Business Law Section Newsletter

Vol. 38, No. 3 — January 2015

Notes from the Editors

by Denise Walsh, Edward Sturchio and Thomas Zalewski

Happy New Year! The editors would like to take this opportunity to thank all of the authors who have contributed to the *Business Law Section Newsletter* in 2014, including the authors who contributed to this edition. We hope many of you will consider writing again in 2015.

The Jan. 2015 issue of the *Business Law Section Newsletter* contains many useful articles for business lawyers. As a follow-up to an article we published in Oct. 2014, one of the articles in this edition focuses on the myriad of issues that arise when buying or selling a business with a unionized workforce. We also are publishing an informative article about designing an effective protection system for a business's trade secrets.

Lawyers frequently write, review and negotiate nondisclosure agreements on behalf of their business clients. With this in mind, we have included an article providing useful insight into the various issues that should be considered in nondisclosure agreements. Likewise, many contracts written, reviewed and negotiated on behalf of business clients contain liquidated damage clauses. This issue of the newsletter includes an article addressing some of the benefits, limitations and risks associated with liquidated damage clauses.

A timely article about a recent amendment to the New Jersey Business Corporation Act regarding the advancement of a corporate agent's expenses is another valuable addition to this issue of the newsletter.

Although you will not find Lydia Stefanowicz's regular opinion column within these pages, do not fret! Lydia's column will be back in the next edition.

As always, we hope the articles contained in this edition of the newsletter are helpful in your practice and when advising your business clients.

We encourage you to submit an article for publication in 2015 on a topic of interest to you and other members of the business law community. We also welcome input from you about topics you would like to see addressed in future editions. Please feel free to reach out to any of the editors with suggestions. ■

Inside this issue

Call for Articles

Is your new year's resolution to have an article published? If so, we are seeking articles for the spring/summer 2015 issue of the *Business Law Section Newsletter* on topics of interest to business lawyers in New Jersey and written by New Jersey State Bar Association members.

The deadline for submitting articles for the spring/summer edition is **April 15, 2015**.

Interested in submitting? Contact any of the editors:

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We look forward to hearing from you.

Are We Buying a Union?

by Martin W. Aron and Eric G. Guglielmotti

Corporate transactions regularly entail a myriad of business risks. This is especially true when a buyer contemplates entering into a transaction with an entity that has a unionized workforce.[1] In this realm, it is critical that the buyer conduct a thorough evaluation of the transaction and due diligence of the target business. The buyer should consider the composition of the workforce, the work being performed, as well as the express terms and conditions of any applicable collective bargaining agreement. Without doing so, the buyer can be exposed to undisclosed liabilities and/or obligations that directly impact the fair market value of an entity.

This article is intended to highlight the common labor and employment issues that arise in transactions where the target entity has a unionized workforce. The analysis is set forth from a buyer's perspective, starting with due diligence review of the target entity and its workforce, considerations in structuring the deal to avoid potential liabilities, and the buyer's obligation to adopt the predecessor corporation's collective bargaining agreement, as well as its ability to relocate the workforce following the sale. Finally, this article touches upon issues that can arise when purchasing an entity through a bankruptcy sale.

Issues for Consideration During Due Diligence

Discovery of undisclosed liabilities and/or obligations of the predecessor may severely impact the buyer's strategy in structuring the deal, as well as justify an adjustment in the negotiated price.

As part of this due diligence review, a prudent buyer should analyze the seller's potential liabilities, including but not limited to, any claims, litigations or administrative charges filed with a local, state or federal agency. In addition, the buyer should consider the composition of the workforce, including the identification of both union and non-union members, exempt and non-exempt employees and independent contractors. For instance, an improper classification of employees may expose the buyer to extensive liabilities following the acquisition, including potential wage and hour violations. Furthermore, by identifying the target business's workforce, a buyer will have a better understanding of the pension, benefit and severance pay obligations that may arise from the acquisition. Contractual agreements with third-party vendors and employees should also be considered by the buyer, as these too may survive the acquisition. The impact of these considerations will likely affect the buyer's position with respect to negotiation.

In addition, a buyer must conduct a review of applicable collective bargaining agreements. Certain provisions may make it easier to organize the buyer's employees in other facilities (*i.e.*, neutrality or card-check provisions); obligate the buyer to maintain certain benefits, pensions, and other fringe benefits and obligations; and hinder the buyer's ability to relocate, close, and/or sell the entity, as well as the ability to layoff employees for legitimate business reasons. In addition, the language of any 'zipper' or 'management-rights' provisions may raise red flags for a buyer. For example, a zipper clause may prevent a buyer from negotiating and/or implementing terms and conditions of employment that were otherwise omitted from the existing collective bargaining agreement.

Similarly, a management-rights provision should be specific and expressly identify issues and rights the buyer seeks to retain as part of the transaction. Moreover, the buyer should conduct a review of any union-related activity, such as grievances, arbitrations, unfair labor practice charges, strikes and lockouts, and settlement agreements. This will provide further insight into the seller's relationship with the existing union, thereby forecasting any issues that may arise following the transaction. A company with a long history of multiple arbitrations each year will be a very different target than one that has little or no such experience.

Structuring the Transaction to Limit Exposure

When a company is in transition between owners (employers), a union is in a vulnerable position. The union has not yet developed a relationship with the new employer and its representatives may be unsure of whether the new employer must bargain with it.

A buyer's obligation to bargain with the union may be determined by the structure of the transaction. Thus, a duty to bargain may be predicated on the express terms and conditions of the purchase agreement. Alternatively, a buyer's obligation may arise from its conduct (*i.e.*, assumption of the collective bargaining agreement) and/or its hiring of all or some of the seller's employees.

Initially, the buyer must carefully consider the type of transaction to be proposed to the selling entity. For example, following the due diligence review period a buyer may consider restructuring the deal from a stock purchase to an asset purchase to avoid assumption of certain liabilities and obligations.

Should a buyer wish to adopt the goodwill and certain known debts of a business, a stock purchase may be the best strategy for structuring the acquisition. In a stock acquisition, the buyer assumes the labor and employment-related liabilities and obligations much in the same way as it assumes the debts, assets and goodwill of the selling entity.[2] This assumption by the buyer includes any liabilities stemming from the seller's employment and labor practices, as well as any unresolved and pending litigations. The buyer also assumes contractual and statutory obligations for current and former employees, clients and vendors, such as severance payments and pension, health and benefit obligations. Essentially, the problems of the target business most often become the problems of the buyer of stock. With regard to a unionized workforce, the buyer would most often be bound by the terms and conditions of any existing collective bargaining agreement.

Conversely, an asset purchase provides more flexibility to the buyer than a stock purchase, enabling the buyer to negotiate the liabilities and obligations it chooses to assume as part of the transaction. When a buyer merely acquires the assets, as opposed to stock, of another company that signed a collective bargaining agreement, the acquiring company normally has no obligation to honor the predecessor's collective bargaining agreement or bargain with the union unless it is found to be a 'successor employer' or 'perfectly clear successor' under the National Labor Relations Act (NLRA).[3] Therefore, if the existing collective bargaining agreement is not favorable and/or hinders a buyer's ability to make substantive operational decisions that are adverse to the buyer's intentions, it would generally be beneficial to structure the deal as an asset purchase. At a minimum, it would enable the buyer to set its own initial terms and conditions of employment and then bargain with the union for a more favorable collective bargaining agreement.

Implications of Being a Successor Employer

Regardless of the label utilized by the parties in the transaction, a buyer may still be obligated to recognize and bargain with the union in the instance it is found to be a successor employer or perfectly clear successor. The issue of successor liability usually arises in the case of an asset purchase deal because a stock purchase buyer generally has already agreed to assume the liabilities and obligations of the target business.

In essence, a successor is required to recognize and bargain with the union representing the predecessor's workforce.[4] Nevertheless, a successor, unlike a buyer in a stock purchase deal, is not required to adopt the predecessor's collective bargaining agreement and may instead establish its own initial terms and conditions of employment. Once the purchaser is determined to be a successor employer, it must then recognize the union and negotiate a new collective bargaining agreement.

Additionally, in certain circumstances, a successor may be obligated to remedy a predecessor's unfair labor practices where: 1) it had notice of the predecessor's liability; and 2) there is a sufficient continuity between the two companies.[5]

In determining whether a buyer is a successor for purposes of assuming the liabilities and obligations of the predecessor business, courts and the National Labor Relations Board (NLRB) consider "whether the new company has acquired substantial assets of its predecessor and continued, without interruption or substantial change, the predecessor's business operations....Hence the focus is on whether there is *substantial continuity* between the enterprises."[6] Under this approach, the factors to be examined include:

1) whether the business is essentially the same;
2) whether the same employees are doing the same jobs, in the same working conditions, under the same supervisors; and
3) whether the new entity provides the same services and has the same customers.[7]

The most significant consideration is the continuity of the workforce.

In contrast, a 'perfectly clear successor' is required to abide by the terms and conditions of the pre-existing collective bargaining agreement until it negotiates a new agreement with the union and/or reaches an impasse in its negotiations with the union. In such a situation, the successor is not entitled to unilaterally implement new terms and conditions of employment without first "consulting" with the union.[8] Courts and the NLRB will find a buyer to be a perfectly clear successor when the agreement affirms the buyer will retain the seller's employees and waives the right to alter the employees' conditions of employment.

A buyer also should be mindful of any existing 'successorship' clauses in the target business's collective bargaining agreement. A distinct and specific successorship clause that expressly requires the target business to sell to a buyer that agrees to assume the collective bargaining agreement may be enforceable. Generally, a boilerplate successorship clause will be deemed unenforceable against buyers. However, if a buyer agrees to adopt or assume the terms of a collective bargaining agreement—either in a purchase agreement or in a communication to its employees or the union representing the predecessor's workforce—then it would be obligated to do so. Further, a buyer may be found to 'adopt' the parties' collective bargaining agreement where it has maintained and applied the substantive terms of the agreement. As such, buyers should be mindful of these considerations.

Additionally, a buyer will be precluded from establishing new terms and conditions of employment in the instance it is determined to be an 'alter ego' or 'single employer.' An alter ego status will be found "where the two enterprises have 'substantially identical' management, business purpose, operation, equipment, customers and supervisors, as well as ownership."[9] Similarly, a single employer is a consolidation of several nominally separate business entities that comprise an "integrated enterprise." [10] In this latter scenario, one entity's collective bargaining agreement will be applied to the other's employees if the employees of each constitute a single appropriate bargaining unit.

Accordingly, merely labeling the deal as an asset purchase will not necessarily avoid the obligation to bargain. Nevertheless, a buyer that wishes to retain sufficient control and establish its own terms and conditions of employment at the outset should consider structuring the deal as an asset purchase because the buyer, at a minimum (*i.e.*, even if found to be a successor), would be entitled to establish its own initial terms and conditions of employment with the union.

Relocating the Bargaining Unit Work

Potential buyers often seek to relocate the bargaining unit work to a more financially favorable location. A buyer's decision to relocate the bargaining unit work may be a mandatory subject of bargaining if it is shown that the "employer's decision involved a relocation of unit work unaccompanied by a basic change in the nature of the employer's operation."[11] An employer may rebut this *prima facie* showing by establishing the following:

- that the work performed at the new location varies significantly from the work performed at the former plant;
- that the work performed at the former plant is to be discontinued entirely and not moved to the new location; or
- that the employer's decision involves a change in the scope and direction of the enterprise.[12]

Alternatively, an employer has no bargaining obligation if it can demonstrate that even though labor costs were considered in its decision to relocate unit work, it would not remain at the present plant because, for example, costs of modernization of equipment were greater than any labor cost concessions the union could offer.[13]

On the other hand, an employer does have an obligation to bargain if the union could and would offer concessions that approximate, meet or exceed the anticipated costs and/or benefits that prompted the relocation decision, since the decision would then be amenable to resolution through the bargaining process.[14]

An employer can enhance its chances of establishing the above-described defense by articulating to the union its reasons for relocating, fully explaining the underlying costs and/or benefits motivating its decision, and asking whether the union could offer concessions that would enable the employer to meet its profit objectives without resorting to relocation.

Successor Liability in Bankruptcy

Purchasing an entity and its assets becomes significantly more complex when the seller files for bankruptcy. In this instance, the seller's assets are encumbered by security interests in the property, including petitions filed by general unsecured creditors for satisfaction of their claims from the same pool of assets. Therefore, a buyer should be cognizant of the claims and security interests filed in the bankruptcy court and its effect on the potential value of the entity and its assets. A buyer's ability to purchase a debtor's assets through a bankruptcy sale is typically governed by Section 363(f) of the Bankruptcy Code. Pursuant to Section 363(f), a bankruptcy court has the power to order a sale of some or all of the assets "free and clear" of any "interest" in the property.

A critical issue when analyzing a sale under Section 363(f) is the court's interpretation of 'interest' in property. Bankruptcy courts have reached different interpretations of what constitutes an interest in property under Section 363(f). For example, in the Third Circuit's seminal decision in *In re Trans World Airlines*[15] (*TWA*), the court applied a more expansive reading of interests in property under Section 363(f). In *TWA*, the court extinguished the liability of American Airlines as a successor of TWA with regard to TWA's settlement of a sex discrimination class action asserting discrimination as well as claims related to a travel voucher program. Under Section 363(f), the court approved the sale of the assets to American Airlines "free and clear" of the outstanding claims and settlement, reasoning the claims against TWA were connected to or arose from the assets sold, and thus constituted interests in property. Thus, because the claims had a direct relationship to the TWA assets, they constituted interests in property within the meaning of Section 363(f).

This expansive approach has not been adopted by all jurisdictions. As an example, in *Teed v. Thomas & Betts Power Solutions,*[16] the Seventh Circuit affirmed the imposition of successor liability for the predecessor's pre-sale violations of the Fair Labor Standards Act. In extending the reach of successor liability in suits to enforce federal labor and employment laws, the Seventh Circuit shirked the implications of Section 363(f) and the meaning of interests in property, choosing instead to impose successor liability absent "good reasons" to withhold such liability.[17]

These cases highlight the varying approaches to imposing successor liability in a bankruptcy sale. Accordingly, a buyer considering an asset purchase in bankruptcy court should carefully review the applicability of Section 363(f) of the Bankruptcy Code to the assets at issue. A buyer also may consider designating funds to an escrow account pending the bankruptcy court's final sale order; in particular, whether the assets would be discharged free and clear under Section 363(f). Additional safeguards should also be considered when structuring a bankruptcy sale, such as an indemnification clause for claims based on liabilities not expressly assumed in the asset purchase agreement.

Conclusion

Buying a business can give rise to a host of challenging labor and employment issues that mandate careful review. A fundamental conflict exists between the rights of buyers that wish to conduct business without restriction and the rights of employees seeking stable employment conditions with or without union representation. This tension has resulted in the expansion of the buyer's and seller's duties to the employees. Proper planning and due diligence can directly impact fair market value, dictate the structure of a transaction, and help minimize unanticipated liabilities.

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Endnotes

1. Importantly, the authors note that although this article addresses and focuses on the labor and employment-related implications of such a transaction, there are a multitude of other factors that should be considered by legal counsel; in particular, the potential tax implications for structuring a corporate transaction.
2. *TKB International Corp.,* 240 NLRB 1082, 1085 (1979).
3. *Fall River Dyeing & Finishing Corp. v. NLRB*, 482 U.S. 27, 40 (1987).
4. *NLRB v. Burns Int'l. Security Services, Inc.*, 406 U.S. 272, 80 LRRM 2225 (1972).
5. *Golden State Bottling v. NLRB*, 414 U.S. 168 (1973).
6. *Fall River Dyeing & Finishing Corp.*, 482 U.S. at 43.
7. *Id.*
8. *Canteen Corp.*, 317 NLRB 1052 (1995), *enforced*, 103 F.3d 1355 (7th Cir. 1997).

9. *Crawford Door Sales Co.*, 226 NLRB 1144 (1976).
10. *Radio Union v. Broadcast Service of Mobil, Inc.*, 380 U.S. 255 (1965).
11. *Dubuque Packing Company, Inc.*, 303 NLRB 386, 137 LRRM 1185 (1991), *enforced*, 1 F.3d 24 (D.C. Cir. 1993), *cert. granted*, 114 S. Ct. 1395 (1994).
12. *Id.*
13. *Id.*
14. *See id.*
15. *In re Trans World Airlines (TWA)*, 323 F3d 283 (3rd Cir. 2003) (affirming the bankruptcy court's order approving the sale "free and clear" of successor liability).
16. *Teed v. Thomas & Betts Power Solutions,* 711 F.3d 763 (7th Cir. 2013).
17. *Id.* at 769.

Trade Secrets: Considerations in Designing an Effective Protection System

by Bruce D. Vargo

Seventy-nine percent of employees may steal from their employers at some point during their employment. According to a study conducted by Kessler International, employees can be broken down as follows: honest employees (21 percent), dishonest employees (13 percent), and 'on the fence' employees (66 percent).[1] In other words, those on the fence employees would consider theft if they were convinced the risk and consequences of detection were outweighed by the potential gain. Other studies show similar results.

A common reaction to these statistics is to believe the results include the so-called minor thefts by employees of items such as pens, paper and staples, and thus does not shed any real light on the risk a company faces with regard to its trade secrets and confidential business information. Consider the following, however: According to a study of trade secret litigation in federal and state courts published in 2010/2011, 93 percent of the state court cases included allegations of misappropriation against an employee or business partner.[2] And, of those cases, 78 percent contained allegations of theft directly against an employee.[3]

The damage caused by employee theft greatly exceeds those minor costs of pens and paper. According to the Association of Certified Fraud Examiners in its 2014 report to the nations, the median cost to a company as a result of an occupational theft event is $145,000.[4] For its report, the association reviewed nearly 1,500 cases with roughly 22 percent of those cases resulting in a loss to the company of $1 million or more.[5] Furthermore, according to certain reports, intellectual property and other so-called intangible assets constitute a major part (up to 75 percent) of the wealth of many companies.

The point is that a company's trade secrets and confidential business information—some of its most valuable information—are not only at risk of being stolen by some outside hacker, but there is a real risk those assets will be stolen from within by a trusted employee. Some recent examples confirm this point.

An employee of a large U.S. futures exchange company pleaded guilty in late 2012 to stealing more than 10,000 files containing source code for a proprietary electronic trading platform. Prosecutors estimated the value of these trade secrets at between $50 and $100 million. The employee said he and two business partners had planned to use this source code to develop their own company.[6]

In 2012, a former employee of a North American automotive company and the employee's spouse were found guilty of stealing trade secrets related to hybrid vehicle technology worth $40 million. The couple intended to sell the information to a Chinese competitor.[7]

In 2011, a former employee of an automotive company was sentenced to 70 months in prison for copying some 4,000 documents on the design of engine-transmission and electric power supply systems. The employee intended to take these documents to a new job with the China branch of another North American company.[8]

Unfortunately, all too often the theft is accomplished by the employee simply bringing in a flash drive—small in size, large in storage capacity—inserting it into a computer and copying whatever files are needed. As a result, many companies are re-evaluating their current asset protection systems and policies. This article provides a high-level framework for business law attorneys—things to consider, if you will—should the attorney find him or herself participating in, or even responsible for, that effort.

Protection System Design Considerations

Set Expectations

It is important to understand at the outset that it is impossible to create a protection system that will absolutely prevent the theft of a company's intellectual property assets. Any protection system designed by one person can be cracked by another person, if given enough time and the proper motivation. So rather than setting an impossible goal, such as complete theft prevention, a company's effort should look to fulfill three different goals.

The first goal of the protection system should be deterrence. This goal is directed primarily at the 66 percent of employees who essentially consider themselves to be on the fence about whether they would steal from their employer. If a company's employees understand the consequences of a theft attempt will be severe, they are unlikely to risk their careers, and possibly their liberty.

The second and third goals relate to the post-theft needs of the company. The protection system should include ways to help the company detect a theft event, either while it is occurring or as soon as possible thereafter, as well as help uncover what was stolen, when it was stolen, how it was stolen and by whom.

Finally the system should help the company control or minimize the damage from the theft, and help the company enforce whatever rights it has via litigation and criminal charges, if necessary.

Understand the Nature of the Assets You Hope to Protect

The phrase 'intellectual property' or 'IP' usually brings to mind the so-called big three of IP—patents, trademarks and copyrights. These three areas of IP generally have one characteristic in common that distinguishes them from trade secrets and confidential business information. They are almost always published.

Patents are published upon the granting of the patent by the United States Patent and Trademark Office (USPTO). Publication of a patent is the public policy trade-off for the years of exclusivity that accompany a patent.[9] Trademarks (and trade dress) are created for use in commerce. Their very purpose is to establish with the consumer a link between a product and a company so the company comes to mind whenever the consumer sees the product on the shelf. Federal registration, in fact, requires an affirmation of prior or current use in commerce, or an 'intent to use' in commerce in the near future. A similar purpose accompanies the types of things that secure copyright protection such as music, lyrics, literature, films and movies and art.

As a result of publication, a system to protect the company's patent rights, trademark rights and copyrights, is an *outwardly* focused system. It monitors the world for possible infringement. There is no concern about maintaining secrecy over the information already disclosed to the public.

On the other hand, a system to protect the company's trade secrets and confidential business information, in addition to having an outward focus to monitor who might be using any information that has been stolen, must have an *inward* focus that, in essence, monitors the activities of the company's employees by monitoring the information. The nature of the assets drives the requirements, and thus the design of the system.

Understand the Sources of the Threat to the Assets

There is a tendency when implementing a protection system that monitors access to sensitive information, such as trade secrets and confidential business information, to focus on the general employee population while excluding upper management and executives. Perhaps it is because one often believes an executive would not risk his or her career, and perhaps liberty, by stealing the trade secrets and/or confidential business information of the company. The statistics, however, show otherwise.

According to the 2014 report to the nations, the perpetrator of the occupational theft events in its study were as follows:

- Employee – 42 percent
- Manager – 36 percent
- Executive – 19 percent
- Other – 3 percent[10]

Thus, the protection system must be designed in a manner that will monitor access of the information regardless of the level of the employee.

Identify and Categorize the Assets

New Jersey adopted its version of the Uniform Trade Secret Act, which went into effect in Jan. 2012. The act defines a "trade secret" as follows:

> "Trade secret" means information, held by one or more people, without regard to form, including a formula, pattern, business data compilation, program, device, method, technique, design, diagram, drawing, invention, plan, procedure, prototype or process, that:
>
> (1) Derives independent economic value, actual or potential, from not being generally known to, and not being readily ascertainable by

proper means by, other persons who can obtain economic value from its disclosure or use; and

(2) Is the subject of efforts that are reasonable under the circumstances to maintain its secrecy.[11]

"Proper means" is defined under the act as follows:

"Proper means" means discovery by independent invention, discovery by reverse engineering, discovery under a license from the owner of the trade secret, observation of the information in public use or on public display, obtaining the trade secret from published literature, or discovery or observation by any other means that is not improper.[12]

A company's trade secrets and confidential business information will be found across all aspects of the business—sales, marketing, engineering, manufacturing, finance, technology etc. Given the broad language in the act's definition of trade secret, the task of developing a proper list of trade secrets and confidential business information requires cooperation between the legal department and the various business departments.

For many reasons, the list should be more than a generic description of the information. First, in post-theft matters such as a civil litigation to enforce the company's rights to protection over the information, the company will have the burden to show the information qualifies under the definition of trade secret. It will also have the burden to show that the employee had notice of the information's protected status, and that the employee "misappropriated" the information by "improper means."

The act defines "misappropriation" as:

(1) Acquisition of a trade secret of another by a person who knows or has reason to know that the trade secret was acquired by improper means; or (2) Disclosure or use of a trade secret of another without express or implied consent of the trade secret owner by a person who: (a) used improper means to acquire knowledge of the trade secret; or (b) at the time of disclosure or use, knew or had reason to know that the knowledge of the trade secret was derived or acquired through improper means; or (c) before a material change of position, knew or had reason to know that it was a trade secret and that knowledge of it had been acquired through improper means.[13]

Meanwhile, "improper means" is defined in the act as:

the theft, bribery, misrepresentation, breach or inducement of a breach of an express or implied duty to maintain the secrecy of, or to limit the use or disclosure of, a trade secret, or espionage through electronic or other means, access that is unauthorized or exceeds the scope of authorization, or other means that violate a person's rights under the laws of this State.[14]

Both of those terms include references to notice and/or knowledge of the secrecy attached to the information and an obligation to maintain that secrecy.

Further, the list of trade secrets and confidential business information should be more than a generic description because of certain other provisions within the act involving punitive damages and attorneys' fees and costs, including costs of experts.

The act provides for an award of punitive damages if the company can show the misappropriation was "willful and malicious":

If willful and malicious misappropriation exists, the court may award punitive damages in an amount not exceeding twice any award made under subsection a. of this section.[15]

Thus, the greater the evidence against the employee that he or she was fully aware of the sensitive nature of the information, the easier it will be to prove the theft was willful and malicious.

As for attorneys' fees and costs, including the costs for experts, the act authorizes an award of both to the prevailing party. Again, the company has the burden to prove the misappropriation was both willful and malicious, so a more detailed list would be helpful.[16]

A more detailed list also would be helpful to fend off any claim for attorneys' fees and costs should the defendant prevail in litigation since, under the act, a defendant would be entitled to fees and costs if it was shown that the company brought its misappropriation claim in bad faith.[17]

Once the trade secret and confidential business information assets are identified, it is important to group them into categories of significance. All assets are not of equal value. Some of the questions to consider are:

- How critical is the information to the fundamental operation of the business?
- Is the information part of a unique product or product line, or is there a similar, competing product or product line already on the market?
- How much of a benefit would the information be to an actual competitor or to an entity perhaps looking to enter the market?
- What would be the impact to the company's revenue and market share if the information was stolen?
- What would be the impact to the company's reputation in the industry if the information was stolen?

Consider a Broad Array of Protection Avenues

Lawyers always start with the law. It is vital that the proper legal documents are executed by the company's employees, such as restrictive covenants, confidentiality agreements and assignments of ownership rights for inventions. These documents are frequently cited by courts as a crucial factor when analyzing the question of whether the company took reasonable measures to protect its trade secrets.[18] These documents must be kept updated with the evolution of the company's operations and information. They must also be the topic of annual training seminars by the company.

Technology is another vital component of any protection system. The options and capabilities that exist today allow a company to track and log access events for all the protected information regardless of its location. The logs can maintain information such as IP addresses and time/date stamps of access. This evidence can help the company with regard to its claim for punitive damages and fees and costs by showing the extent of the employees' actions needed to perpetrate the theft.

Creating access logs, however, is just the first step. The logs can be used for pattern recognition so any access outside the norm can be flagged and alerts issued. As additional security, alerts should be issued simultaneously to multiple personnel rather than to only one person. With multiple people receiving the alerts, it becomes exponentially more difficult for a perpetrator to cover his or her actions. Web 'bugs' should be selectively deployed for the more critical information to track both access and circulation.

Finally, attention must be given to the company's business policies. Absent supporting corporate policies, the legal protections and investments in technology may be for naught.

Thorough background checks should be conducted regarding any new employee. Training seminars should be established to reinforce the company's expectations regarding the information considered secret and the consequences of any violation of those expectations. It must be made clear to all employees that the company has and enforces a 'zero tolerance' policy. Additional policies should be implemented regarding the mandatory use of confidential agreements by all non-employees, including vendors. Consideration should also be given to the establishment of a policy for materials used by employees during presentations to outsiders to ensure no protected information is inadvertently revealed.

Related to the above issue is the issue of the employees' use of social media, such as LinkedIn, Twitter, Facebook, Reddit, Instagram and YouTube. This is an area of trade secret and confidential business information law that is only now bubbling to the surface.

The company must develop a cohesive policy regarding the employees' use of social media sites in the course of their business activities. If the company encourages its employees to use social media in the performance of their jobs, the company must balance that use against the divergent corporate policy of keeping certain information confidential. For example, if the company strives to keep its customer lists secret yet encourages its sales force to utilize social media to connect with customers, the natural tendency for the sales force is to connect with their contacts within their customer base. Those contacts may be viewed by competitors, enabling them to learn the identity of, and possibly other information about, the company's customers.

Lastly, the company should establish a 'theft response unit' comprised of a cross-section of employees and executives to ensure a swift response once a theft has been discovered for maximum damage control and enforcement.

Conclusion

This article is meant to provide a high-level framework of issues and policy considerations regarding the development of an asset protection system for a company's trade secrets and confidential business information.

The issues and considerations identified above are just a small sampling of the challenges in implementing a protection scheme that addresses not only pre-theft deterrence but also aids the company in its post-theft investigation and enforcement efforts in this rapidly changing technological landscape.

Bruce D. Vargo is a founding member of Scarpone & Vargo LLC. He is an experienced business litigation and trial attorney, who also counsels clients on intellectual property protection issues. He is licensed in New Jersey and Pennsylvania, registered as a patent attorney with the United States Patent and Trademark Office, and admitted to practice law in various federal courts.

Endnotes

1. Kessler International, https://investigation.com/1999/08/11/study-shows-employee-theft-big-problem-u-s-companies/.
2. A Statistical Analysis of Trade Secret Litigation in State Courts, 46 *Gonz. L. Rev.* 1 (2010/11); A Statistical Analysis of Trade Secret Litigation in Federal Courts, 45 *Gonz. L. Rev.* 291 (2010).
3. *Id.*
4. Report to the Nations on Occupational Fraud and Abuse, Association of Certified Fraud Examiners, 2014 Global Study.
5. *Id.*
6. Office of the President of the United States, "Administration Strategy on Mitigating the Theft of U.S. Trade Secrets." Feb. 2013.
7. *Id.*
8. *Id.*
9. This public policy was recently reaffirmed by the New Jersey Appellate Division in *UCB Manufacturing Inc. v. Tris Pharma, Inc.*, 2013 N.J. Super. Unpub. LEXIS 2126 (App. Div. Aug. 27, 2013) (applying New York law).
10. Report to the Nations on Occupational Fraud and Abuse, Association of Certified Fraud Examiners, 2014 Global Study.
11. N.J.S.A. §56:15-2.
12. *Id.*
13. *Id.*
14. *Id.*
15. N.J.S.A. §56:15-4.b.
16. N.J.S.A. §56:15-6.
17. "Bad faith" is defined to mean "that which is undertaken or continued solely to harass or maliciously injure another, or to delay or prolong the resolution of the litigation, or that which is without any reasonable basis in fact or law and not capable of support by a good faith argument for an extension, modification or reversal of existing law." N.J.S.A. §56:15-6.
18. A Statistical Analysis of Trade Secret Litigation in State Courts, 46 *Gonz. L. Rev.* 1 (2010/11); A Statistical Analysis of Trade Secret Litigation in Federal Courts, 45 *Gonz. L. Rev.* 291 (2010).

It's Our Little Secret: Considerations in Drafting Non-disclosure Agreements

by Charles V. Quinn

Non-disclosure agreements, or NDAs, are essential in many corporate and business contexts and transactions. And yet, in many instances this agreement is treated more as a technicality—a mere prologue to serious negotiations or a 'boilerplate' provision in a substantive agreement. This can be a serious mistake, as not all NDAs are the same. The NDA provisions need to be carefully drafted to take into account the parties involved, the type of information to be disclosed, and the reason for the disclosure, in order to address all relevant issues and allocate rights and responsibilities appropriately.

Because of the importance to the entity of its internal information regarding its products, services, business methods and financial results, a business places a very high value on maintaining confidentiality. But companies also need the flexibility to share and receive information when necessary to accomplish certain goals, such as exploring a business combination, attracting investment or financing, hiring employees, servicing electronic storage systems or other purposes. The following article provides a brief refresher course and offers some important considerations for practitioners drafting, reviewing and/or negotiating such agreements.

To begin with, the attorney should, of course, familiarize him or herself with the parties, the type of information at issue and the reason it is being disclosed. Who is the client? What party is disclosing and to whom? Will there be reciprocal disclosure or will information be disclosed by only one party to the other? Will multiple parties be involved? What is the relationship between the parties? Is the purpose of the disclosure to provide information to potential investors, to explore a possible business combination, in connection with employment or for some other purpose? The answers to all of these questions will impact the drafting and negotiation process.

An agreement between an issuer and potential investors will likely anticipate disclosures only from the issuer. An agreement signed before the commencement of merger or related discussions will almost certainly provide for disclosures by both parties. An NDA involving a public company will differ from one involving only closely held entities. In many instances, a party will suggest a form that anticipates reciprocal exchanges of information, although in practical terms only one party will be providing virtually all of the disclosures. This aspect may factor into negotiating tactics for such reciprocal agreements. For instance, a party may impose a term that on its face 'applies to everyone,' even though in reality only one party will benefit.

The purpose for the disclosure should be expressly set forth in the agreement to the extent possible. "Business discussions regarding a possible transaction between the parties" or "a potential investment by the recipient in the disclosing party's business" are common general formulations. Whether the purpose should be stated broadly or more narrowly with respect to the agreement in question is another issue to be considered during the drafting process.

The next issue to consider is what exactly constitutes the 'confidential information' subject to the terms of the NDA? The typical agreement defines confidential information by reference to several elements. A common formulation is "all confidential, nonpublic or proprietary information disclosed by the disclosing party to the recipient, including but not limited to" several listed categories of items. In virtually all cases involving corporate clients, the information to be protected can be broadly categorized as business information and product information.

'Business information' encompasses the information expected to be found at virtually all companies, including, among other things, financial statements, business plans, corporate books and records and lists of customers, suppliers and employees. As a general rule, these categories of items will be somewhat standard for most businesses, so the listing of such items may not vary widely.

'Product information,' on the other hand, will mean very different things for different businesses. While there are some standard categories of product information to list in any NDA, care must be taken to have sufficient knowledge and understanding of the business in question to accurately list all such types of information. For instance, an NDA for a manufacturing or technology company will want to expressly protect items such as properties and/or equipment, intellectual property and know-how, plans, diagrams, schematics, processes, programs, codes and/or similar types of information. A service industry may focus more of its concern on research and reports, personnel training programs, customer service manuals and similar information. Even though NDAs do include the introductory 'catch-all' language set forth at the beginning of this paragraph, listing specific types of information (while making clear that the list is not exhaustive) serves to focus the attention of the parties on the specifics of information being requested and emphasizes the privacy expectations of the disclosing party.

The parties also must address the question of how the information is disclosed. Certainly any agreement should state that any nonpublic/proprietary information disclosed orally or in writing is to be held in confidence. It would be advisable to include any information given in electronic or machine-readable form, as well as information gained by observation of the business or of specific production processes or company procedures. Some agreements specify that all information disclosed is confidential information, while others limit the definition to information produced or disclosed under circumstances indicating that the information is to be held in confidence. Still other agreements provide that in order for information to qualify for protection under the NDA, it must be marked as confidential by the disclosing party or written notice of confidentiality must be sent to the recipient for any information disclosed orally, through observation, etc. This is one of several areas in which attorneys will want to consider the context of the disclosure in drafting and negotiating the NDA. What are the expectations of the parties, and which standard is most workable and/or most advantageous to one's client in the situation in question? Some NDAs define confidential information to include information disclosed *before or after* the date of the agreement, which can easily become a trap if information has already been disclosed but the recipient has not known or focused on the disclosing party's expectation of confidential treatment. The recipient should seek to remove such a provision. Absent unusual circumstances, it is simply too easy for a recipient to fail to safeguard or refrain from using information disclosed before any formal agreement regarding confidentiality has been signed.

Often among the information requested to be kept confidential is the fact that any information is being transmitted at all, or that discussions between the parties are taking place. This is one area where the 'governmental disclosure' exception (discussed below) can become particularly important. Finally, NDAs usually seek to protect any notes, extracts, reports, summaries, analyses, etc. prepared with respect to the information disclosed.

Of course, there are several standard exceptions to the contractual definition of confidential information, which exclude certain information from the restrictions set forth in the agreement. Information that is public, or that becomes public through no breach of the agreement, typically is excluded. Information received from third parties not known to the recipient to have a duty of confidentiality to the disclosing party (as opposed to merely information received from a third party having no duty of confidentiality to the disclosing party) also is a standard exception, as is information already in the possession of the recipient before disclosure. It is advisable to specify that the recipient must be able to demonstrate by competent evidence that the information was already in its possession. The same concern is heightened where there is an exception for information independently developed by the recipient without resort to the confidential information.

In some circumstances, a party will request an exemption for information that exists "in the unaided memory" of an employee or agent of the recipient. This exemption can be quite problematic, and should be avoided where possible. Especially in scientific and technical fields, the recipient usually is concerned that a worker will use a concept or information learned from the disclosed information without even realizing it. On the other hand, the disclosing party fears an exception potentially swallowing up much of the definition of confidential information set forth by the parties. There is no hard and fast rule. Rather, attorneys need to be sensitive to the risks and take all circumstances into account with respect to this type of provision.

And now we come to the central provisions of the agreement: limitations with respect to the information disclosed. Boiled down to its essence, the NDA includes two basic prohibitions: the recipient may not *disclose* the information, and the recipient may not *use* the information for any purpose other than the purpose for which the information was disclosed. With respect to non-disclosure, typically an NDA will state that the recipient will exercise the same degree of care to prevent the disclosure of the information it uses to protect its own information, but in no instance shall it use less than reasonable care to keep the information confidential. Alternatively, the agreement may simply state that the recipient shall use commercially reasonable efforts to secure and safeguard all information to prevent unauthorized disclosure.

Disclosure to the recipient's employees, agents, and advisors (including but not limited to attorneys and accountants) is routinely allowed, provided that such persons (typically designated as 'representatives') are subject to confidentiality obligations to the recipient and the recipient agrees to be legally responsible for any breach of the provisions of the agreement by such representatives. In some circumstances, a broker-dealer to whom information is disclosed will ask for the ability to disclose information to potential investors. In this instance, the NDA should require that potential investors sign agreements in form and substance substantially identical, or no less restrictive, to the NDA being signed between the parties. Of course, the party sharing information with potential investors must exercise care that the agreements to be negotiated with such potential investors are, in fact, substantially similar or no less restrictive. And as stated above, the purpose for which the information is being disclosed—a possible investment, merger or other transaction, or some other purpose—should be clearly spelled out in the agreement.

As an aside, NDAs are especially useful for companies reporting to the Securities and Exchange Commission (SEC) in light of Regulation FD.[1] This regulation was adopted in 2000 to ensure 'fair disclosure' and 'a more level playing field' with respect to information divulged by public companies. Essentially, Regulation FD requires that material nonpublic information provided to certain individuals and entities be publicly disclosed immediately (or promptly, if the disclosure was unintentional). Regulation FD seeks to ensure that information provided to securities market professionals such as large investors or broker-dealers on company conference calls regarding earnings, financial results of operations and similar information is also disseminated to the market in general.[2] An exception to Regulation FD allows disclosure "[t]o a person who expressly agrees to maintain the disclosed information in confidence."[3] Where a public company is concerned, counsel should include an additional provision in the NDA, reciting that the recipient acknowledges the information disclosed may constitute 'material non-public information' under applicable securities laws of a public company subject to SEC reporting rules. The recipient also should agree to refrain from trading while in possession of such information, or from communicating the information to others. In addition, the recipient should represent that it has adopted the appropriate safeguards to prevent trading on or dissemination of the information by employees of, agents of and advisors to the recipient while such persons are in possession of the information.

A standard provision in NDAs allows the recipient to disclose information if required by law, regulation, court order, legal process or any governmental regulatory agency. In this instance, the disclosing party will want to receive prior notice of such request (which the recipient will usually amend to a requirement that the prior notice be given only to the extent practicable and legally permissible) so the disclosing party can attempt to contest the disclosure order and/or obtain a protective order for the disclosed information. The NDA should specify that the expense of any such proceeding shall be borne by the disclosing party seeking the order, not the recipient of confidential information. The disclosing party can request that the recipient agree to cooperate in such an effort.

There are some routine regulatory inquiries, however, that the recipient may wish to have the ability to address without having to notify the disclosing party. Attorneys for banks, brokers, investment companies and other regulated entities should consider provisions taking their clients' regulated status into account, and allowing routine disclosure to examiners, regulatory authorities and similar agencies and authorities. And, of course, public companies must be able to make disclosures required by law or regulation; signing an NDA should not become an agreement to violate, for example, any SEC or Financial Industry Regulatory Authority (FINRA) disclosure rules. These considerations are another instance where the attorney must be sensitive to any provision regarding nondisclosure of the existence of any discussions and the disclosure requirements applicable to the client under relevant laws and regulations.

NDAs routinely include provisions requiring that the recipient return or destroy all confidential information provided under the agreement at some point, usually at the end of the relationship. The drafter should consider whether the decision to return or destroy is at the option of the disclosing party. If the information is destroyed, the agreement typically requires the recipient to certify as to the destruction. Any copies, notes, summaries, extracts, analyses or reports, including the confidential information (or alternatively, to the extent they include confidential information), should be included in the return or destroy requirement. The NDA should allow the recipient to retain information the recipient is required to retain by law or by the recipient's document retention policies, provided the information remains subject to the provisions of the agreement. Some agreements also permit the retention of information retained in computer storage systems that cannot readily be erased, which is a somewhat nebulous concept. In the age of computerized information storage, clients must be aware of, and have the systems and safeguards in place to ensure compliance with, ongoing confidentiality requirements.

Frequently, and depending on the reason for the disclosure, an NDA will include a non-solicitation provision preventing a recipient from hiring or soliciting employees of the disclosing party's business. This prohibition may be for a shorter period of time than the term of the remainder of the confidentiality agreement. And there is a generally recognized exception for solicitation by virtue of general advertising or any other method not specifically targeting the disclosing party's business. In addition, provisions requiring parties not to contract with or approach vendors or customers of the other party are not uncommon, although exception should be made for those with whom the recipient already has a relationship. The appropriate provisions depend in large part on the businesses involved, the contemplated transaction, and any relevant market practice for the industry.

Several concepts that are grouped for purposes of this article under 'disclaimers' should be considered for inclusion in the NDA. The agreement should state that the disclosing party is making no representations or warranties under the agreement with respect to any confidential information disclosed, including any implied warranties. Any representations or warranties would be made in a definitive agreement, if any, with respect to any potential transaction. In addition, the agreement should state that no license or other ownership interest is being transferred pursuant to the agreement; the disclosing party retains ownership of all confidential information, including but not limited to any intellectual property, trade secrets, or know-how. Finally, the NDA should expressly state that the parties are not obligated by virtue of the NDA to enter into any transaction or arrangement. The NDA is not a letter of intent, nor an agreement to agree. Rather, it is an agreement to provide or exchange information only.

NDAs include an acknowledgement by the recipient that it understands an unauthorized disclosure of the information or other breach of the agreement could cause irreparable harm not compensable by monetary damages. The disclosing party thus may, in addition to any other remedies available, request and receive injunctive relief and/or specific performance without the posting of a bond or other security. Sometimes the applicable provision states that the disclosure will, rather than could, cause irreparable harm, and that the disclosing party would, rather than may, be entitled to the equitable remedies listed above. Occasionally, a liquidated damages provision may be included but recipients should resist them and enforceability is questionable in any event.

Depending on the circumstances, the term of the NDA can vary as well. For example, where the NDA is necessary in connection with a potential investment in an issuer, much of the information expected to be disclosed may consist predominantly of recent financial results. Under such circumstances, potential investors will be sensitive about a long confidentiality period. In this case, a relatively short term may be appropriate. A common market standard is one year, although occasionally two years is used. Where there are discussions regarding, for instance, a possible merger or acquisition involving manufacturing, processing, or technology companies, or other entities possessing sensitive technical information, the parties may insist on a longer period. In this context, a term of several years (for example, five years) is more likely to be requested. But a finite term should be set forth, and the 'term' provision should specify that the agreement will terminate sooner if a transaction is agreed to between the parties or the information is otherwise released other than through a breach of the agreement. Any continuing obligations of confidentiality should be set forth in a definitive transactional agreement, be it a corporate combination or purchase, or an investment, loan or similar financing. The drafter must ensure the proper provisions of the agreement survive the expiration of the agreement at the end of the term.

Finally, counsel should consider the value of an indemnity provision for breach or non-performance, as well as suitable choice of law, submission to jurisdiction, and severability provisions. Severability may be especially important in an employment context, if there is any chance that restrictions on the employee after termination of employment can be attacked.

Because of the differing interests and considerations applicable to various contexts, attorneys should avoid the temptation to 'pull out a form' when drafting an NDA. When drafting such an agreement, it is important to consider the parties involved, the information to be disclosed, the reason for the disclosure and the relative position and negotiating leverage of the parties. The foregoing brief description of several important considerations should be helpful in counseling clients and in preparing agreements that allow information to be disclosed while protecting the parties' interests and helping shape expectations regarding the dissemination and use of information. The agreement can be concise and yet accomplish its goals—to protect the parties and also allow communication so businesses can take advantage of (and create) opportunities in dynamic and ever-changing markets.

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Endnotes

1. 17 C.F.R. 243.100-243.103 (2014).
2. Form 8-K, providing for rapid disclosure of certain corporate events, was amended at the same time to take Regulation FD disclosures into account. *See* SEC Release Nos. 33-7881, 34-43154, IC 24599, Aug. 15, 2000.
3. 17 C.F.R. 243.100(b)(2)(ii) (2014).

When is a Liquidated Damages Clause Enforceable?

by Betsy G. Ramos

Liquidated damages clauses are often used in commercial contracts as a mechanism to set damages in the event of a breach of contract. However, before considering the inclusion of such a provision, as well as the formulation of an amount, practitioners should consider whether the court will enforce the clause as drafted. Additionally, one also must consider that the inclusion of a liquidated damages clause may prevent the non-breaching party from recovering its actual damages, if they exceed the amount of the stipulated damages.

Under New Jersey law, it is now well settled that a liquidated damages clause is presumptively enforceable, at least in the commercial context.[1] The courts recognize that "[i]n commercial transactions between parties with comparable bargaining power, stipulated damages provisions can provide a useful and efficient remedy."[2]

In *Wasserman's Inc. v. Township of Middletown*, the New Jersey Supreme Court enunciated the proper method of evaluating liquidated damages clauses.[3] The touchstone is whether the clause is reasonable under the circumstances.[4] If the clause is unreasonable, it will constitute an unenforceable penalty.[5]

The party challenging the clause bears the burden of proving its unreasonableness.[6] The courts "will enforce liquidated provisions if (1) the stipulated amount is a 'reasonable forecast of just compensation,' and (2) actual damages are impossible or difficult to estimate."[7]

Courts have upheld the enforceability of liquidated damages clauses in a variety of contracts. A liquidated damages clause has been upheld, for instance, in a commercial loan contract for a late fee, a contract for sale of an apartment building, an asset purchase agreement, and a contract for a band at a wedding.[8]

Wasserman's may be interpreted as permitting reasonableness to be established at either the time of formation of the contract or at the time of contract breach.[9] In a case applying New Jersey law, in which the clause was enforced, the Third Circuit Court of Appeals, in *Vanderbeek v. Barefoot*, found under its facts, that the clause was reasonable at both points of time and enforced the liquidated damages provision when the contract was breached.[10]

In *Vanderbeek*, the parties agreed to enter into an asset purchase agreement in which defendant Bridgewater Sports Arena, L.P.'s reorganization plan would be funded by Arena Equity Partners, L.L.C., providing for Arena to purchase most of Bridgewater's assets.[11] The parties heavily negotiated a liquidated damages clause in the event that Arena breached the agreement. As per this clause, Bridgewater's sole remedy was Arena's $250,000 deposit if Arena breached. The court noted that actual damages were hard to determine at the time the contract was formed. Also, the potential damages remained unclear at the time of the breach.[12] Hence, the Third Circuit found the clause to be enforceable.

In other cases, the courts have refused to enforce a liquidated damages provision, finding it to be a penalty. For example, in *Nohe v. Roblyn Development Corp.,* the New Jersey Appellate Division refused to enforce the clause, which permitted the seller to retain a deposit of $79,027 in a contract for sale of a residential property between a corporate developer and a consumer.[13] The consumer failed to purchase the home but the corporate developer was able to resell the home for an additional $193,995; thus, the developer suffered no damages. Under these circumstances, the Appellate Division refused to permit the developer to retain the deposit.[14]

The more interesting issue is what happens if the non-breaching party's damages exceed the amount of the liquidated damages? If the contract contains a liquidated damages clause, is that party limited to the amount of damages contained in that clause? The answer is likely yes.

As an example, in *Corner Property Investments, LLC v. Winderman,* the parties entered into a real estate contract that contained an unambiguous liquidated damages clause, limiting the plaintiff's recovery to $5,000.[15] Ultimately, the real estate sale did not close and the plaintiff suffered a loss of $30,627. The defendants did not challenge the court's finding that they breached the contract but, rather, that the judgment should have been limited to the $5,000 liquidated damages clause. The plaintiffs argued to the Appellate Division that their recovery should not be limited to the $5,000 as liquidated damages.[16]

In the *Corner Property Investments* case, where a non-breaching seller sued for a greater amount of actual damages, the Appellate Division noted that other jurisdictions applied the same traditional analysis of reasonableness in determining whether the clause should be enforced. Utilizing this test, the Appellate Division found the clause to be reasonable and enforced it, limiting the plaintiff's damages to the agreed upon $5,000.[17]

What if the parties include a clause that the injured party is entitled to the alternate remedy of liquidated damages or any actual greater damages proven? Would such a clause be enforceable to permit the non-breaching party to recover more than the amount of the liquidated damages, if its actual damages were greater? One reported Appellate Division case and a recent unreported New Jersey District Court case suggest that, if included in a contract, such a clause may permit the recovery of actual damages.[18]

In the recent New Jersey District Court case of *East Brunswick Bd. of Educ. v. GCA Services Group*, the court considered a liquidated damages clause in the context of a publicly bid custodial contract. In this case, the bid specifications contained a liquidated damages clause whereby if the successful contractor to the bid refused to execute and deliver the contract and required bond within 10 days of the notice of acceptance of its bid, the contractor shall forfeit to the East Brunswick Board of Education as liquidated damages the $20,000 security deposit.[19]

The defendant contractor who won the bid thereafter refused to sign the contract. The board was forced to award the contract to the next lowest bidder at a substantially higher contractual amount. The board sought damages in excess of the $20,000 security deposit, while the contractor sought to enforce the liquidated damages clause in the contract and limit the board's damages to that amount. The court, however, found the clause to be reasonable and enforced it, whereby the board was precluded from recovering its actual damages. The court found no evidence that the "Board's intent was to provide itself with alternative remedies, such as specific performance or compensatory damages, if a bidder refuses to enter the contract."[20] Thus, the court implied that if the contract had included an alternative remedy clause, and assuming the actual damages exceeded the liquidated damages amount, the non-breaching party would have been permitted to pursue its actual damages.

The bottom line is, when parties decide to include a liquidated damages clause in a contract they must consider all of the implications of their remedies in the event of a breach. First, they must consider whether the amount of stipulated damages will pass the 'reasonableness' test to be enforceable. Second, they must realize that if no damages are actually suffered, the clause may nonetheless be unenforceable. Lastly, and most important, they must consider the consequences of what will happen if the actual damages exceed the stipulated amount.

While the usual scenario is that the amount of stipulated damages exceeds the actual damages, in the event the actual damages exceed the stipulated amount the inclusion of a liquidated damages clause will likely prevent the recovery of the greater actual damages. Some case law suggests that the inclusion of an alternative damage clause in the contract may permit the recovery of actual damages should they exceed the stipulated sum. However, one must be concerned that the inclusion of such an alternative remedy clause could weaken or negate the enforceability of the liquidated damages clause itself. ■

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Endnotes

1. *Wasserman's Inc. v. Township of Middletown*, 137 N.J. 238, 252 (1994); *5907 Blvd. L.L.C. v. West NY Suites, L.L.C.*, No. A-3709-11T4, 2013 N.J. Super. LEXIS 1807 (App. Div. July 19, 2013).
2. *Wasserman's, supra*, 137 N.J. at 252.
3. *Id.*
4. *Metlife Capital Financial Corp. v. Washington Avenue Associates, L.P.*, 159 N.J. 484, 495 (1999).
5. *Id.* at 496.
6. *Id.*
7. *5907 Blvd. L.L.C, supra,* 2013 N.J. Super. LEXIS 1807 at 20.
8. *Metlife Capital Financial Corp. v. Washington Avenue Associates, L.P.*, 159 N.J. 484, 495 (1999); *5907 Blvd. L.L.C., supra*, 2013 N.J. Super. LEXIS 1807; *Vanderbeek v. Barefoot*, 226 Fed. Appx. 209 (3d Cir. 2007); *Morrocco v. Limetree Enterprises, Inc., d/b/a Barry Herman Orchestras & Entertainment*, No. A-4361-06T3, 2008 N.J. Super. Unpub. LEXIS 840 (App. Div. March 24, 2008).
9. *Vanderbeek v. Barefoot, supra*, 226 Fed. Appx. at 214.
10. *Id.*
11. *Id.*
12. *Id.* at 215.
13. *Nohe v. Roblyn Development Corp.*, 296 N.J. Super. 172 (App. Div. 1997); *see also Psaros v. Saropoulos*, No. A-4293-07T3, 2009 N.J. Super. Unpub. LEXIS 1229 (App. Div. May 20, 2009), *certif. denied*, 200 N.J. 368 (2009).
14. *Id.* at 174.
15. *Corner Property Investments, LLC v. Winderman*, No. A-0276-10T1, 2011 N.J. Super. Unpub. LEXIS 2259 (App. Div. Aug. 22, 2011), *certif. denied*, 210 N.J. 108 (2012).
16. *Id.* at 15.
17. *Id.* at 20-23; for other similar cases, *see also Naporano Associates, L.P. v. B & P Builders*, 309 N.J. Super. 166 (App. Div. 1998); *Board of Education of Borough of Fair Lawn v. Fair Lawn Plaza Taxi*, 55 N.J. Super. 357 (App. Div. 1959), *aff'd*, 32 *N.J.* 129 (1960); *Sugarman v. Gabriel Bldg. Group, Inc.*, No. A-4438-12T1, 2014 N.J. Super. Unpub. LEXIS 1892 (App. Div. Aug. 4, 2014).
18. *See Monsen Engineering Co. v. Tami-Githens, Inc.*, 219 N.J. Super. 241, 253 n.6 (App. Div. 1987); *East Brunswick Bd. of Educ. v. GCA Services Group, Inc.*, No. 13-4623, 2014 U.S. Dist. LEXIS 122958 at 20 (D.N.J. Sept. 3, 2014).
19. *East Brunswick Bd. of Educ. v. GCA Services Group, Inc., supra* at 2014 U.S. Dist. LEXIS 122958.
20. *Id.* at 20.

Amendment to the New Jersey Business Corporation Act: Advancement of Expenses to Corporate Agents

by Gianfranco A. Pietrafesa

Current and former directors, officers, employees and agents of a corporation (corporate agents)[1] may be parties in legal proceedings where the corporation's attorney may not be able to represent them. In such cases, they must retain and pay their own attorneys.

The New Jersey Business Corporation Act provides for indemnification of corporate agents for the "reasonable costs, disbursements and counsel fees"[2] they incur in such proceedings, and for their liabilities, which include "amounts paid or incurred in satisfaction of settlements, judgments, fines and penalties."[3] The act broadly defines a "proceeding" as "any pending, threatened or completed civil, criminal, administrative or arbitrative action, suit or proceeding, any appeal, and any inquiry or investigation which could lead to such action, suit or proceeding."[4]

The act provides that if a corporate agent wins a proceeding, the corporation is required to indemnify the corporate agent for his or her expenses (theoretically, the corporate agent would have no liabilities if he or she wins the proceeding).[5] If a corporate agent fails to win a proceeding, the corporation has the discretion to indemnify the corporate agent for his or her expenses and/or liabilities, depending on the nature of the proceeding, if the corporate agent acted in good faith and in a manner he or she believed to be in, or not opposed to, the best interests of the corporation.[6] However, a corporate agent is not entitled to indemnification if it is determined in court that the agent's acts or omissions were not in good faith or involved a knowing violation of law, were in breach of the corporate agent's duty of loyalty to the corporation or its shareholders, or resulted in the corporate agent's receipt of an improper personal benefit.[7]

The act also allows a corporation to advance reasonable expenses incurred by a corporate agent in a proceeding.[8] The rationale for permitting advancement of expenses is that a corporate agent is required to personally pay such expenses and may not be indemnified for such expenses until the final disposition of the proceeding, which may be months or years later. Note that the right to indemnification is separate and distinct from the right to advancement of expenses.[9] That is, even if it is likely the corporation will be required to indemnify a corporate agent for such expenses, that alone does not require the corporation to advance such expenses to a corporate agent.

Historically, a corporation's board of directors has the responsibility to make the determination whether to advance expenses to a corporate agent.[10] However, as a result of a recent amendment to the act, a board may now delegate this responsibility to others in the corporation and/or establish a procedure for determining if and when such expenses shall be advanced.[11]

The board has many options. It may: 1) retain the right to make such determinations, 2) create a committee of the board to make such determinations, 3) allow senior management to make such determinations, 4) provide that independent counsel make such determinations, or 5) adopt a policy on how to make such determinations.[12] The board also may split the responsibility based on the type of corporate agent. For example, it can reserve the right to make such determinations for directors and senior management, and allow others, such as senior management, to make such determinations in cases of lower management and employees.[13] The board also may split the responsibility to make such determinations based on the type of proceeding or the amount of the advancement.

If the certificate of incorporation or bylaws do not specify who makes the determination, it remains a board determination, but the board may delegate the determination on a case-by-case basis to a committee, senior management, independent counsel, or even the shareholders.[14]

The amendment to the act did not change the requirement that the corporation receive an undertaking by, or on behalf of, the corporate agent to repay the amount of any advancement of expenses if it is ultimately determined the corporate agent is not entitled to indemnification.[15] In other words, if the corporate agent is not entitled to indemnification, he or she was not entitled to an advance and the corporate agent must repay the advanced expenses to the corporation. Therefore, in determining whether to advance such expenses to a corporate agent, the decision-maker for the corporation must take into account the financial ability of the corporate agent to repay such expenses in the event it is determined he or she is not entitled to indemnification. If the corporate agent does not or will not have the ability to repay the advanced expenses, the corporation may determine not to advance such expenses.[16]

In light of this new flexibility in the act, corporate attorneys should review their advancement of expenses provisions in their forms of certificate of incorporation and bylaws, as well as in other documents such as employment agreements and employee handbooks. ■

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Endnotes

1. N.J.S.A. 14A:3-5(1)(a) (definition of corporate agents).
2. *See id.* 14A:3-5(1)(c) (definition of expenses).
3. *See id.* 14A:3-5(1)(d) (definition of liabilities).
4. *Id.* 14A:3-5(1)(e).
5. *Id.* 14A:3-5(4).
6. *See id.* 14A:3-5(2) & (3).
7. *See id.* 14A:3-5(8).
8. *Id.* 14A:3-5(6).
9. *See New Jersey Corporations and Other Business Entities* §12.10[5] n.75 (cases cited therein).
10. *See* N.J.S.A. 14A:3-5(6) (stating that the corporation may advance expenses "as authorized by the board of directors").
11. *See* P.L. 2014, c.77 (approved Dec. 11, 2014, and effective immediately). The amendment makes New Jersey law consistent with Delaware and New York law. *See* Statement to A2603.
12. *See* Statement to A2603. *See also* N.J.S.A. 14A:3-5(5)(a) (the statutory provision for determining whether a corporate agent has met the standard of conduct entitling him or her to discretionary indemnification can also be used for determining who should make the determination for the advancement of expenses).
13. *See, e.g., New Jersey Corporations and Other Business Entities*, Form 12.03 and Form 12.04.
14. N.J.S.A. 14A:3-5(5)(c) allows the shareholders to make the determination whether a corporate agent has met the standard of conduct entitling the corporate agent to indemnification so long as the shareholders are so authorized by the certificate of incorporation, bylaws or resolution of the directors or the shareholders. There is nothing in the act that prevents the shareholders from making the determination of the advancement of expenses based on the same type of authorization.
15. N.J.S.A. 14A:3-5(6).
16. *See, e.g.,* Statement to A2603.