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The Increasing Importance of Trade Secret Protection for Artificial Intelligence

Artificial Intelligence (AI) has quickly become one of the pillars of the modern economy. According to one widely cited study from 2017, AI could contribute up to $15.7 trillion dollars to the global economy by 2030. *See* PwC's Global Artificial Intelligence Study: Exploiting the AI Revolution at 3, https://www.pwc.com/gx/en/issues/data-and-analytics/publications/artificial-intelligence-study.html. That prediction is already coming to fruition. According to a White House report on AI from February 2020, "AI is already having a substantial economic impact, not only for companies whose core business is AI, but also for nearly all other companies as they discover the need to adopt AI technologies to stay globally competitive." American Artificial Intelligence Initiative: Year One Annual Report (Feb. 2020) at 1, https://www.whitehouse.gov/wp-content/uploads/2020/02/American-AI-Initiative-One-Year-Annual-Report.pdf. The recognition of the importance of AI is both broad and worldwide. Russia's Vladimir Putin has gone as far as to state that "whoever becomes the leader in [AI] will become the ruler of the world." *See* The Verge (Sept. 4, 2017), https://www.theverge.com/2017/9/4/16251226/russia-ai-putin-rule-the-world.

It is thus no surprise that companies are heavily investing to protect the intellectual property generated from their investments in AI technology. *See* PwC MoneyTree Report (Q4 2018), https://www.pwc.com/us/en/moneytree-report/moneytree-report-q4-2018.pdf. The question becomes how best to protect those investments in this critical space. For example, an autonomous driving company may be looking at its AI training data (i.e., records of previous test drives), the artificial neural network implementations generated from that training data (i.e., the software that helps the car drive itself), and assortments of other data necessary to operate an autonomous car. For each of these elements, the company must examine what aspects are patentable, subject to trade secret protection—or both. A misstep could result in the company being left with no meaningful intellectual property protection for its most important research and development.

But patenting AI technology today can be difficult. Due to the prohibition on patenting abstract ideas, acquiring meaningful patents on artificial intelligence systems is not straightforward. Thus, companies are increasingly turning to trade secret protection to protect their AI-related intellectual property. This article explores the tradeoffs between patents and trade secrets in the AI sector. It then describes how trade secrets have become essential tools for companies to protect their AI-related intellectual property. Finally, it concludes with practical guidance on how to leverage both patents and trade secrets to best protect valuable intellectual property regarding AI.

What is "Artificial Intelligence"?

First, a word on terminology. Some companies invoke the term "artificial intelligence" to describe their products at the earliest opportunity—even when the underlying technology does not fit within the established definition of artificial intelligence. For the purpose of this article, artificial intelligence generally refers to technology that, in some sense, mimics human intelligence. In particular, AI under this definition permits computers to perform some task without being expressly programmed to do so. To that end, this article will focus on machine learning, neural

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networks, and related training models, algorithms and data.

Patents Versus Trade Secrets – The Tradeoff of Public Disclosure

Patents confer a legal right to exclude others from making, using, selling, and importing into the United States the claimed invention for a number of years. But, in order to take advantage of this government-sanctioned monopoly, the inventor must disclose the invention to the public with enough detail such that the invention can be recreated by others in that field. This *quid-pro-quo*—a disclosure of the invention to the public in return for a limited-in-time monopoly on the invention—is a fundamental underlying policy objective of U.S. patent law.

By contrast, trade secrets, as the name suggests, protect information that is "secret." Trade secrets can provide protection for any information where the owner "has taken reasonable efforts to keep such information secret" and the information "derives independent economic value, actual or potential, from not being generally known" to other persons. *See, e.g.*, 18 U.S.C. § 1839(3) (Federal Defend Trade Secrets Act, definition of "trade secret"); Cal. Civil Code § 3426.1(d) (California Uniform Trade Secrets Act, definition of "trade secret"). Both federal and state law provide protection for trade secrets. Historically, trade secret protection has been applied to a wide variety of subject matter, including compilations of public data, source code, schematics, diagrams, and customer lists—amongst many other pieces of information.

In many ways, trade secret law can be broader or more flexible than patent law. Unlike patents, trade secret protection can be obtained without any application or registration—it arises automatically if the trade secret owner takes appropriate steps to ensure the information is secret, so long as the information provides a competitive benefit. Trade secret protection can also theoretically last as long as the information is kept secret. And trade secret law "protects items which would not be proper subjects for consideration for patent protection under 35 U. S. C. § 101." *Kewanee Oil Co. v. Bicron Corp.*, 416 U.S. 470, 482-3 (1974). For example, a list of customers could be protected as a trade secret, but certainly not by a patent.

In other ways though, trade secret protection is weaker than patent protection. Importantly, independent development is a defense to trade secret misappropriation but not for patent infringement. As explained by the Supreme Court in 1974:

> Trade secret law provides far weaker protection in many respects than the patent law. While trade secret law does not forbid the discovery of the trade secret by fair and honest means, e. g., independent creation or reverse engineering, patent law operates "against the world," forbidding any use of the invention for whatever purpose for a significant length of time. The holder of a trade secret also takes a substantial risk that the secret will be passed on to his competitors, by theft or by breach of a confidential relationship, in a manner not easily susceptible of discovery or proof. Where patent law acts as a barrier, trade secret law functions relatively as a sieve.

Kewanee, 416 U.S. at 489-490 (footnote and citation omitted).

This view is not universal. One can ask whether Coca-Cola, the holder of one of the most famous trade secrets—the formula for Coca-Cola—would agree with it. More to the point, times have changed since the *Kewanee* decision in the 1970's. For certain types of innovations related to AI, the pendulum may be swinging away from patent protection and towards trade secret protection.

The Difficulties in Patenting AI – *Alice* and Abstract Ideas

Recent years have seen a rapid acceleration in the number of patent applications directed to inventions in the field of artificial intelligence. More than half of all AI-related patent applications have been published since 2013. *See* WIPO Technology Trends 2019, Artificial Intelligence, at 13 https://www.wipo.int/edocs/pubdocs/en/wipo_pub_1055.pdf. Within that time, applications related to machine learning have grown by an average of 28% each year, applications related to computer vision have grown by an average of 46% each year, and applications related to robotics and control methods have grown by an average of 55% each year.

Despite this surge in applications, however, there are potential pitfalls to seeking patent protection over AI-related inventions. In particular, to receive a patent, the patent must claim patent-eligible subject matter under 35 U.S.C. § 101. One category that is ineligible for patent protection is abstract ideas. *Alice Corp. v. CLS Bank International*, 573 U.S. 208 (2014). Over the last 15 years, the general trend in the case law has been to apply the prohibition on patenting abstract ideas more strictly to software-centric inventions.

Given the limitations articulated in *Alice* and its progeny, it is unclear how many of the AI-related patents that have made their way through the U.S. Patent Office would survive in eventual litigation. *See, e.g.*, *Hyper Search, LLC v. Facebook, Inc.*, No. CV 17-1387-CFC-SRF, 2018 WL 6617143, at *10 (D. Del. Dec. 17, 2018) (invalidating patent with "neural network module"); *see also Purepredictive, Inc. v. H20.AI, Inc.*, No. 17-CV-03049-WHO, 2017 WL 3721480, at *5 (N.D. Cal. Aug. 29, 2017), *aff'd sub nom. Purepredictive, Inc. v. H2O.ai, Inc.*, 741 F. App'x 802 (Fed. Cir. 2018) (invalidating patent directed to automating predictive analytics). While each of these patents stands on its own and the decisions do not indicate that any future AI-related patents are necessarily invalid (or valid), they stand as guideposts that companies should be mindful of when considering patenting artificial intelligence inventions.

Finally, some AI-related innovations are simply not eligible to receive patent protection at all. For example, raw data collected for use in machine learning algorithms is not patentable in and of itself. That raw data combined with a conventional and well-known machine learning algorithm may also be unpatentable, even though the result may be incredibly valuable to the company. Considering these risks, many companies are turning to alternatives to protect their intellectual property in the AI space—namely, trade secrets.

Trade Secrets – An Apt Tool for Protection of AI Intellectual Property

While it is impossible to know the number of AI trade secrets being closely held by organizations around the world, it is likely that most AI intellectual property generated in the United States today is being protected through the use of trade secrets. While specific details remain confidential in light of strict protective orders, courts have already indicated that certain areas of information related to AI are protectable as trade secrets, such as algorithms, source code, and the way a business utilizes AI to implement machine learning.

There are certain practical advantages to trade secret protection—no filings fees, protection in real-time, theoretically unlimited length of protection, and broadly eligible subject matter. For AI in particular, there are several reasons why trade secrets are particularly valuable and suitable for intellectual property protection as compared to patents:

- AI technology is rapidly developing and improving at a rate the patent system is not designed to keep up with.
- Companies can create highly valuable intellectual property by understanding and creating a knowledge base about what technology does **not** work. While this knowledge does not qualify for patent protection, it can be protected as a "negative trade secret." Cal. Civil Code § 3426.1(d); *accord XpertUniverse, Inc. v. Cisco Sys., Inc.*, No. CIV.A. 09-157-RGA, 2013 WL 867640, at *2 (D. Del. Mar. 8, 2013), *aff'd* (Jan. 21, 2015) ("The definition [of a trade secret in Cal. Civil Code § 3426.1(d)] includes information that has commercial value from a negative viewpoint, for example the results of lengthy and expensive research which proves that a certain process will not work could be of great value to a competitor."). If a company were to misappropriate a negative trade secret, it could short circuit the need to conduct years of research to discover that a particular development path is unworkable.
- Some of the most important technology in AI is implementation know-how that is not suitable for patent protection. For example, because autonomous cars are not yet widely on the market, some companies have kept their specific implementations of the technology secret from their competitors to gain an advantage. Implementation know-how must have potential or actual economic value to qualify as a trade secret, however. "Proprietary ways of doing the same thing that others in the same field do are not trade secrets." *Agency Solutions.Com, LLC v. TriZetto Grp., Inc.*, 819 F. Supp. 2d 1001, 1017, 1021 (E.D. Cal. 2011). If particular software functionality is known or knowable without resort to clandestine means, then some aspects of the code may not comprise a trade secret even though the associated source code may itself be kept secret. *But see id.* ("Note, however, that while the way something is done is not a trade secret, some discrete fact concerning that way could conceivably be a trade secret.").
- As discussed, many AI developments are software-based, making patents potentially more difficult to obtain under *Alice*.

While trade secrets are increasingly important for AI companies, one major drawback in utilizing trade secrets is that protection is only afforded to the extent the intellectual property can be kept secret. Keeping software a "secret" can be challenging and operationally taxing for several reasons: (1) given the turnover at technology companies, strong employment agreements are needed to ensure departing employees are legally required to keep trade secrets secret; (2) given the ease of "stealing" software—which can be as easy as downloading code to a USB drive—strong cybersecurity policies need to be created and enforced;

(3) because reverse engineering can be a defense to trade secret misappropriation, software needs to be designed and deployed in a way to ensure reverse engineering is not possible (*see, e.g.*, *Sargent Fletcher, Inc. v. Able Corp.*, 110 Cal. App. 4th 1658, 1670 (2003) ("Evidence of independent derivation or reverse engineering directly refutes the element of use through improper means."); *N. Am. Deer Registry, Inc. v. DNA Sols., Inc.*, 2017 WL 2402579, at *7 (E.D. Tex. June 2, 2017) (trade secret is not misappropriated if there is reverse engineering or independent derivation)); and (4) in order to conduct business, it is often necessary to share technology widely with employees and partners, which increases the risk that a trade secret could be disclosed publicly.

In light of these concerns, maintaining trade secret protection can incur meaningful costs for a company and requires significant ongoing vigilance. Ultimately, a trade secret is only protected so long as it remains a secret. Even with strict regulations in place, companies always run the risk that the information will become public.

Patent vs. Trade Secret: Making the Right Decision for AI-Related Inventions

Even though trade secrets are important to protect AI-related intellectual property, there remain different advantages and drawbacks for both patents and trade secrets. The decision whether to patent or keep as a trade secret a given innovation thus represents an important strategic decision for any company. Here are some guiding factors to consider when making these kinds of critical decisions:

1. ***Is the innovation eligible for patent protection?*** Does the innovation satisfy the requirements of the Patent Act, including being patent-eligible subject matter under 35 U.S.C. § 101? If not, then patents are unavailable and trade secret protection is the best option.
2. ***Does the innovation comprise the type of information that can be kept secret as part of your business?*** If the innovation is readily discernable from the product itself or by other appropriate means, trade secret protection is unavailable. The trade secret in that instance would not be "secret." Thus, patent protection would be the best option.
3. ***Is the innovation likely to become generally known soon?*** Trade secrets only protect information that is not generally known. If the innovation is one that competitors or academia is likely to be making public relatively soon, then trade secret protection is sub-optimal. Instead patent protection may be the best option.
4. ***How likely is the patent able to withstand an attack in litigation?*** Even if the patent may be approved by the patent office, if you believe the patent is unlikely to withstand an attack in litigation, it may be better to keep the innovation as a trade secret so the underlying intellectual property does not have to be disclosed to the public.
5. ***How quickly will the invention become obsolete?*** If the invention will become obsolete quickly, the length of protection that patents provide (and the cost and effort to file the patent), may not be worth the benefit.
6. ***How quickly can the invention be commercialized?*** Conversely, if the invention will take a long period of time to monetize, the length of protection afforded by a patent will allow time for long-term investment and capitalization.
7. ***Is the innovation worth patenting?*** Patents cost time and money to prosecute and obtain. Not all innovations are worth that effort. For certain types of know-how, it may be more practical to utilize trade secrets to protect the innovation rather than a patent.

Both patents and trade secrets offer powerful ways for companies to protect their AI-related intellectual property. Each can be effective in certain circumstances. In most cases, optimal protection strategies will involve a thoughtful use of both regimes. Q

Tomasco and Clark Published in the *Best of ABI 2019* Journal

Quinn Emanuel partners Patty Tomasco and Sara Clark have been recognized in the *Best of ABI 2019: The Year in Business Bankruptcy* for their article "Asymmetric Discovery in Chapter 15." Complete details and the opportunity to purchase the full article are available at https://store.abi.org/ebook/best-of-abi-2019-the-year-in-business-bankruptcy.html. The American Bankruptcy Institute is the nation's largest association of bankruptcy professionals, which focuses on the latest bankruptcy regulations, laws and trends through industry conferences, continuing education, and legal research. Q

Policyholders Be "Fore" warned: Fourth Circuit Finds Insurance Broker Not Responsible for Hole-in-One Policy

On January 21, 2020, the Fourth Circuit affirmed a district court order granting summary judgment to an insurance broker on a claim that the broker had failed to procure the coverage necessary to protect a non-profit organization from losses associated with a charity golf tournament. While many businesses rely on a broker to place appropriate insurance coverage for the organization, this decision highlights the importance of understanding what is in your organization's policies—and policy applications—rather than relying solely on a broker to ensure coverage responds appropriately.

Charity Contest Gone Awry

In 2015, fans won big at the Greenbrier Classic, a golf tournament in West Virginia on the PGA Tour. Old White Charities, Inc., the entity which operates the tournament, promised fans at the 18th hole $100 each if a player were to sink a hole-in-one and $500 if players were able to make a second. Professional golfers George McNeill and Justin Thomas each shot holes-in-one on the 18th hole from a distance of 137 yards, which led to a payout to fans of nearly $200,000.

Insurance has long been available to protect charitable organizations that sponsor contests where winners may collect grand prizes, such as expensive vacations, cars, or cash. Its use in golf tournaments is so common that this "prize indemnification insurance" is often colloquially known as "hole-in-one insurance." Hole-in-one insurance, when properly obtained, allows contest sponsors to draw crowds and encourage donations or purchases while simultaneously protecting themselves from the risk of a large payout.

Underlying Coverage Action

When McNeill, and then Thomas, landed their shots, West Virginia Governor (and Greenbrier owner and chairman) Jim Justice handed out one hundred dollar bills to the lucky winners of the "Hole-In-One Fan Jackpot." Unfortunately, when Old White Charities attempted to collect from its insurer, it realized that a misstep during the policy application process had sunk its claim.

The insurance policy application—which a broker completed on Old White's behalf—required a minimum yardage of 150 yards for the hole to be used in the contest. In response to this restriction, the broker included an addendum noting that the 18th hole played an average of 175 yards, but represented to the insurer that Old White had no knowledge or control over the length of the hole on any given day of the tournament because the PGA determined the placement of the tee boxes and pins. Without securing the insurer's agreement to any modified terms, a representative of Old White signed the application, and the policy ultimately provided that the hole needed to be at least 170 yards for coverage to apply.

Because the holes-in-one were shot from a distance of 137 yards, the insurer disclaimed coverage, and the parties litigated the issue. The U.S. District Court for the Southern District of West Virginia granted summary judgment on the insurers' declaratory judgment claim, citing the unambiguous policy language restricting coverage to holes greater than 170 yards in length. Mem. Op. & Order, *Talbot 2002 Underwriting Capital Ltd. v. Old White Charities, Inc.*, No. 5:15-cv-12542 (S.D. W. Va. Jan. 6, 2017), ECF No. 246 at 9. The Fourth Circuit affirmed the district court's decision. *All Risks, Ltd v. Old White Charities, Inc.*, 715 F. App'x 274, 277 (4th Cir. 2017). In doing so, the Fourth Circuit agreed with the district court that the policy yardage restriction was unambiguous and that Old White failed to show it had a reasonable expectation of coverage. *Id.* at 275-76.

Broker Negligence Action

In response to the loss in the coverage action, Old White brought suit against its broker, Bankers Insurance, LLC, asserting state law claims of negligence, reasonable expectations, and misrepresentation. The district court granted summary judgment to Bankers on each of these claims and again the Fourth Circuit affirmed. *Old White Charities, Inc. v. Bankers Ins. LLC*, No. 18-1914, 2020 WL 290664 (4th Cir. Jan. 21, 2020).

In this suit, Old White argued that Bankers had violated the doctrine of reasonable expectations and that, as a result, Old White's "objectively reasonable expectations . . . regarding the terms of insurance contracts [should] be honored even though painstaking study of the policy provisions would have negated those expectations." *Id.* at *2 (citing *State ex rel. Universal Underwriters Ins. Co. v. Wilson*, 825 S.E.2d 95, 100 (W. Va. 2019)). The Fourth Circuit disagreed, noting that this doctrine applies only when the terms of the insurance contract are ambiguous. Here, the distance warranty in the application was clear, even when considering the broker's "addendum" to the application.

The Fourth Circuit also concluded that the district court correctly determined that Old White failed to establish the elements of duty and proximate causation in regard to its negligence claim and likewise failed to establish a claim for fraud or negligent misrepresentation against Bankers. *Old White Charities, Inc. v. Bankers Ins. LLC*, No. 18-1914, 2020 WL 290664 at *2 (4th Cir. Jan. 21, 2020). In West Virginia—along with many other jurisdictions—a broker has a duty to obtain the coverage requested by its client or inform the client if it is unable to do so. *See Wilson Works, Inc. v. Great American Ins. Grp.*, No. 1:11-CV-85, 2012 WL 12960778, at *2 (N.D.W. Va., June 28, 2012). However, because the organization had read and signed the application—which included the unambiguous yardage restriction—the district court held that "Bankers owed Old White no duty to secure an insurance policy outside the bounds of that application language." *Old White Charities, Inc. v. Bankers Ins., LLC*, 325 F. Supp. 3d 681, 691 (S.D.W. Va. 2018).

Conclusion

Old White Charities, Inc. v. Bankers Ins. LLC presents a cautionary tale to organizations that rely on insurance brokers to obtain adequate coverage. Not only must the responsible representative carefully read any policies obtained on its organization's behalf, he or she should also scrutinize any restrictions put forward in the policy application. While this may not seem efficient, given that brokers are typically retained precisely for their special expertise in these areas, this decision demonstrates the potential risks involved with taking a hands-off approach to your organization's coverage. Q

PRACTICE AREA NOTES

Securities & Structured Finance Litigation Update

Auto Loan Put-Back Claims: The Next Big Thing?

Since the 2008 financial crisis, the world of residential mortgage-backed securities ("RMBS") has been a well-spring of litigation. Over the last ten or so years, trustees, investors, and insurers have brought scores of lawsuits—many involving billions of dollars—against the lenders whose shoddy mortgage practices led the economy into crisis.

Back in the early 2000s, mortgage companies such as Countrywide Home Loans, and many others, began issuing as many loans as they could, as fast as they could, whether or not the borrowers could actually afford to repay them. This was catalyzed by the rapid expansion of securitization in the mortgage industry at the time. Through securitization, lenders were able to sell massive numbers of loans off their books for a profit immediately after originating them, while shifting the risk of borrower default to the investors and monolines who often insured these deals. This practice led to a flood of fraudulent and poorly-underwritten mortgage loans across the nation, fueling the rapid rise, and then precipitous collapse, of the housing market.

Investors and insurers had one key protection against these shoddy origination practices under the RMBS contractual framework: the "put-back" provision. In order to make their loan packages appealing to investors and insurers, mortgage companies sponsoring these transactions made certain promises about the quality and characteristics of the loans being securitized (representations and warranties or "R&Ws") —for example, that the loans on average had a particular FICO score, were tied to owner-occupied homes as opposed to secondary properties, or had an average appraisal value of a particular amount. If any of the loans did not comply with those promises, the investors, their trustees, and insurers had the right to "put back" those loans, *i.e.*, demand that the sponsor repurchase them.

Virtually all RMBS litigation during the past decade has been rooted in the enforcement of some form of put-back provision. In fact, RMBS put-back claims have been so prevalent that investing in that type of litigation became a market itself. But the time of RMBS litigation is coming to an end—previously filed cases are in the final stages of litigation, are settling, or the like—and new, similarly situated claims have not been following.

Another wave of loan put-back litigation, however, appears to be developing in a different industry: the auto loan asset-backed security ("ABS"). Like the mortgage lenders of the early 2000s, auto lenders of today appear to have abandoned prudent underwriting in order to make more and more loans. This is because, as was the case previously in the RMBS industry, approving more loans means that lenders can then bundle and sell those loans for a profit through securitization. GM Financial, one of the major auto lenders in the U.S., for example, touts on its website that securitizing auto loans "plays an essential role in financing our business." *Understanding Securitization*, GM Financial, https://www.gmfinancial.com/content/dam/gmf/about-us/understanding-securitizations.pdf (last visited Mar. 6, 2020).

The growing securitization of auto loans has led to the same problems that pervaded the mortgage industry fifteen years ago: lenders are making as many loans as they can, regardless of the borrowers' ability to repay. As the Wall Street Journal reported last October:

> Incomes have risen at a sluggish pace in the past decade, but car prices have grown rapidly . . . consumers are seeking bigger loans than ever to purchase a car. A lending machine has revved up in response, making it possible for more Americans to procure a vehicle by spreading the debt over longer periods. Wall Street investors snap up these loans, which are bundled into bonds. Dealers now make more money on the loans their customers take than on the cars they sell.

Ben Eisen & Adrienne Roberts, *The Seven-Year Auto Loan: America's Middle Class Can't Afford Its Cars*, Wall St. J. (Oct. 1, 2019), https://www.wsj.com/articles/the-seven-year-auto-loan-americas-middle-class-cant-afford-their-cars-11569941215.

Despite the comparatively slow growth of incomes during the same time period, the average auto loan "has grown by about a third over the past decade" and now "stretches for roughly 69 months, a record." *Id.* As a result, "U.S. consumers held a record $1.3 trillion of debt tied to their cars at the end of June [2019], according to the Federal Reserve, up from about $740 billion a decade earlier." *Id.* This has fueled massive profits for auto lenders who offload the risk of these loans through securitization. In 2018 alone, "investors bought a record $107 billion of bonds backed by cars." *Id.*

Like the mortgages of the early 2000's, the auto loans being purchased as assets are not always a good investment. As of February 2019, a record seven million Americans were at least 90 days delinquent on their auto loan payments, according to the Federal Reserve Bank of New York. The major cause, University of Utah law professor Christopher Peterson argues, is that many auto dealerships and finance companies "are fully aware that they are making loans that have a high probability of defaulting." *Is a Subprime Auto Loan Crisis Brewing?*, Knowledge@Wharton Radio (Feb. 18, 2019), https://knowledge.wharton.upenn.edu/article/auto-loan-subprime-crisis/. According to Peterson, auto lenders "are really driving these high default rates. And my suspicion is that a lot of that has to do with . . . the fact that they are likely shedding off a lot of this risk by selling them into securitization pools that are sold on Wall Street." *Id.*

In the words of Yogi Berra, it's like de ja vu all over again, except now the culprit is the auto loan, not the residential mortgage. The similarities are striking—not just in the bad acts potentially causing another crisis, but also in the claims for recompense that are sure to follow.

Indeed, the respective structures of RMBS and auto loan securitizations are essentially the same. An issuer takes thousands of loans it either originated or bought from another lender and packages them into a pool. That pool of loans is then transferred to a trust. The trust then uses the loans as collateral for corporate bonds that are sold to investors. The investors are then paid by the cash flow generated by the borrowers' monthly payments on the loans. As with RMBS, auto loan ABS investors do not get paid if the borrowers default on their loans. Under this structure, RMBS and auto loan ABS "sponsors" alike make numerous R&Ws vouching for the quality and characteristics of the loans being securitized. At the heart of these R&Ws is the sponsor's promise that the loans were properly underwritten, *i.e.*, that each of the loans in the trust was approved based on the borrower's ability to repay, as opposed to the sponsor's ability to sell the loans off its books.

RMBS sponsors typically do this by promising that the loans were approved in accordance with their underwriting guidelines. Similar promises are typically made in the auto loan context. One auto loan ABS sponsor, for example, promised that the loans at issue were originated in accordance with the sponsor's "credit policies." Sale and Servicing Agreement ("SSA"), GM Financial Consumer Automobile Receivables Trust 2018-2, at Schedule B-1 (Apr. 19, 2018), https://www.sec.gov/Archives/edgar/data/1347185/000119312518126921/d571764dex43.htm [hereinafter GM Financial 2018-2]. Another auto loan ABS sponsor represented in the deal's prospectus that the loans at issue were approved based upon that sponsor's "origination guidelines," including those concerning "affordability." Prospectus for Santander Drive Auto Receivables Trust 2017-1, at 39 (Feb. 23, 2017), https://www.sec.gov/Archives/edgar/data/1383094/000119312517058266/d345750d424b5.htm#rom345750_45 [hereinafter Santander 2017-1].

Auto loan ABS sponsors make a number of other R&Ws, also typically included in RMBS deals, that go to the quality of the loans being securitized. One sponsor, for example, promised that: (i) the auto loans at issue complied with "applicable federal, state and local laws," *e.g.*, they weren't approved as a result of predatory lending; and (ii) there was no "default, breach, violation or event permitting acceleration under the terms of" any auto loan, which could be argued constitutes a promise of no borrower fraud, to the extent borrower fraud was a default, breach, or violation of the relevant loan agreement. *See, e.g.*, Purchase Agreement for Santander 2017-1, at Schedule II(b), (e) (Feb. 28, 2017), https://www.sec.gov/Archives/edgar/data/1383094/000119312517058229/d315860dex101.htm.

Even more significantly, auto loan ABS sponsors, like RMBS sponsors, typically promise to "repurchase"—again, often referred to as "put back"—any loan that breaches one or more of the sponsor's R&Ws, so long as the breach "materially and adversely" affects the interests of the investors. *See, e.g.*, GM Financial 2018-2, at 24. These are commonly called "defective loans."

In the RMBS context, courts have held that a defective loan need not actually default for the breach to be material and thus require repurchase, so long as the breach increases the risk of default. *See Home Equity Mortg. Trust Series 2006-1 v. DLJ Mortg. Capital, Inc.*, 175 A.D.3d 1175, 1177 (1st Dep't 2019); *Wilmington Tr. v. MC-Five Mile Commercial Mortg. Fin. LLC*, 171 A.D.3d 591, 592 (1st Dep't 2019). Because of this, RMBS plaintiffs have been able to seek repurchase of materially defective loans even if the borrowers have not defaulted, which has significantly broadened the scope of RMBS put-back claim recovery. The same standard for repurchase could govern auto loan ABS, given their similarities to RMBS.

In short, there is strong potential for a tidal wave of auto loan put-back litigation. Like their RMBS counterparts, auto loan ABS sponsors are obligated to repurchase defective loans, and tens of billions of dollars' worth of auto loans have been securitized in just the past several years. To the extent these loans suffer from the same rampant R&Ws breaches that plagued RMBS deals, the potential for plaintiff-side recovery could be substantial. At the very least, the recent news reports suggest that this is a topic worth exploring further.

International Litigation Update

English Court of Appeal Finds Jurisdiction To Compel Non-Party Deposition in Aid of Foreign Arbitration

The "long-standing controversy" over whether orders made by English courts "for the purpose of and in relation to arbitral proceedings" under s.44 of the Arbitration Act of 1996 can be made against non-parties to the arbitration was at least partially resolved on March 19, 2020, when the English Court of Appeal ruled in *A & B v. C, D & E.* [2020] EWCA Civ 409. The Court of Appeal held that section 44(2)(a), which provides for the Court's powers in respect of "the taking of evidence of witnesses," gives the Court power to order the deposition of a non-party witness in England in support of an arbitration seated in and being conducted in a foreign jurisdiction. *Id.* at [49]. Respondents could still seek to appeal the ruling to the Supreme Court.

Background

The case concerned a New York arbitration arising from a dispute between co-venturers in a Central Asian oil field. An issue arose concerning the proper categorization of certain payments and one witness involved in negotiating those payments, an English resident, refused to go to New York to give evidence. With the permission of the arbitration tribunal, the Appellants sought to compel his testimony and applied to the English Court under s.44(2)(a) of the Arbitration Act of 1996 for an order under CPR34.8 for the taking of his evidence by deposition, so that it might be adduced in the New York arbitration. Accordingly, the application was opposed, with the dispute centering on the Court's power over "the taking of the evidence of witnesses" pursuant to s.44(2)(a).

After a careful review of the statutory language and authorities on the application of s.44 to persons other than the arbitrating parties, the English Commercial Court (Foxton J.) concluded that it "does ***not*** have jurisdiction under s.44 to make an order against a non-party to the arbitration agreement." [2020] EWHS 258 at [34] (emphasis added). The Commercial Court acknowledged that, absent authority, the Court's view would have been that it had jurisdiction under s.44; however, the Court felt compelled to follow the interpretation of s.44 in *Cruz City I Mauritius Holdings v. Unitech Ltd.*, [2014] EWHC 3704 (Comm), and *DTEK Trading SA v. Morozov*, [2017] EWHC 1704 (Comm). [2020] EWHC 258 at [18]. *Cruz City* held that s.44(2)(e) "does not include any power to grant an injunction against a non-party" to the arbitration, [2014] EWHC 3704 (Comm) [47], and *DTEK* held that s.44(2)(b) does not include jurisdiction to make an order for the preservation and inspection of a document in the possession of a non-party in the Ukraine, [2017] EWHC 1704 (Comm). Recognizing the controversy over its ruling, the Court granted permission to appeal. *See* [2020] EWCA Civ 409 at [1-2].

Court of Appeal Ruling

The Court of Appeal decided the case on the "narrow approach," holding "that section 44(2)(a) does give the Court power to make an order for the taking of evidence by way of deposition from a non-party witness in aid of a foreign arbitration, whatever the scope of the other heads of the subsection and whether or not they also apply in relation to non-parties." [2020] EWCA Civ 490 [35]. The Court expressly declined to decide whether *Cruz* and *DTEK* were correctly decided with respect to the scope of the subsections of s.44(2) at issue in those decisions. *Id.*

The Court of Appeal held that section 44(2)(a) applies to non-parties based largely on the language of s.44(2)(a) with its reference to "the taking of evidence of witnesses," not to "parties." The Court noted: "[T] here is no justification in the wording of the statute for limiting 'witnesses' to those who are in the control of one or other of the parties. If Parliament had intended that limitation, it would have said so." [2020] EWCA Civ 490 [37], [59] (Males LJ).

In addition, the Court of Appeal explained that the wording of s.44(1), when read with section 2(3) and the definition of "legal proceedings" in section 82(1) makes it clear that, provided the other limitations built into the section are satisfied, the English Court has the same powers under s.44(2)(a) in relation to arbitrations, wherever their seat, as it has in relation to civil proceedings before the High Court or the county court. [2020] EWCA Civ 490 [36]. Those powers include the power to take evidence on deposition wherever necessary and just to do so. *Id.* at [38], [61] (Males LJ). Thus, the Court of Appeal ordered the examination of the non-party by deposition before an examiner of the Court. *Id.* at [49].

The Court of Appeal noted that its ruling leads to the "somewhat anomalous situation that the English Court can order a deposition in support of a foreign arbitration when it could not make an equivalent order in support of foreign court proceedings unless there was an inwards letter of request." *Id.* at [39]. The Court explains, however, that this situation is less anomalous that it would appear because in most instances, absent agreement of the parties or urgency, a party will need to first obtain permission of the tribunal under s.44(4) to make an application, and the Court always has discretion not to Order a deposition if it considers it inappropriate to do so. *Id.*; *see also id.* at [69] (Males LJ).

In sum, the decision appears to provide comparable discovery mechanisms under English law to those discovery mechanisms available under U.S. law. In the United States, 28 U.S.C. § 1782 ("Section 1782") empowers U.S. federal courts to compel discovery from persons in the U.S. for use in foreign proceedings. While the issue of whether Section 1782 can be used for private arbitrations is currently unsettled, the express language of the statute only requires that the discovery target is "found or resides" in the district in which the discovery application is made. Further, the discretionary factors that generally guide U.S. courts in Section 1782 actions would weigh the target's non-signatory (*i.e.*, non-party to the arbitration) status in favor of granting discovery. *See Intel Corp. v. Advanced Micro Devices, Inc.*, 542 U.S. 241, 264 (2004) (finding non-party status weighs in favor of granting discovery).

Significance of the Ruling

The Court of Appeal decision in *A & B v. C, D & E* is important for two reasons. First, as a practical matter, those involved in arbitrations outside the U.K. can now seek the support of the English courts in obtaining testimony from a non-party witness present in England where the arbitration tribunal is otherwise powerless to compel that witness's attendance. To that end, in a concurring opinion, Lord Justice Males offers practice guidance regarding depositions conducted pursuant to s.44(2)(a). According to Lord Justice Males, pursuant to CPR 34.9, "the examination must be conducted in the same way as if the witness were giving evidence at a trial." [2020] EWCA Civ 490 [67] (Males J.). It follows that questions must be "calculated to elicit admissible evidence and that the witness will be entitled, if appropriate, to rely on such matters as legal professional privilege and the privilege against self-incrimination." *Id.* at [68].

Second, the decision in *A & B v. C, D & E* suggests that, despite *Cruz* and *DTEK*, the Court of Appeal may be willing to revisit the correct interpretation of section 44 as a whole with respect to non-parties. The Court's conclusion on s.44(2)(a), reached by construing s.44 as a whole, suggests that the Court may still apply a broader construction of s.44 to other subsections, allowing for injunctions and other interim relief to be ordered against non-parties in support of arbitrations, even where seated or conducted abroad. *See* [2020] EWCA Civ 490 [44] ("I would prefer to leave the issue of the scope of the other subsections and whether *Cruz City* and *DTEK* were correctly decided to an appeal where that issue arises directly."); [2020] EWCA Civ 490 [57] (Males J.) ("I see no reason to doubt the actual decisions in *Cruz City* and *DTEK*, but I would reserve my opinion whether their reasoning on this point is correct as regards the other paragraphs of section 44(2). There are, in my view, strong arguments either way and it may be that the position varies as between the various paragraphs of subsection (2).").

Finally, while the Court of Appeal did not grant permission to appeal its decision, an application for permission to appeal to the Supreme Court could still be made.

Summary Judgment Victory Establishes Basis for Recovering Attorneys' Fees for Breach of Release

The firm recently secured back-to-back victories for pharmaceutical executive Ray Mirra over Gigi Jordan, his former business partner who is currently serving an eighteen-year prison sentence for killing her eight-year-old autistic son. In 2008, Mirra and Jordan terminated their longtime business partnership by entering into a separation agreement and mutual general release. Two years later, Jordan killed her autistic son in a suite at the Peninsula Hotel in Manhattan by force-feeding him a lethal dose of painkillers. As part of her criminal defense, Jordan concocted the outrageous narrative that she had acted under the influence of an extreme emotional disturbance caused by her belief that Mirra and his business associates had engaged in a decades-long conspiracy to steal hundreds of millions of dollars from her, and that Mirra was trying to kill her to cover up the theft. In the process of spreading this lie, she filed a series of lawsuits against Mirra and several of his companies and employees, including a $225 million diversity action in federal court for fraud, fraudulent inducement, breach of fiduciary duty, breach of promissory notes, unjust enrichment, and conversion, among other causes of action.

Quinn Emanuel moved to dismiss nine of the ten causes of action as barred by the statute of limitations and by the terms of the release agreement and for failure to plead the elements of fraud. In November 2017, the District Court for the District of Delaware granted the motion to dismiss with prejudice on all three grounds. While Jordan was left with a single claim for breach of warranties—the only claim we did not contest on the motion to dismiss—we moved for summary judgment on our potentially more valuable counterclaims seeking money damages for Jordan's breach of the release agreement. On December 20, 2019, the District Court granted our motion for summary judgment as to Jordan's liability for breach of the release and Mirra's entitlement to reimbursement of the legal fees he incurred in defending against the released claims, with the precise amount of recoverable fees to be determined at trial. The victory sets an important new precedent on the ability to sue for legal fees incurred in defending against released claims.

Exactly three weeks later, on January 10, 2020, we achieved the complete dismissal of a related action brought by Hawk Mountain, LLC, an entity controlled by Jordan, seeking $5.3 million plus interest from RAM Capital, LLC, an investment and management company controlled by Mirra, under the terms of a promissory note. The New York Supreme Court, New York County Commercial Division, granted our motion to dismiss the action in its entirety on both grounds we moved upon—that the claims were barred by the statute of limitations and by the terms of the release agreement between Jordan and Mirra. In light of the precedent set in the summary judgment victory three weeks earlier, Mirra now stands to recover his legal fees from the state court action in addition to all the other legal fees to which he is now entitled.

Quinn Emanuel Secures Settlement for Tier 1 Bondholders in Hamburg Commercial Bank Thwarting Attempted Accounting Gimmickry

The firm represented a group of investors in litigation against HSH Nordbank AG based in Hamburg (meanwhile renamed Hamburg Commercial Bank AG) before the Kiel District Court. The amount in controversy was in excess of EUR 1 bn.

The litigation centered on hybrid capital instruments (so-called Tier1 instruments), indirectly issued by HSH. The instruments were based on silent partnership agreements between HSH and special funding vehicles. The funding vehicles held silent participations in HSH. They issued derivative, publicly traded instruments in their own name. With respect to these instruments, profit share, coupon payments etc. were directly dependent on the book value of the silent participations. The book value of the silent participations was linked to the annual balance sheet loss/profit generated by the bank. The overall nominal value of the instruments was approximately USD 2 billion.

As of 2008, and as a result of the financial crisis significantly affecting the shipping market, HSH being one of the world's largest shipping financiers made significant losses. HSH's loan book was full of non-performing shipping loans. The bank turned to its state owners (Hamburg and Schleswig-Holstein) and those injected about 20 billion Euros in capital. However, the European Commission viewed this bail out as impermissible state aid under EU rules and demanded that the bank be privatized or liquidated.

In preparation of its sale to private buyers, HSH made extensive use of a provision in the German Commercial Code, permitting banks to allocate funds to a "fund for general banking risks" in their accounts. This fund did not count as a reserve for balance sheet purposes (which would mean that allocations would have to come out of profits) but as an expense and, therefore, reduced the available annual profit. This had a severe impact on the book value of the silent participations and, consequently, the value of the bonds. The allocations to that fund consumed essentially all available profits from 2011 onwards and, in several years, turned a profitable year into a loss-making one. Since the bank thus started to show an annual balance sheet loss, the bonds' face value was written down and coupon payments ceased.

In early 2018, the sale of the bank to a group of private equity firms led by New York based hedge funds Cerberus and J.C. Flowers was about to close. The sale of the bank was structured as a combination of a loan portfolio sale and an outright sale of shares with the same group of investors buying both assets. The loan portfolio was sold at a huge discount against the already depressed book value, resulting in a balance sheet loss of HSH of about EUR 1 billion. Accordingly, the book value of the silent participations and the bond prices fell.

The bank's new owners then announced that they intended to keep the balance sheet loss as "loss carry forwards", potentially indefinitely, and use it to write down the face value of the bonds each year - a scheme used by other privatized Landesbanken and known as "double burden strategy". They also gave notice of their intent to call the bonds by the end of 2020 and repay the remaining face value, expected to be well below 10 cents on the Euro.

Quinn Emanuel then filed suit against HSH. As the investors lacked a direct contractual relationship with the bank (since the bonds had been issued by offshore funding subsidiaries), the firm used a German law concept known as "contract with protective effect for third parties." This concept had been established through case law in the early 20th century as an exception to the privity of contract. The firm argued that the silent partnership agreement between the bank and its funding subsidiary had protective effect for the holders of bonds issued by the funding subsidiary. The bank only used the structure with their funding subsidiaries so they had one counterparty and could avoid the inconvenience of having to contract with a plurality of investors who each bought relatively small amounts (some as low as 50,000 Euro). For all intents and purposes, the bondholders were the counterparties providing the silent contributions.

On that basis, the firm argued a breach of contract by the bank based on the bank's accounting irregularities (misuse of the "fund for general banking risks" to secure against specific loan risks and in relation to the state bail-out) and the undervaluation of the loan portfolio. Approximately one year after the firm had filed suit, the client group and the bank entered into a settlement agreement. The parties agreed on the transfer of the bonds to the bank at a price of 37.5% plus reimbursement of all litigation expenses. This is a significant improvement over the bank's intended repayment at a price well below 10% in 2021. Q

Robert Schwartz Again Named a Power Lawyer by *The Hollywood Reporter*

Robert Schwartz was named a 2020 Power Lawyer by *The Hollywood Reporter*, making this his fourteenth consecutive year of selection. The Power Lawyers annual listing features the most influential attorneys in the entertainment and media industry. Q

Rüdiger Lahme Recognized as a "Future Leader" by *Who's Who Legal*

Rüdiger Lahme was recognized by Who's Who Legal and Global Competition Review (GCR) in their annual "Future Leaders" competition category for 2020. *Who's Who Legal* is published by Law Business Research Limited and is regarded as a trusted source for identifying the world's leading lawyers and consulting experts in various areas of business law. Q

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business litigation report

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