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Practical Suggestions for Practicing Lawyers

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PRACTICAL SUGGESTIONS for PRACTICING LAWYERS



HOW TO ASSESS LITIGATION EXPOSURE

When measuring “litigation exposure” you assess the likelihood that a business will suffer a loss based on legal liability. Problems of litigation exposure vary. This article takes a general look at the task. Assume you represent a client making preliminary efforts to invest in, join forces with, or take some measure of control over an ongoing business. You are looking at a whole business, not at risks in designated categories.

Investigating Litigation Exposure

General due diligence, of which litigation assessment may be a subcategory, begins after a precipitating event: Your client has expressed formal interest in close dealings with a business (“Target”). This interest may eventually lead to:

- A tender offer;
- A white knight agreement;
- A purchase of assets; or
- A joint venture, among other possibilities.

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Understand the Deal

Determine what your client wants to know and why. Ascertain whether the results of your work will:

- Determine whether a deal will go forward;
- Set an offering price and other terms in a takeover; or
- Satisfy the client that there are no “smoking guns” or “skeletons” lurking in the Target.

Business considerations will determine your agenda. Within these constraints, explore the Target as broadly and deeply as you can. One way to assert your interest in doing a complete job at the outset is to suggest that your client enter into a written agreement to keep confidential what you learn about Target. Especially in the beginning enthusiasm and energy on your part will help. The harder you look, the more you will learn about Target, both in the areas you study and in their connections to new subjects below the surface. Remember, when the due diligence investigation is over, it's over. You cannot revisit to fill the gaps left by earlier indifference.

On-Site Investigation

Once you understand your mission, it is time to go to the company. Your welcome will range from respect (when you represent a white knight, a courted investor, or a much-needed joint venturer) to neutrality, to resistance and fear. Functional cooperation will not vary much, however; even the most hospitable management will not much like your lawyerly probing, while the employees of a company subject to a hostile transaction are probably under orders to be civil. Perhaps the best predictor of your reception is whether the company has been the subject of regular outside audits or examination and how your predecessors behaved. Bring your own office supplies. Respect the work hours of Target (which may begin and end earlier than your own). And behave like visitors rather than Sherman's army on the march.

Litigation Records

Set up a morning appointment with Target's general counsel. The general counsel's office is the source of litigation records. After introducing yourself and explaining your purpose, you should be given a centralized litigation summary maintained by the general counsel. All publicly held companies and most businesses subject to outside audit will keep a summary record of this kind. Examine concise records before prolix ones. If the Target counsel tells you that the

litigation record covers shelves, or rooms, or a warehouse floor, ask for whatever short version is available. The last three auditor's letters describing litigation exposure will suffice initially. Do not imply that you will not need the full record, even if you are certain that you will never wade through a roomful of complaints.

Interview General Counsel

Talk to the general counsel, explain that some background will help you understand the records; you will return later with better-informed questions. Your personal style—in particular, whether you prefer to have swum in documents before any factfinding interview—will determine the tone and length of this meeting.

My approach is to try for an easy tone: We are here to look and learn, not to second guess the decisions or the success rate of litigation at the company. The remainder of the interview covers matters not appearing in the litigation record, for example:

- The number of in-house lawyers;
- The tasks performed by in-house counsel;
- What litigation insurance the target holds (larger companies have insurance specialists); and
- The procedure for authorizing settlements.

As an alternative to interviewing the general counsel you might choose to take the litigation record and say you will be back, especially if the general counsel seems hostile or harried. Before you leave, however, open the record to a random page. Have the general counsel explain the format, date range, and any puzzling codes and abbreviations.

Bias

Any kind of review calls for some trust of Target. You will have to assume that records are complete and true. But even in their frankest moments, lawyers for the company are likely to cast their description of litigation exposure in rosy terms. Or at least these descriptions will appear so. (The reverse situation, in-house lawyers playing Cassandra in an attempt to discourage a transaction, is a theoretical possibility, but it would cut against the basic human instinct to look good.)

Recognize that the general counsel's office has lived with the present level of litigation risk and cannot join you in any alarm. Moreover, this level of exposure reflects their protection of the Target's treasury. Whatever implicit threats exist—such as job cuts in a takeover setting, or the loss of your client as an investor—can put pressure on lawyers to describe a present and future under their complete control.

You may, therefore, hear that:

- The Environmental Protection Agency these days seldom designates new toxic waste sites;
- After a pattern of loss in court, Target now benefits from a shift in legal doctrine, a new statute, or an exhaustion of the source of litigation;
- A recent favorable outcome has lowered risk to the vanishing point; or
- Title VII lawsuits have gone out of vogue.

Statements of this sort are almost always sincere and may be true. If their truth is relevant to your task, make an effort to verify them.

Press (gently) the company lawyer to elaborate on the rosy picture you have just been given. "What if," you begin, the worst contingency were to occur? Or if the case law changed? A different trend developed? When you start getting answers describing cash reserves or excess insurance levels, keep listening—you may need this information—but be aware that the lawyer has shifted from description to defense. This is not performance review of the department: it is an effort to gauge litigation exposure. Reward objectivity and candor by appearing pleased to hear pessimism, worried by cheerful reassurances.

Rosy Litigation Records

Litigation records, like the Target employees who created them, may also seem to look on the bright side. Root

about for violation notices, unfavorable judicial opinions or consent decrees, news stories about any large trials or administrative proceedings, and representative pretrial briefs or memoranda opposing a company motion for summary judgment. It is a rare Target that will volunteer the amounts paid in settlement of repetitive litigation such as product liability, but you should try to get these figures and plot them over time. Are settlement values increasing or decreasing? Does much of the pending litigation appear active, or abandoned by plaintiffs?

Lawyers' Resistance to Questioning

Some company lawyers will resist your questions, pleading confidentiality, especially when Target is not being acquired. Stand your ground. Even in a friendly deal, it is a poor advocate who allows another lawyer to issue boundary decrees. Refer to the agreement you made not to disclose what you learn. Preparation can help. If you know something about a subject in advance, and assert your obligation to learn more, Target's lawyer may feel impelled to "complete the picture" or "correct the record." This urge to dominate a narrative, which makes lawyers such bad direct-case witnesses, can help your client.

After you have a general impression of the litigation exposure from interviews and documents, consult with the business team at your firm. You are now in a better position to un-

derstand which issues require further probing. If a third party such as an investment bank, limited partnership, credit syndicate, or other financial source is awaiting the results of your examination, then learn this new set of concerns and address them.

A Checklist

Should you receive instructions no more precise than "Find out what's the story with litigation," start by mastering the topics below as they exist in Target. Encourage Target employees to add to the list. Welcome expansions. Do not delete a topic from the list until you are sure it does not apply.

The Main Event

The main event is what the company makes, sells, or provides. For a manufacturing company, consider product liability. Service companies may also encounter some repetitive, predictable, mainstay litigation. Understand the plaintiffs' theory, the history of this litigation, routine procedures of the defense, and the company's (as well as your own) projections about future litigation.

Environmental Issues

Environmental issues come up in nearly all exposure assessments of manufacturing companies. Both the federal government and state governments may sue to force cleanups and levy penalties. Citizens and other

businesses may bring lawsuits as well. Your research in this subject may spread beyond formal litigation.

For instance, some states require notification to environmental authorities when companies change control. Federal, state, and local permits are required for the discharge or storage of certain waste. Many communities have enacted "right to know" regulations about changes of corporate control or of plans that affect the environment.

Intellectual Property

Some companies segregate intellectual property litigation as "too technical" for nonspecialists. Look at it anyway. There may be lawsuits alleging patent, trademark, or copyright infringement, breaches of license or joint venture agreements, or shared technology contracts gone sour. Look also for potential litigation in the form of administrative proceedings, demand letters, and unasserted claims recorded in whatever search reports you have. Especially if Target is a licensor of intellectual property that produces sizeable revenues, intellectual property litigation can affect its future.

Computers

In a company that uses its own mainframe computers, this category includes disputes with software vendors or licensors over site limitations, renewal rights, unauthorized use, and royalties. Does Target plan any data

processing changes that might provoke a vendor? If Target leases computers or pays for remote processing, these contractors might resent some planned transfer of computer functions.

Real Estate/Land Use

Any company, no matter what its business purpose, might own the land on which its plants are located. Or a real estate group in the company may make investments. Check for state attorney general actions alleging, for example, fraudulent sales practices or public nuisances. (California and New York are especially fond of elaborate real estate laws.) Falling into the real estate category are disputes with communities over land-use decisions such as utility easements or road enlargement.

Shareholder Derivative Litigation

Shareholder derivative litigation is a category that may have eluded official records divided by subject matter. Ask.

Employee Relations

If Target is a union company, look for National Labor Relations Board decisions, arbitrator's reports, and records of strikes, work stoppages, or other concerted action. For a non-union Target inquire into any past conflict over unionization. (This area is one where you might well believe "Believe me, it's nothing," but the sub-

ject of employees is worth consideration, as it will arise in the business context.)

Also look for Employee Retirement Income Security Act litigation, administrative proceedings (in the Occupational Safety and Health Administration or the Equal Employment Opportunity Commission, for example), plant closing disputes, lawsuits over employee termination, and individuals' covenants not to join a competing business. Get a sense of whether Target is reputed to be violating anti-discrimination laws.

Target as Plaintiff

Many litigation summaries, especially those in the auditor's letters, emphasize loss contingencies, so you may have to seek out information about Target as plaintiff. Company lawyers of the optimistic sort will eagerly describe gain contingencies in great detail. Initiating litigation, however, can mean potential loss—counterclaims, expense, publicity, discovery and disclosure—as well as gain.

Insurance

Like environmental issues, insurance may overlap litigation and non-litigation assessment. From the perspective of litigation with insurers, consider coverage disputes, refusals

to issue new policies, and classification controversies. Others with whom Target might have disagreements include state insurance departments and insurers of third parties. If you are forced beyond your expertise in evaluating retention levels for future litigation defense, keep in mind that insurance generally has become more expensive and less available. You may not be able to make projections with the numbers you have.

Assessment

When the review of Target ends, prepare a summary of what you learned. A litigation-exposure assessment is sometimes incorporated into a larger report by multiple authors. Under more casual instructions to “just write it all up,” you might divide your findings into topics, interviews, and documents, detailed in outline form. Append copies of crucial or representative material to the section describing your review of documents.

Reply carefully when someone asks you about the “bottom line.” It is unlikely that your research has revealed a hidden catastrophe, or a state of litigation that makes the company far more of a gem than expected. You can offer only a factual report, leavened by your judgment in deciding what to find out, when to keep going, and which inferences to draw.