HOW THE CREDIT MELTDOWN IS INCREASING YOUR LITIGATION EXPOSURE AND WHAT TO DO ABOUT IT

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Nixon Peabody

Sixth Annual MAC Survey

A Nixon Peabody study of current negotiation trends of Material Adverse Change clauses in M&A transactions

NIXON PEABODY℠
SURVEYS

Nixon Peabody's Sixth Annual MAC Survey provides an expanded analysis of publicly disclosed M&A transactions and finds a trend toward more seller-friendly terms, which continues the trend found in last year's study.

As in years before, we are pleased to announce the completion of our annual MAC study of agreements with transaction values of $100 million or greater based on agreements dated between June 1 of the prior year and May 31 of the current year. We initiated this annual survey because of the dramatic stock market decline in 2000 and the events of September 11—to track their effects on the negotiation of MAC provisions in M&A deals. Since that time, this annual exercise has undergone significant expansions of scope and analysis to help identify current negotiation trends and the concomitant advantages and disadvantages provided to transacting parties in mergers and acquisitions.

By way of explanation, a material adverse change ("MAC") or material adverse effect ("MAE") provision in an agreement generally comprises two elements. In the first, the MAC or MAE definition describes the circumstances that would constitute a material adverse change or effect on the target. This definition is used in the representations and warranties of the target or sellers, i.e., "The company's material contracts are in full force and effect, except as would have a Material Adverse Effect." The definition is also used to delineate the circumstances that, upon their occurrence, permit a buyer to withdraw from the transaction without penalty. This latter use is known in common parlance as the "MAC out" and appears in the buyer's conditions precedent to close, i.e., "that there shall not have occurred a Material Adverse Change to the company." The flip side of the coin is the listing of specific events — the "MAC exceptions"— that would prohibit a buyer from backing out of a deal.

The elements of MAC clauses generally are negotiated heavily, with sellers attempting to narrow the MAC definitional elements and include as many exceptions as possible, and buyers doing the reverse. This year we have again compared our random sampling of 413 deals with the top 100 deals (measured by dollar size of the transaction) during the period examined. In comparison to the sampling as a whole, we have seen that these top 100 deals generally followed the same percentage trends of the MAC definitional elements and had a slightly higher percentage trend in the MAC exceptions, but in certain categories, contained significantly more MAC exceptions. These findings indicate, again, that in larger deals, sellers have more bargaining power.

Impact of Credit Crisis

We completed this year's survey before the onset of the credit crisis that began in July 2007. As such, we have not reviewed agreements since that date to determine the impact the crisis will have on deal terms in general and MAC clauses in particular. However, we do believe that the credit crisis will have a chilling effect on the larger transactions and would expect that the overheated pro-seller market will cool off significantly as a result of less leverage being available to private equity buyers. Accordingly, we would expect deal terms (including the MAC provision) to become more buyer-friendly. The extent and swiftness of the change is difficult to predict and may take some time to work its way into the agreements themselves.

For deals that have already signed but have not yet closed, we would expect that both buyers and sellers are carefully examining the closing conditions and MAC clauses in the agreements. While we doubt that the current credit crisis would actually result in a Material Adverse Effect on many target companies, we believe private equity buyers may look to the MAC clause as leverage to renegotiate the deal to achieve more favorable terms so that the transaction continues to work from a financial perspective. As such, sellers will face a difficult decision either to litigate to force the buyer to abide by the terms of the original transaction or to accept a price cut. This decision will be greatly influenced by how successful the seller was in obtaining many of the carve-outs discussed in our survey.

We will be monitoring the changes carefully and will report back in our next annual update.

Methodology

In completing this year's survey, we examined 413 asset purchase, stock purchase and merger agreements. The surveyed transactions represent all significant industries and range in value from $100 million to $32.9 billion. The top 100 agreements were derived from the list of top deals announced each month in Mergers & Acquisitions: The Dealmaker's Journal.

In selecting our 413-agreement sample, we made every attempt to obtain a random and unbiased sample. To do so, we generated a list of deals signed between June 1, 2006 and May 31, 2007 from publicly available information submitted to the Securities and Exchange Commission and randomly selected agreements from that list. Although this analysis is not technically scientific, we believe that the results are statistically representative of the current climate of M&A transactions.

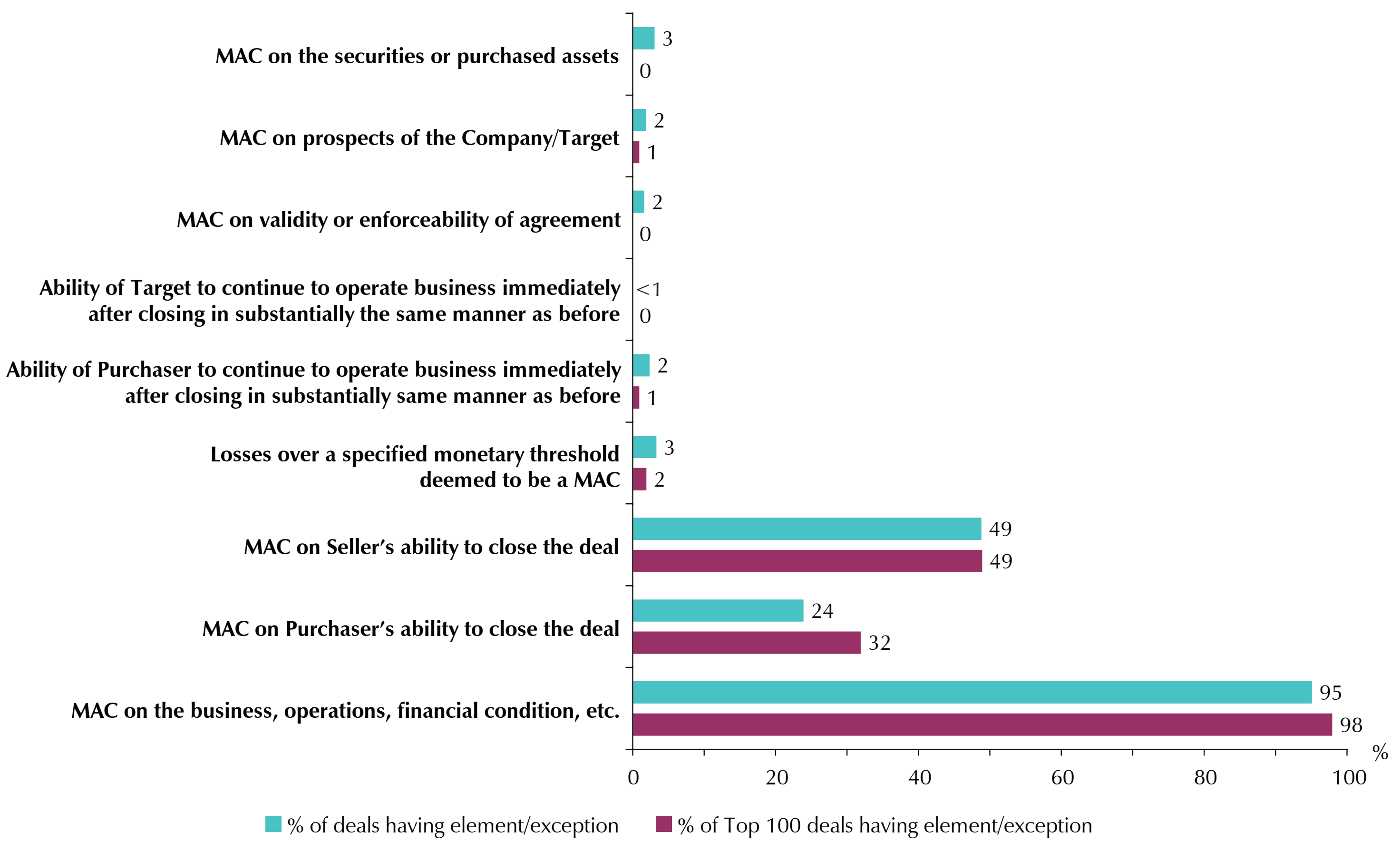
Results

In the agreements surveyed, the MAC definitional elements were generally narrower than last year, which indicates only a slight advantage gained by sellers. This advantage is buttressed, however, by increases across the board in MAC exceptions. Therefore, the slight narrowing of MAC definitional elements combined with the significant increases in MAC exceptions signifies an increasing negotiating advantage for sellers.

The continued shift toward seller-friendly terms noted over the past two years may be due to increased competition in the private equity market. With more buyers and higher fund values, there is more money available for a limited number of sellers. Buyers are finding that they have to offer sellers top prices and seller-friendly terms in order to compete.

Set forth below is a table detailing the prevalence of the MAC elements in our survey:

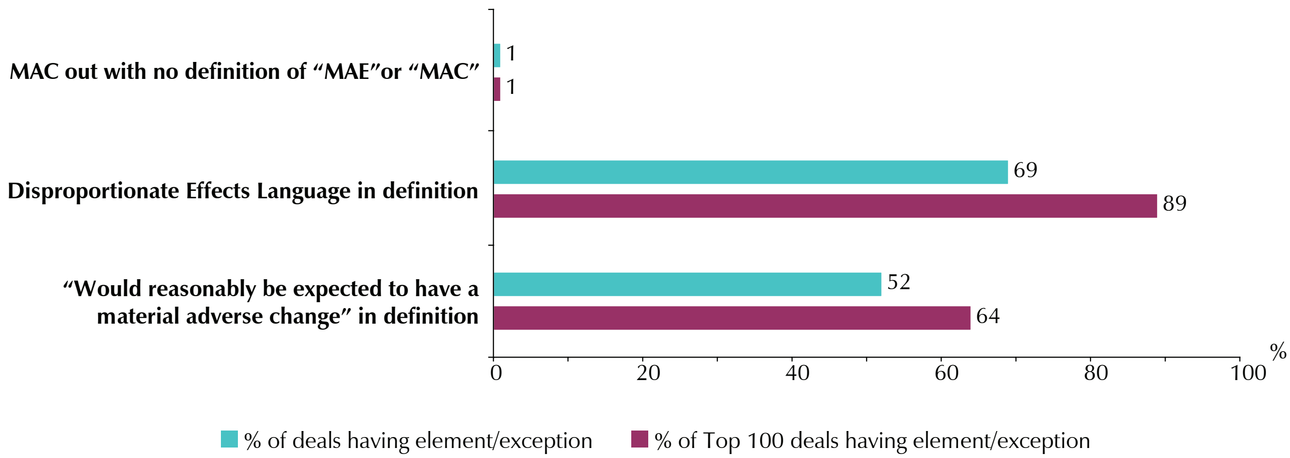
MAC Elements



In conducting our review this year, we also sought to determine how often certain highly negotiated provisions appeared in MAC definitions. One example is the language that a given event "would reasonably be expected to have a Material Adverse Effect" on the target—as opposed to simply stating that it has had such an effect. This nuance is important because the "would reasonably be expected to" formulation puts the onus on the seller to think thoroughly through the effects of certain events. For example, if there were a threatened litigation, no event actually affecting the target's balance would have occurred. However, if the case were a strong one, it would reasonably be expected to have an MAE. We found that 52 percent of the agreements we reviewed included the "would reasonably be expected to" formulation. Likewise, when reviewing certain items like changes in markets or the target's industry, we found that 69 percent of the agreements we reviewed included a qualification to exceptions that such events would not be considered MACs if they disproportionately affect the target. An example of such a carve-out from the MAC out would be "changes resulting from general economic, financial, regulatory, or market conditions, provided that such changes shall not have affected the target in a materially disproportionate manner as compared to other companies operating in the target's lines of business." The "disproportionate effects" language is a sophisticated tool for the buyer to push back on what would typically be a seller's negotiation victory. Lastly, we observed that it is extremely rare in today's market for the term "material adverse change" to be undefined.

Set forth below is a table detailing the findings in our survey in respect of the miscellaneous definitional matters above described:

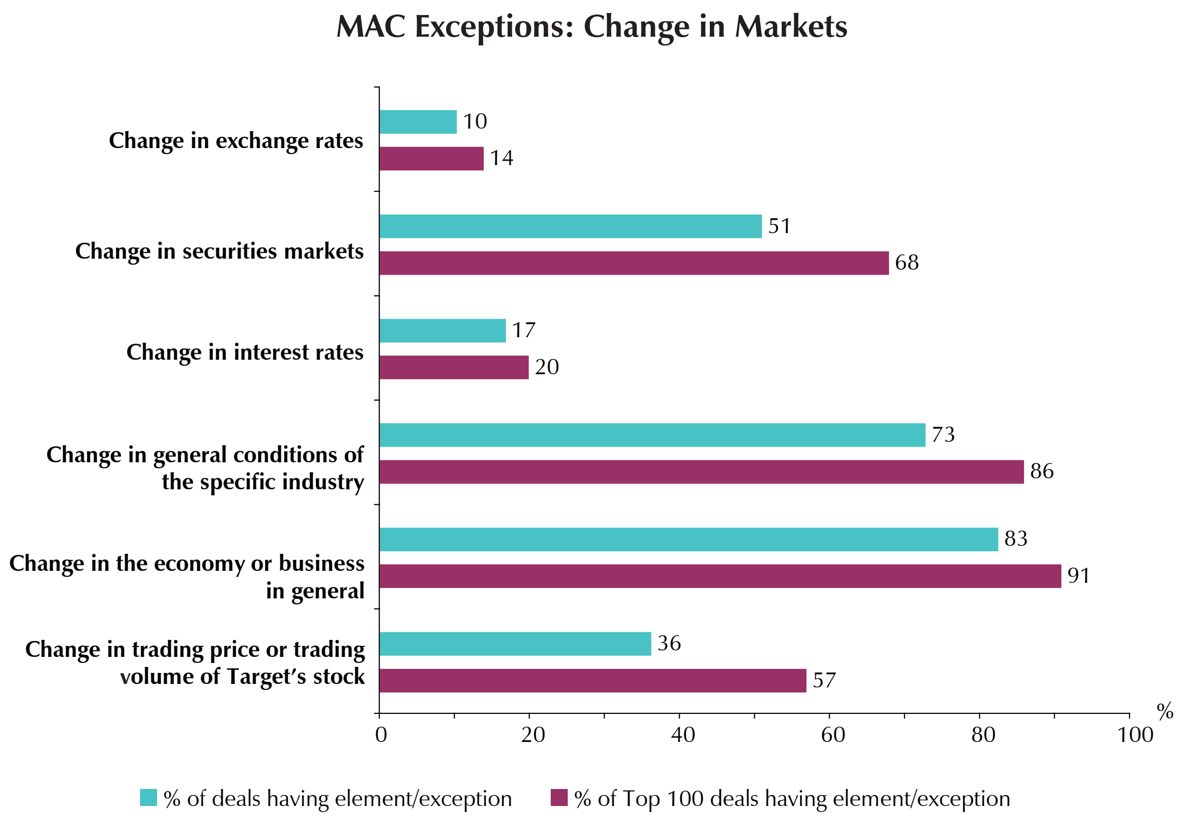
MAC Elements: Miscellaneous



Increase in exceptions relating to change in markets

This year marked an increase in MAC exceptions for "changes in securities markets" and "changes in trading price or trading volume of target's stock." Of the total deals examined, 51 percent included a MAC exception for "changes in securities markets," while 36 percent included "changes in trading price or trading volume of target's stock" as an exception. The occurrence of the foregoing "Changes in Market" exceptions increased 24 percent and 18 percent, respectively, when compared to last year's survey. This noteworthy increase may indicate growing concerns in the volatility of the public markets today.

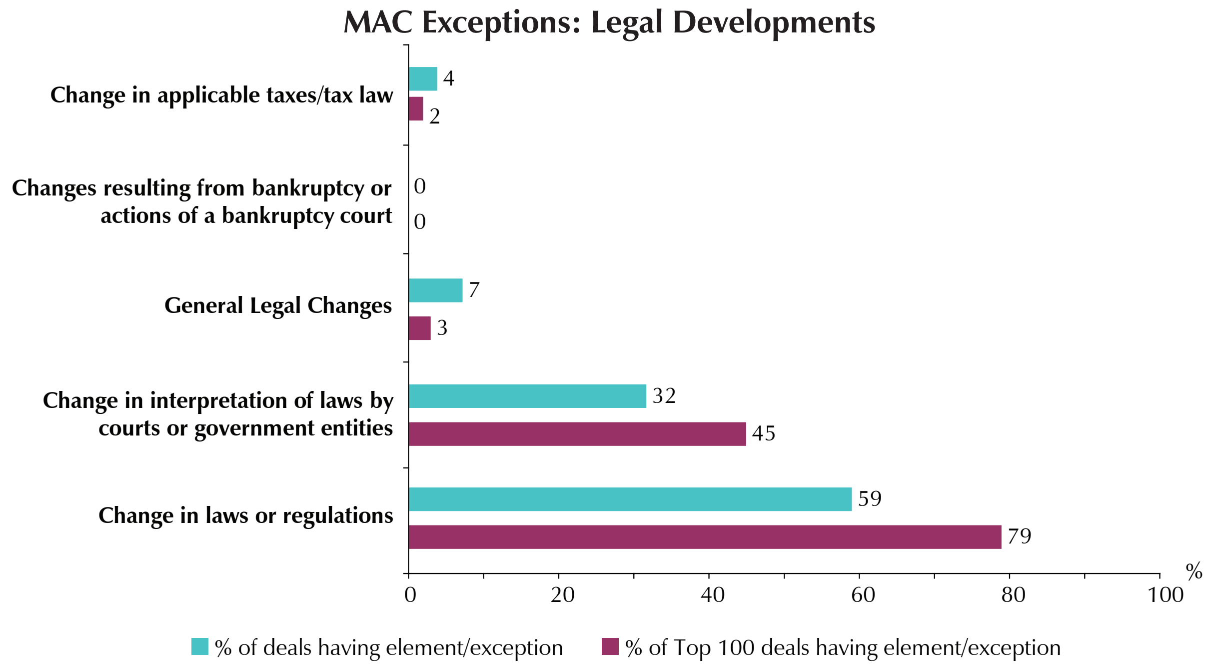
Set forth below is a table detailing the prevalence of MAC exceptions found in our survey which relate to "Changes in Markets":



Increase in exceptions relating to changes in legal developments

During the past two years, the MAC exceptions for "changes in laws or regulations" and "changes in interpretation of laws by courts or government entities" have steadily increased. The "changes in laws or regulations" MAC exception is up 34 percent from two years ago (17 percent from last year) and was found in 59 percent of agreements surveyed. Likewise, the MAC exception "changes in interpretation of laws by courts or government entities" is up 22 percent from two years ago (11 percent from last year) and was found in 32 percent of agreements we surveyed. In addition to these increases, a new, all-encompassing MAC exception for "general legal changes" was found in 7 percent of all agreements reviewed. Thus, 66 percent of the agreements reviewed contained some sort of MAC exception to "Changes in Legal Developments," an increase of 19 percent over last year. We note, however, that in the top 100 deals this trend was even more dramatic—82 percent of agreements had some type of MAC exception to legal developments, an increase of 49 percent over the year prior. This shift may be a reaction to the changing legal landscape in what has been a watershed year in changing laws—whether foreign, domestic, securities rules and regulations, privacy laws or even, as we have recently observed, in the tax code.

Set forth below is a table detailing the prevalence of MAC exceptions found in our survey which relate to "Changes in Legal Developments":



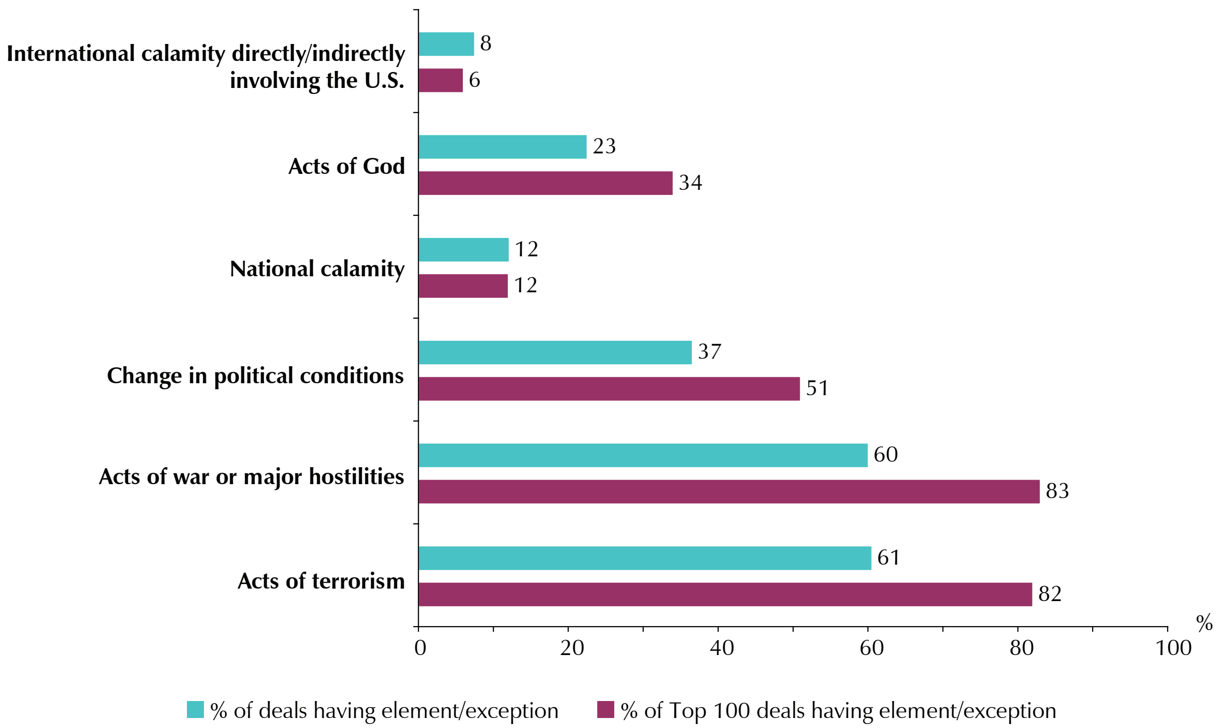
Increase in exceptions for changes because of terrorism, acts of war, changes in political conditions, national and international calamites and acts of God

In line with last year's trend, there was an across-the-board increase of MAC exceptions for changes resulting from terrorism, acts of war, changes in political conditions, and international calamities. The frequency of MAC exceptions for changes due to acts of terrorism in the United States or abroad rose to 61 percent of agreements surveyed, compared to 35 percent last year. Similarly, the number of agreements that contained exceptions for changes due to "acts of war or major hostilities" increased from 35 percent of last year's surveyed agreements to 60 percent of this year's surveyed agreements, and the percentage of agreements containing MAC exceptions for changes in political conditions and international calamities also rose, 14 percent and 6 percent, respectively. These dramatic increases may be due to some combination of geopolitical and public health disaster concerns—including the growing unease with continued hostilities in Iraq and the Middle East, continued trepidation resulting from the September 11, 2001, World Trade Center and July 7, 2005, London Underground attacks; worries about impending warfare; in Iran and even the threat of pandemic spread of infectious diseases such as SARS and Avian influenza virus.

Another trend that continued from last year was an increase in agreements containing exceptions for changes caused by acts of God (as before, we have tabulated events of weather and natural disasters in the "acts of God" category). Last year, 10 percent of agreements reviewed contained a MAC exception for events of weather and other acts of God, compared to this year, where it appeared in 23 percent of the agreements surveyed. These increases may reflect heightened concerns in the wake of recent catastrophic weather events, such as the Southeast Asia tsunami in 2004 and Hurricane Katrina in 2005.

A table detailing the prevalence of MAC exceptions found in our survey which relate to "Changes arising from Hostilities, Calamites and Acts of God" follows:

MAC Exceptions: Hostilities, Calamaties and Acts of God



Conclusions

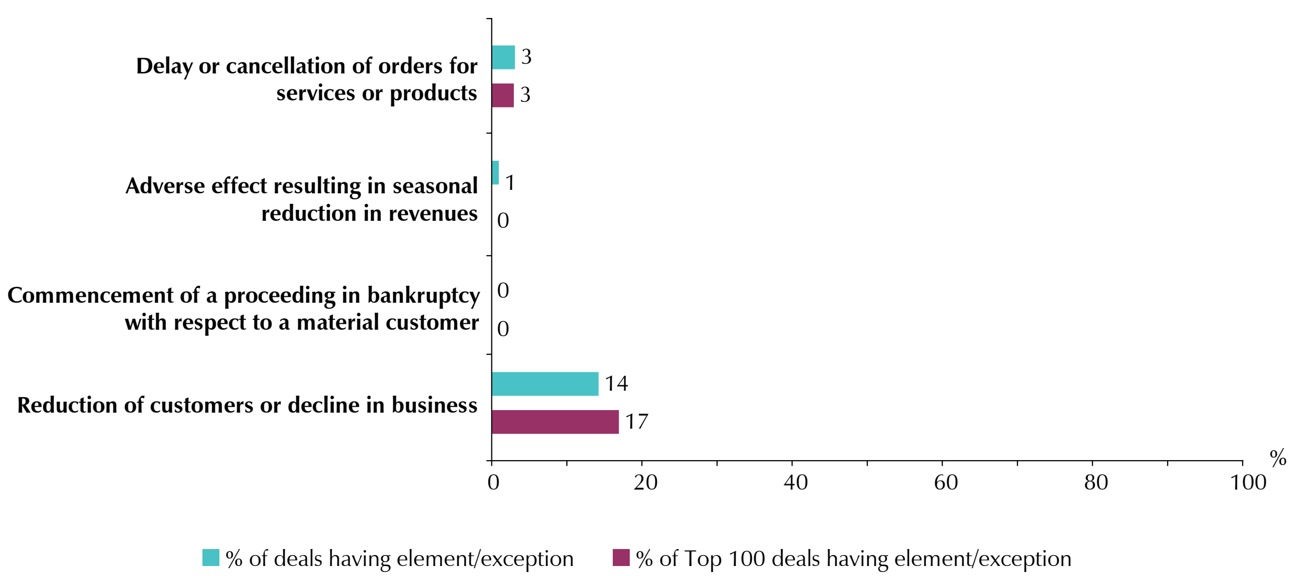
Conclusions and notable comparisons with the top 100

Generally, MAC exceptions appeared with slightly greater frequency within the top 100 deals in comparison to total deals surveyed, indicating that sellers have slightly greater negotiating power in larger transactions. This observation is a continuation of last year's trend. Notable examples of this trend are MAC exceptions relating to legal developments as noted above. Other exceptions such as "acts of terrorism," "acts of war," and "acts of God" appeared about 20 percent more often in the top 100 deals in comparison to total deals surveyed.

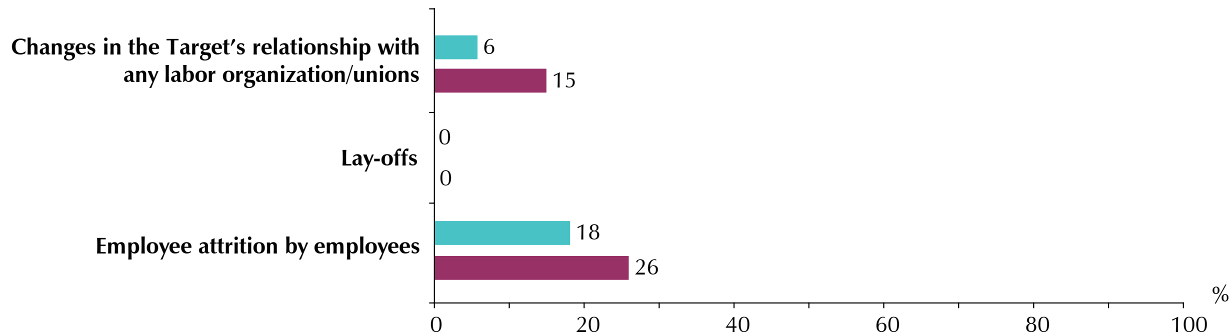
Additionally, MAC exceptions appeared with greater frequency when compared to last year's top 100 reviewed deals, suggesting that the acquisition climate remains increasingly seller friendly, especially for deals greater than $1 billion. Overall, we again found a trend toward more seller friendly terms, particularly in the largest transactions — a continuation of our observations from last year. The outcome of the current credit crisis will influence whether this trend will continue in the large deal market.

The following chart shows the remaining results of our survey:

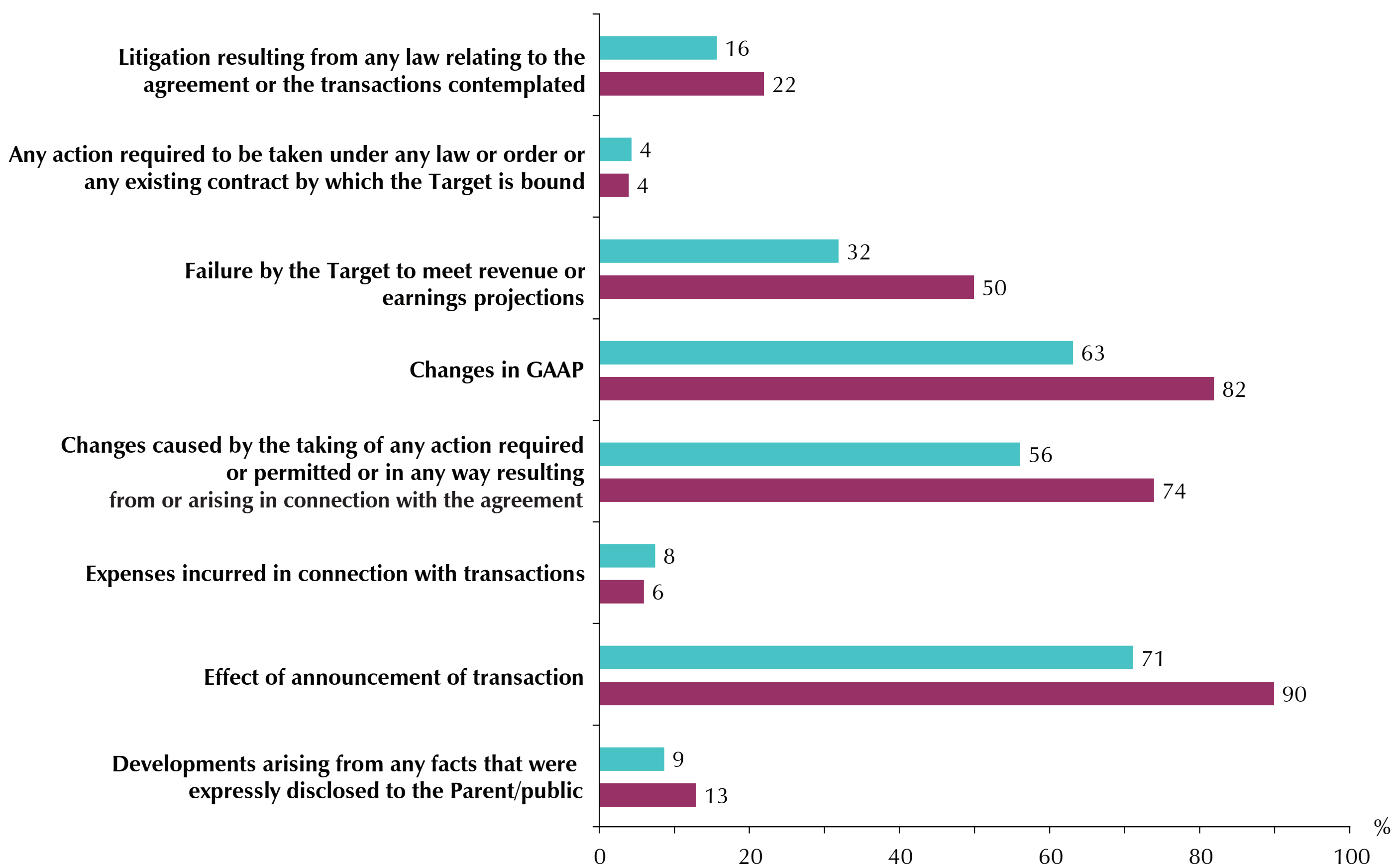
**MAC Exceptions:
Changes in Ordinary Course of Business**



MAC Exceptions: Employee Matters



MAC Exceptions: Miscellaneous



% of deals having element/exception % of Top 100 deals having element/exception

Nixon Peabody LLP is one of the largest law firms in the United States with more than 700 attorneys collaborating across 25 major practice areas in 17 office locations, including Boston, Chicago, London, Los Angeles, New York, San Francisco, Silicon Valley and Washington, D.C.

Mergers & Acquisitions

Nixon Peabody is considered to be a thought-leader in the mergers and acquisitions marketplace for its continuing efforts to maintain in-depth awareness of the current legal landscape affecting M&A transactions. Our annual transactions surveys give us keen insights about deal terms and conditions that our clients rely upon for optimizing their transactions.

We devise innovative solutions for overcoming the challenges and issues that arise in a acquisition or divesture resulting in faster, smoother, and more cost-efficient transactions. We provide counsel on strategic and financial acquisitions, divestitures, and investments ranging in value from a few million to billions of dollars.

Private Equity

Nixon Peabody provides strategic advice and legal counsel to private equity, distressed and venture capital funds, hedge funds, portfolio companies and institutional investors. Services include leveraged buyouts, control and non-control investments, business combinations, growth financings, joint ventures and other strategic transactions.

The group brings together an interdisciplinary team experienced in all areas of corporate finance, business counseling, corporate governance, securities, tax, ERISA, labor and employment, real estate, technology, intellectual property, and litigation.

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Nixon Peabody LLP
Corporate Responsibility Alert
Developments in the law of Corporate Governance

JANUARY 4, 2007

Beware the Congressional subpoena: Democrats promise wide-ranging investigations

By Kelly B. Kramer and Laura Ariane Miller

As the 110th Congress takes office, Democrats control both the House of Representatives and the Senate for the first time in 12 years. After years without subpoena power, party leaders are eager to reassert Congressional oversight over many industries and programs. Rep. Henry Waxman (D-CA), the veteran investigator whom *Time* magazine dubbed the "Scariest Guy in Town" because of his role as Chairman of the House Committee on Government Reform, expects the Committee to take on an ambitious agenda, including investigations into corporate lobbying practices, earmarking and appropriations, defense contracting, and health-care programs and reimbursements. As Rep. Waxman has told the press, there are so many topics to investigate that "[t]he most difficult thing will be to pick and choose."

New Congressional probes mean that the relationship between business and the government will be scrutinized in ways not seen for decades, but revived Congressional oversight is only part of the story. The Federal Bureau of Investigations is also prioritizing public corruption investigations. FBI Director Robert S. Mueller III recently told the Senate Judiciary Committee that "[p]ublic corruption is the top criminal priority for the FBI." Other FBI officials are promising aggressive investigatory tactics, including undercover, Abscam-like sting operations. As one assistant director put it, "I would do [a sting] on Capitol Hill. I would do it in any state legislature.... If we could do an undercover operation, and it would get me better evidence, I'd do it in a second."

This new climate of heightened scrutiny does not only affect politicians. Businesses, political action committees, trade associations, and not-for profit entities will be more likely than ever to be pulled into public corruption investigations. Entities in industries that do business with or lobby the government – such as defense contractors, pharmaceutical companies, and universities – are especially likely to find themselves under the government's microscope.

Any investigation is a big deal, but Congressional probes and public corruption cases almost always play out on the front pages of America's newspapers. Congressional investigators never hesitate to summon corporate executives to appear before them for public hearings, and federal prosecutors have made headlines in the past year for securing guilty pleas and convictions in major corruption investigations. Because of the often high-profile nature of these investigations, the mere fact of an investigation can be costly to your business and your reputation even if it doesn't result in an indictment.

Responding appropriately to government requests for information can be tricky and fraught with peril. In these instances, it is crucial to have experienced counsel advising you and acting to protect your rights from the earliest stages of an investigation. Our attorneys have extensive experience in counseling, investigating and litigating all forms of government inquiry. We represent public officials, lobbying firms, not-for-profit entities, and businesses in many contexts and investigations. The often high-profile nature of these cases requires the utmost delicacy from the initial stages of the investigation. We work to protect your business, reputation and liberty.

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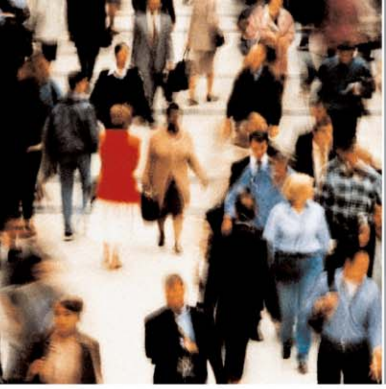

Class Action Alert

Recent developments in class action law

A publication of Nixon Peabody LLP

SEPTEMBER 2007

Vioxx reversal: Supreme Court of New Jersey overturns order certifying nationwide class in Cox-2 consumer fraud class action

On September 6, 2007, the Supreme Court of New Jersey overturned a class certification order of the New Jersey Superior Court in *International Union of Operating Engineers Local No. 68 Welfare Fund v. Merck & Co., Inc.*, Civil Action No. A-22, which had threatened to dramatically alter the landscape of products-based consumer fraud litigation, particularly in the drug and medical device arenas.

The plaintiffs, a putative class of third-party payors, asserted claims against Merck & Co., Inc. (Merck) under the New Jersey Consumer Fraud Act (CFA) in the wake of the Vioxx personal injury actions. They alleged that Merck engaged in a fraudulent and deceptive marketing campaign that misrepresented Vioxx's efficacy as compared with traditional pain medications, and actively concealed clinical data linking Vioxx with cardiovascular side effects. *Id.* at 7. The plaintiffs claimed that, as a result of this purported scheme, Vioxx was improperly accorded preferred status on formularies, causing third-party payors to overpay for the price of the medication. *Id.* at 13.

In July 2005, the Superior Court certified a nationwide class under the New Jersey CFA, thereby extending the reach of the statute well beyond New Jersey's borders. *Id.* at 4. The decision, which in the eyes of many observers effectively converted the New Jersey CFA into federal legislation, was affirmed by the New Jersey Appellate Division on March 31, 2006. *Id.* at 19.

On appeal to the Supreme Court of New Jersey, Merck contended that the certification as a nationwide class under the New Jersey CFA ran afoul of New Jersey's choice of law jurisprudence. *Id.* at 21. In addition, Merck argued that individual issues of fact and law predominated over the plaintiffs' claims and that a class action was not the superior vehicle to provide redress. *Id.* Although both Merck and the plaintiffs had identified the propriety of a nationwide class as the central issue of the appeal, the Supreme Court of New Jersey declined to address it. Instead, the Supreme Court of New Jersey reversed the Superior Court's decision, based on its analysis of the predominance and superiority elements. *Id.*

Predominance Analysis

As they had successfully argued below, the plaintiffs contended that the facts relating to Merck's marketing campaign and alleged concealment of information related to Vioxx's safety and efficacy were common to all class members. *Id.* at 25. Merck countered that, while each class member may have received the same information, they all reacted differently. *Id.* at 25-26. In particular, Merck asserted that some of the Prescription Benefit Managers (PBMs), which determined the status accorded to Vioxx in each of the third-party payors' formularies, assigned the medication a "preferred status" and placed it in a "low co-payment tier." *Id.* at 12. However, other PBMs responded to the information that Merck provided by giving Vioxx "non-preferred status" and placing it in a "high co-payment tier." *Id.*

The Supreme Court of New Jersey agreed with Merck. While noting that there was some factual commonality with regard to Merck's alleged conduct, the record conclusively demonstrated that the PBMs "made individualized decisions concerning the benefits that would be available for whom Vioxx was prescribed." *Id.* at 26. Therefore, "the commonality of [Merck's] behavior is but a small piece of the [plaintiff's] required proofs" and "the common fact questions surrounding what [Merck] knew and what it did would not predominate." *Id.* at 26-27.

In addition, the court squarely rejected the plaintiffs' argument that the issues of causation and damages could be established without offering individualized proof. Although, like many state consumer protection acts, the New Jersey CFA does not require a plaintiff to show reliance, a plaintiff must still demonstrate a "causal relationship" between the alleged misconduct and "an ascertainable loss." *Id.* at 24. To satisfy their burden on these elements, the plaintiffs employed a strategy that has become increasingly common in consumer fraud class actions. They relied on the testimony of an expert who opined that Merck's advertising program influenced the market and directly caused the price for Vioxx to artificially soar across the board. *Id.* at 27. The Supreme Court of New Jersey held that the plaintiffs were improperly eschewing their burden of proof by effectively advancing a "fraud on the market" theory, which the New Jersey courts have consistently limited to application in the securities fraud setting:

> To the extent that [a] plaintiff intends to rely on a single expert to establish a price effect in place of a demonstration of ascertainable loss or in place of a proof of a causal nexus between [a] defendant's acts and the claimed damages … [the] plaintiff's proof would fail. That proof theory would indeed be the equivalent of fraud on the market, a theory we have not extended to CFA claims.

Id. at 28. Therefore, the court concluded that the plaintiffs had not met their burden of establishing commonality of fact and law on these "critical" elements of their CFA claim. *Id.* at 29.

Superiority Analysis

The Supreme Court of New Jersey also found the superiority element to be lacking. The court noted the stark contrast between the third-party payors' claims and those of the plaintiffs in *Illiadis v. Wal-Mart Stores, Inc.*, 191 N.J. 88 (2007), a case in which it had recently affirmed certification. *Illiadis* involved a wage claim by a class of employees against Wal-Mart. There, in the court's view, the amount of relief available to any one class member was small and would not likely be pursued absent the use of the class device. As a result, the case presented "the quintessential example" of circumstance that would argue for certification. *Id.* at 31.

The court noted that the third-party payors stood on a "vast[ly] different" footing:

> Unlike individual wage earners, the [third-party payors] … allege that they have been damaged in large sums. Unlike those hourly wage earners, the [third-party payors] are well-organized institutional entities with considerable resources. Unlike in *Illiadis*, here we see no disparity in bargaining power and no likelihood that the claims are individually so small that they will not be pursued. In short, we find no ground on which to conclude that this proposed nationwide class meets the test for superiority that we have traditionally required.

Id. at 31-32. Thus, in terms of sophistication, financial wherewithal, and incentives, the third-party payors were more than capable of pursuing their claims against Merck without the aid of a class action.

Conclusion

While the intriguing, if not controversial, question of nationwide certification ultimately was not addressed, this decision will likely have a significant impact on consumer fraud class actions, even those that involve putative statewide classes. The plaintiffs' use of expert testimony to avoid individualized proof, one of the more popular tricks of the trade of the plaintiffs' bar, was debunked as an inappropriate application of the fraud on the market theory, outside the securities fraud arena. Equally significant is the role that superiority played in the Supreme Court of New Jersey's analysis. Superiority is an element that is often over-looked in attacking class certification. Here, however, the court appears to indicate that it would have reversed certification based on superiority alone. Due to the higher amount of recoverable damages in play for third-party payor classes relative to individual consumer classes, third-party payor classes are frequently the engine driving consumer fraud class actions in cases involving pharmaceutical and medical device products. If this decision gains traction in other jurisdictions, it could sound the death knell for third-party payor classes altogether and, thereby, lessen the financial attractiveness of consumer fraud actions to the plaintiffs' bar.

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Corporate Responsibility Alert
Developments in the law of corporate governance

A publication of Nixon Peabody LLP

AUGUST 14, 2007

The New ICE Age
The new immigration rules raise significant compliance concerns and increase employer exposure to civil and criminal liability

By Anjali Chaturvedi and Matthew Zandi

New ICE regulations regarding hiring or continued employment of unauthorized aliens

The Department of Homeland Security (DHS) has issued an advance copy of the final regulation it is planning to publish this week, relating to procedures an employer will be required to follow after receiving a Social Security Administration no-match letter or following a DHS investigation. The final regulations will replace proposed regulations issued in June 2006. A no-match letter is a letter from the Social Security Administration (SSA) that informs an employer of a mismatch between an employee's name and Social Security Number as reported on W-2 forms and in SSA records.

Guidance on Social Security no-match letters

The regulation significantly changes the legal standard for "constructive knowledge" of an employee's unauthorized work status but also creates safe harbor procedures for employers who receive SSA no-match letters.

However, entering this safe harbor is problematic. Of particular concern, employers who receive no-match letters from SSA face a real dilemma. Employers must be able to demonstrate to the Bureau of Immigration and Customs Enforcement (ICE) that they have attempted to resolve the discrepancies brought to their attention, but an aggressive response can lead to complaints by employees alleging discrimination, harassment, wrongful discharge, and privacy violations.

Constructive knowledge of an employee's unauthorized status

Under the new regulation, when an employee is ultimately found to lack work authorization, the employer will be deemed to have constructive knowledge of the employee's unauthorized status if the employer fails to take reasonable steps after receiving a no-match letter from SSA or a similar

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notice from the DHS. The regulation requires employers to take action to attempt to resolve the discrepancy within 30 days of receipt of the no-match letter or other notification from the DHS. An employer that is deemed to have constructive knowledge can be subject to civil or criminal penalties.

The employer will also be found to have constructive knowledge if the employer fails to complete or improperly completes the Form I-9, acts with reckless and wanton disregard for the legal consequences of employing an undocumented worker, or has information available to it that would indicate that the employee is not authorized to work.

Safe harbor provision

ICE included in its regulation a "safe harbor" procedure. An employer who follows this procedure avoids the risk of being found to have constructive knowledge of an employee's unauthorized status. To qualify for the safe harbor, the employer must make an attempt to resolve the discrepancy that is the subject of the SSA or DHS notice within the required period of time. The employer must first audit its own records to determine if it has committed an error. If checking its records cannot resolve the discrepancy, the employer must contact the employee and request confirmation that the employee's information is correct. If the records are correct according to the employee, then the employer must ask the employee to pursue the matter him- or herself with the SSA or DHS. Once again, ICE will consider employers who take these corrective actions within 30 days of receipt of a no-match or DHS letter to have acted reasonably.

Based on the new regulations, it appears that ICE will consider the discrepancy resolved only if the employer verifies with the SSA or DHS that the employee's name matches a number assigned to that name in SSA's records, and that the number is valid for work or work with DHS authorization.

If the no-match issue is not verified within 90 days of receipt of the no-match letter, the regulations also describe another procedure that employers must take to verify the employee's identity and work eligibility. This new procedure would require the employer and employee to complete a new Form I-9 **as if the employee were a new hire,** with these restrictions:

- The new Form I-9 must be completed within 93 days after receipt of the written notice from the DHS or SSA.
- The employer must not accept any document referenced by the DHS or SSA, and any document that contains a disputed Social Security account number or alien number referenced in any written notices from the DHS or SSA, or any receipt for an application for a replacement of such document, to establish employment authorization or identity or both; and
- The employee must present a document that contains a photograph to establish identity or both identity and employment authorization.

Tread lightly, do not over react, but stay diligent

Employers need to comply with the new rules, but must not employ discriminatory policies or methods to verify employment eligibility. At the end of the day, employers are caught in a cross-fire between the government and the employee, and, if the employee fails to resolve the SSN or DHS discrepancy, the employer does not have an automatic right to terminate the employee.

Strengthened immigration enforcement

The no-match letter is just one recent example of increased immigration enforcement. It has become obvious that what was once more limited enforcement against employers a few years ago has dramatically changed. ICE has stepped up inspections of employers, bringing 445 criminal charges against employers in the first 10 months of FY06, compared to 25 in FY02. ICE says it is targeting businesses built on hiring illegal workers. In the past, ICE has primarily relied on civil monetary penalties to punish "bad actor" employers. Now, however, ICE is cracking down and seeking harsh criminal sanctions against employers and appears determined to punish companies under criminal statutes, including RICO, alien smuggling, harboring, and drug and money laundering statutes. In addition to the statutes mentioned above, ICE is also relying on the "reckless disregard" provision in the Immigration and Nationality Act (INA) to support its efforts. And ICE plans to place ICE attorneys in U.S. Attorney offices to strengthen criminal enforcement of immigration laws.

As reported in our *Immigration Law Alert* in April, ICE raids on April 19, 2006, took place in 26 states, pursuant to criminal search warrants at more than 40 facilities of one employer. More recently, federal agents raided the meat processing plants of another employer in six states as part of a 10-month investigation. More than 1,200 people were arrested for alleged immigration violations and about 65 face criminal charges, including identity theft. Since 1997, this particular employer has been using a government pilot program to confirm whether Social Security numbers are valid.

Compliance

Prudent employers now need to review and update their ICE regulation compliance procedures and make sure they are building in policies and procedures to avoid even the appearance of discriminatory conduct and prevent privacy violations. This is not an easy task. In addition, employers should update their government investigation response procedures.

If you have further questions about the new regulations, or need compliance and/or enforcement activity response, please contact your Nixon Peabody attorney or one of the authors of this *Alert* at:

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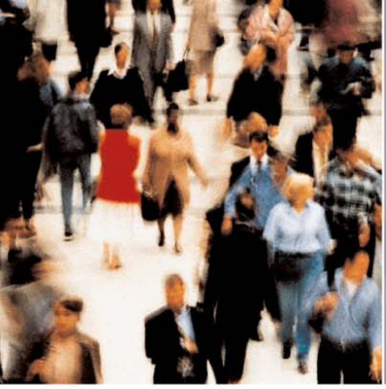

Class Action Alert
Recent developments in class action law

A publication of Nixon Peabody LLP

JUNE 2007

The Supreme Court decides what is "willful" in Fair Credit Reporting Act class actions

By Christopher M. Mason and Elizabeth G. Land

Earlier this week the United States Supreme Court released a unanimous opinion that resolved a significant split in the Circuit Courts of Appeals on the definition of "willful" in civil cases under the Fair Credit Reporting Act (the "FCRA"), 15 U.S.C. § 1681 (2000). *See Safeco Ins. Co. v. Burr*, No. 06-84, 2007 U.S. LEXIS 6963 (June 4, 2007). The Court's opinion, authored by Justice Souter, also set out a new standard for what is an "adverse action" for some purposes under the FCRA.

The *Safeco* decision may be important to all businesses that use credit reporting information, extend credit, or provide receipts to customers who use credit or debit cards. For example, well over 100 class actions have recently been filed just against businesses supposedly violating the credit-card receipt provisions of the FCRA. In all of those cases the plaintiffs have sought statutory damages. Because the predicate for statutory damages under the FCRA is proof of a "willful" violation of the statute, *see* 15 U.S.C. § 1681n (2000), the definition of "willfulness" matters.

In the cases consolidated for disposition in the Supreme Court under the *Safeco* name, the issue of "willfulness" arose in the context of an FCRA requirement that businesses send a consumer an "adverse action" notice when the consumer's credit report negatively affects credit terms and rates provided to him or her. *See id.* § 1681m (2000). The two insurance companies before the Supreme Court (Safeco and GEICO) had offered or sold insurance at different rates to different customers based on the creditworthiness of those customers. The plaintiffs in the putative class actions against the two companies had either been offered, or had purchased, insurance at rates higher than the lowest rates the companies charged their most-creditworthy customers. The reason for this difference was supposedly the credit scores of the plaintiffs when they initially applied for insurance from the companies.

After finding out that the rates offered to them were not the lowest, the plaintiffs sued. The theory was not that their rates were higher than some other (more-creditworthy) customers' rates, a permissible discrimination, but rather that the companies should have given them an "adverse action" notice. As applied to insurance companies, an "adverse action" is "a denial or cancellation of, an increase in any charge for, or a reduction or other adverse or

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unfavorable change in the terms of coverage or amount of, any insurance, existing or applied for . . . ." *Id.* § 1681a(k)(1)(B)(i) (2000). The plaintiffs argued that offering or selling them insurance at rates higher than the companies' lowest rates for anyone, while a permissible practice, would still be an "adverse action" requiring a notice, and that Safeco and GEICO had willfully failed to provide such notices.

District Courts rejected the plaintiffs' arguments and granted motions for summary judgment in favor of both insurance companies. On appeal, the United States Court of Appeals for the Ninth Circuit reversed. In doing so, the Ninth Circuit held, among other things, that the definition of a "willful" act entitling a plaintiff to statutory damages pursuant to 15 U.S.C. § 1681n included acts that, while not "knowing", were in "reckless disregard" of the law.

A number of other Circuit Courts of Appeals had taken a stricter view of the term "willful", requiring that a plaintiff show that the defendant acted with actual knowledge and was not merely reckless. For example, the Eighth Circuit in *Phillips v. Grendahl*, 312 F.3d 357, 370 (8th Cir. 2002), had defined willful noncompliance for purposes of Section 1681n of the FCRA as a "knowing and intentional commission of an act the defendant knows to violate the law." Similarly, the Sixth Circuit in *Duncan v. Handmaker*, 149 F.3d 424, 429 (6th Cir. 1998), had held that a party could not have acted willfully for purposes of the FCRA if the party believed it had acted lawfully.

The Supreme Court resolved this split among the Circuits by rejecting the "actual knowledge" standard and adopting a "reckless disregard" test for "willfulness" in the context of civil actions under the FCRA instead. Justice Souter's cleanly written opinion held that, while "'willfully' is a 'word of many meanings'" in statutes involving civil liability, "we have generally taken it to cover not only knowing violations of a standard, but reckless ones as well." *Safeco Ins. Co.*, 2007 U.S. LEXIS 6963 at *19. In turn, the "common law has generally understood [recklessness] in the sphere of civil liability as conduct violating an objective standard: action entailing 'an unjustifiably high risk of harm that is either known or so obvious that it should be known.'" *Id.* at *39. Given "that Congress knows how we construe statutes and expects us to run true to form", *id.* at *20, and with "no indication that Congress had something different in mind," Justice Souter therefore saw "no reason to deviate from the common law understanding" of the term "willfully" as including "recklessness" for purposes of the FCRA. *Id.* at *40-41.

With respect to the underlying substantive issue of "adverse action" notices, the Court's opinion contained several additional holdings. As to GEICO, the Court held that, because GEICO had shown that the plaintiff suing it would have had the same rate even if GEICO had not considered his credit score, there could not have been an "adverse action" of which GEICO could have given notice. *Id.* at *37-38. It therefore held for GEICO.

As to Safeco, the Court reached the same result a different way. Safeco had not shown that the rates for the plaintiffs suing it would have been the same even if Safeco had not considered their credit scores. But Safeco's view of the FCRA had been that the statute did not require any "adverse action" notice for initial applications for insurance, but only for changes after an initial purchase. Whether or not this was actually right, according to Justice Souter, "Safeco's reading of the statute was not objectively unreasonable, and so falls short of raising the 'unjustifiably high risk' of violating the statute necessary for reckless liability."

Id. at *9. As result, the plaintiffs could not have sought statutory damages from Safeco, either.

In the future, however, Safeco's reading of the statute will not work: the Court expressly held that the "increase" in an insurance rate for purposes of an "adverse action" requiring notice to a consumer "speaks to a disadvantageous rate even with no prior dealing; the term reaches initial rates for new applicants." *Id.* at *29. (This does not, however, mean that a rate is "disadvantageous" just because it is higher than the lowest rate for anyone—it is "disadvantageous" only if it is higher than the rate that the consumer would have gotten without reliance on his or her credit score. *See id.* at *6.)

While the outcomes were good ones for the individual insurance companies in *Safeco*, the announcement of a less-stringent standard for "willful" behavior under the FCRA was not as good for future defendants. With minimum statutory damages of $100 per violation (and an attorneys' fee provision), *see* 15 U.S.C. § 1681n, the Court's somewhat less-strict standard for "willfulness" could encourage more FCRA class actions.

We welcome your questions and comments. If you need assistance on any matter, please call or e-mail Christopher M. Mason (cmason@nixonpeabody.com 212-940-3017) or Paul J. Hall (phall@nixonpeabody.com 415-984-8266) as the coordinating heads of our class action defense practice across our substantive litigation teams, or contact any of our partners listed below:

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- Successful defense of a "Big 5" accounting firm in connection with the failure of a New Hampshire bank and its holding company;
- Successful defense of $10 million lender liability action brought against a Boston-based bank;
- Successful defense of a national bank against a $15 million lender liability action involving fraud, misrepresentation, and civil RICO;
- Internal investigation and resulting civil RICO action against certain inside officers and directors in three related national banks;
- Successful arbitration in New York of $4 million civil fraud and conspiracy case concerning alleged false postal documents and no-prosecution decision in related criminal investigation;
- Successful defense of a "bet the company" closely held corporate control/shareholder dispute and receivership action in the Delaware Chancery Court;
- $1 million judgment after trial in cellular partnership dispute and successful dismissal of $6 million counterclaims;