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Navigating the Multiple Roles of "Constituency Directors" on Public Company Boards

"Constituency" directors are becoming an ever increasing presence in U.S. public corporations' ("Corporation") board rooms. The term "constituency" director refers to public company directors whose board membership is tied to one or more specific voting constituency or sponsor (i.e., a significant stockholder). This article focuses on potential challenges arising when hedge fund or private equity representatives serve as constituency directors.

Oftentimes constituency directors nominated by hedge funds or private equity firms are employees or principals (the "Designated Director") of nominating firms ("Nominating Firms"). The Designated Director may be a principal of the Nominating Firm, with overall responsibility for the firm's financial performance, or a portfolio manager or analyst with industry or company-specific expertise. In practice, Designated Directors would be expected to, and oftentimes do, have substantial ongoing interaction with their Nominating Firm.

The prevalence of Designated Directors on public company boards raises myriad questions regarding the fiduciary duty of loyalty and the sharing of information between parties. Hedge funds and private equity funds benefit from having a Designated Director on the board of a public company in which the firm has

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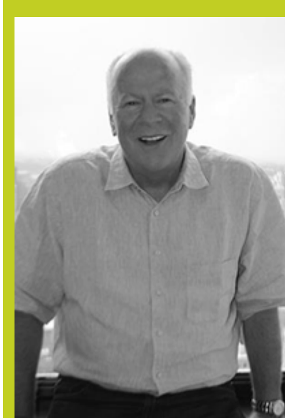
INSIDE

Firm Mourns Passing of Bill Urquhart – Name Partner and Visionary Who Drove Growth



Bill Urquhart – whose vision, bonhomie and flair for recruiting fueled the growth of Quinn Emanuel Urquhart & Sullivan, LLP from a fifteen-lawyer firm into a global litigation juggernaut – has passed away. As a lawyer, Urquhart battled for clients in complex business disputes ranging from international arbitrations and patent disputes to class actions; he earned a reputation as a brilliant negotiator. His talents earned him multiple plaudits, including being named "One of California's Most Successful Business Lawyers" multiple times by *California Law Business*, "One of the Most Influential Attorneys in California" by the *Los Angeles Daily Journal*, and one of the "Outstanding Trial Lawyers of America" by *Chambers USA*.

Urquhart leaves behind a firm of over 800 lawyers in 23 offices spread across four continents. Quinn described Urquhart as "indisputably the driver of" the firm's transformation and international growth. He leaves behind his wife Mary and 6 children, and our thoughts are with them in this time of grief. He will be deeply missed by all who knew him.

Survey Shows Quinn Emanuel Is the Most Feared Law Firm in the World

Quinn Emanuel is the one law firm in the world that major companies least want to see as opposing counsel. Top legal decision makers at over 300 organizations with more than $1 billion in annual revenue were interviewed by leading independent research provider BTI Consulting Group for its *Litigation Outlook 2020*. Those interviewed were asked to name the law firm they least wanted to see as opposing counsel. Quinn Emanuel ranked number one as the most feared.

a significant ownership stake. Designated Directors may allow the Nominating Firm to better monitor and protect its investment, can ensure that a significant stockholder has a say on the board, and bring additional sophisticated financial and industry expertise thereby benefiting the board, the Nominating Firm, and all of the stockholders. With these benefits come potential legal complexities related to fiduciary duties. This article addresses challenges in the Designated Directors context, focusing primarily on the duty of loyalty under Delaware law.

The Duty of Loyalty

Under Delaware law, all directors owe a duty of care and a duty of loyalty to the Corporation and all stockholders. Duty of care "requires that directors of a Delaware corporation 'use that amount of care which ordinarily careful and prudent men would use in similar circumstances,' and 'consider all material information reasonably available' in making business decisions, and that deficiencies in the directors' process are actionable only if the directors' actions are grossly negligent." *In re TIBCO Software Inc. Stockholders Litig.*, 2015 WL 6155894, at *23 (Del. Ch. Oct. 20, 2015) (quoting *In re Walt Disney Co. Deriv. Litig.*, 907 A.2d 693, 749 (Del. Ch. 2005)).

Of greater significance to this article is the duty of loyalty, which "mandates that the best interest of the corporation and its stockholders takes precedence over any interest possessed by a director . . . and not shared by the stockholders generally." *Cede & Co. v. Technicolor, Inc.*, 634 A.2d 345, 361 (Del. 1993). "Corporate officers and directors are not permitted to use their position of trust and confidence to further their private interests," and instead must act with "undivided and unselfish loyalty to the corporation" and ensure that "there be no conflict between duty and self interest." *Id.*

Designated Directors, who owe their position on the board to their own Nominating Firm, owe a duty of "uncompromising" loyalty to all the Corporations' stockholders and cannot put the interests of the Nominating Firm above any other stockholders. *Klaasen v. Allego Dev. Corp.*, 2013 WL 5967028, at *11 (Del. Ch. Nov. 7, 2013) ("corporate directors do not owe fiduciary duties to individual stockholders" but instead to "the entity and the stockholders as a whole"). Delaware law makes no allowances in the duty of loyalty when a director holds multiple fiduciary obligations. *In re Trados Inc. S'holder Litig.*, 73 A.3d 17, 46–47 (Del. Ch. 2013).

Ramifications of Breaching the Duty of Loyalty

When a Designated Director approves of an action that may appear to benefit the Nominating Firm in a unique or non-ratable manner as compared to the other Corporation's stockholders or otherwise appears to have acted in a non-independent or self-interested manner, the transaction generally will be subject to judicial review under the entire fairness standard rather than the business judgment rule. Delaware's business judgment rule is a deferential standard of judicial review that creates a presumption that the directors acted on an informed basis, in good faith, and in the honest belief that the action was in the best interests of the corporation. *Cede & Co.*, 634 A.2d at 361. Unless the plaintiff stockholder can rebut the business judgment rule at the pleading stage, the fiduciary duty claim will be dismissed so long as a "rational" business purpose can be attributed to the challenged board action. *See, e.g.*, *Sinclair Oil Corp. v. Levien*¸ 280 A.2d 717, 720 (Del. 1971).

The business judgment rule can be rebutted by alleging facts that, if proven, would constitute a breach of loyalty. For example, allegations that the directors were self-interested in the challenged transaction—i.e., stood on both sides of the transaction or personally stood to gain a benefit not received by the stockholders generally—are sufficient to rebut the business judgment rule. The burden then shifts to the directors, who must prove that the challenged action was "entirely fair" to the corporation and its stockholders, which can be a difficult standard to satisfy. *Cede & Co.*, 634 A.2d at 361.

Under Delaware law, Delaware corporations can include in their certificate of incorporations a clause that eliminates or limits a director's personal liability to a corporation or its stockholders for monetary damages for breaches of fiduciary duty. 8 *Del. C.* § 102(b)(7). However, Section 102(b)(7) expressly precludes exculpation of breaches of loyalty, and therefore directors remain subject to personal liability for breaches of loyalty.

Designated Directors and the Duty of Loyalty

The question becomes: how can a Designated Director navigate the potentially competing loyalties owed to the Corporation and the Nominating Firm? As noted above, the Designated Director owes a duty of loyalty to the Corporation and its stockholders, which requires the Designated Director to perform his or her board duties without giving any special or preferential treatment to the Nominating Firm. At the same time, however, the Designated Director may face competing pressures emanating from the Nominating Firm. For example, the Designated Director's compensation at the Nominating Firm may be tied in part to the firm's investment returns associated with the Corporation. The Designated Directors may also owe fiduciary duties or contractual obligations to the Nominating Firm and investors in that firm, which could be seen to interfere with the Designated Directors' obligations to the Corporation and its stockholders. "Because [constituency] directors are often affiliated with entities whose interests may differ from those of the stockholders as a whole, and because [constituency] directors are often dual fiduciaries who also owe a duty of loyalty to their differently situated entities, this standard poses particular risks to the [constituency] directors." J. Travis Laster & John Mark Zeberkiewicz, The Rights and Duties of Blockholder Directors, 70 Bus. Law. 33, 49 (2015).

Many times, however, these hypothetical competing tensions do not elevate to an actual conflict because the interests of the Nominating Firm and the other stockholders are fully aligned. *In re Synutra Intern., Inc.*, 2018 WL 705702, at *4 (Del. Ch. Feb. 2, 2018) ("The Delaware Supreme Court has held that a 'charge that a director was nominated by or elected at the behest of those controlling the outcome of a corporate election' does not rebut the presumption that a director was independent."). Indeed, directors should be focused on enhancing long-term corporate value for all stockholders. *In re Citigroup Inc. S'holder Deriv. Litig.*, 964 A.2d 106, 139 (Del. Ch. 2009) ("Ultimately, the discretion granted directors and managers allows them to maximize shareholder value in the long term by taking risks without the debilitating fear that they will be held personally liable if the company experiences losses."). Where the Designated Director supports a particular value-maximizing corporate transaction that benefits all stockholders equally, there are no diverging interests and hence no potential conflict for the Designated Director. *In re Trados*, 73 A.3d at 46 ("If the interests of the beneficiaries to whom the dual fiduciary owes duties are aligned, then there is no conflict.").

On the other hand, the interests of the Nominating Firm and Corporation's other stockholders can diverge due to differing investment horizons or investment objectives. *Id*. For example, suppose the Nominating Firm wants to liquidate its position in the Corporation in the near term. The Nominating Firm would therefore prefer a particular corporate transaction that may have a short-term benefit (stock price appreciation) but, due to strategic reasons, would not maximize the value of the corporation over the long term. In that circumstance, a Designated Director who "also serves in a fiduciary capacity for [the Nominating Firm] can face a conflict of interest: the [Designated Director's] duties to the corporation require that the director manage for the long term, while the [Designated Director's] duties to the [Nominating Firm] require that the director manage for an exit." Laster & Zeberkiewicz, at 50. What should the Designated Director do under the circumstances?

Given the serious potential reputational and financial consequences, public companies, Nominating Firms, Designated directors, and boards must all grapple with the question of how to avoid a potential violation of the duty of loyalty. The following topics are among the most relevant to consider.

Advocating for the Nominating Firm's Preferred Course of Action on the Board

Assume the Corporation's board is contemplating a particular transaction that the Nominating Firm strongly supports because it believes it will improve value for all stockholders. May the Designated Director advocate in favor of the transaction before the board without breaching the duty of loyalty? The answer should be "Yes"——if the Designated Director is fully informed and honestly and objectively believes the transaction is in the best interests of the Corporation and all of its stockholders. Thus, while Designated Directors cannot blindly represent the positions of a Nominating Firm, they are permitted to advocate for a position which the Nominating Firm would favor, if that position is based on the honest and objective understanding that such position is in the best interest of the corporation and all of its stockholders. *See, e.g.*, *In re Lear Corp. S'holder Litig.*, 967 A.2d 640, 655 (Del. Ch. 2008) ("During their term of office, directors may take good faith actions that they believe will benefit stockholders, even if they realize that the stockholders do not agree with them.").

Whether a Designated Director Should Recuse Himself or Herself from Voting on the Potential Board Action

Assume the board is considering a particular transaction. The Designated Director believes he or she has a disabling conflict that compromises his or her ability to comply with the duty of loyalty with regard to the proposed transaction. What can he or she do?

The Designated Director's safest course of action may be to fully disclose the conflict to the board; remove himself or herself from any discussions concerning the matter; and abstain from the board vote. *See Kahn v. Stern*, 2017 WL 3701661, at *8 (Del. Ch. Aug. 28, 2017) (explaining that to plead a claim for breach of loyalty, "the Complaint must contain 'sufficient facts to show that a *majority of the Board of directors* breached their fiduciary duty of loyalty'") (emphasis in original); DGCL § 144(a) (providing safe harbor for a transaction between a corporation and a director or the corporation and an affiliate of the director where the interested director discloses the conflict to the entire board and the transaction is approved by a majority of disinterested directors). It is important to note, however, that where a conflicted director abstains from voting, the board action cannot be approved by written consent due to the unanimity requirement of DGCL § 141(f); *Solstice Capital II, Ltd. P'ship v. Ritz*, 2004 WL 765939, at *1 (Del. Ch. Apr. 6, 2004).

In this way, the Designated Director ensures that the board action was approved by a majority of disinterested directors free from any suggestion that the Designated Director somehow tainted or improperly influenced the board's decision. *See, e.g.*, *Yucaipa Am. All. Fund II, L.P. v. Riggio*, 1 A.3d 310, 326 (Del. Ch. 2010) (noting that the independent directors failed to hold discussions outside the presence of the conflicted director); *Emerald Partners v. Berlin*, 2003 WL 21003437, at *28 (Del. Ch. Apr. 28, 2003) ("The single flaw in the non-affiliated directors' decision-making process was their failure to insist that [the conflicted directors] absent themselves entirely from that process."), *aff'd* 840 A.2d 641 (Del. 2003).

Sharing of Confidential Information Between the Corporation and the Nominating Firm

As a board member, the Designated Director is entitled to the same information that is provided to the other directors. *Schoon v. Troy Corp.*, 2006 WL 1851481, at *1 n.8 (Del. Ch. June 27, 2006) (A director's right to information is "essentially unfettered in nature"); *Intrieri v. Avatex Corp.*, 1998 WL 326608, at *1 (Del. Ch. June 12, 1998) ("a sitting director is entitled to … receive whatever the other directors are given."). Can the Designated Director share confidential information he or she learned as a board member with the Nominating Firm? The answer is it depends.

It is a breach of the duty of loyalty for a Designated Director to share the Corporation's confidential information with the Nominating Firm if such communication would harm the Corporation. *See Shocking Techs., Inc. v. Michael,* 2012 WL 4482838, at *8–11 (Del. Ch. Oct. 1, 2012) (disclosure of confidential information in a way that harmed the corporation was a breach of the duty of loyalty). However, there are circumstances where Delaware law permits the Designated Director to share the Corporation's confidential information with the Nominating Firm.

For example, in the 2013 case of *Kalisman v. Friedman*, the Delaware Chancery Court held that the corporation could not deny a Designated Director, who also served as the principal at a hedge fund which owned 13.9% of the public corporation, access to company information, including attorney-client privileged material, out of fear that the Designated Director would share the information with the Nominating Firm. 2013 WL 1668205, at *5 (Del. Ch. Apr. 17, 2013). In dicta, the court stated "[w]hen a director serves as the designee of a stockholder on the board, and when it is understood that the director acts as the stockholder's representative, then the stockholder is generally entitled to the same information as the director." *Id.* at *6.

Suppose the Designated Director gains confidential information from the Nominating Firm regarding the Corporation. Must the Designated Director disclose the information to the Corporation? Again, it depends.

If a Designated Director gains confidential information from his or her Nominating Firm that is relevant to the action being contemplated by the board, the duty of loyalty may require disclosure of such information. *Big Lots Stores, Inc. v. Bain Capital Fund VII, LLC*, 922 A.2d 1169, 1184 (Del. Ch. 2006) (a director does not have a general duty to disclose but rather a duty to disclose in "circumstances in which the director is personally engaged in transactions harmful to the corporation, but beneficial to the director"). The required disclosure of information about the Nominating Firm could be detrimental to the firm and should be considered when deciding whether to nominate Designated Directors.

* * *

As set forth above, the increasing prevalence of constituency directors on U.S. public company boards, and Designated Directors in particular, requires careful and proactive navigation of potential conflict issues. Q

NOTED WITH INTEREST

Federal Court Finds Privilege Waiver, Highlighting Risk of Inadvertent Waiver by "Constituency Directors"

In *Argos Holdings, Inc. v. Wilmington Tr. Nat'l Ass'n*, 2019 WL 1397150 (S.D.N.Y. Mar. 28, 2019), a federal court in the Southern District of New York held that the attorney-client privilege was waived when lawyers from Kirkland & Ellis LLP and Simpson Thacher & Bartlett LLP communicated with three directors of a company client. The three directors were also partners in the private equity firm that owned the company. Because hedge funds, venture capital funds, and private equity funds frequently appoint employees or principles from among their own firms to serve on the boards of companies they invest in, this decision is an important reminder that accidental privilege waiver can occur in these types of situations.

In *Argos Holdings*, the Court distinguished attorney communications with the three directors pertaining to their role as directors from attorney communications with the three directors pertaining to their role as partners in the private equity firm. The Court held that the former communications were protected as privileged whereas the latter communications were not.

Attorney Client Privilege

As the U.S. Supreme Court explained in *Upjohn Co. v. U.S.*, 499 U.S. 383, 389 (1981), the attorney-client privilege exists to encourage open and honest communications between attorneys and their clients. The privilege "shields from disclosure any confidential communications between an attorney and his or her client made for the purpose of obtaining or facilitating legal advice in the course of a professional relationship." *Argos Holdings*, 2019 WL 1397150, at *3 (internal quotations marks and citation omitted). The privilege applies where there is a "(1) communication (2) made between privileged persons (3) in confidence (4) for the purpose of obtaining or providing legal assistance for the client." Restatement (Third) of the Law Governing Lawyers § 68 (2000). The party asserting the privilege has the burden of establishing that the attorney-client privilege applies. *Ambac Assur. Corp. v. Countrywide Home Loans, Inc.*, 27 N.Y.3d 616, 624 (2016). Not all communications with an attorney are privileged. Rather, to qualify for the privilege, the communication must be "generated for the purpose of obtaining legal advice as opposed to business advice." *In re County of Erie*, 473 F.3d 413, 419 (2d. Cir. 2007).

Of central importance to the Court's holding in *Argos Holdings*, a privileged communication must be made in confidence where the "communicating person reasonably believes that no one will learn the contents of the communication except a privileged person." Restatement (Third) of the Law Governing Lawyers § 71. Thus, the general rule is that communications made in the "presence of third parties, whose presence is known to the client, are not privileged from disclosure because they are not deemed confidential." *Ambac*, 27 N.Y.3d at 624. Privilege will also be waived where a communication is made in confidence but is later shared with a third party. *Id*; Restatement (Third) of the Law Governing Lawyer § 79.

Factual Background

Kirland & Ellis and Simpson Thacher (the "Law Firms") represented plaintiffs PetSmart Inc. and its parent Argos Holdings, Inc. ("Argos Holdings"), along with Argos Holdings GP LLC ("Argos GP"), and Argos Holdings, L.P. ("Argos LP"), to provide advice in connection with the 2017 acquisition of Chewy, Inc. ("Chewy") and the transfer of Chewy stock to Argos Holdings. *Argos Holdings*, 2019 WL 1397150, at *1. Neither law firm represented the private equity firm BC Partners Inc., which owned a stake in both Argos GP and Argos LP and had designated three directors to the Argos GP Board (the "BCP-Designated Directors"). Following the transaction, plaintiffs filed suit seeking a judgment compelling Wilmington Trust—as Administrative Agent under the credit agreement that financed BC Partner's acquisition of PetSmart in 2015—to release certain liens on Chewy's assets and stock, and to release Chewy's guarantees of PetSmart's debt. *Id.* at *1-2.

Following a discovery dispute, the plaintiffs filed a motion for a protective order regarding thirteen sets of documents involving the Law Firms and the BCP-Designated Directors. The plaintiffs did not assert that BC Partners was a client of the Law Firms or that the common interest doctrine protected the communications. Instead, plaintiffs argued that the documents were privileged because the BCP-Designated Directors received the communications in their capacity as Argos GP Board members and because BC Partners—as a stakeholder of Argos GP—was entitled to the same information as its designated directors. *Id.* at *2.

The defendants opposed the motion, asserting that because the BCP-Designated Directors were also partners in BC Partners, which was not a client of the Law Firms, the privilege had been waived by the presence of a third party to the attorney-client relationship. *Id.* Defendants also countered that BC Partner's status as a stakeholder in Argos GP did not automatically encompass BC Partners within Argos GP's attorney-client privilege with the Law Firms. *Id.*

The Court's Decision

The District Court rejected the plaintiffs' argument that Argos GP's privilege automatically extended to BC Partners as a stakeholder in Argos GP, finding that the "weight of authority holds that shareholders are not entitled to corporate documents protected by attorney-client privilege absent litigation between the shareholders and the company and a showing of good cause." *Id.* at *7 (referring to the so-called "Garner exception"). The Court focused its analysis on whether the BCP-Designated Directors received the challenged communications in their capacity as Argos GP Board members, in which case the communications were privileged, or in their capacity as partners of BC Partners, in which case the privilege was waived. *Id.* at *4.

With respect to three sets of documents, the Court found that the plaintiffs had carried their burden of establishing that the BCP-Designated Directors had received the communications in their capacity as Argos GP board members. *Id.* *5. These communications were sent to the entire Argos GP Board (including the BCP-Designated Directors); specifically identified the three BCP-Designated Directors by their relationship to PetSmart or Argos GP rather than their association with BC Partners; or were sent to the BCP-Designated Directors at their PetSmart.com email addresses rather than their BC Partners email addresses. These facts evidenced that the BCP-Designated Directors were acting in their capacity as Argos GP Board members when they received the communications.

By contrast, for the remaining documents the Court found privilege waiver because there were no "indications that the correspondence with the [BCP-Designated Directors] was in connection with their service as directors of Argos GP as opposed to their partnership in BC Partners." *Id.* at *6. Perhaps most significant to the Court, the communications were sent only to the BCP-Designated Directors and not to the entire Argos GP Board. *Id.* In addition, many of the communications referenced the BCP-Designated Directors as the "BCP contact," used BC Partners or "external" email addresses, and did not appear to have any "particular relevance" to the business of Argos GP as opposed to BC Partners. *Id.* at *6-7. For these reasons, the Court concluded that the privilege was waived and required production of the documents.

Conclusion

Argos Holdings provides a cautionary tale of accidental privilege waiver—and the steps that can be taken to avoid it. For example, the Court suggested that a "document, protocol or training designed to protect privilege," *id.* at *5, would have militated against waiver. Such a protocol could educate designated directors on the risk of forwarding privileged board communications on to their investment firm colleagues and encourage designated directors to use portfolio company email addresses rather than an investment firm email address. Likewise, portfolio companies should encourage their attorneys to send privileged communications to the entire board whenever possible, to use portfolio company email addresses for directors, and to use language clearly delineating communications with directors that relate to their capacity as directors versus their capacity as partners or employees of a shareholder. Finally, portfolio companies and their investment firm shareholders should consider entering into common interest agreements or joint representation where applicable. Undertaking these types of initiatives should go a long way towards avoiding accidental privilege waiver. Q

PRACTICE AREA NOTES

Insurance Litigation Update

***Universal Cable Productions, LLC v. Atlantic Specialty Insurance Co.*: Applicability of War Exclusions to Evolving Warfare/Untraditional War/Hamas Conflict**

In a widely-publicized recent decision, the Ninth Circuit held that two differently-worded war exclusions did not bar insurance coverage for a television production company forced to relocate filming due to violence between Hamas and Israel security forces.

Factual Background and Procedural History

In the first half of 2014, Universal began filming a television show entitled *Dig* in Jerusalem, Israel. In late June 2014, Hamas began firing rockets from Gaza into Israel, which sparked an Israeli campaign against Hamas in response. The Universal security team became concerned about "acts of terrorism" near Jerusalem. Universal moved the production out of Israel and notified its insurance company, Atlantic, that it sought coverage for costs of delay and relocation.

Two days later, Atlantic denied coverage. The policy contained three relevant war exclusions, covering "war," "warlike action," and "insurrection, rebellion, revolution, [or] usurped power." Atlantic denied coverage under the first two exclusions for "war" and "warlike action."

Universal filed suit against Atlantic for breach of contract based on Atlantic's denial of coverage. The district court granted summary judgment in favor of Atlantic, holding that the first two exclusions, for "war" and "warlike action," barred coverage because the conflict between Israel and Hamas "would be considered 'war' by a layperson." Universal appealed.

The Ninth Circuit's Decision

Universal's appeal was premised on the argument that in the insurance context, "war" has a specialized meaning, applying only to conflicts between "de jure or de facto" governments.

Agreeing with Universal, the Ninth Circuit reversed the district court's decision. The Ninth Circuit held that the district court had erred in holding that the war exclusions should be understood based on the ordinary and plain meaning of their terms instead of applying the specialized meaning given to them in the insurance context.

Under California law, terms in an insurance policy are understood in their ordinary and popular sense "unless a special meaning is given to them by usage, in which case the latter must be followed." Cal. Civ. Code § 1644.

While courts generally apply customary usage only when both parties are engaged in the relevant business (here, insurance), the Ninth Circuit found that Universal is a sophisticated party that regularly engages in insurance-related business, and both parties were on notice of the customary usage such that applying the customary usage of the terms was appropriate.

Having determined that special meaning of the relevant terms in the insurance context would apply, the court moved on to the application of that meaning to the conflict in Israel.

The first war exclusion excluded from coverage costs incurred due to "[w]ar, including undeclared or civil war." Because customary usage includes only wars between de jure or de facto governments, the key question before the Ninth Circuit was whether Hamas was acting as a de jure or de facto government at the time of the 2014 conflict.

In finding that Hamas was neither a de jure nor a de facto government, the Ninth Circuit focused on the historical background and political position of Hamas in the region. At the time of the 2014 conflict, the Palestinian Authority was the de jure government, and Hamas had recognized this controlling government and agreed not to disturb it. The Ninth Circuit supported its conclusion by pointing out that the executive branch—which has the exclusive authority to recognize foreign regimes—has refused to recognize Hamas as either a de facto or de jure sovereign.

In holding that the claim was not covered by the second exclusion for "warlike action by a military force," the Court applied similar reasoning. The Court also relied on expert testimony, treatises, and case law indicating that "warlike" acts generally do not include violent acts by political groups not associated with governments. *See Pan Am. World Airways v. Aetna Cas. & Surety Co.*, 505 F.2d 989, 1012 (2d Cir. 1974). Acknowledging that this approach seemingly conflates "war" and "warlike action," the Ninth Circuit stated that it did not need to parse the difference between the two exceptions to determine that the Israeli-Hamas conflict did not fall under either.

Practical Implications

Moving forward, with terrorist attacks becoming more common, insureds should make sure their policies do not have terrorist attack exclusions and that they take advantage of the right to purchase coverage for terrorist acts under the Terrorism Risk Insurance Act. Additionally, insureds should aim to keep any war exclusions worded narrowly. Insurers negotiating policies related to activities set to take place in at-risk areas may choose to add broader exclusions to their policies encompassing violence involving political groups or terrorist groups.

The Ninth Circuit's holding is limited to policies interpreted under California law where customary usage is afforded to terms in insurance policies if both parties are on notice of that usage. *See, e.g., DIRECTV v. Factory Mut. Ins. Co.*, 692 F. App'x 494, 495 (9th Cir. 2017) (rejecting insurer's efforts to apply plain and ordinary meaning of the phrase "direct supplier" as to contingent business interruption). In a majority of jurisdictions, terms in insurance policies are construed according to their plain, ordinary meaning. If one of these jurisdictions faces a similar issue, a Circuit split may result. In fact, the Tenth Circuit has already held (in an admittedly somewhat dated opinion) that the inclusion of the phrase "undeclared war" in an insurance policy indicated that the parties "chose not to use the word 'war' in its technical or formal sense," a holding seemingly at odds with the Ninth Circuit's opinion. See *N.Y. Life Ins. Co. v. Durham*, 166 F.2d 874, 876 (10th Cir. 1948).

Further, the inapplicability of the first two war exclusions at issue in Universal may not be determinative if the district court determines on remand that the third exclusion, covering "insurrection, rebellion, [or] revolution," covers the Israeli-Hamas conflict.

EU Litigation Update

***Metall auf Metall* – 20 years of litigation over the sampling of two seconds, but no end in sight?**

A. Introduction

More than 20 years of litigation. Already eight court decisions. Hamburg, Karlsruhe, Brussels back and forth. But no resolution so far. And why? Because of the sampling of two seconds!

These are the remarkable characteristics of an exceptional copyright case called "*Metall auf Metall*". The latest stage in this far reaching litigation has recently concluded, when the Court of Justice of the European Union ("**CJEU**") responded to six legal questions referred to it by the German Federal Supreme Court ("**FSC**"). In short, the CJEU ruled that the sampling of a sound recording, even a very short excerpt, must be regarded as a partial reproduction of the original work if it is still recognizable. The use of such unmodified and still recognizable samples therefore requires the consent of the right holder.

While the facts of the case are rather simple and quickly summarized, the dimensions of the legal problem to be solved were unforeseeable in the beginning. And its outcome remains unpredictable.

On March 8, 1999, the German electronic music band *Kraftwerk* filed a copyright infringement action against the German music producer *Moses Pelham*. *Pelham* had used two seconds of *Kraftwerk's* song *"Metall auf Metall"* (published in 1977) as a sample in the 1997 hip hop song *"Nur mir"* performed by artist *Sabrina Setlur*. In that song, the sample was used as a repeated sequence for the background rhythm and played at a 5% slower speed. *Kraftwerk* claimed they had never consented to such use. According to *Kraftwerk*, this reproduction infringed their exploitation rights as producers of an audio recording (so-called performance right protected under copyright law). They claimed an injunction, information and damages.

The central legal question in dispute, thus, was whether the use of a two second sample of an audio recording in a new audio work is sufficient to constitute an infringement of the exploitation rights of producers of audio recordings under the German Copyright Act ("**GCA**").

B. Procedural History

While the case appeared to be rather narrow, the FSC and later the German Constitutional Court ("**GCC**") expanded the issue by starting to discuss the conflicting constitutional rights of users (*freedom of arts*) and producers of audio recordings (*guarantee of property*) in cases of music sampling.

I. Hamburg Regional Court (file: 308 O 90/99) – *Metall auf Metall*

The Regional Court of Hamburg rendered its decision on October 8, 2004. The court ruled that *Kraftwerk's* exploitation rights as producers of audio recordings were infringed and granted the injunction, information and damages claims (the latter on the merits only). The court held that even the smallest parts of a recording were protected, while no copyright exceptions or limitations applied.

II. Higher Regional Court of Hamburg (file: 5 U 48/05) – *Metall auf Metall*

The Higher Regional Court of Hamburg dismissed *Pelham's* appeal and confirmed the decision on June 7, 2006. While the Court emphasized that even though "smallest samples" may not be generally protected, it held that copyright protection had to be granted if the sample represented the characteristic element of the audio recording, which needed to be perceptible in the song using the sampling.

III. Federal Supreme Court (file: I ZR 112/06) – *Metall auf Metall*

On November 20, 2008, the FSC referred the case back to the Higher Regional Court of Hamburg. While the FSC confirmed that even the copy of a small sample of a recording could suffice to infringe (under no further requirements), the FSC found that the appeal court had not evaluated whether sampling could be exempted under an analogous application of the *free use* exception in Sec. 24 para. 1 of the GCA (which in summary provides that an independent work created by the free use of the work of another person can be published or exploited without the consent of the author of the work used; the term "free use" obviously needs interpretation, but in essence, this exemption covers the use of another's work if the other's work is still recognizable and also not just copied but, for example, put into a new context by the independent work). The FSC also shared its thoughts on an exemption for sampling:

- In principle, Sec. 24 para. 1 GCA could be applied to sampling by way of analogy.
- However, no analogous application was possible, if:
  - (i) the user could have rerecorded the sample by himself, instead of copying the original recording (equal replay), or
  - (ii) the sample was perceptibly used as the melody of the new song.

IV. Higher Regional Court of Hamburg (file: 5 U 48/05) – *Metall auf Metall II*

After the FSC's remand, the Higher Regional Court of Hamburg dismissed the appeal again on August 17, 2011, confirming the infringement also in light of Sec. 24 GCA. The Court found that the corresponding requirements, even if applied by way of analogy, were not met. While it denied that the sample was a melody, it held that a copy had not been necessary, because the defendants could have equally replayed the sequence themselves, referring to two expert witnesses.

V. Federal Supreme Court (file: I ZR 182/11) – *Metall auf Metall II*

On December 13, 2012, the FSC confirmed the appeal decision of the Higher Regional Court of Hamburg. The FSC confirmed that the appeal court was right when it found that the capabilities of an average music producer were decisive for the question, if an equal replay of the sample could be conducted. The Court pointed out that without such an objective test, an inexperienced and lousy music producer could more easily claim than an experienced and skilled producer that he with his individual skills and substandard equipment would not have been able to create a replay of the original sample of sufficient quality. The user's freedom of art was further not constrained by such interpretation, even if such a replay was costly and time consuming.

VI. Constitutional Court (file: 1 BvR 1585/13) – *Metall auf Metall*

After the civil case had been concluded by the FSC's second decision, *Moses Pelham* successfully claimed that this decision infringed Art. 5 para. 3 sent. 1 of the German Constitution (*freedom of arts*). On May 31, 2016, the previous decisions were vacated by the Federal Constitutional Court and the case was referred back to the FCS, because the alternatives of licensing or equal replay were found to be too limiting. On the one hand, there was no right to be licensed, on the other hand, such replay could be costly and time consuming, while it would not ensure the same result. In addition the GCC argued that sampling was a characteristic feature of hip hop music, which did not much hurt the economic interests of producers of audio recordings.

VII. Federal Supreme Court (file: I ZR 115/16) – *Metall auf Metall III*

Before assessing the case for a third time and in the light of the GCC's decision, the FCS stayed the proceedings and referred the following six questions to the CJEU on June 1, 2017:

- **Questions 1 & 2**: Is there an infringement of the phonogram producer's exclusive right to reproduce its phonogram if only very short audio snatches are taken and transferred to another phonogram? Can the latter be defined as a copy within the meaning of the Directive?
- **Question 3**: Can the Member States enact a provision limiting the producer's exclusive right in such a way that an independent work created in free use of its phonogram may be exploited without his consent?
- **Question 4**: Can it be said that a work or other subject matter is being used for quotation purposes if it is not evident that another person's work is being used?
- **Question 5**: Do the provisions of EU law allow any latitude in terms of implementation in national law?
- **Question 6**: In what ways are the EU fundamental rights to be taken into account when ascertaining the scope of protection (and of exceptions or limitations) of the exclusive right of the producer to reproduce its phonogram ?

C. Court of Justice of the EU (file: C-476/17) – *Pelham e.a./Hütter, Schneider-Eisleben*

The CJEU rendered its decision on July 29, 2019 by essentially ruling that musicians cannot sample other artists' records without permission, regardless of their length. The Court's primary rationale is very clear: The reproduction by a user of a sound sample, even if very short, must be regarded as a "partial" reproduction of that audio recording so that such a reproduction falls within the exclusive right granted to the producer. Yet, one exception applies if a party makes use of an audio recording's sample in order to embody it, in a modified and *unrecognizable* form, in another audio recording. To strike a fair balance between different interests, such a use could not qualify as 'reproduction' and no consent of the producer would be necessary (due to the *freedom of arts*, Art. 13 of the Charter of Fundamental Rights of the EU).

As for Question 3, the Court declared Sec. 24 para. 1 GCA (applied by way of analogy) - allowing a distinct work, created in the free use of a protected work, to be published and exploited without the consent of the right holder - to be non-compliant with EU law. In fact, exceptions and limitations provided at the EU level must be considered exhaustive, so that the Member States do not enjoy any margin of discretion in the determination of further limitations, distinct to the ones already provided by EU law.

Lastly, the Court set forth the perimeter for the "exception for quotations" (Sec. 51 GCA): If the work from which a sample was taken was still recognizable to the ears of the user, the use may still amount to quotation, especially where the intent of the use is to enter "into a dialogue" with the protected work. However, the use of a sample is not a quotation if it is not possible to identify the work in question.

D. Outlook

Undoubtedly, the CJEU decision will have a significant impact on the music industry. Following the reasoning of the Court, it all comes down to a strict scrutiny of originality in musical compositions. While clearer requirements have been put in place for the quotation exception, can the same be said for sampling? Who will be the ultimate ear to decide whether a sample can be recognized within a different song where it is copied?

Many are the questions still unanswered, almost certainly as many as the years of litigation yet ahead. Q

Quinn Emanuel Launches New Sexual Harassment and Employment Discrimination Practice

The "Me Too" Movement has shown that sexual harassment is pervasive throughout industries, and at all corporate levels. Yet to date no AmLaw100 firm has taken on sexual harassment and discrimination cases on behalf of victims and survivors. Quinn Emanuel's entry into this practice area is a watershed event that will finally level the playing field for victims and survivors. The firm will be working with various industry trade groups and non-profits, and will be partnering with other firms as it develops this practice. The practice will be co-chaired by Manisha M. Sheth of the New York Office and Diane Cafferata of the Los Angeles office. Q

Quinn Emanuel Holds Successful Inaugural Event for QE Institute on the Future of the Auto Industry on Artificial Intelligence

On October, 14, 2019, Quinn Emanuel hosted the first Quinn Emanuel Institute for the Future of the Auto Industry event. The Institute, based in the heartland of the German auto industry in Stuttgart, Germany, focuses on pressing topics for the future of the industry from all different angles: legal, policy, and regulatory.

The inaugural event was a seminar regarding autonomous vehicles ("AV") and artificial intelligence ("AI") in the auto industry. The speakers discussed the legal, regulatory and safety concerns during the transition from the research and development phase to actual AI and AV products on the road. Attendees included executives and in-house counsel from several of Germany's major auto makers and their suppliers.

The keynote speaker was the former Administrator of the United States National Highway Traffic Safety Administration ("NHTSA"), Dr. Mark Rosekind. While at NHTSA, Dr. Rosekind helped create the first federal guidance on self-driving technology in the United States. His presentation, entitled "Safety Innovation in Autonomous Vehicles: Opportunities and Risks," provided unique insights on regulatory and policy issues for self-driving technology. In his current role as Chief Safety Innovation Officer at autonomous vehicle startup Zoox, Dr. Rosekind provided additional perspective as a current "safety practitioner" involved in testing and building self-driving vehicles today.

Thomas Andrae, a Europe-based venture capitalist and advisor to AI start-up Merantix and Continental's digital / future mobility division also provided his perspective on how artificial intelligence is likely to change the face of mobility worldwide—going well beyond robo-taxis to logistics and flying autonomous drones.

Quinn Emanuel partner and Chair of the Firm's Autonomous Vehicle Practice, Jordan R. Jaffe, gave a presentation on early lessons learned from the front lines of autonomous vehicles litigation, including based on his recent experience in the *Waymo v. Uber* case. Mr. Jaffe addressed how autonomous vehicle intellectual property issues are being litigated, how to best protect AI and AV intellectual property, as well as product liability and data privacy issues likely to arise due to the use of artificial intelligence in the auto industry.

The event concluded with Quinn Emanuel partner Boris Bronfentrinker announcing the topic and date for next seminar from the Institute on April 23, 2020. The topic will be "Cooperation in the Automotive Industry – A Necessity Complicated by Competition Laws. A Transatlantic Perspective." For more information regarding the Institute or this event please contact events-qeautoinstitute@quinnemanuel.com. Q

Second Circuit Victory Clarifies Materiality Law

The firm recently achieved a decisive appellate win in the United States Court of Appeals for the Second Circuit, which unanimously affirmed the district court's summary judgment ruling dismissing all Rule 10b-5 securities fraud claims against our clients Mickey Gooch and Colin Heffron, the former Chairman and CEO of GFI Group, Inc. GFI is an interdealer broker, which disclosed its plans to merge with the Chicago Mercantile Exchange in a 2014 press release. The CME wanted to buy GFI's software business, and spin the brokerage business off to a private consortium led by Gooch and Heffron, all at a major premium over traded prices. The merger ultimately failed when a GFI competitor made a higher bid for the whole company, which led one plaintiff to bring a class action alleging that Gooch's description of the planned merger in the press release as a "singular and unique opportunity to return value" was actionable securities fraud.

Together with co-counsel, the firm succeeded in convincing the district court to grant our clients' motion for summary judgment, which the district court based on the grounds that the plaintiffs could not possibly prove either scienter or loss causation at trial. The firm led the defense efforts on appeal, which the Second Circuit resolved by affirming on yet another ground the firm had briefed: that the challenged sentence was not material because no reasonable investor would have placed reliance on such a vague and open-ended statement in making an investment decision, especially not given all the caveats also contained in the press release. The decision brought a decisive end to a long-running case against our clients, and will also help future defendants who are sued in securities fraud class actions on the basis of what the Second Circuit called mere "vague and indefinite expressions of corporate enthusiasm." Q

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Source: BTI Litigation Outlook 2020; bticonsulting.com/themadclientist/clients-name-the-33-most-feared-firms-in-litigation 9/24/2019

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business litigation report

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