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Patent Protection for Medical Technology: Implications of *In re Bilski*

By Jason R. Kraus and Brian W. Oberst

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Medtech companies employ a broad range of patent claim strategies to protect their technology. At a basic level, these strategies include pursuing claims directed to medical devices (both the overall device and individual components), systems for delivering medical treatment and diagnostic test kits.

Companies may also utilize different types of method claims, including, for example, claims directed to methods of delivering medical treatment or therapy and claims directed to diagnostic methods. Whether these medical method claims define patent-eligible subject matter is assessed under the standards set forth in *In re Bilski*, which was decided by the U.S. Court of Appeals for the Federal Circuit on October 30, 2008.

While *Bilski* has received much attention for its impact on the patentability of business methods and software, the decision also has important implications for medtech companies working to protect diagnostic and therapeutic methods.

In re Bilski: Court Articulates Definitive Patent Eligibility Test

Bilski involved a patent claim by inventors Bernard L. Bilski and Rand A. Warsaw for a "method of hedging risk in the field of commodities trading." In its much-anticipated decision, the Federal Circuit articulated a new test for determining whether a process is eligible for patent protection under U.S. patent law. In *Bilski*, the court relied heavily on Supreme Court precedent to overturn its previous "useful, concrete, and tangible result" test. In its place, the court adopted a more narrow "machine-or-transformation" test, which requires that a process (1) be "tied to a particular machine" or (2) "transform a particular article to a different state or thing."

Section 101 of the U.S. patent law provides that "any new and useful process, machine, manufacture or composition of matter" is eligible for patent protection. In its last two decisions addressing the contours of section 101, *Diamond v. Diehr* (decided in 1980) and *Diamond v. Chakrabarty* (1981), the Supreme Court stated that patentable subject matter includes "anything under the sun that is made by man." And the Supreme Court set forth three categories of inventions that are not patentable subject matter: "laws of nature, natural phenomena, and abstract ideas."

Processes that Preempt Use of a Fundamental Principle Not Patent Eligible

In *Bilski*, a decision joined by nine of 12 judges, the Federal Circuit explained that patents should not "pre-empt substantially all uses of a fundamental principle" such as a law of nature or a mathematical formula. Thus, the court explained that the question before it was whether the applicant's claim "recites a fundamental principle and, if so, whether it would pre-empt substantially all uses of that fundamental principle if allowed."

The court further recognized, however, that "this inquiry is hardly straightforward." And, explained the majority, a claimed process "wherein all of the process steps may be performed entirely in the human mind is obviously not tied to any machine and does not transform any article into a different state or thing," and thus "would not be patent-eligible under § 101."

Accordingly, after canvassing Supreme Court decisions on the patent-eligibility of process claims, the *Bilski* majority determined that the Supreme Court had "enunciated a definitive test," under which a claimed process "is surely patent-eligible under § 101 if: (1) it is tied to a particular machine or apparatus, or (2) it transforms a particular article into a different state or thing." The Federal Circuit further explained that the machine-or-transformation test requires that the use of a specific machine or transformation of an article "must impose meaningful limits on the claim's scope," and "must not merely be insignificant extra-solution activity." Thus, merely adding a "data-gathering" step to a mathematical algorithm "is insufficient to convert that algorithm into a patent-eligible process."

Bilski *Method Claim Did Not "Transform an Article"*

The particular claims evaluated in *Bilski*, for a "method of hedging risk in the field of commodities trading," admittedly did not limit any process step to any specific machine or apparatus. Thus, the court did not apply the "specific machine or apparatus" test to Bilski's claims. Notably, the court stated, "We leave to future cases the elaboration of the precise contours of machine implementation, as well as the answers to particular questions, such as whether or when recitation of a computer suffices to tie a process claim to a particular machine."

The court did, however, apply the "transformation" test to Bilski's claim, and in doing so, elaborated on "what sorts of things constitute 'articles' such that their transformation is sufficient to impart patent-eligibility under § 101." The court stated it is "virtually self-evident that a process for a chemical or physical transformation of physical objects or substances is patent-eligible subject matter." Additionally, a transformation of electronic signals or data that "represent[s] physical and tangible objects" can be patent-eligible.

The court concluded, however, that Bilski's claims did not "transform any article to a different state or thing." According to the court, "Purported transformations or manipulations simply of public or private legal obligations or relationships, business risks, or other such abstractions cannot meet the test because they are not physical objects or substances, and they are not representative of physical objects or substances."

Impact on Medtech Companies

Although interest in *Bilski* has largely centered around its anticipated effect on so-called "business method" patents, the machine-or-transformation test for patentability applies to all process or method claims and is not limited to any particular class of technology. Accordingly, in formulating a patent strategy, medtech companies must consider the impact of the machine-or-transformation test on claims directed to medical diagnostics or methods of medical treatment.

Medical Diagnostic Methods

Claims directed purely to diagnostic methods may be most susceptible to challenge under *Bilski*. Indeed, in his dissenting opinion, Judge Randall R. Rader recognized the potential impact of the *Bilski* decision on medical technology. Specifically, he noted that denial of patent protection for medical diagnostics would "undermine and discourage future research for diagnostic tools" by undermining the ability to protect such innovations.

In another recent opinion, *Classen Immunotherapies, Inc. v. Biogen Idec*, which was issued just six weeks after *Bilski*, the Federal Circuit evaluated the patent eligibility of a claim to a "method of determining whether an immunization schedule affects the incidence or severity of a chronic immune-mediated disorder in a treatment group of mammals."

The claim recited two method steps:

- "immunizing mammals in the treatment group of mammals with one or more doses of one or more immunogens, according to [an] immunization schedule"; and
- "comparing the incidence, prevalence, frequency or severity of said chronic immune-mediated disorder or the level of a marker of such a disorder, in the treatment group, with that in the control group."

In a one-paragraph, non-precedential opinion, the Federal Circuit, quoting *Bilski*, found that the Classen claims were not directed to patentable subject matter, as they were "neither 'tied to a particular machine or apparatus,'" nor did "they 'transform[] a particular article into a different state or thing.'" While the Classen panel provided no explanation or analysis, the court's decision presumably turned on the "transformation" test, as the claim is not expressly tied to any particular machine or apparatus.

In another case currently on appeal before the Federal Circuit, *Prometheus Labs, Inc. v. Mayo Collaborative Services*, a California district court struck down patent claims directed to a "method of optimizing therapeutic efficacy" of a Crohn's disease therapy by (a) administering a drug providing a metabolite and (b) determining the level of the metabolite in the subject, wherein the level indicates a need to increase or decrease the amount of drug subsequently administered to the subject.

The district court held that the claims "wholly pre-empt" the correlation and thus fail to define patent-eligible subject matter. It further found that the consumption of the drug and physical transformation into metabolites were merely "necessary data gathering steps," which likewise did not satisfy section 101.

Medical Treatment Methods

While the Federal Circuit has not recently addressed the patent eligibility of claims directed to medical treatment methods, the Board of Patent Appeals and Interferences recently considered this issue, in July 2008.

In *Ex parte Roberts*, the board evaluated a claim that included the following steps: (a) obtaining a first measurement of a cornea; (b) determining a first ablation specification based on this first measurement; (c) obtaining perturbation data from the cornea to obtain biodynamic response data; (d) obtaining a second measurement of the cornea, (e) correlating the perturbation data with the biodynamic response data; and (f) establishing an individualized, customized ablation specification for that individual cornea. The board characterized steps (a), (c) and (d) as data gathering steps, and steps (b), (e) and (f) as mental steps in forming an individualized ablation specification.

Although *Roberts* was decided before *Bilski*, the board applied a version of the machine-or-transformation test. It found that the claim requires "no transformation of subject matter" and further noted that even assuming the data gathering steps are performed by a machine, such steps are not sufficient to satisfy section 101.

After *Bilski*: Craft Claims to Satisfy Machine-or-Transformation Test

Medtech companies should carefully evaluate their patent strategy relating to medical diagnostic and medical treatment claims in view of *Bilski*. While these claims continue to be a valuable tool for protecting medical technology, they should be carefully crafted to satisfy the machine-or-transformation test.

Further, courts analyzing section 101 issues will likely continue to scrutinize the extent of the preemptive effect of the claims. In other words, claims that appear to preempt a broad range of applications of a particular concept or algorithm are more likely to fail a section 101 analysis than claims that are expressly directed to a particular application. Thus, medtech companies should consider expressly tying medical diagnostic and therapy process claims to a particular purpose or application.

Diagnostic Method Claims

Claims drawn primarily to diagnostic methods should be scrutinized to ensure they are either appropriately tied to a specific diagnostic device or recite a complete "transformation" of data into a different state. One possible strategy for strengthening the section 101 position of medical diagnostic claims is to avoid trigger words such as "compare" or "correlate," which appear in many of the claims that courts and the Board of Patent Appeals have deemed to be ineligible for patent protection under section 101.

At a minimum, applicants should avoid claims that only recite limitations directed to "comparison" or "correlation" steps. Rather, claims should require additional steps or actions either before or, preferably, after these steps. For example, claims requiring visually displaying the results of such comparisons or correlations will likely satisfy the "transformation" test.

Medical Treatment Method Claims

Claims directed to treatment methods performed by a medical device, for example, should be drafted to expressly include a nexus or tie between the method of treatment and a specific medical device. For example, a claim that expressly requires method steps to be carried out by or using a particular medical device (*e.g.*, an implantable pacemaker or a catheter) should satisfy the "machine" aspect of the test.

Moreover, courts may be more likely to find that certain medical treatment methods satisfy the "transformation" branch of the *Bilski* test, which requires a physical transformation of an article to a different state or thing.

The *Bilski* court stated that a qualifying transformation includes a "physical transformation of physical objects or substances." The Federal Circuit has previously stated, in *In re Abele*, that "physical objects" includes the "structure of bones, organs, and other body tissues."

Courts may determine that a transformation of a person from a "diseased" state to a "healthy" state satisfies the transformation branch of the test. Accordingly, consider crafting medical treatment claims to expressly recite steps resulting in such a transformation.

Supreme Court Will Review *Bilski* Decision

Bernard Bilski and Rand Warsaw have asked the Supreme Court to review the Federal Circuit's decision, and on June 1, 2009, the court issued an order granting the inventors' petition for writ of certiorari. Briefing will take place over the next several months, with a decision likely in 2010. Stay tuned, as it is quite possible the Supreme Court will decide to broaden or narrow the machine-or-transformation test, or even to articulate an entirely different test. FB

Finding Funding in 2009—What's a Medtech Startup to Do?

By Amy C. Seidel

Amy Seidel (aseidel@faegre.com) joined Faegre & Benson in 1998, and is a member of the firm's public companies and executive compensation practices as well as the medical technology industry team.

The current economic climate has forced many companies to think seriously about available funding alternatives and, in some cases, to get a little creative. The good news for many emerging medtech companies is that more alternatives may be available in medical technology than in other industries. Though it may not be easy to locate, there is investment money to be found. At the same time, though, companies that find new investors or lenders must realize the considerations for spending and conserving capital are somewhat different in 2009 than in more prosperous times.

Who Has the Money?

Angel Investors. There are still plenty of individuals who didn't invest with Bernard Madoff and have funds to invest. But such high-net-worth individuals can be difficult to identify. Finding these dollars tends to be a "who-do-you-know" game—but they are out there. In fact, many of these individuals are looking for longer-term returns and are tired of sinking money into the lackluster public equity markets. Some communities have networks of angel investors, and others can be identified by contacting local venture capitalists and small business resources.

Venture Capital Firms. Venture capitalists are still closing new deals and making additional investments in their existing portfolio companies. Valuations may be less favorable to companies, and down rounds are not out of the question.

Strategic Investors. Many large medtech and pharmaceutical companies have active practices of investing in and acquiring emerging companies as a means of growth. Many of these strategic investors have quite a bit of capital to invest and are looking at the current market and depressed valuations to do some bargain shopping. The decision to sell securities to a strategic investor shouldn't be taken lightly, particularly if the investment involves a package deal that includes other commercial or strategic provisions (i.e., distribution, licensing or other arrangements). Strategic investors often seek to structure financing in tranches, with subsequent rounds of investment contingent upon the achievement of operational milestones, such as completing a clinical trial or obtaining FDA approval.

Banks. Banks and other commercial lenders are among the toughest sources of capital to access in this market. When bank funding is available, it may involve relatively high interest rates, stricter covenants and increased collateral requirements.

When You Get the Money

Companies that find sources of funding in this difficult economic climate need to be especially careful about how they spend—and conserve—newfound capital. Below are a few tips.

Take the Money. Under other circumstances, companies might be afraid to take on more dilution than seems necessary in the short-term, at the current valuation, especially when that valuation seems depressed. Most companies would rather fund operations through their next key developmental milestone and then seek to raise additional capital at a higher valuation. However, given the current uncertainty in the market, now may not be a time to focus too much on concerns about dilution. Many companies are properly focused on raising as much capital as possible—to fund operations through 2009 and well into 2010, they hope, if those funds are made available now.

Don't Spend It All in One Place. More than ever, diversification is important. Most companies are looking to invest in multiple strategies, as opposed to putting all their eggs in one basket. Diversification is particularly important in this evolving economy, and with a new presidential administration that may establish new sets of regulatory regimes. As a result, it may be difficult to predict which business strategies will be successful, or even possible, over the next few years.

Don't Forget the Cushions. It's pretty easy to get comfortable spending money when you have it, but now is the time for all companies to conserve cash—without jeopardizing long-term growth, they hope. Every company should spend time "tightening the belt" and looking for expense reductions. Having the ability to stretch funds can enable you to defer seeking capital in periods when it is not available on favorable terms—or at all.

Maintain Relationships. Investors are naturally concerned about their investments. It is particularly important to keep a good relationship with your investors, whether they are banks, venture capitalists, angel investors or strategic investors, during these uncertain times. Situations can change quickly, and it is important to feel you can contact your lender if you need to request a covenant waiver or modification, or your investors if you need a bridge loan. Lenders and investors don't appreciate surprises, so keeping them informed of your financial condition is critical if you may need their assistance in the coming year.

Invest the Money Wisely. A difficult decision these days is how to invest the money you've raised while you are waiting to deploy it. Many companies are moving toward increasingly conservative investment strategies focused on government obligations and debt securities rated by rating agencies.

Evaluate Counterparties. Conduct a thorough evaluation of the financial viability of your key suppliers and financial partners to determine how they are weathering the current economic challenges. If you are concerned that some of them may not be around in coming months, start looking for other potential partners or evaluate the possibility of conducting necessary development and production in-house. FB

Material Adverse Effect Clauses in the Wake of *Hexion Specialty Chemicals, Inc. v. Huntsman Corporation*

By Matthew Kuhn and Jonathan Nygren

An associate based in Minneapolis, Matthew Kuhn (mkuhn@faegre.com) has a comprehensive transactional practice working in the firm's corporate group. Minneapolis-based associate Jon Nygren (jnygren@faegre.com) also works in the corporate group, focusing on mergers and acquisitions for public and private companies and general corporate issues.

The decision by the Delaware Court of Chancery in *Hexion Specialty Chemicals, Inc. v. Huntsman Corporation* provides an opportunity to revisit material adverse effect (MAE) clauses. Often the subject of extensive negotiations, MAE clauses generally are a closing condition that may allow the buyer to walk away from a transaction if an event or condition adversely affecting the target company has occurred. They are often subject to exceptions, or carveouts, for events such as a deterioration in general economic conditions, general market volatility or changes in a target's industry. *Huntsman* involved Hexion's attempt to terminate an agreement to acquire Huntsman on the basis of an MAE, which allegedly occurred after Huntsman reported lower-than-projected earnings in the period between signing and closing. This article analyzes *Huntsman's* insights into the interpretation of MAE clauses and highlights matters to consider when negotiating acquisition agreements.

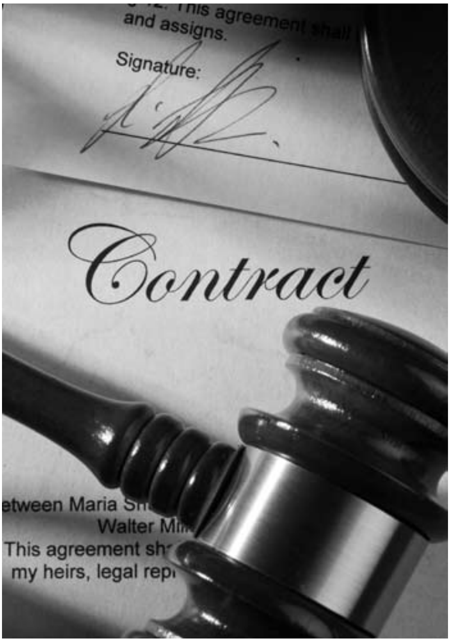
How to Interpret an MAE Clause

Buyer Bears the Burden of Proof

The *Huntsman* court first decided which party bore the burden of proving an MAE had, or had not, occurred. Allocating the burden of proof is significant because, as the court noted, a party faces a "heavy" burden when invoking an MAE clause. The court reaffirmed the prior decision of *In re IBP, Inc. Shareholders Litigation* by deciding that the party invoking the MAE clause, typically the buyer, must prove an MAE has occurred. The court noted, however, that parties are free to explicitly allocate the burden of proof with respect to an MAE clause in an agreement. With the deterioration of economic conditions and increased negotiating leverage that buyers may have as a result, buyers could seek to contractually alter the default burden of proof *Huntsman* establishes, which may make it easier to successfully invoke an MAE clause.

EBITDA Determines Whether an MAE Has Occurred

After resolving that Hexion bore the burden of proof, the *Huntsman* court discussed the metrics it would examine to determine whether an MAE had occurred. The court decided that, in a cash merger where all the target's debt will be paid off, the proper benchmark for determining whether an MAE has occurred is earnings before interest, taxes, depreciation and amortization (EBITDA), which is closely tied to results of operations and is "what matters." The court's focus on EBITDA refines IBP, which examined both earnings per share (EPS) and earnings before



interest and taxes in the context of a deal with an option for payment in cash or a combination of cash and stock. Although Delaware courts may consider EPS in addition to EBITDA in future deals if stock constitutes all or part of the consideration, EBITDA likely will be the default MAE metric courts will examine in *Huntsman*'s wake.

First Determine Whether an MAE Has Occurred, Then Examine Carveouts

Huntsman clarifies the framework courts use when analyzing MAE clauses. First, the court examined whether an MAE affecting Huntsman's financial condition or business had occurred. Only if the court found that an MAE had occurred would it then determine whether a carveout applied.

The court fashioned this rule in light of Hexion's argument that Huntsman's performance, relative to the chemical industry overall, demonstrated that Huntsman had suffered an MAE. The merger agreement included a carveout providing that changes affecting the chemical industry did not constitute an MAE even if those changes materially and adversely affected Huntsman. The court ruled that Huntsman's performance relative to industry peers could not in itself determine whether an MAE had occurred because MAE carveouts, including the carveout for changes to a target's industry, are intended to prevent a circumstance that would otherwise be an MAE from being found to be one. If the only evidence an MAE has occurred is Huntman's performance relative to industry peers, then the carveout Huntsman negotiated would be meaningless. The court therefore first sought to determine whether an MAE occurred before focusing on facts primarily applicable to the carveout for changes to industrywide conditions.

Huntsman varies from the framework used by a Tennessee court, applying Tennessee law, in *Genesco, Inc. v. The Finish Line, Inc*. The *Genesco* court ruled that an MAE occurred, but concluded that the cause of the MAE fell within a carveout similar to the one considered in *Huntsman*. However, in contrast to *Huntsman*, the *Genesco* court determined that the carveout applied before deciding whether an MAE had occurred and "include[d] its MAE analysis for completeness" only. *Huntsman* provides a principled approach for applying MAE clauses that most courts likely will use in the future.

Practical Consideration for Negotiating and Using MAE Clauses

The *Huntsman* court ultimately ruled that Huntsman had not suffered an MAE. Its decision and prior cases such as *IBP* and *Genesco* highlight a number of issues to consider when negotiating an acquisition agreement.

Buyers Intending to Rely on Diligence Materials Should Include Specific Provisions

It is critical for buyers to obtain specific representations or closing conditions regarding any diligence materials, such as projections, that are important to their investment decision. The initial document most parties sign before entering into acquisition negotiations is a confidentiality agreement, which typically provides that the buyer may not rely on diligence materials provided by the target. Definitive agreements also may (and, from the target's perspective, should) include a provision stating that a party is only making the representations set forth in the definitive agreement. The Hexion-Huntsman agreement, for example, disclaims any representation with respect to projections Huntsman provided to Hexion prior to signing and any representation not explicitly set forth in the agreement. These provisions are intended to eliminate any argument that one party relied on materials produced by the other to enter into a transaction, and are so interpreted by courts. If any materials produced during diligence are of particular importance to a party—such as projections of the target's future performance—that party should negotiate to include a specific representation regarding the accuracy of those materials. Otherwise, the party may not have a remedy if its reliance on the materials is misplaced.

Buyers Should Negotiate Specific Clauses Relating to Identified Issues

Delaware courts have consistently said the purpose of MAE clauses is to serve as a "backstop" to protect against unknown risks. *Huntsman* reaffirms this position. To the extent a party is aware of an issue and does not address it specifically in the definitive acquisition agreement, a court may find that the issue was not fundamental to the transaction. That is especially likely where, as in *IBP*, the buyer knew of potential problems and continued to increase its purchase price after obtaining knowledge of them. Therefore, if a buyer has identified an issue it views as fundamental to the desirability of a target or transaction, the best course is to negotiate a specific representation or closing condition, such as maintenance of a particular credit rating or achievement of a given level of EBITDA for a certain period, that addresses the issue. Otherwise, there is a significant risk the issue will be ignored—or, worse, used as evidence that the buyer was not concerned about the issue—when a court analyzes whether an MAE has occurred.

Delaware Law Makes It More Difficult for Buyers to Prove an MAE Has Occurred

As noted in *Huntsman*, no Delaware court has ever found that an MAE has occurred in the context of a merger agreement (including in *IBP*, which interpreted New York law). By choosing Delaware law to govern a definitive agreement, the parties make it difficult for a buyer to terminate the agreement based on the occurrence of an MAE.

Changes That Could Make MAE Clauses More Favorable to Buyers

Huntsman and its predecessors provide helpful pointers regarding negotiating and drafting MAE provisions.

The Hexion-Huntsman agreement defines an MAE as "any occurrence, condition, change, event or effect that is materially adverse to the financial condition, business, or results of operations of [Huntsman]…" From the buyer's perspective, several changes could make this language stronger. First, if a buyer is concerned about the target's future operations, the word "prospects" could be added. A second possible change would be to say an MAE is any occurrence or effect "that is *or is reasonably likely to be* materially adverse," adding a forward-looking component to the definition. Delaware courts also have hinted that use of the word "could" rather than "would" or "is" may, on the margins, make it easier to prove an MAE has occurred. Finally, if a buyer has identified particular areas of concern regarding a target, it should seek to incorporate specific provisions that define an MAE to include a failure to achieve express metrics that provide comfort on the areas of concern.

The second portion of a typical MAE definition contains the carveouts to the general MAE definition. It is important for both parties to make sure the carveouts appropriately limit the scope of the MAE definition. A target should negotiate carveouts for events that are of particular concern. A buyer will want to ensure the carveouts do not exclude events that are intended to be covered by the MAE definition. For example, in *SLM Corporation v. JC Flowers*, the target negotiated for certain changes in applicable law to be carved out from the MAE definition, but the adopted legislation was different from the description of legislation incorporated into the MAE definition. Ultimately, the limited scope of the carveout, arising from its specificity, may have caused the target to receive a less favorable settlement.

Overall, an MAE clause with carefully considered carveouts and clear criteria for what constitutes an MAE is most likely to yield a result consistent with the parties' expectations.

A Buyer Should Act in Good Faith if It Thinks an MAE Has Occurred

Absent an express agreement on clear, identifiable metrics for an MAE in an agreement, determining whether an MAE has occurred is subject to considerable judgment and debate. Identifying an MAE in any particular instance therefore can be difficult.

If a buyer believes an MAE has occurred and decides not to close a transaction, it should communicate that belief to the target shortly after deciding not to close on the basis of the MAE. Waiting exposes a buyer to the argument that declines in the target's business at the time of the decision were not sufficiently significant to justify finding an MAE. The *IBP* court, for example, discounted the significance of the decline in the target's business by noting the buyer's failure to assert an MAE along with the other reasons initially provided for refusing to close.

A failure to promptly communicate an alleged MAE also may violate a buyer's covenants in the acquisition agreement and its obligation to act in good faith. Acquisition agreements commonly require each party to make certain efforts to close the transaction. A buyer that does not promptly inform a target that it does not plan to close will likely run afoul of the spirit and letter of any such covenant. Moreover, a failure to inform a target that the buyer intends not to proceed can be seen as violating the general duty to perform an agreement in good faith. The *Huntsman* decision contains an overtly negative tone in describing Hexion's actions leading to the suit, which included transmitting an opinion regarding the insolvency of the combined company to its lenders before that opinion was communicated to Huntsman. Hexion's failure to consult with Huntsman prior to sending the opinion to lenders led the court to find that Hexion "knowingly and intentionally" breached the agreement and seemingly did not leave the court inclined to resolve any ambiguity in Hexion's favor.

Conclusion

Huntsman provides several key insights into how courts should interpret MAE clauses. Overall, like its predecessors, the case serves as a reminder that, despite the negotiating effort involved in MAE provisions, they are inherently ambiguous and buyers should not rely on them if specific concerns surface during the diligence process. Rather, buyers should negotiate specific clauses to address their concerns or try to renegotiate if a deal has not proceeded as anticipated. Although sellers may be emboldened by Delaware courts' refusal to find an MAE in the acquisition context, the prospect of lengthy litigation could provide strong motivation to renegotiate a deal even if a seller's chances of a favorable judgment seem high. FB

U.K. Organizations Get Ready for the "Carbon Reduction Commitment"

By John Duffy

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The U.K. government has committed the country to reduce greenhouse gas emissions. The government cannot do it alone, so it has begun to introduce legislation that will provide incentives for individuals and organizations throughout the U.K. to reduce energy consumption.

The latest legislation is the Climate Change Act 2008, which sets ambitious goals for reducing carbon dioxide emissions throughout the U.K. It requires the U.K. to reduce greenhouse gas emissions at least 26 percent below 1990 levels by 2020, and 80 percent below 1990 levels by 2050. A central element of the legislation is a carbon budgeting system that limits emissions over a series of five-year periods, beginning June 1, 2009.

Overview

This article looks at one aspect of the Climate Change Act—a mandatory Emissions Trading Scheme for large users of electricity, known as the Carbon Reduction Commitment, which will apply to public and private sector enterprises throughout the U.K. (the "Regulations"). The government estimates that about 20,000 organizations, including all central government departments, will have to report electricity consumption to it as a result of the Regulations, while about 5,000 will have to participate fully in the Emissions Trading Scheme and purchase credits to account for energy usage. Organizations that use more than 6,000 megawatt hours per year of electricity (an annual bill of about £500,000) will be most affected. Although qualification for the scheme is based upon electricity usage, the Regulations cover—and organizations will have to purchase credits for—all energy, including heat, but not transportation fuels.

To simplify the process, the Regulations require corporate and other groups to participate as a single entity, with responsibility for reporting, monitoring and paying for energy usage at the top. Hilton Hotels, for example, will be responsible for all its hotels, including subsidiaries such as Doubletree, throughout the U.K.

The Carbon Reduction Commitment is designed to complement other efforts to reduce CO_2 emissions in the U.K., such as the European Union's Emissions Trading System and domestic Climate Change Agreements, which govern energy-intensive industries such as glass manufacturing. The U.K. government claims many if not all organizations will more than recoup the costs of compliance by conserving electricity and switching to cleaner energy sources. Although details—and thus costs—of the scheme are yet to be worked out, estimates are that participants will have to spend a minimum of £38,000 a year on credits.

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Faegre & Benson Named Top Corporate Law Firm in Minneapolis

General counsel in the Twin Cities metropolitan area named Faegre & Benson LLP as their preferred firm for corporate law matters in an annual survey conducted by *Corporate Board Member* magazine. More than 2,200 general counsel and directors serving on boards of publicly traded companies in the Minneapolis area were invited to participate in the ninth annual America's Best Corporate Law Firms survey.

Using the *Martindale-Hubbell Law Directory*, *Corporate Board Member* compiled a list of the ten largest local firms with a corporate or business law practice and asked respondents about their preferences for working with those firms. Participants selected Faegre & Benson as the first choice to represent their companies on a broad range of corporate legal issues. The response rate was 10.5 percent. FB

Firm Expands London Office to Enhance Global Reach, Strengthen Key Practices

Reflecting its clients' increasing need for integrated legal representation on a global basis, Faegre & Benson has again expanded its London office, adding two partners and one special counsel to its corporate practice. In all, seven experienced lawyers have joined the London office in 2009, bolstering the firm's corporate, real estate, and finance and restructuring practices.

Paul Finlan

Gary Laitner

Linda Crow

Partners **Paul Finlan** and **Gary Laitner** and Special Counsel **Linda Crow** all formerly worked in the London office of U.S. law firm Crowell & Moring.

Finlan has extensive cross-border merger and acquisition experience and advises on corporate finance transactions, including acquisitions, disposals and joint ventures. He frequently represents clients in the U.K., U.S., Germany and Russia.

Laitner has considerable experience in cross-border merger and acquisition work both domestically and internationally.

Crow works across all types of domestic and cross-border corporate finance transactions, and also advises company directors on corporate recovery. Her considerable experience in the food and beverage sector will complement Faegre & Benson's strong food, agriculture and biofuels industry expertise.

Thomas G. Morgan (Partner, Minneapolis), chair of the firm's management committee, said the addition of these lawyers is part of a firmwide strategic repositioning of resources to respond to clients' evolving legal needs. "Among our U.S.-based clients, there is growing demand for integrated, cross-border legal services in the European Union and worldwide. Strengthening our position in the U.K. gives clients access to more first-rate lawyers who handle sophisticated matters and transactions in a variety of countries." FB

William Killion Recognized for Legal Writing Excellence

William Killion

William L. Killion (Partner, Minneapolis), a member of the firm's litigation practice, has received a 2009 award for legal writing from the Burton Awards for Legal Achievement, a national program run in association with the Library of Congress. Only 30 lawyers nationwide are selected annually. It is the ninth consecutive year a Faegre & Benson lawyer has received this distinction.

Killion received the award for his article, "The Modern Myth of the Vulnerable Franchisee: The Case for a More Balanced View of the Franchisor-Franchisee Relationship," which appeared in the Summer 2008 issue of *Franchise Law Journal*.

Emphasizing franchise law in his practice, Killion has handled virtually every variety of franchise/distributor-related dispute. He provides counseling and litigation services to franchisors and manufacturers in all areas of product distribution, including franchise, antitrust and products liability. He has defended several class actions on behalf of franchisors. FB

Janet Lawler McDaniel Joins Elite Group of LEED-Accredited Attorneys

Janet Lawler McDaniel

Janet Lawler McDaniel (Partner, Denver) has earned the prestigious Leadership in Energy and Environmental Design Accredited Professional (LEED AP™) designation granted by the United States Green Building Council. Only eight other attorneys in Colorado, and fewer than 350 in the entire U.S., have earned this designation since the LEED AP™ exam was launched in 2001.

McDaniel's practice focuses on commercial litigation, with an emphasis in construction law. To achieve the LEED Accreditation, she passed a rigorous examination that tested her deep understanding of the green building practices and principles established by the Green Building Council's LEED rating system. FB

Faegre & Benson Advises Soléco U.K. on Acquisition of Fresh Food Company

Faegre & Benson has advised new client Soléco U.K. on its acquisition of fresh food company Salads To Go for an undisclosed sum. The acquisition creates a £75 million turnover presence in the U.K., with a 20 percent share of the U.K. prepared salads market. West Midlands-based Soléco U.K. is part of the well-established Groupe Florette, which is owned by the French €1.9 billion turnover Agrial Co-operative.

Lancashire-based Salads To Go, which operates from one of the most modern salad processing plants in Europe, has a strong reputation for providing high-quality products and will continue to operate as a separate company from its new parent.

The Faegre & Benson team advising on this deal was led by **Linda Crow** (Special Counsel, London) with assistance from London associates **Oliver Staple**, **Kathryn Dowsett** and **Christabel Oh**. FB

Former Supreme Court Clerk David Stras Joins Firm's Appellate Practice

David Stras

David R. Stras (Of Counsel, Minneapolis), an associate professor of law and political science at the University of Minnesota and a former U.S. Supreme Court clerk, has joined Faegre & Benson's appellate practice. Stras, who brings an exceptional knowledge of the federal judiciary and Supreme Court, will represent clients in appellate courts throughout the country, including the Supreme Court. He will also join teams handling complex, large-scale litigation in trial courts to help develop and guide legal strategy.

At the University of Minnesota, Stras serves as faculty advisor for the *Minnesota Law Review* and directs the university's Institute for Law and Politics. He teaches and writes about federal courts and jurisdiction, constitutional law, criminal law, law and politics, and law and economics. FB

Leading Bankruptcy Team Joins Firm

Faegre & Benson has added a leading bankruptcy team to its Denver office, significantly expanding the firm's financing and restructuring practice in turbulent economic times. **Lawrence Bass, Elizabeth K. Flaagan** and **Bradford E. Dempsey** all join the firm as partners, moving from the Denver office of Holme Roberts & Owen.

Lawrence Bass

Bass specializes in corporate reorganization and debtor-creditor relations. He has represented debtors, trustees and creditors' committees in Chapter 11 cases, and secured creditors, purchasers of assets and sellers of assets in bankruptcy proceedings.

Elizabeth Flaagan

Flaagan has represented secured creditors, creditors' committees, trustees, debtors, unsecured creditors and purchasers in complex bankruptcy cases throughout the country. She is certified as a business bankruptcy specialist by the American Bankruptcy Institute's board of certification.

Bradford Dempsey

Dempsey's practice focuses on complex commercial litigation, bankruptcy and real estate litigation, tax litigation and appeals, workouts and debtor-creditor rights litigation.

The new team will work closely with the firm's existing bankruptcy and restructuring practice to bring expanded depth and breadth on a national and international basis. FB

Firm Wins Food Drive Award; James O'Neal, Peter Goss and Kim Marie Smith Honored for Pro Bono Work

Two Faegre & Benson attorneys and a paralegal have been honored for their pro bono work, while the firm earned first place (firm size 151+) in the Denver Bar Association's 2009 Roll Out the Barrels Food Drive for the eighth consecutive year.

The food drive benefits Food Bank of the Rockies, which provides food to more than 1,000 hunger relief programs in northern Colorado and Wyoming. The firm's contributions were valued at more than $18,000, including both food and cash.

James O'Neal

In other pro bono news, **James A. O'Neal** (Partner, Minneapolis), head of the firm's product liability litigation practice, received the 2008 John C. Benson Pro Bono Award, which is given annually by the firm's management committee to an attorney who demonstrates outstanding commitment to the delivery of pro bono legal services. O'Neal was honored for playing a leadership role in the Liberian Truth and Reconciliation Commission Diaspora Project, a groundbreaking effort by the Liberian Truth and Reconciliation Commission, in partnership with the Minneapolis-based Advocates for Human Rights, to include Liberia's diaspora community in the country's transitional justice process.

Peter Goss

The Diaspora Project began in 2006 as an effort to take statements from Minnesota's 25,000-member Liberian community to document human rights abuses during the country's 23-year civil war and grew into an international initiative. In addition to serving on the project management committee and drafting critical documents, O'Neal traveled to Liberia to meet with key stakeholders; took statements from members of the Liberian community; and prepared and presented witnesses at public hearings.

Kim Marie Smith

Volunteer Lawyers Network (VLN) has selected **Peter J. Goss** (Partner, Minneapolis), who works in the firm's drug and medical device litigation practice, as the recipient of its 2008 Volunteer of the Year Award. Goss was recognized for his career-long dedication to pro bono work in housing law, including the provision of direct assistance to low-income tenants and homeowners, as well as internal and external leadership in this area.

Goss is the firm's Housing Court Clinic team leader, a member of the VLN Housing Law Committee, and a member of the organization's board of directors. VLN is a volunteer-based nonprofit organization that promotes access to justice—and the administration of justice—by providing legal services to low-income people, primarily in Hennepin County, without charge to clients.

Denver paralegal **Kim Marie Smith** has been awarded the 2009 Pro Bono Paralegal of the Year Award by the Colorado Bar Association. The award honors the paralegal whose efforts best exhibit a commitment to pro bono activities, serving the indigent with legal assistance in times of need.

Smith, who works in the firm's real estate practice, donated more than 200 hours of time last year to a variety of agencies and programs, including the Metro Volunteer Lawyers Post-Decree Clinic Program, Habitat for Humanity, the Rocky Mountain Children's Law Center Dandelion Project and Project Homeless Connect. She also helped with benefit events for the Denver Children's Home, Urban Peak and the My Hope Chest Foundation. FB

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How the Regulations Will Work

Beginning in April 2010, many large users of electricity throughout England, Wales, Scotland and Northern Ireland will have to purchase credits corresponding to CO_2 emissions, based initially on 2008 consumption. For the first several years, the government will sell credits for £12 per ton of CO_2 produced as a result of the organization's consumption. Organizations that use more energy than anticipated will be able to purchase credits on a secondary market or, if necessary—and for a higher price—from the government. Because energy from renewable sources, such as wind power, results in the generation of less CO_2 than traditional power sources, it will require fewer credits, providing an incentive both to conserve energy and shop for cleaner sources.

The U.K. government will even publish an annual "league table" showing which organizations perform best in limiting emissions, based on a complicated metric. The hope is that this competition will generate good will for companies and public support for the Carbon Reduction Commitment.

Every enterprise in the United Kingdom must consider whether it is affected by the Regulations, as hefty penalties will be imposed for non-compliance. In a nutshell, the regulations will require enterprises to:

1. notify the government of their electricity consumption; and, depending on the amount used,

2. buy credits for the enterprise's expected energy consumption in each tax year.

If an enterprise is required to buy credits, it will lose one credit for each ton of greenhouse gasses deemed to have been emitted through its energy consumption. Excess credits can be banked for future years or sold to other participators in the scheme. At the end of each tax year, all participators are put into a published table to show performance, and those that demonstrate a saving in consumption obtain a cash bonus from the pool of money the government will hold. This bonus will be funded by those whose gas emissions exceed credits.

Who Is Affected

To decide whether they are affected by the Regulations, enterprises will need to determine whether their "Collective Group"—being the company, any subsidiary company, joint venture body in which they have a majority control and franchisees—metered their electricity consumption on a half-hourly basis in 2008. In the U.K., sites with a peak load above 100kw usually have half-hour meters.

If there is metering on this basis anywhere in the Collective Group, the next consideration is whether it consumed at least 6,000 mwh in 2008. If so, the organization will most likely have to participate fully in the Regulations and buy credits. If not, it will most likely to have to make disclosures of energy consumption to the government.

Landlords need to take particular care in determining whether the Regulations affect them, as the electricity a landlord purchases for common parts and, possibly, tenants' space is deemed to be the landlord's consumption. Landlords will need to reflect on whether the lease or other agreement under which tenants occupy allows the recharge of regulatory compliance costs.

The Way Forward

Full details of the Regulations have not yet been published. However, as they will take full effect in 2010, enterprises must prepare themselves by:

4. working out whether and to what extent they will have to participate;
5. starting to gather necessary information—which will include details of all electricity consumed from all half-hourly meters throughout the U.K.;
6. ensuring that everyone within the Collective Group keeps a lookout for an information pack the government will be issuing in September 2009;
7. (if participation seems likely) ensuring that the organization's energy suppliers are notified so they can begin to provide the information required to demonstrate compliance;
8. considering arrangements to budget for the cost of complying (including, for those that have to fully participate, the purchase of credits and the payment of participation fees);
9. considering internal procedures for compiling required reports and preserving records;
10. determining the extent to which the Collective Group participates in the existing EU Emissions Trading System or a Climate Change Agreement;
11. considering (if a landlord or a franchisor) how the organization will secure cooperation from tenants and franchisees in providing information and assistance in compliance with the Regulations—and how to pass on the cost to them;
12. planning future energy requirements, particularly as some forms will require the purchase of more credits than others—for example, combined heat and power units that burn wood chips will require more credits than taking "mains" electricity (buying from traditional sources of power). FB

Condemnation for Energy Corridors: Land Acquisitions for Pipeline, Transmission Line and Other Energy Corridors

By Eleasalo (Salo) V. Ale

Salo Ale (eale@faegre.com) is a partner in Faegre & Benson's litigation practice and member of the firm's corridor acquisition team. He works in the Minneapolis office, focusing on commercial litigation, particularly disputes involving complex real estate transactions.

This article is adapted from a longer White Paper written in conjunction with the American Law Institute/American Bar Association course, "Eminent Domain and Land Valuation Litigation." The full version can be accessed at http://www.faegre.com/showarticle.aspx?Show=8976.

There has been a resurgence in proposed energy corridor acquisitions across the United States in recent years, as energy companies invest in new corridors to transport electricity, natural gas, oil and other energy products. The demand for new corridors is fueled by many factors, including the price of energy, population growth, the demand for alternative and renewable energy sources, and the fact that existing corridors are overly congested and insufficient to handle anticipated demand. It is well documented that the power transmission grid that transmits electricity in most states cannot support current demand, let alone additional electricity generated by wind farms and other renewable sources. Indeed, the lack of sufficient transmission capacity is a major obstacle in the development of renewable energy sources.

New demand for pipeline corridors—especially oil and natural gas pipelines—is also growing. Utilities are, for example, converting coal-fired plants to run on cleaner natural gas, thereby increasing the demand for pipeline infrastructure to supply natural gas to both new and existing users.

The power of eminent domain, which is available to energy companies under state and federal statutes, is a powerful tool for private entities seeking to acquire property for new energy corridors. Energy companies use eminent domain to secure possession of needed property when landowners refuse to negotiate in good faith or delay responding to purchase offers. In so doing, companies must confront complex legal issues, ranging from challenges to their authority to take property to complicated valuation questions. These challenges are amplified in multi-state projects, as companies must carefully navigate varying sets of condemnation and property laws to ensure timely acquisition. Understanding and planning for these complex issues is a critical step in ensuring that the power of eminent domain is properly and effectively employed to meet goals.

The Doctrine of Prior Public Use

One major challenge faced by private energy companies using their eminent domain power involves the acquisition of government-owned property and property already dedicated to a public use, such as railroads, parkland and existing utility corridors. Energy companies are usually required to locate new corridors along the path of, or next to, existing energy or railroad corridors, which are often adjacent to less populated areas, such as parks and industrial properties. As a result, a private company seeking to establish a new corridor often must acquire easements from government entities and utilities with pre-existing property rights. These entities often have the power of eminent domain themselves.

A private company with the power of condemnation normally has the right to take property from private landowners when negotiations fail and possession becomes necessary. With government property or property already dedicated to a public use, however, the right to condemn is not as clear-cut. Indeed, in certain cases, an energy company simply cannot exercise its condemnation power.

The general rule regarding the power of eminent domain over public property is the well-known doctrine of prior public use: A condemnor may not condemn public property or property already devoted to public use unless the authority to do so is expressly or impliedly granted by statute. The power to condemn under a general grant of eminent domain may be implied when the current owner has not put its land to public use. However, if the land is already dedicated to and actually put to a specific public use, mere general authority to condemn is insufficient to interfere with the prior public use. Further, under the prior public use doctrine, if the proposed new use will extinguish or materially impair the prior use, the proposed taking will be prohibited. This doctrine recognizes that the legislature has delegated the power of eminent domain to many municipal and private corporations. If one such body could acquire land used or held for a public purpose by another corporation under a general power of condemnation, the latter would logically be free to re-acquire the property, an absurd result.

For energy companies, the "consistent use" exception to this doctrine is a useful tool in dealing with other utilities or public property users. It allows condemnation of property already dedicated to a public use if the two uses are compatible and can coexist.

This exception is particularly useful when negotiating easement acquisitions along a pre-existing corridor. In most instances, the proposed use interferes little, if at all, with another utility's easements.

Some states have adopted statutes recognizing the doctrine of "higher" or "more necessary" public use. These statutes generally permit a subsequent taking of public use property upon a showing that the subsequent use is a higher or more necessary public use.

Because energy corridor projects are ordinarily subject to rigid timelines, companies may benefit by pursuing alternatives to condemnation. Options include requesting consent from the public entity to be included in the condemnation action, negotiating temporary encroachment agreements to allow immediate access, mediation and arbitration.

Perhaps the most effective way to reduce the risk of not being able to acquire easements is to engage in strategic analysis of the proposed route early in the project. Companies and their legal counsel can assess the types of property along proposed routes so as to minimize legal challenges and reduce costly compensation claims. The goal is to identify problematic properties at an early stage, achieving a greater degree of project certainty.

Valuation of Energy Corridor Takings

Valuations are another important concern. Corridor acquisitions typically involve partial takings of property, as energy companies generally acquire only easement rights. As with any partial taking, the "before and after" method is the predominant appraisal technique. The entire property is valued without the corridor easement (the "before" condition) and then with the easement, in the "after" condition.

A common method of appraising an existing corridor is the "across the fence" approach, in which appraisers determine the value of an easement by the price or value of land "across the fence" from the railroad, pipeline, highway or other corridor. Thus, if the use across the fence is commercial retail worth $20 per square foot, then the corridor receives a value of $20 per square foot.

Public fear of perceived safety hazards associated with natural gas pipelines, oil pipelines, high-voltage transmission lines or electromagnetic fields (EMF) is often asserted as an element of damages in energy corridor condemnation cases. There are three distinct views on the admissibility of evidence of fear in eminent domain cases.

The majority view among courts is that evidence of fear in the marketplace is admissible without proof that such fear is reasonable. This approach focuses on the impact of the alleged fear on property value, and shields the court from having to analyze competing scientific views on issues where no consensus exists, such as the link between electromagnetic fields and cancer. To be compensated for such fear, the property owner must prove a prevalent perception of danger emanating from the objectionable condition and that such perception has affected property values.

The Ninth U.S. Circuit Court of Appeals discussed this issue in a 2008 decision regarding the condemnation of land for electric power lines in California. Quoting its own 1984 decision, the court said:

> Wholly apart from evidence of actual health risks, evidence of public perceptions of health risks—even irrational public perceptions—may properly establish an impact on market value. "[I]f fear of a hazard would affect the price a knowledgeable and prudent buyer would pay to a similarly well-informed seller, diminution in value caused by the fear may be recoverable as part of just compensation."

Some courts have adopted the view that evidence of fear is admissible only if the fear is reasonable. A small minority excludes evidence of fear as too speculative to justify damages.

Natural Gas Corridors

Private companies that transport natural gas in interstate commerce have the benefit of pursuing condemnation under the federal Natural Gas Act (NGA). The NGA governs the transportation, storage and sale of natural gas in interstate and foreign commerce, reflecting Congress's judgment that these activities are of national importance and should be subject to federal regulation. A natural gas company seeking to construct or operate an interstate pipeline must first secure a Certificate of Public Convenience and Necessity from the Federal Energy Regulatory Commission (FERC).

The requirements for the FERC application are found in the Code of Federal Regulations. The application process is extensive and includes public hearings, rehearings and the opportunity for review in a federal court of appeals.

The FERC Certificate establishes the location of the pipeline route and the public purpose and necessity for any taking of property along the route. Once FERC issues the certificate, the company cannot deviate from the approved route. The NGA preempts all state or local regulations that conflict with FERC's authority, including certificates.

Under the NGA, the condemnor has a choice of a state or federal forum in which to commence condemnation and acquire property for a corridor. Federal court jurisdiction is limited to cases when the amount claimed by the property owner exceeds $3,000.

Section 717f(h) of the NGA explicitly states that federal courts should look to the "practice and procedure" of the state in which the subject property is located in resolving the rights and obligations of parties to an eminent domain action. A number of courts, following that explicit language, have applied state practices and procedural law in NGA condemnation cases. The majority, however, hold that Rule 71.1 of the Federal Rules of Civil Procedure governs federal eminent domain actions, including those under the NGA. These courts hold that Rule 71.1, which was adopted in 1951, supersedes Section 717f(h), which was enacted in 1938.

Unlike most state procedures, Rule 71.1 allows the condemning authority to join all separate pieces of property in a single action, regardless of whether they are owned by the same person or sought for the same use. Further, the rule contains no express requirement that the condemnor meet and confer with the owner, obtain an appraisal, or pay for an appraisal requested by the owner. Nor is there a right to a jury trial. If the parties are unable to agree, the issue of compensation can—at the court's discretion—be determined by a three-person commission. Also, unlike most state statutes, Rule 71.1 does not allow the owner to recover expenses, including attorneys' fees, from the condemnor.

The NGA does not give private natural gas companies the right of quick take, which allows condemnors to take early possession, before a final determination of compensation. This lack of an explicit right of quick take poses a risk for pipeline companies by subjecting projects to significant delays while parties litigate just compensation, which can take many months, even years.

A number of courts have maneuvered around this perceived shortcoming by allowing immediate possession by exercise of the court's equitable powers. These courts hold that, upon satisfaction of the standard for injunctive relief, pipeline companies holding FERC certificates may be granted immediate possession of the property prior to a determination of compensation, thus allowing commencement of construction. This view has been criticized as circumventing the power of the legislative branch to grant condemnation power, including the power of quick take. The few courts that follow this opposing view hold that a court's inherent equitable powers cannot be used to unilaterally grant a private party the right of quick take.

The NGA framework has been suggested as a model for the siting, regulation and condemnation of electric transmission corridors, which are currently subject to state laws. Indeed, legislation introduced in the U.S. Senate this year—the Clean Renewable Energy and Economic Development Act—seeks to incorporate NGA-type provisions for electrical transmission acquisitions.

Conclusion

The need for new energy corridors to accommodate projected energy demands and the development of clean energy sources is well documented. Private energy companies and government entities are pursuing plans to acquire energy corridors to meet this need. The eminent domain power, which is available to most private energy companies (either through state or federal law), can be a useful tool. An energy company considering eminent domain must carefully consider the scope and limitations of the authority available to it and how that power may be effectively employed to meet goals. Failure to understand the limitations of the eminent domain power and the rules governing its use may result in significant delays and losses. Involving eminent domain counsel at the early stages of a project is one way to ensure that the power is used correctly and effectively.

Protective Safeguards Endorsements to Property Insurance Policies May Pose Unanticipated Risks for Landlords, Tenants and Others

By Charles D. Calvin, Rikke A. Dierssen-Morice and Charles S. Ferrell



Chuck Calvin (ccalvin@faegre.com) represents clients in a broad range of corporate and commercial transactions. Rikke Dierssen-Morice (rmorice@faegre.com) heads the firm's insurance coverage team. Charlie Ferrell (cferrell@faegre.com) has been a member of the firm's real estate practice since 1977.

One would expect a building equipped with an automatic sprinkler system, central station fire alarm system or other high-tech fire detection or suppression system to be less likely to suffer severe fire damage than a building that lacked such systems. It also stands to reason that properties with such systems should qualify for a break on their property insurance premiums. But what happens if there is a fire and the system fails to function as intended?

For the unwary property owner—or tenant—the result can be disastrous: denial of insurance coverage as a result of what might seem to be a relatively innocuous mistake. In one prominent case, for example, an insurer successfully denied coverage because the owner of an industrial building had capped fewer than 20 of 600 sprinkler heads. Another insured was denied coverage for failing to maintain a contract with a duct cleaning service. For those who purchase property insurance, the lesson is clear: Know what the policy says, and adhere to its requirements pertaining to automatic sprinklers and other protective systems.

Duties of Insureds Under a Protective Safeguards Endorsement

In many states, a premium discount or credit may be given—or otherwise uninsurable property may qualify for insurance—if the property insurance policy includes a "protective safeguards endorsement" (ISO Form IL 04 15 04 98 or the local equivalent). This endorsement calls for a description of the particular type of protective safeguard devices or services that are installed in or applicable to each property covered by the policy. A protective safeguard may be in the form of a service contract with, for example, a security company or private fire department, or it may consist of or be supplemented by a mechanical or electronic system.

After identifying particular protective safeguards, the endorsement form states: "As a condition of this insurance, you [the insured] are required to maintain the protective devices or services listed in [this endorsement]." This point is emphasized with additional language in the endorsement:

"We will not pay for loss or damage caused by or resulting from fire if, prior to the fire, you:

"1. Knew of any suspension or impairment in any protective safeguard listed in [this endorsement] and failed to notify us of that fact; or

"2. Failed to maintain any protective safeguard listed in [this endorsement], and over which you had control, in complete working order."

In other words, each insured under the property insurance policy has at least two additional duties if the policy includes a protective safeguards endorsement: the duty to *notify the insurer* if the insured learns of any "suspension or impairment" of any device or service listed in the endorsement, and the duty to "maintain…in complete working order" any device or service that is listed in the endorsement and *over which the insured has control*.

Failure to Comply With Provisions

If the language of the endorsement is read literally, there is (with one exception mentioned below) no leeway for any delay in notifying the insurer once the insured becomes aware of any suspension or impairment, nor is it sufficient to use reasonable—or even extraordinary—efforts to maintain devices or services if in fact they fail due to a maintenance shortcoming.

Some failures to comply with policy provisions affect coverage only to the extent the insurer's rights are prejudiced by the insured's noncompliance. But based on the language of the endorsement, failure by an insured to perform these duties can be a basis for the insurer to deny all coverage for a loss by fire—whether or not the loss was caused or exacerbated by that failure.

Case Law Examples

Reported cases include a number of situations where insurers successfully denied coverage based on the insured's noncompliance with protective safeguards endorsement provisions:

- In *Burmac Metal Finishing Co. v. West Bend Mutual Insurance Co.*, an Illinois appellate court said in 2005 that a property owner's intentional capping of between three and 19 automatic sprinkler system heads out of 600 in an industrial building, without notice to the insurer, constituted failure to maintain the system and justified a denial of coverage for a fire and explosion.

- In *Goldstein v. Fidelity & Guaranty Insurance Underwriters*, the Seventh U.S. Circuit Court of Appeals ruled in 1996 that although an insurer was obligated to pay for fire loss that occurred during a period when the protective safeguards endorsement had been waived due to an error by the insurer's agent, the insurer was justified in denying coverage for subsequent loss due to the owner's failure to restore a nonfunctioning sprinkler system, as required by the endorsement.
- A California appeals court said, in a 2006 case known as *Y2K Textile, Inc. v. Lexington Insurance Co.*, that the insurer had properly denied coverage for fire loss where the protective safeguards endorsement required the insured to maintain a contract with a duct cleaning service and the insured never obtained such a contract.

Partial Safe Harbor

Subsequent language in the protective safeguards endorsement form provides a partial safe harbor: "If part of an Automatic Sprinkler System is shut off due to breakage, leakage, freezing conditions or opening of sprinkler heads, notification to us will not be necessary if you can restore full protection within 48 hours." Significantly, however, this safe harbor applies only to sprinkler systems, not to any other kind of device or service, and only if "part of" the system, rather than the entire system, is affected. And, it applies only to the notification requirement, not to the duty to maintain all devices and services in complete working order.

Practical Considerations

What is a property owner to do with this information? Although a brief article cannot offer advice that is sound in all circumstances and all jurisdictions, here are some practical considerations:

Identify and understand applicable endorsements. Property owners (and this term is used to include tenants whose leases give them equivalent risks and obligations) should make sure they know whether the applicable insurance policy includes a protective safeguards endorsement. If it does, they should also be sure they have an accurate understanding of what is required by the terms of the endorsement. A Missouri case, *Insurance Corporation of Hannover v. Vantage Property Management*, involved a hotel owner who did not understand the requirement for an automatic fire alarm that was "connected to a central station" and "report[ed] to a public or private fire alarm station." After prolonged litigation, the owner ultimately overcame the insurer's denial of coverage for a fire loss because those terms were not defined in the endorsement and were not generally understood by people outside the fire alarm industry. Without further definition, the court found, the owner reasonably believed its central alarm panel in the basement was a "central station," although the insurer argued that "central station" meant an off-site monitoring facility.

Weigh savings against risk. If the existing property insurance policy includes a protective safeguards endorsement, the party responsible for obtaining or maintaining that policy should investigate the premium savings provided by that endorsement. Affected parties should weigh the savings against the potential risk that a claim for fire loss may be denied if the particular safeguards do not function properly. Doing without the endorsement, of course, is not an option if prospective insurers are unwilling to insure a property without protective safeguards.

Be prepared to give required notices promptly. Insureds under property insurance policies with protective safeguards endorsements should review the notice provisions of their policies to determine how and to what address notices are to be given. Insureds should make sure this information is communicated to those with operational responsibility for each insured property so notice can be given, when appropriate, without delay.

Be clear about notification and maintenance responsibility. Landlords should be sure their leases—and property management agreements—are clear as to which party is responsible for the notification and maintenance duties described above. In some instances, especially in single-tenant buildings, the landlord may reasonably insist that the tenant take responsibility for maintaining systems, devices and contracts. The landlord may not want the tenant to give unapproved notices to the insurer, given the impact any notice may have on property insurance premiums.

Keep detailed maintenance records. Anyone with contractual or practical responsibility for maintaining systems, devices and contracts should keep detailed records of the nature, timing and results of maintenance activities. As noted earlier, it is not clear that maintenance efforts will be sufficient to satisfy requirements of a protective safeguards endorsement if a maintenance failure on a single, critical occasion leads to a failure of a system or device, but an insured is clearly on stronger ground if it can show a consistent pattern of maintenance.

Consider how listed systems might become impaired. Recalling that "impairment" as well as "suspension" of a device or service may require notice to the insurer, any party with an interest in the availability of fire insurance coverage should consider how, as a practical matter, each listed system, device or service might be impaired, and how non-impairment may be demonstrated. These practical considerations may require consultation with system vendors, independent engineers or contractors or other third parties.

Review criteria for permitting alterations. Landlords should think carefully about their criteria and procedures for granting consent to proposed tenant alterations. They should also consider whether it is appropriate for leases to permit any tenant to make alterations that are merely characterized as "nonstructural" or in some other nonspecific manner. Even where the tenant is given broad discretion to make alterations, it may be appropriate for the landlord to require some kind of expert certification that the alterations will not "impair" any facilities listed in a protective safeguards endorsement.

Avoid indemnification risks. Tenants should also consider how they would be able to demonstrate that a seemingly permitted alteration did not impair such facilities, because most leases—even those that grant the tenant broad freedom to make alterations—prohibit the tenant from doing anything that would affect, or increase the cost of, property insurance coverage. An alteration that impaired the functioning of a listed system or device might therefore be a breach of the lease and expose the tenant to serious liability under a typical indemnification clause.

Watch for analogous requirements. This article has focused on protective safeguards endorsements as they affect fire insurance coverage. Protective safeguards endorsements are sometimes issued with respect to risks other than fire, including burglary, theft and damage to construction work in progress. Those endorsements contain similar language and may present similar risks to insureds. They deserve similar thoughtful attention.

Conclusion

Anyone with concerns relating to insurance issues may wish to consult a risk management consultant or an attorney with substantial expertise in the specific kind of coverage involved. While insurance agents are often good sources of practical, front-line suggestions, they generally have no authority to waive or modify policy provisions. For this reason, any assurance that a policy provision or endorsement doesn't mean what it appears to say should be confirmed in writing with the insurer.

Last Word: Trusts and Estates

Clients should be aware of the following changes to the tax laws regarding their traditional (non-Roth) qualified retirement plans and individual retirements accounts (IRAs):

- **Suspension of RMD:** Generally, qualified retirement plans and IRAs are subject to certain required minimum distribution (RMD) rules, requiring withdrawals to begin at age 70½ and failure to take an RMD will result in penalties. The Worker, Retiree, and Employer Recovery Act of 2008 suspended RMDs for the year 2009 in most cases, so that owners and beneficiaries of plans who otherwise would be subject to the mandatory distribution rules in 2009 will be able to leave assets in the plan without suffering a penalty for failure to take a distribution.
- **Conversion to Roth IRA:** Currently, eligibility requirements prohibit those with an annual household adjusted gross income (AGI) exceeding $100,000 from converting a traditional IRA to a Roth IRA. However, the Tax Increase Prevention and Reconciliation Act of 2005 eliminates the AGI limits beginning in 2010, allowing high income individuals to take advantage of conversion and the benefits a Roth IRA may offer—Roth IRAs are not subject to RMDs and are not subject to income tax when distributions are taken, allowing assets to grow tax-free. A traditional IRA would be taxed at conversion to a Roth IRA; nevertheless, conversion could result in overall tax savings if the value of retirement assets increases prior to withdrawal, and your tax bracket at retirement is the same or higher than your current tax bracket.

Given the complexity of these situations, we recommend that you contact an attorney in our wealth management practice to discuss your particular situation.

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