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10 Tips for Helping Corporate Legal Departments Demonstrate Value

By Michael Lipps

The economic conditions facing most U.S. businesses over the past few years have brought to the surface a stark reality: It is no longer enough to simply be a great lawyer and risk manager; corporate counsel must be effective business managers and be able to demonstrate the value they create for their companies in order to be considered successful.

Corporate legal departments are coming under increased scrutiny to prove their value to the executive team like any other cost center in the company. According to a recent LexisNexis CounselLink survey conducted by ALM Legal Intelligence, 94% of U.S. in-house law departments feel pressure to demonstrate value within their organization. *See* www.lexisnexis.com/trial/uslm141789.asp?access=JCM141789 (registration required).

The survey found that the most common way this pressure is manifest is with demands to reduce spending on outside counsel (78%), followed by reduction of risks (65%), reduction of law department budget (64%) and forecasts of future costs (60%). The results of the survey illustrate that this pressure to demonstrate value is ubiquitous across companies in every industry and in organizations of all sizes.

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Federal District Court Applies Supreme Court's 'Nerve Center' Test

Determines That 'Center of Direction, Control and Coordination' Is Not Nominal Headquarters of Corporate Parent

By Robert S. Reder, David S. Schwartz and Brian P. Murphy

Last year, the U.S. Supreme Court resolved a conflict among the federal circuits by establishing a uniform interpretation of the phrase "principal place of business" for determining corporate citizenship under 28 U.S.C. § 1332(a), the federal diversity jurisdiction statute (the "Diversity Statute"). In *Hertz Corp. v. Friend* (130 S.Ct. 1181 (Feb. 23, 2010)), the Supreme Court ruled that corporate citizenship should be determined on the basis of the specific location of a corporation's "center of direction, control, and coordination" — usually, but not always, the state in which its principal headquarters is located. This methodology is aptly labeled the "nerve center" test. To avoid potential "attempts at manipulation," the *Hertz* Court explained that a nominal principal office consisting of "nothing more than a mail drop box, a bare office with a computer, or the location of an annual executive retreat" will not suffice to establish a corporation's nerve center.

Recently, in *Brewer et al. v. SmithKline Beacham Corporation d/b/a Glaxo SmithKline* (Civ. Action No. 10-4443 *et seq.* (E.D. Pa., March 24, 2011)), the United States District Court for the Eastern District of Pennsylvania applied *Hertz* in deciding the citizenship, for purposes of the Diversity Statute, of an operating entity organized as a limited liability company ("LLC") within a corporate holding company structure. In a fact-specific ruling, the district court found that "for purposes of determining the citizenship of a limited liability company whose sole member is a holding company that does not direct or control the operations of the limited liability company, we look to the 'nerve center' of the limited liability company to which the holding company has delegated the operational decision-making."

The purpose of this article is to discuss these significant developments in the jurisprudence underlying the important concept of federal diversity jurisdiction. While corporate executives and their advisers will no doubt appreciate the certainty

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provided by the Supreme Court's affirmation of the "nerve center" test for determining a corporation's principal place of business, they must be mindful that the courts will focus on the actual "center of direction, control, and coordination" rather than artificial attempts to manipulate jurisdiction.

Background of the Federal Diversity Statute

In 1789, acting pursuant to authority granted in Article III of the U.S. Constitution, Congress conferred diversity jurisdiction on the federal courts. Federal diversity jurisdiction exists when the respective parties to a lawsuit are citizens of different states (and the amount in controversy exceeds $75,000). When faced with a claim brought in a state court by a citizen of that state, a defendant who is the citizen of a different state has the option (under 28 U.S.C. § 1441(a)(1)) to remove the suit to federal court. The federal court then has the opportunity to determine if removal is appropriate.

Initially, the federal courts did not recognize corporations as citizens for diversity purposes, and when they finally did, the focus for determining citizenship was the corporation's state of incorporation. In considering enactment of the Diversity Statute, Congress noted that the focus on the state of incorporation for this purpose "was at odds with diversity jurisdiction's basic rationale, namely, opening the federal courts' doors to those who might otherwise suffer from local prejudice against out-of-state parties." Congress also was concerned that a corporation's citizenship was subject to manipulation by the mere filing of incorporation papers in a jurisdiction other than the state in which the corporation's principal business activities were being carried out. Moreover, there apparently was a growing belief among federal judges that their "dockets contained too many diversity cases."

Seeking to address this dilemma, Congress enacted the Diversity Statute in 1958. According to the Statute, a corporation is a citizen both of its state of incorporation "and of the State where it has its principal place of business." However, following enactment of the Diversity Statute, the federal circuits became divided over the proper methodology for determining the principal place of business of a corporation with "'far-flung' business activities." For instance, the Ninth Circuit developed a fact-intensive "business activities" test, which analyzes a corporation's principal place of business on the basis of the "amount of a corporation's business activity" on a state-by-state basis. If the amount of a corporation's business activity in a particular state is "significantly larger" than, or "substantially predominates," the amount in other states, then the former state is identified as the principal place of business. Only if there is no such "predominant" state did Ninth Circuit courts base corporate citizenship on "the place where 'the majority of its executive and administrative functions are performed.'" By contrast, the Seventh Circuit utilized the "nerve center" test, which focuses on the "place where a corporation's officers direct, control, and coordinate the corporation's activities."

Supreme Court Adopts 'Nerve Center' Test to Resolve Split

In February 2010, the U.S. Supreme Court was presented with the opportunity to resolve this split among the federal circuits in *Hertz Corp. v. Friend*.

In September 2007, two California citizens sued Hertz Corporation, a

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Understanding And Mitigating The Legal Risks of Cloud Computing

By Bennett B. Borden and Shannon Smith

It is no secret that an increasing number of enterprises are investing in cloud computing. Whether they are replacing on-premise applications or traditional outsourcing models, rising costs and technical complexity have led organizations to look to third-party providers for some or all of their information technology needs. There can be significant economic efficiencies realized by moving to the cloud. But, just as important are potential benefits associated with data privacy and security, compliance, business intelligence and overall information governance improvements. Entities often struggle with establishing comprehensive information governance programs that capitalize on the value of their information assets while avoiding the risks of ungoverned information. Cloud providers are increasingly aware of these challenges and are shaping cloud solutions to overcome them. That said, there are also potential risks involved if an entity does not adequately consider the information governance implications, especially those involving electronic discovery, when moving to the cloud.

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Three Models

Cloud computing leverages economies of scale to reduce inefficiency and improve performance of IT operations. Essentially, there are three categories of cloud service models — Infrastructure, Platform, and Software-as-a-Service, commonly referred to as IaaS, PaaS, and SaaS, respectively. Infrastructure-as-a-Service involves outsourcing of equipment or hardware to support IT operations. IaaS providers include Amazon Web Services, Rackspace, and Nirvanix, among others. PaaS also includes outsourcing of hardware and includes providers like Microsoft Azure and Google Apps. The difference between infrastructure- and platform-as-a-service is typically around control. With IaaS, a client is usually responsible for the configuration and maintenance of operating systems, whereas with PaaS, the service provider manages those responsibilities. Last, there is Software-as-a-Service, which is a software distribution model where applications or programs are hosted by a third-party provider and are made available over a network, usually the Internet. SaaS providers include SalesForce.com and CaseCentral, among others.

Legal Issues

Most enterprises are finding that moving to the cloud may improve overall IT cost-effectiveness, but the shift raises a number of issues on the legal side of the house that often go unrecognized or unaddressed. Although much of the early discussion around cloud computing focused on availability and security, the conversation has now shifted to topics like custody and control, authenticity and legal preservation. The existence of vast amounts of electronically stored information (ESI) housed offsite, the potential lack of control of this data, and the challenges of preserving and processing it in connection with a lawsuit or regulatory investigation is enough to cause concern among even the most technically inclined corporate legal teams. However, when carefully considered, information governance policies and procedures can be developed to reduce the risks and realize the benefits of cloud computing.

Impact of Cloud Data on eDiscovery Process

Identification, Preservation, and Collection

When corporate data is managed by internal IT resources, the number of data repositories and the physical locations of that data are finite and more or less easy to pinpoint. The enterprise controls how this data is created, stored, distributed and disposed of, and policies and procedures can be developed to respond to litigation or regulatory investigations with some surety. Data stored in the cloud, however, could be stored on multiple servers across multiple jurisdictions, making it more difficult to identify, preserve, and collect for litigation or regulatory investigations.

To ensure that an enterprise can demonstrate to a court or regulator that it took reasonable steps to address relevant ESI, it is important that corporate counsel ask the right questions about where and how data is being stored by a potential cloud service provider before making the decision to move to the cloud. The answers to these questions should be documented so that when a lawsuit arises, corporate counsel and IT can work quickly to locate responsive ESI. To this end, it is also important to note which tools are available to support the identification process. For example, does the provider offer search tools or other capabilities that would allow inside counsel to locate a certain subset of data?

Just as any prudent organization would develop policies and processes to preserve onsite data, information stored by a third party should also be addressed by corporate information governance policies. Will the cloud provider execute a litigation hold or are there tools available that would allow corporate IT or legal to execute a hold against data in the cloud? If the cloud provider

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will not implement the hold, it is critical to understand and document the process for preserving ESI prior to facing litigation. This includes understanding your cloud provider's retention and backup policies and how data can be retrieved before it is potentially destroyed.

Collection can often pose the trickiest challenges when dealing with data stored in the cloud. Corporate counsel will want to understand what the collection process truly entails. For example, are there tools available to cull down data prior to collection or must all data be collected and then processed internally? Secondly, does the provider allow for self-collection and, if not, are there costs associated with data retrieval? Finally, it is important to understand the format of the collected data and how, if at all, the authenticity of the data will be affected by the collections process. Will metadata be altered as a result or can the cloud provider demonstrate that the data has been maintained in its original, unaltered state?

The key point is to do sufficient due diligence on a potential cloud provider and the specific solution it proposes so that policies and procedures can be developed that are crafted to the specific solution.

Reducing Other Risks of Cloud Data

Knowing the answers to these questions before an enterprise is faced with litigation is critical in reducing risk associated with identification, preservation, and collection. However, the e-discovery process is only one piece of the puzzle in governing corporate data in the cloud. Prior to entering into an agreement with a cloud provider, IT and corporate counsel will also want to jointly address the following subjects:

Record Retention and Backup Policies

Part of the identification process involves understanding what data resides in a corporate environment at a given time, which is one of the reasons that organizations develop and regularly update corporate retention policies. Moving to the cloud will likely add to the complexity of adhering to these policies. Will your cloud provider have the ability to execute corporate retention policies? How will the data disposition process be carried out and will it be documented? These are questions to pose to your cloud provider and include in your service agreement to the extent possible. If they cannot be included, then the information governance policies and procedures of the entity should be crafted to work within the strengths and limitations of a particular cloud offering.

Type of Data Being Stored in the Cloud, and Physical Location

In reality, negotiating the terms of the cloud service agreement may prove challenging. Some cloud providers only offer standard contractual terms while others might be willing to negotiate particular terms. With this in mind, it is important to consider what type of corporate data is being stored in the cloud and whether that data can be appropriately secured and governed. For example, if a provider is unwilling to provide the required level of service around privacy, security and authenticity, it would be unwise to store anything but the least valuable corporate data with a third party. Additionally, understanding and documenting where the data will be physically located is equally important. Companies must ensure their data is governed in accordance with whatever laws pertain to the location where the data might be stored. Also, the nature of the data may trigger location-specific issues, especially if the organization is managing information of foreign nationals where issues of privacy laws and/or blocking statutes may arise. Many cloud providers are competent with foreign privacy restrictions, however, and offer Safe Harbor certification, or will agree to restrict the movement or storage of data through or within specific jurisdictions. In this way, cloud solutions can actually strengthen the information governance policies of an entity.

Authenticity and Chain of Custody

Authenticity issues apply to cloud-stored data at any given time during its lifecycle. In order to ensure that the integrity of corporate data is protected at all times, it is critical to understand how the data will be moved into the cloud (if not originally generated in the cloud), out of the cloud, and how it is stored during its life in the cloud. How will the cloud provider ensure that metadata and content remain unchanged and that the data has not been tampered with in the cloud? Equally important is access to logs and reports to verify the security and integrity of the data. Last, you will want to include provisions in the service contract to ensure that the provider will comply with requests for declarations or other testimony necessary to establish chain of custody. As with other aspects of cloud computing, understanding these issues and crafting information governance policies and litigation response protocols around the specific cloud solution is critical to the reasonableness and thus defensibility of those policies and protocols.

Exit Strategy

Often overlooked, an exit strategy should also be discussed prior to entering a cloud agreement. As technology develops, it is likely that corporate IT may want to move data from one cloud provider to another to service its needs. Whatever the driver, corporate counsel needs to understand the legal ramifications of migrating data. How will authenticity and chain of custody be maintained and documented? What is the time frame associated with the migration? This latter question is critical given that an enterprise likely faces at least one lawsuit at a given time. Will the corporate legal team be able to respond to discovery demands if IT is in the midst of a large-scale migration? Finally, any costs associated with an exit strategy should be included in the cloud service agreement.

Conclusion

Although the above discussion may suggest that cloud computing is too risky to undertake, many organizations will discover that the benefits significantly outweigh these risks and, more importantly, that these

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A Compelling Need For Change in Legal Hold Practices

By Brad Harris and Charlotte Riser Harris

Over 17 months ago, Judge Shira Scheindlin sounded the clarion call once again — organizations that fail to take reasonable steps in response to a preservation obligation do so at their peril. In January 2010, *The Pension Committee of the University of Montreal, et. al. v. Banc of America Securities, LLC* (685 F. Supp. 2d 456, SDNY Jan. 11, 2010) opinion reinforced principles that had been laid out as early as 2003. When litigation is reasonably foreseen, affirmative steps must be taken to prevent spoliation of potentially responsive information. Among other actions, failing to issue a written legal hold notice may constitute gross negligence, since the likely outcome of failing to notify those responsible for the custody, ownership or control of electronically stored information will be its modification or destruction.

Yet despite this call, many in-house counsel remain reluctant or unwilling to implement seemingly simple steps deemed reasonable by numerous jurists at the federal court level — Issue a written legal hold. Take steps to ensure understanding and agreement to comply with the hold instructions. Send periodic updates and reminders. And be actively engaged in deciding what and how information needs to be preserved and collected.

Brad Harris, vice president of legal products and Legal Hold Pro for Zapproved Inc., has more than 25 years of experience in the high technology and enterprise software sectors. A frequent author and speaker on legal hold best practices, he previously held senior management positions at Fios, Hewlett-Packard and Tektronix. **Charlotte Riser Harris**, no relation to Mr. Harris, is manager of Litigation Support at Hess Corporation and has over 25 years' experience in the legal industry, including paralegal, team leader, project management, litigation support and department supervision. Ms. Riser Harris has extensive experience in electronic discovery, identification and implementation of litigation support best practices. The opinions expressed in this article reflect those of Ms. Riser Harris and are not necessarily those of Hess Corporation.

Understanding the Need to Change

Throughout 2010, the legal profession saw a dramatic rise in the number of court opinions being issued in response to spoliation claims. As a result, organizations find themselves under increasing scrutiny by their adversaries and the courts to ensure that reasonable and good-faith efforts have been undertaken in response to a duty to preserve information for discovery.

The case that clearly articulated this need was issued in mid-January 2010 by Judge Shira Scheindlin out of the Southern District of New York. The *Pension Committee* opinion specifically dealt with motions for spoliation sanctions brought by the defendant in this case.

The opinion went to great lengths to articulate a framework for the court's review and analysis, including how it determined the level of culpability (negligent, grossly negligent or willful), the interplay between the duty to preserve and spoliation of evidence, which party should bear the burden of proof for both relevance and prejudice, and finally, the appropriate remedy for harm caused by the spoliation.

When meting out sanctions, Judge Scheindlin stated that defendants "demonstrated that most plaintiffs conducted discovery in an ignorant and indifferent fashion" (p.82). The court held that unknown documents were destroyed due to poor preservation and the lack of an effective litigation hold (p.40-1.) For the grossly negligent plaintiffs, the court ruled that relevance and prejudice may both be presumed, and described a detailed spoliation instruction to be given to the jury. For those found to be merely negligent, the court ruled that the defendants would need to demonstrate that any destroyed documents were relevant and the loss was prejudicial. Monetary sanctions were also awarded.

Numerous other cases followed throughout 2010 that reinforced Judge Scheindlin's findings that data preservation must be taken seriously. On the heels of *Pension Committee*, Judge Lee H. Rosenthal in the Southern District of Texas ruled on *Rimkus Consulting Group Inc. v. Nickie G. Cammarata, et al.* (07-cv-00405, SDTX Feb. 19, 2010). The case involved intentional destruction of evidence that was later able to be recovered. Although *Rimkus* reached different conclusions based on the facts of the case regarding the level of culpability and issued reasonable sanctions based on the facts of the case and precedent in her court, Judge Rosenthal cited *Pension Committee* and affirmed the need for taking adequate steps to preserve evidence.

In March 2010, U.S. Magistrate Judge Marian Payson found the plaintiff to be grossly negligent in *Crown Castle USA, Inc. v. Fred A. Nudd Corp.* (2010 U.S. Dist. LEXIS 32982, WDNY Mar. 31, 2010) for not issuing a legal hold and awarded sanctions for cost of additional discovery. The next month, a case before Judge Richard Sullivan in the Southern District of New York, *Merck Eprova AG v. Gnosis S.p.A. et al.* (07 Civ. 5898, SDNY Apr. 20, 2010), cited a failure to issue a written legal hold — which was upheld as a reasonable and good faith response to a preservation obligation — in handing out sanctions, including a $25,000 fine to "deter future misconduct."

The year continued with Judge Paul Grimm's *Victor Stanley, Inc. v. Creative Pipe, Inc., et al.* (D.MD Sep. 9, 2010). The opinion, commonly referred to as *Victor Stanley II*, delved deeply into the standards set at the level of the U.S. Circuit Courts. The court had a case with a defendant who purposely destroyed

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documents and electronically stored information that were later recovered. This case did not address preservation issues, but rather the appropriate sanctions for an egregious spoliator, which included attorneys' fees and costs and a threat of up to two years in prison for contempt until the fees are paid.

Finally, in late October 2010, Magistrate Judge James Francis issued an opinion that continued the judicial debate. *Orbit One Communications, Inc. v. Numerex Corp.* (2010 WL 4615547, SDNY Oct. 26, 2010) involved a shareholder suit where spoliation was found to have taken place. In this case, Judge Francis denied the defendant's spoliation motion despite acknowledging the failure to "engage in model preservation" because there was insufficient evidence that any lost ESI was relevant to the case. Judge Francis takes the view that sanctions should be first weighed against the relevance of the lost data and prejudice suffered, rather than a *per se* conclusion based on preservation practices.

Fear of Change

The risks and consequences of failing to take reasonable steps to preserve information continue to increase, driven by trends in information technology (the proliferation of data types, sources and storage repositories), the increasing likelihood of requests for electronic data, and the standards of care expected by the courts.

Sending and managing legal holds has traditionally utilized a manual process. Yet even for a small number of holds, manual processes can be very time-consuming — drafting the hold notice, sending it to appropriate recipients in a timely manner, and keeping track of who received it (let alone if they understood the instructions and agreed to comply). When the scope of the hold changes (*e.g.*, who needs to be informed or the actions required), the process starts anew. And the courts are now expecting periodic reminders (*e.g.*, every three to six months) to recipients if there is an ongoing duty to preserve. It's little wonder that many organizations tend to resist the idea of sending holds for every anticipated litigation or investigation.

Manual legal hold processes have other shortcomings as well. They tend to be ad hoc, often leading to confusion and greater disruption on the business. Manual tracking is also prone to errors and omissions, and the lack of timely reporting can make management control and defensibility equally challenging. Additionally, manual processes are enormously difficult to scale, since adding personnel or outsourcing can be extremely costly.

So what are the alternatives to a manual legal hold process? One approach is going straight to collection, bypassing the need to notify custodians by copying or quarantining the information. In some cases, a "collect-to-preserve" strategy is very appropriate when the risk of spoliation is otherwise high — such as highly ephemeral data or when dealing with a bad actor — or if the relevant information can be precisely identified at the outset of a case. Evolving search and retrieval technologies can facilitate a collect-to-preserve strategy through automation and targeting.

There are, however, drawbacks and limitations to relying exclusively on collection. Automated collection technologies can be expensive to acquire and maintain. Performing broad collections at the outset of a preservation obligation inevitably leads to significant amounts of data being captured that needs to be stored properly and later sifted through should discovery proceed. Data being stored for one case becomes subject to future preservation obligations should new litigation arise. Last, with the proliferation of data types and the ubiquity of storage devices, attempting to collect from all the potentially relevant sources can be overwhelming and burdensome.

Another approach to responding to preservation obligations is to take advantage of intelligent data repositories that are capable of locking down information where stored in its normal course of business. E-mail archives and content management systems now routinely provide the ability to search for relevant content and place a hold on the data-in-place to prevent it from being modified or deleted. When available, such intelligent repositories have the distinct advantage of avoiding the need to unnecessarily replicate data and enable better information governance by managing retention and routine disposition.

Where intelligent repositories are not in place, and a collect-to-preserve strategy deemed too costly or inadequate to address all potentially relevant data, automating the legal hold notification process can significantly lower cost and risk. So why not automate? In the past, automating the legal hold notification process meant a sizable investment in software, hardware and operating maintenance associated with an enterprise software implementation. An investment typically exceeding $250K meant such automated systems were out of reach for most organizations. Home-grown solutions, if there were resources available to invest, also tended to be expensive and difficult to sustain.

Today, the picture is changing. New solutions for automating the legal hold notification process have been introduced that incorporate capabilities into existing discovery tools, or as best-in-class standalone solutions. The total cost of ownership for standalone solutions can also be dramatically lessened through emerging software approaches such as Software-as-a-Service (cloud-computing). Like many aspects of electronic discovery response, these automated solutions will significantly reduce the perceived burden on an organization for meeting new standards of reasonableness and good faith.

The Benefits of Improved Preservation Practices

With judicial opinions like *Pension Committee*, *Rimkus*, *Victor Stanley II* and *Orbit One*, the awareness of the need to improve legal hold and data

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preservation practices can hardly be argued. Taking affirmative, proportional and timely steps in response to a preservation obligation is the expectation.

Innovative software solutions for automating the legal hold notification and compliance process are affordable, cost-effective and easy-to-use, all but eliminating the argument of burden on those responsible for notifying and on the recipients. With automation, they also significantly mitigate risk while increasing defensibility. By taking proactive steps to improve an organization's response to a preservation duty, the risks and costs associated with discovery can be significantly reduced.

An automated system for issuing and tracking legal hold provides benefits to both the legal department personnel issuing the holds and the business unit employees who are subject to hold. Removing the subjectivity from the process of sending and tracking legal holds ensures each matter requiring preservation will be handled similarly. An automated system that provides notice to legal department employees about the status and need to reissue holds reduces the likelihood of failure to issue timely reminders.

Conclusion

Business employees subject to legal hold may be uninformed or inattentive to the process and requirements. By implementing a transparent, familiar and well-understood process, those responsible for implementing hold instructions are much more likely to take appropriate steps to avoid inadvertent spoliation. Following a defined process that includes keeping an adequate audit trail empowers an organization to defend those actions as "reasonable and in good faith."

Many business employees need guidance to understand what steps to take to preserve relevant materials. Being told to preserve data is one thing — it's quite another for an employee to understand what to do to ensure relevant materials are not being deleted. Most users do not have a thorough understanding of the IT processes and procedures that impact the files and email they create and save everyday nor do they have an understanding of the ramifications of those processes and procedures on the preservation of those files.

Having a defensible data preservation process in place can also create strategic advantage for counsel. Knowing that reasonable and good-faith efforts can be defended affords much greater leverage when negotiating a fair and reasonable scope of discovery or considering settlement offers, and allows counsel to focus on the merits of the case, not the missteps of discovery.

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risks are indeed manageable. Collaboration between corporate IT and legal teams is key to understanding and planning around both the business and legal risks of cloud computing. By developing a consensus on what data is appropriate for the cloud and how that data should be governed throughout its life cycle, many of the risks identified above can be reduced to acceptable levels. Moreover, a thorough vetting of a cloud provider and its ability to meet corporate requirements around retention, access, preservation and recoverability assure corporate legal teams that ESI is being governed appropriately and that they will be able to meet the standards set forth around e-discovery.

10 Tips

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I've spent a great deal of time over the past several months speaking to corporate law department professionals regarding their operational challenges. One of the recurring discussion themes has been about the need to show their management teams and shareholders how they operate a best-in-class legal department that contributes meaningful value to the organization.

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Based on those "best-practices" ideas, here are 10 tips for helping corporate legal departments measure and demonstrate their value to senior management:

1. Identify Metrics That Are Actionable and Drive Results — Then Track Them

Tracking and analyzing the right metrics will give you the insight you need to make the right decisions on how to allocate your law department budget. Consider, for example, the use of alternative fee arrangements (AFAs) versus traditional billing methods. Corporate counsel must be able to forecast whether the use of an AFA will result in a cost-savings or whether a traditional billing method represents the better, more cost-effective alternative for a particular matter. Law departments also need to align their goals with the larger organization's goals. Meet with your business stakeholders to make certain that the metrics you're reporting on correspond to the key areas the business is focusing on, allotting dollars toward the right projects.

2. Distribute Regular Updates on Key Metrics

Promote specific ways in which your law department delivers value and contributes to the overall success of your organization. Circulating critical information on a consistent basis, like spend versus budget, diversity tracking, spend by matter and spend by business unit can help you

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Delaware corporation, in California state court, seeking damages for alleged violations of California's wage and hour laws. Claiming diversity of citizenship, Hertz sought removal to the federal district court for the Northern District of California. Hertz argued that its principal place of business was, for purposes of the Diversity Statute, in New Jersey because, although its business operations were spread over many states, "its core executive and administrative functions … [were] carried out" at its corporate headquarters in New Jersey. Plaintiffs countered that, under the Ninth Circuit's "business activities" test, Hertz is a California citizen and therefore was not entitled to removal on the basis of diversity jurisdiction.

The District Court applied the Ninth Circuit's "business activities" test in determining that the "'plurality of each of [Hertz's] relevant business activities' was in California, and that the 'differential between the amount of those activities' in California and the amount in 'the next closest state' was 'significant.'" Thus, the District Court disregarded the fact that Hertz's corporate headquarters is located in New Jersey. With diversity jurisdiction lacking, the case was remanded to California state court. After the Ninth Circuit affirmed the District Court's decision, the U.S. Supreme Court granted certiorari.

The Supreme Court's Analysis

After discussing the background of the Diversity Statute and the split that had arisen among the federal circuits over the proper test for determining a corporation's "principal place of business," the Supreme Court noted that, in its view, the Ninth Circuit's fact-intensive "business activities" test had "proved unusually difficult to apply." In fact, according to the Supreme Court, the "business activities" test was "at war with administrative simplicity" and "failed to achieve a nationally uniform interpretation of federal law."

By contrast, the Supreme Court found the Seventh Circuit's "nerve center" test, with its focus on the "place where a corporation's officers direct, control, and coordinate the corporation's activities," to be more straightforward. Accordingly, the Supreme Court adopted the Seventh Circuit approach, noting that a corporation's "'nerve center' will typically be found at a corporation's headquarters."

At the same time, the Supreme Court offered a cautionary note. Recognizing that in "this era of telecommuting, some corporations may divide their command and coordinating functions among officers who work at several different locations, perhaps communicating over the Internet," the Court conceded that the "nerve center" test will lead to "hard cases" and occasional "counterintuitive results." For example,

> … if the bulk of a company's business activities visible to the public take place in New Jersey, while its top officers direct those activities just across the river in New York, the 'principle place of business' is New York. One could argue that members of the public in New Jersey would be less likely to be prejudiced against the corporation than persons in New York — yet the corporation will still be entitled to remove a New Jersey state case to federal court. And note too that the same corporation would be unable to remove a New York state case to federal court, despite the New York public's presumed prejudice against the corporation.

The Supreme Court was willing to accept "such seeming anomalies," however, as "the price the legal system must pay to avoid overly complex jurisdictional administration while producing the benefits that accompany a more uniform legal system." The Court further noted that the determination of a corporation's principal place of business for purposes of diversity jurisdiction is not a mere formality. Rather, the "burden of persuasion for establishing diversity jurisdiction ... remains on the party asserting it," and "if the record reveals attempts at manipulation — for example, that the alleged 'nerve center' is nothing more than a mail drop box, a bare office with a computer, or the location of an annual executive retreat — the courts should instead take as the 'nerve center' the place of actual direction, control, and coordination … ."

Nerve Center Test Applied

Recently, in *Brewer et al. v. SmithKline Beacham Corporation d/b/a GlaxoSmithKline*, the United States District Court for the Eastern District of Pennsylvania became one of the first federal courts to have the opportunity to apply the *Hertz* test to a multi-tiered corporate holding company structure. Importantly, the District Court's ruling took to heart the Supreme Court's admonition concerning the potential for manipulation of a corporation's "nerve center."

GlaxoSmithKline plc, the UK-incorporated global pharmaceutical and consumer health care giant, employs a multi-tiered holding structure to conduct its worldwide operations. GlaxoSmithKline LLC ("GSK LLC") is "the entity through which [GlaxoSmithKline plc] conducts its pharmaceutical and consumer healthcare business in the United States." For historical reasons relating to tax considerations and the protection of intellectual property rights, GSK LLC is organized in Delaware. That, however, is its only substantive contact with Delaware, and its business address, books and records and most of its important "corporate functions" are located in Philadelphia.

The sole member of GSK LLC is GlaxoSmithKline Holdings (Americas) Inc., a Delaware corporation ("GSK Holdings"). This is for all intents and purposes a pure holding company, has only one person on payroll (who "works approximately 20 hours annually for the company") and contracts with a Delaware corporate services company to accept mail,

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What In-House Counsel Should Know About the New Lease Accounting Standards

By Lance Dunkley

New accounting laws are in the final stages of being enacted. What does this have to do with in-house counsel? For companies with significant space or equipment leases, it is conceivable that the CFO, already reeling from a potential double-digit decline in revenues, will inquire why the company is now in default on its loans. Are you prepared to respond?

The Financial Accounting Standards Board (FASB) and the International Accounting Standards Board (IASB) are working together to finalize new accounting practices related to operating leases. In August 2010, the two boards jointly issued an Exposure Draft (ED) of the proposed new standards.

While it's still uncertain which aspects of the ED will be included in the final lease accounting rules, it is certain that the new rules will significantly impact many companies. All industries will have some repercussions due to the rule changes, though the most significant impact may be felt in the retail, real estate, food, airline and financial services industries. If your company is in one of these industries or leases space or equipment, you need to know the new lease accounting rules.

Background

The new rules were originally scheduled to be finalized June 30, 2011, though there was some flexibility with the date as the FASB and IASB indicated a greater interest in getting the final law right than issuing the changes prematurely to meet pre-established timelines. The two groups now expect to release a final standard in third-quarter 2011 with a possible second ED, given the enormity of the changes from the original. The rules are scheduled to take effect by January 2013.

Most of the pressure to comply with the proposed standards will fall to a company's corporate real estate, lease administration, accounting and tax departments when it comes to changes on corporate balance sheets, financial reporting requirements and lease agreements. The changes may also heavily involve technology departments as new systems could be necessary to support the increased administrative burden of updating lease payment adjustments at the end of each reporting period.

What In-House Counsel Need to Know

In-house counsel should become well-versed with how the inevitable changes will impact loan covenants, lease type and terms, buy/lease strategies and reporting compliance.

The objective of the proposed lease accounting rules is to create a common accounting standard to ensure assets and liabilities arising from leases are uniformly recognized on balance sheets. Whether the ED appropriately meets this objective is subject to interpretation and extensive debate. The ED proposes capitalizing operating leases by calculating the asset and liability based upon the net present value of the future rent payments. This means converting rental stream into a principal amount by dividing by a rate of interest (the company's incremental borrowing rate). Both the right to use the leased space or equipment (the asset) and the obligation to pay rent (the liability) are capitalized, leading to increased assets and liabilities in the initial years of the lease term.

Significantly, the ED proposes capitalizing not only base rent, but also estimated percentage rents, and extending the capitalized term of the lease by any extension periods. These changes will cause many companies to incur double-digit increases in reported liabilities the day the new standards are implemented. Currently, a lease can be reported as a straight-line rent payment expense on the profit and loss statement, while not being disclosed on the balance sheet.

Dr. Charles Mulford, Director of the Georgia Tech Financial Analysis Lab, in his research report titled, "The Effects Of Lease Capitalization on Various Financial Measures: An Analysis of The Retail Industry," evaluated how lease capitalization would impact income for 19 major retailers. According to his findings, the median change to total liabilities would be a 26.4% increase. The finding also showed that while earnings before interest, taxes, depreciation and amortization (EBITDA) would increase 22.5%, income from continuing operations and earnings per share would each decrease 5.3%. The retailers' liability/equity ratio could be expected to decrease 26.4%, which would be a significant shift in financial leverage.

Impact

Case in point: A notice issued by the Equipment Leasing and Finance Association included an example of how the new lease accounting standard may impact airline companies. For instance, a 17-year lease on a $100 million aircraft would show a first-year expense under the new accounting standards of $2.4 million or 26% higher than straight-line. The cumulative difference reaches a high point in the ninth year at 128% greater than straight-line.

Companies poorly weathering the economic storm may find the accounting changes devastating. If capitalization is weak, even a small change on the balance sheet could significantly influence profitability. Furthermore, many companies may find themselves in default under their loans because the new accounting standards cause them to be in violation of their financial covenants.

The impetus to include operating leases on balance sheets grew out of the Enron scandal. Between 1993 and 2001, Enron created more than 3,000 partnerships, primarily to hide the company's bad debts. Enron circumvented accounting practices by finding partners to take as little as a 3% stake in a partnership. In these cases, Enron was not required to report the partnership's financial

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Accounting Standards

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condition in its own financial statements and could hide underperforming assets by selling them to the partnerships in exchange for IOUs backed by Enron stock.

In the aftermath of Enron, the Securities and Exchange Commission (SEC) focused accounting reform on off-balance sheet transactions and, in particular, operating leases. The latter have been attractive to companies that lease equipment or space because they offer a payment financing alternative and are excellent for bypassing capital budgeting restraints. An operating lease typically qualifies for off-balance sheet treatment, resulting in increased return on assets due to a reduced asset base.

The right to use property for the term of the lease, as well as extension periods, will be recognized as interest expense and amortization, which results in improved EBITDA. The obligation to pay rent, including percentage rent, during the term of the lease and extension periods will replace rent expense and be recognized as a liability, causing EBITDA to free-fall.

One of the most controversial aspects of the accounting changes is the expected outcome technique. This estimate assumes the longest possible lease term that is "more likely than not" to occur, taking into account the effect of any options to extend or terminate the lease and contingent rentals. Options to extend a lease may be included within the lease term, swelling the impact of front-loading, based on factors such as contractual terms, nature of the asset, location, cost of relocating, lessee's intentions and past practices. Recent meetings of the FASB and IASB focused on the definition of lease term. One recent staff briefing paper noted almost universal rejection by the public to include lease options within the definition of lease term, even if they are judged "more likely than not" to be exercised.

The new standards are also expected to include projected percentage rent as part of the expected outcome over the term of the lease, further increasing the front-loaded liabilities of many already debt-laden companies.

Projections of lease extensions and percentage rent must be updated when changes in facts or circumstances indicate there would be a significant change in the assets or liabilities from the previous reporting period. In some instances, this could lead to monthly reporting changes and, in all instances, it will cause administrative nightmares unless appropriate lease administration processes are implemented.

Is Your Company Prepared For the Change?

According to a February 2011 survey by Deloitte, only 7% of executives said their companies were extremely or very prepared for the accounting standard changes. However, executives universally indicated concerns about the impact on debt-to-equity ratios, the effect on existing debt covenants, an increased difficulty in obtaining financing, a possible move toward shorter-term leases and a change to purchasing real estate rather than leasing space.

Following are areas in which companies should dedicate resources in anticipation of the accounting changes:

- *Impact on loan covenants*: Upon inception of the new lease accounting principles, many borrowers may be in default under financial covenants found in their loan documents.
- *Impact on the term of the lease*: Due to the effect of front-ending lease costs, the new rules for lease accounting impact long-term leases more than short-term leases.
- *Impact on the type of lease (net vs. gross)*: Net leases with lower contractual lease payments may be more appealing than gross leases as lower contractual lease payments will help to minimize the impact of capitalization.
- *Impact on administrative costs*: Administration costs associated with lease accounting changes will increase due to the added complexity of disclosure requirements. Estimates of lease term and lease payments will have to be reviewed every time companies report financial results, which will be at least quarterly for large companies. The added administrative responsibility may also require new or upgraded technology solutions to track and report lease obligations.
- *Impact on the buy vs. lease decision*: The accounting benefits of leasing versus buying will be greatly diminished, moving companies toward acquiring property rather than leasing it. Corporate real estate strategies, however, are also driven by a host of other factors including the cost of capital, capital access, tax considerations, governance and budgetary consideration, regulatory constraints and economic conditions, so the decision to buy or lease will vary by company.

What Can You Do?

The requirements and implications of the new lease accounting standards will affect companies differently, but there are steps that all companies can take in anticipation of these changes. Following the FASB/IASB process as it unfolds in the coming months will be imperative. In addition, in-house counsel and other department executives can take action now to:

- Review, revise and update corporate lease administration systems and processes.
- Proactively strategize with lenders regarding the new lease accounting principles and, if required, plan to restructure existing loans.
- Review and possibly restructure long-term lease obligations, extensions and percentage rent obligations.
- Re-engineer lease/buy models to account for the changes in lease accounting.
- Invest in technology systems to track leasing obligations.

Conclusion

In-house counsel should work proactively with the corporate real estate, lease administration, accounting, tax and technology departments to devise an integrated strategy for optimizing the company's short- and long-term options under the new lease accounting guidelines. An effective plan will help mitigate the impact the new lease accounting standards may impose.

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pay bills, provide two officers and a director, and supply an "office" located in Delaware that is only "a 10' x 10' room furnished with a desk, file cabinets and an unused computer."

Crucially, in its role as the sole member of GSK LLC, GSK Holdings has delegated management responsibilities for GSK LLC's business and affairs to GSK LLC's officers and directors. Consequently, GSK LLC is "manager-managed," and its senior officers "direct and control the activities of the United States pharmaceutical business from Philadelphia."

GSK LLC found itself the defendant in numerous pharmaceutical liability cases relating to its Paxil product. Many of these cases were initially brought in Pennsylvania state court by individual citizens of that state. GSK LLC was successful in removing these cases from state court to federal court on the basis that GSK LLC, but none of the plaintiffs is a citizen of Delaware. Plaintiffs subsequently moved to remand the cases to state court, arguing that application of the *Hertz* test indicates that GSK LLC's principal place of business is Philadelphia, thereby depriving the federal courts of diversity jurisdiction. GSK LLC, adamant that it should be considered a Delaware citizen, opposed remand.

The District Court's Analysis

The district court began its analysis by citing the principle, accepted "in the Third Circuit and in all other circuits that have considered the issue," that "[a] limited liability company's citizenship … is determined by the citizenship of its members." Given that GSK LLC's sole member is GSK Holdings, the district court, applying *Hertz*, turned to an examination of Holdings' "center of direction, control and coordination in the context of its dual role as a holding corporation *and* as the sole member of [GSK] LLC." [emphasis added].

The district court concluded that diversity jurisdiction was defeated because, in either context, GSK Holdings' principal place of business is, in fact, in Philadelphia. Although not crucial to its decision, the district court also pointed to instances of purported "post-removal jurisdictional manipulation" on the part of GSK Holdings following initiation of the Paxil lawsuits, including amendments to corporate bylaw and government contract provisions that actually listed GSK Holdings' business address as being in Philadelphia. In any regard, the district court directed the Paxil cases back to state court.

GSK Holdings as GSK LLC's Sole Member

The district court first sought to locate GSK Holdings' "nerve center" in the context of its role as the sole member of GSK LLC. In light of GSK Holdings' limited business activities and its delegation of the management of GSK LLC's operations to Philadelphia-based GSK LLC officers and directors, the court found that GSK Holdings "has effectively transplanted the vast majority of its 'brain' or 'nerve center' to its managers in Philadelphia … ." As such, the court concluded that, in this role, "[GSK] Holdings' 'nerve center' is in Philadelphia."

GSK Holdings As a Holding Corporation

Even when it focused on GSK Holdings' limited activities outside its role as GSK LLC's sole member, the district court concluded that "[GSK] Holdings' principal place of business is not in Delaware." In this regard, the court explained that GSK Holdings "does no more there than is necessary to preserve its corporate status as a Delaware corporation under Delaware law." Its quarterly board meetings held in Delaware "do not direct, control or coordinate its real business activities," and its Delaware operations are largely supplied by a corporate services company that provides an office "the size of a closet" where no business activities are conducted and a Delaware "rent-a-director" who spends "four hours per year on his duties." In fact, in the court's opinion, GSK Holdings "fits the profile of a company described by the Supreme Court in *Hertz* as an artifice to manipulate jurisdiction."

Conclusion

The Supreme Court's decision in *Hertz* to select of the "nerve center" test, rather than the "business activities" test, to determine a corporation's "principal place of business" for purposes of the Diversity Statute is undeniably a positive development for corporations. A test that focuses primarily on a single, relatively straightforward factor — generally, the state in which the corporation maintains its headquarters — will make it easier for businesses to predict their state citizenship when confronted with litigation in a state court. This predictability not only will reduce the risk that corporations will suffer local prejudice in lawsuits, but will enable them to avoid the additional time and expense required to litigate jurisdictional issues even before they get to the merits of the dispute.

Brewer indicates how the *Hertz* "nerve center" test will be applied within the type of complex, multi-tiered corporate holding structure that is prevalent in many large, international business enterprises. It is interesting to note that, in determining the citizenship of a manager-managed LLC for purposes of the Diversity Statute, the *Brewer* Court essentially disregarded the jurisdiction of incorporation of the LLC's sole member, despite Third Circuit precedent that looks to the citizenship of an LLC's member(s) for determining the citizenship of the LLC. Moreover, while there may be other very good reasons for locating the citizenship of a business enterprise in a particular jurisdiction where it may not necessarily conduct significant business operations, *Brewer* demonstrates that, for purposes of a *Hertz* analysis, a federal court seeking to identify an entity's actual center of direction, control and coordination might very well ignore what it views to be an effort to manipulate jurisdiction.

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identify key negotiation points such as volume discounts, billing rates by firm and staffing model by firm.

3. Improve Technology Solutions

Implementing e-billing and matter management solutions enables you to more effectively collaborate with outside counsel, forming stronger relationships and improving efficiencies. In the short term, technology solutions can get a law department's outside spending under control. In the long term, your solution helps you view trends for greater cost savings and more efficient budgeting. E-billing and matter-management solutions enable you to develop and track budgets for each matter, automatically manage events or tasks across multiple firms, and share relevant documents, often using a templated system that standardizes the process while accommodating different types of matters.

4. Position Yourself As a Thought Leader

How do other organizations perceive your law department? Forums that allow you to share best practices with external peers, as well as promote yourself as an indispensable company asset who runs a high-performing legal team, ultimately shine a positive light on your organization as a whole. Participate in user groups, speak on a panel when invited, and share your experiences with other inside counsel via online communities.

5. Find Additional Ways to Cut Costs

Always look for ways to save. Analyze travel budgets and entertainment expenses. Save time and money utilizing alternate technologies: Hold virtual meetings through video and Web conferencing technology such as Skype and WebEx; instead of printing and faxing changes, consider paperless alternatives such as electronic editorial and review tools, electronic faxing and e-mail. Review legal and IT staff so that you're using them to their fullest potential — and don't pay for their downtime. Optimize your internal resources for additional cost savings.

6. Reassess How Outside Counsel Is Chosen

Think creatively when selecting outside counsel for your matter. Consider implementing competitive bidding and initiating requests for proposals when selecting outside counsel to handle new matters. Develop a standard process that outside counsel can use to compete for your business; one that will encourage your current firms to offer competitive pricing and continue to prove their value.

7. Allocate Work More Effectively By Identifying Top-Performing Outside Counsel

Pinpoint the outside counsel that consistently delivers results on time and on budget (case results and fees are a set of metrics to consider) and begin to assign even more projects to them. Once you've identified the top-performing firms that deliver the best value for the money, you can send appropriate matters to them with confidence, knowing you've identified those that work efficiently, that are results-oriented and client-focused.

8. Re-evaluate Outside Counsel Fee Arrangements

AFAs can be a powerful way to cost-effectively utilize the expertise of outside counsel without breaking your law department budget. Consider tying fees to performance, negotiating fixed fees for larger work volumes, or using hybrid agreements (a combination of fixed and hourly rates). Remember that the more work you have to give a firm, the more leverage you'll have when negotiating fees. Volume discounts, for example, can give you more negotiating power. Finally, it's important to understand the methodologies that outside counsel use to determine their fees. Request pricing strategies, and expect firms to provide them. We work with several companies that have implemented AFAs, including one customer where 90% of its litigation matters are billed on an AFA, just 10% of them still billed according to the billable hour.

9. Use Alternative Outside Counsel Resources

Consider using contract attorneys on your cases or outsourcing your legal services overseas. Contract attorneys could offer significant savings over what a law firm would normally charge, and the savings from off-shoring can be even greater.

10. Optimize Internal Resources

Skilled paralegals are priceless to law departments. Instead of sending tasks to outside counsel, use paralegals to perform work appropriate to their level that requires an understanding of your business or access to business teams and to help keep your costs down. In addition, implementing routines on how recurring work is handled, as well as creating templates for documents wherever and whenever you can, is crucial to enhancing your law department's overall efficiency.

Conclusion

In the end, the best advice may well be to turn insights such as these 10 tips into specific action steps. The fact is that corporate counsel now have a tremendous amount of data within their organizations and have a wide range of software tools available to help them convert this data into meaningful information. By putting this information to practical use, in-house legal executives can make better decisions and demonstrate greater value to their corporate management team.

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