instructions, and closing arguments. Instead, use the opening statement as a key opportunity to capture the attention of the jury and emphasize any important facts that the jurors might not remember during deliberations. Use the opening statement to help jurors understand the factual issues and visualize the scene.

4. **Don't give a disclaimer of credibility.**

Some lawyers still say, "Members of the jury, an opening statement is not evidence; it is only what we believe the evidence will show. And so you shouldn't treat it as evidence." When jurors hear this, they may stop listening. At a minimum, some jurors will attach less importance to the rest of what you say during your opening statement. Moreover, if you are concerned that something you say during your opening statement might be construed as evidence, it is time to consider whether commenting that an opening statement is not

evidence opens the door for opposing counsel to argue for the admission of evidence that the jury can construe in a light that does not favor your client.[13]

5. **Don't overuse the phrase "The evidence will show."**

When an attorney says "The evidence will show" in opening statements, he or she is probably trying to avoid an objection from opposing counsel. This phrase does not function as a shield from objections and it is neither necessary nor desirable to use it. If counsel used the "fact test" (if a witness can say it, or if a document or other piece of evidence will prove it, it is fact) to tell the client's story and set the scene, then what is said in the opening statement is permissible. Prefacing factual statements with "The evidence will show" is unnecessary. It is analogous to announcing during cross examination, "I am now going to impeach the witness."

6. **Don't mention evidence if you are uncertain that it will be admitted.**

Every good lawyer listens to what the other side says during opening statement. If opposing counsel says something that does not come out in evidence, then good lawyers know exactly what to do. During closing argument, they remind the jury of what opposing counsel said during her opening statements: "She told us in her opening statement that she was going to prove this, this, and this, but you did not hear *any* testimony or see *any* documents that proved those points."

One court recently discussed an improper opening statement by the city's attorney in an action against City of Chicago police officers for alleged misconduct in a rape prosecution. The court stated that it was "most troubled by the City's attorney's numerous references to evidence that [the attorney had been] warned was not guaranteed would be admitted."[14] The City's attorney "threw caution to the wind" and throughout opening statement referred extensively to that evidence. Ultimately portions of it were not admitted. In all, nearly twenty objections were sustained during the "entirely inappropriate" opening statement.[15] The trial court "admonished the City's attorney that he needed to refrain from improper argument and stick to the facts of the case,"[16] and "warned the City's attorney that he needed to be careful with what he was promising the jury, and cautioned that it would be problematic if there was not evidence to support what he was saying."[17] These warnings and admonitions

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[13] *See* U.S. v. Moore, 98 F.3d 347, 350 (8th Cir. 1996) (where defense counsel asserted in opening statement that defendant was simply "the wrong man at the wrong time at the wrong place" and this assertion put defendant's intent at issue and opened the door to admission of evidence of motive and intent under Rule 404(b)(2) of the Federal Rules of Evidence).

[14] Walden v. City of Chicago, 846 F. Supp. 2d 963, 977 (N.D. Ill. 2012).

[15] *Id.* at 978 n. 6.

[16] *Id.*

[17] *Id.*

probably undercut the effectiveness of the City attorney's opening statement, but they were not so prejudicial as to warrant a new trial.[18] This case should not be considered a "green light" for objectionable opening statements. Take the high ground and follow the Supreme Court's admonition that "[a]n improper opening statement unquestionably tends to frustrate the public interest in having a just judgment reached by an impartial tribunal."[19]

Do not say anything during your opening statement that you are not sure you can prove with evidence during the trial. Also, avoid using phrases that reflect uncertainty, such as: "We think," "We hope to prove," "We believe," "It is our expectation," "If you hear this, then you may hear that." It is far better to err on the side of understating, rather than over promising evidence that the jurors might not hear during the trial. Your credibility will be enhanced, rather than undercut, if you follow this practice.

7. **Don't engage in prohibited conduct.**

At first blush we are likely to think, "Of course I would never do anything in opening statement that is prohibited." But, do you know what prohibited conduct is? Even though some types of prohibited conduct should be obvious, a few key things listed below should never occur during an opening statement.

- Never state your personal belief about your client's case. Likewise, do not attempt to put the jurors in your client's shoes.[20] These types of statements are not only prohibited, it is also unethical to say them. Several examples are:

  "Members of the jury, imagine that you were as careful as possible, but you got sued anyway."

  "If you were in my client's position, you would have done the same thing."

  "If you were in my client's shoes, as a buyer, you too would have refused to honor the contract once the seller disavowed the promises he made."

- It may be overstating the obvious but never touch upon the subject of a motion *in limine* if the court has either granted the motion or reserved ruling on it.[21]

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[18] Walden v. City of Chicago, 846 F. Supp. 2d 963, 977-78 (N.D. Ill. 2012).

[19] Arizona v. Washington, 434 U.S. 497, 512-13 (1978).

[20] U.S. v. Taylor, 514 F.3d 1092, 1095 (10th Cir. 2008).

[21] *See, e.g.*, LaPlace-Bayard v. Batlle, 295 F.3d 157, 164 (1st Cir. 2002).

> At the time that plaintiffs gave their opening statement, they knew that the court had not yet ruled on [defendant's] motion to exclude [a medical expert's] testimony. Well aware of that pending *in limine* motion, plaintiffs proceeded at their peril in promising the jury testimony from more than one expert. Having made that choice, plaintiffs cannot expect … to be relieved of the consequences of their own judgment call.

Id.

In the same vein, never refer to any evidence that has been excluded during pretrial proceedings.

- Never make statements that cannot be supported by evidence.

8. **Don't make admissions that bind your client.**

A statement made by counsel during his or her opening can be considered a judicial admission that is binding on the client.[22] A judicial admission is a clear and unambiguous statement of fact made during trial that concedes an element of a claim or defense.[23] Usually, judicial admissions during opening statements are inadvertent. Obviously, a lawyer would not intentionally make an admission that would bind a client or foreclose introducing evidence on a particular issue or defense. But, if the statement made by counsel is a clear and unambiguous statement of fact, it is conclusive and no further evidence will be considered regarding the element or defense that has been judicially admitted.[24]

Sans v. Monticello Insurance Company[25] is a good example of a statement that could have been considered a judicial admission that conceded an element of a defense. In *Sans,* the insurer brought a declaratory judgment action to establish that it had no duty to defend or indemnify its insured for a claim that arose when a bartender shot an unruly patron at the insured's bar.[26] During opening statements, the attorney for the insurer said, "Because this is a declaratory judgment action about an insurance contract, the sole issue is whether or not there is insurance coverage. This is an unfortunate *accident*, an unfortunate situation, and it's tragic; but we don't need to belabor the point."[27] Counsel for the bar owner argued that when defense counsel characterized the bar shooting as an "accident," he conceded that the shooting was an occurrence covered by the policy. The court, however, took note that counsel swiftly corrected this slip of the tongue and called the shooting a "situation." As a result, the court concluded that defense counsel could not have intended to concede the central issue in the case when he inadvertently used the word "accident" in his opening statement. In fact, the court chastised the insured's counsel, characterizing his argument as

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[22] Oscanyan v. Winchester Repeating Arms Co., 103 U.S. 261, 263 (1881); *see, e.g.,* U.S. v. Alvarez-Becerra, 33 Fed. App'x 403, 406-07 (10th Cir. 2002).

[23] *See* Keller v. U.S., 58 F.3d 1194, n.8 (7th Cir. 1995) (explaining the difference between judicial admissions that are conclusive and evidentiary admissions which may be refuted and weighed by the jury); Mills v. Redington, 736 S.W.2d 522, 525 (Mo. App. 1987) (where counsel for doctor in malpractice action stated that doctor had recommended hospitalization, statement did not concede liability for plaintiff's injuries nor was it a judicial admission on the appropriate standard of care).

[24] *Alvarez-Becerra*, 33 Fed. App'x at 406-07.

[25] 718 N.E.2d 814 (Ind. App.1999).

[26] *Id.* at 816-17.

[27] *Id.* at 816 n.3 (emphasis added) (internal quotation marks omitted).

"not only unpersuasive, but also disingenuous and misleading."[28] Fortunately for the insurer, the court held that "[a]ny claim that this was a clear and unequivocal admission of fact [was] meritless."[29]

Because an admission by a lawyer during opening statement can bind his or her client, it is not only essential to never make such admissions, but it is just as important to listen for an admission made by opposing counsel, and to be prepared to take advantage of it. Our trial notebooks should include citations to cases discussing judicial admissions.[30] Having these citations at your fingertips could be important if your opponent's opening statement includes a clear and unambiguous statement of fact that concedes your defense to the plaintiff's claim.

9. **Don't appeal to passion or prejudice.**

The principles of effective communication are "hear," "believe," and "remember." Listeners must hear what we say, believe what we say, and remember what we say. For example, suppose a lawyer said the following during opening statements: "He bought the car for the same reason we would buy the car – the advertisement claimed it was the safest car on the market. Now, his widow sits here wondering why: Why did the car roll over? Why did her husband die? Why do her kids now have to grow up without a father? Don't turn your eyes away, look at her pain." This appeal to passion and prejudice overstates the case and makes it difficult for the jury to believe the speaker. We are not street hawkers or carnival hucksters. We are lawyers, and we have a concern for imparting the truth by using persuasive techniques and good communication skills.

10. **Don't play off the other side's opening.**

Counsel for the plaintiff should not speculate as to what defense counsel is going to say and should not comment upon it. Likewise, defense counsel should not comment on what the plaintiff's attorney just said in his or her opening statement. Commenting on the other side's opening gets close to argument and may lead to comparisons, characterizations, or inferences that are impermissible in an opening statement. In addition, when we play off the other side's opening, jurors may think that we are actually giving credence to what the other side has just said. If so, we have undermined our effectiveness as an advocate.

11. **Don't discuss the law.**

Law, which is often subject to interpretation, has no business being discussed in an opening statement. In fact, it is impermissible. First, law is notoriously difficult to understand. Imagine a jury trying to interpret what a lawyer means if he or she states the following in an opening statement:

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[28] *Id.*
[29] *Id.*
[30] *See, e.g.,* Walters v. Wal-Mart Stores Inc., 748 A.2d 961, 966-67 (Me. 2000).

> "You have probably wondered why Sue Smith is the defendant when her friend, Jenny Carnes, was the driver of the car that collided with my client. Well, this state has a law that states: 'It shall be unlawful for any person having any vehicle in his custody to cause or knowingly permit any person to drive such a motor vehicle upon the public highways unless such person shall have first obtained a license or permit.'"

Moreover, there is always the possibility that a judge will decline a request to instruct the jury on a particular law. If that occurs, the lawyer who discussed the law during opening statements loses credibility and may even seem incompetent. Thus, the law and how it should be interpreted have no place in opening statements.

B. *The Do's*

1. **Give the jury a theme.**

The theme may start in voir dire examination, but you must address it during opening statement. The theme weaves throughout the case and it is tied together in closing argument. The theme is a group of words (not necessarily a sentence) that captures the jurors' attention while communicating what the case is about. For example:

- The contract controls.
- A design doomed to fail.
- The covenant was clear.
- A failure to communicate/A failure to resuscitate.

Your theme should appeal to higher values that will motivate the jury to support the defense side of the case, such as "personal responsibility" or "reaping the benefits of hard work."[31] Resist the urge to merely attack your opponent's narrative by "discrediting the plaintiff or shooting holes in causation theory."[32] Use a "positive theory that demonstrates why a defense verdict is fair and just."[33]

2. **Tell your story.**[34]

State the facts in a story-like fashion. Telling a story is the best way to keep the jury's attention. During the opening statement the jurors begin to form their factual focus and visual

[31] Paulette Robinette, Ph.D, *An Overview of Juror Perceptions of Witnesses and How to Prepare Witnesses to Properly Convey a Trial Story*, 60 Fed'n Def. & Corp. Couns. Q.133, 138 (2010).
[32] *Id.*
[33] *Id.*
[34] Martha Alderson, *Effective Use of Plot to Convey a Corporate Client's Story,* 60 Fed'n Def. & Corp. Couns. Q. 127 (2010).

images of what took place. Again, return to the keys to good communication: the jury must "hear," "believe," and "remember" what we say. We can make this happen by presenting the opening statement in a story-like fashion.

When telling the jury a story, take the jury to the scene and make them "see the facts." The following is an effective example:

> "Let's go back to that day in early June. We are standing at the intersection of Wayne and Michigan Streets. We watch as the traffic signal turns green for the northbound traffic on Michigan Street. We turn to see a pick-up truck traveling very fast in a westbound direction on Wayne Street. Immediately we think "the pick-up truck is going to run the red light." We glance to Michigan Street and see a school bus entering the intersection, going north on Michigan. We stand frozen in time as the truck runs the red light and crashes into the side of the school bus."

When using storytelling, be sure not to "back in and out" of the scene. Keep the jurors at the scene throughout as much of the opening statement as possible. Using present tense is also effective in keeping the scene alive for the jurors.

When dealing with a weakness in an opening statement, the desired result can be achieved by using positive terms in a story-like fashion.[35] The following is an example:

> "Bobby Taylor, the controller of T.D. Brannon Corporation, asked that delivery be delayed for three months and the Plaintiff agreed. Bobby will tell you he made a mistake by not confirming this in writing. But, he will also tell you that neither party treated this as an attempt to breach the contract."

3. **Diffuse the sense of injustice created by the plaintiff's attorney.**

Following a dynamic opening statement by plaintiff's counsel, the jurors may think that "[a]n evil villain harmed an innocent, or at least undeserving, victim and escaped without penalty; that is, the villain escaped until justice was placed in the hands of good citizens who are empowered to correct the injustice using the defendant's pocketbook."[36] Defense counsel now has the daunting prospect of convincing jurors that by doing nothing, they will be achieving a just outcome. Defense counsel may be tempted to negate the plaintiff's story point by point. However, "adopt[ing] an affirmative case theory that replaces a plaintiff's melodrama"[37] is a much better strategy. Give the jurors a reason to be for the defendant. To successfully deal with this challenge, throw off the constraints of conventional thinking and take unique approaches to presentation.

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[35] *See* Robinette, *supra* note 27, at 137-38.

[36] *Id.* at 133.

4. **Personalize your client.**

During your opening statements make sure that the jury gets to know your client as well as the witness or witnesses who will testify as corporate designees.[38] Look at all the situations that are positive for your client, such as family life, education, work background, the good work of a company, and even what your client does for the community. Introduce the jury to your client in such a manner that they will like your client, regardless of the issues of the case. To sell the theory of your case and the law upon which you are relying, you must first sell your client. This is especially important when your client is a corporation rather than an individual. Don't be put off by the fact that your client is a multi-billion dollar corporation, the Goliath of all Goliaths. Bring it down to the local level to the extent possible and permissible, perhaps through reference to an annual event in the community that the corporation sponsors or the number of people that the client employs in the local community. Remember to emphasize the "motives and behaviors of individual actors who played a role in the case on a micro scale."[39] Show that the corporate witnesses are "good people who exercised their best judgment under the circumstances."[40]

5. **Keep it simple.**

Use words that are understandable. Avoid using words such as "subsequent," "prior," "observation," "proceed," "ramification," "vehicle," or "surveillance." People on the street do not talk that way and we should not speak like that when giving an opening statement. Imagine the expressions of jurors if they heard the following during the opening of a highway construction case:

> "The clear opinion of a plethora of highway structural engineers is that the pitch of the incline effectuated an ingress and egress design sufficiently acceptable to satisfy industrial standards as set forth in the Highway Safety Manual published by AASHTO."

6. **Give only those details that lend authenticity to your opening statement.**

Consider whether the details in your opening statement are really necessary. For example, will the jury care that the defendant lives at particular address, in a particular county, or that the tires on his truck had less than 5,000 miles on them at the time of the accident? Instead of giving unnecessary details use teasers as a communication technique: provide just enough information to "tease" the jury and create an interest in how your client's story will unfold at trial. Here is an example:

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[37] *Id.*

[38] *See* Larry E. Hepler, *Rule 30(b)(6) and the Crisis Client*, 60 Fed'n Def. & Corp. Couns. Q. 143 (2010).

[39] Robinette, *supra* note 27, at 137.

[40] *Id.*

> "A hydraulic engineering expert will tell you what she found when she tested the torque on the valve. She will also tell you that achieving the required amount of torque isn't an exact science. It is matter of judgment that develops over time."

7. **Start strong; end strong.**

The concepts of primacy and recency[41] are important to opening statements: primacy – that which is heard first is likely to be believed; recency – that which is heard last is easiest to remember. Therefore, the first words out of our mouth set the tone for the opening statement. It is unnecessary to reintroduce yourself. There is no need to remind the jury who you represent. And, do not thank the jury before you start. After all, they have not done anything yet.

If the plaintiff has just attempted to smear the defendant and characterize the company as an uncaring predator, the first words of defense counsel's opening statement might be:

> "Our company employs more people in this county than any other employer. The success of our business depends upon the people of this town. We need them. We value them. We care about them."

These words counteract the recency of the plaintiff's opening statement with the primacy of defense counsel's opening statement. If the case involves other defendants and will be lengthy, defense counsel's opening statement might end like this:

> "My client is relying on you to be fair and impartial. Listen to all of the evidence, especially what the witnesses say on cross-examination. Do not make up your mind until you have heard everything. When you finally hear our witnesses testify, you will know who is responsible for the plaintiff's injury and you will understand why it is not my client."

If the final words are most easily remembered, make them count.

8. **Use action words, but be prepared to diffuse them if they help your opponent.**

Action phrases can bring a case to life: The plaintiff heard the tires screech and the horns blaring, but she did not heed their obvious warning. Impatient and in a hurry, the plaintiff drove carelessly into an accident that she could have easily avoided. Action words are fact words, not conclusive words. Words with impact are "smashed" instead of "hit," "shrieked" instead of "yelled," "huge" instead of "large," "fear" instead of "scared," and "anger" instead of "mad."

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[41] *See* Kristi A. Costabile & Stanley B. Klein, *Finishing Strong: Recency Effects in Juror Judgments*, 27 BASIC AND APPLIED SOCIAL PSYCHOLOGY 47, 56 (2005).

From a defense perspective, action words need to be chosen with care. To establish and maintain the defendant's credibility, it may be wise to choose a descriptive, accurate word that will diffuse or call attention to the plaintiff's counsel's exaggerations. For example, if counsel for the plaintiff uses the word "huge," consider whether it is more credible to refute the assertion with the word "small," rather than the word "tiny."

9. **Tell the jury what you want.**

Doing an opening statement in a civil case with potentially large damages can be extremely difficult. It is hard to face the jurors, look them in the eye, and say, "Even though the plaintiff was injured, she deserves nothing." We must use our creativity and let the jury know what they should decide without sounding harsh or uncaring. Here is an example of how defense counsel may want to address damages in a case where liability is disputed:

> "Members of the jury, you have heard Nancy Miller's attorney ask you for $8 million for the loss of her leg. I truly sympathize with her loss, but our evidence will convince you that Dr. Robbins' diagnosis of Ms. Miller's condition was based on the medical history Ms. Miller provided to him. If Ms. Miller had been more forthcoming, we would not be here today. Ms. Miller was the architect of her own suffering and she is not entitled to receive anything from Dr. Robbins."

If liability is clear, but total damages are in dispute, the plaintiff's lawyer will try to accustom the jurors to hearing big figure monetary amounts. For example, if the damages are between $1.5 and $2 million, plaintiff's counsel will say, "The plaintiff's damages will total nearly $2,000,000" instead of saying "The plaintiff's damages will be more than $1,500,000." Defense counsel must counter this strategy by asking the jury to follow the law and use the evidence to determine how much to award the plaintiff. In certain cases, defense counsel should suggest a specific sum and explain why it is more than enough to compensate the plaintiff for her loss, while also being fair to the defendant.

10. **Be cognizant of the burden of boredom.**

During the opening statement, make eye contact with the jurors. Be sure to move along the entire length of the jury box during opening and pay attention to each of the jurors. If the court requires counsel to use a podium during opening statement, ask the judge for permission to deliver part of your comments from the side of the podium or from the front of the podium. Make this request before opening statements begin and outside the presence of the jury.

If you believe jurors are bored and not listening, then the time has come to sit down. Boredom often sets in during an opening statements because it is too long or too detailed. Just because the judge allows an hour for your opening statements does not mean you must use the entire hour. Use only enough time to tell your story, to set the scene, to get the point across, and to convey a sense of what is just; complete these tasks without boring the jury.

11. **Make yourself credible.**

The first lesson in being credible is knowing your case. The second lesson is to show enthusiasm for your case and appropriate compassion toward those who deserve it. The third lesson brings together many of the concepts already discussed. Simply stated, communicate in such a way that the jurors will like you and your client.

Make eye contact with each juror, but avoid invading the jurors' space – this means stay at least five feet from the front of the jury box during an opening statement. When possible, leave your notes, pens, and pencils on the table. Try not to have anything distracting in your hands. Make certain that keys or loose change in your pockets do not distract the jurors. Keep the jurors' attention focused on what you have to say.

In addition, never put both hands in your pockets at the same time and avoid the defensive posture of folding your arms across your chest. Your hands play a major role in establishing and improving credibility. Use them so that your palms are up; gesture affirmatively with them.

12. **Use exhibits during opening statement.**

People retain a much larger percentage of what they see than what they hear. "Studies have shown that juries remember 85 percent of what they see as opposed to only 15 percent of what they hear."[42] Charts, props, or a blackboard may be used during opening statements for illustration.[43] If a piece of evidence is going to help set the scene, use it in opening statement.

Potential exhibits can be used during an opening statement if they satisfy the following requirements:[44]

1. Counsel must have a good faith expectation that the exhibit will be admitted into evidence;[45]
2. The exhibit must be relevant;[46]
3. The exhibit must not be prejudicial or inflammatory;[47]
4. Counsel must have a good faith basis that authentication will occur.[48]

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[42] I. Neel Chatterjee, *Admitting Computer Animations: More Caution and New Approach Are Needed*, 62 Def. Couns. J. 36, 43 (1995) (citing Robert F. Seltzer, Effective Communication: Seeing Is Believing, 381 PLI/Litig. 367, 368 (1988); Robert F. Seltzer, Evidence and Exhibits at Trial, 387 PLI/Litig. 371, 372 (1988)).

[43] Lucas, *supra* note 1, at 354; 4-County Elec. Power Ass'n v. Clardy, 73 So. 2d 144, 151 (Miss. 1954); Coats v. State, 141 S.W. 197, 201 (Ark. 1911).

[44] *See* People v. Harmon, 284 P.3d 124, 129-30 (2011) (holding that the trial court did not abuse its discretion in permitting the prosecutor to display photograph of victim during opening statements).

[45] Model Rules of Prof'l Conduct R. 3.4(e)(2).

[46] Fed. R. Evid. 401.

[47] Fed. R. Evid. 403.

[48] Fed. R. Evid. 901.

Although there is no requirement (unless local rules provide otherwise) that you let the judge and opposing counsel know that you are planning to use exhibits during your opening statement, it is considered common courtesy to notify them of your plans.

V.
OBJECTIONS DURING OPENING STATEMENTS

As a general proposition, use objections sparingly and only object to the other side's opening or to portions of that opening when good reason so demands. Object when something improper is said and that something hurts your client. If the other side does something improper during opening statement, but it does not hurt your client, do not object. It makes no sense to simply bore the jury with your knowledge of the rules by pointing out the impropriety of opposing counsel's statements. Moreover, objections may also cause a juror to believe that your client is attempting to keep something from being heard by the jury. Jurors may also view an attorney who objects during opening statements as someone who is engaged in personal attacks on opposing counsel. For these reasons, assess whether what opposing counsel said will hurt your client's case and, if not, do not object.

The most frequent reason for an objection during the opening occurs when an argument goes on and on. A second principal reason for objection occurs when conclusions of law are being drawn. A third reason to object exists when a court order is violated. For instance, if the court has granted a motion *in limine* forbidding the use of certain items or forbidding mentioning certain topics, and then opposing counsel defies that order, we should object. Finally, object if opposing counsel attempts to have the jury "stand in the shoes" of her client.

VI.
CONCLUSION

By keeping in mind the "Do's" and "Don'ts" suggested in this Article, you can be an effective advocate for your client from the very beginning of the trial. You can craft an opening statement that is credible, and you can begin to establish yourself with the jurors as someone whom they can trust and respect. Certainly, an opening statement is but one piece of the trial, and it is important to follow through by providing the jury with witnesses and evidence to back up the statements you made to them in your opening statement. If you thoughtfully chart the course in your opening statement and help the jury understand what it is that they need to know, and why they should want to rule in favor of your client, you can and will be a vigorous and effective advocate for your client.

The Emperor's New Clothes and Cyber Insurance

A Few Questions Go a Long Way When Evaluating the "Bare" Essentials of a New Product Amidst a New and Dangerous Risk

Michael T. Glascott
Aaron J. Aisen

I.
Illusions About Cyber Risks, Cyber Security, and Cyber Insurance Coverage: The Parallel to *The Emperor's New Clothes*

The Danish storyteller Hans Christian Andersen told the story of a vain and foolish emperor duped by an illusion.[1] Two tailors came to town and offered to make the emperor a set of clothes of the finest quality; however, the tailors told the emperor, the clothes were invisible and could only be seen by the wise. The emperor liked the idea of being able to distinguish which of his subjects were wise, so he instructed the tailors to make the clothes. At first, the emperor felt awkward about the invisible suit, but not wanting to appear foolish, he claimed he could see the clothes and, for the same reason, so did his wife and his servants. Each wanted to avoid appearing foolish.[2]

The emperor wore his new clothes on parade before his subjects and, having heard that only the wise could see the clothes, all of them pretended to see the clothes. The illusion created by the tailors continued until a young boy, unaware of the need to appear wise, cried out that the king was naked. And so, the willingness to embrace an illusion resulted in embarrassment to the king and his subjects.[3]

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1 Hans Christian Andersen, *The Emperor's* New *Clothes*, Project Gutenberg's Andersen's Fairy Tales (last updated Jan. 26, 2013), http://www.gutenberg.org/files/1597/1597-h/1597-h.htm#link2H_4_0001.

2 *Id.*

3 *Id.*

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As society has become more reliant on technology when conducting business, the amount of personal and proprietary information that third parties possess has increased considerably. Information that companies store digitally is vulnerable to data breaches by both malicious hackers and careless employees. The costs associated with these breaches can be staggering. Insurers responded to this new risk by offering cyber insurance products that specifically cover the risk of loss from data breaches and other cyber attacks. Cyber insurance products were also developed to provide coverage for the gap inherent in Commercial General Liability (CGL) policies for damage which is not tangible, along with the peripheral costs caused by cyber security breaches.

Many insurers entered the new cyber insurance market without conducting a systemic evaluation of the unique risk posed by each insured. Had they conducted an adequate evaluation, insurers would have asked effective questions and performed their due diligence. Using this information, underwriters would have been able to accurately assess the nature and extent of the risks being insured. Also, insurers would have been able to explain to their insureds how much insurance they should carry in order to avoid risking an unanticipated exhaustion of policy limits.

Because cyber insurance buyers and sellers both lack correct and adequate information regarding what they are getting in this new market, an information gap exists which creates the very conditions needed for a market based on illusions. Insurers, mesmerized by the allure of the new market, rushed to issue new cyber coverage products. That illusion was fortified by the fact that the market for cyber insurance products seemed extremely lucrative because by all appearances there was significant growth in what seemed to be a robust market. These insurers may be headed down a slippery slope fraught with catastrophic losses not anticipated by the underwriting process. On the demand side, potential cyber insurance customers have their own illusions. Some potential customers do not see cyber security as

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an issue that they need to address with a two-fold strategy: an adequate cyber security plan and adequate insurance in the event that a security breach occurs. These businesses may soon be faced with uninsured (or underinsured) losses from data breaches. Other businesses place too much faith in the cyber insurance they purchased. They think that if they have cyber insurance they can do little or nothing more to mitigate the risk of a data breach. Unfortunately, they may learn that relying exclusively on the policy proceeds as the primary tool in their proverbial cyber tool bag will turn out to be unwise because there is still so much uncertainty and confusion regarding the full extent of cyber risks and the type and extent of the risks covered by different policies.

Reality may be replacing illusions as new notification laws and regulations are forcing organizations to rethink their old policies of self-insuring breaches.[4] One example of these notification requirements is the new Securities and Exchange Commission (SEC) reporting requirements for publicly traded companies on their data security.[5] Insurers and insureds

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[4] Matt Dunning, SEC Guidelines Drive Renewed Interest in Cyber Risk Insurance Coverage, BUSINESS INSURANCE (June 8, 2012 3:20 pm), http://www.businessinsurance.com/article/20120608/NEWS07/120609886 (last visited July 19, 2013).

[5] *Id.*

are discovering that the costs associated with a data breach are high, especially costs related to notifying affected consumers, legal expenses, and settlements.[6] In reality, these actual costs may be greater than reported because even though incidents of data breach are not new, experts think that cyber attacks have been under-reported due to the embarrassment and costs associated with notifying customers.[7]

Comprehensive underwriting standards for evaluating cyber risks are not available yet. Until the standards exist, determining the appropriate cost of coverage is seriously impeded. Because the nature and extent of the risk to be covered can vary significantly, insurers may not be able to fully comprehend the nature or extent of the risks they are underwriting and industry standards for adequate insurance coverage also may be underdeveloped. Unfortunately, companies that choose to forego cyber insurance coverage may be naïvely relying on inadequate data security measures or a false belief that a general CGL policy provides sufficient coverage. Those companies risk discovering that their security measures are inadequate and that their general liability policy does not cover their losses at all or that the coverage is inadequate.

Cyber coverage may well be the emperor's new clothes for both insurance companies and potential insureds if appropriate questions are not asked at the underwriting phase or, in the first instance, at the time a potential insured considers whether to purchase coverage. A lack of understanding as to the insured's security prevention or the insured's coverage needs could give rise to an unwelcome surprise for insurer and insured alike.

This Article proceeds in six parts. Part II describes the growing threat of cyber attacks and importance of cyber security. Part III explains the purpose of cyber insurance and the risks it covers. Part IV contains a thorough discussion of the market for cyber insurance including its growth, supply and demand features, and problem areas. Part V explains how the more developed European market for cyber insurance has addressed some of the problems associated with cyber insurance. It also includes a summary of findings regarding incentives and barriers for a cyber insurance market in Europe and how they can be useful when considering how to correct the market imperfections in the United States cyber insurance industry. In Part VI, we discuss case law regarding how courts have dealt with the issue of whether cyber claims are covered by traditional forms of insurance. A review of the case law also explains the coverage gap that cyber insurance can fill. In Part VII, we offer our recommendations regarding pricing and buying cyber insurance policies and integrating them into a comprehensive plan for managing cyber attack risks.

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[6] Mark Greisiger, Cyber Liability & Data Breach Insurance Claims: A Study of Actual Payouts for Covered Data Breaches, NetDiligence (June 2011), http://www.netdiligence.com/files/CyberLiability-0711sh.pdf.

[7] World Economic Forum, Global Risks 2012 26 (2012), http://www3.weforum.org/docs/WEF_Global-Risks_Report_2012.pdf; Daniel Nelson, *Technology: Understanding the Ins-and-Outs of Cyber Insurance*, InsideCounsel (Sept. 28, 2012), http://www.insidecounsel.com/2012/09/28/technology-understanding-the-ins-and-outs-of-cyber.

II.
CYBER ATTACKS AND CYBER SECURITY

Cyber security is a hot topic with no shortage of written material discussing the subject, and for good reason. Technological advances have caused cyber security to become relevant to every aspect of our lives.[8] As personal and business information is consumed in the digital age, our dependence on cyber space has grown. Unfortunately, our vulnerability to loss increases dramatically when we entrust personal and proprietary information to third parties over whom we have no control. Significant aspects of our lives are held in electronic form by others and the security measures taken by such entities will determine our vulnerability to loss.

Cyber attacks are on the rise. Barry Buchman and Mickey Martinez of Gilbert LLP reported that "between 2005 and 2011, there were over 2300 data breaches, exposing over 535 million records at an average cost to the affected firms of $234 per compromised record. The surge in data breaches alone caused some commentators to label 2011 the 'Year of the Breach.'"[9]

It is not an overstatement to suggest that the digital world is under siege and that cyber attacks permeate all levels of international markets. The World Economic Forum identified cyber security as a major global risk for 2011 and 2012.[10] Richard Clarke, the former U.S. Special Adviser to the President of the United States on cyber security has said, "Every major company in the United States has already been penetrated by China."[11] FBI Director Robert Muller has said that "[i]n the not too distant future, we anticipate that the cyber threat will pose the number one threat to our country."[12] Indeed, the chances of a cyber breach are so

[8] National Security Council, *Cyber Security*, WHITE HOUSE (May 29, 2009), http://www.whitehouse.gov/cybersecurity (last visited July 19, 2013).

[9] Barry Buchman and Mickey Martinez, *Importance of Procuring Cybersecurity Insurance Coverage*, LAW360 (June 29, 2012 1:04 PM), http://www.law360.com/articles/354385/importance-of-procuring-cybersecurity-insurance-coverage (last visited July 22, 2013).

[10] World Economic Forum, GLOBAL RISKS 2011 7 (2011), http://reports.weforum.org/wp-content/blogs.dir/1/mp/uploads/pages/files/global-risks-2011.pdf; GLOBAL RISKS 2012, *supra* note 7, at 12.

[11] Rob Waugh, *'Every Major Company in the U.S. has been Hacked by China': Cyber-Espionage Warning from U.S. Security Chief Who Warned of 9/11*, THE DAILY MAIL (Mar. 28, 2012), http://www.dailymail.co.uk/sciencetech/article-2121624/Every-major-company-U-S-hacked-China-Cyber-espionage-warning-U-S-security-chief-warned-9-11.html (last visited July 19, 2013).

[12] Jeb Boone, *FBI Warns Threat of Cyber Attacks on Par With Terrorism*, GLOBALPOST.COM (Mar. 2, 2012), http://www.globalpost.com/dispatches/globalpost-blogs/the-grid/anonymous-fbi-al-qaeda-cyber-war-attacks (last visited July 22, 2013).

high that it is not a question of if, but when.[13] In September 2012, the White House computer system was attacked when an individual in the White House Military Office opened an email and clicked on the link to open the attachment.[14] As our awareness of this risk grows, cyber insurance has an undeniable appeal. Insureds are becoming acutely aware that cyber insurance coverage must be considered when discussing risk assessment and mitigation.

III.
Cyber Insurance

Much of the literature and professional commentary on the subject of cyber insurance is devoted to encouraging organizations to purchase cyber insurance against the eventuality of a data breach. Even government regulation is promoting the purchase of this product. For example, the SEC encourages publicly traded companies to give a "[d]escription of relevant insurance coverage," and, in some situations, requires disclosures regarding past cyber attacks and future threats.[15] Even the White House promoted cyber insurance stating the belief that "[i]nsurers will require a level of security as a precondition of coverage, and companies adopting better security practices often receive lower insurance rates."[16] In fact, one of the recommendations of this report is to "[r]equire government contractors to carry cyber-insurance [because d]oing this would improve cyber-security among government contractors...."[17]

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[13] The Inkerman Group, *Not If, But When? Businesses and Cyber Security*, Inkerman (Apr. 2012), http://www.inkerman.com/assets/files/Articles%20and%20Reports/The%20Inkerman%20Group%20-%20Business%20and%20Cyber%20Security.pdf.

[14] Gerry Smith, *White House Hacked in Cyber Attack that Used Spear-Phishing to Crack Unclassified Network*, HuffingtonPost (Oct. 1, 2012 12:35 PM), http://www.huffingtonpost.com/2012/10/01/white-house-hacked-cyber-_n_1928646.html (last visited July 19, 2013).

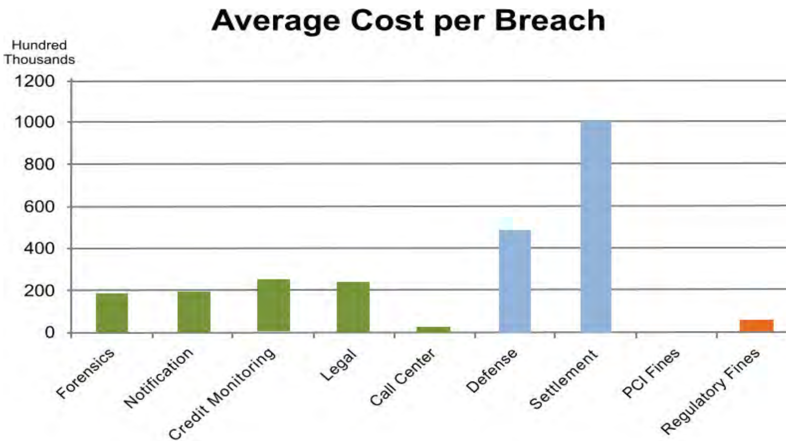
[15] Div. of Corporate Fin., Sec. & Exch. Comm'n, CF Disclosure Guidance: Topic No. 2 Cybersecurity (Oct. 13, 2011), *available at* http://www.sec.gov/divisions/corpfin/guidance/cfguidance-topic2.htm.

[16] Larry Clinton, *Cyber-Insurance Metrics and Impact on Cyber-Security*, White House, 1 (undated), http://www.whitehouse.gov/files/documents/cyber/ISA%20-%20Cyber-Insurance%20Metrics%20and%20Impact%20on%20Cyber-Security.pdf (last visited July 23, 2013) [hereinafter *Cyber-Insurance Metrics*].

[17] *Id at* 8. This particular idea that the cyber insurance industry would ultimately drive organizations to make their systems more secure is also discussed in the academic literature. *See, e.g.* Jay P. Kesan, Rupterto P. Majuca & William J. Yurcik, *The Economic Case for Cyberinsurance* 9-11 (Univ. of Ill. Coll. of Law Working Paper No. 2, 2004), *available at* http://www.queensu.ca/dms/DMS_Course_Materials_and_Outline/Readings-MPA831/Cyberinsurance-831.pdf (discussing how cyber insurance might promote safer IT environments where the premium of the insurance is tied to safety measures an organization takes). Whether this is actually the case is still an open question. Given the fact that some insurance companies are not necessarily requiring these safeguards and audits to confirm the safeguards, the incentive to put the safeguards in is not there. This situation leads to increased risk for the insurance company and any reinsurers.

Cyber insurance generally covers two broad categories of risk associated with a data breach. First, such insurance "covers a business in case of unauthorized access or use of its computer network whether internally or externally."[18] Second, cyber insurance "protects a business that violates privacy laws or regulations that protect data from 'unauthorized eyes.'"[19] An organization can buy coverage for everything, or for a discrete group of risks associated with a cyber attack including, but not limited to business interruption, forensics, notification, credit monitoring, litigation, and settlement costs.

One recent study which examined cyber insurance claims for incidents between 2005 and 2010 provides a glimpse of long-term cost. This study, released by NetDiligence in June 2011, is entitled *Cyber Liability & Data Breach Insurance Claims: A Study of Actual Payouts for Covered Data Breaches*.[20] In this report, NetDiligence reviewed information on claims for 117 breaches, including 77 claims which contained a detailed itemization of the costs and indemnity paid. While this is a relatively small sample over a relatively short period, the data collected offers insight as to what we might expect to see in the future. Below is a graph which lays out the average payout by claim.[21]



Litigation and settlement costs were, by far, the largest costs associated with the payment of cyber liability and data breach claims.

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[18] Casualty Actuarial Society, *Insurers Trying to Keep Up With New Cyber Liability Exposures*, CASACT (June 29, 2012), http://casact.org/media/index.cfm?fa=viewArticle&articleID=2007(last visited July 22, 2013) [hereinafter CAS].

[19] *Id.*

[20] Greisiger, *supra* note 6.

[21] *Id.* at 5.

IV.
The Cyber Insurance Market

Reactions to the cyber insurance market are mixed and the statistical analysis of market response varies; however, the conclusions of most surveys are generally consistent. In a survey sponsored by Zurich, 35.1% of survey participants responded that they purchased cyber insurance, while 60.1% stated they had not.[22] Thirty-six percent of those that had not purchased cyber insurance were larger organizations defined by $1 billion or more in annual revenue.[23] Of those that did not purchase cyber insurance, 24.3% responded that they would purchase it in the next year, while 52% said they would not, and 23.6% responded they did not know if they would purchase cyber insurance.[24] As reported in the Zurich survey, companies may not purchase cyber liability insurance for one or more of the following reasons:

- They are investing in prevention rather than insurance.
- There are limited markets for cyber liability insurance.
- They experience broker disconnects when trying to purchase cyber liability insurance.
- They think cyber liability policies lack clear coverage.
- They lack information to make informed decisions.
- They think cyber liability policies are too expensive.
- They find the application process too difficult.
- They think deductibles are too high.
- They think costs and benefits are difficult to quantify.
- They think policy coverage is too limited.[25]

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22 Josh Bradford, *A New Era in Information Security and Cyber Liability Risk Management: A Survey on Enterprise-wide Cyber Risk Management Practices*, Advisen 8 (Oct. 2011), http://corner.advisen.com/pdf_files/cyberliability_riskmanagement.pdf .

23 *Id.*

24 *Id.*

25 *Id.*

Other surveys present a less optimistic picture. One recent survey showed that only 28% of major United States companies have any form of cyber insurance.[26] More interestingly, 66% of those that do not have cyber insurance believe "they don't have significant data exposure, since they believe their internal controls are adequate."[27] Jane Taylor, a consulting actuary at Huggins Actuarial Services responded to the data by opining that it may be "hubris."[28] Taylor is not alone in this opinion.

Bruce Webster of Bruce F. Webster & Associates noted that many organizations experience a "Thermocline of Truth" as it pertains to IT.[29] Just as there is a defining line between the hot and cold water in a freshwater lake, those responsible for drafting corporate budgets often have little understanding of their company's IT system.[30] Corporate budgets are driven by a desire to increase profits which, by definition, requires that unnecessary costs must be cut where possible.[31] If management determines that its company's security measures are adequate to resist a potential data breach, the company's decision makers that set the budget will surely allocate company resources to other projects, initiatives or costs.[32] Webster also noted that, ironically, because of intellectual property and privacy concerns, many companies are hesitant to open their IT doors for review.[33]

Webster and Taylor's sentiments are supported by the Zurich survey. Nearly 72% of those responding to the survey said "information security risks are a specific risk management focus within their organization."[34] However, when asked, "In your experience, are cyber risks viewed as a significant threat to your organization?" only 45.3% said "yes" as to the Board of Directors, and only 57.9% said "yes" as to "C-suite executives."[35]

Such survey responses may well explain how the cyber response is organized. When asked "Which department is PRIMARILY responsible for spearheading the information security risk management effort?" nearly 75% of the respondents said it is the IT Depart-

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[26] CAS, *supra*, note 18.

[27] *Id.*

[28] *Id.*

[29] Telephone Interview with Bruce Webster, Principal and Founder, Bruce F. Webster & Associates LLC (Sept. 13, 2012). (Bruce Webster is an internationally recognized expert in information technology. He has testified before Congress and given presentations all over the world, given private briefings to the U.S. intelligence community and representatives of other countries. He has also appeared several times in the media and is called upon as an expert witness in litigation. Bruce F. Webster, Brucefwebster.com, http://brucefwebster.com/about-bruce-f-webster/ (last visited July 27, 2013).

[30] *Id.*

[31] *Id.*

[32] *Id.*

[33] *Id.*

[34] Bradford, *supra* note 22, at 4.

[35] *Id.*

ment.[36] While the majority of survey participants acknowledged that mitigating cyber risk should be an enterprise-wide operation, only 57% of respondents said they had an information security risk team that was comprised of individuals from multiple departments.[37] This could give rise to other legal problems for such organizations. Survey results also included the following findings:

> More than two thirds of respondents said their organizations have a disaster response plan in place in the event of a major breach. For 41 percent of respondents, the role of the IT department includes fulfilling state data breach notification laws following a breach. This may represent a significant deficiency in emergency response planning. The IT department often is ill-equipped to interpret the notification requirements of dozens of states and to marshal the resources necessary to fulfill the requirements of each state following a major breach.[38]

This caused those conducting the Zurich survey to conclude:

> While most companies have implemented information security and cyber risk management programs, for the majority of these organizations, cyber insurance is not incorporated as part of the overall strategy for many. The growing interest in the coverage, however, is apparent with the increased number of companies that have purchased protection in recent years, or are planning on buying coverage in the near future.[39]

The Zurich report noted that since half of those that did not currently maintain cyber insurance were thinking about procuring it, the cyber insurance market may be a growth opportunity for brokers and insurers.[40] While the number of large companies with cyber insurance might be relatively small, the market is relatively large. Michael L. McCarthy of Axis Capital has estimated that cyber insurance generates approximately $500 million in premiums and that the market is growing at a steady rate of 10% to 25% annually with midsized and smaller companies making up a larger segment of customers.[41] Another source

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[36] *Id.* at 7.

[37] *Id.* at 6.

[38] *Id.* at 9.

[39] *Id.*

[40] *Id.* at 8.

[41] CAS, *supra* note 18.

estimates that premiums were approximately $800 million in 2011.[42] As more organizations follow the trend and purchase cyber insurance several problems may arise.

More than thirty companies offer cyber insurance, but cyber insurance is a relatively new product and few claims have been paid under such policies.[43] This has resulted in inconsistent standards for determining how insurers evaluate risk and set appropriate premiums. Absent underwriting guidelines, it is problematic for insurers to set a fair premium without significant due diligence by insurers evaluating the risk presented by each insurance application. Significantly, a lack of due diligence could result in a premium which is unfair to the insurer and the insured, depending on the true nature of the risk. The potential exposure to insurers for this product is unknown because data regarding indemnity payments is undeveloped and, for that reason, the methodology for determining premiums is not consistent.[44]

Some insurers conduct due diligence as part of the underwriting process. John Merchant of Freedom Specialty Insurance Company noted that underwriters pay attention to certain things including the type and amount of data a customer has, internal controls, third party evaluations, and public filings,[45] especially with the new SEC regulations regarding publicly traded companies.[46] However, such due diligence is not consistent. Cyber insurance risk remains significant in light of the fact that premiums are not calculated on the basis of loss history and standards for rating such risk have not yet been established.

While a cyber insurance policy may appear to be a proper risk mitigation strategy, the placement and/or procurement of coverage requires appropriate, substantive questions in order to properly evaluate the risk for which coverage is sought. The failure to ask the right questions could lead to losses not expected by either the insurer or the insured. Attitudes reflected by responses to the Zurich survey suggest a number of problems.

First, the perception of the risk illustrated by the responses may well prevent potential data breach victims from buying the insurance. Second, if these organizations decide to purchase cyber insurance without proper due diligence as to their needs and potential exposures, there is no way to truly evaluate the nature of the risk for which coverage is sought and, therefore, it is difficult understand the appropriate type and amount of coverage to procure. Finally, without an audit that would reveal the purported insured's needs and potential risks, there could be a reduced incentive to implement security measures to mitigate the possibility of a data breach as part of an overall strategy to avoid exposure for such intrusions.

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[42] Juliette Fairley, *Insurance Industry Responds to Cyber Attack Increase*, INSURANCE NETWORKING NEWS (Apr. 20, 2012), http://www.insurancenetworking.com/news/cyber-insurance-standards-zurich-cna-liberty-30256-1.html?zkPrintable=true (last visited on July 26, 2013).

[43] Eduard Kovacs, *ENISA Wants a Cyber Insurance Market for European Companies*, SOFTPEDIA (June 29, 2012, 7:48 GMT), http://news.softpedia.com/news/ENISA-Wants-a-Cyber-Insurance-Market-for-European-Companies-278214.shtml (last visited on Nov. 5, 2012).

[44] Bradford, *supra* note 22, at 8.

[45] John Merchant, *Insurance of Cyber Liability* (June 4, 2012) (unpublished CAS Reinsurance Seminar Slides) (on file with the editor); CAS, *supra* note 18.

[46] Dunning, *supra* note 4.

V.
The European Approach

Analysis of the U.S. cyber insurance market warrants consideration of trends in the European market. European analysis of the cyber insurance market has taken into account issues that U.S. insurers and policy makers have either failed to consider, or have considered and chosen to ignore.

A. *The European View of Privacy*

As a background on the European regulatory environment, privacy is defined and articulated as a concept with greater priority in Europe than in America. Article 8 of the European Convention on Human Rights ("ECHR") is entitled the "Right to Respect for Private and Family Life."[47] Similarly, the Charter of Fundamental Rights of the European Union ("The Charter" or the "CFREU"),[48] is labeled in Article 7 as "Respect for private and family life."[49] Consistent with the notion that privacy must be a priority, Article 8 of the Charter states:

1. Everyone has the right to the protection of personal data concerning him or her.
2. Such data must be processed fairly for specified purposes and on the basis of the consent of the person concerned or some other legitimate basis laid down by law. Everyone has the right of access to data which has been collected concerning him or her, and the right to have it rectified.
3. Compliance with these rules shall be subject to control by an independent authority.[50]

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[47] Convention for the Protection of Human Rights and Fundamental Freedoms, Nov. 4, 1950, 213 U.N.T.S. 221, art. 8, *available at* http://www.echr.coe.int/Documents/Convention_ENG.pdf (last visited July 22, 2013).

[48] While the Charter is formally an EU document and formally published in the Official Journal C84 of 30 March 2010, the drafters based it off of "fundamental rights and freedoms recognized by the European Convention on Human Rights, the constitutional traditions of the EU Member States, the Council of Europe's Social Charter, the Community Charter of Fundamental Social Rights of Workers and other international conventions to which the European Union or its Member States are parties." *The Charter of Fundamental Rights of the European Union* European Parliament (Feb. 21, 2001), http://www.europarl.europa.eu/charter/default_en.htm (last visited Sept. 11, 2012).

[49] *The Charter of Fundamental Rights of the European Union (2010/C 83/02)*, Official Journal of European Communities 10 (Feb. 21, 2001), http://www.europarl.europa.eu/charter/pdf/text_en.pdf.

[50] *Id.*

In line with this emphasis on privacy, the EU published directive 95/46/EC on data privacy in 1995 with the introduction, "on the protection of individuals with regard to the processing of personal data and on the free movement of such data."[51] Because this was a directive, each member state was responsible for creating its own individual law to satisfy the requirements of the directive. For example, the United Kingdom passed the Data Protection Act 1998.[52]

B. *The Incentives and Barriers Report*

In June 2012, The European Network and Information Security Agency (ENISA) issued a report called *Incentives and Barriers of the Cyber Insurance Market in Europe* (Incentives and Barriers Report).[53] In this report, ENISA noted the interesting paradox of cyber insurance that, initially, there should not be a market for cyber insurance. The Incentives and Barriers Report states the following:

> Commonly, theoretical analysis usually portrays this in the context of the following three properties of cyber-risk:
>
> - *Interdependent security* – the risks faced by a firm depends not only on its own choices but also on those of others. As more firms decide not to invest in security, the probability of a successful terrorist attack [or data breach] grows, and there is no economic incentive for any specific firm to invest in security. As the number of firms/organisations gets large, a firm will not be willing to incur any costs to invest in security because it knows it will be contaminated by other unprotected firms;
> - *Correlated risk* – a supply side problem where the many potential losses from a single event can be so extensive as to force insurers not only to price contracts to accommodate these losses but also to protect against the possibility of themselves suffering ruin by multiple claims occurring at once. This is seen by some as being driven from monocultures of equipment (a single vulnerability affecting many) and therefore an opportunity for market intervention;

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[51] Council Directive 95/46, 1995 O.J. (L 281) 31 (EC), *available at* http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=CELEX:31995L0046:en:HTML.

[52] Data Protection Act, 1998, c. 29 (U.K.), *available at* http://www.legislation.gov.uk/ukpga/1998/29.

[53] *Incentives and barriers of the cyber insurance market in Europe*, ENISA (June 2012), http://www.enisa.europa.eu/activities/Resilience-and-CIIP/national-cyber-security-strategies-ncsss/incentives-and-barriers-of-the-cyber-insurance-market-in-europe/at_download/fullReport [hereinafter *Incentives and Barriers Report*].

- *Information asymmetries* – specifically insurers lacking information on the risks that the insured may be bearing which can also lead to adverse selection (where the insurer cannot efficiently segment the market, leading to insurers inefficiently pricing premiums on the basis of the 'lowest common denominator'). This is compounded by the aspect of network externalities as a common characteristic of cyberspace related phenomena. The related aspect of moral hazard (where the insured may act in a more insecure manner by investing in less security after the acquisition of insurance because they now know that the insurer will bear some of the negative consequences) informs this consideration. In either case these situations reflect opportunistic behaviour on the part of either the supply or demand side of the market.[54]

For example, the United Kingdom is home to Lloyd's of London and is one of the world's financial centers. Market exposure (in terms of claims exposure) in the UK is approximately $250 million.[55] However, consistent with other statistics which illustrate a disconnect between premiums and risk, the gross written premiums for such coverage net approximately £3 to £4 million,[56] or approximately $4.87 million to $6.49 million. The estimate for the current size of the global market for premiums is approximately $500 to $700 million.[57] Michael McGavick of XL Insurance has estimated that the world market could be worth $1 billion.[58]

ENISA notes three concerns with regard to the incongruity of these figures. First, if an insurance company does not understand the risk, how can it accurately charge premiums which sufficiently reflect the risk? Second, in a market in which worldwide technology continues to grow rapidly, will a policy written today accurately reflect the technology as it continues to evolve throughout the policy period? Finally, with limited actuarial data, how can an insurer buy adequate reinsurance in the event of a catastrophic loss?[59]

Despite perceived, perhaps theoretical barriers, the cyber insurance market appears to have "taken off."[60] One cause for this explosive growth is regulation. The Incentives and Barriers Report cited an article on the Lloyd's website entitled *Rising Claims Reflect Cyber*

[54] *Id.* at 11-12 (footnotes omitted).

[55] *Id.* at 14.

[56] *Id.*

[57] *Id.*

[58] Mike McGavick, *Innovate or Risk Irrelevance*, Intelligent Insurer-Monte Carlo Today (Dec. 12, 2012), http://content.yudu.com/A1yg18/MCTWednesday/resources/index.htm?referrerUrl= (last visited July 26, 2013).

[59] *Incentives and Barriers Report*, *supra* note 53, at 19.

[60] *Id.* at 14 (internal quotation marks omitted).

Concerns of Multi Nationals,[61] which identifies a number of factors driving the claims including the increased use of technology and the growing sophistication of hackers.[62] However, the most significant driver of the market is likely regulation. Paul Bantick, a cyber underwriter at Beazley, opined that "[t]he cyber insurance market has really taken off in recent years in the U.S. where demand has grown with strengthened legislation."[63] Bantick also added, "Demand for cyber insurance is growing among UK and European companies, as the changing regulatory environment and recent high profile data breaches are increasing awareness."[64] This sentiment was echoed by Jeremy Smith, a broker at Willis who stated, "At Willis we have seen a 56% increase in cyber claim notifications in the past year. This rise is reflecting the evolving environment and a growing dependency on IT systems."[65] NetDiligence's survey results support these facts and figures.[66]

Laws are changing in the EU. Currently, the data protection framework can be found in Directive 95/46/EC; however, because it is a directive, each EU member state has flexibility as to how to implement the directive.[67] The EU is moving toward increased uniformity with regard to the implementation of such directives, perhaps best illustrated by a proposal for General Data Protection Regulation, which could create uniform notification requirements across the EU if it goes into effect.[68] Such new requirements are addressed in Articles 30, 31, and 32 of the new General Data Protection Regulation.[69] The regulation also addresses a loophole in the 1995 directive which limited personal data breach notifications to the electronic communications sector.[70]

ENISA made four recommendations in the Incentives and Barriers Report. First, "[c]ollect empirical evidence on the use of cyber-insurance products in Europe, including the types of products purchased, types of risk insured, premiums, payouts etc. in order to thoroughly determine the current and future market trends in this domain."[71] This empiri-

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61 *Id.* at 14; *Rising Claims Reflect Cyber Concerns of Multi Nationals*, LLOYD'S (Sept. 16, 2011), http://www.lloyds.com/news-and-insight/news-and-features/market-news/industry-news-2011/rising-claims-reflect-cyber-concerns-of-multi-nationals (last visited July 23, 2013) [hereinafter *Rising Claims*].

62 *Rising Claims, supra* note 61.

63 *Id.*

64 *Id.*

65 *Id.*

66 Greisiger, *supra* note 6.

67 Morey Elizabeth Barnes, *Falling Short of the Mark: The United States Response to the European Union's Data Privacy Directive*, 27 NW. J. INT'L L. & BUS. 171, 178 (2006).

68 Barbara Daskala, Dr. Marnix Dekker & Christoffer Karsberg, *Cyber Incident Reporting in the EU: An overview of security articles in EU legislation*, ENISA 3 (Aug. 2012), *available at* http://www.enisa.europa.eu/activities/Resilience-and-CIIP/Incidents-reporting/cyber-incident-reporting-in-the-eu.*Id.*

69 *Id.*

70 *Id.* at n. 4.

71 *Incentives and Barriers Report, supra* note 53, at 3.

cal data is needed to adequately assess risk and ensure that the premium is commensurate with that risk, regardless of the reasons for the increase in purchases of cyber insurance. Second, ENISA suggests strengthening the regulatory framework to encourage companies to prevent data breaches rather than rely primarily on cyber insurance.[72] Third, ENISA recommends consideration of frameworks to help firms appraise the value of information.[73] These frameworks may help risk managers determine how to accurately assess how cyber insurance will play a role in their risk management strategy. It may also assist underwriters in deciding what premiums to assess. Finally, they suggest considering the government as the insurer of last resort.[74]

VI.
Coverage for Cyber Risks Under Traditional Policies

Prospective cyber insurance policyholders need to understand the limited scope of coverage which may be available for cyber losses under CGL policies. Many policyholders operate under the mistaken belief that the CGL policies will provide coverage in the event of a data breach. However, since not all CGL policies are written to provide the same or similar coverage, CGL policyholders must be cautious when determining the scope of coverage, if any, under their general liability policy.

In this Part, we discuss the most significant case law regarding coverage for data breaches under traditional forms of insurance. These cases are also instructive regarding issues which may exist in the future with regard to the cyber risk insurance products that are starting to be introduced to the market.

A. *The Sony PlayStation Case: Zurich v. Sony*

The seminal case on the issue of coverage under a general liability policy for a data breach is *Zurich v. Sony*.[75] In April 2011, several of Sony's systems, including its "PlayStation" system were hacked and credit card numbers were stolen.[76] It is estimated that over 100 million individuals had personal information stolen and this data breach resulted in several class action suits.[77] Sony sought to have its insurer, Zurich, defend and indemnify it against these suits.[78] However, Zurich filed a declaratory judgment action against Sony seeking a judicial determination that no coverage was owed.[79]

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[72] *Id.*

[73] *Id.*

[74] *Id.*

[75] Compl. for Declaratory Judgment at 5-6, Zurich v. Sony, No. 651982/2011 (N.Y. Sup. Ct. July 20, 2011), 2011 WL 2905600.

[76] *Id*.

[77] *Id.* at 6-8.

[78] *Id.* at 8.

[79] *Id.* at 16-17.

Zurich asserted that the underlying claims pertaining to losses for a data breach did not allege property damage within the insuring clause of the Zurich policy.[80] While this case has not yet been decided, other cases are instructive as to how the court may rule.

B. *"You've Got Mail": AOL v. St. Paul Mercury Insurance Co.*

Consider *America Online, Inc. v. St. Paul Mercury Insurance Co.,* a case in which America Online (AOL) was sued by customers claiming that AOL 5.0 had damaged their computers.[81] Specifically, the customers alleged that AOL 5.0 caused physical damage to, and loss of use of, customers' tangible property in the form of computers, computer data, software, and systems.[82] AOL tendered the suit to its insurer, St. Paul Mercury Insurance (St. Paul), seeking coverage under its CGL policy.[83]

Since the St. Paul policy expressly covered loss to "tangible property," the issue before the court was whether computer data, software and systems are tangible property. AOL argued these items are tangible property because they are "capable of being realized."[84] The court held that "computer data, software, and systems" are not tangible property.[85] The court noted that the Multidistrict Litigation complaint alleged loss of use of the consumers' computers, not that the computer itself was "physically damaged."[86] The court concluded the injury alleged fell squarely within the label of "property which isn't physically damaged" under the impaired property exclusion.[87]

The impaired property exclusion provided that harm to property that is not physically damaged is excluded from coverage where it is caused by a faulty or dangerous product. The court noted:

> Finally, the allegations of harm to consumers' computers run squarely into the common law economic loss rule. At bottom, the underlying complaint alleges that AOL 5.0 is a defective component incorporated into a larger product, the consumers' computers. Any damages stemming from the loss of computer use are purely economic, do not constitute harm to property other than the integrated product, and are thus not recoverable under any tort theory.[88]

80 *Id.* at 8-16.

81 207 F. Supp. 2d 459 (E.D. Va. 2002).

82 *Id.* at 461.

83 *Id.*

84 *Id.* at 466.

85 *Id.*

86 *Id.* at 470.

87 *Id*.

88 *Id*. at 462.

The court further noted that "[f]inding that computer data and software is intangible is also consistent with the long line of precedent holding that ideas, information, and designs are not tangible property."[89]

The court held that physical damage to the computer is not the same as the loss of the use of the computer and that the plain language of the policy required "physical damage," defined as "'relating or pertaining to the body, as distinguished from the mind, soul or the emotions.'"[90] The court noted that the computer data and systems are the "brains" of the computer.[91]

In affirming, the Fourth Circuit held:

> [T]he conclusion that physical magnetic material on the hard drive is tangible property is quite separate from the question of whether the data, information, and instructions, which are codified in a binary language for storage on the hard drive, are tangible property. Certainly the hard drive itself is a medium in which the data, information, and instructions are stored, but the data itself must be considered apart from the medium. Thus, if a hard drive were physically scarred or scratched so that it could no longer properly record data, information, or instructions, then the damage would be physical, affecting the medium for storage of the data.[92]

The court continued:

> But if the arrangement of the data and information stored on the hard drive were to become disordered or the instructions were to come into conflict with each another, the physical capabilities and properties of the hard drive would not be affected. Such disordering or conflicting instructions would amount to damage to the data and information and to the instructions (i.e., the software) but not to the hard drive. The magnetic material on the hard drive could be reoriented and reordered with reinstallation of the instructions. So it is that we make the distinction between hardware and software.[93]

C. *The Fourth Circuit's Approach: American Guaranty v. Ingram*

The Fourth Circuit's ruling in the AOL case has not been accepted in all jurisdictions. In *American Guaranty & Liability Insurance Co. v. Ingram Micro, Inc.,*[94] Ingram Micro's

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[89] *Id*. at 468.

[90] *Id*. at 469 (quoting Black's Law Dictionary 794 (1991)).

[91] *Id.*

[92] America Online, Inc. v. Saint Paul Mutual Ins. Co., 347 F.3d 89, 95 (4th Cir. 2003).

[93] *Id*.

[94] 2000 WL 726789 (D. Ariz. 2000).

data center in Tucson experienced a power outage "caused by a ground fault in the fire alarm panel."[95] While the building still had electric power and was not disrupted, "all of the electronic equipment at the Data Center, including the computers and telephones, stopped working."[96] The United States District Court for the District of Arizona found that "'physical damage' is not restricted to the physical destruction or harm of computer circuitry but includes loss of access, loss of use, and loss of functionality."[97]

To reach this conclusion, the court reviewed the federal code and the penal laws of several states and observed that while these were not insurance statutes, "[l]awmakers around the country have determined that when a computer's data is unavailable, there is damage; when a computer's services are interrupted, there is damage; and when a computer's software or network is altered, there is damage."[98] The court concluded that "[r]estricting the policy's language to that proposed by [the plaintiff] would be archaic."[99] It should be noted that while this rationale and decision was criticized in *America Online, Inc. v. St. Paul Mercury Insurance Co.*,[100] *American Guarantee* was not appealed.

D. *The Eighth Circuit's Approach: Eyeblaster v. Federal Insurance Co.*

Some courts have taken the middle ground regarding CGL coverage for cyber losses. For example, in *Eyeblaster Inc. v. Federal Insurance Co.*,[101] David Sefton said that when he used one of Eyeblaster's products, spyware uploaded and "caused his computer to immediately freeze up."[102] Sefton sued Eyeblaster and Eyeblaster in turn sued Federal Insurance in order to force Federal to defend against the Sefton suit.[103]

In deciding the case, the Eight Circuit agreed generally with the Fourth Circuit in how they define physical property. The Eighth Circuit said:

> The General Liability policy Eyeblaster purchased from Federal obligates the insurer to provide coverage for property damage caused by a covered occurrence. Property damage means "physical injury to tangible property, including resulting loss of use of that property…; or loss of use of tangible property that is not physically injured." The definition of "tangible property" excludes "any software, data or other information that is in electronic form."[104]

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[95] *Id.* at *1.

[96] *Id.*

[97] *Id.* at *2.

[98] *Id.* at *3.

[99] *Id.*

[100] Amer. Online, Inc. v. St. Paul Mercury Ins. Co., 207 F. Supp. 2d 459, 469-70 (E.D. Va. 2002).

[101] 613 F.3d 797 (8th Cir. 2009).

[102] *Id.* at 800.

[103] *Id.*

[104] *Id.* at 801.

The court then largely agreed with the Fourth Circuit's analysis in *America Online* that without physical damage to the computer, the plaintiffs had to claim "physical injury to the hardware in order for Eyeblaster to have coverage for 'physical injury to tangible property.'"[105]

The court noted that the policy also included coverage under the second clause which stated "loss of use of the tangible property that is not physically injured."[106] Sefton claimed in his suit against Eyeblaster that "his computer was 'taken over and could not operate,' 'froze up,' and would 'stop running or operate so slowly that it will in essence become inoperable.'"[107] Federal argued that an exclusion in the General Liability Policy for "Damage to Impaired Property or Property Not Physically Injured" precluded them from having to pay the claim.[108] The exclusion read: "This exclusion does not apply to the loss of use of other tangible property resulting from sudden and accidental physical injury to your product or your work after it has been put to its intended use."[109] Federal pointed to the definition of the term Impaired Property in the policy:

> [T]angible property other than your product or your work, that cannot be used or is less useful because:
>
> - it incorporates your product or your work that is known or thought to be defective, deficient, inadequate or dangerous; or
> - you have failed to fulfill the terms or conditions of a contract or agreement;
>
> if such property can be restored to use by:
>
> - the repair, replacement, adjustment or removal of your product or your work; or
> - your fulfilling the terms or conditions of the contract or agreement.[110]

The court rejected this argument noting that "no evidence exists that the computer can be restored to use by removing Eyeblaster's product or work from it."[111] The court further explained:

105 *Id.* at 802.

106 *Id.* at 801-02 (internal quotation marks omitted).

107 *Id.* at 802.

108 *Id.*

109 *Id.*

110 *Id.* at 802-03.

111 *Id.* at 803.

> Sefton alleges that the website that he believes caused the damage to his computer "was owned and operated by Eyeblaster or person's [sic] or entities that are controlled directly or indirectly by Eyeblaster." Such a broad characterization does not suffice to satisfy the requirement that Eyeblaster incorporated its product or work into Sefton's computer.[112]

In this case, the court recognized the differences between tangible and intangible property, and because of the language of the policy found that the policy did not cover damage to intangible software. In contrast, coverage existed for the damage to the computer caused by the spyware.

E. *Computer Fraud Riders to Blanket Crime Policies: The DSW Case*

In *Retail Ventures Inc. v. National Union Fire Insurance Co. of Pittsburgh, PA,*[113] National Union Fire Ins. Co. (National Union) denied coverage under a computer fraud rider to a blanket crime policy for losses DSW Shoe Warehouse (DSW) and its affiliates sustained as a result of a computer hacking scheme that compromised customer information. The court considered, among other things, whether the plaintiffs suffered a loss resulting directly from the theft of insured property by computer fraud.[114]

Directly after the breach, the plaintiffs "incurred expenses for customer communications, public relations, customer claims and lawsuits, and attorney fees in connection with investigations by seven state Attorney Generals and the Federal Trade Commission."[115] As a result of the FTC investigation, the plaintiffs entered into a consent decree which required them to "establish and maintain a comprehensive information security program designed to protect the security, confidentiality, and integrity of personal information collected from or about consumers."[116] In addition, DSW lost over $4 million from compromised credit card information, such as "costs associated with charge backs, card reissuance, account monitoring, and fines imposed by VISA/MasterCard."[117]

The policy included "Computer & Funds Transfer Fraud Coverage"[118] which provided coverage for any loss sustained by the insured directly from theft of any [i]nsured property by Computer Fraud."[119] However, the policy also contained three exclusions which stated that the policy did not apply:

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[112] *Id.*

[113] 691 F.3d 821 (6th Cir. 2012).

[114] *Id.* at 824.

[115] *Id.*

[116] *Id.*

[117] *Id.*

[118] *Id.* at 826.

[119] *Id.*

> (k) to the defense of any legal proceeding brought against the Insured, or to fees, costs or expenses incurred or paid by the Insured in prosecuting or defending any legal proceeding whether or not such proceeding results or would result in a loss to the Insured covered by this Policy, except as may be specifically stated to the contrary in this Policy;
>
> . . .
>
> (m) to damages of any type for which the Insured is legally liable, except direct compensatory damages arising from a loss covered under this Policy;
>
> (n) to costs, fees and other expenses incurred by the Insured in establishing the existence of or amount of loss covered under this Policy.[120]

The court of appeals noted that, with the exception of the clause dealing with compensatory damages, the exclusions limited first-party claims and were largely silent on third-party claims.[121]

National Union also denied coverage under a policy exclusion which stated that coverage does not apply to any loss of proprietary information, trade secrets, confidential processing methods, or other confidential information of any kind.[122] The court rejected this argument, holding that proprietary information is information which is held solely by the insured.[123] Here, the stolen information was held by the insured, the insured's customers, their banks, other financial institutions, as well as other merchants.[124] Therefore, such information could not be considered proprietary.[125]

National Union also claimed the exclusion "other confidential information of any kind"[126] covers information belonging to anyone who is expected to be protected from unauthorized disclosure, and which would include not only the other terms in this exclusion, but also the coverage for computer fraud.[127] Again, the court disagreed with National Union and noted that other terms in the exclusion referred to things which were internal to DSW and gave DSW "an opportunity to obtain advantage over competitors who do not know or use the information."[128] So, the term "other confidential information of any kind" referred to other

[120] *Id.* at 827.

[121] *Id.*

[122] *Id.* at 832.

[123] *Id.* at 833.

[124] *Id.*

[125] *Id.*

[126] *Id.* at 832.

[127] *Id.* at 834.

[128] *Id.*

information that dealt with how the business was operated, which would not include the stolen credit card information.[129]

It is noteworthy that although *National Union* was decided in 2012, it was based on an event that occurred seven years earlier. The cyber insurance industry and the cyber insurance products on the market have changed considerably since 2005. Also, *National Union* considered such issues with regard to a computer fraud rider to a crime insurance policy. Albert E. Lietzau V, of Cyber Risk Solutions, noted, "Often, general liability policies will have a flat-out exclusion that says 'We will not cover any sort of cyber-liability information loss[.]'… So if a customer or client wants to make sure they're fully protected, they shouldn't rely on just a general liability or crime policy."[130] Mr. Lietzau's admonition is appropriate with regard to *National Union* because the court's analysis pertained to a policy covering activities similar to those covered by cyber insurance. *National Union* demonstrates the challenge of policy interpretation with regard to such policies and losses.

VII.
Pricing and Buying Cyber Insurance: Some Recommendations

It would be unwise to expect that a typical CGL policy provides coverage in the event of a data breach and, for that reason, the cyber insurance market is growing rapidly; however, the procurement of a cyber risk policy is also fraught with danger. Insureds and insurers must understand the specific nature of the risk for which coverage is sought; otherwise, one of the parties to the insurance policy could face exposure which was not anticipated at the time of underwriting the risk. The insured and the insurer must understand the risks sought to be covered so that coverage is appropriate for the unique circumstance of the insured's business.

What kind of questions should an organization ask when deciding to purchase cyber insurance? John Proctor of Gartner Inc. notes that most literature on cyber insurance encourages organizations to buy cyber insurance.[131] However, Proctor also encourages organizations to avoid the hype because many authors writing about cyber insurance are in the "supply chain" for cyber insurance.[132]

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[129] *Id.*

[130] Ericka Chickowski, *Fluke DSW Win Shouldn't Erase Breach Insurance Needs*, Dark Reading (Sept. 5, 2012), http://www.darkreading.com/database-security/167901020/security/news/240006829/fluke-dsw-win-shouldn-t-erase-breach-insurance-needs.html (last visited July 26, 2013).

[131] Eric Chabrow, *10 Concerns When Buying Cyber Insurance,* Bank Info Security (June 14, 2012), http://www.bankinfosecurity.com/10-concerns-when-buying-cyber-insurance-a-4859/op-1 (last visited July 23, 2013).

[132] *Id.*

Purported insureds need a solid risk management plan for their IT systems. First, insureds should perform a comprehensive review of their IT systems.[133] Proctor suggested that, as part of this review, organizations must determine the type of coverage needed and which coverage will provide coverage for the risks anticipated by the insured.[134] Don Fergus, an IT risk consultant and the 2012 chairman of the IT Security Council for ASIS, a security professionals' organization, gave this advice:

> The IT people and the risk people desperately need to get together to talk about risk in terms of information technology and the likelihood and outcomes of a breach occurring.… Information professionals, especially information security leaders, need to step up. They need to understand that they're in charge of more than just security. They need to understand and articulate the vulnerabilities that they face in terms of risk."[135]

Cyber insurance can be relatively expensive. As of January 2012, the range of cost for cyber insurance was $7,000 to $40,000 per millions of dollars of loss."[136] "With losses possibly totaling in the tens – or even hundreds of millions of dollars, getting a policy able to cover such costs can present a staggering additional cost in insurance premiums."[137] Proctor suggests that when an organization considers the purchase of a cyber policy, the organization must find a broker that "has experience with actually working with clients who filed claims, not somebody reading the back of the policy to see what's in it."[138] In short, there may be no substitute for experience.

Proctor noted that cyber policies contain a litany of exclusions. So, before buying a policy, an organization should understand the type of breaches to which it may be vulnerable and procure coverage for such breaches.[139] Organizations that use cloud-based services should also determine whether such services are covered and how this might affect any coverage for non-cloud items.[140] Similarly, many in the insurance industry do not understand cyber security issues, especially with respect to the processing the claims.

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[133] Mary K. Pratt, *Cyber insurance offers IT peace of mind – or maybe not*, ComputerWorld (Jan. 13, 2012 6:00 AM), http://www.computerworld.com/s/article/9223366/Cyber_insurance_offers_IT_peace_of_mind_or_maybe_not?taxonomyId=17&pageNumber=1 (last visited July 23, 2013).

[134] Chabrow, *supra* note 131.

[135] Pratt, *supra* note 133.

[136] *Id.*

[137] *Id.*

[138] Chabrow, *supra* note 131.

[139] *Id.*

[140] *Id.*

An organization must be educated about what is and is not covered. Proctor cites the example of an organization with an advanced firewall but has it turned off.[141] Having the protection is simply not good enough. Further, does the organization understand what types of breaches might be covered? If an employee accidentally downloads a virus, is that covered? Is there only coverage for a cyber attack from an outside source?[142]

After noting the many exclusions which may be included in a cyber policy, Proctor observed that companies must be meticulous when completing cyber insurance application surveys. In short, do not make a misrepresentation on the insurance application. If an organization claims to have a firewall on its application and it does not, a claim may not be paid. If an organization represents on the insurance application that it has an 8-digit alphanumeric password policy, but does not require employees to follow the password policy, a claim might be denied.[143]

Those who consider purchasing cyber insurance coverage should bear in mind that it is a new product. Relatively few claims have been made and although insurers say that they pay claims, there is no statistical data that documents their history of paying cyber insurance claims.[144] In this regard, Proctor cautions, "If you have significant cyber insurance and experience a loss … you still may have a fight on your hands."[145]

VIII.
CONCLUSION

A few questions go a long way when procuring cyber coverage. Insurers and insureds must carefully consider the nature of the risk, the vulnerability of an insured to a data breach, and the potential costs which could arise if a breach occurs. In addition, procuring a cyber policy must be just one component of an overall risk strategy plan, rather than a safety net that the insured relies upon to make it whole in the event of a data breach. Just as an investment counselor might recommend a diverse investment portfolio, an insured must implement a diverse program to protect itself from a data breach in the digital age.

A cyber audit should be part of any risk management program. Taking appropriate steps to implement preventative measures from a data breach must be part of a strong risk management infrastructure. The infrastructure should not consist of only the IT department. Rather, an appropriate risk management culture must be perpetuated by the CEO and Board of Directors. In short, organizations must better analyze how cyber insurance fits with the company's overall risk management strategy.

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[141] *Id.*

[142] *Id.*

[143] *Id.*

[144] *Id.*

[145] *Id.*

Conversely, insurers must better understand the specific needs and vulnerabilities of each potential insured in the underwriting process. A one-size-fits-all insurance application could miss the mark in evaluating the risk presented by a particular business. An appropriate evaluation of the risk of a particular insurance application may allow the insured (and the insurer) to avoid the embarrassment of walking down the street in a cloak of security which covers nothing, but was procured because it sounded like a good idea at the time.

The Young and the Restless: Gen Y'ers in the Workplace! Are You Prepared?†

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I. Introduction

Gen Y'ers – those born (roughly) in the 1980s and 1990s and variously also referred to as Millenials, Gen Next, and the Echo Boomers – will make up approximately thirty-six percent of the U.S. workforce by 2014.[1] By 2020, it is estimated that Gen Y'ers will comprise nearly half of working Americans[2] and possibly seventy-five percent by 2025.[3] These workers, who are the most highly educated generation yet, are not just holding entry-level and blue collar jobs but are quickly moving into the professional ranks.

Gen Y'ers come to the workplace with drastically different expectations and values than the generations before them, including the now-aging Baby Boomers – in part due to having grown up in a world of helicopter parenting and 24/7 access to technology. Gen

† Submitted by the authors on behalf of the FDCC Employment Practices and Workplace Liability section.

1 Jessica Brack, Maximizing Millenials in the Workplace 2 (2012), *available at* http://www.kenan-flagler.unc.edu/executive-development/custom-programs/~/media/DF1C11C056874DDA8097271A1ED48662.ashx.

2 *Id*.

3 Business and Professional Women's Foundation, Gen Y Women in the Workplace 1 (April 2011), *available at* http://www.bpwfoundation.org/documents/uploads/YC_SummaryReport_Final.pdf; *see also* Dan Schwabel, *The Beginning of the End of the 9-to-5 Workday?*, BusinessTime (Dec. 21, 2011), http://business.time.com/2011/12/21/the-beginning-of-the-end-of-the-9-to-5-workday/.

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Y'ers tend to be confident and self-centered. They are tech-savvy multi-taskers who value schedule flexibility over salary. In fact, a recent survey found that forty-one percent of Gen Y-ers said they would take a pay cut if it meant more flexibility on the job.[4] They prefer to work collaboratively on team-based projects. And, this generation of individuals who "have been constantly coached, praised and encouraged for participation- rather than for accomplishments"[5] (*i.e.*, the "everyone gets a trophy" syndrome) crave immediate and constant positive feedback on their progress at work.[6]

For this generation, the Internet is an integral part of their lives, and a Gen Y'er is likely to appear on at least one social networking site containing embarrassing material (from an employer's perspective). It is interesting to note that more than half of Gen Y'ers say they will not accept jobs where they cannot access social media at work.[7] About thirty percent believe it is acceptable to share opinions about their work on social media – compared to about fifteen percent for Baby Boomers.[8] And when evaluating a job offer, almost half of

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4 Mom Corps, 2012 Labor Day Survey (2012/2013), *available at* http://momcorps.com/Libraries/News_PDFs/Mom-Corps-2012-Labor-Day-Survey-infographic.sflb.ashx; *see also* Schwabel,*supra* note 3.

5 Adrienne Fox, *Mixing It Up*, 56.5 HR MAGAZINE 22 (May 1, 2011), *available at* http://www.shrm.org/publications/hrmagazine/editorialcontent/2011/0511/pages/0511fox.aspx.

6 *Id.*

7 Cisco, 2011 Cisco Connected World Technology Report 59 (2011), *available at* http://www.cisco.com/en/US/solutions/ns341/ns525/ns537/ns705/ns1120/2011-CCWTR-Chapter-3-All-Finding.pdf.

8 Kelly, When Worlds Collide: The Rise of Social Media for Professional and Personal Use 12 (June 2012), *available at* http://www.kellyocg.com/uploadedFiles/Content/Knowledge/Kelly_Global_Workforce_Index_Content/When%20Worlds%20Collide%20-%20The%20Rise%20of%20Social%20Media%20for%20Professional%20and%20Personal%20Use.pdf.

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Gen Y'ers say they would prioritize access to social media,[9] and they value the ability to work remotely over a higher salary.[10]

It is well-known that Millenials eschew suits for jeans, even at work. And then there's the ink, and maybe a nose ring or other piercing. A 2010 Pew survey showed that nearly four in ten have at least one tattoo (contrast that with fifteen percent of Baby Boomers).[11] According to a 2006 Pew survey, fifty-four percent of Gen Y'ers have a tattoo, dyed hair that is a non-traditional color, or a body piercing other than on their ear lobe.[12]

Gen Y'ers also hold a different view of corporate management than the older generations. Unlike their predecessors, Millenials don't view their managers as content experts. That's because this generation knows where to find multiple versions of the information they need to do their jobs. As a result, their managers are viewed more as coaches and mentors.[13]

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[9] Cisco, *supra* note 7, at 62.

[10] *Id.* at 65.

[11] PEW RESEARCH CTR., MILLENIALS: PORTRAIT OF GENERATION NEXT 57 (2010), *available at* http://pewsocialtrends.org/files/2010/10/millennials-confident-connected-open-to-change.pdf.

[12] PEW RESEARCH CTR., HOW YOUNG PEOPLE VIEW THEIR LIVES, FUTURES, AND POLITICS: A PORTRAIT OF "GENERATION NEXT" 23 (2007), *available at* http://people-press.org/reports/pdf/300.pdf.

[13] Brack, *supra* note 1, at 4.

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Not surprisingly, the workplace juxtaposition of Gen Y'ers and older generations can result in tensions. In a recent survey, seventy-two percent of respondents indicated that intergenerational conflict is an issue in their workplaces.[14] Forty-seven percent of younger workers complained that older managers were resistant to change and tended to micromanage.[15] About thirty-three percent of older workers griped that younger workers' informality, need for supervision, and lack of respect for authority were problematic.[16] Furthermore, thirty-eight percent of older workers in the survey raised concerns about younger employees "inappropriate use or excessive reliance on technology."[17] Thirty-one percent of younger workers responded that their managers had an "aversion to technology."[18]

Underlying these facts and figures is the need for employers to recognize the challenges – and benefits – of the evolving workforce, including employment law concerns involving dress codes, age bias, and social media issues that can arise from intergenerational conflicts. This article explores these challenges in depth. Part II examines how Millenials are forcing changes in the traditional workplace dress and grooming codes – and the legal limits on what employers can do to set limits on employee appearance. Part III takes a close look at age discrimination and harassment in employment – a common problem in today's workplace where Gen Y'ers are working side-by-side with older employees. Finally, Part IV discusses the legal implications of growing social media use and employer restrictions on social media in the workplace.

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14 Society for Human Resource Management, Intergenerational Conflict in the Workplace SHRM Poll 3 (April 29, 2011), *available at* http://www.shrm.org/Research/SurveyFindings/Articles/Pages/IntergenerationalConflictintheWorkplace.aspx.

15 *Id.* at 12.

16 *Id.* at 9.

17 *Id.*

18 *Id.* at 12.

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II.
WING TIPS TO FLIP FLOPS: THE EVOLVING WORKPLACE DRESS CODE[19]

Mark Zuckerberg, founder and CEO of Facebook, made recent headlines when he chose to wear pajamas to a meeting with potential investors. Shortly after that, he "dressed up" in a hooded sweatshirt and sneakers to make his Facebook IPO pitch.[20] Is Zuckerberg an eccentric? Or is his choice of clothing an indicator of attitudes towards traditional corporate attire?

In many corporate offices, suits and ties have already been replaced by "business casual" attire. Some offices eschew formality altogether and allow their employees to wear jeans, t-shirts, and flip flops to work. Casual Fridays are par for the course. This more laid-back approach to employee dress, coupled with the increased popularity of piercings, tattoos, colorful hair dye, and diverse cultural dress, can create difficult issues for employers, whose desire to allow individual expression among employees is tempered by the need to present appropriate-looking employees to clients and to the public.

A. *Aloha Fridays*

"Casual Fridays" have been linked back to Hawaii in the 1960's. In an attempt to sell more shirts, the Hawaiian garment industry came up with the idea that businesses should allow employees to wear Hawaiian shirts on Fridays. By the early 1990's Aloha Fridays started to catch on in the mainland when more casual dress became acceptable on the last workday of the week. In 1992, Levi's launched a campaign to promote its Dockers brand as

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19 Angela Brandt is the author of Part II.

20 Mark Milian, *Zuckerberg's Hoodie a 'Mark of Immaturity,' Analyst Says*, BLOOMBERG (May 8, 2012 6:01 PM), http://go.bloomberg.com/tech-deals/2012-05-08-zuckerbergs-hoodie-a-mark-of-immaturity-analyst-says-2/.

appropriate for the office. A brochure titled, "A Guide to Casual Businesswear" was sent to 25,000 human resource managers around the country. Since that time, khakis have become the unofficial uniform of many office workers.[21]

B. *Tattoos and Piercings*

In recent years, tattoos and piercings have become more prevalent and more widely accepted. A recent Pew Research poll found that nearly forty percent of 18- to 40-year-old adults have a tattoo or a non-earlobe piercing.[22] However, there remains a certain stigma associated with tattoos and piercings. In a survey conducted by Careerbuilders, three out of four managers said they believe visible tattoos are unprofessional.[23] The prevalence of visible tattoos, body piercings, and other forms of body modification has caused some companies to adopt policies that either prohibit or place restrictions on tattoos and piercings. And it is generally recognized that employers are free to set reasonable dress codes and grooming standards that are justified by the business environment and applied in a non-discriminatory manner. There is no federal law that explicitly provides protection from employment discrimination to individuals with tattoos and piercings. Employers have wide latitude to regulate employee appearance and workplace dress. But that latitude must be exercised in conformity with Title VII, which prohibits employment discrimination based on race, color, religion, sex, or national origin.

C. *Title VII*

Religion is the most common area where dress code policies come into conflict with Title VII. Under Title VII, an employer must reasonably accommodate an employee's sincerely held religious beliefs even when those beliefs conflict with a condition of employment (such as a dress code) unless the accommodation would create an undue hardship for the employer. The Equal Employment Opportunity Commission (EEOC) may take enforcement action against an employer who discriminates with respect to any aspect of employment, including hiring, firing, pay, job assignments, promotions, training, and fringe benefits.

Courts apply a three-part burden-shifting framework to evaluate claims brought under Title VII.[24] First, the court determines whether the policy is discriminatory on its face or whether it has a discriminatory effect. Next, if discrimination is shown, then the employer must provide a legitimate, non-discriminatory reason for its policy. If the employer succeeds,

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[21] Krissy Clark, *Dress code: The history of 'business casual'*, Marketplace.org (Aug. 17, 2012), http://www.marketplace.org/topics/business/workplace-culture/dress-code-history-business-casual.

[22] Ed Sealover, *Generations Clash Over Tattoos, Body Piercings in the Workplace*, Denver Business Journal (Dec. 6, 2009, 10:00 PM), http://www.bizjournals.com/denver/stories/2009/12/07/story3.html?page=all.

[23] Regina Robo, *Body Art in the Workplace*, Salary.com, http://www.salary.com/body-art-in-the-workplace (last visited July 21, 2013).

[24] *See* McDonnell Douglas Corp. v. Green, 411 U.S. 792, 802-05 (1973).

then the burden shifts back to the plaintiff to prove that the employer's stated reason for the policy is a pretext for discrimination.[25] The employee might show that the dress code policies were enforced inconsistently, or that religious or racial differences were not tolerated in the workplace.

If an employee's physical appearance conflicts with the public image the employer wishes to convey to the public, some courts have found that accommodating the employee's physical appearance would impose an undue hardship on the employer. For example, the United States Court of Appeals for the First Circuit held that Costco did not violate Title VII by terminating an employee whose facial piercing violated the "no facial jewelry" provision of the company's dress code.[26] The employee claimed that Costco failed to offer a reasonable accommodation of her religious practice as a member of the Church of Body Modification.[27] The court held that it would pose an undue hardship to require Costco to grant an exemption because it would adversely affect the employer's "public image," given Costco's determination that facial piercing detracts from the "neat, clean and professional image" that it aims to cultivate.[28]

The EEOC, however, has taken the position that

> [w]hile there may be circumstances in which allowing a particular exception to an employer's dress and grooming policy would pose an undue hardship, an employer's reliance on the broad rubric of "image" to deny a requested religious accommodation may in a given case be tantamount to reliance on customer religious bias (so-called "customer preference") in violation of Title VII.[29]

However, an employer's desire to present a family-friendly atmosphere will not always suffice as a business justification. In Washington state, the EEOC sued Red Robin restaurants for firing a server who had refused to cover tattoos on his wrists that he claimed represented his devotion to Ra, the Egyptian sun god.[30] Red Robin argued that its policy forbidding visible tattoos was essential to its family-friendly image.[31] The court disagreed, finding that Red Robin failed to demonstrate that allowing an employee to have visible religious tattoos

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[25] *Id.*

[26] Cloutier v. Costco Wholesale Corp., 390 F.3d 126, 132 (1st Cir. 2004).

[27] *Id.* at 128.

[28] *Id.* at 136.

[29] EEOC Compliance Manual, (CCH) ¶ 8340, at 6841-42 (Aug. 2008), *available at* http://www.eeoc.gov/policy/docs/religion.html#_ftnref184.

[30] EEOC v. Red Robin Gourmet Burgers, Inc., No. C04-1291, 2005 WL 2090677, at *1 (W.D. Wash. Aug. 29, 2005).

[31] *Id.* at *5.

was inconsistent with its goals, and instructing Red Robin to provide further evidence to demonstrate undue hardship.[32]

D. *Other Grooming Issues*

Facial-hair policies are appropriate where there is a legitimate business reason.[33] Courts have upheld requirements that employees be clean-shaven, though employers must reasonably accommodate employees whose religious beliefs require certain hairstyles or facial hair – such as Rastafarian dreadlocks or Sikh uncut hair and beard.[34]

Body odor and personal hygiene are sensitive topics. Though body odor is not itself protected under the Americans with Disabilities Act,[35] the subject employee may have a medical condition as the underlying cause of hygiene problems. Certain medical conditions may be protected under the ADA. Here, again, the employer must reasonably accommodate the employee if that accommodation does not cause undue hardship for the employer.

E. *Best Practices*

Employers can avoid problems with employee dress and grooming by adhering to a few basic guidelines:

- **Have a policy.** If employers are to expect appropriately outfitted workers, they must give these workers guidance. A policy also enables the employer to enforce its preferred dress code and grooming policies. Employers with clearly written appearance policies who consistently apply those policies will likely not run afoul of Title VII.
- **Be reasonable.** Restrictive policies may reduce a company's ability to attract and retain talent. Depending on the job responsibilities, some departments could have less restrictive dress code requirements. Perhaps the more difficult question is whether the existing dress code is necessary or outdated. Is dress code and appearance important enough to the business to require conformity by the Zuckerberg generation or is there a broader benefit to loosening (or forgoing altogether) the proverbial tie?

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[32] *Id.*

[33] *See* Hussein v. The Waldorf Astoria, 134 F. Supp. 2d 591 (S.D.N.Y. 2001).

[34] *See* Brown v. F.L. Roberts & Co., Inc., 896 N.E.2d 1279 (Mass. 2008).

[35] Americans with Disabilities Act of 1990, Pub. L. No. 101-336, 104 Stat. 327 (codified as amended at 42 U.S.C. §§ 12101-12213 (2006 & Supp. V 2011)); *see* Georgy v. O'Neill, No. 00-CV-0660, 2002 WL 449723 (E.D.N.Y. 2002).

- **Be clear, when possible.** Appropriateness is in the eye of the beholder, so vague policies are subject to different interpretations. If visible tattoos and visible non-earlobe piercings are prohibited, the policy needs to clearly state the prohibition. On the other hand, the policy cannot possibly spell out every scenario and should allow room for managers and supervisors to address situations where dress or grooming falls outside of the accepted company practice.
- **Be consistent.** Discipline resulting from dress code violations must be consistent. The easiest way for an employee to get into trouble with their dress code policy is to be selective in its enforcement. However, in certain instances an employer may need to make a reasonable accommodation if it would not cause undue hardship.

III.
AVOIDANCE OF AGE HARASSMENT IN THE WORKPLACE: YOUNGER SUPERVISORS, OLDER SUBORDINATES[36]

Most supervisors and managers are highly mindful of legal prohibitions against harassment on the basis of race, gender, ethnicity, disability, and religion, but they are not always as careful as they might be with regard to how they treat workers older than they. Whether it is a younger manager and an older subordinate, or the other way around, employers need to be aware of the potential liability for age-based harassment in the workplace, and take steps to avoid liability while maintaining a workplace environment that is conducive to getting the most out of their workforce, young and old.

1. *Statutory Authority*

In 1967, Congress enacted the Age Discrimination in Employment Act[37] (ADEA) which provides in pertinent part that:

> It shall be unlawful for an employer –
>
> (1) to fail or refuse to hire or to discharge any individual or otherwise discriminate against any individual with respect to his compensation, terms, conditions, or privileges of employment, because of such individual's age;
>
> (2) to limit, segregate, or classify his employees in any way which would deprive or tend to deprive any individual of employment opportunities or otherwise adversely affect his status as an employee, because of such individual's age; or
>
> (3) to reduce the wage rate of any employee in order to comply with this chapter.[38]

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[36] Eric A. Schneider is the author of Part III.

[37] 29 U.S.C. §§ 621-634 (2006).

[38] 29 U.S.C. § 623(a) (2006).

2. *Case Authority*

Crawford v. Medina General Hospital,[39] features a helpful discussion as to age-based harassment being actionable under ADEA even though the term "harassment" does not appear within ADEA as it does under certain state laws[40] (although in *Crawford*, the court did not find that the conduct in question amounted to unlawful harassment). The Sixth Circuit's view in *Crawford* that ADEA prohibits age-based harassment is shared only by the Fifth Circuit.[41] On the basis that a hostile work environment affects a "term, condition, or privilege" of employment within the meaning of Title VII,[42] the court in *Crawford* set forth the prima facie criteria:

(1) the employee is 40 years or older;

(2) the employee was subjected to harassment, either through words or actions, based on age;

(3) the harassment had the effect of unreasonably interfering with the employee's work performance and creating an objectively intimidating, hostile, or offensive work environment; and

(4) there exists some basis for liability on the part of the employer.[43]

Mary Ann Crawford was fifty-seven years old and had worked at the hospital for twenty-nine years when she sued her employer and certain co-workers for violation of ADEA claiming that the defendants had discriminated against her by creating a hostile work environment. With regard to when an environment is sufficiently hostile so as to become actionable, the court stated that while "the environment must in fact be objectively hostile, it is not necessary that the plaintiff be committed to a psychiatric institution in order to have a legal complaint."[44] The court quoted the Supreme Court's decision in *Harris v. Forklift System, Inc.*:

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[39] 96 F.3d 830 (6th Cir. 2003).

[40] *See*, *e.g.*, Cal. Gov't Code § 12940(j) (West 2011).

[41] Dediol v. Best Chevrolet, Inc., 655 F.3d 435, 445 (5th Cir. 2011); *cf.* Burns v. AAF-McQuay, Inc., 166 F.3d 292, 294 (4th Cir. 1999); EEOC v. Massey Yardley Chrysler Plymouth, Inc., 117 F.3d 1244 (11th Cir. 1997); Rivera-Rodriguez v. Frito Lay Snacks Caribbean, a Division of Pepsico, Puerto Rico, Inc., 265 F.3d 15, 24 (1st Cir. 2001).

[42] *See* Ellison v. Brady, 924 F.2d 872, 876 (9th Cir. 1991).

[43] *Crawford*, 96 F.3d at 834-835.

[44] *Id.* at 835.

> [We] can say that whether an environment is "hostile" or "abusive" can be determined only by looking at all of the circumstances. These may include the frequency of the discriminatory conduct; its severity; whether it is physically threatening or humiliating, or the mere offensive utterance; and whether it unreasonably interferes with an employee's work performance.[45]

The court upheld the summary judgment granted by the district court in favor of the hospital employer. The court found that the only two comments that were "objectively indicative of age-based animus" were that Crawford's supervisor said that she did not think "women over 55 should be working," and "old people should be seen and not heard."[46] Without more it did not amount to a hostile working environment within the meaning of ADEA.

Also instructive is a more recent California Supreme Court case, *Reid v. Google, Inc.,*[47] where the court held that the jury would have to determine whether the alleged conduct constituted unlawful discrimination. Brian Reid joined Google as director of operations and director of engineering when he was fifty-two years old. At the time that he filed suit (for wrongful termination), Reid had worked for Google for less than two years, unlike Crawford's twenty-nine year career. Like Crawford though, he alleged derogatory, ageist comments on the part of his co-workers, including that

- his opinions and ideas were obsolete and too old to matter;
- he was slow, fuzzy, sluggish, and lethargic;
- he did not display a sense of urgency and lacked energy;
- he was an old man/old guy;
- his knowledge was ancient;
- he was an old fuddy-duddy; and
- his CD jewel case office placard should be an LP instead of a CD.[48]

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[45] *Id.* (quoting *Harris,* 510 U.S 17, 20 (1993) (internal quotation marks omitted)).

[46] As to the first comment, the supervisor denied having made it stating instead that she did not care when anyone else wanted to retire, but that she herself would like to retire by the time she reached fifty-five. *Id.* at 835. The court made mention of that although presumably it would have to had accepted the plaintiff's version of the events as true for purposes of summary judgment.

[47] 235 P.3d 988 (Cal. 2010).

[48] *Id.* at 1004.

During the course of his short career with Google, Reid was removed from his position of director of operations and relieved of his responsibilities as director of engineering although he was able to retain that title. He was given responsibilities relative to an in-house graduate degree program and an undergraduate college recruitment program, but he was given no staff or budget to support the programs. Soon after, he was told that the engineering department no longer had a place for him, that the graduate degree program was being eliminated, and that he was being terminated because of job elimination and poor performance. Reid, though, maintained that he was given no reason for his termination other than the lack of a cultural fit.

It is not clear from the opinion whether Reid's complaint included a cause of action for harassment, but it is evident that he was claiming that the ageist comments were indicative of a company mindset adverse to older workers.

The trial court granted Google's summary judgment, but the Court of Appeal reversed. The California Supreme Court affirmed the Court of Appeal decision.

Google had argued that the statements referenced above were irrelevant because they were made by non-decision makers, they were ambiguous, and they were unrelated to the adverse employment decision.

The court addressed the Stray Remarks Doctrine noting that the term "stray remarks" first appeared in a concurring opinion by Supreme Court Justice O'Connor.[49] Justice O'Connor said that stray remarks, statements by non-decision makers, or statements by decision makers unrelated to the decisional process itself, do not constitute direct evidence of decision makers' substantial negative reliance on an illegitimate criterion in reaching their decision. They could however be probative of discrimination.[50]

Ultimately the court determined that the age-related comments could not be discounted as stray remarks because to do so would be to permit the court to do what it is otherwise prohibited from doing on a summary judgment, *i.e.,* weighing the evidence rather than allowing the jury to do so. While mere stray remarks with nothing more are insufficient to establish age discrimination, when combined with other evidence of pretext, such as Reid's claim that he was told that his termination stemmed from him not being a good fit, the remarks were sufficient to defeat summary judgment.[51]

3. *Best Practices*

As Gen Y'ers rise in the ranks, employers must take steps to avoid actionable harassment among older and younger co-workers, or a younger supervisor and an older subordinate. With respect to the hiring process:

49 *Id.* (citing Price Waterhouse v. Hopkins, 490 U.S. 228, 276 (1989)).

50 *Id.*

51 *Id.* at 1008.

- First and foremost, focus on whether the candidate can perform the job effectively;
- Consider the candidate, and not the candidate's birthdate;
- Do not ask the candidate if he/she would be uncomfortable working under a younger supervisor;
- Do not consider why this candidate is looking for a job usually filled by much younger people;
- Recognize the value of experience in terms of maturity, job knowledge, problem solving, and reduced needs or training.

With respect to managing older workers:

- Older workers may be less willing to respect their supervisors on the basis of position alone. Such respect will be earned through effective management of personnel;
- Along the same lines, the younger supervisor will not engender respect by employing a "because I said so" approach;
- Overcome biases in appraising older workers—evaluate the job performance;
- Provide additional training where needed even though the employee would seem to have sufficient experience to know the job.

It also, of course, stands to reason that employers should incorporate the prohibition of age-based comments in their overall anti-harassment training. Employees who grasp that gender, race, and other ethnic comments are taboo, need to understand that age-related dialogue can both violate the law and give rise to unnecessary discord. To ask another worker "How old *are* you?" is inherently counterproductive, regardless of whether the inquiring employee is older or younger than his or her colleague. Similar comments or questions that can result in disharmony – and possible liability – include:

1. "Considering this is your first job, you probably wouldn't understand."
2. "When I was your age…"
3. To an older worker: "Do you know how to use e-mail?"
4. To a younger worker: "Are you the new intern?"
5. To an older worker: "*You're* going back to school?"

IV.
Why Can't We Be (Facebook) Friends?
Social Media's Evolving Impact On Labor and Employment Law Issues[52]

A short decade ago, no one had ever heard of Facebook, Twitter, Pinterest or LinkedIn. Indeed, they did not exist. Today, some 1.5 billion individuals – over twenty percent of the world's population – use these and other social media sites.[53] According to PewInternet, nearly seventy percent of online adults in the United States use social media.[54] The social media boom has hit with unprecedented force and there is no sign of its abating.

As social media has come to dominate personal lives, it has inevitably spilled into the professional realm. The most basic terminology of social media amply illustrates this trend: the act of "friending" coworkers or supervisors, not to mention customers or clients, suggests a relationship beyond merely professional.

From recent NLRB decisions to state and federal legislative activity, one thing is clear: the rise of social media has created a number of never before seen legal issues for employers, their lawyers, and policymakers, who are all rushing in to fill the void.

A. *Social Media and the National Labor Relations Act*

The rights of employees under the National Labor Relations Act[55] (the "Act") are enumerated in Section 7, which provides:

> Employees shall have the right to self-organization, to form, join, or assist labor organizations, to bargain collectively through representatives of their own choosing, and to engage in other concerted activities for the purpose of collective bargaining or other mutual aid or protection, and shall also have the right to refrain from any or all of such activities except to the extent that such right may be affected by an agreement requiring membership in a labor organization as a condition of employment as authorized by section 8(a)(3).[56]

Section 7 rights are enforced through the prohibition of certain conduct by either employers or unions called unfair labor practices. Prohibitions on employer conduct are contained

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[52] Kay Hodge is the author of Part IV. Ms. Hodge thanks Geoffrey Bok, John Simon and Katherine Clark, all partners at Stoneman, Chandler & Miller, LLP, for their contributions to this article.

[53] *Where in the World Are the Hottest Social Networking Countries?,* eMarketer (Feb. 29, 2012), http://www.emarketer.com/Article/Where-World-Hottest-Social-Networking-Countries/1008870.

[54] Kathryn Zickuhr, *Mobile is the needle; Social is the thread*, PewInternet 20 (2012), http://www.pewinternet.org/~/media/files/presentations/2012/oct/wsu%20mobile%20is%20the%20needle.pdf.

[55] Pub. L. No. 74-198, 49 Stat. 449 (1935) (codified as amended at 29 U.S.C. §§ 151-169 (2006)).

[56] Act § 7, 29 U.S.C. § 157 (2006).

in Section 8(a) of the Act, and prohibitions on the conduct of a labor organization are in Section 8(b). Each of the requirements will be discussed seriatim.

1. Section 7 – The Right to Engage in Other Concerted Activities

Although the core purpose of the Act is to protect the right of employees to unionize, Section 7 also protects the right of employees to act together as a group without a union in order to protect activities unrelated to union organization.[57] To be protected under Section 7, the employee activity must be both "concerted" and pursued either for union related purposes or other "mutual aid and protection."[58] "Concerted" means that the activity is undertaken by two or more employees or by one on behalf of others.[59]

Examples of protected concerted activity include:

- work stoppages[60]
- honoring picket lines[61]
- filing or processing grievances in concert[62]
- protests of racial or other discrimination[63]

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57 *See, e.g.,* Mojave Elec. Coop. Inc., 327 NLRB 13, 13 (1998), *enforced* 206 F.3d 1183, 1188-90 (D.C. Cir. 2000) (employee and co-workers petitioned for injunctive relief against harassment by two officials of employer's subcontractor); Brown & Root, Inc. v. NLRB, 634 F.2d 816, 818 (5th Cir. 1981) (refusal to work in the face of dangerous working conditions); Redwing Carriers, Inc., 137 NLRB 1545 (1962), *aff'd sub nom*. Teamsters Local 79 v. NLRB, 325 F.2d 1011 (D.C. Cir. 1962), *cert. denied*, 377 U.S. 905 (1964) (refusing to cross picket line located at another employer's place of business); Salt River Valley Water Users' Ass'n v. NLRB, 206 F.2d 325, 329 (9th Cir. 1953) (circulating petition to authorize individual to collect wages allegedly due under Fair Labor Standards Act); Tri-County Transportation Inc., 331 NLRB 1153, 1155 (2002) (employer violated Act by definitely laying three employees off because they, in concert, filed for unemployment benefits during summer recess).

58 Act § 7, 29 U.S.C. § 157 (2006).

59 *See* Meyers Industries, 268 NLRB 493, 497 (1984), *rev'd sub nom*. Prill v. NLRB, 755 F.2d 941 (D.C. Cir.), *cert. denied sub nom*. Meyers Industries v. Prill, 474 U.S. 971 (1985), *decision on remand* 281 NLRB 882, 885-87 (1986), *aff'd sub. nom*. Prill v. NLRB, 835 F.2d 1481, 1484 (D.C. Cir. 1987), *cert. denied sub nom.* Meyers Industries v. NLRB, 487 U.S. 1205 (1988).

60 NLRB v. Washington Aluminum Co., 370 U.S. 9, 17 (1962).

61 GPS Terminal Services, 333 NLRB 968, 970 (2001); Cooper Thermometer, 154 NLRB 502, 505 (1965).

62 Prime Time Shuttle International, 314 NLRB 838, 841-42 (1994).

63 Franklin Iron & Metal Corp., 315 NLRB 819, 824 (1994), *enforced* 83 F.3d 156 (6th Cir. 1996) (race); Gatliff Coal Co. v. NLRB, 953 F.2d 247, 251-52 (6th Cir. 1992) (sex); Vought Corp.-MLRS Sys.Div., 273 NLRB 1290, 1294 (1984), *enforced* 788 F.2d 1378, 1383 (8th Cir. 1986); NLRB v. Magnetics International, 699 F.2d 806, 813 (6th Cir. 1983), *enforcing* 254 NLRB 520 (1981) (filing and pursuing Title VII claim protected activity).

- employees advocating for use of sick time during FMLA leaves.[64]

Examples of concerted activity that are not protected include:

- disparaging employer's product[65]
- disloyalty[66]
- releasing confidential information[67]
- disruption of work[68]
- sit-down strikes[69]
- partial or intermittent strike[70]
- advocating for an employee stock ownership plan.[71]

2. Section 8(a)(1) – Interference, Restraint or Coercion of Rights

Section 8(a)(1) makes it an unfair labor practice for an employer "to interfere with, restrain or coerce employees in the exercise of rights guaranteed by section 7."[72] The type of conduct that will result in unlawful interference, restraint or coercion and lawful conduct is often elusive. Contributing to the difficulty of predicting in any given situation whether

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64 Phillips Petroleum Co., 339 NLRB 916, 918 (2003).

65 NLRB v. Electrical Workers (IBEW) Local 1229 (Jefferson Standard Broadcasting Co.), 346 U.S. 464, 475-76 (1953) (discharge of employees, who during impasse in collective bargaining, distributed handbill criticizing the quality of the employer's programming, etc. upheld for disloyalty to the employer).

66 American Arbitration Association, 233 NLRB 71, 71 n. 1 (1977) (AAA lawfully terminated an employee who mailed a letter and questionnaire to AAA's consumers where its, "tone and content constituted disloyalty to and disparagement of [AAA's] judgment and capacity to effectively perform its services").

67 Lafayette Park Hotel, 326 NLRB 824, 826 (1998) (divulging private, confidential information of the employer to those not authorized to receive it).

68 Washington Adventist Hospital, 291 NLRB 95, 102-03 (1988) (discharge of employee for sending system-wide computer message protecting impending layoffs and criticizing management lawful because it disrupted the work of 100 terminal users and was in violation of the computer security agreement the employee signed).

69 NLRB v. Fansteel Metallurgical Corp., 306 U.S. 240 (1939).

70 Yale University, 330 NLRB 246, 247-49 (1999) (withholding of grades by teaching fellows in effort to obtain recognition of their union was a partial strike and hence, unprotected).

71 Harrah's Lake Tahoe Resort Casino, 307 NLRB 182, 182 (1992) (not protected as it did not advance interests of employees as employees but only their interests as entrepreneurs, owners and managers).

72 Act § 8, 29 U.S.C. § 158 (2006).

it will be lawful or not, is the composition of the Board, the particular circuit court hearing the appeal and the inevitable differences in facts and circumstances.

In the NLRB's view, motive is not an essential element of a section 8(a)(1) violation. The NLRB follows its "well settled" test that

> interference, restraint, and coercion under Section 8(a)(1) of the Act does not turn on the employer's motive or on whether the coercion succeeded or failed. The test is whether the employer engaged in conduct which, it may reasonably be said, tends to interfere with the free exercise of employee rights under the Act.[73]

a. Freedom of Speech and Section 8(a)(1)

Section 8(a)(1) violations are frequently asserted in the context of verbal conduct by an employer. The starting point of any analysis of verbal conduct begins with Section 8(c) of the Act which provides:

> The expressing of any views, argument, or opinion, or the dissemination thereof, whether in written, printed, graphic, or visual form, shall not constitute or be evidence of an unfair labor practice under any of the provisions of this subchapter, if such expression contains no threat of reprisal or force or promise of benefit.[74]

In *NLRB v. Gissel Packing Co*.,[75] the Supreme Court stated that the requirements of Section 8(c) "merely implement[] the First Amendment." However, in *Gissel*, the Supreme Court made it clear that

> [a]ny assessment of the precise scope of employer expression, of course, must be made in the context of its labor relations setting. Thus, an employer's rights cannot outweigh the equal rights of the employees to associate freely, as those rights are embodied in § 7 and protected by § 8(a)(1) and the proviso to § 8(c).[76]

Thus, the Board is frequently called upon to balance an employer's rights to free speech and the rights contained in Section 7.

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[73] American Freightways Co., 124 NLRB 146, 147 (1959). *See, e.g.,* Correctional Med. Servs. Inc., 356 NLRB No. 48, at *4 (2010).

[74] Act § 8, 29 U.S.C. § 158(c) (2006).

[75] 395 U.S. 575 (1969).

[76] *Id*. at 617.

b. Employer Work Rule or Policy

An employer violates Section 8(a)(1) by having a work rule if that rule "would reasonably tend to chill employees in the exercise of their Section 7 rights."[77] If the work rule in question does not explicitly restrict protected concerted activity, then the Board will only find a violation of Section 8(a)(1) if "(1) employees would reasonably construe the language to prohibit Section 7 activity; (2) the rule was promulgated in response to union activity; or (3) the rule has been applied to restrict the exercise of Section 7 rights."[78]

Rules will be deemed unlawful if they are ambiguous about whether they apply to Section 7 activity, unless they contain limiting language or context that makes it clear to employees that the rule does not restrict protected concerted activity.[79] Accordingly, rules that clarify and restrict their scope by including examples of illegal or unprotected conduct so that a reasonable employee would understand that the rules do not apply to protected concerted activity will not be found to be unlawful.[80]

c. Rules Regarding Employee Use of Social Media

Against this backdrop regarding protected concerted activity, the Board has faced a variety of cases involving employer rules that restrict employees' use of social media. In many of these cases, the Board has found the rules are overbroad and unlawful because they restrict employees' Section 7 rights.

In May 2012, the Board General Counsel issued an Advice Memorandum concerning recent social media cases.[81] The General Counsel ruled that the following employer policy provisions were unlawful:

(1) A nationwide retailer's handbook statement on "Information Security" that provided:

If you enjoy blogging or using online social networking sites such as Facebook and YouTube, (otherwise known as Consumer Generated Media, or CGM) please note that there are guidelines to follow if you plan to mention [Employer] or your employment with [Employer] in these online vehicles. . .

- Don't release confidential guest, team member or company information. . . .[82]

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[77] Lafayette Park Hotel, 326 NLRB 824, 825 (1998), *enforced* 203 F.3d 52 (D.C. Cir. 1999).

[78] Lutheran Heritage Village-Livonia, 343 NLRB 646, 647 (2004).

[79] University Medical Center, 335 NLRB 1318, 1320-22 (2001), *enforcement denied in pertinent part*, 335 F.3d 1079 (D.C. Cir. 2003).

[80] Tradesmen International, 338 NLRB 460, 460-62 (2002).

[81] NLRB, Office of the General Counsel, Memorandum 12-59 (May 30, 2012) (hereinafter OM 12-59), *available at* http://www.NLRB.gov/reports-guidance/operations-management-memos.

[82] OM 12-59 at 3-4.

This provision was unlawful because it could reasonably be interpreted as prohibiting employees from discussing and disclosing information regarding their employment, which was clearly a protected activity.[83]

(2) Instructing employees to make sure their personal internet posts were "completely accurate and not misleading and that they do not reveal non-public company information on any public site."[84]

This rule was deemed overbroad because it could reasonably be interpreted to apply to discussions about and criticism of the employer's labor policies and treatment of employees.[85]

(3) Instructing employees not to post "[o]ffensive, demeaning, abusive or inappropriate remarks," and stating that "communications with coworkers ... that would be inappropriate in the workplace are also inappropriate online."[86]

This rule was deemed overbroad because it covered a spectrum of communications that would include criticism of the Employer's labor policies and treatment of employees.[87] In addition, it did not specify which communications the employer would find inappropriate at work, making it ambiguous about the rule's application to protected concerted activity.[88]

(4) Directing employees not to comment on "legal matters, including pending litigation and disputes."[89]

(5) Instructing employees to "[a]dopt a friendly tone when engaging online. Don't pick fights."[90]

(6) Encouraging employees to "resolve concerns about work by speaking with coworkers, supervisors, or managers" rather than resorting to "social media or other online forums" to resolve concerns.[91]

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83 *Id.* at 4.

84 *Id.* at 6.

85 *Id.* at 6-7.

86 *Id.* at 8.

87 *Id.*

88 *Id.*

89 *Id.* at 10.

90 *Id.*

91 *Id.* at 11.

Notably, many of these policies included "savings clauses," statements that these policies would be administered consistently with the requirements of the National Labor Relations Act. These savings clauses are generally not sufficient to cure overbroad policies that restrict Section 7 rights.[92]

On the other hand, some employer policies were acceptable:

(1) An Employer's policy stating: "[H]arassment, bullying, discrimination, or retaliation that would not be permissible in the workplace is not permissible between coworkers online, even if it is done after hours from home and on home computers."[93]

According to the Associate General Counsel's memorandum, "this provision would not reasonably be construed to apply to Section 7 activity because the rule contains a list of plainly egregious conduct, such as bullying and discrimination."[94]

(2) An Employer's policy providing: "No unauthorized postings: Users may not post anything on the Internet in the name of [Employer] or in a manner that could reasonably be attributed to [Employer] without prior written authorization from the President or the President's dedicated agent."[95]

(3) An Employer's policy providing: "Respect all copyright and other intellectual property laws ... [I]t is critical that you show proper respect for the laws governing copyright, fair use of copyrighted material owned by others, trademarks, and other intellectual property, including [Employer's] own copyrights, trademarks and brands."[96]

The Board also found that Walmart's revised social media policy was lawful. The revised policy corrected unlawfully overbroad and ambiguous provisions in the earlier policy by providing sufficient examples of prohibited and egregious conduct so that employees would understand that the revised policy did not reach or cover activities protected by Section 7.[97]

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[92] *Id.* at 12, 14.

[93] *Id.* at 13.

[94] *Id.* at 14.

[95] *Id.* at 15.

[96] *Id.* at 10-11.

[97] *Id.* at 19-20. Walmart's entire revised social media policy is attached to the Associate General Counsel's Memorandum. *Id.* at 22-24.

B. *Privacy Laws Governing Social Media in Employment*

Apart from social media postings by employees that may be considered "protected concerted activity" under the NLRA, the rise of social media in people's private and professional lives has caused a more general concern for employee privacy in the digital age. At least ten states – Arkansas,[98] California,[99] Colorado,[100] Illinois,[101] Maryland,[102] Michigan,[103] New Mexico,[104] Oregon,[105] Utah,[106] and Vermont[107] – have enacted statutes attempting to limit employer access to the social media accounts of their employees and applicants for employment.[108] Many other states are currently considering legislation that would similarly address these privacy concerns.[109]

These legislative undertakings come on the heels (and in the midst) of a number of high-profile cases in which employees were fired, or applicants not hired, because of their social media postings. The issue perhaps first drew national attention in early 2011, when a Maryland corrections officer revealed that he had been required to provide his Facebook user name and password as part of his application for recertification.[110] More recently, the internet was abuzz about the California woman who was terminated by Cold Stone Creamery for her post-election Facebook rant calling President Obama the "n" word and hoping for his assassination.[111] Similarly, in response to the outcry from veterans' groups, a Massachusetts non-profit employee was also fired after posting a photograph on Facebook taken on a work-related trip to the Tomb of the Unknowns, in which she – standing by a sign that reads

[98] H.B. 1901, 89th Gen. Assemb., Reg. Sess. (Ark. 2013) (to be codified as Ark. Code Ann. § 11-2-24.

[99] Cal. Labor Code § 980 (West 2011).

[100] H.B. 13-1046, 69th Gen. Assemb., 2d Sess. (Colo. 2013) (to be codified as Colo. Rev. Stat. § 8-2-126).

[101] 820 Ill. Comp. Stat. Ann. 55/10(b) (West 2008 & Supp. 2013).

[102] Md. Code Ann., Lab. & Empl. § 3-712 (LexisNexis 2008 & Supp. 2012).

[103] Mich. Comp. Laws § 37.273 (West 2001 & Supp. 2013).

[104] S.B. 371, 51st Leg., Reg. Sess. (N.M. 2013).

[105] H.B. 2654, 77th Leg., Reg. Sess. (Or. 2013).

[106] H.B. 100, 60th Leg., Reg. Sess. (Ut. 2013) to be codified as Utah Code Ann. § 34-48-201.

[107] S. 7, 2013-2014 Sess. (Vt. 2013).

[108] National Conference of State Legislatures, *Employer Access to Social Media Passwords Legislation 2013*, http://mgaleg.maryland.gov/2012rs/chapters_noln/Ch_234_hb0964T.pdf (last visited July 20, 2013) [hereinafter *Employer Access to Passwords Legislation*].

[109] *Id*.

[110] Aaron C. Davis, *Md. corrections department suspends Facebook policy for prospective hires*, Washington Post (Feb. 22, 2011, 9:58 PM), http://www.washingtonpost.com/wp-dyn/content/article/2011/02/22/AR2011022207486.html.

[111] Victoria Cavaliere, *California woman fired from job, probed by Secret Service after Obama 'assassination' post on Facebook,* NY Daily News (Nov. 10, 2012, 9:57 AM), http://www.nydailynews.com/news/election-2012/woman-fired-racist-anti-obama-facebook-post-article-1.1199917.

"silence and respect" – shows her middle finger and pretends to yell.[112] A Chili's server was recently terminated for a Facebook posting in which she warned customers: "Next time you tip me $5 on a $138 bill, don't even bother coming in cause I'll spit in your food and then in your [expletive] face you cheap bastards!!!!!!!!!"[113]

As these and the many other cases in the news demonstrate, employers routinely search the internet for information on prospective and current employees and freely use the information gathered in making their employment decisions. Indeed, a CareerBuilder survey found that as of early 2012, some 40% of employers were using social networking tools to screen candidates.[114] According to human resource software maker TribeHR, in 2011, 42% of companies took disciplinary action based on their employees' social media activities, compared with 24% in 2009.[115]

These practices are not surprising; after all, private employers of at-will employees have the general authority to terminate employees for any reason that is not unlawful – good or bad, fair or unfair. Indeed, it would seem to be imprudent – if not downright negligent – for an employer on the cusp of a hiring decision not to take a minute to simply search an applicant's name in Google to see what comes up. Furthermore, because employers always have the right to ensure that employee work time is spent working and not wasted on personal matters such as texting, tweeting and surfing the internet, vetting employees' social media activity seems all the more appropriate and necessary.

However, lawmakers are now pushing back. The recent laws are by and large designed to prohibit employers from requiring that employees or applicants, as a condition of their employment, provide user names, passwords and other ways for an employer to access personal information on websites such as Twitter, Facebook and LinkedIn. The goal is generally to prevent employers from using applicant's private social media activity during the hiring process and from monitoring the off-duty, private social media activity of employees.[116]

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[112] Rheana Murray, *Woman on unpaid leave after taking disrespectful photo next to soldier's grave during work trip,* NY DAILY NEWS (Nov. 21, 2012, 8:33 AM), http://www.nydailynews.com/news/national/vulgar-facebook-pic-woman-canned-article-1.1205609.

[113] *Chili's Server Fired After Facebook Tip Rant,* HUFFINGTON POST (June 21, 2012, 11:22 AM ET), http://www.dailymail.co.uk/news/article-2163871/chilis-waitress-fired-threatening-spit-food-bad-tippers-facebook.html.

[114] *Thirty-seven percent of companies use social networks to research potential job candidates, according to new CareerBuilder Survey*, CAREERBUILDER.COM (Aug. 18, 2012), http://www.careerbuilder.com/share/aboutus/pressreleasesdetail.aspx?id=pr691&sd=4%2F18%2F2012&ed=4%2F18%2F2099.

[115] TribeHR Staff, *How Can Social Software Get You Fired? [Infographic],* TRIBEHR (Sept. 1, 2011), http://tribehr.com/blog/how-can-social-software-get-you-fired-infographic; *see also* Irma Wallace, *How Can Social Software Get You Fired?*, INFOGRAPHIC J. (Feb. 13, 2012), http://infographicjournal.com/how-can-social-media-get-you-fired/.

[116] It should be noted that these laws (at least facially) do not prohibit employers from accessing non-private social media content that is generally available to internet users – that is, social media postings that anyone can access without a password or "friend" status.

A review of the earliest statutes reveals lawmakers' evident belief in an individual's right to privacy in the personal information available on social media websites. The new laws also demonstrate a legislative concern about employers accessing social media accounts that would very often provide them with the ability to gain information regarding an employee's religion, sexual orientation, marital status, off-duty activities and associations, which could lead to potential discrimination in the workplace.

The first state to enact such a social media privacy law was Maryland in its User Name and Password Privacy Protection and Exclusions Act, which took effect in October 2012.[117] This statute, with certain limited exceptions related to investigations of securities fraud and trade secret misappropriation, prohibits employers from

> (1) requesting or requiring that an employee or applicant disclose any user name, password, or other means for accessing a personal account or service through certain electronic communications devices;
>
> (2) taking, or threatening to take, certain disciplinary actions for an employee's refusal to disclose certain password and related information; and
>
> (3) failing or refusing to hire an applicant as a result of the applicant's refusal to disclose certain password and related information.[118]

Illinois' Right to Privacy in the Workplace Act,[119] which became effective in early 2013,[120] makes it

> unlawful for any employer [1] to request or require any employee or prospective employee to provide any password or other related account information in order to gain access to the employee's or prospective employee's account or profile on a social networking website or [2] to demand access in any manner to an employee's or prospective employee's account or profile on a social networking website.[121]

Statutory violations expose employers to actual damages, costs, a criminal petty offense, and, if willful and knowing, a civil penalty and attorney's fees.[122]

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[117] S.B. 433 (H.B. 964), 2012 Leg., Reg. Sess. (Md. 2012) *available at* http://mgaleg.maryland.gov/2012rs/chapters_noln/Ch_234_hb0964T.pdf.

[118] *Id.*; MD. CODE ANN., LAB. & EMPL. § 3-712 (LexisNexis 2008 & Supp. 2012).

[119] 820 ILL. COMP. STAT. 55/1 (2008).

[120] Pub. Act 97-875, 97th Gen. Assemb., Reg. Sess. (Il. 2012) *available at* http://www.ilga.gov/legislation/publicacts/fulltext.asp?Name=097-0875&GA=97.

[121] 820 ILL. COMP. STAT. 55/10(b)(1) (2008 & Supp. 2013).

[122] *Id.* at 55/15.

In September, 2012, California passed the Employer Use of Social Media Act,[123] which became effective on January 1, 2013 and prohibits an employer from

- requesting or requiring that employees or applicants disclose social media log-in credentials;
- requesting or requiring that employees or applicants access personal social media in the employer's presence;
- requesting or requiring that employees or applicants divulge any personal social media content; or
- discharging, disciplining, threatening to discharge or discipline, or retaliating against an employee or applicant for not complying with any prohibited request or requirement.[124]

The sole exception to the California law allows employers to request that an employee divulge social media content if the employer reasonably believes is related to an investigation of employee misconduct or violation of law.[125]

More states will be enacting similar laws in the future.[126]

C. *Best Practices*

In light of these events, what are employers to do? Most obviously, employers should keep abreast of new federal and state laws and update their workplace policies and practices to promote compliance. Employers should be certain of the parameters of those laws, *i.e.,* what is and what is not permitted and any applicable exceptions. This is particularly important for employers with a presence in multiple states, as the laws in each state could (and already do) vary.

In addition, employers should be extremely careful about engaging in online research of applicants and employees. This has special ramifications in the realm of discrimination law – should an employer discover and make employment decisions based on potentially damaging information regarding an employee in a protected class, this could result in a discrimination or retaliation claim, especially where information about an employee's protected status (which employers are otherwise prohibited from requesting), is only available from his or her social media accounts. Employers should instruct hiring and human resource managers, and others conducting interviews of job applicants of any legislative changes

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[123] Assemb. B. 25, 2013-2014 Assemb., Reg. Sess. (Cal. 2013).

[124] Cal. Labor Code § 980 (West 2011).

[125] *Id*.

[126] As this article went to press, social media legislation had been introduced or was pending in thirty-five states. *Employer Access to Passwords Legislation*, *supra* note 108.

and make sure that they comply with all relevant laws. Furthermore, all employees with decision-making authority should be kept apprised of legislation that would prohibit them from requesting access to and/or investigating employees' social media accounts.

Finally, within the parameters of the NRLB's recent decisions regarding such policies, employers should adopt a clearly expressed, consistently-applied and well-communicated policy on social media use that clearly sets out acceptable and unacceptable usage both inside and outside the office. Just as with electronic communication policies regulating e-mail and internet usage in the workplace, the social media policy should clearly state that: (1) there is no expectation of privacy in digital media content accessed using company systems; (2) all communications using company systems may be monitored; (3) the use of the employer's computer system and/or internet access is for business purposes only; and (4) the use of personal electronic devices are prohibited during work time.

Employers should also consider narrowly tailored policy provisions requiring that employees: identify themselves when promoting the company or its products and services; not disclose the company's confidential or proprietary information; separate personal social networking activities from those that are work-related; not represent that their personal opinions are the views of the company; and not use the employer's electronic systems for illegal or unlawful activities.

Employers must exercise extreme caution regarding the use of social media. The law is in a constant state of flux, and will no doubt continue to evolve as social media becomes even more prevalent and our society adjusts its comfort level with it. The bottom line for employers today: employment-related decisions based on information discovered on employees' social media accounts should only be taken after careful consideration in close consultation with legal counsel.

V.
Conclusion

As Gen Y'ers enter the U.S. workforce in greater numbers, their generationally unique preferences, attitudes and work ethic are changing workplace dynamics and forcing a rapid evolution in workplace policies and practices on a wide range of issues – from new and more tolerant dress and grooming expectations, to managing intergenerational differences in order to avoid age discrimination and harassment problems, to grappling with the limits that can and cannot be placed on employee social media use in and out of the office. Employers can stay in step – and out of court – only by gaining an understanding of this new workforce generation and adapting workplace expectations, policies and practices in a way that balances multigenerational demands at work with existing employment laws.

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